

# Chapter 8

## Beyond the Crisis: Toward Balanced and Sustainable Growth

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**Abstract** The global financial crisis of 2007–2009 shattered Asia’s complacency regarding the sustainability of its export-led growth strategy. The sharp decline in the region’s economic expansion in 2009 arising from the collapse in developed countries’ demand for its exports highlighted the need for a more balanced structure for Asian economies that is less dependent on external demand—particularly from the US and the European Union—and more reliant on domestic and regional demand. Asian economies should contribute to global economic adjustment by creating their own growth engines and transform themselves into a large consumer market, while maintaining their competitiveness as the world’s factory. The global financial crisis provided Asian countries with an opportunity to bring regional policy coordination and cooperation to the next level. Asia’s future growth must be balanced, sustainable, and supportive of the global economy. This includes implementing measures to encourage rebalancing of production, expanding social protection, deepening the financial system, and forging regional cooperation.

**Keywords** Rebalancing growth • Sustainable growth • Macroeconomic stability • Social protection • Regional cooperation

**JEL Codes** F15 • F42 • F43

### 8.1 Introduction

Despite the 2009 collapse in its exports to destinations outside the region, developing Asia came out of the 2007–2009 global financial crisis ahead of the rest of the world. The uneven pace of recovery between developing Asia and the developed

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economies suggests that Asia will once more be an attractive destination for capital inflows. Faster growth in developing Asia also meant it began to remove accommodative fiscal and monetary policies earlier than the rest of the world, bringing higher yields and an anticipation of currency appreciation that spurred several currency carry trades. Indeed, some countries, including the PRC, began to tighten policy. As a result, capital began to flow in again.

But large and volatile capital flows entail some risks. Massive inflows could fuel inflation and asset price bubbles, while an abrupt withdrawal of foreign capital could lead to a financial crisis in a country with an insufficient amount of international reserves relative to short-term foreign debt payments and/or an unhealthy financial system. As the 1997–1998 Asian financial crisis demonstrated, a rapid reversal of capital flows can have catastrophic economic effects. Excessive openness would thus leave Asia susceptible to another global crisis.

One positive outcome of the global financial crisis is the reduction in global imbalances. In 2009 global imbalances contracted to a significant extent, due to a substantial decline in, both the current account deficit of the US and the surplus of oil exporters. But the world's current account balance remains precarious. Before the global turmoil erupted, there had been concern that a “disorderly unwinding” of this burgeoning and unsustainable problem could spark a global crisis. In the end, it was not the direct cause of the 2007 subprime crisis. Instead, inadequate financial market regulation and overly easy monetary policy, particularly in the US, were at its root. Combined, these factors encouraged US consumers to overspend. Excessive saving and large current account surpluses in other parts of the world, particularly Asia were the mirror image of the US current account deficits. The current account surpluses of developing Asian economies, in particular the PRC, might increase again once the US economy fully recovers, raising the risk of future global turmoil unless significant reductions in these levels are made (IMF 2009).

The 2007–2009 global financial crisis underscored the urgency for Asia to reduce its dependence on exports to the developed economies. This would shift the economy to a more balanced and sustainable growth pattern, more reliant on the strengthening of domestic and regional demand and the pursuit of more socially inclusive and environmentally friendly growth.

Making progress toward this growth pattern requires consistent adjustments on the demand side and supply side of the economy. It also necessitates increased regional cooperation to augment policy measures at the national level. This study is an attempt to provide a comprehensive analysis of the impacts of the crisis and a set of policy recommendations, encompassing the dimensions of macroeconomic policy, real sector structural policy, social policy, financial reform and regulation, and regional cooperation and architecture. The major agenda items by thematic area are summarized in Table 8.1. Among its key recommendations, it suggests that Asian policymakers need to:

- Implement a monetary policy framework that takes into account asset prices and financial market stability, and adopt a judicious mix of policies to manage volatile capital flows effectively in order to achieve greater macroeconomic sta-

