

# From the Asian Miracle to an Asian Century? Economic Transformation in the 2000s and Prospects for the 2010s

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## Abstract

Asian economies went through significant transformation during the 2000s. They became part of global supply chains, major global commodity consumers and large capital exporters, and were also deeply involved in regional co-operation initiatives. These factors contributed to global disinflation in manufactured goods prices, abundant global liquidity and strong growth in commodity-exporting economies including Australia. In the coming decade, Asian economies are likely to continue their ascendancy, albeit at a slower pace, which should eventually decouple Asia from the advanced economies. With increasing domestic cost pressures, Asia may also become a new source of global inflation. Asia's exports of capital to advanced economies may shrink as the region rebalances and outflows should focus more on portfolio investment and foreign direct investment (FDI). In the coming decade, a potential crisis in a major Asian economy such as China could trigger the next global recession.

## 1. Introduction

In September 1993, the World Bank launched a landmark report entitled *The East Asian Miracle* (World Bank 1993). The report discussed the relationship between public policy and rapid economic growth in the so-called High Performing Asian Economies (HPAEs).<sup>1</sup> Despite wide diversity in natural resources, culture and political institutions, these HPAEs also shared some common features in their public policy, including limited price distortion and careful policy interventions. But even then the Asian miracle story was controversial. Krugman (1994), for instance, argued that Asian growth was not sustainable since it was mainly driven by increasing inputs and not improving productivity.

The onset of the 1997–1998 Asian financial crisis brought many of the Asian economies to their knees: currencies depreciated; financial markets melted down; investment declined; and growth collapsed in almost all HPAEs. Even the Chinese and Indian economies, despite being relatively more isolated from the rest of the region at that time, suffered a significant growth slowdown. The Asian financial crisis was triggered by the withdrawal of foreign capital from the region. However,

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<sup>1</sup> The World Bank study identified eight Asian economies as the HPAEs, including Japan, Hong Kong, Korea, Singapore, Taiwan, Indonesia, Malaysia and Thailand (World Bank 1993).

excessive borrowing, overheating economies and declining investment returns in previous years had already laid the foundations for the financial disasters.

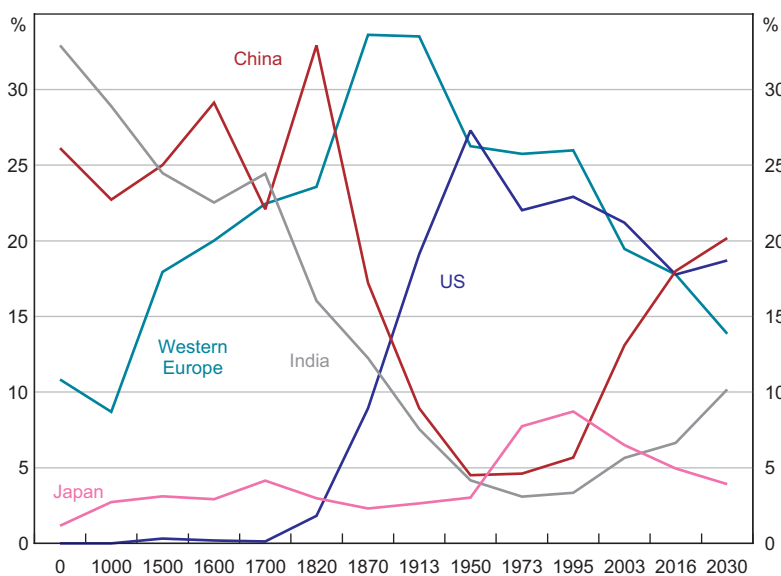
As a result of the emergence of China and India – two countries not included in the HPAEs by the World Bank in the 1993 report – the story of the Asian miracle did not end there. In fact, Asian economies have contributed around half of the world's economic growth during the past decade. In 1999 and 2000, most crisis-affected economies managed a quick turnaround and between 2002 and 2007, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand all achieved average annual GDP growth above 5 per cent. Meanwhile, China and India achieved average annual GDP growth of 10.5 per cent and 7.3 per cent, respectively, during that period.

The recent global financial crisis (GFC) has accelerated the shift of global economic gravity toward Asia and probably reinforced the prediction of a new Asian century (Drysdale and Armstrong 2010). When the world economy suffered negative GDP growth in 2009, growth in both the Chinese and Indian economies stayed above 9 per cent and although many regional small open economies, especially Hong Kong, Malaysia, Singapore and Thailand, also experienced negative growth that year, the magnitudes were smaller than in 1998.

