Perspectives and Issues

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Introduction

This may be the Asian Century, but it is also a period of deep global uncertainty. If the global economy is characterized as consisting of five dominant pillars—Europe, North America, Japan, the People’s Republic of China (PRC), and a group of major emerging economies—then only the latter two are vibrant and dynamic. The first two dominated the world economy during most of the 20th century, and together with Japan they were the key engines of growth in the post-war period. Now, however, all three are beset by serious problems of low growth, high debt, and a political economy environment that renders growth-oriented economic reform very difficult.

The developing Asian economies therefore have to sustain growth in an exceptionally difficult environment, and one in which they will have to assume increasing responsibility for the maintenance of global economic growth. Their export dynamism is threatened by slow growth in most rich economies, compounded by attendant rising protectionism. As major savers, they also have a stake in the construction of global and regional economic and financial architectures that both hasten recovery and reduce the likelihood of further crises. And yet there is the paradox that rich countries are looking to much poorer countries both as sources of needed capital and as global economic locomotives. After all, in spite of the economic vitality, many millions of people in these developing Asian countries exist in precarious circumstances, at best living only marginally above very modest national poverty thresholds. Moreover, even before the recent global economic recession (GER), some appeared to be in danger of losing their economic dynamism, with investment levels well below those achieved prior to the Asian financial crisis (AFC) of 1997–1998.

The central question of this volume is how developing middle-income Asian countries maintain their economic dynamism and navigate through deep economic crises.
against the backdrop of continuing global uncertainty and instability. At least four broad sets of issues are pertinent in addressing this question. The first is growth dynamics, including long-term growth performance, resilience in response to exogenous shocks, recovery from crises, and the special challenges of upgrading for upper middle-income economies. The second is savings and financial development, with lessons learned from recent events, especially the AFC and the GER. The third is investment behavior after the AFC, including in some countries the challenges of sluggish investment levels and difficulties in funding long-term infrastructure projects. The fourth concerns international and regional dimensions, including uneven recovery patterns, large current account imbalances, and the special problems of coordination and provision of global “public goods.”

These questions can be answered only with reference to both broad thematic studies and detailed country-level analyses. This volume therefore includes both. Consistent with our analytical framework and questions, the volume includes studies of investment and productivity, savings behavior, financial development and reform, infrastructure, investment agreements, and institutions and governance. These cross-cutting chapters are combined with six developing-country studies, comprising Asia’s two very large developing economies, the PRC and India; the world’s fourth most populous nation, Indonesia; and three important mid-sized economies: Malaysia, the Philippines and Thailand. These countries share common membership of the middle-income developing group, geographic proximity, and generally strong economic performance. But there is considerable diversity among them, which provides an analytical and policy richness in addressing the major issues. For example, they vary significantly in their growth rates, size, crises experiences, savings–investment levels and balances, openness, financial development, infrastructure levels, and institutional quality.

Deep crises of the sort that occurred in 2008–2009 during the GER are generally defining and unsettling events, which have significant analytical and policy implications. They shake up—and sometimes overturn—complacent governments, and may push them to undertake major reforms. As one comparative political economy study concluded, “Turning points [in economic policy] are invariably associated with macroeconomic crises.” (Lal and Myint 1996, 288) Crises also force
scholars to reevaluate scholarly orthodoxy, to understand these events, and to develop new ways of forestalling them. The resulting academic debates may continue for a decade or more, as was the experience following the 1930s Great Depression, and is clearly evident in contemporary debates.

The next section of this chapter provides the context for the study, investigating in particular the historic shifts in the global economy occasioned by the rise of middle-income developing Asia, the longer-term growth dynamics of the six economies, and the special challenges of graduation for the more advanced economies in this group. The section that follows examines the impact of, response to, and lessons learned from crises in the six economies, focusing mainly on the events of 2008–2009, but referring also to the AFC, which for three of the economies (Indonesia, Malaysia, and Thailand) was a far more serious event. The chapter then analyzes the patterns and determinants of savings and investment behavior and balances in the six economies, including a reference to the special challenge of infrastructure investments. Following that analysis, is a section that considers some of the key economic policy issues in the wake of the crises, including the development of an efficient and resilient financial sector, some major macroeconomic policy challenges, nurturing institutions and structures of governance that support durable growth, and the potential for regional and international policy coordination. The final section provides some summary observations.

The Context

The rise of Asia

Most of the six economies have grown quickly since 1980. This observation is subject to four main caveats that will be developed below. First, the high-growth momentum took root in India from the early 1990s and in countries such as Viet Nam from late 1980s. Second, the major exception was the Philippines from 1980 to 2000 when there was no net increase in real per capita gross domestic product (GDP). Third, the AFC and GER slowed growth significantly in all but the two largest economies. Fourth, the three Southeast Asian economies that were severely affected
by the AFC recovered quite quickly from the crisis, but for the following decade their
growth and investment trajectories remained substantially lower than before the crisis.

The very high growth of the PRC since the late 1970s and India since the late 1990s
is one of the most important global economic events of the past four decades. The
share of global GDP of the PRC and India declined from 1960 to 1980 as both
disengaged from word commerce and accorded a low priority to economic
development. But the increases in the share of global GDP have been dramatic since
then, especially for the PRC, from 1.7% to 8.6%, while the Indian share rose from
1.8% to 2.4%. Propelled by these increases, over the same period, the share of
developing Asia also rose very quickly, from 1.8% to 19.9%. The shares of trade and
foreign direct investment (FDI) have also risen very quickly, especially for the PRC
where the increase has been about eightfold. According to various projections these
two countries, together with the rest of emerging Asia, may well constitute about half
of the global economy by the middle of the 21st century (see Table 1.1). Asian
economic prominence is not however a new phenomenon. According to the path-
breaking estimates of the late Angus Maddison (2007), the PRC and India together
accounted for a similar ratio prior to the onset of the European industrial revolution
and the rise of the United States (US).

[Table 1.1. Insert here].

The rise of emerging Asia was under way in the last quarter of the 20th century as
growth rates in several of these economies began to exceed that of global GDP by a
large margin. But two events began to have a major impact: the spread of high
growth from the smaller economies to the giants and the onset of the GER resulted
in sluggish growth in the major rich economies. Since the PRC and India—and also
Indonesia—have maintained their growth momentum in recent years, their share of
the increment to global economic activity in 2008 and 2009 was very large. That is,
they have become major global economic locomotives, with all the geopolitical
ramifications associated with this historic relocation of the center of global economic
gravity. Over the past two decades, the PRC alone has accounted for 16% of the
increase in global GDP, and Asia (with the exception of Japan) for almost one-third
(see Table 1.1). In the past decade the incremental shares rose to 23% and 42%
respectively, while since 2005 the emerging Asia share has been dominant at almost 60%. The shares for trade and FDI have been similarly large and rising.

*The six economies and their growth dynamics*

As noted, the six economies are diverse in most respects apart from geographical location, middle-income status, and generally strong economic growth. Several features stand out in the economic growth record since 1980 (see Figure 1.1). The PRC’s growth is consistently very high, while India’s growth is rising and begins to join the very high-growth group from the late 1990s. Another latecomer, Viet Nam, has been growing very fast for most of the period. There are some synchronized growth variations, especially during the two crises. But there are differences too, with the PRC and India—and Viet Nam to some extent—being much less affected. Indonesia, Malaysia, and Thailand were deeply affected in 1997–1998, while in 2008–2009 Indonesia continued to register moderately strong growth, whereas Malaysia and Thailand slid into slightly negative growth. The Philippines is something of an outlier, experiencing a deep crisis in the mid-1980s while the rest of the neighborhood prospered. However, it was not deeply affected in either the AFC or the GER, and its growth since the early 1990s has been better than is generally recognized.

