Navigating Crises and Maintaining Growth: Challenges for Middle-Income Developing Asia

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The rise of Asia. The seven economies. The challenge of upgrading

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(1) Introduction

Draws on, attempts to synthesize a large ADB-funded project comprising four thematic papers, seven middle-income developing economy case studies.

Context:
Developing Asia came through the GFC in relatively good shape, much better than AFC.

But: very uneven impacts; uncertain global economic environment; won’t be able to rely on ‘export-led’ growth as much as in past.

And what are the analytical and policy lessons for (a) domestic economic management and (b) coordinated regional/global economic and financial architecture in the aftermath of the GFC?
Deep crises are often defining, unsettling events. Force governments to undertake major reforms; and scholars to rethink the conventional wisdom.

Lal and Myint: ‘Turning points [in economic policy] are invariably associated with macroeconomic crises.’

Krugman: ‘When historians look back on 2008-10, what will puzzle them most is the strange triumph of failed ideas. Free-market fundamentalists have been wrong about everything – yet they now dominate the political scene more thoroughly than ever.’

This is a large, complex and challenging project, with several inter-related issues cutting across country and thematic papers, against the back-drop of a fast-changing and uncertain international and regional environment:
1) Growth dynamics, including long-term growth performance, resilience in response to exogenous shocks, recovery from crises, and the special challenges of upgrading for upper middle-income economies.

2) Savings and financial development, with lessons learnt from recent events, especially the Asian financial crisis and the great crash in rich economies.

3) Investment behaviour after the Asian financial crisis, including in some countries the challenges of sluggish investment levels and difficulties in funding long-term infrastructure projects.

4) International and regional dimensions, including uneven recovery patterns, large current account imbalances, the special problems of coordination and provision of global public goods.

Key theme: Great diversity among the seven economies. No one-size-fits-all prescriptions for many of the project’s central issues, no single ‘Asian model of development’.
(2) The Context

(2.1) The rise of Asia

Most of the seven economies have grown fast most of the time. With caveats: high growth started later in India and Vietnam; the Philippines an outlier; the AFC and the GFC interrupted growth, but little for China and India; post-AFC growth slower in some of SE Asia.

Resulted in rapidly rising global shares of output, trade and investment. Table 1. Eg, China 1.7% to 8.6% of global GDP, India 1.7% to 2.3%.

For China and India, a return to their global importance. Maddison, Figure 1.

The contributions to global increments rising faster still, particularly during the recent GFC. Table 2.
Table 1: Global Shares

<table>
<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>India</th>
<th>Asia ex. Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>4.5</td>
<td>2.7</td>
<td>10.8</td>
</tr>
<tr>
<td>1982</td>
<td>1.8</td>
<td>1.8</td>
<td>11.5</td>
</tr>
<tr>
<td>2000</td>
<td>3.7</td>
<td>1.4</td>
<td>12.7</td>
</tr>
<tr>
<td>2009</td>
<td>8.6</td>
<td>2.4</td>
<td>19.9</td>
</tr>
<tr>
<td>2015f</td>
<td>11.8</td>
<td>2.9</td>
<td>27.0</td>
</tr>
</tbody>
</table>

Source: Staff calculation using data from WDI; IMF WEO
Note: 2015 forecast is from IMF

<table>
<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>India</th>
<th>Asia ex. Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>1.0</td>
<td>0.7</td>
<td>17.1</td>
</tr>
<tr>
<td>2000</td>
<td>3.4</td>
<td>0.8</td>
<td>22.1</td>
</tr>
<tr>
<td>2009</td>
<td>7.9</td>
<td>1.8</td>
<td>28.3</td>
</tr>
</tbody>
</table>

Source: Staff calculation using data from UN UNCTAD

<table>
<thead>
<tr>
<th>Year</th>
<th>China</th>
<th>India</th>
<th>Asia ex. Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>0.6</td>
<td>0.1</td>
<td>21.7</td>
</tr>
<tr>
<td>2000</td>
<td>1.6</td>
<td>0.2</td>
<td>9.2</td>
</tr>
<tr>
<td>2009</td>
<td>6.5</td>
<td>2.2</td>
<td>21.8</td>
</tr>
</tbody>
</table>

Source: Staff calculation using data from UN UNCTAD
Figure 1: China’s (and now India’s) rise, fall and rise again