**Table 8.1** An agenda for rebalancing for sustainable growth

Themes	Objectives	Policy measures
Improving macro-economic stability	Improve the effectiveness of macroeconomic policy frameworks	Secure sufficient policy space, strengthen coordination of monetary policy and macro-prudential policy to achieve financial and price stability, and enhance automatic stabilizers
	Promote macroeconomic stability	Exit from easy monetary and fiscal policy when recovery takes hold, and accept currency appreciation in response to persistent capital inflows
	Facilitate global rebalancing	Use regional cooperation to provide liquidity in the event of a crisis
Rebalancing production	Enhance human capital investment, technological innovation, and productivity	Provide workers with high quality education and marketable skills and invest in R&D
	Promote the services sector and green growth	Remove obstacles to investment, market entry, and business activity and promote energy efficiency and environmental protection
	Liberalize trade and investment globally and regionally	Support the World Trade Organization Doha Round and regional FTAs
	Encourage cross-border infrastructure investment	Improve intraregional infrastructure and connectivity
Enhancing social protection	Strengthen social protection programs and provide support to the vulnerable	Design cost-effective social protection programs and reform pension systems
	Improve targeting of social protection programs	In low-income countries, focus on extreme poverty, basic health, and nutrition
	Ensure sustainability and adequacy of social benefits	Provide capacity building to improve governance and administrative efficiency
Deepening the financial system	Broaden and deepen financial markets while maintaining financial stability	Create effective frameworks for financial regulation and supervision, including adoption of macroprudential supervision and resolution regimes
	Increase the ability to prevent and manage financial crises	Promote Asian bond markets and improve market infrastructure
	Improve efficiency of regional financial intermediation	Develop credit databases and raise accounting standards and services
	Enhance financing for SMEs	
Forging regional cooperation	Strengthen regional liquidity provision, surveillance, and macroeconomic policy cooperation	Strengthen the Chiang Mai Initiative Multilateralization (CMIM) leading to the creation of an Asian Monetary Fund (AMF) and establish an Asian financial stability dialogue
	Integrate regional markets	Create a Regional Comprehensive Economic Partnership (RCEP) to liberalize regional trade in goods and services and investment
	Initiate exchange rate policy coordination	Create an Asian Currency Unit index to facilitate policy dialogue
	Contribute to reform of global financial architecture	Increase Asian voice on global financial institutions

bility and resilience. Authorities also need to ensure adequate monetary and fiscal space in good times to provide capacity to react when growth is threatened.

- Encourage growth of domestic and regional demand and facilitate the reorientation of the supply side of the economy more non-tradable activities. Subsidies and other distortions that favor exporters and tend to suppress labor's share of income should be removed. Authorities should also deregulate and encourage investment in growth areas of the services sector, including health, education, information and telecommunications, and other knowledge-intensive sectors; support greater investment in infrastructure, and promote a shift to a low-carbon society and support green growth industries; and promote a more supportive regime for small and medium-sized enterprises, including greater access to finance.
- Strengthen social protection in the areas of health insurance, unemployment insurance, and pensions to enhance social resilience. Enhancing such social protection can help reduce the need for precautionary saving, contributing to a post-crisis rebalancing. Governments also need to increase public spending on education and health to support productivity growth. Targeted social assistance programs to address extreme poverty, basic nutrition and health needs also should be strengthened.
- Increase the stability of the financial sector: this requires stronger surveillance and regulatory regimes, including an institutional framework for macroprudential surveillance and regulation, and a systemic stability regulator with adequate enforcement tools and mandates.
- Deepen and develop domestic bond markets in order to facilitate the use of domestic funds to support investment and consumption in the region by adopting measures, such as harmonizing regulation and tax rules, strengthening legal frameworks, and further developing credit rating agencies.
- Enhance regional efforts to pursue financial and economic policy cooperation and coordination, structural adjustment, and integration of regional markets. Key elements of these efforts include: strengthening the Chiang Mai Initiative Multilateralization (CMIM), and the ASEAN+3 Macroeconomics Research Office (AMRO); establishing an Asian financial stability dialogue (AFSD) to foster economic and financial coordination; promoting measures to support increased regional infrastructure investment including an Asian infrastructure investment fund; and establishing the Regional Comprehensive Economic Partnership (RCEP) to encourage intra-regional trade in goods and services and foreign direct investment (FDI) so Asia can benefit from the economies of scale and dynamic efficiency of a larger market. Asian policymakers should also strengthen cooperation on exchange rates, which will help them overcome concerns about unilateral currency adjustment and promote intra-region exchange stability to support trade and investment within the region.
- Participate actively in major global forums and policy dialogues—and ensure Asia's global voice is commensurate with Asia's economic and financial importance. Asia can benefit and help lead the global economy through a stronger, balanced, and more resilient Asian economy, with multiple sources of growth.