*Figure 1.1. Insert here*

Growth has been episodic in most of the countries and quite volatile in the very open economies and commodity exporters that are more exposed to international shocks. Domestic political factors have also affected the growth paths, with political instability an occasional factor in Indonesia, the Philippines, and Thailand. The period under examination is generally not long enough to observe significant turning points in economic fortunes, particularly those associated with major, growth-enhancing economic reforms. These are typically dated at around 1978 for the PRC (Naughton 2007), 1991 for India (Panagariya 2008), 1966 for Indonesia (Hill 2000), and the mid-1980s for Viet Nam. The Philippines experienced a “lost decade” of economic crisis in the transition to democracy (Balisacan and Hill 2003). These turning points are much less relevant for Malaysia and Thailand, where the major policy settings have
been broadly consistent since the 1960s.

The decomposition of the sources of economic growth, in particular the contribution of net exports to growth, also underlines the region’s diversity (see Table 1.2, column 7). The range is very large, in our sample from 20% (for the Philippines) to –4.2% (for India). The median for emerging Asia is 10.8%, and 9.1% for all six countries in this study. However, this figure is pulled up by the much higher percentages for the three more advanced economies, Hong Kong, China; the Republic of Korea; and Singapore. The ratio for our six economies is much less than that of the two powerful advanced-country exporters, Germany and Japan. Therefore the conclusion that these middle-income Asian countries, as a group, are behaving in a mercantilist fashion, relative to current international norms, is not sustainable.

[Table 1.2. Insert here]

Table 1.3 further illustrates the diversity of the six economies with reference to some key (and admittedly highly simplified) “stylized facts” for each one, focusing on variables of relevance to this study. These include growth dynamics and the impact of the two major economic crises, fiscal policy and debt, monetary policy and exchange rates, savings, investment, current account balances, infrastructure, and finance development. We return to these stylized facts in the country analysis below.

[Table 1.3. Insert here]

According to two strands of literature, these generally high growth rates are either misleading because they are primarily input driven, or they are the fortuitous result of exceptionally favorable but temporary demographic dividends. Fukao (Chapter 4) comprehensively examines the productivity record in these economies finding that, as expected, the growth of total factor productivity (TFP) closely follows that of GDP and the business cycle. He also finds little evidence in support of the notion that growth has been achieved primarily through “perspiration,” that is input growth. The story is a mixed one across countries: TFP increased quite strongly in the Republic of Korea after the AFC, the Philippines continues to be an outlier with its consistently slow growth, while both Indonesia and Thailand experienced a sharp drop during the
AFC. In both these economies it took about a decade to recover to pre-crisis levels, a finding similar to that of Latin American economies after their crisis episodes. A factor in the decline and slow growth in TFP in some crisis-affected economies has been slowing structural change, with the result that resources have remained locked in the low-productivity agricultural sector. Clearly, the balance sheet effects of crises are serious and long lasting, and it takes time for investment levels and the financial sectors to recover.

Fukao (Chapter 4) also cautions that there are considerable differences in the TFP estimates depending on the methodologies and databases employed. The measurement of labor quality and capital stock has its limitations, while intra-sector TFP is not well measured.

Demographic issues are discussed below with reference to the savings rate. Suffice it to note here that these economies are currently in a development phase characterized by a “demographic bonus,” that is with a high proportion of their population of working age. This bonus will progressively come to end for the six, very soon in the case of the PRC and Thailand, and growth rates are therefore likely to decline. But these demographic factors are not the primary explanation of the region’s high growth, and thus the transition from “bonus” to “burden” will not lead to a growth collapse (Bloom and Finlay 2009).

The challenge of upgrading

With the partial exception of the Philippines, which along with Malaysia had the highest per capita income of the six in the 1950s, these economies have effectively managed the transition from low- to middle-income developing economy status, very recently in the case of India and Viet Nam, owing to their high growth. The richer ones among them—primarily Malaysia, but increasingly also the PRC and Thailand—have now set their goals to achieve developed-country status quite soon, 2020 in the case of Malaysia. A more or less linear projection of past growth rates would suggest that such a goal is readily achievable, that countries are on track to achieve the arbitrarily defined threshold of gross national income (GNI) per capita of
$12,000, although later than most official projections indicate.

Is there anything more to the issue than simply a projection forward of the past growth momentum? An emerging body of literature suggests there might be. Illustrative of some of the thinking is the following observation of the World Bank (2007, 1):

> History shows that while many countries have been able to make it from low income to middle income, relatively few have carried on to high income. ... A lot of complex challenges have to be met, from raising the skills and innovativeness of the labor force to creating sophisticated financial systems, to maintaining social cohesion, to greatly reducing corruption. Without these sorts of tough policy and institutional changes, countries stay where they are, unable to bust out of middle income.

Conventional growth theory, built on the assumption of “convergence,” provides little guidance, as it rests uncomfortably alongside the empirical observation that the gap between high- and low-income countries over the past two centuries has widened rather than narrowed. Almost all of the catch-up exceptions have been the high-growth developing economies of East Asia, with Chile in Latin America and Botswana and Mauritius in Africa the only exceptions in the other major developing regions (Collier 2008; Edwards 2010).

One informative body of literature on these issues is that of evolutionary economics, developed by Richard Nelson and others; see for example Nelson (2008), who is the source of the quotes in this paragraph. According to this thesis, the key to catch-up is innovation, “learning to do effectively what countries at the frontier have been doing, often for some time.” (2008, 16) Compared to the earlier success stories of the Republic of Korea and Taipei, China, the contemporary challenges are both easier and harder, Nelson argues. They are easier in the sense that the body of codified knowledge underlying most technologies has become much stronger than was the case 30 years ago, and it can also be accessed through training in advanced sciences at leading universities through the world. But in some ways they are also harder. There is arguably a greater need to build up indigenous skills and capacity in
engineering and science. Institutional and political economy factors are central. First, “catch-up will be impossible unless a country builds up its education system from bottom to top.” (2008, 16). Second, the process of catch up entails rapid structural change, including sometimes a painful process of creative destruction as older firms and technologies are swept away. This may be difficult in view of the “political power of old firms. … For comfortable, politically well-connected old firms, creative destruction is not a welcome thing.” (2008, 17).

This evolutionary economics literature is indicative of the sorts of policy reforms that are required to facilitate the structural adjustment that sustains the growth momentum beyond the middle-income range. These include a commitment to high-quality education through to the tertiary level; investments in research and development facilities and innovation; regulatory, financial and legal institutions that underpin an advanced market economy; competitive market structures that support the process of rapid structural change and “creative destruction”; and credible, prudent macroeconomic management.

The country in our sample for which this literature is most relevant is Malaysia, which has clearly lost comparative advantage in labor-intensive activities and whose government’s pronouncements focus heavily on the graduation objective. As Tham (Chapter 7) observes, “Malaysia is facing increasing pressure on the external front. … Internally, the country is at the crossroads politically, economically, and socially.” Its slower growth since the late 1990s does provide some prima facie support for the hypothesis that graduation is difficult. However, on closer inspection (see Hill, Tham, and Ragayah 2012), its recent record provides mixed support for the thesis. The major problems appear to be homegrown: a dominant party in continuous rule for over half a century, displaying all the symptoms of a long period in government—arrogance, complacency, and corruption. An additional factor has been the country’s long-running affirmative action program that, while introduced for commendable reasons to preserve social harmony in an ethnically diverse country, has been captured by an elite intent on enriching itself. Thus the country’s polity is not able to undertake the requisite institutional and policy reforms for the economy to manage the transition, or at least finds it very difficult to do so.
Navigating Crises

A detailed study of the economic crises of 1997–1998 and 2008–2009 is beyond the scope of this volume, but these two events are central to the issues under examination. That is, the crises are both the key to understanding the countries’ growth dynamics, and more than any other event over the past two decades they have set the economic policy agendas at the country, regional and international levels. We therefore briefly consider their impacts on the six economies.