Measured in purchasing power parity (PPP) terms, GDP in emerging Asia was already greater than either the United States or the EU in 2009. According to International Monetary Fund (IMF) forecasts, in 2016 China is likely to take over the United States to become the largest economy in the world. Even conservative estimates suggest that the emerging Asian economies will be equivalent to those of Europe or North America in terms of their share of global production in the coming decade (Maddison 2006; Garnaut 2007). If such trends continue, Asia could account for more than half of the world economy by the middle of the century.

As shown in Figure 1, this would not be new for the global economy. For more than a thousand years before the industrial revolution, the combined share of China and India in the world economy was routinely greater than 50 per cent. Their importance declined significantly during the past two hundred years, as the western economies advanced more rapidly. Of course, the re-emergence of the two giants would not simply be a repeat of history. China and India will likely assert influences on the world economy that they never have before. This conclusion, however, is dependent on the important assumption that Asian growth is sustainable, which to date remains an open question.

The Asian financial crisis and the GFC were about 10 years apart from each other and between them Asian economies experienced a number of changes. Many of the changes were initially triggered by developments during the Asian financial crisis or subsequent policy responses. For instance, when foreign capital left the region, many Asian economies suffered from a balance of payments crisis. Following this, most countries introduced new measures to restrict external borrowing, especially short-term borrowing, and to accumulate foreign exchange reserves.

**Figure 1: Shares of Major Economies in World GDP**

Note: Based on purchasing power parity (PPP) valuation of country GDP

Sources: International Monetary Fund (IMF), *World Economic Outlook* database, April 2011; Maddison (2006)

The purpose of this paper is to examine the key transformations of the Asian economies during the first decade of the 21st century. This provides the basis for an assessment of the challenges facing these economies in the decade ahead and for drawing important implications for the rest of the world, including Australia. We will focus on the three most fundamental changes to the Asian economies during the past decade: (1) the vertically integrated supply chains across the region and increasingly important role of the Asian economies as commodity consumers; (2) the emergence of large current account surpluses, accumulation of gigantic foreign exchange reserves and massive capital exports from the region; and (3) important steps in promoting regional co-operation, such as free trade agreements (FTAs) and the Chiang Mai Initiative (CMI), despite these having only achieved very little so far.

These changes have already had an important impact on the rest of the world. Asian demand, particularly Chinese demand, has been identified as the key driver behind the so-called super-cycle of global commodity markets. Asian capital exports have contributed to low interest rates around the world, and were sometimes blamed for excessive borrowing and asset bubbles in developed economies, especially the United States. In the meantime, Asia still faces important challenges in the decade ahead: Can Asian growth continue? Might Asian demand for commodities moderate? Will Asia be able to substantially reduce its current account surplus? Should Asia continue with its regional co-operation or focus more on global initiatives?

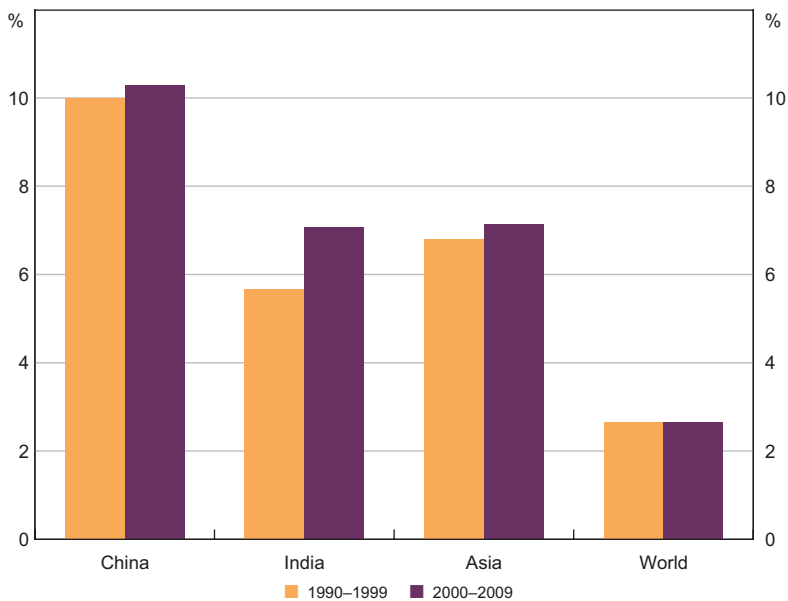
The remainder of the paper is organised as follows. Section 2 assesses the formation of regional supply chains and emergence of important commodity consumers in the Asian region. Section 3 examines changes in Asia's external accounts and its capital flows. Section 4 outlines the key

policy initiatives on regional co-operation. Finally, Section 5 discusses the new challenges facing the regional economy and tries to draw some implications for the rest of the world, including Australia.