Export-led growth served Asian nations well. But, it also raised the cost of economic vulnerability and introduced substantial economic distortions—while its prospective benefits now look much diminished. Simply put, Asia has grown too big to maintain its pre-crisis share of world exports, and, as such, the global financial crisis presents authorities an opportunity for structural reforms that can ensure a more balanced and sustainable growth pattern.

## 8.2 Improving Macroeconomic Stability

With ample space for implementing monetary and fiscal policy, most Asian economies were able to quickly adjust monetary and fiscal policies in the early stages of the crisis, providing substantial stimulus that contributed significantly to the rapid recovery. Clearly, this means that in good times, countries must secure sufficient monetary and fiscal policy space by keeping interest rates high enough and public debt-to-gross domestic product ratios low enough.

But greater effort is needed to make macroeconomic policy frameworks work toward stable and sustainable growth. First, the experience of developed economies underlines the need for monetary policy frameworks that take account of asset prices and financial stability. Second, as Asian economies shift toward more balanced growth, Asian currencies need to have greater flexibility against the US dollar. Asian economies should move beyond beggar-thy-neighbor policies of large-scale intervention to depress their currencies, and instead develop an institutional framework that accommodates greater exchange rate flexibility of regional currencies vis-à-vis the US dollar, as well as greater intra-regional exchange rate stability. Further work is also needed to enable regional institutions to provide more adequate hard-currency liquidity.

Although most Asian economies did not fall into a “liquidity trap,” a number of countries made effective use of unconventional monetary policy measures. In particular, the emergence of a shortage of US dollar liquidity in the region underlined the necessity to strengthen institutions to provide hard-currency liquidity. In addition, central banks need to be proactive in responding to signs of an asset bubble, i.e., “lean against a bubble.” Price and financial stability are not incompatible; central banks can achieve financial stability without being given an explicit mandate to do so. As long as their objective is to minimize some combination of fluctuation in inflation around a target value and fluctuation of output around its natural level, central banks should consider all relevant information, including asset prices and financial stability.

The recent crisis also presents fiscal policy lessons. For instance, policies should specifically target liquidity-constrained economic agents, as general spending measures and tax cuts can be ineffective and wasteful. Large-scale public investment can also be problematic in that it entails serious implementation problems. Despite that, investment spending has an important role to play in economic stimulus programs, given the importance of infrastructure to long-term economic growth. As

the crisis makes clear, such investment should ideally accelerate projects already under way. Over the medium-term, building sound fiscal institutions is crucial to effective fiscal management. Once binding fiscal rules are introduced, governments can more likely use fiscal policy countercyclically without creating debt sustainability concerns. Governments should also give high priority to enhancing automatic stabilizers which are designed to benefit those likely to be hurt by an economic downturn.

In the area of exchange rate policy, it is clear that Asian economies should not go on keeping their exchange rates stable against the US dollar and continue amassing foreign exchange reserves. This path led to unsustainable payments imbalances. Achieving rebalancing growth and gaining greater domestic macroeconomic stability require that authorities allow their currencies to be more flexible against the US dollar, and to exit from an easy monetary policy promptly when recovery takes hold.

In the event of upward pressure on Asian currencies, regional cooperation may help these governments overcome the fear of unilateral appreciation—by helping to foster collective appreciation—and the loss of export competitiveness. Such cooperation should focus on increasing collective flexibility against the US dollar, while promoting the stabilization of intra-regional exchange rates. A framework for closer coordination of macroeconomic policy would make countercyclical fiscal policy more effective and exchange rate cooperation more enduring. There must at least be a dialogue process when the region's currencies diverge from each other abruptly and substantially.

### **8.3 Rebalancing Production**

Adjustment of the supply side of the economy is also needed for more sustainable growth, which, broadly speaking, is likely to involve a shift of resources from tradables to non-tradables. Policies to aid this adjustment include: eliminate subsidies and factor-price distortions that favor tradable goods producers in countries; deregulate services sectors; improve the environment for investment and productivity growth; and promote a regional free trade agreement. Services can be made more open, efficient, and competitive if governments remove regulatory distortions, which would raise productivity not only in services, but also in other sectors for which services such as transportation and telecommunications are important production inputs.