The major point to observe is again diversity. Figure 1.2 presents quarterly GDP data for the six for the relevant years, 1997–1999 and 2008–2010. As noted above, economic growth in the PRC and India was little affected on either occasion. In the Philippines and Viet Nam growth slowed markedly but in neither case would it be accurate to characterize the event as an economic crisis. In the case of the Philippines, growth was close to zero in the most affected year, while for Viet Nam growth fell to about half the trend rate. Malaysia and Thailand experienced a year of negative growth on both occasions, but the magnitudes of the growth reversals in the later period were much smaller, around 8 percentage points from peak to trough compared to 15%–18% in 1997–1998. The capital flight out of these economies in 2008 was smaller, and consequently there was no generalized exchange rate and financial sector collapse. The most interesting case of difference was Indonesia, where the peak-to-trough growth collapse was a spectacular 20 percentage points in 1997–1998, but only 2% in 2008–2009. Like its higher-income neighbors in the Association of Southeast Asian Nations (ASEAN), in the latter period there was no financial and exchange rate crisis—and for similar reasons.

[Figure 1.2. Insert here]

In comparing the two crises, the global context is of course crucial. Since the global economy was robust in the late 1990s, the large exchange rate depreciations in these open economies were a major boost to their competitiveness, and largely explained their “V-shaped” recoveries, albeit to a somewhat slower trend growth rate. By contrast, such an export-led recovery strategy in the more subdued global
environment of the later part of the first decade of this century has not been possible, although the more open economies have recovered quite quickly, the more so if they are closely connected to the Chinese economy.

It is beyond the scope of this chapter to analyze these outcomes in any detail, but some general observations are pertinent. At least four major analytical and policy issues arise in thinking about crises. The first are measures to anticipate them, or at least to mitigate their impact. Much of this discussion focuses on the search for “vulnerability indicators,” that is, a rigorous set of indicators that can forewarn policy makers of potential dangers. Discussion of vulnerability indicators also involves the interaction with “trigger” events, such as the collapse of the Thai baht on July 2, 1997, which sparked the AFC, and the US subprime difficulties presaging the GER in 2007–2008. The second is the development of resilient systems of macroeconomic management and financial supervision since these are at the heart of crises and their management. We discuss these issues in Section 5 below. The third concerns protection for the vulnerable, which in turn entails the development of quick and effective social safety networks. Finally, there is the issue of a coordinated international response to crises. This is required most obviously when crises have global impact. But even for single-country crises, the international community is likely to be involved, at least through the International Monetary Fund (IMF) and other agencies.

Crises of course vary enormously in their origins and duration. Some are single-country events, entirely homegrown (e.g., Indonesia in the mid-1960s and the Philippines in the mid-1980s). Others are almost entirely external, such as for most developing economies in 2008–2009. In some crises, a mix of external and domestic factors is at work, such as in the AFC. Moreover, recoveries range across the stylized letters of the alphabet, including the “V,” “L,” and “W” outcomes. But there are common elements too. As Krugman and Wells (2010) note, crises have their origins in excessive debt: “Too much debt is always dangerous. It’s dangerous when a government borrows heavily from foreigners, but it’s equally dangerous when a government borrows heavily from its own citizens. It’s dangerous too when the private sector borrows heavily …”
There is a general presumption that the country impacts of a crisis will be milder to the extent that:

- A country has historically conservative macroeconomic management, so markets are less likely to mark down its debt, and the government has ample scope for short-run Keynesian macroeconomic policy.
- The international economy is buoyant, offering the scope for export-led recovery following the boost to competitiveness from an exchange rate depreciation. The V-shaped recoveries in the Republic of Korea and most of Southeast Asia after 1998 are good examples of this proposition. Conversely, the US has not had this lifeline in the current crisis; in fact the value of its currency rose for a period during 2008–2009 owing to the “safe-haven” effect.
- A resilient financial sector, so that financial institutions do not have to be bailed out—hence leading to fiscal stress—and firms may trade through the crisis, taking advantage of the lower exchange rate.
- A swift and coordinated response from major economies (e.g., of the G20 variety in 2009), and the IMF and donors for country crises.
- Domestic institutional capacity to respond to corporate and social distress in the form of credible central banks, financial regulators, and social providers.
- A strong, effective, decisive, and “legitimate” government able to make quick and tough decisions. This is contrary to the cases of the Marcos regime in the Philippines in 1986 and the Suharto regime in Indonesia in 1998, where economic and political crises interacted and aggravated the situation. More recently, there is also some concern that Thai policy capacity has been partially incapacitated by ongoing political uncertainty.

With these general observations in mind, why were the country outcomes different in the two periods? We focus initially on the country of greatest difference, Indonesia, drawing on Kuncoro (Chapter 8) and Basri and Hill (2011). It is convenient to classify the explanatory factors as “good management,” “good luck,” and other such factors. Among the former—and central to the explanation—was a more effective response to the crisis, based in part on the lessons learned from 1997–1999. The financial sector was more cautious, somewhat better regulated, and little connected to the imploding sectors in the US and the United Kingdom (UK). The exchange rate regime had become more flexible and was able to operate as a shock absorber in
response to external events. Macroeconomic policy was also improved. Bank Indonesia, the central bank, had greater autonomy, and it was able to quickly adopt looser policy. There was room to move in fiscal policy, too, thanks to the decade of effective fiscal consolidation after the earlier crisis. Underpinning these policies was a greatly reformed political system, with a legitimate government able to respond effectively and draw upon a community consensus that the origins of the crisis were primarily external and not of the government’s making. The international community was also moderately helpful, and there was not the disastrous standoff between the IMF (and hence also the major donors) and the government.

Good luck also played a role. In Indonesia’s case, three such factors were at work. First, apart from the financial contagion, the international transmission mechanism of the 2008–2009 crisis came through declining export demand, and Indonesia is not as trade-connected as some of its ASEAN neighbors. Also, in particular, it is much less plugged into that part of global trade that fell the fastest, namely the electronics and automotive industries, where consumers quickly deferred expenditures on durable consumer goods. Another helpful international connection was Chinese locomotive factor, and the two countries’ strong complementarity in the natural resource trade. Although commodity prices fell briefly in late 2008 and early 2009, they recovered quickly, and so Indonesia’s terms of trade remained buoyant. A third fortuitous factor was that the agricultural sector, which still employs almost 40% of the workforce, remained quite resilient thanks to good rainfall, generally strong prices, and the modest exchange rate depreciation.