## 2. Integrated Supply Chains and Dominant Commodity Consumers

During the past decade, GDP growth in most Asian economies continued at a steady pace. Growth in China and India showed clear trends of acceleration, at least until the GFC. Japan's growth performance also improved from the last decade of the 20th century, although it came from a very low base. Growth of the Asian economies as a whole picked up slightly during the 2000s from the previous decade, while growth in the world economy as a whole stayed almost unchanged (Figure 2).

**Figure 2: Average Annual GDP Growth in Asia and the World**



Note: Asia refers to eastern, southern and south-eastern Asia

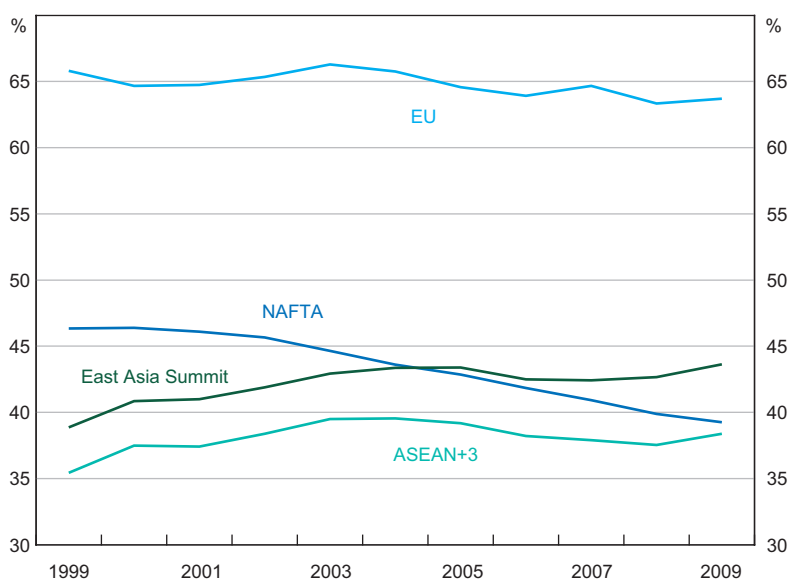
Source: authors' calculations based on data sourced from the UNCTAD (United Nations Conference on Trade and Development) database

There were some fundamental changes in Asia's industrial structure and regional division of labour over the past decade. The Asian economies were once described as 'flying geese', with Japan as the head, the newly industrialised economies (NIEs) (Hong Kong, Korea, Singapore and Taiwan) in the middle and the other countries in the region (Indonesia, Malaysia and Thailand) at the tail (Ahearne *et al* 2006). But this pattern started to change during the past decade when China entered the game after its World Trade Organization (WTO) accession at the end of 2001. FDI into China grew dramatically, especially in the electronics and heavy industry sectors. Many regional

producers started to move their final stages of production to China but kept production of more sophisticated parts and components in the rest of the region. This was the beginning of the vertical integration of supply chains, of which China became the central hub. Such a production network enables each process to be located in the most cost-effective economy (Kawai and Wignaraja 2011).

As a result, China's exports to the developed world skyrocketed, as did Chinese imports from the rest of the region. This was the beginning of the shifting supply chain across the region, which was facilitated by market-driven forces of cross-border trade, FDI and financial flows (Kawai 2007). The shifting supply chain and growing regional interdependence are clearly illustrated by the increasing share of intra-regional trade in Asia. While globally the EU is still the most integrated region (Figure 3), in Asia, intra-regional trade has been gaining importance since the Asian financial crisis. The share of intra-regional trade in the ASEAN+3 economies increased from 33 per cent in 1998 to 38 per cent in 2009, while for the EAS (East Asia Summit) region the share rose from 37 per cent to 44 per cent.<sup>2</sup>

**Figure 3: Intra-regional Trade Shares of Selected World Regions**



Source: authors' calculations based on data sourced from the UNCTAD database

The supply chain story is at least partially confirmed by Asia's growing share in China's total imports, which increased from 38 per cent in 1998 to 42 per cent in 2009 (Table 1). But this increase was probably not all about intermediate goods, as China is also an importer of large volumes of consumer goods (Park and Shin 2009) and in 2009, China became the world's largest market for luxury goods. However, the consumer goods story is probably better reflected in the Indian story.

<sup>2</sup> ASEAN+3 comprises the ten ASEAN (Association of Southeast Asian Nations) countries, plus China, Japan and Korea. The EAS region includes ASEAN+3 plus Australia, India and New Zealand.

