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**Lessons of the Crisis and
Global Imbalances:
Should and Can Asia Reduce its
Reliance on Exports to US and
Europe and Focus More on Internal
(Regional) Markets?**

Asian Development Bank

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Should and Can Asia Reduce its Reliance on
Exports to US and Europe and Focus More
on Internal (Regional) Markets?**

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CHAPTER 1: POST-CRISIS CHANGES IN THE GLOBAL ECONOMIC LANDSCAPE

1.1 Key changes in the global environment

We see the following key changes in the post-crisis global economy impacting Asia. Table 1.1 outlines how the drivers of economic growth will change in the post-crisis global economy:

Table 1.1: Changing drivers of global economic growth

Factor	Determinants	Impact on global economy	Outlook
Commodity-related costs fell in the past, now likely to rise			
Oil prices	<ul style="list-style-type: none"> ▪ OPEC production rises relative to non-OPEC, raising former's pricing power. ▪ Demand set to rise relative to supply. 	<ul style="list-style-type: none"> ▪ Permanently higher cost of transportation and power. 	<ul style="list-style-type: none"> ▪ Higher business costs reduce profitability of investment. ▪ Some existing production capacity made redundant, forcing painful restructuring. ▪ Supply chains need to be rethought as costs of transport rise.
Other non-food commodities	<ul style="list-style-type: none"> ▪ Strong demand growth as the People's Republic of China (PRC), India, Brazil, etc. enter resource-intensive phase of economic development. ▪ Long lags before supply catches up. ▪ Unlike in past when supply-demand balance depressed real prices. 	<ul style="list-style-type: none"> ▪ Increase some input costs in manufacturing sector. 	<ul style="list-style-type: none"> ▪ A period of rising prices in basic metals, rubber and other economically sensitive commodities is likely.
Food	<ul style="list-style-type: none"> ▪ Strong demand growth in rapidly growing emerging economies. ▪ Scramble by Middle Eastern and East Asian countries to gain access to farmland in low income countries. 	<ul style="list-style-type: none"> ▪ Higher prices trigger inflationary expectations unless monetary conditions tighten. 	<ul style="list-style-type: none"> ▪ Opportunities for growth in land-abundant, water-rich low-income economies, particularly those that are close to rapidly growing economies such as the PRC and Middle Eastern sheikdoms.
Ageing trends turn more negative even in Asia			
Demographics	<ul style="list-style-type: none"> ▪ Lower population growth, actual fall in number of working age in Japan, the PRC, and many European countries. 	<ul style="list-style-type: none"> ▪ Unless there is a sharp rise in productivity, potential growth will fall. 	<ul style="list-style-type: none"> ▪ Slowing impact becomes more pronounced starting middle of next decade. ▪ Could generate major changes in immigration policy, producing far larger flows of migrant workers.
Easy credit: no longer promoting growth, now a constraint: Bad for US consumption			
Monetary and credit conditions	<ul style="list-style-type: none"> ▪ Easy US, Japan, etc. monetary policy 	<ul style="list-style-type: none"> ▪ Created asset price boom, wealth effect 	<ul style="list-style-type: none"> ▪ Credit conditions will improve as the financial crisis ends

Factor	Determinants	Impact on global economy	Outlook
	2001-2005. <ul style="list-style-type: none"> Financial innovations created a shadow banking system, now largely defunct. Asians' purchase of G3 bonds, depressed long term rates. 	<ul style="list-style-type: none"> Boosted personal consumption in major economies. Supported housing booms. <u>All these are reversing and acting as drags on global growth.</u>	but as companies and non-bank financial units focus on balance sheets and as they reduce risk and leverage, credit demand will remain weaker than pre-crisis. <ul style="list-style-type: none"> More of available savings will be used to fund fiscal deficits than during pre-crisis.
Housing: Developed economies' booms turn into busts: Bad for US consumption			
Housing – US, EU, Japan	<ul style="list-style-type: none"> Loose money (as above) now reversing. 	<ul style="list-style-type: none"> Consumption was boosted by wealth effect, mortgage equity withdrawal. Real estate, services/construction boomed. 	<ul style="list-style-type: none"> Down cycle across the world in real estate values will bottom by 2010 but overhang of excess supply and detritus of the crisis in the US, UK, Spain, and Ireland in particular will constrain revival of sector as a source of growth, at least in the immediate future.
Housing: Developing economies will see a boost			
Housing – rapidly growing developing economies	<ul style="list-style-type: none"> Rapid income growth, supportive monetary and other policies, urbanisation, improved connectivity in large developing economies such as the PRC, India, etc. 	<ul style="list-style-type: none"> Purchase of new homes usually leads to purchases of home appliances etc. Expansion of real estate related services including mortgage industry. High growth usually boosts real estate prices, wealth effect on consumption. 	<ul style="list-style-type: none"> Positive for most developing economies in Asia.
Chinese fixed asset investment less of a driver, Chinese consumption demand could figure more in global growth			
Chinese demand	Factors that used to drive fixed investment in the PRC are changing: <ul style="list-style-type: none"> Below-normal costs of land, labour and capital induced by policy. Under-valued currency. Easy lending by banks and illegal lending networks 	<ul style="list-style-type: none"> Drove up demand for capital goods, commodities. 	Post-crisis, the PRC will emphasise quality over quantity in growth: shift to higher value activities. Currency appreciation, imposition of more rigorous labour codes, reduced subsidies over the longer term and tighter enforcement of environmental regulations will all raise costs. Renewed currency appreciation will help boost demand for imports.
Supply Side Gains in Developing Economies replace those in developed economies as a source of global growth			
Efficiency improvements in developed economies	Supply side factors that drove US and other OECD growth weakening or reversing:	<ul style="list-style-type: none"> Raised potential growth in developed economies: lower sustainable unemployment. 	<ul style="list-style-type: none"> Negative: Most gains from end of Cold War, IT revolution, economic integration have been reaped.

Factor	Determinants	Impact on global economy	Outlook
	<ul style="list-style-type: none"> ▪ End of Cold War released resources for productive purposes in developed economies. ▪ Corporate restructuring in 1980s/1990s. ▪ New technologies. ▪ Economic integration – Single European Market, NAFTA, etc. 	<ul style="list-style-type: none"> ▪ Monetary policy could be easier. 	<ul style="list-style-type: none"> ▪ Positive: New technologies are coming on stream in medical technology, bio-tech, nanotechnology, alternative fuels, etc.
Efficiency gains in developing economies	<p>Powerful supply side factors kicking in/ strengthening:</p> <ul style="list-style-type: none"> ▪ Lagged effects of reforms. ▪ Improved connectivity through transport rollout. ▪ Increased regional integration. 	<ul style="list-style-type: none"> ▪ Increasing returns on investment will spur rising capital spending – virtuous cycle. 	<ul style="list-style-type: none"> ▪ Reduced positive impact from supply side improvements in developed nations (e.g., outsourcing, lengthening of production supply chains) can be offset by domestic supply-fed growth.
New technologies	<ul style="list-style-type: none"> ▪ Rising oil prices prompt development of new sources of energy. ▪ Technological advances open new opportunities in other areas such as bio-technology, nanotechnology, etc. 	<ul style="list-style-type: none"> ▪ New opportunities for growth. ▪ Can help improve productivity. 	<ul style="list-style-type: none"> ▪ Newer technologies – alternative energy, nanotechnology, etc - are evolving and will produce more discernible effects in the coming decade.
Production sharing which drove FDI in manufacturing into Asia losing steam			
Consolidation of production networks	<ul style="list-style-type: none"> ▪ Costs of labour and other inputs. ▪ Tax and other incentives by host nations. ▪ Relatively low transport costs. ▪ Liberalisation of trade. 	<ul style="list-style-type: none"> ▪ Slicing production and allocating each slice to different locations produced higher profits, spurring FDI into low-cost developing economies. 	<p>Argument for production sharing remains but with less vigour:</p> <ul style="list-style-type: none"> ▪ Increased transport costs. ▪ Rising developing economy currencies (e.g., the PRC's RMB). ▪ Rising labour costs (PRC). ▪ Customer needs becoming more complex pushing some producers to locate production closer to end user market¹. ▪ Businesses more aware of the risks of offshoring production – cultural, language, unexpected delays, etc.