Asian countries also need to encourage production networks to graduate to higher value-added, knowledge-intensive activities. Governments can aid this process by promoting environment friendly FDI to allow local firms to participate more in regional production networks. Authorities should encourage higher levels of investment in research and development and higher education to achieve this aim. SMEs can, additionally, play an important role in supporting industrial clusters and producing higher domestic value-added. Policymakers can also take a number of steps to create an eco-friendly system for them, which could lead to “green” industrial agglomeration and technology transfer to domestic firms.

Regional integration can also play a greater role in bringing firms and consumers in the region together, an important step for Asia's burgeoning middle classes. An East Asia-wide free trade and investment agreement that covers goods and services and FDI could help regional firms reorient production more broadly toward the needs of Asian consumers. RCEP among ASEAN+6 countries (ASEAN plus Australia, the PRC, India, Japan, the Republic of Korea, and New Zealand) is expected to integrate Asian markets more deeply and support Asia's supply chains.

The lessons of the global financial crisis also suggest that Asian countries should not simply rebuild their economies as before, depending excessively on a few export-oriented and polluting industries fueled by a few carbon-intensive energy sources. The aftermath of the crisis presents the chance to shift economies onto a more environmentally sustainable path. By decarbonizing economic growth to help control climate change and fostering green industries, governments could enhance long-term sustainability, help create jobs, raise skills, and boost competitiveness. A decarbonized Asia could be a world leader in green technology, innovation, and growth.

Infrastructure investment can also help achieve greater productivity and bring together demand and supply within the region. Estimates of the need for new infrastructure run into more than \$ 8 trillion, and the implementation of these plans would often require strong regional planning and financing arrangements.

## 8.4 Enhancing Social Protection

Although many Asian countries for some time now have chased economic growth with only limited regard for social protection and policy, new circumstances point to those playing a more important role. First, urban migration and lower birth rates have put pressure on traditional family support mechanisms, especially on old age support. Second, governments increasingly are recognizing that health care, education, and economic security boost economic competitiveness in a globalized world, and help economies reach a higher growth path. Third, in many countries households tend to maintain high precautionary household savings—for education costs, health expenses, unemployment, and retirement—which tends to depress consumer spending. By easing the burden in these areas, effective social programs can encourage consumers to spend more, stimulating domestic demand.

The global economic and financial crisis presents the opportunity to expand and improve the coverage of social protection systems, and operate in a financially sustainable manner. This would include broadening the coverage of major programs such as public health insurance, unemployment insurance, and public pension schemes and raising spending on public education. Targeted income transfers to improve the distribution of income and provide a more sustainable environment for investment should also play an increasingly important role.



## 8.5 Deepening the Financial System

Asian economies came out of the global financial crisis relatively unscathed. This mainly reflected effective management and regulation, but also was partly due to the underdevelopment of financial markets. As such, the crisis serves as an alarm. Asian countries must review and strengthen their own financial regulatory systems to avoid making the same mistakes as countries outside Asia that thought they had good systems for financial stability. This applies to both crisis prevention and management. Reforms must aim to reduce the disruptive potential of volatile capital flows, and to develop domestic financial markets to enhance resilience to outside shocks and keep funds for investment and consumption within the region. While predominantly undertaken at the national level, many of these reforms can be better taken at the regional level. Such measures will need to be coordinated with the ongoing work of the international institutions, particularly the Basel Committee and the Financial Stability Board (FSB).

In that light, crisis prevention is best tackled by: reducing procyclicality not just by removing the perverse incentives in capital buffers and accounting valuations but also through positive incentives to adopt countercyclical buffers and similar mechanisms; improving microprudential monitoring that ensures individual financial institutions strive to be prudent in their own interests and implement a better calibrated system of risk assessments; and establishing a mechanism for effective macroeconomic surveillance and action, particularly a high-level systemic stability regulator integrating monetary, financial supervisory, and fiscal authorities, and empowered with policy tools it can employ separate from monetary policy. Several changes could also improve crisis management. These include: establishing a coordinated set of institutions that between them cover all phases of the crisis; forming a credible system for handling the failures of all types of financial institutions, particularly those that operate across borders; implementing an effective deposit insurance system; and improving resilience against shocks by substantial enhancement of regional mechanisms, among other things, through an AFSD.

To develop regional bond markets, governments should encourage foreign participation, especially by multinational institutions and corporations; improve government debt management, including maintenance of a reliable set of government bond benchmark issues and adequate liquidity; improve market infrastructure to allow issuers to hedge maturity and currency risk; expand the coverage of private issues by credit rating agencies; and cooperate at the regional level to achieve adequate scale economies.