**Table 1: Share of China and India Total Imports by Selected Regions**  
Per cent

Period	China			India		
	US	EU	Asia	US	EU	Asia
1995–1996	11.9	15.5	34.6	9.8	32.8	20.1
1997	11.5	13.6	37.3	9.4	29.0	20.3
1998	12.0	14.9	37.9	9.1	26.9	23.8
1999–2007	8.9	13.1	43.6	8.2	24.5	29.3
2008	7.2	11.7	42.5	7.1	15.6	32.1
2009	7.7	12.7	41.9	6.8	15.8	33.7

Note: Asia refers to eastern, southern and south-eastern Asia

Source: authors' calculations based on data sourced from the UNCTAD database

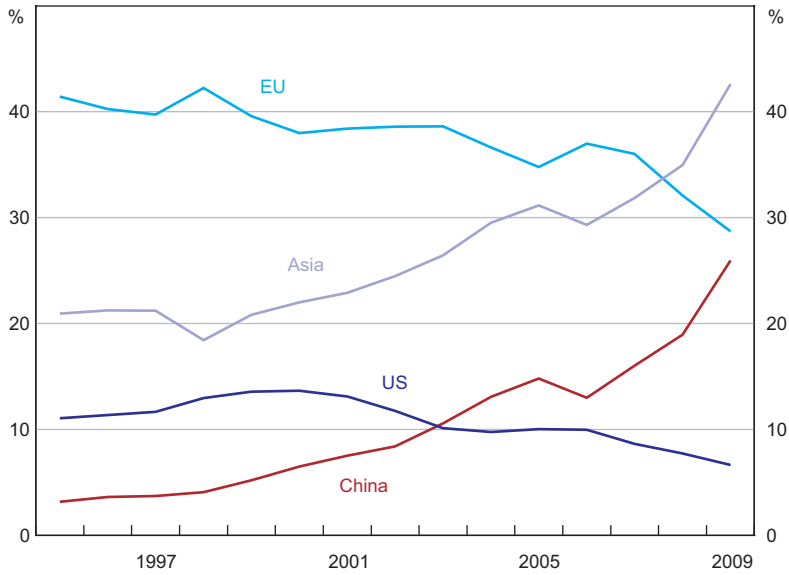
The supply chain story means that China is currently a derived source of demand rather than an independent source of demand for the region, and intra-regional trade still relies heavily on extra-regional final demand (ADB 2007; Athukorala 2008, 2010; Athukorala and Yamashita 2009). This fact has two important implications. Firstly, the so-called Sino–US trade imbalance is actually an Asia–US trade imbalance, while China only acts as a pivotal final assembly centre in the production process. Secondly, it is premature to make the argument that Asia has decoupled from the United States.

Asia and particularly China have become the most important commodity users in the world due to rapid industrialisation and urbanisation. Today, China accounts for an average of 30 per cent of global commodity consumption and more than 50 per cent of worldwide consumption of iron ore, cement and coal.

For ores and metals, for instance, Asia has been a larger importer than the EU since 2008. In 2009, Asia's share of global imports of ores and metals was 42.6 per cent, while for the EU and the United States the shares were 28.7 per cent and 6.6 per cent, respectively (Figure 4). In Asia, China was the largest importer, followed by Japan and Korea. The pattern looks very similar for the non-ferrous metals market. While Asia's share had been on the rise and the EU's share had been on the decline, they were at similar levels in 2009 at around 34 per cent.

The 'China factor' is more striking for Australia (Figure 5). China's share of ores and metals imports from Australia has increased dramatically, from 13.3 per cent in 2000 to 55.1 per cent in 2009. Accordingly, the share of EU and, in particular, US imports from Australia has been declining. China, Japan and Korea jointly accounted for nearly 80 per cent of Australian exports of ores and metals. In the case of non-ferrous metals, Japan had been the largest importer from Australia until 2008. In 2009, China's share jumped to 27.2 per cent, up from 10.6 per cent in 2008, partly as a result of the GFC.

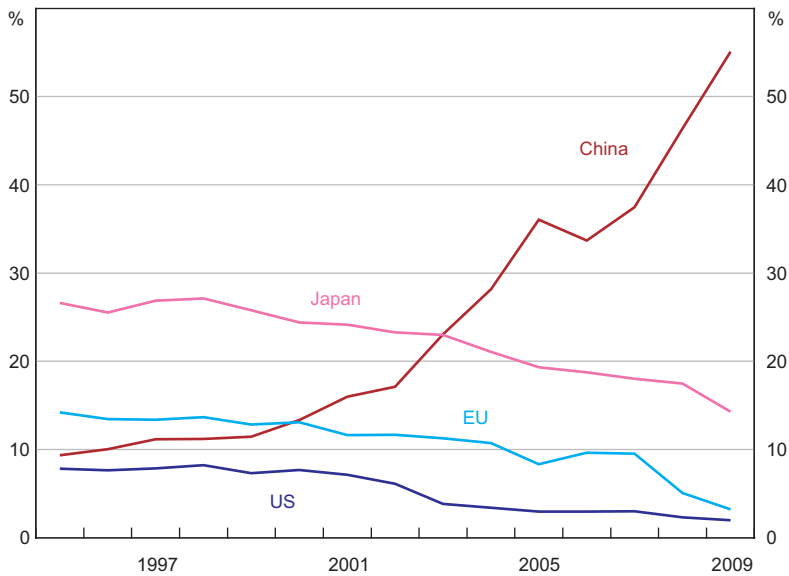
**Figure 4: Shares of Global Ores and Metals Imports by Selected Regions**



