

ADB-BNM-EC JOINT CONFERENCE
"BEYOND THE GLOBAL CRISIS: A NEW ASIAN GROWTH MODEL?"

*"The challenge of developing sound policies and institutions:
Future for Asia's integration after the crisis"*

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The main topic we are discussing in this final panel is what are the challenges for Asian countries in order to develop policies and institutions at regional level that will help achieve the objective of sound and sustainable economic growth. Related to this, I think we will also touch upon the issue of what are the challenges that need to be addressed for having Asia as a region playing its role in full in the governance of the global economy that has started to be put in place. In this respect, I see four main challenges.

The first challenge is to bring about in-depth changes in the intra-regional trade patterns and supply chain networks that have been the driving force of Asian economic integration in the last two decades.

As has been amply discussed yesterday, the Asian supply chain is based on a huge expansion of intra-regional trade of intermediate products, so as to profit at best of the comparative advantages of the various countries in the region and enhance dramatically competitiveness.

This has important consequences both in terms of external imbalances (since in the end the Asian region as a whole is relying on an export-led growth model) and in terms of the inherent fragility of the economic system of the Asian countries because of its external dependency.

If Asia has been hit so hard in the last quarter of last year and the first half of this year despite the fact that its financial sector was in good shape and not burdened by a large amount of impaired assets, this was due to its excessive reliance of its final exports on the European and American market.

In the post-crisis world, Asia cannot rely any longer on large external imbalances by the United States or hope that the European Union will replace the United States "as consumer of last resort".

Furthermore, East Asia in general and China in particular, can not continue to build up their amount of reserves. The levels already reached are well above any conceivable precautionary level, and, if these trends continue, they will create problems to both Asian countries and the EU and the US.

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The issue of an adjustment, or to be more precise, of an appreciation of a number of Asian currencies, and *in primis* of the Renminbi, cannot be further eluded. With the dollar sliding and the Chinese currency being *de facto* hard pegged to it, there is no chance to see any time soon an improvement in global imbalances once the economies of advanced countries start to recover.

Despite the good news reported in the paper by Kim Soyoung and Jong-Wha Lee about changing China's trade pattern, my impression is that these changes are slow and they can be reversed in the future, in particular if the structure of relative prices continues to evolve in favour of Chinese (and Asian) exporting industries. This is why the exchange rate instrument should be put at the service of and helps the emergence of a new growth model in the region.

In sum, the continuation of the past pattern of trade integration, which, we have to admit, has been so successful in the past (bringing millions of people out of poverty), risks putting not only Asia, but the entire world economy, on a suboptimal growth path. Therefore a different pattern of intra-regional trade is needed, in which, without hindering the existing specialisation patterns, there would be much stronger demand for final goods.

The second challenge, which is strongly related to the previous one, is to foster at *regional* level a new growth model, based on self-sustained domestic demand.

In the last decade the export share of Developing Asia's GDP rose from 35% to 45% of GDP, while the share of private consumption fell to a record low of 45%. In this respect I can *partly* share Steve Roach's assessment when he says that, under these conditions, "the region does not satisfy the most basic pre-condition of autonomous economic leadership – an economy where production support is dependent increasingly on home markets rather than external demand".

I say *partly*, because there are tentative signs in recent trade developments that China is very gradually becoming more of a consumer and less of an assembler, as well as a number of Asian economies. We, as European Union, recognise the efforts undertaken and the progress made since the beginning of the crisis towards a different and sounder growth model. Therefore, I'm more optimistic than Steve Roach on both the possibility and capability of Asian countries to play a leadership role in future. However, we have to admit that the efforts so far produced are still insufficient to allow Asian economies to act as an independent engine for sustained balanced growth, not only for the global economy but also for the region itself.

In this regard, more has to be done on three fronts:

Firstly, more has to be done in terms of creating social safety nets, since this would help reduce excessive precautionary savings;

Secondly, efforts are needed to remove direct and indirect incentives to the creation of excessive capacity in the manufacturing sector, which would dampen the drive to export more and more in the absence of sufficient domestic demand;

Thirdly, further efforts are needed to promote the shift towards more service-oriented economies, which would lower the reliance on export-led growth and have a positive in terms of pollution abatement and environmental remediation.

Based on the European experience, this is one of the key areas where I see real value added in having Asian countries moving together and adopting measures, including with regard to exchange rates, which would enhance domestic demand and redefine their growth models. By

moving together competitiveness related concerns and free riding fears would become much less important, with positive spill-over effects within the region.

