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How Can Asia Respond to Global Economic Crisis and Transformation?

Asian Development Bank

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Foreword

Asia's rapid economic and social development over the past several decades has been an inspiration for all.

The region has significantly boosted its share of global output and forged strong links with the global economy. Its success in economic growth and poverty reduction has been among its greatest achievements. Yet, sustaining its growth momentum while confronting new and existing challenges remains a formidable task.

Since the onset of the global financial crisis in 2008, developing Asia has proven its resilience. Nonetheless, some of the fundamental structural weaknesses in developed economies are unlikely to be resolved soon, and the region might be exposed to financial contagion. Developing Asia therefore must adapt to what could be a prolonged slowdown in mature markets.

Currently, the focus is on ways to contain risks emanating from trade and financial transmission channels. These include ensuring adequate availability of trade finance, sufficient foreign currency liquidity, managing large and volatile capital flows, and protecting the region's financial stability.

It is imperative to establish strong regional financial safety nets to complement both national and global financial arrangements. I strongly believe regional collective actions can cement our past gains and bring future shared prosperity.

In this regard, I am happy to see the progress and discussions to expand and strengthen regional safety nets—like the Chiang Mai Initiative Multilateralization and its surveillance arm, the ASEAN+3 Macroeconomic and Research Office—to enhance crisis prevention and improve mitigation.

Even as Asia deals with these immediate challenges, it must not lose sight of its long-term development goals. To sustain its growth momentum and consolidate its economic and social transformation, Asia needs to re-assess its own growth model.

With weak demand in traditional markets in advanced economies, Asian economies must rebalance the sources of growth toward domestic and regional markets. This shift has already begun to happen. Regional cooperation and integration are vital to this process. In addition, Asia should increase its economic links with Latin America and Africa—a process which has already started. These regions represent markets for diversification as well as sources of sustained future growth, given their endowments of natural resources. If regional cooperation and integration initiatives are to succeed, whether within or across regions, their overall goal must be to increase the welfare of people through shared prosperity.

The re-emergence of Asia as the world's growth engine has brought enormous responsibilities as well as opportunities. How Asia responds to the global economic transformation is critical. Asia must pursue growth that is inclusive and sustainable, and above all, growth that enhances the welfare of the people. Asia also must grapple with how to effectively balance environmental considerations against its aspirations for growth.

This monograph aims to stimulate debate on these issues. It is my hope that the meeting will provide us with a wealth of feedback and strategic considerations to guide ADB's further analytical and operational work in these key areas.

I would like to express my deep appreciation to Jeffrey Sachs, Director of The Earth Institute and and Professor, Columbia University; Bindu N. Lohani, Vice President, ADB; Iwan J. Azis, Head of the Office of Regional Economic Integration, ADB; Masahiro Kawai, Dean, ADB Institute; and their respective teams who contributed to the preparation of this study.

Haruhiko Kuroda
President
Asian Development Bank

Section 1
Introduction

Asia's ongoing economic transformation has captured the world's imagination. Many marvel at the speed a diverse region packed with poverty has laid the groundwork for future prosperity. They acknowledge the massive hurdles crossed to get this far, but are nonetheless awed by those still to be surmounted. Asia's role in the world economy is growing, but so too are the challenges in keeping its transformation on track.

The genesis of Asia's transformation is critical. History is fundamental for thinking about the future. Yet the goal of sustained economic growth equitably distributed remains central to the debate—and still elusive.

With the recent economic crisis and renewed recession looming in Europe—and the United States (US) economy growing but fragile—how can Asia weather another global economic disruption? Is there sufficient monetary and fiscal space to respond effectively? How will finance, production, and trade be affected? Is Asia's structural reform adequate—not simply to withstand another crisis, but to augment the drive toward continued strong, yet more inclusive growth?

With the People's Republic of China (PRC)—and India—indisputably core players in the region, how can their disparate yet fundamental growth challenges be met? To rise in the global economic firmament, how will their trade and investment strategies meld with those of other economies or sub-regions such as Southeast Asia, South Asia, and Central Asia and other agendas? Is regional cooperation a canard? Or is there room for real synergy?

> The global crisis is a wake-up call for Asia. Is its current resilience to be taken for granted? Is the region adequately prepared to deal with the opportunities and risks of the ongoing global rebalancing? Is there adequate policy coordination within and across countries, to ensure that key policy actions constantly improve peoples' welfare? Is regional cooperation a pursuit only in times of stress? Authorities in the region have begun asking these questions, recognizing that there is no room for complacency. This monograph is designed to stir debate. Answering the questions could lead to well-articulated structural reforms that help sustain the region's growth.

Many speak of a seismic shift in economic gravity to rapidly developing and highly diverse Asia. For the region to lead global recovery and meet the multiple challenges of forming a strategy to sustain robust yet inclusive growth, is a new development paradigm needed? What are its components and do we have the institutional architecture to make it work?

These are ambitious questions. Yet they are worth investigating.

This monograph aims to build a foundation for discussion on how to confront and use current events to clear a better path toward sustainable, inclusive growth and development in Asia—always cognizant of the region's growing responsibility to help build financial and economic stability globally.

People tend to forget that Asia's much vaunted economic emergence over the past few decades is a re-emergence. Prior to the Industrial Revolution, Asia accounted for 60% of the world economy. That share declined to 15% by 1950, when Japan began post-war reconstruction. Japan doubled its per capita income in a decade.

As countries throughout the region—most newly independent—began to set national agendas amid an evolving technological revolution in the 1960s, the seeds of transformation were planted. The so-called Asian miracle accelerated in the 1970s. Natural resource exploitation returned, but more in partnership—the precursor to a more even playing field. Easing the regulatory environment allowed foreign direct investment to flourish. Trade soon followed.

Import substitution gave way to export promotion. The private sector leapt to the fore in building production networks and supply chains—as the 1980s turned into the 1990s. Tiger economies became industrial and financial entrepôts. And then Asia's economic giants—the PRC and India—entered the fray, using market reforms to varying degrees to introduce millions upon millions of low-cost workers to the global labor pool, using globalization to speed economic growth—even if increasingly unequal.

The result so far—Asia's share of global gross domestic product (GDP) reached 35% in 2010. Studies suggest it could reach as high as 52% by 2050.

The consequences of this growth have been dramatic. Not only has the middle-class grown to become a force in the region, but hundreds of millions have been lifted out of extreme poverty. Yet Asia remains home to a majority of the world's poor. Polarization and inequalities are also on the rise. While there is significant economic momentum, Asia needs to do more in bringing opportunities for inclusive and sustained growth to the majority of its people.

The origin of the 2008/09 global financial crisis—the worst since World War II—sets the stage.

A long period of rapid credit growth, flush liquidity supported by easy monetary policies, and the growth of asset market bubbles—notably in real estate—led financial institutions to boost leverage that exposed both real and financial sectors to sharp corrections in asset prices. As a result, the collapse of the US subprime market, a small slice of the overall financial pie, shook the edifice of the entire financial system and exposed long-gestating global structural flaws. It laid bare the debated linkages between global imbalances and a potential financial meltdown.

Its roots were seeded by global structural change—the integration of Asia into the global economy, the dissolution of the Soviet Union, and most recently, the emergence of Africa. This wholesale liberalization more than doubled the global labor force. Jobs, mostly unskilled, relocated from developed countries to emerging economies—primarily the PRC and Southeast Asia. To compensate for lost competitiveness in low-end manufacturing and assembly, high-income countries focused on boosting non-tradable sectors. This included mortgage and financial deregulation to stimulate job growth.

Low and stable inflation reduced macroeconomic volatility. A "Great Moderation" led to expansionary monetary policy globally in the 1990s and early 2000s. Loose credit plus financial deregulation encouraged risk taking. Large real estate bubbles in Europe and the US meant new construction jobs for displaced industrial workers. But it also stimulated financial innovation (like mortgage securitization) to hide risk, supported by perverse incentives for credit-rating and deal-maker greed.

Together, the expanded global labor force and "shadow" financial system led to severe global structural imbalances—current account imbalances, excessive debt in advanced economies, over-reliance on assembled and low value-added manufactured exports in some emerging economies, and growing income inequality across the board.

In its early days, the crisis squeezed liquidity and risk premia skyrocketed. Financial insolvency of several institutions surfaced, but largely disguised the wider systemic risk. It was the collapse of Lehman Brothers in September 2008 that lifted the veil as confidence evaporated, investors retreated, and markets tumbled. Recession ensued.