Note: Asia refers to eastern, southern and south-eastern Asia

Source: authors' calculations based on data from the UNCTAD database

**Figure 5: Shares of Ores and Metals Imports from Australia**



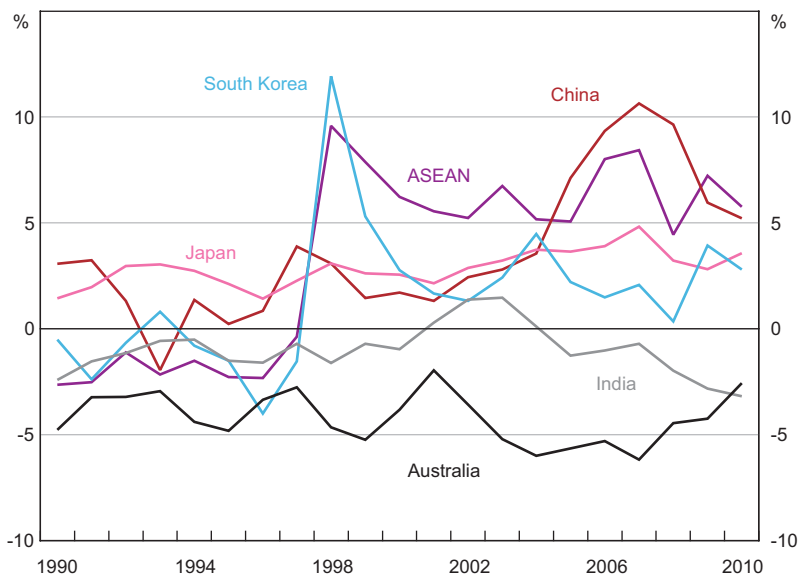
Source: authors' calculations based on data from the UNCTAD database

### 3. Large External Surpluses and Major Capital Exporters

Before the Asian financial crisis, most emerging Asian economies were capital importers, evidenced by widespread current account deficits in the mid 1990s. During much of the past decade, however, most Asian economies' current accounts remained in surplus, implying significant capital exporting (Adams and Park 2009). In fact, Asian economies, especially China and Japan, were an important part of the growing global imbalances during the years leading up to the GFC.

As can be seen in Figure 6, there were some differences in the trajectories of the current accounts among Asian economies. The ASEAN economies and Korea saw dramatic turns from deficits to surplus around the Asian financial crisis.<sup>3</sup> Japan maintained a current account surplus throughout the period 1990 to 2010, averaging 2.8 per cent of GDP, while Australia had a consistent deficit, around 4.2 per cent of GDP. China's current account fluctuated between deficit and surplus in the 1990s but its surplus grew sharply after 2003. India had a current account deficit in most years, which increased recently.

**Figure 6: Current Account Balances**  
Per cent of GDP



Source: IMF, *World Economic Outlook* database, April 2011

The turnaround in Asia's current account positions was mainly a result of the Asian financial crisis. Many Asian economies suffered from the Asian financial crisis for the following reasons: (1) massive borrowing from the international capital markets before the crisis; (2) over-investment and bubbles in certain parts of the economy or certain markets such as the chaebols in Korea and real estate in Thailand; (3) current account deficits implying significant pressure for currency depreciation; and (4) generally small amounts of foreign reserves that were insufficient to defend Asia's currencies. In

<sup>3</sup> The current account surplus in Malaysia has been expanding since 2002, whereas for Vietnam, its current account has returned to deficit.



the wake of the Asian financial crisis, Asian policy-makers made special efforts to support export growth, promote current account surpluses and accumulate foreign exchange reserves.

In fact, the first change to occur was the collapse of investment in much of Asia (Table 2). China was an exception, where the rate of investment rose, but with the increase in savings being even greater, China's current account surplus also increased. Investment rates also increased in India and Vietnam, both of which, however, had current account deficits during the past decade.