Figure 1: Changing GDP shares in the world: China and the major economies: 1300-2030 (per cent, based on 1990 international dollar)
Table 2: Global Increment Shares

<table>
<thead>
<tr>
<th></th>
<th>China</th>
<th>India</th>
<th>Asia ex. Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Share of Global GDP Increment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1990-09</td>
<td>16.1</td>
<td>4.0</td>
<td>32.6</td>
</tr>
<tr>
<td>2000-09</td>
<td>23.0</td>
<td>5.6</td>
<td>42.3</td>
</tr>
<tr>
<td>2005-09</td>
<td>36.4</td>
<td>8.5</td>
<td>59.2</td>
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</table>

Source: Staff calculation using data from WDI

<table>
<thead>
<tr>
<th>% Share of Global Trade Increment</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-09</td>
<td>10.4</td>
<td>2.3</td>
<td>32.9</td>
</tr>
<tr>
<td>2000-09</td>
<td>12.6</td>
<td>2.9</td>
<td>34.8</td>
</tr>
<tr>
<td>2005-09</td>
<td>17.2</td>
<td>4.4</td>
<td>43.5</td>
</tr>
</tbody>
</table>

Source: Staff calculation using data from UN UNCTAD

<table>
<thead>
<tr>
<th>% Share of Global FDI Flows Increment</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1990-09</td>
<td>7.9</td>
<td>2.8</td>
<td>25.4</td>
</tr>
<tr>
<td>2000-09</td>
<td>-24.2</td>
<td>-10.8</td>
<td>-57.4</td>
</tr>
<tr>
<td>2005-09</td>
<td>17.3</td>
<td>11.6</td>
<td>50.2</td>
</tr>
</tbody>
</table>

Source: Staff calculation using data from UN UNCTAD
(2.1) The seven economies and their growth dynamics

Great diversity, though some synchronized growth. Figure 2.
China, Vietnam, and now India consistently high.
Variable crisis impacts.
Indonesia, Malaysia and Thailand have grown more slowly since 1997-98.
The Philippines lags, but not by as much as is commonly perceived.
Episodes, turning points, especially where there have been major reforms.
Eg, China (1978), India (1991?), Indonesia (1966), Vietnam (late 1980s).

The sources of growth illustrate this diversity. Table 7, col. 7, contribution of net exports to growth, 2000-08.
Emerging Asia median is 10.8%; 9.1% for 6 of our 7 countries, pulled up by the much higher percentages for the 3 more advanced economies, HK, Korea and Singapore.
Moreover, the range is large, 20% (Philippines) to -4.2% (India).
So difficult to sustain the argument that these countries are behaving in a ‘mercantilist’ fashion, relative to current international norms.
Figure 2: Economic Growth, 1990-2009

GDP Growth
Annual percentage change

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database
Table 7  Contributions to economic growth, 2000–2008

<table>
<thead>
<tr>
<th>GDP Economy</th>
<th>Average GDP growth</th>
<th>GDP growth contributions</th>
<th>Net exports’ share of contribution to growth</th>
<th>Net exports as percent of GDP, 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2) (3) (4) (5) (6) (7) = (6)/(1) (8)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>10.2</td>
<td>4.1 2.8 1.3 5 1.1</td>
<td>10.8</td>
<td>7.9</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>5</td>
<td>2.3 2.1 0.2 1.3 1.7</td>
<td>34</td>
<td>12.2</td>
</tr>
<tr>
<td>India</td>
<td>7.2</td>
<td>4.1 3.5 0.5 3.6 -0.3</td>
<td>-4.2</td>
<td>-4.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>5.2</td>
<td>3.1 2.5 0.6 1.4 0.4</td>
<td>7.7</td>
<td>9.6</td>
</tr>
<tr>
<td>Korea</td>
<td>4.9</td>
<td>2.5 1.9 0.6 1 1.4</td>
<td>28.6</td>
<td>4.4</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5.1</td>
<td>4.6 3.5 1.1 0.4 0.1</td>
<td>2</td>
<td>13.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>5</td>
<td>3.9 3.8 0.2 0.7 1</td>
<td>20</td>
<td>1.4</td>
</tr>
<tr>
<td>Singapore</td>
<td>5.5</td>
<td>2.8 2.1 0.6 1.5 1.5</td>
<td>27.3</td>
<td>20.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>4.8</td>
<td>2.7 2.4 0.4 1.5 0.5</td>
<td>10.4</td>
<td>15.4</td>
</tr>
<tr>
<td><strong>Median:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Countries</td>
<td>5.1</td>
<td>3.1 2.5 0.6 1.4 1</td>
<td>10.8</td>
<td>9.6</td>
</tr>
<tr>
<td>All excl. China</td>
<td>5.1</td>
<td>3 2.5 0.6 1.4 0.8</td>
<td>15.2</td>
<td>10.9</td>
</tr>
<tr>
<td><strong>International comparisons:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1.4</td>
<td>0.5 0.3 0.2 0.1 0.9</td>
<td>64.3</td>
<td>6.8</td>
</tr>
<tr>
<td>Japan</td>
<td>1.5</td>
<td>1 0.6 0.4 0.2 0.5</td>
<td>33.3</td>
<td>4.9</td>
</tr>
<tr>
<td>U.S.</td>
<td>2.3</td>
<td>2.3 2 0.3 0.1 -0.1</td>
<td>-4.3</td>
<td>-3.3</td>
</tr>
</tbody>
</table>