When the global financial system began stuttering in mid-2007, the impact on Asia was limited. The region was neither highly exposed to the structured credit products that caused problems for the US and European financial institutions, nor heavily dependent on global capital markets for funding, except for one or two economies. Nonetheless, it was vulnerable to swings in global investor sentiment and increasingly cautious investor appetite.

The Lehman Brothers bankruptcy was the tripwire. Asia felt the liquidity crunch, markets plummeted, trade fell dramatically, capital flows reversed outward, and growth slowed markedly or contracted in several economies. Massive fiscal stimulus and accommodative monetary policy, liquidity injections, government guarantees, and local currency financing helped the region stave off the liquidity crisis and resuscitate growth.

Recovery came first and rapidly to emerging economies, and volatility spiked, with growth in advanced economies anemic. By the first half of 2009, confidence had returned and portfolio inflows started trickling in. Toward the end of 2009 and early 2010, policymakers were increasingly confident of the recovery's traction and turned their attention to exiting stimulus and normalizing monetary policy. Asia's rapid recovery was helped as global financial markets stabilized following US and eurozone government intervention to restore confidence.

But global economic growth has stalled since the crisis. And it has gradually exposed the unsustainable fiscal policies in Europe and its fragile banking system—a second and likely more prolonged phase of the global crisis.

By 2010, important eurozone members were struggling. Greece, Portugal, Ireland, Italy, and Spain struggled to convince investors they could repay sovereign debt. The possibility of contagion spreading from escalating European debt problems has kept financial markets and global policymakers on edge. A slew of political statements, bailouts, and austerity packages have struggled to restore investor confidence or kick-start the economic growth needed to allow struggling economies a way out. To the end of this decade at least, global growth—including Asia's—will likely be lower than the past three decades. Short-term fixes do not solve structural problems.

> The global crisis showed that while day-to-day "fire fighting" is needed in the short-term, policy makers should also take time to invest more capital in developing medium and long-term policy options.

The Great Recession and current eurozone crisis lay bare the need for Asia to confront major challenges to its ongoing economic transformation. How should Asia position itself—crisis or not? This monograph analyzes these challenges and links the effects of a potential new crisis to the next steps in Asia's continuing economic transformation. The global economy needs to readjust. And Asia—increasingly central to global economic growth—must contribute by diversifying its sources of growth, allocate its large financial resources more effectively and efficiently toward productive and socially equitable investment, and bolster domestic and regional demand.

> Developing Asia has certainly added resilience to the global economy to face financial shocks. Many countries have comfortable current account surpluses, low external debt, and high foreign reserves. Most of the region's banking systems are sound with a high capital base and low nonperforming loan ratios. Many countries also have adequate fiscal space should a reintroduction of fiscal stimulus be required.
>
> The ongoing global uncertainties have forced us to reevaluate the role and structure of global finance. At the same time, we have seen the center of economic gravity shifting gradually to Asia, implying more responsibilities for our region. The challenges we face are huge. Asia's role in sustaining global growth is critical—and this will be best achieved by ensuring that Asia's own growth remains strong and sustainable. For this, growth must be inclusive, balanced, and environmentally friendly.
>
> *Excerpts from remarks made by Haruhiko Kuroda, President, Asian Development Bank, at the consultative workshop in New Delhi on 1 February 2012.*

The next section briefly examines how a crisis would be transmitted through financial and trade channels. The ongoing eurozone debt crisis is taken as a point of departure. Any contraction in external demand, tighter liquidity, rise in risk premiums, or a stricter regulatory environment will impact Asia's real economies, its companies and banking systems. The section also provides an estimate of the impact the eurozone debt crisis might have on Asia's economic growth in 2012. It ends with a list of potential risks and vulnerabilities for the region's economies.

The third section presents policy options on short-, medium-, and long-term structural challenges central to the region's crisis mitigation and ongoing economic transformation, ranging from rebalancing to trade policy to regional financial safety nets. A conclusion follows.

Section 2

Impact of the Eurozone Debt Crisis on Asia

Europe's sovereign debt crisis could have strong repercussions on developing Asia. Both the United Stated (US) and eurozone are major markets for the region's exports and sources of financial capital and portfolio investments. Memories of the sharp slowdown from the 2008/09 "Great Recession" remain fresh. The region's financial sector and stock markets were battered as foreign investors fled to "safe havens" elsewhere. Many Asian economies suffered large declines in trade and output. Still, the region recovered quickly due to prompt and effective fiscal and monetary stimulus, fairly healthy financial systems, and stringent prudential regulations.

> Asia is enjoying bright momentum of economic prospects, with countries maintaining rapid economic growth, and becoming the major engine of world economic growth. At the same time, with the uncertainty of external environment increasing, as well as risks and challenges, Asian countries, in varying degrees, are confronted with the challenges of economic restructuring and promoting sustainable and equitable economic growth.
>
> *Excerpt from remarks made by Zheng Xiaosong, Director General, International Department, Ministry of Finance of the People's Republic of China at the consultative workshop in Beijing on 1 March 2012.*

Thus far, the eurozone sovereign debt crisis has had limited impact on developing Asia's growth. While the region's economic expansion has moderated, it remains robust, roughly in line with recent historical trends. Financial systems have been little affected by global financial market volatility and have continued to channel funds to support economic activity. The economic resilience is partly due to the ongoing process of rebalancing sources of growth from external to domestic demand. For now, no large or mid-sized economies will likely experience a hard landing.

However, if conditions were to worsen in Europe, the impact on the region could be more severe and the crisis could last longer. With advanced economies' sovereign credit ratings under scrutiny, the scope for rescuing troubled financial institutions is limited. This may make it even harder to quickly resolve any new crisis.

Given Asia's diversity, different sub-regions face different priorities and challenges. One common priority is how to sustain economic growth and boost people's welfare. In East and Southeast Asia, the focus is likely to be on trade and financial integration. For South Asia, boosting productivity and moving to higher value production and services, while ensuring adequate employment opportunities, will be key challenges. In Central and West Asia, priorites include economic diversification and overcoming geographic constraints through greater and efficient connectivity. Pacific economies face unique challenges of balanceing growth, while adapting to and mitigating climate change. The next two sections on provide analysis offer suggestions that can be applied across all sub-regions. More in-depth dialogue—along with research and analysis—is required to establish specific sub-regional policy options to better deal with global transformation.

For the most part, the region's financial systems show limited vulnerability and appear able to weather any impact from the eurozone crisis (barring a low probability "perfect storm" collapse—in which the euro tumbles sharply, yen borrowing rates rise, and growth falls sharply in the People's Republic of China (PRC), Japan, and other parts of Asia). Although Asia's exposure to eurozone and US banks is significant, external vulnerabilities for the region are lower than in 2007. In general, current account balances are healthy, and thus less susceptible to the impact of tightening liquidity, as they are less dependent on external borrowings. Also, the region's external debt exposure has improved from 2008. For the most part, foreign reserves are more than adequate and can comfortably cover imports and short-term external debt repayments. The region's banking systems also remain sound with sufficient capital adequacy ratios and—for now at least—low levels of nonperforming loans. During the global recession, the region's banking systems remained largely unaffected, and this overall soundness continues (**Table 2: External Vulnerabilities**).

2.1 The Financial Channel

With the global financial system closely intertwined, any financial system distress in Europe will have transmission effects on Asia. Over the past decade or so, the region's economies have liberalized their financial systems. While this has benefited economies, it has also made the region more vulnerable to external shocks, given the effects of globalization and close integration with