Some of these factors were also present in the other Southeast Asian economies. But there were differences too. Malaysia especially and also Thailand are much more trade-dependent economies, with electronics alone comprising over half of merchandise exports. They were therefore more adversely affected by the global trade slowdown (Bhanupong, Chapter 11; Tham, Chapter 7). The Philippines is also a participant in the global electronics production chains, but on a smaller scale, and its primary international connection is increasingly through remittances (Desierto and Ducanes, Chapter 12), which held up better than other forms of capital flows. These countries had also restored the credibility of their macroeconomic policy institutions after the crises. In the Philippines this had occurred earlier, in the wake of its mid-
1980s crisis. Malaysia derived special credibility from the fact that in 1998 the government had eschewed the orthodox IMF approach and instead successfully pursued an alternative strategy of a fixed exchange rate and controls over short-term capital movements. Viet Nam was the one country in the group that in 2008–2009 might have experienced a reenactment of the AFC, and for largely similar reasons. That is, the government was attempting to hold on to a fixed nominal exchange rate, in the context of large capital flows and a fragile state-dominated banking sector (Leung et al. 2010). However, in its favor, it had tremendous growth momentum, it is not yet as internationally connected as its more advanced ASEAN neighbors, and agriculture is relatively more important.

In fact, the lower-middle income developing Asian story broadly resembled that of low-income economies in general. The IMF (2010) concluded that real per capita GDP growth stayed positive in two-thirds of these countries. The main effects of the GER were transmitted not so much through movements in terms of trade and interest rates, as in previous occasions, as through a sharp contraction in export demand, FDI, and remittances. Growth was supported by countercyclical fiscal policy, an unusual outcome for these economies, and a response that was facilitated by prudent macroeconomic policy over the preceding decade. While most of the fiscal stimulus occurred through automatic stabilizers, some additional spending was directed to the social sectors and infrastructure.

**Savings and Investment Behavior**

The high-growth Asian economies have invariably also been high savers and investors. Until the AFC, they typically ran current account deficits, that is, their abundant investment opportunities attracted savings from abroad to supplement their own savings. Nevertheless, until the 1990s and the emergence of some very large current account deficits, their growth was primarily funded from domestic resources. Since the late 1990s, however, some very large savings–investment imbalances have arisen, resulting in historically large foreign exchange reserves and, where the economies are large—most notably the PRC—serious global imbalances, with capital flowing from poor to rich economies. We now consider each element of the
In spite of the dramatic increase in savings rates since the 1960s and the high overall savings record, the patterns among the six economies are diverse (see Figure 1.3). The PRC stands out for its extraordinarily high savings rate, akin to that of Singapore’s in recent decades. These are arguably cases of “over-saving” in some sense. Savings rates have risen rapidly from very low levels in the once very poor economies of India, Indonesia and Viet Nam, more than doubling since the 1970s. Savings rates also appear to be resilient in times of economic slowdowns, in the sense that there was no prolonged dip during either the AFC or the GER. The one major outlier among the Asian economies is the Philippines. Its savings rates were broadly comparable to regional norms prior to its deep crisis of the mid-1980s. Savings levels then declined, and they have remained very low ever since, around 20% of GDP, even when moderately strong growth has been restored.

Horioka and Terada-Hagiwara (Chapter 5) provide an authoritative analysis of these savings patterns. They conclude that aging (the age–dependency ratio) has a negative effect, as expected. GDP per capita is negative, but GDP per capita squared is positive. So there is a nonlinear relationship, such that by the late 1970s per capita incomes were generally high enough to exert an impact on savings rates. Credit (credit–GDP) is positive, significant and also nonlinear, the fiscal balance ratio relative to GDP is positive, while social security provisions appear to be negative and
significant. Most other variables are generally not significant, including—and perhaps surprisingly—inflation.

Looking forward, the authors conclude: “A shortage of domestic saving will not be a binding constraint on growth and investment in developing Asia, at least for the next two decades.” Moreover, “Government policies to stimulate investment and growth are more necessary than government policies to stimulate saving.” Demographics are central to their modeling, with the demographic bonus having been completed in Japan around 1990 (hence its savings rate is likely to decline), and progressively for the others from around 2010. They conclude that savings and investment in developing Asia will continue to be highly correlated. That is, following Feldstein-Horioka (1980), investment will still be predominantly domestically financed. But the correlation will gradually weaken over time, as capital accounts become more open.

*Investment*

The high-growth Asian economies have also been high investors, with a similar story of positive growth–investment interactions (Fukao, Chapter 4). However, the investment picture is more varied, particularly since the AFC (see Figure 1.4). The PRC is again distinguished by its very high level of investment: at 40%–45% of GDP, there is the question as to whether it is “overinvesting” in projects with diminishing marginal returns (Chia, Chapter 10). Investment in India and Viet Nam has also risen rapidly since the 1980s. Investment in the three Southeast Asian economies most adversely affected by the AFC fell sharply at that time and has yet to fully recover. The fact that savings has remained buoyant provides a proximate explanation for the large current account surpluses observed in some of them, particularly Malaysia. The Philippines is again an outlier, with very low investment, itself an indicator of the economy’s current upper growth limits.

*Figure 1.4. Insert here*

Conventional explanations for this investment record emphasize the growth–investment interactions, the generally stable and favorable investment climate
(especially compared to alternative country destinations in a world of mobile capital),
the readily available pool of investible funds (both domestic and foreign), and the
 provision of essential supply-side and growth-enhancing inputs such as infrastructure
and education. Thus, departures from the high-investment trajectory are generally
explained in similarly conventional terms. For example, the World Bank (2009, 53)
explained the continuously sluggish investment rate in Malaysia since the AFC as
follows: “Malaysia’s large private surplus on the current account suggests that
investors find it more attractive to invest overseas than domestically.”

The evidence as to whether public investment “crowds in” or “crowds out” private
investment is mixed, and depends on country circumstances. As a generalization,
other things being equal, “productive” public investment such as infrastructure and
education will be conducive to private investment by overcoming key bottlenecks to
expansion. This appears to be the case for both Indonesia and the Philippines. But in
Viet Nam, fears of crowding out appear justifiable given the still extensive public
investment levels and its call on scarce savings, together with the uneven playing
field for private (especially domestic private) firms.

Concerns about the sluggish investment levels are essentially confined to these
three Southeast Asian economies. Several points warrant emphasis. First, their
investment levels do appear to be below the norms of very high-growth economies,
for example Japan and the newly industrialized economies (NIEs) during their
periods of exceptional growth. Second, investment levels have fallen sharply since
the late 1990s, but that was from an exceptionally high base. A more relevant
comparison is with the levels prevailing in the 1980s, and in this case the decline has
been much less pronounced. Third, at issue is not just the level of investment but its
composition, with investors showing a preference for short-term, quick-yielding
projects such as real estate, as compared to longer-term, more uncertain activities
such as infrastructure and mining. This is particularly the case for Indonesia. Fourth,
the decline in investment appears to have occurred for all three main investment
sources, that is, private domestic, foreign, and public. With increasingly open capital
accounts, foreign and domestic investors are evidently responding to a similar set of
commercial calculations. Fifth, the fact that the decline has been mostly concentrated
in the three crisis-affected economies—and also the Philippines after 1986—
underlines the deep and long-lasting impact of the crisis. That is, the crisis caused a growth slowdown that, combined with the resultant excess capacity, obviated the need for investment for several years. The process of financial restructuring and corporate workouts extended for longer than is commonly realized, and resulted in greater commercial caution. Sixth, Kuncoro (Chapter 8) points to an issue that appears to be unique to Indonesia, namely that monetary policy has provided perverse incentives for investment. This arises because Bank Indonesia, in an effort to mop up excess liquidity resulting from its attempt to stem the appreciation of the rupiah, offers attractive risk-free securities, known as SBIs, that channel savings into its reserves—which in turn are invested abroad in very low-yield securities—and away from much-needed investment projects.