Source: Prasad (2009); CEIC, IMF’s WEO, ADB, and authors’ calculations.
Can see this diversity also with reference to some key ‘stylized facts’ for these economies, focusing on variables of interest to this project (Table 4).

**Drivers:**
Not just ‘perspiration’. With the usual caveats, Fukao shows TFP growth generally follows GDP growth and the business cycle. Here also diverse outcomes. Indonesia and Thailand – sharp decline after the AFC; slowing structural change a factor.

Demographics: demographic bonus helps, but end of the bonus won’t lead to a growth collapse.
### Table 4: The Seven Economies – some key stylized facts

<table>
<thead>
<tr>
<th>Variable</th>
<th>China</th>
<th>India</th>
<th>Indonesia</th>
<th>Vietnam</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth dynamics</td>
<td>Extremely high growth</td>
<td>Accelerating growth from the 1980s</td>
<td>High growth, slower since 1998</td>
<td>Very high growth since Doi Moi</td>
</tr>
<tr>
<td>Crisis effects</td>
<td>Little impact of AFC and GFC</td>
<td>Little impact of AFC and GFC</td>
<td>Deep crisis in 1998, resilient in 2008</td>
<td>Positive but slower growth in AFC and</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>GFC</td>
</tr>
<tr>
<td>Fiscal policy &amp; debt</td>
<td>Large deficits &amp; debt, but</td>
<td></td>
<td>Debt explosion in 1998, quickly</td>
<td>Struggles to maintain fiscal discipline;</td>
</tr>
<tr>
<td></td>
<td>mainly domestic</td>
<td></td>
<td>contained</td>
<td>SOE contingent liabilities</td>
</tr>
<tr>
<td>Monetary policy &amp;</td>
<td>Size dictates global</td>
<td>RBI a credible institution, inflation</td>
<td>Although BI independent, struggles to</td>
<td>Challenge of multiple targeting</td>
</tr>
<tr>
<td>exchange rate</td>
<td>attention on ER regime</td>
<td>contained</td>
<td>curb inflation</td>
<td></td>
</tr>
<tr>
<td>Savings rate</td>
<td>Extremely high savings</td>
<td>Rapid increase in savings since 1970s.</td>
<td>Moderately high savings, recovered</td>
<td>Rapid increase in savings</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>since 1998</td>
<td>since Doi Moi</td>
</tr>
<tr>
<td>CA balance</td>
<td>Large surpluses, a major</td>
<td>Modest deficits</td>
<td>Modest deficits or surpluses</td>
<td>Sizeable deficits, rising ST funding</td>
</tr>
<tr>
<td></td>
<td>internal issue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Major investments, high</td>
<td>Struggles to keep up</td>
<td>Struggles to keep up since 1998</td>
<td>Major investments, overcoming backlog</td>
</tr>
<tr>
<td></td>
<td>quality</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance sector</td>
<td>State dominated, vulnerable</td>
<td>Well established and supervised</td>
<td>Gradual recovery from 1998 collapse</td>
<td>State dominated, vulnerable</td>
</tr>
<tr>
<td>Variable</td>
<td>Malaysia</td>
<td>Philippines</td>
<td>Thailand</td>
<td></td>
</tr>
<tr>
<td>------------------------</td>
<td>-----------------------------------------------</td>
<td>--------------------------------------------------</td>
<td>------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Growth dynamics</strong></td>
<td>Very fast but slowing since 1998</td>
<td>Historic underperformer but quite solid since 1992</td>
<td>Very fast but slowing since 1998</td>
<td></td>
</tr>
<tr>
<td><strong>Crisis effects</strong></td>
<td>Negative growth in both AFC &amp; GFC</td>
<td>Maintained weak positive growth in both</td>
<td>Negative growth in both AFC &amp; GFC</td>
<td></td>
</tr>
<tr>
<td><strong>Fiscal policy &amp; debt</strong></td>
<td>Consistent deficits, but domestically financed</td>
<td>Continuous fiscal policy struggle</td>
<td>Historical prudence, recovered from AFC debt</td>
<td></td>
</tr>
<tr>
<td><strong>Monetary policy &amp; exchange rate</strong></td>
<td>BNM a credible institution, low inflation</td>
<td>BSP a credible institution, inflation contained</td>
<td>Low inflation, BOT a credible institution</td>
<td></td>
</tr>
<tr>
<td><strong>Savings rate</strong></td>
<td>Consistently high savings</td>
<td>Consistently low savings; very large remittances</td>
<td>Moderately high savings, recovered since 1998</td>
<td></td>
</tr>
<tr>
<td><strong>CA balance</strong></td>
<td>Very large surpluses since 1998</td>
<td>Generally modest deficits</td>
<td>Switch from deficits to surpluses after AFC</td>
<td></td>
</tr>
<tr>
<td><strong>Infrastructure</strong></td>
<td>Effective infra provider, though politicized</td>
<td>Struggles to keep up</td>
<td>Effective infra provider, though politicized</td>
<td></td>
</tr>
<tr>
<td><strong>Finance sector</strong></td>
<td>Well developed, prudent since 1998</td>
<td>Cautious, well supervised since 1980s collapse</td>
<td>A major rebuilding after 1998 collapse</td>
<td></td>
</tr>
</tbody>
</table>
(2.3) The challenge of upgrading