¹ See AT Kearney Procurement & Analytic Solutions, March 2009.

1.2 Implications of these changing drivers

The implications of these structural changes are assessed below:

(A) Slower growth in G3 economies and retrenchment of US consumers for several years

Unwinding the massive policy responses unavoidable but will slow growth

The fiscal cost of the crisis includes both the stimulus packages as well as the cost of rescuing the financial sector. These fiscal costs are raising public sector debt to GDP ratios in the United States, United Kingdom and some parts of the Eurozone well beyond the 100% level considered safe. Once economic growth resumes and financial institutions have stabilised, governments of major economies will have to cut back sharply on fiscal deficits in order to begin reducing the public sector debt ratios. This means several years during which fiscal policy will essentially act as a drag on economic growth.

In addition, monetary easing has also been substantial, involving both sharp reductions in interest rates as well as quantitative easing. Central banks are likely to tighten policy as soon as it is feasible.

- First, central banks are still led by a generation of policy makers whose experience of the damaging inflation of the 1970s is still strong. In repeating their determination to prevent inflation, they have set a rigorous benchmark that financial markets will use to judge their policy decisions as the crisis gives way to recovery.
- Second, key central banks have sketched out their exit strategies, showing that they have thought through a credible non-inflationary path out of the crisis. Federal Reserve Bank Chairman Bernanke for example, has outlined the various policy tracks he has in mind to ensure a small risk of inflation. These include the natural unwinding of time-delimited policies, the use of reverse repos, paying interest on reserves placed with it by banks and the sale of assets the Federal Reserve has acquired in rescuing the financial sector. The European Central Bank (ECB) has also made clear that it will unwind emergency monetary measures as soon as it can. The ECB strategy appears to be to avoid as drastic a response as in the United States so as to make such an early exit more feasible and credible.
- Third, even where there are central banks of some major nations which might hesitate to tighten appropriately, the presence of conservative central banks such as the ECB will make it difficult for the recalcitrants to get away. The bond market is also likely to severely punish central banks that are seen as lax in anticipating and countering future inflation.

Thus, monetary and fiscal policy will both be drags on growth in the major economies.

Other government intervention in developed economy growth also likely to be negative

There is a considerable backlash that is unfolding against the excesses of the free market. Two dimensions of this increased government intervention in economic matters in rich countries will detract from economic growth.

- First, political leaders will have to assuage voters' real anger with the worsening of income inequality. Increased taxation of corporate profits will be one response.

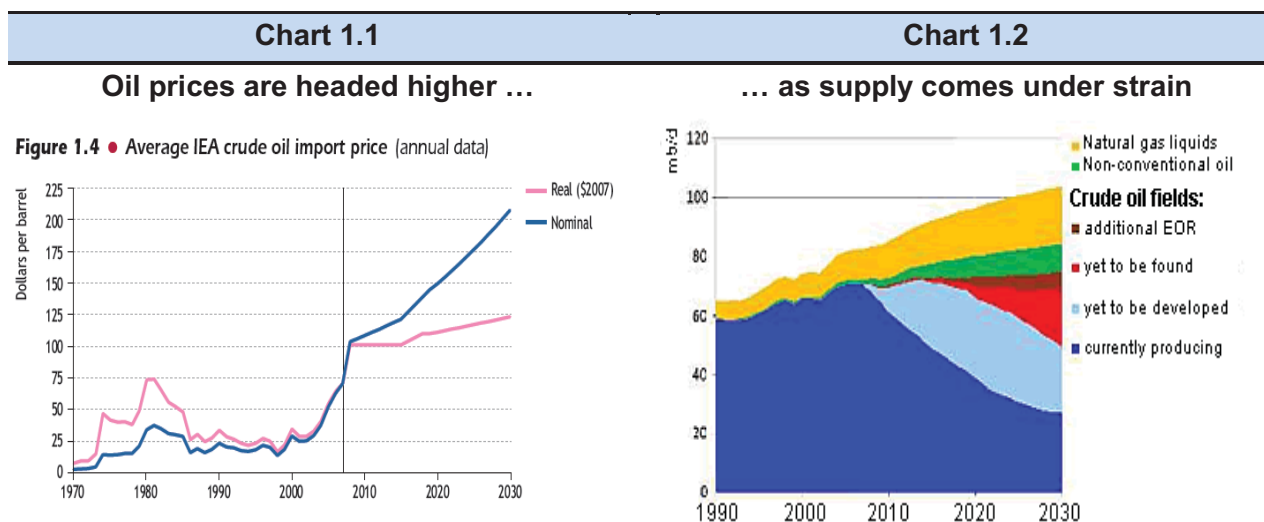
- Second, there will be more intrusive and rigorous regulation of economic affairs, especially in the financial sector. By reducing the room for innovation in financial products, growth in the financial sector is likely to be slow compared to pre-crisis days.

Oil prices will tend to rise, translating into higher costs of transport and power

There are powerful forces at work pushing up oil prices over the next 20 years. Chart 1.1 shows the International Energy Agency's forecast of oil prices to 2030. Other agencies are similarly predicting significantly higher oil prices in real, inflation-adjusted terms.

- **Depletion rates vs. new fields damages demand-supply balance.** As Chart 1.2 shows, currently producing oilfields are set to deplete rapidly and replacement fields are not being found or being developed quickly enough. At the same time, oil demand will rise as large emerging economies grow rapidly - even assuming that the PRC and India's demand for energy will grow more slowly than historic trends because of improved technology.
- **OPEC's share of supply will rise, strengthening its ability to raise oil prices.** World oil supply growth is projected to lag growth in demand. With OPEC production rising faster than non-OPEC, Table 1.2 shows that OPEC's share of world oil production will rise substantially to more than half by 2030. This will strengthen further its pricing power.

A new equilibrium price of oil is likely to prevail into the post-crisis, one that is much higher than in the 1990s and 2000s.



Source: Collated by Centennial Group from International Energy Agency.