Savings-investment imbalances

These varied savings and investment patterns in turn explain the mixed picture on current account balances (see Figure 1.5). Prior to the AFC, there were no significant surplus economies in emerging Asia, apart from Singapore. But then there was a generalized transition to surplus in several: the Southeast Asian economies for the reasons noted, the PRC based on its ever-rising savings rates, and the other NIEs. However, India and Viet Nam continued to behave as traditional developing economy capital importers. Most of these current account balances have been within conventional bounds of up to 5% of GDP. Importantly, the unusual feature of the PRC’s large surpluses is not their size relative to GDP but the aggregate size of the economy. The principal outliers have been Malaysia (and Singapore) with exceptionally large surpluses, regularly in excess of 10%, and Viet Nam with its investment boom and very large deficits.

[Figure 1.5. Insert here]

These surpluses have had two results. First, there has been a large increase in foreign exchange reserves (see Figure 1.6). Governments have not been unhappy with such an outcome since it provided a means of self-insurance in the wake of the AFC, owing to their diminished trust in global institutions, particularly the IMF, and
global economic architecture. An exacerbating factor in recent years has also been the attempts to ameliorate exchange rate appreciations in response to rising capital inflows and terms of trade, resulting in greater reserve accumulation than would otherwise have been the case.

[Figure 1.6. Insert here]

The second consequence of the surpluses is, obviously, more comfortable external debt positions (see Figure 1.7). Debt–GDP ratios have generally declined since the 1990s, after rising sharply in the late 1990s in the crisis economies. The blip in the latter period was as much the result of plunging currencies, owing to the fact that the debt was typically denominated in foreign currencies. The stabilization and then partial recovery of currencies, combined with current account surpluses and the implementation of debt–equity swaps, quickly pushed down debt ratios. In the countries that continued to run current account deficits, that is India and Viet Nam, the orders of magnitude relative to GDP were typically less than the GDP growth rate, so the overall ratio did not rise.

[Figure 1.7. Insert here]

In global terms, therefore, emerging Asia has switched from being a significant net borrower from the rest of the world to a major net saver (see Figures 1.8 and 1.9). The switch occurred in 1997, and the surpluses have risen continuously since then. The PRC has been by far the dominant contributor, in aggregate overshadowing the smaller Southeast Asian economies, even though in relative terms some of the latter’s surpluses are larger.

[Figures 1.8 & 1.9. Insert here]

Investment: the infrastructure challenge

Returning to investment levels, two frequently debated issues are infrastructure investment, and why it lags in certain countries, and whether regional and bilateral investment agreements have an impact. We consider each in turn.
The provision of high-quality physical infrastructure is a key development policy issue than connects to all the main themes of the volume: it constitutes a major supply-side constraint to growth for several countries, including India, Indonesia, and the Philippines in our sample; its under-provision presumably reflects to an important extent the underdeveloped state of the financial sector, particularly the provision of long-term financing; the sector is regarded as a vehicle for recycling current account surpluses; and its highly uneven provision across the group of countries raises important questions about governance and institutional quality.

Brooks and Go (Chapter 3) provide a detailed analysis of the issues. They note the “public good” characteristics of infrastructure, and contrast its diverse state among Asian developing countries. Comparative rankings are generally similar to those of per capita GDP, although the PRC’s infrastructure ranking is considerably higher. They affirm the empirical relationship between growth and infrastructure, and also the empirical challenges, including causality, establishing reliable proxies for infrastructure quality and data constraints. Different types of infrastructure are arguably more relevant for certain economies. In more open economies, for example, international ports and airports are critical. At low levels of per capita income, the international financial institutions are typically more important providers. Pricing and long-term funding issues are often significant constraints.

Five main factors appear to account for the inadequate infrastructure provision, although not all of these are present in all cases.

First, to the extent that infrastructure is a public good, at least in the sense that it is not always possible to charge for its use (e.g., much of the road system), infrastructure provision depends on the government’s fiscal capacity. Where a government is fiscally constrained—as is often the case in the wake of crises—capital works are typically accorded a low priority as compared to routine expenditures. Moreover, governments may be unable or unwilling to borrow, even for apparently profitable public sector projects. This was clearly evident in post-crisis Indonesia and the Philippines.
Second, governments are often reluctant to allow private sector participation, at least on terms that would attract private sector providers. Infrastructure projects typically have long time horizons, with commensurate funding requirements. Private providers attach a high premium to certainty. They will therefore tend to avoid jurisdictions where there is price uncertainty, as is often the case with roads, power, and water, where there may be strong political pressure to cap prices. Third, and related, governments are sometimes reluctant to liberalize the provision of infrastructure services. This may be partly for ideological reasons, based on the view that these are properly government functions. Or it may be an exaggerated belief in the notion of natural monopolies. In some cases, the reluctance may result from a desire to protect inefficient state-owned enterprise (SOE) providers. Whatever the case, the results of deregulation in sectors such as telecommunications and civil aviation have invariably been dramatic.

Fourth, owing to the scale and time horizons involved, infrastructure projects often attract serious governance problems. Their scale introduces the possibility of high-level corruption and thus reluctance on the part of senior officials to sign off on such projects for fear of possible retribution. This is especially true as trade barriers have fallen, and thus rent-seeking behavior has shifted to non-tradable sectors, of which infrastructure projects are often the most lucrative. Where government is diffused—e.g., between the executive and the legislature, or between central and local governments—coordination and “ownership” problems may exacerbate the under-provision of infrastructure. This problem is present in the three countries mentioned above. Low levels of trust in public institutions and the judiciary may also result in widespread land claims that stymie progress. Public–private partnerships (PPPs) often encounter similar sets of problems, owing to a weak separation of responsibilities.

Fifth, there are often constraints to the funding of long-term projects. Bond markets are still underdeveloped in much of developing Asia. For example, the region has one-quarter of global GDP but only 8% of outstanding bonds. Local currency bonds are still not widely used in middle-income developing economies. There is also the reluctance of some countries to borrow abroad, especially in foreign currencies, in the wake of the AFC.
Some Major Policy Issues

*What sort of financial system?*

As Fukuda (Chapter 6) emphasizes, building an efficient and robust financial sector is essential for long-run economic development. Moreover, he notes that the “failure of traditional financial development might be responsible for persistent stagnation of capital accumulation after the AFC.” The structure and regulation of equity markets may also be inimical to economic development. He reminds us that, as Claessens, Djankov, and Lang (2000) showed, before the AFC, governance structures in most East Asian conglomerates were based heavily on family ownership and control, and minority stockholders had few rights. Collusion with government officials often resulted in a kind of “crony capitalism.” In addition, in economies such as the PRC and Viet Nam, there is still the problem of a large state-owned banking sector making command loans with soft-budget constraints (Chia, Chapter 10).

Financial crises have been central to virtually every major crisis episode. Here there is a tension between the need for a responsive, competitive, and open financial sector, alongside recognition of the fact that information asymmetries and moral hazard increase the likelihood that such a system will be more crisis prone. The proposition pedaled by powerful vested interests—that “this time is different” and that more elaborate financial instruments, more sophisticated techniques of assessment, and greater risk spreading alleviate the need for tighter regulation—has been shown to be self-serving and illusory, as Reinhart and Rogoff (2009) remind us. But one wants a system that encourages innovation and risk taking.