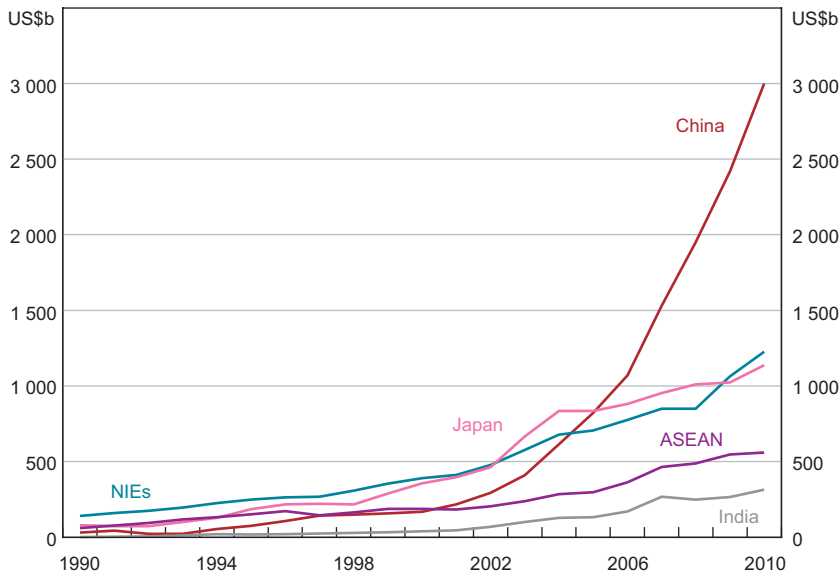
**Table 2: Investment Rates of Selected Economies**  
Per cent of GDP

	1990 –1996	1997	1998	1999 –2007	2008	2009
Vietnam	18.1	28.3	29.1	34.2	39.7	38.1
Indonesia	39.3	39.1	25.4	23.5	27.8	31.0
Malaysia	38.8	43.0	26.7	22.9	19.3	14.5
Philippines	22.8	24.8	20.3	17.2	15.3	14.7
Thailand	41.2	33.7	20.5	25.5	29.1	21.2
Hong Kong	29.4	34.0	28.9	23.1	20.4	21.3
South Korea	37.5	35.5	25.0	29.6	31.2	25.9
Singapore	34.2	37.2	30.0	23.9	30.2	26.4
Taiwan	25.8	25.1	26.0	22.3	22.4	17.7
Australia	24.1	23.9	26.0	26.4	29.5	27.9
China	39.8	38.0	37.1	39.7	44.1	48.2
India	23.8	24.6	23.3	28.8	34.9	37.0
Japan	30.1	28.3	26.3	23.9	23.6	20.2

Source: authors' calculations based on data from IMF, *World Economic Outlook* database, April 2011

Accompanying the widening current account surpluses in Asia was the rapid accumulation of foreign exchange reserves. Asia's foreign reserves totalled US\$878 billion before the Asian financial crisis but reached US\$6.2 trillion after the GFC (Figure 7). China's foreign reserves increased from about US\$100 billion in 1996 to US\$3 trillion at the end of 2010. India's reserves also saw significant growth, increasing from US\$20.8 billion to US\$314 billion during the same period.

Therefore the Asian region has become a major exporter of capital. But its outflows mainly take the form of debts and securities in advanced economies. For instance, about 67 per cent of China's total international assets during the period 2004–2010 were held in the form of international reserves, while only 6 per cent and 10 per cent, respectively, were in form of FDI and portfolio investment. Intra-regional portfolio investment flows are typically extremely low (Kawai 2007). Of China's total foreign reserves, about 70 per cent was in US dollar-denominated assets. China and Japan are among the world's largest investors in the US Treasury bond market.

**Figure 7: Asia's Foreign Exchange Reserves**

Source: UNCTAD database

While Asia's transition to being a key exporter of capital was related to the policy choices following the Asian financial crisis, this development was somewhat odd as developing economies would be expected to import, rather than export, capital. In that sense, the experience of India and Vietnam is more normal. It is therefore uncertain whether or not Asia's capital exports, which helped to hold down the cost of capital in the global market during the past decade, will continue at current levels.

Another issue related to Asia's capital outflows was the dominance of the US Treasury market as a destination of funds. While in the past this choice was understandable since the Treasury market was probably the safest investment, its return is very low. Taking China as an example, currently its total international assets are roughly double its total international liabilities. But the total returns on assets and liabilities are almost equal, meaning that the investment return on its assets was only half that of its liabilities. More importantly, the safety of such investments has also become a key concern.