Table 1.2: Rising OPEC Share of World Oil Production

	Units	2000	2007	2015	2030
World Oil Supply	Million bbl per day	75.0	82.3	92.0	103.8
from OPEC	Percent Share	42.8	43.6	48.3	51.0
from non-OPEC	Percent Share	57.2	56.4	51.7	49.0

Source: US Dept of Energy/EIA March 2009.

The US consumer will be retrenching

The household savings rate in the United States is set to reverse its long term decline as the two main forces that depressed it wane:

- Household wealth is now falling with declining real estate prices, and it will take many years of recovery before households have the same level of wealth as they did during pre-crisis. About \$13 trillion of wealth or almost 100% of the US GDP has been destroyed by the current crisis. Within this is a massive fall in the value of pension assets: this means that American households have to raise their savings rate substantially just to make up for the erosion of their pension funds. Americans lost a fifth of the value of their 401(k) retirement accounts - some \$603 billion - last year, according to the Employee Benefit Research Institute in Washington.
- Mortgage refinancing with equity withdrawal, is no longer the force it used to be and with financial institutions set to be far less adventurous in lending practices post-crisis, this factor is unlikely to influence household savings as it did pre-crisis. The surge in household debt allowed consumer spending to rise 3.5% a year in the decade to the peak of the boom in 2007 despite a decline in the personal savings rate to a low of – 0.7%, in 2007.

Moreover, this crisis has had a thoroughgoing effect on American consumers, forcing a fundamental shift to a more frugal mindset. A survey by AlixPartners, a business-advisory firm, found Americans plan to save 14% of their total earnings once the recession ends. Two-thirds of those surveyed said they plan to buy less in the future, while more than half plan to buy less-expensive things.

Given this, only a rapid growth in household incomes can allow a simultaneous rise in the savings rate as well as continued decent consumer spending growth. On average, the United States economy has to create 125,000 jobs per month in order to absorb the number of new entrants into the labour force. If job growth were to average the roughly 160,000 per month seen in the 2003–2007 economic boom, it would still take a decade to find jobs for those who lost jobs in this recession as well as to absorb new entrants. This suggests a large overhang of excess labor that will depress wage growth for many years. Thus, household incomes are unlikely to grow by enough to allow consumers to increase savings and spending at the same time.

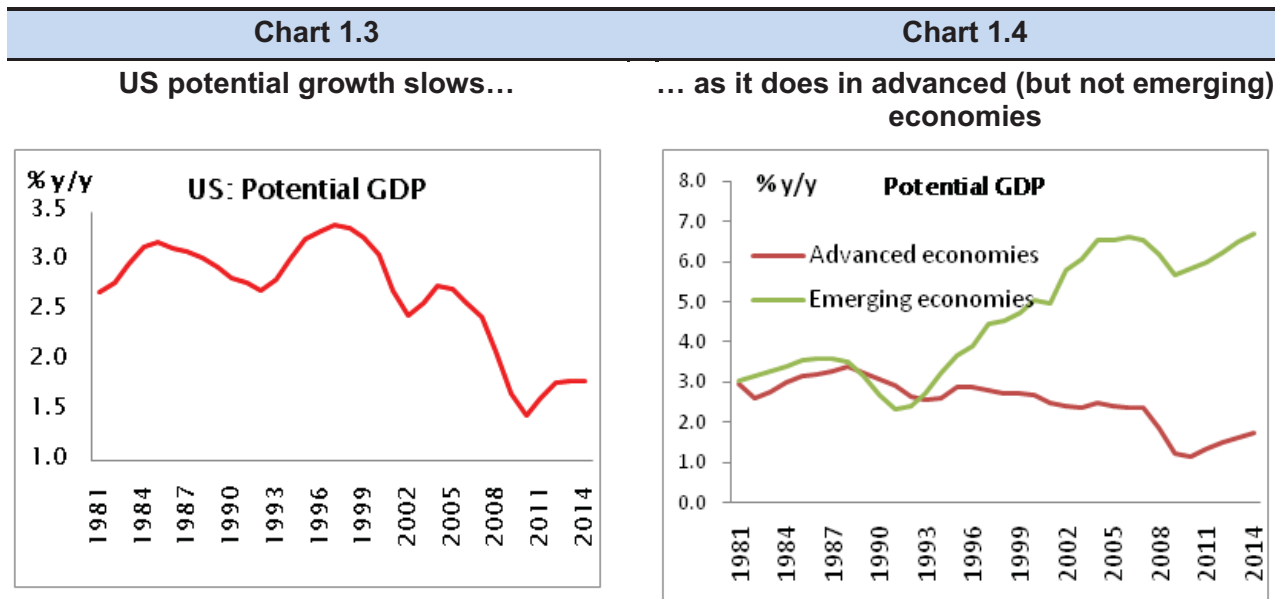
In short, the post-crisis period could see American consumer spending growth fall materially. American households have accounted for more than one-third of global growth in private consumption since 1990: thus, its impact on global demand for Asian exports will be substantial.

This change in the behaviour of the US consumer—combined with the expected drop in the value of dollar—is though necessary to raise US savings rate and reduce the country's large trade deficit and thus resolve, these in turn are key to resolving the issue of global imbalances. These developments in the US would though need to be complemented by efforts in the major surplus countries the PRC, Germany, Japan, and the Gulf states.

Potential growth in the US and major developed economies will slow

The IMF estimates that potential growth in the United States and other developed economies will fall noticeable post-crisis. They also estimate that potential growth in the emerging economies will edge down as a result (Charts 1.3 and 1.4). This is supported by analyses of the supply side of the United States economy as well. The Congressional Budget Office expects a 0.6% annual increase over the next decade compared to labour

supply growth of 1.1% on average in 1991-2007. Other studies, such as by Robert Gordon of Northwestern University, project the potential growth rate of the American economy to fall to 2.35% over the coming years, roughly in line with the IMF projection.



Source: Collated by Centennial Group from IMF World Economic Outlook, April 2009.

Climate change impact on growth will become material

The impact of climate change on the global economy as a whole is also likely to be negative.

First, there is now virtually irrefutable evidence that things are going awry with the world's climate. The United Nations Environment Programme² believes that "the evidence suggests that we may be within a few years of crossing tipping points with potential to disrupt seasonal weather patterns that support the agricultural activities of half the human population, diminish carbon sinks in the oceans and on land, and destabilize major ice sheets that could introduce unanticipated rates of sea level rise within the 21st century". The already accelerating pace of the melting of the Arctic ice as well as glaciers that are critically important to the flow of water in Asia's major rivers attests to the dangers for Asia in particular.

Second, the recent meeting in Copenhagen made it clear that the political will does not yet exist at the international level to undertake the consensually agreed and globally coordinated policies and binding actions needed to bring emissions of greenhouse gases down to levels that can avoid significant damage to the planet and its inhabitants.

Therefore, there is no escape from increased climate-induced costs to business and the economy in coming years. Either the policy makers act in time, with measures that will raise the cost of carbon-based energy and other climate-damaging economic activities; or actual damage caused by climate change such as water shortages, disruptive weather, etc. will feed through into rising business costs which will hamper economic growth.