As Paul Volker, one of the world’s most experienced central bankers, has observed, for policy makers the greatest structural challenge is how to deal with extremely large international banks, which in turn has at least three dimensions (Volker 2011). First, the risk of the failure of large international banks must be minimized by reducing their size, curtailing their connectedness, or limiting their activities. Second, ways have to
be found to promptly manage the orderly process of debt workouts, including minimizing the potential impact on markets and the real economy. Third, these procedures have to be broadly consistent across all the major global financial centers in which the banks operate. Most important, these measures have to adopt “… a truly convincing approach to deal with the 'moral hazard' posed by official rescue efforts.”

The challenge is how to insulate the general economy and fiscal policy from the sometimes-undesirable consequences of highly competitive financial systems. The solution is obviously tighter regulation, a reversal of the post-war trend toward lighter regulation. While this general proposition is widely accepted, the debate over the substance is unresolved. Presumably reforms entail measures to force banks to behave more conservatively than they would otherwise. But how, and is it politically achievable? Higher capital adequacy ratios, greater liquidity, less leverage, less exposure to risky sectors, stricter policing of balance sheets, and greater restrictions on foreign borrowing are the most commonly mentioned. More controversial is the proposition that there should be a return to a two-tier banking system, comprising the “utilities” that are low-risk, low-return entities with government guarantees, alongside a more adventurous set of entities with no government guarantees and presumably restricted in scale so that their collapse would not set off a generalized fiscal and economic crisis. This was the spirit behind the US Glass-Steagall Act, but pressure from Wall Street brought about its repeal in 1999. The US Dodd-Frank Act is an attempt to address this problem, but it does not cover international bank operations, and the separation of propriety trading of the banks has not progressed.

Finally, there is the question of whether the financial sector has become so powerful that it is able to effectively prevent major reform of the financial sector. Reviewing the interim report from Britain's Independent Commission on Banking (the Vickers Report), the former Deputy Governor of the Reserve Bank of Australia opined that since 2008, the “mergers and failures in the US have left the largest banks even larger, more complex, more conglomerated, and probably more unmanageable.” Similarly, the issue of bailouts has also become more difficult as banks have become larger, and more international, interconnected, and complex.

This is an area where most developing Asian economies have made significant
progress since the late 1990s, with the AFC providing a salutary lesson (see Lee and Park, 2011). As Bhanupong (11) observes in the case of Thailand, the financial sector is now “… stronger and resilient, thanks to foreign capital injection, good governance and strengthened financial rules.” The bond and stock markets and other non-bank financing may remain underdeveloped. But it is striking that, during even the depths of the GER, as shown above, there was not a single major bank failure in any of the six countries.

Macroeconomic policy in an interdependent world

Major economic crises result in a reevaluation of the central tenets of macroeconomic policy, including the institutions and conduct of fiscal and monetary policy, exchange rate regimes, and how to manage volatile capital flows. We consider each one briefly, on the basis of these country studies.

Fiscal policy

Crises typically lead to large increases in public debt as governments resort to deficit financing owing to the effects of automatic stabilizers, the need to expand social safety nets, and as a result of the socialization of corporate and banking debt. This is arguably the most important macroeconomic impact of the GER in economies of the Organisation for Economic Co-operation and Development (OECD). US general government debt (federal, state, and local) has now surpassed the post-war record of 120% of GDP. Japan is more than 200%, while several other OECD economies are approaching 150% (Reinhart and Rogoff 2011). Moreover, this is in peacetime, and low interest rates are restraining debt service costs. What happens when rates begin to rise, as they must? As Reinhart and Rogoff observe, “Debt crises tend to come out of the blue, hitting countries whose debt trajectories simply have no room for error or unplanned adversity.”

Public debt levels certainly rose sharply in the economies affected by the AFC (see Figure 1.10). However, apart from this episode, most but not all the countries in the study have run reasonably prudent fiscal policy, in some cases reinforced by
legislated restrictions on the size of deficits, so they had room at the onset of the GER to adopt fiscal stimulus measures (see Figure 1.11). This was a particularly important option in those countries where monetary policy was in some sense incapacitated either because interest rates were already very low or the financial sector was partially frozen. Moreover, some governments in the region have been able to carry higher levels of debt where there are high savings rates and the community is willing—or sometimes forced—to fund these deficits. Japan is the classic case in recent times; Malaysian governments have also been able to run quite large deficits owing to the cushion of buoyant—and partially forced—domestic savings (Narayanan 2012). Hence the medium-term fiscal consolidation challenges for most of developing Asia are not nearly as serious as in most OECD economies.

Nevertheless, much fiscal policy reform is required. In most of the economies under study, fiscal policy has been at best mildly countercyclical and often pro-cyclical. Traditionally, the explanation in developing economies has been that when hit by a crisis, they did not have alternative fiscal financing means at their disposal: they could not borrow internationally, there was not a domestic bond market, and printing money would be inflationary and would be prohibited by an IMF program, if operative. Vaidya (Chapter 9) notes this problem in the Indian context and explains it as follows: “Given that India is a federation, running surpluses in good times seems to be difficult because of pressures from states for larger shares of revenues of the central government.” Bhanupong (Chapter 11) attributes the absence of countercyclical fiscal policy in Thailand during the past decade to weak institutions and a highly politicized environment.

Governments have also frequently lacked the administrative capacity to quickly push up expenditures, especially in much-needed infrastructure, and thus the crisis response was more commonly on the revenue side, which was less effective as tax cuts are more likely to be saved in times of uncertainty. Moreover, the medium-term fiscal policy agenda is substantial in many countries: the revenue effort is often weak; there are low levels of public sector efficiency; more cost-effective social safely nets are required, in place of large, poorly targeted subsidies; the fiscal implications of a
rapidly aging population are yet to be addressed; large public sector projects are often corruption prone; SOE sector reform is slow; and the facilities for longer-term debt markets for infrastructure are underdeveloped.

One reform that is gaining currency in the wake of the GER is to establish independent fiscal advisory councils to elevate public understanding of the issues, to force governments to acknowledge hidden costs of their guarantees and off-balance sheet costs, and to help overcome the very strong deficit bias inherent in the political cycle. Several countries already have independent fiscal watchdogs, such as the US Congressional Budget Office, but these typically have limited analytical capacity and they generally accept official budget documents at face value. More powerful bodies might be created, with independence analogous to that of many central banks.

**Monetary policy and exchange rate regimes**

This has generally been an area of policy success over the past decade. In the wake of the AFC, most countries gradually adopted a regime of independent central banks, inflation targeting, and greater exchange rate flexibility. That is, there has been recognition that “fixed but adjustable” crawling peg regimes do not work in the case of large and sometimes volatile capital flows (and terms of trade movements) in which private borrowers assume no exchange-rate risk. Exchange rates fell steeply during the AFC as central banks found they could no longer defend their fixed rates. But after this sharp adjustment, over the past decade and including during the GER, they have generally remained quite stable (see Figure 1.12). Financial markets and corporations are becoming more comfortable with flexible exchange rates. This flexibility also acts as a discipline on government excesses. Hence serious inflation problems are now comparatively rare (see Figure 1.13), and there was scope for running looser monetary policy during the GER.

**[Figures 1.12 & 1.13. Insert here]**

Flexible exchange rates only work, of course, if the overall policy settings are conducive. This proposition is clearly evident in the case of the PRC (Chia, Chapter 10). That country’s large current account surplus can only be addressed with a
comprehensive package of measures that includes not just further exchange rate appreciation but also the removal of distortions in the labor, land and capital markets. Moreover, to the extent that exchange rate fluctuations introduce greater food price volatility, especially for poorer countries where 30%–50% of the population is clustered very close to the poverty line, cost-effective social safety nets are required to protect the poor.