Table 1: Risks and Vulnerabilities

Risks	Description	Vulnerable Countries
Trade openness	Economies with large export to GDP ratios could see severe contraction in exports should the eurozone crisis suddenly deepen, the US economic recovery stalls, or a new global crisis develops.	People's Republic of China; Republic of Korea; Malaysia; Philippines; Singapore; Sri Lanka; Taipei,China; Thailand
Commodity price volatility	Economies reliant on commodity exports, in particular oil and gas, could be severely affected by a contraction in demand for resources.	Brunei Darussalam, Kazakhstan, Kyrgyz Republic, Turkmenistan, Uzbekistan
Rising inflation	Inflation from flow-on effects of commodity price volatility on agricultural and food prices, with others experiencing price spikes from supply bottlenecks or weather-related disturbances.	Bangladesh, Brunei Darussalam, People's Republic of China, India, Republic of Korea, Kyrgyz Republic, Lao PDR, Pakistan, Singapore, Sri Lanka, Thailand, Uzbekistan, Viet Nam
Slowdown in overseas remittances or official aid	Economies with large remittances as a percentage of GDP could see personal consumption weaken should demand for overseas labor wane. Also, countries dependent on official development assistance could see donor contributions decrease.	Bangladesh, Cambodia, Kyrgyz Republic, Philippines, Tajikistan
Capital flow and exchange rate volatility	Economies with large new foreign direct investments or large shares of foreign holdings in portfolio investments and bonds are prone to capital flight due to heightened risk perception or flight to quality. This could induce currency depreciation, increase current account deficits and foreign debt values, as well as raise imported inflation.	India, Indonesia, Kazakhstan, Republic of Korea, Kyrgyz Republic, Myanmar, Turkmenistan, Uzbekistan, Viet Nam

continued on next page

Table 1 *continued*

Risks	Description	Vulnerable Countries
High household debt	Economies with high household debt could see consumer demand weaken if credit tightens worldwide.	Republic of Korea
Limited fiscal space	Slippage in expenditures and revenue weakness deteriorate in net operating balances and increase government debt.	India, Indonesia, Malaysia, Myanmar, Pakistan, Philippines
Excessive credit growth, asset price bubbles, banking vulnerabilities	High credit growth contributes to macroeconomic instability and fans asset property bubbles. Bank asset quality could deteriorate as credit growth also appears in rising nonbank or informal credit, or off-balance sheet financing. Macroeconomic tightening and falling asset prices after a credit boom adds stress on borrowers and lenders alike.	People's Republic of China; Hong Kong, China; Kazakhstan; Singapore; Viet Nam
Limited access to finance	Several countries have limited private sector credit, with funds going mostly to state-owned enterprises.	Lao PDR, Myanmar, and most of South Asia
Natural disasters	Severe weather events, earthquakes, and other natural disasters induce shocks to domestic production and regional supply chains.	Bangladesh, Cambodia, Lao PDR, Pakistan, Philippines, Thailand, Sri Lanka, Viet Nam

global financial markets. This became clear during the 2008/09 crisis when both Singapore and Hong Kong, China—the region's financial hubs—had the largest drop in output as measured against trend. In contrast, countries with smaller amounts of international financial assets saw far less disruption to output growth.

Failure to resolve the eurozone crisis would likely result in accelerated capital outflows similar to 2008, when, after Lehman Brothers collapsed, capital exited as a result of risk aversion and initial uncertainty over who held toxic sub-prime assets. Most capital outflows were in bank lending and portfolio investments,

Table 2: Assessment of External Vulnerabilities (%)

Country	Current Account/ GDP (latest available)	External Debt/ GDP[a] (Q22011)	Short-Term External Debt/ Reserves (Q32011)[b]	Broad Money[c]/ Foreign Reserves (latest available)	Foreign Reserves (number of months of imports)[d]	Foreign Liabilities/ Foreign Assets[e] (latest available)
Brunei Darussalam	*50.0* (2011)	**14.5**	*82.7*	*6.5* (Mar11)	*3.8* (Mar11)	*1.8* (Nov11)
Cambodia	*(11.6)* (2011)	*19.6*	*30.2*	**1.5** (Dec11)	**4.5** (Dec11)	*62.4* (Dec11)
China, People's Republic of	**2.7** (H211)	**8.4**	**16.1**	**4.2** (Dec11)	*22.3* (Dec11)	**32.1** (Dec11)
Hong Kong, China	**7.0** (Q311)	**264.7**	*195.2*	*3.6* (Nov11)	*7.3* (Jan12)	**76.8** (Oct11)
India	*(3.8)* (Q311)	*17.9*	**80.6**	**4.8** (Nov11)	**6.9** (Jan12)	–
Indonesia	*(0.4)* (Q411)	*16.9*	*61.7*	*3.0* (Dec11)	*7.2* (Feb12)	**137.2** (Jan12)
Japan	*(3.8)* (Q411)	*17.5*	**76.1**	**8.1** (Nov11)	*17.3* (Feb12)	**60.0** (Nov11)
Kazakhstan	**0.8** (Q411)	*18.8*	*45.4*	**2.1** (Dec11)	*8.9* (Jan12)	*69.7* (Dec11)
Korea, Republic of	**3.8** (Q411)	**30.3**	*85.4*	*5.0* (Nov11)	*7.0* (Feb12)	*195.1* (Nov11)
Lao People's Democratic Republic	*(9.4)* (2011)	*32.0*	*60.3*	**3.7** (Dec10)	**2.0** (Dec10)	**75.3** (Dec10)
Malaysia	**9.9** (Q411)	**31.8**	*48.0*	**2.9** (Dec11)	**8.5** (Feb12)	*98.4* (Dec11)
Myanmar	**(2.6)** (2010)	*3.4*	*11.9*	–	**2.6** (Jun07)	–
Philippines	*3.7* (Q311)	*37.9*	*46.6*	*1.9* (Oct11)	*13.7* (Feb12)	**97.0** (Jan12)
Singapore	*20.3* (Q411)	*235.4*	*240.9*	**1.4** (Dec11)	*8.0* (Feb12)	**103.1** (Dec11)
Taipei,China	*10.4* (Q411)	**22.7**	*26.0*	*2.8* (Feb11)	*17.0* (Feb12)	*62.4* (Dec11)
Thailand	*2.3* (Q411)	**17.0**	*28.9*	*2.6* (Dec11)	*9.1* (Feb12)	**102.9** (Dec11)
Viet Nam	**(1.5)** (Q311)	*29.9*	**121.2**	**8.5** (Oct11)	**1.7** (Oct11)	**135.9** (Oct11)

( ) = negative, – = unavailable, GDP = gross domestic product, y-o-y = year-on-year.

Note: Italicized figure implies an improvement from Aug 2008 for monthly data, Q3 2008 for quarterly data, or 2008 for annual data. Bold-faced figure implies a deterioration from the same base periods.

[a] Data for Brunei Darussalam, Cambodia, Lao People's Democratic Republic, and Myanmar are computed using World Economic Outlook and the Joint External Debt Hub.

[b] Short-term external debt includes loans and credits due and debt securities due within a year as defined in the Joint External Debt Hub. Total reserves data for Brunei Darussalam as of March 2011; Lao People's Democratic Republic as of December 2010; Myanmar as of June 2007.

[c] Data for Brunei Darussalam, Philippines, Taipei,China; and Thailand refer to broad money; for Cambodia, People's Republic of China; Hong Kong, China; Indonesia, Japan; Kazakhstan; Republic of Korea; Lao People's Democratic Republic; and Malaysia refer to M2; for Myanmar and Viet Nam to money plus quasi-money; for India M3—from *International Financial Statistics*, International Monetary Fund.

[d] Refers to reserves minus gold over a 12-month moving average of imports (cost of insurance, freight). Latest month when data is available. Import data may be earlier, the same, or later than period indicated.

[e] Foreign liabilities and assets of banking institutions, deposit money banks, and other depository corporations.

Source: ADB calculations using data from CEIC; national sources; *Asian Development Outlook Update 2011*, Asian Development Bank; Joint External Debt Hub, BIS-IMF-OECD-WB; *International Financial Statistics, World Economic Outlook*; and Article IV Consultations, International Monetary Fund.

> Thus far, Asia's financial sectors have shown resilience, even if several economies have seen a foreign currency liquidity crunch for short periods of time. Current resilience, however, does not mean low downside risks. Banks in major financial centers in the region rely on US and European banks for funding. Any credit tightening in advanced economies will affect banks in the region. Likewise, monetary easing in the US and eurozone will have significant impact for Asian finance. Corporate bond markets can be affected by capital flight. These factors, coupled with regional stock market co-movements with global markets, call for continuous monitoring, vigilance, and timely preemptive or remedial measures to maintain financial stability.

while foreign direct investment remained relatively stable. This suggests that, in the event of a deeper eurozone crisis, the channel of transmission to the region will likely be via a sudden drop in bank lending and portfolio investments.

Tighter global credit conditions would return should the eurozone crisis intensify, bringing a knock-on effect to the region's banking system liquidity. Politically, eurozone banks will find it easier to cut lending abroad rather than domestically; thus bank lending to the region would drop. Banks incorporated in the US and the United Kingdom with close ties to eurozone banks would likely be hurt as well (**Table 3: Exposure to US and European Banks).** It is not surprising that financial centers such as Hong Kong, China and Singapore rely heavily on European bank borrowings, while several other economies also have substantial European bank exposure.