² United Nations Environment Programme 2009 Yearbook.

Restructuring at micro level dampens growth initially

Companies in crisis-hit economies are re-jigging business models – they are raising productivity by economising on labour, squeezing their suppliers, improving business processes etc. Initially, this will slow growth as workers are laid off and small businesses are hurt by big companies reducing their profit margins.

Over time, as policies to address climate change are expanded, many business costs may rise either directly or indirectly.

(B) Consolidation of production sharing networks

The emergence of production sharing networks was an important driver of economic growth in both developed and developing economies. Carving manufacturing production processes into tinier slices that were each allocated to the location which best improved profitability drove a wave of foreign direct investment (FDI) into developing economies, accelerating growth in the latter. Developed economies also benefited through the higher profitability of their companies and because resources released by such restructuring of production could be re-allocated to higher value activities. They also gained from improved environmental effects as polluting manufacturing activities were sent abroad.

This production restructuring will remain a source of growth for lower income countries in Asia. But, it will probably be less potent as a source of growth in the future:

- Tax and other incentives given by developing economies to multinational companies (MNCs) are coming under more critical scrutiny in developed economies. The Obama Administration has changed tax regulations to close off loopholes which allowed MNCs to take advantage of such tax incentives.
- If oil prices rise materially and stay higher as indeed might happen, the resulting permanently higher costs of transportation will reduce the economic case for outsourcing production of goods for which the unit cost of transportation is high. The cost advantages of production outsourcing must outweigh the additional costs incurred in such off-shoring – which relates substantially to the costs of transportation.
- Costs in major developing economies are now rising. In the most important beneficiary of production sharing networks, the PRC, we are seeing a stronger currency, rising labour costs and higher costs of intermediate inputs all reducing the economic justification for some types of production sharing.
- At the same time, costs in some major sources of FDI such as the United States are likely to fall relative to the more successful developing economies. The worst recession in 60 years will force wages down while the restructuring efforts of companies will improve productivity. Unit labour costs in the United States will almost certainly fall materially relative to many developing economies. Most importantly, a steady decline of dollar relative to other major currencies would make US more competitive. The same is likely in some European countries worst hit by the combination of the financial crisis, housing bust and financial crisis – such as the United Kingdom. Consequently, there is likely to be some degree of “re-industrialisation” in both the United States as well as the United Kingdom. Again, these developments could contribute to reducing the global imbalances.
- With much experience behind them now, MNCs are more aware of the risks of production sharing – product safety issues, unexpected delays, costs imposed by cultural, and language difficulties as well as unanticipated problems due to lower than

expected labour productivity. One major concern in recent years has been over the theft of intellectual property. Consequently, some MNCs are becoming warier of relocating production.

- As customer demand becomes more diverse and complex, the case for locating production closer to end-markets is strengthened – this would improve the producer's ability to respond swiftly to rapid changes in customer needs and fashions. This argues for either retaining production in local markets or relocating production to a developing economy close to the main market – for Europe this would be Eastern/Central Europe and for the United States, this would be Mexico or the Caribbean.

The upshot of this must be a reduced pace of FDI flows into green field manufacturing investments in developing economies. FDI will remain a driver since MNCs will still find many activities in which cost differentials still offset the downsides of production outsourcing. Many MNCs are also keen to participate in the growth of domestic demand in large, populous economies and realise that locally based production would promote their chances of gaining market share. But the growth induced by FDI, driven by production outsourcing, is likely to be less than it was in the pre-crisis days.

CHAPTER 2: POLICY IMPLICATIONS FOR ASIAN ECONOMIES

2.1 A fundamental change in the economic model may be unavoidable

Policy makers in Asia will confront a new world marked by:

- **Noticeably slower economic growth.** If G3 and the PRC economic growth slows and other headwinds such as higher commodity (including oil) prices and the costs of climate change do become material constraints on growth as argued above, Asian economies will find it hard to avoid a long period of slower export led economic growth.
- **Changes to fundamental assumptions.** Global growth will be slower and more dependent on large developing economies rather than the G3 economies. Changes in global currencies, the PRC's move up the value chain, India's emergence in global manufacturing, the consolidation of global supply chains and the backlash in the West against the use of tax and other incentives by developing countries will all change the structure of competitiveness. What is more, the larger Asian economies such as the PRC and India can no longer behave as passengers in the global economy, reacting to global changes: they will have to share responsibility with the G3 for global economic governance. This means that they will be less able to shield currency and other macro-economic policy from critical scrutiny by other powerful economies.
- **A more volatile global economy.** A far riskier world is emerging where financial stresses and outright crises are likely to be more frequent. This is probably especially so in the early phase of the post-crisis period when the costs of the policy steps taken to end the crisis begin to affect markets and economies. But these stresses will continue as we begin to adjust to the step changes that will occur such as the downshift in the role of the US Dollar.

This means that within Asia policy has to change in order to build more resilience to external shocks. Policy also has to help the economy adjust to the changed structure of competitiveness mentioned above. These changes will offer enormous opportunities for transformations:

- **PRC.** Once the PRC's policy makers feel confident that the country has overcome the fallout from the global crisis, it will probably return to its strategy of moving up the value chain. As its economy prospers and grows rapidly, the PRC's domestic costs are rising. Moreover, we believe that the PRC will also revert to its post-July 2005 exchange rate strategy of a gradual currency appreciation. Driving all this is its policy objectives of emphasising the quality rather than quantity of growth. This means a de-emphasis on labour-intensive activities while developing greater capacity in medium technology areas such as the production of electronics components.
- **India.** Indian manufacturing is also set to become more competitive in more areas as the restructuring by manufacturing companies there produces results in terms of lower costs and greater efficiency: India is set to compete more actively in areas that Southeast Asian economies such as Malaysia compete in.
- **Indonesia.** Indonesia is putting aside more than a decade of tumultuous political and economic dislocation: if the newly re-elected Yudhoyuno Administration succeeds in improving the business climate and raising infrastructure spending, Indonesia is likely to enjoy a significant improvement in competitiveness.

- **Viet Nam.** Viet Nam is enduring two sets of challenges currently – the impact of the global crisis as well as its own slow-burning banking crisis. We believe that the latter will force financial sector reforms which will improve financial intermediation, while accession to the World Trade Organisation is bringing in a wave of foreign investment whilst also committing Viet Nam to more growth-enhancing economic reforms. Thus, once Viet Nam has overcome its current problems, we are likely to see a shift to near 10% growth rates in Viet Nam.

If the changes in the drivers of extending production networks continue, we are likely to see multinational manufacturing companies preferring to relocate production to low-cost emerging economies with sizeable population bases, such as the PRC, India, Indonesia or Bangladesh, rather than the smaller economies of Southeast Asia.

2.2 Specific policy implications to enhance resilience and help tackle global imbalances

The new economic models that will eventually emerge, will of course take different shapes and colourations in different countries but they will all have to tackle the following areas:

Rebalancing domestic vs. external demand: Asia's role in tackling global imbalances

The emerging consensus believes that Asian policy makers have to do two main things to boost domestic demand (in some countries this will more consumption rather than investment) as a driver of economic growth in Asia – allow their currencies to appreciate and build social safety nets so as to reduce the household savings rate. Both are prerequisite to reducing the fundamental problem of massive global imbalances, but additional measures may be needed to tackle this issue.