Finally, to help SMEs, governments should encourage banks to build capacity in transaction technologies, and encourage them to innovate and try technologies that have a comparative advantage in a certain institutional environment; encourage foreign-owned banks; raise accounting standards and services; and set up a consistent and accessible SME financial database.



## 8.6 Forging Regional Cooperation

Several major initiatives for enhancing regional financial cooperation and architecture for Asia will be needed to support the region's sustainable growth. Some initiatives are still in development following the Asian financial crisis, but have not made enough progress, such as the provision of foreign exchange liquidity through the CMIM. Other issues stem directly from the global financial crisis, for example, the need to bolster financial and economic stability through closer economic and financial surveillance and to enhance the potential of domestic and regional demand to support economic growth through regional trade agreements and institutions to facilitate investment in infrastructure.

Authorities should intensify and improve the regional surveillance process through AMRO, a regional surveillance institution, as part of the CMIM, potentially, leading to development of an Asian monetary fund. Surveillance also needs to be extended outside the region, as Asia remains heavily dependent on export markets and the destination of its financial investment. Finally, in view of the need for a global rebalancing of demand, cooperation could foster a collective adjustment of the region's currencies against the US dollar. Policymakers must seriously consider exchange rate cooperation to deal with the global imbalance, and to support the region's economic integration in the longer term.

Removing trade barriers and facilitating trade among East Asian countries, by establishing a regional free trade and investment area in the form of RCEP, would help stimulate intra-regional trade in final goods and services.

Further steps are also needed to develop domestic and regional funding sources to better address Asia's huge infrastructure investment needs. Efforts to develop Asian bond markets through the Asian Bond Markets Initiative and the Asian Bond Funds should continue, as well as new initiatives. An Asian infrastructure investment fund could raise funds from a combination of sources, such as governments, the private sector, and multilateral agencies, thereby supplementing existing funding facilities through multilateral agencies and bilateral organizations.

Globally speaking, Asia also has a much bigger role to play, particularly given the changes taking place that promise to transform the global financial architecture. The Group of 20 meetings are now emerging as a major global forum for economic policy cooperation and coordination. Asia must ensure that its voice is heard and its needs reflected in any major global dialogue and policy development. Given the region's financial resources in the form of savings, private sector financial assets, and foreign exchange reserves, the decisions affecting how these are invested have major implications for global financial markets, so the region needs to play a more proactive role in influencing the direction of the global financial system.

## 8.7 The Path to Sustainable Growth

The global financial crisis of 2007–2009 shattered Asia’s complacency regarding the sustainability of its export-led growth strategy. The sharp decline in the region’s economic activity in 2009 arising from the collapse in developed countries’ demand for its exports highlighted the need for a more balanced structure for Asian economies. Asia cannot continue to rely on exports as its main driver of growth. Asia needs a more balanced and sustainable growth strategy.

It would be wrong to say that Asia’s export-led strategy was the main problem. In fact, Asia’s growth in the medium-term will likely remain partly export-led. The crucial difference is that the target market for the region’s exports should no longer be the developed countries in the west, but rather focused on the region’s large and growing middle class.

It is unlikely that the US and Europe will fully resume their roles as engines of global growth in the medium to long run; Asian economies should contribute to a global economic adjustment by creating their own growth engines. Only then can Asia sustain its own growth and contribute more to global long-term economic growth in the post-global financial crisis era. In order to achieve this, Asia needs to transform itself into a large consumer market while maintaining its competitiveness as the world’s factory, by rebalancing sources of growth away from excessive dependence on external demand—particularly the US and the European Union—toward domestic and regional demand. Asian firms can target the rising high-income and middle class in emerging Asia—the PRC, India, and the ASEAN countries—which could become a major source of final consumption demand.

The core challenge is that Asian economies must work together to avoid the next crisis. It will require a multifaceted effort at the national, regional, and global levels. The global financial crisis provided Asian countries with an opportunity to bring regional policy coordination and cooperation to the next level. The region must coordinate regionally, but stay globally connected. Asian policymakers must actively participate in global dialogues and policy coordination to support strong and sustainable growth for the global economy. Asia’s future growth must be balanced, sustainable, and supportive of the global economy.

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