A deeper or prolonged crisis in Europe would likely result in higher global risk aversion, drawing portfolio investors away from the region. Stock markets indexes in several of the region's economies could plummet once more, reducing investor confidence and hurt consumption through the wealth effect. It would also increase the cost of raising funds, thus depressing investment. It may also make raising capital in domestic financial markets more challenging. Co-movements between the region's stock markets and major global financial markets are increasing. Since the start of the eurozone sovereign debt crisis, Asian and eurozone stock markets have moved almost in lockstep. Apart from the stock market impact, bond markets will likely be affected. A crisis would likely push bond yields up in the region as foreign investors flee to "safe haven" assets. This could make it more difficult and expensive for companies to raise funds in bond markets, and firms could face liquidity crises should financing—including trade financing—become more difficult. Countries with more external bond holdings would likely be affected as fund outflows would have greater impact. Among the region's economies, Malaysia and Indonesia have large foreign holdings in government bonds.

Table 3: Exposure to US and European Banks (as of September 2011, % of Borrower's Domestic Credit)

	Lender						
		European Banks					
Borrower	US Banks	Total	France	Germany	UK	GIIPS	Rest of Europe
Developing Asia + Japan	**2.3**	*5.1*	*0.8*	*0.5*	**2.8**	*0.1*	*0.9*
Japan	**1.7**	*2.3*	*0.7*	*0.3*	*0.7*	*0.0*	*0.6*
Developing Asia	**3.0**	*8.9*	*0.9*	*0.8*	**5.6**	*0.3*	*1.4*
ASEAN-4 + Viet Nam	**3.9**	*9.8*	*1.1*	*1.2*	**6.1**	*0.1*	*1.3*
Indonesia	**5.0**	*12.1*	**1.3**	*1.9*	**6.2**	*0.1*	*2.6*
Malaysia	**5.6**	*14.9*	*0.9*	**1.4**	**11.6**	*0.1*	*0.9*
Philippines	**6.8**	*15.1*	**2.4**	*1.8*	**7.1**	*0.1*	*3.7*
Thailand	**2.2**	*4.5*	*0.4*	*0.7*	**2.8**	*0.0*	*0.6*
Viet Nam	*1.2*	*6.4*	*2.4*	*0.6*	*2.8*	*0.1*	*0.6*
NIEs	**9.6**	*29.9*	*2.9*	*2.1*	**19.7**	*0.4*	*4.8*
Hong Kong, China	**10.4**	*69.6*	*4.8*	*2.1*	**54.7**	*1.4*	*6.6*
Republic of Korea	**7.5**	*13.9*	*2.0*	*1.5*	*8.0*	*0.2*	*2.2*
Singapore	**26.2**	*71.4*	*6.4*	*8.2*	*35.0*	*0.8*	*21.0*
Taipei,China	**6.4**	**12.1**	*1.9*	*0.7*	**7.6**	*0.0*	*1.9*
People's Republic of China	**0.8**	*2.6*	*0.3*	*0.2*	**1.5**	**0.2**	*0.4*
India	**8.0**	**17.3**	**2.0**	**2.4**	**9.7**	*0.4*	*2.8*
Kazakhstan	**4.2**	*17.0*	*1.0*	*1.4*	**3.2**	**8.7**	*2.8*
United States	na	*11.0*	*1.7*	*1.7*	*3.3*	**0.9**	*3.4*
eurozone	*3.2*	*26.8*	*5.8*	*4.9*	*4.6*	*4.3*	*7.1*

eurozone = Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain; GIIPS = Greece, Ireland, Italy, Portugal, and Spain; na = not applicable; NIE = newly industrialized economy; UK = United Kingdom; US = United States.

Note: Bold-faced figure implies an increase in exposure compared with September 2008 in terms of domestic credit percentage value greater than $100 million; italicized figure implies a decrease in exposure. Developng Asia includes People's Republic of China; India; Kazakhstan; ASEAN-4 plus Viet Nam; and NIEs. Domestic credit or domestic claims based on International Financial Statistics definition of International Monetary Fund.

Source: ADB calculations using data from Table 9D (Consolidated foreign claims of reporting banks—ultimate risk basis) of the Bank for International Settlements and CEIC.

In sum, the transmission of an exacerbated eurozone crisis to emerging Asia through the financial channel could be significant. Due to longer lags in data availability compared with trade flows for instance, a crisis impact may appear muted when in fact it is simply delayed. Therefore, providing liquidity support remains important, as does bolstering existing bilateral and other swap arrangements.

2.2 The Real Economy

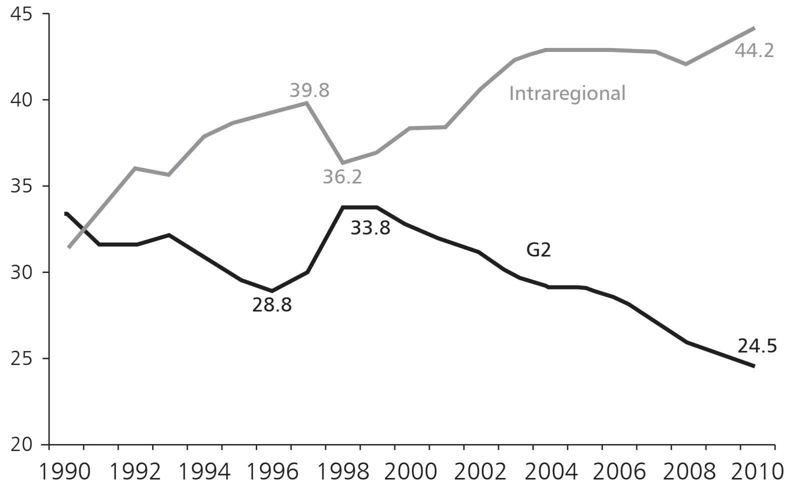
Ring-fencing the real sector against the impact of financial market contagion should the crisis escalate is critical.

The past four episodes of US or eurozone recessions show an increase in the impact of external shocks on Asia. As may be expected, the more export-oriented newly industrialized economies suffered more than the middle-income Association of Southeast Asian Nations (ASEAN) economies during these periods. Moreover, the PRC economy's sensitivity to recession in advanced economies has grown in consonance with its export growth.

A prolonged or deeper eurozone sovereign debt crisis will affect the region through the trade channel as demand from developed countries falls. During the 2008/09 global financial crisis, economic growth in the region collapsed as demand for Asian exports contracted due to weak global growth. This was exacerbated by the collapse of trade financing from tight global liquidity. As a consequence, economies with closer trade ties with the US and eurozone were the most severely affected. Singapore; Hong Kong, China; Malaysia; and Thailand recorded larger declines in gross domestic product (GDP) growth in 2008 and 2009. In contrast, more domestic demand-oriented economies—the PRC, Indonesia, and India—remained resilient and had only minimal output contractions. This would likely repeat should the global economy slump in 2012.

Nonetheless, the trade impact would probably be less today compared with 2008/09, as Asia's export markets have diversified. For instance, the region's exports to the eurozone and US have declined from 33.8% of total exports in 1999 to 24.5% in 2010. The contribution of domestic and regional demand to export growth has also increased. The share of intraregional exports to total exports in emerging East Asia, for example, rose from 36.9% to 44.2% during the same period (**Figure 1: Direction of Exports Emerging Asia**). The region has also developed stronger trade ties with Latin America and Africa.

Figure 1: Direction of Exports—Emerging Asia[a]
(% of total exports)



G2 = United States and eurozone.

[a] Includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

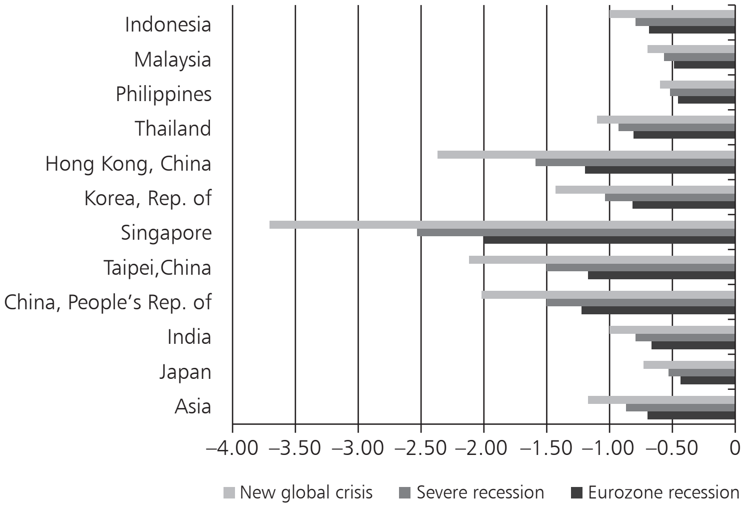
Source: ADB calculations using data from *Direction of Trade Statistics*, International Monetary Fund.