All now graduated from ‘LICs’ to ‘MICs’. Concern in several that ‘stuck in the middle’.
World Bank: ‘History shows that while many countries have been able to make it from low income to middle income, relatively few have carried on to high income.’

The evolutionary economics literature (eg Nelson, 2008) provides a useful framework for thinking about these issues. Emphasizes need for commitment to education, innovation, institutional reform, and facilitating the process of ‘creative destruction’.

The theory most relevant to Malaysia, a major policy preoccupation. Tham: ‘Malaysia ... is at the crossroads politically, economically, socially.’ But major problems seem to be home grown, rooted in the country’s complex political economy. See also Hill, Tham, Ragayah (2011).
(3) Navigating Crises

Diverse crisis impacts, across countries and for both the AFC and GFC. Figure 3.
China, India little affected. See Chia, Vaidya for discussion.
The Philippines, Vietnam growth slowdown, not collapse.
Malaysia, Thailand negative growth both crises, but GFC lighter.
Indonesia: the deepest crisis in the AFC, light in GFC.

Note also:
The global context is crucial. Export-led recovery in AFC.
Search for vulnerability indicators useful.
Macro and financial resilience the core of crisis management.
Scope for international and regional coordination?
Figure 3: Quarterly GDP Growth Rate during Crisis Periods

People's Republic of China

India

2008-10 Crisis
1997-99 Crisis

2008-10 Crisis
1997-99 Crisis
Figure 3

Indonesia

Republic of Korea

2008-10 Crisis
1997-99 Crisis

2008-10 Crisis
1997-99 Crisis
Figure 3

Malaysia

- 2008-10 Crisis
- 1997-99 Crisis

Philippines

- 2008-10 Crisis
- 1997-99 Crisis
Figure 3

Singapore

Thailand

2008-10 Crisis
1997-99 Crisis

2008-10 Crisis
1997-99 Crisis
Why Indonesia so different? Kuncoro and others:
‘Good management’: Lessons learned from the AFC – ER flexibility; more cautious and better supervised financial sector; political integrity; international community moderately helpful.
‘Good luck’: Indonesia not as globally connected, especially electronics; China connections; buoyant commodity/agriculture sectors.