First, currency appreciation. In practice, this may not be as big a solution in the near term as it appears at first glance. Much depends on the PRC's willingness to allow its RMB to appreciate. So long as the PRC adopts a gradual approach to taking this fundamental step, other Asians will not allow any material appreciation of their respective currencies, for to do so would mean a loss of export competitiveness. Our view is that the PRC may be willing to allow its RMB to rise only gradually over the next year or two and would complement such a policy with administrative measures and indirect incentives that help its export sector preserve competitiveness. Hence, the ability of the PRC's developing Asian competitors to allow their currencies to rise sufficiently to produce an expenditure switch to imports and reduce exports is not that strong.

Second, building social safety nets. Some argue that building more extensive social safety nets will be crucial to improving domestic demand – by persuading households to reduce their precautionary savings rate, the propensity to consume would rise. We believe that such social safety nets will be rolled out in coming years. The PRC has begun a massive effort to rebuild its rural healthcare system for instance, and is experimenting with various forms of retirement funding and unemployment insurance. Indian political leaders have seen the electoral success of the ruling Congress Party's National Rural Employment Guarantee scheme and will be inclined to do more in this area. However, social safety nets take years to fully implement and even longer to materially alter spending and savings behaviour.

Consequently, we believe that Asian policy makers will be persuaded to try additional policies to boost domestic demand which will have more immediate and potent effects:

- ***Boosting housing sectors with easy monetary policy.*** The PRC experience has shown that boosting home ownership can trigger off a surge in consumer spending as

new homeowners also purchase home appliances while others feel wealthier and more willing to spend. A more active housing market also spurs construction, real estate services and financial services linked to housing. Other Asian policy makers are likely therefore to follow this route – one that others such as SER, Hong Kong, China and Singapore have also taken. One way to do this is through supportive monetary policy. With the US Dollar likely to depreciate and the RMB appreciating gradually, other Asian countries would have more leeway with monetary policy. With less risk to their currencies, they can afford to run easier monetary policies than if otherwise have been the case.

- **Increasing infrastructure spending.** Governments across Asia have been planning major infrastructure programmes for much of this decade without actually succeeding in getting them off the ground for a variety of political and bureaucratic reasons. With external demand likely to be weaker and a more urgent need to boost domestic demand, we believe that political leaders will push through such programmes with greater success. A particularly potent area for infrastructure spending will be in improving transport linkages in archipelagic countries such as Indonesia and the Philippines. Here, improved road/rail/bridge links among the islands could help integrate what are now fragmented local economies with sub-par economic scale into larger markets with better scale economies.

Intra-regional trade vs. dependence on G3 demand

While increasing domestic demand is important, many Asian economies know that they cannot rely on domestic demand alone to grow rapidly. Hence, the likely interest in giving a new impetus to boost intra-Asian trade. There are several ways this could be done:

- **Summoning the political will to create more effective regional trade arrangements.** So far, regional trade agreements such as the ASEAN Free Trade Agreement have only had limited success in creating a single market because there was not enough political will to overcome non-tariff and other barriers. With G3 demand growing slowly but Asian economies performing well, there will now be greater incentive to fortify the existing agreements. We also see greater interest in expanding sub-regional integration in areas such as the Greater Mekong Sub-Region (GMS) and the Central Asia Regional Economic Cooperation (CAREC).
- **Improving connectivity within the region.** One early but essential way to improve the sub-regional integration would be through improved transport connectivity. We see more efforts to build road and rail networks spanning the sub-regions such as the GMS or the Iskandar Region straddling the Malaysia-Singapore border.
- **Increasing labour migration.** So far, intra-Asian regional labour mobility has been partial. There have been large flows of Filipinos into Hong Kong, China, Malaysians into Singapore, Indonesians and Bangladeshis into Malaysia and Burmese and Cambodians into Thailand. With much of East Asia experiencing an accelerated pace of ageing, we see countries such as Japan and the Republic of Korea that have resisted migration beginning to open up as well. We also see existing regional trade arrangements being expanded to allow limited flows of professional or skilled labour.

Building greater economic resilience

Asian economies need to further build up their resilience to external shocks.

Since there is not likely to be any escape from frequent shocks and stresses in the global economy, policy makers could conclude that the best they can do is to improve resilience

(see parallel paper 1 for a more detailed discussion of our concept of resilience). This means building greater diversity, increasing economic flexibility and strengthening shock absorbers in the system while reducing the shock amplifiers in the system:

- **Diversity in export structures.** Apart from having larger and more diverse domestic demand drivers, Asian countries are also likely to try diversifying the geographic concentration (less reliance on the US and European markets and more exports to Latin America, Middle East etc.), as well as product concentration of their exports. Some degree of industrial policy may be needed to achieve this.
- **Creation of more automatic stabilisers.** As social safety nets are extended, domestic demand would tend to become less volatile – since unemployment benefits and related social payments would tend to increase in an economic downturn.
- **Reduction of shock amplifiers.** This crisis has highlighted the role that financially mobile capital plays in amplifying an external shock. A disproportionate amount of foreigners' holdings of short term debt and equity instruments in relation to the financial depth of the economy or in relation to its foreign exchange reserves amplifies shocks because the abrupt withdrawal of such capital forces precipitate currency weakness that arouses investor concerns. It also causes a sudden drying up of liquidity in the financial system. We suspect Asian policy makers will implement policies to discourage or even limit the inflow of short-term capital inflows during periods of financial market hubris such as what we saw in 2006–2007. Brazil has recently taken steps to discourage inflows of speculative capital flows that have led to a sharp appreciation of its currency.

Building new engines of growth

With currency and cost differentials with developed economies narrowing, there will be particular pressure on the more successful economies such as the PRC or Singapore to change economic strategies. While the previously less dynamic or low income economies can still rely on catch-up with the successful economies and will benefit from the PRC vacating areas of lower-value add, the more successful economies will now depend more on innovations in business processes and adopting new technologies which can then raise total factor productivity and boost competitiveness. Asian policy makers are likely to be pragmatic about how they go about achieving this.

State-oriented economies such as the PRC and Singapore will continue to see the state playing a directing role in industrial development, using policy incentives to attract chosen MNCs and relying on government-linked companies to pursue chosen strategies. However, even these governments probably realise that they need to go beyond such strategies.

- **Massive investment in human capital development.** East Asian economies and Singapore have invested heavily in tertiary education. We are likely to see countries such as Thailand and Malaysia step up efforts in this area – expanding the number and quality of tertiary institutes.
- **Increasing competition in the domestic economy.** Innovation is best spurred when companies in the domestic economy are forced to compete against one another. Many countries in Asia are beginning to introduce legislation to improve the competition frameworks in their respective economies. Moreover, as regional trade agreements become more ambitious, as argued above, we are likely to see more regional companies allowed to compete in domestic markets.