There were certainly monetary policy lessons from the crisis. Mishkin (2010) provides a convenient survey, mainly with reference to OECD economies, that reaffirms the constants and highlights some lessons learned and new challenges:

The bad news is that we have just been through a once-in-a-hundred-year credit tsunami that has had a devastating impact on the economy that will last for years to come. The good news is that macro/monetary economists and central bankers do not have to go back to the drawing board and throw out all that they have learned over the past forty years.

What essentially remains unchanged is the recognition that inflation is fundamentally a monetary phenomenon, that there is no necessary long-term trade-off between unemployment and inflation, that expectations play a crucial role in determining inflation, that increased real interest rates are needed to deal with higher inflation, and that central bank independence and commitment to a strong nominal anchor are crucial. What has changed, according to Mishkin (2010), is the need to pay much more attention to the financial sector, and its occasional nonlinear behavior, owing to the extremely high cost of severe financial crises. Therefore there is a stronger case for leaning against credit (but not necessarily asset price) bubbles, and for focusing on the close interdependence between monetary and financial stability policy.

Returning to exchange rates, a major challenge for policy makers in some high-growth developing Asian economies in the wake of the GER has been how to adjust to upward exchange rate pressures. These originate from three sources. First, the US dollar has been depreciating progressively. This is a necessary requirement for that country to work its way through its twin deficits, and it is in the global community’s interest that there be international coordination to facilitate this. In the
buoyant Asian economies, this inevitably means exchange rate appreciation relative to the US. Second, the region’s strong economic growth and higher interest rates have attracted large capital inflows. Gross capital flows to emerging markets are now running at about 6% of their GDP, similar to levels immediately prior to the AFC and GER. Third, an additional factor for some commodity exporters has been strong terms of trade, adding further to the exchange rate pressures.

How should governments respond? Central banks understandably worry that the appreciating rates exacerbate competitiveness concerns in tradable sectors and that the mobile capital that enters the country can just as quickly exit. Ideally, as noted, there needs to be international coordination to facilitate exchange rate adjustment, and reform of international institutions and architecture, so countries do not feel compelled to self-insure with large foreign exchange reserves. But in the absence of these major reforms, or at least while that coordination is being developed, countries need to develop a policy response. There is no simple solution. As the following policy menu illustrates, each option has advantages and disadvantages.

First, central banks could let the currency appreciate, perhaps with smoothing interventions. But this accentuates competitiveness problems, necessitating a major adjustment in tradable goods industries. The problems will be more severe if a major economy, for example, the PRC, does not allow its currency to appreciate. Alternatively, these capital inflows could be viewed as an opportunity to build productive capacity and raise productivity on the premise that a well-managed economy is likely to continue to attract capital inflows and use them productively. That is, the exchange rate movements signal a likely permanent change in relative prices and there is a need for an adjustment.

A second option is to attempt to hold the fixed rate in the face of these capital inflows through central bank market operations in the hope that the inflows are temporary. This is unlikely to be a credible option as it will exacerbate the overheating that the capital inflows are causing. This will result in rising inflation, which with a fixed nominal rate will cause a loss of competitiveness.

Third, the flows could be sterilized by keeping the funds offshore and building up
international reserves. This is also an attractive option if there is limited trust of the international financial institutions and other crisis-resolution facilities. However, it entails locking up these funds in low (often negative) return assets, as several authors note. For larger countries, especially the PRC, the scale of the reserves is likely to attract international criticism.

Fourth, the government could respond by instituting a compensatory fiscal contraction, so that there is no net increase in domestic demand. However, this might be a difficult option: fiscal policy is typically not quick acting, especially if it gets held up in the legislature. And there is, in any case, political pressure to spend at a time of buoyant resource inflows.

A fifth policy option would be the introduction of tighter restrictions on bank lending to restrain credit growth and thereby take pressure off asset prices. This is on the premise that the banking sector is a key conduit for capital inflows. Such a measure would generally be worthwhile but it would not necessarily prevent an exchange rate appreciation.

Finally, there is the option of deliberately discouraging inflows, at least those that are considered short term or speculative, through some form of capital controls. This option is theoretically appealing, but in practice not necessarily easy to implement, especially in countries that have recently adopted open capital accounts to escape the corruption and mismanagement often associated with these controls (Gochoco-Bautista, Jongwanich, and Lee 2011). A high-quality central bank is obviously an essential prerequisite for such a strategy.

The extensive international literature regarding the effectiveness of these controls is also ambiguous and cautious. If they are to be implemented, this historical evidence suggests that they are likely to be more effective when they take the form of market-based mechanisms, such as unremunerated reserve requirements, “analogue” measures that can be more easily altered to adjust to flows, and they are not “over-engineered” and too detailed. Obviously, also, they should not be employed to prop up a fundamental disequilibrium in the exchange rate. There needs to be a clearly communicated exit strategy, and there needs to be a distinction between short- and
long-term capital flows. Moreover, in the context of any globally coordinated measures, it is important to focus on the “push” factors, principally the extremely loose monetary policy in the rich economies (especially the US) as much as these “pull” factors.

An additional lesson from the AFC is that countries need to introduce accompanying reforms in the process of opening their capital accounts. Bhanupong (Chapter 11) concludes that, in the case of Thailand, “The major deviation from the long-term [growth] trend can be attributed to the premature liberalization of the capital account.”

*Governance and institutional reform*

Systems of governance and institutional quality vary widely in the sample of countries (De Dios and Ducanes, Chapter 2), and it is therefore difficult to be too prescriptive. Different governance issues seem to matter at different levels of development. For example, modern economies tend to need more formal institutions, since commercial transactions are more likely to involve “contracting with strangers.” Levels of institutional quality typically change very slowly, and they tend to correlate with per capita income across countries. The measurement of governance is highly subjective and empirically elusive, and sometimes the various indicators may diverge. For example, historically much of developing East Asia ranked well with regard to bureaucratic quality and government effectiveness, but rather poorly on democracy. Informal institutions may be just as effective as formal institutions, for example in the case of legal and judicial systems.

We do learn about the political economy of economic policy making, and building institutions more generally, from crises and their aftermath. Crises also test the quality of governance: the speed of response to a crisis is often a critical determinant of the severity and longevity of a crisis. Examples include how quickly governments can respond to ensure that the banking system remains viable, the effectiveness of fiscal stimulus packages, and the ability to protect the poor through social protection measures. Bhanupong (Chapter 11) considers institutional quality to be crucial in understanding the Thai response to crises: “The low quality of institutions impaired
the timely response to shocks.” Desierto and Ducanes (Chapter 12) have similar observations for the Philippines, noting the highly politicized policy environment, perverse agricultural interventions, and the difficulty of managing major infrastructure projects.

With these observations in mind, a few general observations appear relevant. First, as noted above, a large literature posits that crises may be good for reform to the extent that they embolden governments and force them to push aside vested interests. Crises also typically empower reform-minded ministries of finance, and the resultant weaker currencies may facilitate trade policy reform. There is some evidence for these hypotheses in Indonesia in the mid-1980s, India in 1991, and some of the reforms introduced in Southeast Asia after the AFC. However, crises can be a two-edged sword, to the extent that they weaken governments and create a divided polity, as for example in Indonesia and the Philippines after their crises. The GER does not appear to have led to any significant reforms in the countries represented in this volume, although it may lead to more effective financial sector regulation in some OECD economies.

Second, externally imposed crisis-response programs are rarely successful unless they have a domestic constituency. This was one of the central lessons of the AFC, and it explains the region’s continuing reservations about the IMF.