These factors led to the set-up of a number of sovereign wealth funds (SWFs) around the region during the past decade. Singapore, with Temasek Holdings and the Government of Singapore Investment Corporation (GIC), was a pioneer in this area. Korea and China established their own SWFs, Korea Investment Corporation (KIC) in 2005 and China Investment Corporation (CIC) in 2007, respectively. Despite the relatively small amounts, these SWFs began to impact Asia's capital exports by becoming involved in not only portfolio investment but also FDI through mergers and acquisitions (UNCTAD 2008 ; Park and Estrada 2009).

Another development was efforts to encourage more outward FDI. In the past, outward FDI was mainly a phenomenon of advanced economies (Huang and Wang 2011), with developing

economies tending to be on the recipient side of such investments. This traditional pattern started to shift gradually when China commenced economic reform in the late 1970s and Hong Kong, Korea and Taiwan, still developing economies at that time, began to gradually relocate their labour-intensive manufacturing factories to the Chinese mainland.

In fact, more than half of outward FDI from developing economies since the 2000s has been from Chinese-speaking regions; China, Hong Kong and Taiwan (see Table 3). In the 1980s, Latin America was a more influential outward FDI player, with Brazil alone accounting for 44 per cent of outward FDI from developing economies. But its share has declined to less than 6 per cent during the past decade. In comparison, China's share is on the rise, with outward FDI flows from China increasing from US\$2.85 billion in 2003 to US\$56.53 billion in 2009 and its share in the stock of outward FDI from developing economies rising from 3.5 to 8.5 per cent during the same period.

**Table 3: Shares of Outward FDI Stock from Developing Economies**  
Per cent

	1981 –1989	1990 –1999	2000 –2003	2004 –2008	2009
<b>Asia</b>					
China	1.2	4.6	3.8	4.5	8.5
Hong Kong	3.2	24.3	39.4	36.9	31.0
India	0.1	0.1	0.4	1.5	2.9
Malaysia	0.8	1.3	1.3	2.0	2.8
Philippines	0.3	0.3	0.2	0.2	0.2
Singapore	1.4	7.7	8.6	9.2	7.9
South Korea	0.6	2.8	2.6	3.2	4.3
Taiwan	16.5	14.3	8.4	7.5	6.7
Thailand	0.1	0.5	0.3	0.4	0.6
<b>Latin America</b>					
Argentina	6.7	3.4	2.4	1.5	1.1
Brazil	44.4	16.0	6.0	6.2	5.9
Chile	0.1	0.7	1.4	1.5	1.5
Colombia	0.3	0.3	0.4	0.5	0.6
Mexico	2.2	1.4	1.4	2.0	2.0
<b>Africa</b>					
Egypt	0.1	0.1	0.1	0.1	0.2
South Africa	10.5	7.2	2.8	2.8	2.4

Source: authors' calculations based on data sourced from the UNCTAD database

## 4. Trade, Financial and Macroeconomic Co-operation

A major trend during the past decade, which was relatively less successful, was policy co-operation among Asian countries. Economic liberalisation in Asia has been going on for decades, with the distinct feature being unilateral reform. Individual economies decided on their own liberalisation programs regardless of other countries' policy choices. This approach has generally been effective, evidenced by the region's unusual growth performance in the past.

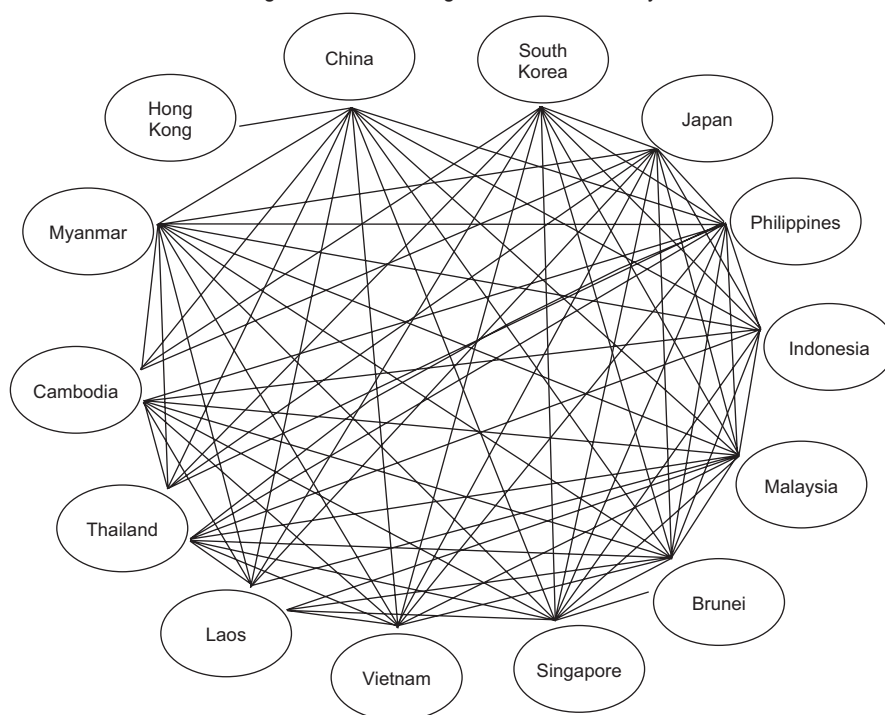
After the Asian financial crisis, however, there was an important change in this unilateral approach and policy-makers made efforts to promote regional co-operation. We think two factors were important in driving this change. The first was deeper integration in the region and possibly even stronger competition among the regional economies. The second was the problems revealed by the Asian financial crisis: individual economies were normally not strong enough to protect themselves and global financial institutions such as the IMF were not seen as reliable.