Corporate sector will undergo significant restructuring

Asian companies will have to respond to a much more challenging environment: slower growth, higher cost of capital, less supportive export environment with more competition, stronger domestic currencies, higher climate-related and energy related costs and more. They will have to restructure to adapt to this new landscape. These efforts to reduce costs, acquire new technology, move up the value chain and ramp up productivity will unleash supply side efficiency gains in each economy; gains which can help to boost economic growth.

2.3 Opportunities for smaller Asian economies

Much of the above discussion has focused on the challenges and difficulties that major Asian economies will need to cope with. But as policy makers and companies respond, there will also be some positive developments for others as well, especially for smaller Asian economies:

- ***Economic take-off spreads to other large economies.*** The economies of India, Viet Nam and Indonesia are likely to join the PRC in enjoying a degree of economic take-off, opening up huge new opportunities for everyone in Asia.
- ***This creates more spill-overs for others.*** As the PRC moves up the value chain into higher value products and services, it will compete more with the developed Asian economies such as the Republic of Korea, Taipei,China, Hong Kong, China and Singapore. But it will also open up space for the poorer economies to enter the activities that the PRC vacates – benefiting Indonesia, Viet Nam, Sri Lanka, and Bangladesh for example.

The end result will be to make the economic and investment environment in Asia a more positive one. In essence, challenges will grow, but the responses that are stimulated will help move Asia up several notches in the global economy.

Smaller Asian economies should also make modifications to their policy to create additional space to reap the shifting of economic growth toward Asia.

Attracting low cost manufacturing industries

A clear hierarchy in the manufacturing sector has emerged over the last decade. With innovative and research and development industries located in Taipei,China and the Republic of Korea, other countries which have the benefit of large masses of labour and land target medium and low cost manufacturing. However, we expect the PRC, India and some South East Asian economies to gradually climb the value chain and start producing higher cost and higher value added products.

Thus the market for lower cost and labour intensive manufacturing will be open and smaller Asian economies should try to attract these manufacturing companies to relocate in their countries. Viet Nam stands as a case in point, as it displayed a strong comparative advantage in labour intensive production and created the support infrastructure to allow smooth functioning of the entire supply chain. Anecdotal evidence indicates how some MNCs have or are planning to shift some of their labour intensive operations to Viet Nam or Malaysia.

The PRC government is already in discussion with the World Bank to set up low cost manufacturing facilities in Africa. Production of goods, such as toys and footwear, could be

shifted to Africa. Assuming that such plans are strictly economic in nature, other Asian economies can compete with their African counterparts to gain market share. The close proximity of Asian economies and the better cultural/historic fit gives Asian economies an added advantage compared to the Africans.

Policy makers in smaller Asian economies should improve/create policies to attract such labour intensive manufacturing:

- **Reforming labour laws.** Many Asian economies still suffer archaic labour laws which prevent any flexibility in the system and the rigidity is a major disincentive. Issues such as difficulty in hiring, rigidity of hours, and high firing costs are among the main problems (Table 2.1).
- **Creating an easier business environment.** The time and costs involved in registering a company should be reduced. Costs could be associated with fees, taxes, stamp duties etc.
- **Instilling law and order.** Better law and order cannot be ignored. Countries could gain an advantage over others if they improved business conditions including the law and order situation.

Table 2.1: Employment conditions in Asian economies

	Rigidity of employment index	Firing cost (weeks of salary)
India	30	56
PRC	31	91
Bangladesh	28	104
Sri Lanka	20	217
Nepal	46	90
Bhutan	7	10
Maldives	18	9
Pakistan	43	90
Afghanistan	20	30
Indonesia	40	108
Philippines	29	91
Malaysia	10	75
Thailand	11	54

Source: World Bank Doing Business 2010.

Note: In case of rigidity, a higher value implies greater rigidity.

Reaping benefits of increased tourism

The increased prosperity of Indian and Chinese households also increases their disposable incomes. Smaller Asian economies like Nepal and Maldives which have traditionally targeted European and North American tourists, should also create incentive schemes for Asian (particularly Japanese, Indian, and Chinese) tourists.

- **Creating packages to suit new tastes:** Package tourism would be an important tool to attract attention. Unlike earlier packages, these packages should be directed towards Japanese, Chinese and Indian and other Asian tourists. Restaurants catering to this new clientele should be encouraged. There should be some coordination between airline

operators, hotels and travel agents. For example, offering special packages with options for vegetarian food will help attract Indian tourists.

- **Marketing and advertising.** Increasing the awareness of tourist locations can be done through advertisement and marketing campaigns in target countries.

Attracting FDI from these markets

Besides being appealing locations for FDI, India and the PRC have also become large outward investors. While historically these investments have been targeted toward the developed world, the slow growth forecasted for the coming years in US and Europe indicates that returns on investment in these markets will be low. Investors could look towards developing countries in Asia and Africa for new investment opportunities.

A good example is the sudden increase in Chinese FDI flowing into Taipei, China after the two economies reconciled their historical differences. With the opposite incentives in place, other Asian economies could also play host to sudden increases in FDI. India has also been a keen investor abroad with multiple investments in the Indonesian mining sector. The World Bank is planning to partner with India in a large railway project in Africa. Indian MNCs have also been active in other resource and infrastructure industries in Africa.

Policy makers should reform laws regarding Public Private Partnerships and foreign investments in the countries. Biddings for infrastructure projects should be opened to local as well as overseas companies. Incentives such as tax breaks and subsidized land could be offered to make the business more profitable and attract more investors.

Filling gaps in domestic excess workers

Several Asian economies have traditionally been dependant on remittances mainly from the Middle East and the US. But as we noted earlier, there will be a sizable number of workers who will be returning to their home countries. In addition, new job opportunities will likely be limited. This will be especially true for economies where the bulk of their overseas workers are in the G3 economies. Thus, there could be sudden excesses in job markets in certain Asian economies like the Philippines, the Maldives, Sri Lanka, and Bangladesh.

Such countries should try to tie into the developments in India, the PRC and other large Asian emerging market economies. This will be a slow process and cannot occur immediately. India and the PRC still have large reserves of unskilled labour, low labour costs as well as tough regulations for hiring foreign workers.

CHAPTER 3: GREATER RELIANCE ON REGIONAL COOPERATION AND INTEGRATION: FINANCE; INFRASTRUCTURE; TRADE; AND REGIONAL COMMONS

The changes in the post-crisis global economic landscape require Asian economies to re-think or refine the economic growth models that they have chosen. Some of the areas where changes are needed are indicated below:

- First, much of Asia is still heavily dependent on ultimate exports of final products to the US and Europe. As discussed above, we expect consumers in these countries to cut back spending and overall economic growth rates to remain anaemic. Asia needs to reduce its reliance on these markets to the extent possible.
- Second, while intraregional trade in East Asia approaches European Union levels, the numbers are inflated by trade amongst production networks designed to export low cost products to the West. In sharp contrast to East Asia, intra-regional trade in both South Asia and Central Asia is very low. Overall, very few Asian economies are taking advantage of fast growing domestic demand within the region.
- Third, physical connectivity within the region—with the major exception of GMS—is still very limited.
- Fourth, while Asia as a whole has become a major exporter of capital thanks to its high savings rates and exports. But, instead of these surpluses being intermediated by financial centres and institutions within the region, this crucial function is still performed in the US and Europe tightly linking Asia's fortunes with the vagaries of the global financial system.
- Fifth, the financial dimension of Asian economies remains in some cases a source of vulnerability. Better financial supervision and regulation frameworks to accompany liberalization and currency flexibility will be useful in helping these economies manage capital flows.
- Sixth, while there is a plethora of regional financial integration initiatives, it is fair to say that regional co-operation has not been a key component of Asian countries economic development policies. Given the weak prospects for G3 demand and the stronger growth of the PRC, India, and other Asian economies, Asian demand is likely to become a more important source of demand. Greater financial integration is also likely to help Asian economies diversify the sources of funds for their financial markets. Hence, it is becoming more important that regional co-operation become a key component of economic development strategies in Asia.