2.3 Estimating Crisis Impact

The crisis impact on European and US economic performance will largely determine how it affects Asia. Should downside risks materialize, the eurozone could fall into a deep recession and drag the US economy to lower growth or even recession. A low-probability scenario would find both the eurozone and the US in deep recession, with output reaching the economic troughs of 2009. The three possible scenarios for 2012 are

- a recession confined to the eurozone, with the economy contracting 3.9% for 2012, with US economic growth slowing to 1.6% in 2012,
- a deep recession in the eurozone that drags the US economy into technical recession, contracting 0.1% in 2012,
- a renewed global crisis where output in both the eurozone and US fall to 2009 troughs.

Figure 2: Impact of Eurozone and US Crisis on 2012 GDP Growth (deviation from baseline forecast,[a] percentage points)



GDP = gross domestic product, US = United States.

Eurozone, according to the Oxford Economic Forecasting model, includes Austria; Belgium; Finland; France; Germany; Greece; Ireland; Italy; Luxembourg; Netherlands; Portugal; Slovakia; and Spain.

[a] ADB's baseline assumptions forecast 2012 GDP growth in the eurozone and the US will be 0.5% and 2.1%, respectively. Japan is forecast to grow 2.5%. For developing Asia, GDP should grow about 7.0%. These figures are based on ADB forecasts made in December 2011.

Note: A eurozone recession exists when eurozone 2012 GDP returns to its 2009 trough. New global crisis comprises a eurozone recession plus US 2012 GDP returning to its 2009 trough. Severe recession combines a eurozone recession and a technical recession in the US for the first two quarters of 2012.

Source: ADB calculations using the Oxford Economics Forecasting Model.

Asia's GDP growth will drop from "moderate to severe" under the three scenarios, but even the outcomes of the low-probability scenario will still be better than the 2008/09 impact.

- Under the first scenario, Asia's economies will see a drop in 2012 output growth of between 0.4 and 2.0 percentage points with—Singapore; and Hong Kong, China worst affected, followed by the PRC; the Republic of Korea; Taipei,China; India; and finally Japan (**Figure 2: Impact of eurozone and US Crisis on 2012 GDP Growth**).

- Should the eurozone recession drag the US economy into technical recession, Asia's output growth will drop between 0.5 and 2.5 percentage points, with the same order of severity among the region's economies.
- If a new global crisis drives eurozone and US output down to 2009 levels, the region's growth will fall between 0.6 and 3.7 percentage points, still well below the 2008/09 impact.

These projections likely underestimate the true effect of a new global crisis. The moderate impact on East Asia can be explained in part by (i) increased intraregional trade as a share of total trade; (ii) understated financial-channel transmission due to modeling limitations; (iii) the lack of an appropriate variable to capture confidence or expectations variable—confidence was an important economic drag during 2008/09; and (iv) Japan's resilience due to post-disaster reconstruction. Realized economic growth can also vary depending on the nature and intensity of policy responses.

Thus, the actual impact can be stronger than what is discussed above. In fact, there is a worst case "perfect storm" scenario that goes well beyond the model simulations here. This would be an extremely low probability case in which a real financial crisis ignites—say, through a disorderly sovereign default in one country—and spreads across the European Union (EU). Markets begin to question whether the euro can survive and risk premiums on euro-denominated assets rise sharply. This could be a shock worse than the 2008 Lehman's collapse. Markets could question the solvency of global financial institutions, leading to a dramatic credit squeeze. What happens should Japanese rates rise? And what if the perfect storm strikes the PRC hard, dropping its GDP growth below sustainable levels? While this scenario is highly unlikely, it cannot be ignored.

Section 3

Policy Challenges

> Asia needs to keep a medium- and long-term perspective and not be too short-term focused. Avoiding financial bubbles should be the the principal focus of short-term policy making, involving: prudential regulation; maintaining adequate financial reserves; adequate bank capital; avoidance of high levels of short-term indebtedness. Asia learned the hard way about financial bubbles in 1997, while the US and Europe have learned the hard way in 2008–2010. The lessons should give us pause on too much short-term macroeconomic manipulation, and force us to think long-term.
>
> *Excerpts from remarks made by Jeffrey Sachs in preparatory workshops in New Delhi and Jakarta.*

As explained in Section 2, even in the extreme scenario where eurozone and United States (US) gross domestic product (GDP) fall to 2009 levels, the short-term impact on Asia would likely be muted compared with the 2008/09 Great Recession. Asia should be able to weather another crisis if the region's policymakers respond quickly, properly, and firmly by deploying financial, monetary, and fiscal policies to boost liquidity, restore confidence, ensure financial stability, and support growth.

To maintain long-term, sustainable, and increasingly inclusive growth, policymakers must avoid knee-jerk reactions that paper over structural issues. Regardless of whether a global crisis occurs, emerging Asia, however diverse, must stick to its tradition of medium-term national development plans and perspectives. It has the opportunity to focus on a structural transformation that can bolster macroeconomic and financial stability while boosting human capital, supporting needed capital investment, and addressing environmental risks. All this will require active governments, committed to good governance and pursuing regional or global cooperation in addressing common challenges.

3.1 Safeguarding Growth in a Crisis

Asia's most immediate challenge would be to contain risks emanating from financial channels should the eurozone plummet into a full-blown

> From the 1997 Asian currency/financial crisis, the region learned that self-insurance is critical. Amongst the measures taken, two prominent ones were building up foreign reserves and strengthening of the financial sector. Both worked, and that is why we did not have much of the financial channel spillovers in 2008/09. Despite a range of criticisms, accumulating foreign reserves turned out to be a good strategy. Moving ahead, continued accumulation may be costly for some Asian countries. An alternative is the Chiang Mai Initiative Multilateralization. The region should think hard about using it effectively to supplement self-insurance.
>
> *Excerpts from remarks made by Takatoshi Ito at the consultative workshop in Jakarta on 6 February 2012.*

financial and economic crisis. The most important of these are relieving pressure on foreign currency liquidity, managing large and destabilizing capital flows, and minimizing the risk of contagion. Asia must also prepare for a possible slowdown in domestic demand.

Financial policy must buttress the foundations of financial stability and avoid deterioration in market confidence. The region's policymakers will need to ensure adequate and timely provisioning for foreign and domestic liquidity. In emerging East Asia, substantial foreign reserves could cushion the impact of sudden capital outflows. East Asia also has the option of tapping the Chiang Mai Initiative Multilateralization (CMIM), a reserve pool for emergency liquidity, which may double in size this year. Nonetheless, bilateral swap lines may prove the first line of liquidity insurance. Central banks have been active and several new lines have been arranged. In parallel, work is underway to design crisis prevention mechanisms. In this regard, to complement the International Monetary Fund's (IMF) *ex ante* financing mechanisms, the ASEAN+3 could explore the possibility of developing similar *ex ante* liquidity support facilities. In fact, ASEAN+3 finance ministers confirmed the desirability of pursuing this option at their 2011 Ha Noi meeting. For the option to be effective, several issues need to be examined: financing mechanisms for such a facility; conditions under which it would be triggered; stipulations over the amount of funding available to member countries, and; the nature of IMF cooperation.

Monetary policy must remain flexible to respond to extreme exchange rate volatility. Where excess volatility and overshooting undermine currency markets and severely disrupt economic activity, there may be merit in foreign exchange market intervention and temporary capital controls. However, policy makers should be mindful that these measures are likely to force a more disruptive adjustment down the road, and should therefore only been seen as short-term remedies.

Investment in financial instruments should not overshadow real investment. In the short term, myriad problems with real investment—mostly investment climate-related—has led to over-investment of Asia's savings into financial assets. The margin at which tighter credit (or more lax credit) affects investment must be the level of small- and medium-sized enterprises, as dominant corporations hold sufficient cash to avoid serious impact from tightening credit. This needs to be considered from a monetary standpoint.

To restore the balance of investments, a financial tax may be appropriate on a case by case or country by country basis. This would improve allocative efficiency in a second best world where incentives to invest in the real sector cannot be targeted directly, and raise additional revenue for fiscal targeting.

Effective inflation management is critical, and in a globalized world that requires effective collaboration between central banks. In a world economy where there are sufficient barriers across countries, the standard instrument of managing interest rate works. But in a globalized economy, where the patterns and challenges faced in different parts of the world happen to be very different, managing arbitrage possibilities becomes quite difficult, with industrialized countries lowering interest rates as much as possible to pump in liquidity and emerging economies raising interest rates to fight inflation. Monetary policy has to be coordinated carefully, and there needs to be greater collaboration between central banks across and also within regions, including Asia. We talk about coordination on labor and trade matters, and we need to think more about monetary and fiscal coordination.