(3) Savings and Investment Behaviour

High growth Asia typically also high S & I rates. But major imbalances since 1990s.

(4.1) Savings

Diverse patterns, though not as varied as investment. Figure 4. China (and Singapore) the stand-outs, arguably ‘over-saving’ (why?). India rising rapidly (Vaidya). Savings behaviour generally resilient during crises. The Philippines very low, possibly understated (remittances?).

Horioka and Terada-Hagiwara:
Ageing (age dependency) negative, GDP/capita negative (squared positive), credit negative, fiscal balance positive, social security negative.
Figure 4: Gross Domestic Savings, 1990-2009

Gross Domestic Savings
Percentage of GDP

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database
‘A shortage of domestic saving will not be a binding constraint on growth and investment in developing Asia, at least for the next two decades.’ Demographics are central to their modelling. Feldstein-Horioka confirmed, but the I/S correlation will gradually weaken as capital accounts continue to open.

(4.2) Investment

A diverse picture, few region-wide patterns. Figure 5. China very high, Vietnam also. Possibly over-investing? Diminishing returns. India rising quickly. Indonesia, Malaysia, Thailand fell sharply after 1997-98; yet to recover; Malaysia the sharpest decline. All investing less than NIEs during their high growth phases. The Philippines very low, an outlier.

Some debate about whether public investment crowds in or out private investment. Generally positive; maybe crowding out in Vietnam (Huong)?
Figure 5: Gross Capital Formation, 1990-2009

Gross Capital Formation
Percentage of GDP

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database

Notes here
Sluggish I/GDP mainly in the three SE Asian economies. Sharp falls from pre-crisis levels. Below historical norms? Appears also to be a compositional shift, away from longer-term projects.

Occurs for the major investment sources (foreign, public, private). Less attractive investment climate?
Eg, World Bank: ‘Malaysia’s large private surplus on the current account suggests that investors find it more attractive to invest overseas than domestically.’

Note also special Indonesian circumstances. Kuncoro – perverse incentives arising from misaligned macroeconomic policy.
FIGURE 44. INVESTMENT LEVELS IN MOST COUNTRIES IN THE REGION ARE LOWER THAN IN JAPAN AND THE NIEs IN THE PAST AT SIMILAR INCOME LEVELS

(in percent of GDP)

Sources: Datastream and World Bank staff calculations.
(4.3) Savings-Investment imbalances

Current account balances: here also no common picture. (Figures 6, 6a) Prior to AFC, no major surplus countries (Singapore excepted), but then a generalized transition to surpluses, mainly owing to subdued investment levels while savings remained high. Malaysia (and Singapore) exceptionally large surpluses; China rising after about 2003, but not a dramatic outlier. The others mostly ‘normal’, within +/- 5% range. Except Vietnam, very large deficits, and policy settings similar to pre-AFC crisis-affected economies.

General increase in forex reserves after the AFC, reflecting the changed current account balances (Figure 7). Also, reflects the lack of trust in global institutions and architecture, hence the desire to self-insure. In recent years also, attempts to ameliorate exchange rate appreciations in response to rising capital inflows and terms of trade. Malaysia, China, Thailand the largest; China stands out because of its absolute size, not its relativity.
Figure 6: Current Account Balances, 1990-2009

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database

Notes here
Figure 6a: Investment/Saving Balances, 1990-2009

Gross Capital Formation - Gross Domestic Savings
Percentage of GDP

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database

Notes here
Figure 7: Foreign Exchange Reserves, 1990-2009

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database

Notes here
Also resulted in a general decline in external debt, apart from the blip in 1997-98, especially for Indonesia. Figure 8.

So Emerging Asia switching from net investor to net saver around 1997, and its rising importance as a net saver thereafter. Dominated by China, but with smaller Southeast Asian economies also contributing. Figures 9 & 10.
Figure 8: External Debt, 1990-2009

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database
Figure 9: Global Savings and Investment, 1990-2009

Global Savings and Investments
Percentage of GDP

Source: Economist Intelligence Unit, staff calculation

Notes here
Figure 10: Emerging Asia Savings and Investment, 1990-2009

Emerging Asia Savings and Investments
Percentage of GDP

Source: Economist Intelligence Unit, staff calculation

Notes here
(4.4) Investment: the infrastructure challenge

An important topic that connects to all the main themes of the project – supply-side constraints on growth, I/S imbalances, under-developed financial markets, etc.