In this context, let me stress the pivotal role played by the single market in the EU integration process and in promoting sustained growth. I am somewhat surprised that this issue has drawn little attention in the conference. The EU experience shows that the creation of a single market for goods and services injects great dynamism in the economy. In order to function properly, it also requires supranational programs in several fields, in particular competition and taxation. The latter in turns call for appropriate independent institutions at the regional level.

The third challenge complements and is instrumental to the achievement of the previous two. Asian financial markets are not much integrated and there are no market leaders in finance in the region despite the overall size of its economies (and even more of the savings) in this part of the world. As a result, Asia is not using in the most effective way the financial resources it has at its disposal, rather channelling many of them overseas.

It may be of some comfort that the conservative policies adopted in the banking sector after the Asian financial crisis and the relative un-sophistication of the financial markets in the region have avoided the spreading of the financial contagion. But, looking ahead, maintaining the status quo is an unsatisfactory option, with large potential losses in the area of foreign reserves and which also risks to perpetuate the financial distortions that contribute to the accumulation of external imbalances.

Well-regulated, but more innovative, financial systems are needed in most Asian countries (1) to support consumer financing, (2) to help develop a more vibrant and dynamic service sector and (3) to foster competition.

I fully concur with Governor Zeti Akhtar Aziz, who stressed in her speech yesterday that progress is needed in four areas: further liberalization of financial services; capital account liberalization; development of regionally integrated payments and settlements systems; and enhanced regional co-operation among regulators and supervisors.

I have the impression that one of the fears in letting leading markets in the region emerge is that this may have important geopolitical repercussions in the region (and, conversely, may imply additional obligations for the countries where these leading markets are located). This may be a well-founded concern in a region with different political regimes and wide economic disparities. This concern may be partly addressed if independent and effective regional institutions are created, which brings me to my fourth challenge.

The fourth challenge I want to touch upon is regional institution building. A defining feature of the European experience is that the integration process was essentially driven by policymakers and was characterized by both the creation of independent, strong, regional institutions and the explicit transfer of sovereignty in a number of key areas (e.g. trade, competition).

In contrast, the Asian integration process is more market-driven and more institution-light intergovernmental decision-based than the EU integration process. Whilst this has allowed some achievements, it is questionable whether further progress will be possible without the political will and institutional infrastructure that created the momentum for strong economic, monetary and financial integration in the EU. In this context, it appears that the current global financial crisis may provide an opportunity to move ahead with this institutional infrastructure.

Indeed, at the ASEAN+3 meeting in Bali, practically at the trough of the crisis, Asian Finance Ministers agreed to multilateralise the Chiang Mai Initiative and on some rules of activation of the facility. More importantly, they agreed on setting up a surveillance mechanism (initially jointly managed by the ADB and the ASEAN Secretariat), which is the precondition for making Chiang-Mai really operational and also for moving forward to real policy cooperation among Asian countries.

The European lesson in this respect is crystal clear: multilateral surveillance works and is effective if it is backed by clear procedures carried through by independent regional institutions. In this respect, the Asian process is still half way through: the right preconditions have now been laid down, but we have still to see how they are implemented as well as the independent institutions that will monitor this implementation. The fact that since Bali, ASEAN+3 has not been a vocal actor in the discussion on the redefinition of global governance may signal that the agreement reached in Bali, although it represents a huge step forward, may still be insufficient to have East Asian economies acting together as a regional actor on the global scene. Therefore, I would be very interested to understand why, since Bali, so little progress has been made in terms of surveillance and ASEAN+3 has remained practically silent on the world scene.

I think that it is important for East Asian countries not to lose this unique opportunity to move further ahead in their integration. Indeed, effective regional economic processes and mechanisms in East Asia would allow it as a region and not only as individual Asian countries to play a constructive and proactive role in the G20 and in other international institutions and fora like the IMF or the Financial Stability Board that have become key actors in the global governance. This leadership role can be enhanced by deepening Asian economic integration and by strengthening policy coordination mechanisms.

For us Europeans a proactive role of Asia as a region would not be a threat, but a welcome development. It would strengthen the effectiveness and legitimacy of the governance mechanisms and structures that have been put in place at the global level.

Indeed, the best way to build an inclusive multipolar economic system is for this system to also make a place for well integrated economic regional groupings, which would allow more ownership of policies, coordinated in the world international fora, also by countries which are not formally part of them.