Excerpts from remarks made by Kaushik Basu, Chief Economic Advisor to Government of India at the consultative workshop in New Delhi on 1 February 2012.

Authorities need to be ready to use fiscal stimulus more effectively in supporting domestic demand. If spillovers from the eurozone and US hit East Asia once more, several economies should hold sufficient fiscal and external positions—though not as much as in 2008/09—to reintroduce stimulus to support growth. At the same time, authorities should carefully design targeted fiscal support to cushion the purchasing power of the most vulnerable from the immediate effects of a potential global downturn. Several countries have faced persistent food inflation, affecting the poor in particular. Central banks may want to pay greater attention to a consumer price index (CPI) subset—say, a "CPI for the Poor"—to keep the impact of macro policies on the poor in the forefront of policy makers' minds. Too much divergence could act as an early warning system against potential social or political tension. Safety net mechanisms will need to be strengthened, with targeted support where feasible.

3.2 Keeping Economic Transformation on Track

In the medium- to long-term, Asia must confront the more difficult task of adjusting to a "new normal" in the global environment to continue its ongoing economic transformation—a new normal where both the US and the eurozone face a prolonged era of structural weakness due to poor economic fundamentals. This new normal comes with considerably increased responsibilities for the region. More specifically, Asia must confront three major challenges:

(i) Asia must finally rise to the task of shifting to a more balanced growth model. The shift toward a domestic demand-oriented strategy is appropriate for some countries—like the People's Republic of China (PRC)—but not for others, like India. The other important aspect of rebalancing is the changing trade pattern, where the share of Asia's trade intraregionally and with other emerging markets—in Africa and Latin America—will increase, while its share with traditional markets—the European Union (EU) and the US—will likely decline. Indeed, although policymakers have come to accept the need for rebalancing where required, the risk of a meltdown in the US and eurozone adds urgency.

(ii) The region must strengthen its resilience to external shocks emanating from financial channels, by improving regional financial arrangements and strengthening crisis prevention and mitigation. These can be done with an eye to ring-fence or build a firewall against financial contagion. These initiatives can help the region cope with financial volatility by reducing both economic disruption from sudden swings in capital flows and the perceived need for excessive reserve accumulation. They will also play a critical role in supporting the region's efforts at rebalancing.

(iii) Finally, Asia must ensure that its new growth trajectory is not only sustainable, but inclusive. Many of the policies in pursuit of rebalancing are consistent with and supportive of the broader objectives of sustainable growth. However, from a development standpoint, Asia's attempts at rebalancing need to impact social and environmental outcomes in a *significantly positive* way in order for them to be worth pursuing. Developing human capital to stay ahead of the industrial curve; harping on increasingly inclusive financial system development; using existing and new technologies (ICT, for example) for improved

> Asia's great strength is that its emerging economies have 5-year plans, and a 10–20 year focus. Active government is essential in this regard, to ensure a strong vision with strong public investment strategies, and policy frameworks. Asia needs to maximize its advantages on this front.

service delivery in education and health, for example; and innovating for environmentally sustainable development are all features that need to coalesce at the top of public policy. Indeed, it presents Asia with the opportunity to think deeply and comprehensively reassess the entire development paradigm—and how it should be implemented.

> In many countries, it is evident that achieving economic growth is not sufficient to reduce poverty. The higher overall economic growth has not always resulted in poverty and hunger reduction.
>
> Developing Asia's rapid growth comes at the expense of the damaged environment. Further, the depletion of non-renewable energy resources has intensified global competition for seeking new energy resources. We need to be cautious that the impact of a commodity and food crisis would potentially be more disastrous than the one of financial crisis. For that reason, the policies to cope with challenges posed by climate change remains a key to economic resilience.
>
> *Excerpts from remarks made by Agus D.W. Martowardojo, Minister of Finance of the Republic of Indonesia at the consultative workshop in Jakarta on 6 February 2012.*

A broad range of fiscal measures will be needed to rebalance demand toward domestic consumption and investment. Governments can increase social expenditures and enhance access to credit to moderate household savings and boost consumption. Again, this will be important only in countries that are heavily reliant on external sources for growth. In these economies, prioritizing public investments with favorable secondary effects can crowd-in additional private investment or support sectors that produce for domestic or regional markets. These fiscal interventions will not only help strengthen domestic demand, but also support the region's goal of improving social outcomes. Increased fiscal spending on health, education, and food security, for instance, should substantially lessen poverty and hunger and lead to improvements in the productive potential of the poor. Meanwhile, higher public spending on infrastructure should create additional space for green investment, with leadership in environmental technology and production now shifting to Asia.

Fiscal measures to boost domestic demand will have to be complemented by reforms to strengthen the financial sector, improve financial literacy, and foster financial inclusion. These reforms will be critical in creating an efficient financial system that can effectively channel savings into productive uses, lower the cost of borrowing, enhance economic growth by pooling risk, and boost efficiency and welfare by providing financial services to the poor and those unbanked. Currently, most policymakers in the region can consider these reforms in the context of continued robust growth. This is why strong prudential regulation has worked fine thus far in many Asian economies. Regulation works well when nations grow quickly. But once it slows, then bad credit allocation becomes more apparent and burdensome, accompanied by huge pressure to ease regulation. This seems to be the case for Europe, Japan, and the US. One implication is that tougher regulation should be entrenched institutionally, making it harder to relax when growth slows.

Raising demand for investment will require policymakers to improve Asia's business and investment climate. Together with improvements in infrastructure and human capital, regulatory reform will be needed to address demand-side factors that limit the uptake of investments due to prevailing uncertainties. Among others, this will involve improving the quality of governance (and legal and institutional frameworks), minimizing unnecessary regulatory barriers, encouraging private incentives and market discipline, and creating a level playing field across all sectors.

Policies to foster domestic demand should be tailored to country conditions. The reasons for weak domestic demand will be different for each country in the region. In the PRC, for instance, high savings would be key, while in others, such as the bigger ASEAN countries, poor investment has been a major constraint. For developing Asia as a whole, however, recent empirical analysis by ADB has pointed to savings as the main contributor to most of developing Asia's large persistent current account surpluses. More importantly, one must avoid the tendency for excess savings to be channeled more toward financial assets than real investment—a trend which may have contributed to declining employment elasticity and widening income disparity.

The composition of investment in current account surplus countries should shift from exports to human capital formation, appropriate industrial policy, and urbanization. There has been a gradual rebalancing in sources of growth from external to domestic demand, with consumption and investment emerging as important drivers of growth. Thus far, these changes appear to have ameliorated the negative impact of the downturn in advanced economies in Asia's real sector. However, there are indications that growth in consumption and investment has been driven primarily by fiscal stimulus in response to the Great Recession, rather than any structural changes that would shift the composition of aggregate demand in a more permanent way. For example, in the case of the PRC, its new 5-year plan suggests a shift away from investment-led growth toward more consumption.

Global trade has played a pivotal role in Asia's economic growth, and this should continue. Asia accounts for one-third of the world's exports and almost one-third of the world's imports. Growing intraregional trade is also becoming a key facet of Asia's growth story. Intraregional trade has grown substantially since the 1997/98 Asian financial crisis, facilitated by relative stability of intraregional exchange rates. Moreover, the private sector has built an extensive intraregional supply chain network that has underpinned growth in regional trade making use of individual country resource endowments.

> While intraregional trade and investments can bolster Asia's growth in the years to come, the region also has tremendous potential to diversify its exports to other regions, including to Africa. Africa right now has 850 million people in the sub-Saharan region and 1 billion people overall—including North Africa; with a huge deficit of basic infrastructure, but a huge potential in minerals, agriculture, and hydrocarbon development; and with a significant potential for increasing in productivity. Africa can become a main source of global growth in the future. It is still a very poor continent but it is a continent in need of huge investments. Asia will have real potential to lead a lot of that infrastructure investment and training and education investment as well. This is one heart of a diversification—a south-south diversification. It may also be the heart of Asia's future—because Asia will be a low cost provider of the world—of a lot of basic infrastructure that Africa needs.
>
> *Excerpts from remarks made by Jeffrey Sachs in the consultative workshops in New Delhi and Jakarta.*

While the growth of intraregional trade is dramatic, globalization continues to be important for Asia, especially for exports of final goods. For the region's active industrial networks, intraregional trade remains heavily dependent on demand for final goods from the US and eurozone. Since the Great Recession, Asia's export markets have diversified with increasing intraregional trade in East Asia and the PRC's growing trade links with Africa and Latin America. However, whether this trend is cyclical (due to the current weakness in the EU and the US) or structural (sustained export market diversification) remains to be examined.