Given the importance of regional co-operation, we will focus on this issue in the remainder of this chapter.

Asian economic cooperation and integration could become a key factor in sustaining high economic growth, making growth more internally driven and increasing the region's resilience to global economic volatility. The efforts at regional cooperation should focus on achieving practical results in four concrete areas: 1) make financial markets increasingly interlinked; 2) accelerate efforts to achieve physical interconnectivity not only within individual sub-regions but also across sub-regions; 3) extend free trade regime beyond ASEAN; and 4) promote regional wide initiatives to tackle regional and global commons issues (climate change). These issues are discussed in turn below.

3.1 What does financial integration mean?

We define regional financial integration as a framework that allows any financial institution – banks, insurance companies, investment banks, fund managers, financial advisories such as pension fund advisors, investment consultants – within a region, such as ASEAN, to be free to operate and acquire assets, including controlling interests in another ASEAN country, exactly as if it were registered in the target ASEAN country. Similarly, consumers of financial services would be free to buy those services from anywhere in ASEAN and from ASEAN financial institutions regardless of the country of establishment.

The reason for seeking financial integration must be related to the overall policy goals of accelerating the kind of economic growth that delivers sustainable improvements in welfare while also ensuring resilience to shocks and a capacity to adjust and adapt to changing circumstances. Thus, removing current obstacles to such growth and resolving current problems should be a priority.

Asian financial integration would need to encompass the following in order to be meaningful:

- Crisis Management Regimes: The Chiang Mai Initiative – Multilateralisation (CMI-M) is a step in the right direction but needs to be more relevant than the previous CMI.
- Harmonisation of Regulations and Mutual Recognition.
- Removal of restrictions on foreign ownership.
- Implementation of some system of competition law, so as to ensure a level playing field for financial institutions from another ASEAN country.
- Liberalisation of capital account.
- An effective forum for macro policy co-ordination.

3.2 Current state of integration – limited despite the benefits

We will take ASEAN or ASEAN+3 as a case study since the greatest integration efforts within Asia have been in these areas. The current state of financial integration in the ASEAN region is dismal:

- **Volume of intra-regional flows is relatively small.** Intra-ASEAN+3 portfolio capital flows have grown more slowly than all global flows and slower than external flows into ASEAN. Intra-ASEAN+3 flows have declined as a percentage of total flows into ASEAN countries and remain a small percentage of market capitalization in both equities and bonds.
- **Limited in range.** Recipient of intra-regional flows are concentrated on a few countries with only Malaysia in ASEAN+3 receiving a significant share of flows. Similarly host countries, where the flows originate from, are also limited. Singapore generates two-thirds of all intra-ASEAN+3 flows with Japan as the next largest point of origin.

There are several possible reasons for the limited success in regional financial integration. Intra-regional trade is not as large as it seems since much of it is intra-firm trade within the production networks of transnational companies – hence the spin-offs from trade flows into financial flows within the region do not occur. Financial sectors in the region are still immature and lack financial depth. Moreover, savings institutions are under-developed in

most countries in the region. With the exception of Singapore and to some extent Malaysia, household savings are consequently fragmented.

Yet, the benefits of increased regional integration are substantial.

- A single market will help effectively manage the continued likelihood of crises in an unreformed post-crisis global economy. As discussed above, we expect Asian economies to be exposed to stresses and strains emanating from the global level. When risk appetites of global investors are strong, there could be huge inflows and when risk appetites weaken, there could be massive outflows. Unless Asia develops healthy intra-regional sources of finance, businesses may not get enough capital at an acceptable cost.
- A single market may also help the region better to manage the impact of rising the PRC and India. For example, in ASEAN, financial institutions may become less competitive when compared to their expanding Chinese and Indian financial institutions which enjoy substantially greater economies of scale. Banks and financial companies in India and the PRC can leverage off these scale economies when expanding into new markets. These conditions will only worsen as these new Asian giants become more powerful. But if the fragmented ASEAN region were to be better integrated, it could offer these economies of scale. With total population of 577 million and a per capita income of \$5,962, an integrated ASEAN will be able to compete more effectively.
- A single financial market in the region might help it avoid the Wimbledon Effect. Again, taking ASEAN as an example, currently there are few globally competitive ASEAN-owned financial institutions. Even within the region, no ASEAN-owned financial institutions have a sizeable market share. This is analogous to the Wimbledon Tennis Championship which is held in England but has produced very few English champions. It would be desirable for many reasons to want a diversified financial eco-system where ASEAN-owned financial institutions have a place alongside ex-ASEAN institutions.
- A single financial market boosts economic resilience. The Asian economies have become excessively dependent on external portfolio capital flows. This has often been a key destabilising factor despite the region's fundamental strengths. International capital flows tend to fluctuate with the vagaries of all emerging market economies such that regional financial markets suffer when adverse conditions in other emerging markets creates a contagion effect to all emerging markets. Intra-regional sources of capital will be better aware of conditions in neighbouring economies and less inclined to disruptive capital withdrawals. This will reduce sudden outflows which hurt domestic liquidity and cause damaging exchange rate fluctuations.

3.3 But what path should regional financial integration take?

While it is important to aim at increasing regional financial integration, the very real obstacles to integration argue for a judiciously chosen path towards integration as argued below:

First, most Asian economies are currently more integrated with the global economy than with each other

Asia has reaped huge benefits from this integration with the global economy. This must not be changed as the region pursues an activist policy of promoting regional financial integration. Indeed, there may well be areas and occasions where it is optimal to go for globalised integration rather than just regional integration.

Second, allocating a large amount of resources and political goodwill to regional currency unification might be ill advised at this juncture

The idea of moving towards some kind of monetary union has been floated on several occasions. We would argue that the payoff from a monetary union will take a very long time to come to fruition and that its benefits may indeed be limited. Therefore, the limited political desire and goodwill to promote regional cooperation and integration should be directed elsewhere in the next 4-5 years in order to achieve some concert results and build momentum for more ambitious efforts.

First and most critically, the political will simply does not exist to make monetary unification within any reasonable time frame feasible. To begin with, there is not even a consensus within the region on which countries legitimately constitute the region, as the differing visions for Asian integration show.

