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December 2009





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ISSN: 1882-6717

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1 ■ Introduction

Since the beginning of the second quarter of 2009, Asia has staged an impressive recovery. The People's Republic of China (PRC), Indonesia, Republic of Korea, and Singapore grew by an average annualized rate of more than 10% and emerging Asia should grow by more than 5% in 2009 (International Monetary Fund [IMF] 2009). Asia has benefited from a strengthening of domestic demand and exports, but the IMF (2009) has raised doubts about whether the recovery can be self sustaining even if the United States and Europe fail to pull themselves out of the current recession. All Asian countries, including the PRC, struggled with falling exports and stagnant domestic demand in a global economy plunged into a state of extreme volatility and uncertainty following the collapse of Lehman Brothers. To break free of the crisis, they have implemented stimulus packages of varying proportions consisting of increases in public spending, tax cuts, and the expansion of credit at lower interest rates. To return to the path of pre-crisis growth in East Asia, however, these stimulus measures will need to be followed by and combined with institutional and policy reforms that reorient long-term growth such that it depends more on domestic demand. The purpose of this policy brief is to articulate the rationale behind these policy changes and reform.



2. Relative Economic Performance Across Countries in Asia

The severity of the impact of the crisis has varied from country to country. The PRC and most of the Association of Southeast Asian Nations (ASEAN) member countries have been holding up much better than some of their neighboring countries and are likely to register positive growth in 2009. In contrast, Japan and Asia's newly industrializing economies have been hit hard by the crisis. None of these countries are forecast to realize positive growth in 2009 and the group of Asian newly industrializing economies is expected to see a contraction of 4% of their combined gross domestic product (GDP) (IMF 2009). In general, a high degree of export dependence, dominance of manufactures in exported products, and openness of domestic financial markets are shown to have accounted for the differences in the impact of the crisis and the relative importance of crisis contagion.

3. Crisis Management: Stimulation of Domestic Demand

In stimulating domestic demand, Asian countries have lowered interest rates and improved the availability of credit, but these measures have proved to be of limited effectiveness for economies in a liquidity trap.¹ This perception of ineffectiveness

¹ The term liquidity trap is used to refer to a situation where the demand for money becomes infinitely elastic.



has driven policymakers to rely more on fiscal measures, such as cutting taxes and increasing spending on public works projects, as the prime instruments of the stimulus. The PRC, Japan, Republic of Korea, and Malaysia have all implemented large fiscal stimulus packages, but there are indications that these expansionary macroeconomic policies may not be sufficient and that they will have to be fortified further to ensure that Asian economies do not fall deeper into recession if the recovery of the American economy stagnates.

In managing fiscal policy, the authorities will first need to estimate the magnitude of multipliers of government spending and tax cuts, which, according to recent studies (IMF 2008; Barro and Redlick 2009), tend to be small, and then use these estimates to formulate a variety of public expenditure programs and tax reductions to enhance stimulus packages with a minimum of administrative lag. At the same time, public spending programs will need to be chosen not only for their short-term expansionary effect, but also in terms of their ability to contribute to long-term improvements in total factor productivity. Even if the countercyclical effects are strong, fiscal stimulus could be counterproductive in the long run as it could raise the real interest rate, mask structural weakness, and postpone much needed structural reforms. Furthermore, in the short run, Asian policymakers are well aware that, for their export-oriented economies, there is a limit to the extent to which expansionary monetary and fiscal policy can fill the void created by the decline in external demand.



4. Rebalancing Growth: Ensuring Neutrality of the Incentive System

To sustain robust, long-term growth in Asia, the above-mentioned short-term measures need to be carried out in parallel with institutional and policy reforms that will usher in a new development strategy that focuses on internal demand as a source of growth. This is because, with the global economy in deep recession and the rise in trade protectionism, the region cannot export its way out of the crisis. Even when the global economy recovers and financial stability is restored, it may no longer be viable to return to the pre-crisis export-led strategy (Asian Development Bank 2009).

Throughout Asia, there is an emerging consensus that the short-term stimulus packages should be viewed as the first step toward achieving the goal of rebalancing growth, the key to surviving the global economic crisis. In this policy brief, rebalancing is defined as the process of removing the bias against the non-tradable sector. Countries adhering to an export-led growth strategy are likely to maintain internal terms of trade that are in favor of tradables. In such economies, the relative prices of tradables are kept at artificially higher levels so as to induce the allocation of resources to export-oriented industries. Rebalancing growth will require the elimination of this structural bias so as to facilitate the allocation of more resources to the non-tradable sector. To this end, it is necessary to wind down the incentive schemes for export promotion that often include tax breaks, preferential lending, and other explicit and implicit subsidies to exporters.