Remaining bottlenecks constraining greater intraregional and "South-South" trade should be removed. Although average tariff levels in the South have fallen dramatically over the past two decades, tariffs faced by exporters from these regions are, on average, higher than in the North. Non-tariff barriers are a growing problem, with gains from tariff reductions outweighed by existing and newly emerging non-tariff barriers. At the same time, many developing Asian economies continue to face major hurdles in trade facilitation, though significantly varying across countries. Special financing mechanisms or targeted liquidity support may be required to revive trade. There may also be the temptation, as there was in

2008/09, to introduce temporary protectionist measures to safeguard employment in sensitive industries—and this needs to be resisted.

In the broader context of rebalancing, further research is needed on the composition of Asian trade. Specifically, from a policy point of view, it will be useful to know if the bulk of changing trade flows from or within the region is due to a realignment of production networks and product fragmentation. In parallel, further work is needed to understand if the continuing increase in the number of free trade agreements (FTAs) can support rebalancing by encouraging growth in intraregional trade. In particular, since FTAs may not be boosting trade emanating through production networks or product fragmentation,[1] an important policy question will be how to improve the structure of FTAs with the goal of promoting trade in general. At the same time, it may be useful to examine more closely the links between the growth of production networks with a multilateral system where most favored nation preferences are offered more widely. This would help minimize trade diversion and the need to implement rules of origin, as well as increase the benefits that flow from non-discriminatory trade."

In addition to rebalancing toward domestic demand in some countries and a shift in trade direction, Asia also needs to rebalance in two other ways. First, middle income Asian economies must diversify their production base up the value-added chain. A well-designed structural transformation process—guided by public policy—is essential. Second, as large economies like the PRC move into higher value-added manufacturing and expand growth in services, other countries will fill in the production gap as intermediate products are further outsourced.

Also, as economic integration deepens, Asia must establish a more effective framework for policy dialogue and cooperation to mitigate political tensions from spillovers and to find wider scope for collective action. There are at least four key areas where increased regional cooperation will be necessary: infrastructure development, exchange rates, trade credit, and financial safety nets

- **Narrowing the infrastructure gap could be key to maintaining rapid regional growth** despite weak economies in Europe, Japan, and the US; and the threat of a global economic and trade slowdown. ADBI estimates Asia needs to invest approximately $8 trillion in overall national infrastructure between 2010 and 2020—$750 billion a year over the 11-year period. It translates into a significant boost in regional

[1] This is because most if not all product fragmentation trade already travels duty-free or at very low tariffs across the region—either because of the ITA agreement that covers trade in electronics parts and components, various duty-drawback schemes, or the fact that most multinationals operate out of export processing zones, where they operate duty-free.

domestic demand in a period when external demand becomes a less important source of growth than over the past decade. Improving interconnectivity raises productivity—especially in remote and low-income regions—and helps in bolstering inclusive growth. As we know from past crises, short-term priorities generally get more attention in situations of immediate crisis management, with critical medium-term issues either postponed or resources re-targeted to the most vulnerable. While such trade-offs are inevitable, they impose high opportunity costs on development. The decline in infrastructure spending after the 1997/98 Asian financial crisis is a good example. It took several economies a decade to return to pre-crisis spending levels. As a result, infrastructure quality has worsened in the region. It is imperative not to allow an economic or financial crisis to become a development crisis. To avoid this, policymakers could manage their fiscal space efficiently. Specifically, better fiscal risk management frameworks can be developed where large-scale investment can be shared effectively between public and private sectors.

> The main lesson from the Global Financial Crisis is that we need to keep unfettered focus on short-term challenges without losing perspective on medium- to long-term issues. As markets and economies become more integrated, crises are inevitable. In parallel, structural reforms are even more critical. Speaking for Kazakhstan, we have dealt with short-term challenges from the 2008 global crisis effectively, and we need to stand ready in the future. As the recovery of the Eurozone and US economies is likely to be weak, it is critical for Kazakhstan—and this region—to reflect on the structural weaknesses that have intensified the crisis in the West. We need to diversify our economy as well as ownership of assets. Oil revenues will be directed at building both physical and social infrastructure, particularly human capital. Regional cooperation and connectivity are vital to convert the challenges of being landlocked to an "ocean of opportunities".
>
> *Excerpts prepared by ADB staff from remarks made by Kairat Kelimbetov, Deputy Prime Minister of the Republic of Kazakhstan at the consultative workshop in Astana on 12 April 2012.*

- **Greater regional cooperation on setting exchange rate policies could provide a transparent way to facilitate rebalancing and guarding against a currency war.** A major risk to sustained regional economic integration during global economic volatility could come from competitive devaluation or a contagious exogenous shock—as

> No country or region is immune from the risk of a future crisis. New crises will always be a reality, and each can be different. An important lesson is the need to have a robust financial safety net which can be provided, among others, through regional financial arrangements (RFA). The global nature of many crises and the interconnectedness of the financial system call for coordinated policy responses which may be done through RFA and, if and where necessary, together with the IMF. The provision of a safety net by RFA together with regional surveillance can be complementary to domestic and global financial reform. While global arrangements may be in a better position to mobilize large amounts of resources (hence serving as a backdrop to regional pools), RFA has the advantage of having stronger ownership and in-depth understanding of regional issues. The working of RFA in Asia is still far from what most analysts expect, and their effectiveness remains limited. From crisis after crisis—the eurozone being the latest—we have learned a clear lesson that the required amount of liquidity support is large, and activation mechanisms need to be rapid in order to be effective. Complacency should be avoided at all cost, since the current resilience of the Asian financial sector may ironically stand in the way of having a stronger RFA.
>
> *Excerpt from Iwan J. Azis, March 2012, Regional Financial Safety Nets and Financial Stability, ADB, Manila.*

during the Asian financial crisis. Moreover, since global rebalancing implies a generalized exchange rate appreciation across most of developing Asia, individual economies may be reluctant to be the first to let their currency appreciate—as this means losing competitiveness, especially in weakening global conditions. Greater regional cooperation on exchange rate policies can help. This would take into account exogenous shocks to any particular economy (disasters, sharp deterioration in the terms of trade, inflation, among others) and thus would encompass flexible rate adjustments to avoid undue reliance on internal price and cost adjustments in those economies. Also, by doing this Asia could play an important role in preventing competitive devaluations in the global context should, for example, a depreciating euro drive the US and others to attempt to follow suit. Given the diversity in economic and financial development in Asia—and the general desire to retain monetary (and fiscal) policy sovereignty—the adoption of a common exchange rate is clearly not viable. The region does not satisfy many of the conditions required of an optimal currency area. In light of this, regional economies could instead agree on a gradual, cohesive adjustment of their currencies toward equilibrium levels. Regional exchange rate cooperation can start from informal and institution-light arrangements. One possible approach would be informal reference or monitoring zones for regional exchange rates to reduce intraregional exchange rate variability over time. Current arrangements in East Asia, such as the CMIM and Economic Review and Policy Dialogue, could support this kind of informal approach. If East Asian countries, or a subset, conclude that monetary and exchange rate cooperation ought to be strengthened, then they should begin taking more ambitious, but carefully crafted, steps in that direction.

- **The ability of countries to counter trade credit volatility is strengthened by a strong reserve position and backup credit lines.** Establishing and substantially expanding bilateral currency swap lines makes sense. The PRC already has a policy to expand country coverage and swap lines to settle trade transactions in renminbi. The PRC's intention to extend credit lines and allow trade settlement through banks in ASEAN could provide an important reserve enhancement to foster trade and exchange rate stability.
- **There is a major challenge in strengthening regional financial safety nets to improve crisis prevention and mitigation**. Financial safety nets generally come from surveillance and finance mechanisms. Through vigilant surveillance, a country's vulnerability to crisis and the impact of policy adjustments on regional and global stability can be better assessed. In addition, financing can be extended to address liquidity problems particularly for crisis prevention or resolution. This way, financial safety nets help countries cope with financial volatility by reducing both economic disruption from sudden swings in capital flows and the perceived need for excessive reserve accumulation. Although regional financial safety nets such as the CMIM exist, their usefulness remains largely untested. If anything, more ambitious programs need to be explored. During the 2008/2009 global financial crisis, the CMIM was not used. Instead, the Republic of Korea conducted swaps with the PRC, Japan, and the US, while Indonesia did swaps with the PRC and Japan. There are two explanations for this. First, the reserve pooling arrangement was small and not multilaterlized until March 2009 (it was a collection of bilateral swap arrangements beforehand)—even its current size is less than 3% of the $4.2 trillion ASEAN+3 reserves. The second and more likely explanation is the stigma attached to IMF conditionality: prior to multilateralization, the CMI—then lacking a dedicated surveillance secretariat—required that financing beyond 20% of the bilateral swap facility be available only to a country under an IMF-supported program. Now that the ASEAN+3 Macroeconomic Research Office (AMRO) has been established, this link is being reviewed. With AMRO in place, the 20% limit could be increased or perhaps removed altogether; otherwise the role of AMRO will be diminished. To establish

an effective regional financial safety net for Asia, two things are needed: adequate size/scope and credibility. As far as the CMIM is concerned, there is clearly a need to boost its current size by encouraging member countries to shift more funds toward the CMIM and away from self-insurance (foreign reserves). In this regard, discussions are ongoing on a possible doubling in size of the fund to $240 billion, and a change in the amount linked to an IMF program. There is also a need to consider whether the CMIM should include other financing mechanisms to improve the timeliness of emergency financing (as noted in Section 3.1). Most critical is the need to boost CMIM's credibility, which must rely more on its own assessments when making lending decisions, and about both the amount and any conditionality. If the CMIM is to evolve into a wider regional safety net, then membership may need to be opened up and expanded. Increased membership can add to fund size, but again the key challenge is establishing credibility to "lead" any rescue package. Greater human than financial resources will be required for such an arrangement to work.