Equally important, it takes decades to achieve the alignment of political, economic and business interests and the level of mutual understanding necessary for a political consensus behind any meaningful degree of monetary union. Such conditions might take many many years to fall in place. Note the following major political obstacles:

- There is an insufficient critical mass of visible, tangible benefits of regional integration – This obscurity prevents the creation of interest groups not just favouring faster integration in rhetoric, but actively lobbying for it. Much political bandwidth and goodwill has been taken up on top down initiatives. Initiatives such as the Chiang Mai Initiative and the Asian Bond Fund have not produced discernible benefits on the ground. The true test of effectiveness is whether it changes the behaviour of economic agents such as financial institutions and stimulates them into strategies that promote further integration.
- Regional integration does not have priority among the myriad of problems that political leaders have to deal with.
- There remains a lack of trust among countries even within ASEAN, which has existed for many years. ASEAN economies have a short history of coordinated policy effort unlike the countries involved in European integration. Certain cultural and historical differences and rivalries remain hindrances. Despite working together as a regional grouping for many years, ASEAN is bedevilled by petty disputes and unresolved bilateral disagreements.

Second, even if the political will were to be found, the economic diversity within the region creates arguments against a single monetary framework being optimal for the region as a whole. There are far too many divergences in rates of productivity growth, inflation differentials and interest rates which have to be accommodated by differing exchange rate movements and this cannot be achieved through a stable exchange rate regime across countries. For example, it would be optimal for those countries in the region which are substantially and consistently out-performing the rest of the region in productivity growth to allow their currencies to appreciate. Moving towards monetary union will hinder this necessary process.

Consequently, in the immediate future the region should focus on politically feasible actions which yield perceptible results

Policy makers should avoid using up scarce bureaucratic resources and limited political goodwill on huge initiatives which do not have prospects of yielding tangible benefits at the ground level within the next few years. Instead, the focus should be towards smaller-scale

efforts. “Graduated regionalisation” should be the objective of policy co-ordination rather than a full-scale integration effort.

The process should be carefully managed and aimed to harvest the low-hanging fruits and building constituencies of political support for more integration in the future. This will also allow policy makers to test the waters, find out the problems and enable them to introduce larger scale integration more confidently at a later stage:

- **Through bilateral agreements.** A series of bilateral agreements to allow the larger financial institutions in one country to expand/acquire large banks in the other country. That will allow some banks in ASEAN to gain economies of scale and hopefully grow more competitive and gain global competitiveness.
- **Through cross-border, sub-regional integration efforts.** Expanded financial sector privileges could be extended to countries in such economic zones that straddle borders, such as the Greater Mekong Sub-Region or the Iskandar Region scheme that has been proposed between Singapore and Malaysia.
- **Through cultural harmonization efforts.** Accelerated efforts to achieve harmonisation and mutual recognition.

3.4 What path should regional physical connectivity take?

As the Eminent Persons Group’s report as well as ADB’s Long Term Strategic Framework stated, physical connectivity is and must be the bedrock of all regional cooperation initiatives.

There are a few welcome examples of the benefits of such efforts within Asia, with the East-West and North-South corridors in Great Mekong Sub-region (GMS) as the most prominent case. Unfortunately, there are very few, if any, other such examples even at sub-regional level with more than two countries. And, there are still no Pan Asian programs or projects either already completed or underway.

This state of affairs must be changed, and changed soon, if Asia wants to tap “domestic (regional) demand in order to reduce (gradually) its current heavy dependence on exports to the west.

Policy makers may consider the following four-pronged approach:

- First, to emphasize physical connectivity projects that would serve likely market demand and boost regional trade and investment rather than follow any idealistic road map. For example, most of international and regional trade—except for land locked countries—is by sea or air. It seems therefore that development of compatible port facilities through out the Pacific, South China Sea, Indian Ocean, and the Persian Gulf should be a high priority as should be a network of airports for cargo shipments throughout Asia preferably under an “open skies’ agreement.
- Second, given the great hunger for energy in countries like the PRC and India and the simultaneous availability of surplus oil, gas or hydro power in other Asian countries, a network of pipelines and transmission lines can be mutually beneficial provided the national leaders can overcome historic distrust and bureaucratic hurdles. A technical institution trusted by all parties such as the ADB may be an essential intermediary at the initial cases (as in GMS).
- Third, the successful experience with physical connectivity at sub-regional level in GMS should be replicated in other parts of Asia. For example, regional energy networks

(pipelines, transmission lines) in the CAREC region in addition to recent projects linking some of these countries to the PRC. In South Asia, the sub-region with least progress so far, perhaps the most immediate opportunities may be to complete a road corridor between Bangladesh and Nepal through India and to link the new East West national highway in India with the GMS road corridor in Thailand that will link India with Viet Nam.

- Finally, the above efforts at the sub-regional would not achieve the broader objective of Asia wide economic cooperation and integration. For that to happen, the regional must consider development of a few Pan Asian corridors and networks: roads, railways, power transmission lines as well oil and gas pipelines. This will require careful technical and economic analysis to identify the most viable corridors but even more importantly clear vision and political courage on part of the national leaders throughout Asia.

3.5 In trade and investment how to go beyond ASEAN?

There are two fundamental reasons why Asia cannot rest on its laurels (in case of East Asia) and further increase—gradually but steadily—intra-regional trade and investment. First, this is essential for the regional to become more resilient to future episodes of global economic turmoil. And second, being the fastest growing region of the world it is logical for countries and companies to focus on Asia.

2009 was a land mark year for ASEAN, the most successful regional trade group. First, ASEAN and India signed an FTA. And, second at midnight on 31 December 2009, ASEAN-PRC FTA came into force. The later agreement makes the resultant free trade area the third largest in the world, after the EU and NAFTA.

But, Asia needs to well beyond these welcome developments:

- First, large parts of Asia are not covered under these two agreements. Indeed, most large economies have additional bilateral agreements with each other Japan, the Republic of Korea, Singapore, India, Australia and so on. Full gains from free trade agreements would not come until all major countries are covered under one FTA. In this context, the next step might be some variation of an Asian Economic Community with ASEAN Plus Six countries forming the core.
- And, Mexico's experience since joining NAFTA stands in sharp contrast to countries in Eastern Europe (Poland). Many observers ascribe this to the fundamental weakness of an FTA from a Common Market approach. Despite joining NAFTA, Mexico has not reformed its basic institutional framework and standards. On the other hand, the newer members of the EU had to and did transform most economic institutions and standards. In moving forward, Asian policy makers must keep this lesson in mind.

3.6 Need for common Asian approach and actions to regional and global commons

Earlier in this report, we have discussed the likely adverse effects of climate change and global warming on countries and businesses. The problem of climate change, as is the case with other regional and global commons, cannot be handled individual companies or countries alone. It must be tackled collectively by countries throughout Asia.

Possible ways to tackle issues related to climate change and other regional commons were discussed at some length in ADB's Long Term Strategic Framework. It has been approved by the ADB Governors. We will therefore not repeat that discussion here except to say that implementation of the agreed strategy has become even more urgent now.

Report 2

Lessons of the Crisis and Global Imbalances:
Should and Can Asia Reduce its Reliance on Exports to US and
Europe and Focus More on Internal (Regional) Markets?

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 substantially 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.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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