Brooks and Go: note the public good characteristics; affirm the growth-infrastructure empirical relationship; major country differences.

Large variations across countries, with India, Indonesia, The Philippines in particular struggling to keep up. Why the constraints?

i) Government’s constrained fiscal positions, to the extent some infra spending comes out of the core budget; low priority for capital works.

ii) Reluctance to allow private sector participation; or high levels of uncertainty created, unrealistic price caps imposed, etc.
iii) Owing to scale, coordination and time horizons, infra projects often have serious governance problems. For example: Diffused authority across jurisdictions creates ‘ownership’ problems. As trade barriers have fallen, rent-seeking behaviour shifts to non-tradables, and infra projects often the most lucrative. Govt officials reluctant to sign off for fear of corruption allegations. Property rights also a constraint, especially obtaining land access.

iv) Political economy constraints. SOE regulators and providers often reluctant to liberalize the sectors they control. Confusion also as to what constitutes the genuine ‘natural monopolies’, where optimal policy is a single but regulated provider.

v) Underdeveloped bond market, as a source of funding. Owing partly to reluctance to borrow after the AFC. Eg, Emerging Asia has ¼ of world GDP but only 8% of outstanding bonds. Local currency bonds typically little used in middle-income developing economies.
(5) Some Major Policy Issues

(5.1) What sort of financial system?

Fukuda: the failure of traditional financial development the case of investment stagnation? Also conglomerates heavily family-based. SOB issues, particularly in China, Vietnam.

Need an open, efficient, competitive, innovative financial sector. But Rogoff and Reinhart remind us that it’s a folly to think that ‘this time is different’. Excessive debt is a central factor: ‘too much debt is always dangerous.’ (Krugman) Both the AFC and the GFC originated in the financial sector, and the economic and social costs have been extremely high.

How much and what kind of regulation? Need to force banks to behave more conservatively, avoid one-way risks involving govt guarantees. Eg, higher CARs, greater liquidity, less leverage, less exposure to risky sectors, stricter scrutiny of balance sheets, restrictions on foreign borrowings; Basel III, etc.
Or something more radical? Eg, a 2-tier system, of ‘utilities’, low-risk, low-return entities, with government guarantees; alongside investment banks, riskier, higher return, unguaranteed, restricted in scale so as to avoid ‘too big to fail’ syndrome.

How serious in Asia is the political economy problem, that banks in the US and UK have become so powerful that they are beyond regulation? See Stiglitz review of Gordon Brown, FT, 11-12 December 2010.
(5.2) Macroeconomic policy in an interdependent world

a) Fiscal policy

Most but not all the countries in the study have run reasonably prudent fiscal policy, so they had room to adopt fiscal stimulus measures during the GFC, recognizing that monetary policy is generally less effective.

Although most governments rarely employ fiscal policy in a counter-cyclical way; some had trouble increasing spending quickly (especially for infrastructure) and hence had to resort to tax cuts.

Thus the medium-term fiscal consolidation challenges are not nearly as serious as in most OECD economies. Major fiscal policy challenges are microeconomic/resource allocation, including poorly targeted subsidies in some countries; weak revenue effort; fiscal implications of a rapidly ageing population; SOE sector reform; and facilities for longer term debt markets for infrastructure. Is there a case for independent fiscal advisory councils?
b) Monetary policy and exchange rate regimes

This has generally been a success story: most countries gradually adopting a regime of independent central banks, inflation targeting and greater exchange rate flexibility. A major lesson from the AFC, à la Mundell-Fleming.

Exchange rates generally declined during the AFC, especially for crisis-affected economies; then fairly stable. Figure 11. Some slight nominal appreciations in recent years; also real appreciations in countries with higher inflation rates.

But some monetary policy lessons (Mishkin 2010): costs of crises underestimated; need to pay a lot more attention to financial sector; lean against bubbles; financial/monetary policy coordination.