Section 4

Conclusion

There is much fodder for debate here.

This year could prove critical for the world economy. The financial tensions in Europe could still degenerate into a disorderly sovereign default and full-blown economic crisis. Contagion remains a real risk. While the United States recovery keeps nudging forward, politics or a eurozone recession could reverse its momentum.

And that could all spread to Asia. The immediate challenge for the region's policymakers is to prepare options for responding to a sudden economic disruption, funneling into Asia through financial and trade transmission channels. The region should have the policy tools available.

But even more challenging is to deal with these immediate issues with a strategic eye on avoiding a disruption in the region's continuing economic transformation. The debate must include some discussion on how to adjust the development paradigm to better accommodate global economic change while ensuring sustained growth is possible—growth that is more inclusive and responsible, ultimately boosting the welfare of the majority of Asia's population.

Given the complex range of issues, it is not easy to summarize or be conclusive. The work on this monograph and the consultative workshops indicate where much more work is needed:

1. Are the transmission channels of various policies fully understood? Can "trickle down" be taken for granted?
2. How can domestic, regional and global policy coordination be fostered, and what is Asia's role?
3. How should rebalancing be done to ensure Asia sustains its contribution to global growth?
4. How should Asia approach the growth versus inequality versus sustainability dilemma?
5. With the center of economic gravity shifting to Asia, is there need for a new "development paradigm"? What are the areas where Asia can lead?

Appendix

The monograph was produced by an ADB team led by Iwan J. Azis (head, Office of Regional Economic Integration [OREI]). Members include Noritaka Akamatsu (deputy head, OREI), Ramesh Subramaniam (senior director, OREI), Jayant Menon (lead economist, OREI), Sabyasachi Mitra (principal economist, OREI), Thiam Hee Ng (economist, OREI), and Lei Lei Song (principal economist, OREI). The study also benefited from the guidance of Masahiro Kawai (dean, ADB Institute) and Changyong Rhee (chief economist, ADB). James Villafuerte and the ARIC team provided valuable research assistance. Guy Sacerdoti provided very able editorial assistance.

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Preparatory Workshops for the 2012 ADB Annual Meeting Governors' Seminar

List of Participants

Delhi (1 February 2012)

1. Shankar Acharya	Honorary Professor, Indian Council for Research on International Economic Relations
2. Puneet Agarwal	Deputy Secretary (ADB II), Department of Economic Affairs, Ministry of Finance, India
3. Prema Chandra Athukorala	Professor, Australian National University
4. Kaushik Basu	Chief Economic Adviser, Government of India

5.	Peter Boone	Associate, Centre for Economic Performance, London School of Economics and Political Science
6.	Hon Cheung	Regional Director, Official Institutions, State Street Global Advisors
7.	Hal Hill	Professor, Australian National University
8.	Rajiv Kumar	Secretary General, Federation of Indian Chambers of Commerce and Industry
9.	Junkyu Lee	Senior International Economic Advisor to the Minister of Strategy and Finance, Republic of Korea
10.	Michael Plummer	Head of the Development Division of the Trade and Agriculture Directorate, Organisation for Economic Co-operation and Development
11.	Venu Rajamony	Joint Secretary, Department of Economic Affairs, Ministry of Finance, India
12.	M. Govinda Rao	Director, National Institute of Public Finance and Policy
13.	Jeffrey Sachs	Director, Earth Institute; Professor, Columbia University

Jakarta (6 February 2012)

1.	Prema Chandra Athukarola	Professor, Australian National University
2.	Bambang Brodjonegoro	Head of Fiscal Policy Office, Ministry of Finance, Indonesia
3.	Muhammad Chatib Basri	Vice Chairman of the National Economic Committee of the President, Indonesia
4.	Peter Boone	Associate, Centre for Economic Performance, London School of Economics and Political Science
5.	Stephen Grenville	Visiting Fellow, Lowy Institute of International Policy
6.	Hal Hill	Professor, Australian National University
7.	Takatoshi Ito	Professor, Tokyo University
8.	Agus D.W. Martowardojo	Minister of Finance, Indonesia
9.	Mari Elka Pangestu	Minister of Tourism and Creative Economy, Indonesia

10.	Anny Ratnawati	Vice Minister I, Ministry of Finance, Indonesia
11.	Jeffrey Sachs	Director, Earth Institute; Professor, Columbia University (via videoconference)
12.	Mahendra Siregar	Vice Minister II, Ministry of Finance, Indonesia
13.	Wing Thye Woo	Professor, University of California, Davis

Beijing (1 March 2012)

1.	Isher Judge Ahluwalia	Chairperson, Indian Council for Research on International Economic Relations
2.	Narongchai Akrasanee	Former Minister of Commerce, Thailand; Chairman of the Board of Directors, Seranee Group
3.	Peter Boone	Associate, Centre for Economic Performance, London School of Economics and Political Science
4.	Ding Yifan	Director, Institute of World Development, Development Research Center of the State Council
5.	Gao Haihong	Senior Fellow, Institute of World Economics and Politics, China Academy of Social Sciences
6.	Liu Erfei	Country Executive, Managing Director of Bank of America, Merrill Lynch
7.	Liu Peng	Deputy Director, International Department, China Banking Regulators' Commission
8.	Lu Feng	Deputy Dean, National School of Development, Peking University
9.	Jeffrey Sachs	Director, Earth Institute; Professor, Columbia University (via videoconference)
10.	Shi Zihai	Deputy Director General, Policy Research Department, National Development and Reform Commission
11.	Tang Min	Executive Vice Chairman of Board of Directors, China Social Entrepreneurs Foundation

12.	Wang Yida	Deputy Director General, Comprehensive Department, Ministry of Finance
13.	Yang Weiqun	Director, Asian Department, Ministry of Commerce
14.	Zheng Xiaosong	Director General, International Department, Ministry of Finance

Astana (12 April 2012)

1.	Shigeyuki Abe	Faculty of Policy Studies, Doshisha University
2.	Peter Boone	Associate, Centre for Economic Performance, London School of Economics and Political Science
3.	Ralph Christy	Professor, Cornell University
4.	Oraz Jandosov	Director, RAKURS Center for Economic Analysis
5.	Kairat Kelimbetov	Deputy Prime Minister, Kazakhstan
6.	Sabit Khakimzhanov	Head of Research, Halyk Finance
7.	Meruert Makhmutova	Director, Public Policy Research Center
8.	Kairat Mynbayev	Professor, Kazakh-British Technical University
9.	Jeffrey Sachs	Director, Earth Institute; Professor, Columbia University (via videoconference)
10.	Bakytzhan Sagintayev	Minister, Economic Development and Trade, Kazakhstan
11.	Madi Umbetaliev	Vice President, Economic Research Institute

How Can Asia Respond to Global Economic Crisis and Transformation?

This monograph aims to stimulate debate on the measures available to policymakers to dampen the effects of any abrupt economic shocks should recovery in the United States fail to gain traction or if the sovereign debt problems plaguing Europe were to escalate into a full-blown crisis. In addressing current issues, it is imperative to also focus on pursuing the long-term goal of sustaining Asia's growth momentum and consolidating its economic and social transformation. How Asia responds to the current crisis and ongoing global structural transformation is critical, including how it pursues inclusive and sustainable growth in a manner that uplifts the welfare of the majority of its people.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than $2 a day, with 903 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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