In embracing a rebalancing strategy, distinctions should be made between an export-led growth strategy and export-led growth. The former is a strategy in which the underlying incentive structure is biased in favor of exports; this is not the case for export-led growth. Because of comparative advantage and other structural characteristics, some market-oriented open economies may rely more on external demand for growth than others, even though their incentive schemes are neutral, and they may run either deficits or surpluses on their current accounts.² With the exception of the PRC, most East Asian export-oriented economies have phased out the subsidization of exports, including keeping the currency undervalued, and as such they may be classified as export-led growth countries with relatively neutral incentive schemes (Blanchard and Giavazzi 2006).

Since the 1997–1998 Asian financial crisis, weak investment has been one of the major causes of slow growth in non-PRC Asia. Stimulating domestic investment will therefore need to be a top priority for rebalancing growth in the region, in addition to consumption expansion. While reviving investment is critical, it will also have to be managed in a way that will refocus the allocation of investment away from export-led industries and toward the non-tradable sector, improving social welfare education, health care, and the pension system, and protecting the environment. In this regard, the adoption of a low carbon and green growth strategy will help protect the environment and also help boost the domestic demand for a variety of new services that a green growth strategy is expected to generate.

² The ratio of exports to GDP is close to 60% in the Netherlands and about 40% in the Republic of Korea. No one would argue that the Netherlands is a country pursuing export-led industrialization.



5. Adjustment of Propensity to Save

In view of the high rates of saving and relatively neutral incentive schemes in emerging Asia, one may conclude that the bulk of Asia's current account surplus does not come from Asia's exceptional success in pushing out exports as much as it does from a high propensity to save and stagnant investment demand. Growth rebalancing should therefore be geared to removing structural impediments to consumption and investment. Such a rebalancing strategy would help improve the allocative efficiency of the economy, while making it less vulnerable to external shocks. The high rate of saving has long been regarded as one of the virtues of East Asian societies. Among Asian countries, the PRC's savings rate has been exceptionally high—close to 50% of GDP—and has exceeded investment, thereby generating a current account surplus year after year (Horioka and Wan 2008). The savings rates of other countries are lower and, in fact, declining, but are still high enough to produce current account surpluses. People in Asia save more than people in other regions not necessarily because they are intrinsically frugal or that they live in cultures that greatly value saving, but that, as a number of studies have shown, in many cases they are forced to save more because of the poor quality or nonexistence of such vital services as public health care, education, and social security that have long been institutionalized in western societies. Another contributing factor is their inability to smooth their consumption over time through borrowing from and lending to financial institutions and markets.



Rebalancing growth therefore entails policy changes and institutional reform that would eliminate structural impediments that constrain households to save more than their counterparts in advanced countries. Although there is a vast literature on saving behavior in emerging economies, variables that are closely associated with changes in the propensity to save tend to differ from country to country. In terms of the rebalancing strategy, some of the reforms that would help induce households to consume more as a proportion of their income include: (i) the establishment of an efficient system of social protection; (ii) the expansion and improvement of the efficiency of public and private pension, public health care, and education systems; (iii) the phasing out of restrictions on consumer credit; and (iv) the creation of financial institutions specializing in household lending.

6. Regional Cooperation for Policy Coordination

Asia's policymakers all emphasize the need to stimulate domestic demand and, to further this aim, the need to improve the effectiveness of regional policy coordination for crisis management. To this end, Asian countries must avoid the collective action trap. Unless all countries in the region join in a simultaneous expansion of domestic demand, the expansionary policies of some individual countries will not add substantially to regional aggregate demand. For more than ten years since the 1997–1998 Asian financial crisis, the member states of



ASEAN+3³ have discussed the establishment of a modality of and institutions for mutual assistance and policy coordination at the regional level. They have yet to make significant progress in creating a workable scheme for policy coordination because of the failure of the PRC and Japan to provide leadership for regional cooperation.

³ An East Asian regional arrangement for economic cooperation among the ten countries that comprise ASEAN, plus the PRC, Japan, and Republic of Korea.

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About this Policy Research Brief

Asia has staged an impressive turnaround in 2009, but it is unclear whether the recovery can be self sustaining even if the United States and Europe fail to pull themselves out of the current recession. This policy brief discusses the impact of the global financial crisis on emerging Asia and seeks to articulate the rationale behind the policy changes and reform necessary to return East Asia to the path of pre-crisis growth.

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The Asian Development Bank Institute (ADBI), located in Tokyo, Japan, is a subsidiary of the Asian Development Bank (ADB). ADBI was established in December 1997 to respond to two needs of developing member countries: identification of effective development strategies and improvement of the capacity for sound development management of agencies and organizations in developing member countries. As a provider of knowledge for development and a training center, ADBI serves a region stretching from the Caucasus to the Pacific islands.

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