Financial markets and corporates are becoming more comfortable with flexible exchange rates. They also act as a discipline on govt excesses. Hence serious inflation problems now comparatively rare, and there was scope for running looser monetary policy during the GFC.
Figure 11: Exchange Rates, 1990-2009

Source: WDI (World Bank), EIU (The Economist Database), CEIC Database

Notes here
Note also that flexible exchange rates no substitute for structural reform, eg China with severe factor market distortions (Chia).

Major concern in several countries: how to handle exchange rate appreciation in response to capital inflows, and rising ToT in some. Essential if US is to work through its twin deficits.

First-best option - a coordinated two-part global solution:
1) Generally agreed currency realignments, in particular China gradually appreciating (though not as fast as the Yen after the Plaza Accord, and as part of a package of domestic structural reform), and the US$ depreciating.
2) A major redesign of international institutions and architecture, so countries don’t feel compelled to self-insure with large reserves.

But these may not occur quickly, so need alternative, unilateral options. No simple solutions – consider the following options:
(i) Let the currency appreciate. But there are competitiveness issues, tradables goods industries need to adjust; especially if China doesn’t appreciate.

(ii) Attempt to hold the fixed rate with capital inflows. Not credible, will exacerbate over-heating, result in rising inflation.

(iii) Sterilize the flows, build up reserves. But entails locking up funds in low-return assets, and for large countries may attract international criticism.

(iv) Govt runs compensatory fiscal contractions. But fiscal policy not quick-acting; legislative pressure to spend the resources flowing in.

(v) Impose tighter restrictions on bank lending, as key conduit for inflows, to restrain credit growth and avoid asset bubbles. But doesn’t necessarily prevent ER appreciation.

(vi) Short-term capital controls. Risky, probably not feasible; mixed evidence as to effectiveness (Gochoco-Bautista et al).

But if haven’t opened the capital account, caution re premature liberalization. Eg the Thai experience from the early 1990s (Bhanupong).
(5.3) Governance and institutions

A large reform agenda but, with widely varying systems of governance and institutional quality, difficult to be too prescriptive. Different governance issues at different levels of development. And East Asia tended to perform better on government effectiveness than democracy (De Dios and Ducanes). Institutional quality a key factor in understanding response to crises (Bhanupong).

A few general observations:

i) Some evidence that crises are good for policy reform, embolden govts to take tough decisions, empower reform-minded ministries of finance, weaker currencies may facilitate trade reform, etc. More from AFC than GFC.

ii) Externally-imposed crisis-response programs are rarely successful unless they have a domestic constituency.

iii) Desirable to insulate or delink key institutions and policies from political pressures, eg, central banks, regulatory agencies, fiscal deficits.

iv) Competitive reforms and liberalization can be helpful, both within and between countries, eg benchmarking performance indicators, etc.
d) Regional cooperation and coordination

As noted, many of the major policy challenges have regional and global ‘public good’ attributes and therefore require inter-govt coordination. Some achievements, eg in 2008-09 avoidance of beggar-thy-neighbour trade and exchange rate policies; G20; some coordinated fiscal responses.

But coordinated international governance seems very difficult. No resolution of Doha Round; very little progress on climate change, counter-terrorism, nuclear proliferation, etc; still a serious prospect of a G2 ‘currency war’; ‘financial protectionism’ a feature of the GFC; key international institutions like the IMF still regarded with suspicion; troubles in the EMU.

Perhaps regional initiatives with an open international agenda can move faster. Mixed evidence from the Asia-Pacific region to date, eg with AEC, EAS, CMIM, etc. G20 still work in progress, and within it the possibility of an ‘Asian G6’ caucus. As fears of another GFC recede, the impetus for coordinated action may also.
(6) Concluding Remarks

1) Developing Asia emerged from the GFC in good shape; accelerated the relocation of global economic activity.

2) Global economy likely to remain subdued. So: domestic demand and regional trade become more important drivers; running under-valued exchange rates not a viable strategy.

3) The large fraction of global imbalances that has its origins in developing Asia is unlikely to disappear quickly. Savings likely buoyant.

4) Some progress on macro, financial reform, but still a large unresolved agenda. Eg, on how to manage volatile capital flows, technicalities on financial regulation, regional/international coordination.

5) Heterogeneity of country circumstances; no one-size-fits-all. Eg, on macro/finance policy, openness, macro balances, infrastructure, etc.