Third, it is desirable to insulate or delink key institutions and policies from political pressures so they may effectively implement objectives prescribed by the executive and legislature. Examples include independent central banks, limits on fiscal deficits, independent regulatory agencies (for example competition commissions), and perhaps even free-trade zones (although they are very much second-best reforms). Judicial and civil service reform appear to be the most difficult areas of progress, and in several countries they constitute a key obstacle to reforming the investment climate.

Fourth, competitive reforms and liberalization can be helpful drivers of policy. This can be achieved through arms-length benchmarking of key performance indicators between countries. As countries decentralize government administration, inter-
jurisdictional competition on governance quality can also be a spur to improved policy at the local level.

*Regional cooperation and coordination*

As noted, many of the major policy reforms have regional and global “public good” attributes and therefore require intergovernmental coordination. Progress on the development of durable regional and global institutional structures for economic policy coordination is mixed. The major achievement since 2008 is that governments have not adopted “beggar-thy-neighbor” trade and exchange rate policies, at least not on any significant scale. The G20 has also emerged as the preeminent forum for the discussion of major international economic issues, and it contributed to the adoption of coordinated fiscal stimulus measures in the major economies (Drysdale 2011).

However, the pressure for unilateral action among the major economies and blocs, regardless of the broader consequences, is very powerful. For example, the very loose monetary policy in these economies, the US in particular through successive rounds of “quantitative easing,” has greatly increased global liquidity. With traditional stock market options increasingly unattractive, this liquidity has resulted in the increased “financialization” of commodity markets. In turn, this has contributed to their price volatility, with potentially serious social consequences for the poor. The world’s most significant example of deep economic integration, the European Union (EU) and the Economic and Monetary Union (EMU) of the European Union, is deeply troubled and the future of the latter is highly uncertain. The possible implosion of the EMU is already shaking global financial markets, and the resolution of the Euro impasse will certainly involve the major East Asian surplus economies.

Moreover, in many other respects, coordinated international economic governance seems to getting more difficult. Although markets have not been closed, at least to any significant degree, there is still no resolution of the ailing Doha Round. International financial governance has progressed little, notwithstanding the adoption of Basel 3. “Financial protectionism” reared its ugly head during the GER, perversely,
as capital flowed back to the fiscally more powerful jurisdictions from where the crisis emanated. There is still a nontrivial prospect of some sort of a G2 “currency war” between the PRC and the US. Key international institutions, most notably the IMF, are still regarded with suspicion in the developing world. Most currency-swap and fiscal-standby agreements during the GER were organized on a bilateral basis. The current crisis in the Euro zone is likely to deter any attempts at currency regions for the foreseeable future, except those of the voluntary variety (for example, currencies voluntarily pegged to the US dollar). There is also very little progress on other major global issues, such as climate change, counterterrorism, and nuclear proliferation.

In the Asia Pacific region, it is possible that initiatives with an open international agenda can move faster than reform at the global level (Drysdale 2011). But the evidence to date is mixed. Although ASEAN remains a highly effective diplomatic community, the economic initiatives centered around and involving it, for example, the ASEAN Economic Community, the East Asian Summit, and the Enhanced Chiang Mai Initiative, are variable in impact and still evolving. The mooted “Asian G6” caucus within the G20 appears to have made little progress. It is therefore important to avoid unrealistic expectations about these regional initiatives, and to keep in mind that unilateral reform at home is always going to be the key reform building block.

A special subset of regional cooperation concerns various kinds of international, regional, and bilateral investment agreements that at the margin may improve the overall investment environment. Investors look for certainty and protection, so the argument goes, and these agreements may assist in providing it, especially where the investors are venturing abroad into less familiar legal environments. Desierto (Chapter 13) examines this issue through a detailed examination of ASEAN investment treaties. This is relevant to the volume because four of the countries are ASEAN members and because the issue is evidently being approached more seriously than it had in the past, as part of its ASEAN Economic Community timetable.

Desierto maintains that the ASEAN Charter of 2008 “transformed ASEAN into an official international legal organization, with a distinct legal personality and capable of binding all 10 states under new treaty organizations.” This is in preparation for the full
ASEAN Economic Community, which scheduled to be realized by 2015. Since the Charter was announced, three new agreements have incorporated various clauses and protections into investment treaties, the most important being the 2009 ASEAN Comprehensive Investment Agreement (ACIA). There is no doubt that ASEAN is serious about these initiatives. Whether they are effective remains to be seen. Other ASEAN programs—mostly notably the concessions under the ASEAN Free Trade Area (AFTA)—have been little used to date, and so the test will come if and when investors have recourse to the ACIA. Moreover, legal guarantees of this kind work only in partnership with broader reforms of the commercial climate, and as noted the record has been mixed in this this regard in several of the signatory countries.

**Conclusion**

Five main conclusions emerge from our analysis.

First, these economies emerged from the GER in relatively good shape. Thus far, they have been either little affected by the global slowdown, as in the case of the three largest economies, or they have recovered quite quickly. The traditional macroeconomic prudence of these countries has been rewarded, and it has been reinforced in the case of the AFC-affected economies by their reforms over the past decade.

Second, an immediate effect of the GER has been to accelerate the reorientation of global economic activity toward Asian developing economies. However, the global economy is likely to remain subdued for several years, since three major parts of it—the US, the EU, and Japan—are likely to grow slowly as they resolve their debt problems. As a result, domestic demand and regional trade will become relatively more important engines of growth. As a corollary, running large current account surpluses on the basis of undervalued exchange rates will not be a viable strategy going forward. The rich crisis-affected economies have to be allowed to depreciate their currencies, just as they have to be constrained from taking unilateral action (for example, very loose monetary policy) that has the effect of “exporting” the costs of their macroeconomic adjustment to the rest of the world.
Third, the large fraction of global current account imbalances that has its origins in East Asia is unlikely to disappear quickly based on current trends. On plausible assumptions, future savings rates are likely to continue to be high for a decade or more in emerging Asia (that is, excluding Japan, where they are likely to start falling significantly), at least until demographic factors begin to exert a major depressing influence, while investment could well remain subdued.

Fourth, there has been some progress on the reform of macroeconomic and financial regulation policies, but the unresolved agenda is also substantial. For example, there is a consensus on the desirability of conservative fiscal policy, except during periods of crisis, on independent central banks, and on some flexibility in exchange rates—though how much is an issue. But there is less consensus on how to manage volatile capital flows and on the technicalities of enhanced financial supervision. Regional and international cooperation has progressed somewhat, but it is not clear how durable that progress will be in the event of a significant global economic recovery.

Finally, it is crucial to keep in mind the heterogeneity of country experiences, including the countries in this study, and consequently the fact that there is no one-size-fits-all approach. There is no single “Asian model of development” for this group, or for the region as a whole. For example, the country sample includes those running current account surpluses and deficits. Some have generally prudent, conservative macroeconomic policy settings, while others are somewhat more adventurous. Some countries have fragile, underdeveloped financial sectors that are vulnerable to exogenous shocks, while others are resilient and well supervised. Some are highly open, trade-dependent economies, while others are much less internationally engaged. Some countries have a well-developed infrastructure stock, and a seemingly in-built propensity to anticipate future requirements, while others are barely able to keep up with demand.

Thus, for example, the issue of “rebalancing” is really only relevant to those economies running large current account surpluses, and any case for “reassessment” of an export-led strategy will apply only to these economies, which in addition are also highly trade dependent. Similarly, concerns about low investment levels, both in general and specifically in key growth-enhancing sectors such as infrastructure, are
relevant only for certain countries.
References