One area of significant progress during the past decade was the formation of FTAs. The number of bilateral FTAs grew exponentially after the Asia-Pacific Economic Cooperation (APEC) multilateral liberalisation approach failed and led to the so-called 'noodle bowl syndrome' (Baldwin 2008) (Figure 8). The surge of FTAs among the ASEAN+1 economies reflected a domino effect. ASEAN dialogue partners that did not have a FTA with ASEAN would try to sign one to avoid unfavourable economic and diplomatic conditions relative to those dialogue partners that had already signed a FTA (Hamanaka 2010; Ravenhill 2010).<sup>4</sup> From 2000 to August 2010, the number of concluded FTAs in east Asia increased from only 3 to 61, of which 47 are currently in effect. Another 79 FTAs are either under negotiation or proposed. In fact, Asia is ahead of the Americas in terms of FTAs per country – on average Asia has 3.8 concluded FTAs per country compared with 2.9 in the Americas (Kawai and Wignaraja 2011).

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4 ASEAN has ten dialogue partners: Australia, Canada, China, EU, India, Japan, Korea, New Zealand, Russia and the United States.

**Figure 8: Asia's FTA Noodle Bowl Syndrome**  
FTAs signed and under negotiation as at January 2006



Source: Baldwin (2008)

More important changes, however, took place in financial areas. One proposal, made by Japan in the wake of the Asian financial crisis, was to establish a US\$100 billion Asian Monetary Fund (AMF). This proposal had the purpose of at least partially replacing the role of the IMF. While the proposal got support from ASEAN economies and Korea, it was rejected by the United States, China and the IMF and the idea was immediately killed. But with suggestions to establish a European Monetary Fund emerging the proposal might be revived again in the region.

A more concrete step for regional liquidity arrangements was the CMI. It was launched at a meeting of ASEAN+3 finance ministers in May 2000 in Chiang Mai, Thailand. At the core of the CMI was a series of bilateral swap arrangements (BSAs),<sup>5</sup> providing liquidity to Asian countries in case of a possible currency crisis in the future (Table 4). This constituted a *de facto* AMF but avoided the political difficulties in establishing a formal institution, which might have encountered United States opposition (Bowles 2002).

<sup>5</sup> The CMI also included a wide package of financial co-operation measures, including policy dialogue; capital flow monitoring; international financial institutions reform; bond market initiatives; and regional bond funds for the future.

**Table 4: Bilateral Currency Swap Arrangements in Asia**

As at April 2009, US\$ billion

From:	To:	China	Japan	Indonesia	Malaysia	Philippines	Singapore	South Korea	Thailand	Total
China			3.0 <sup>(a)</sup>	4.0	1.5	2.0 <sup>(a)</sup>	na	4.0 <sup>(a)</sup>	2.0	16.5
Japan		3.0 <sup>(a)</sup>		12.0	1.0 <sup>(b)</sup>	6.0	3.0	13.0 <sup>(c)</sup>	6.0	44.0
Indonesia		na	na		na	na	na	2.0	na	2.0
Malaysia		na	na	na		na	na	1.5	na	1.5
Philippines		na	0.5	na	na		na	2.0	na	2.5
Singapore		na	1.0	na	na	na		na	na	1.0
South Korea		4.0 <sup>(a)</sup>	8.0 <sup>(c)</sup>	2.0	1.5	2.0	na		1.0	18.5
Thailand		na	3.0	na	na	na	na	1.0		4.0
<b>Total</b>		<b>7.0</b>	<b>15.5</b>	<b>18.0</b>	<b>4.0</b>	<b>10.0</b>	<b>3.0</b>	<b>23.5</b>	<b>9.0</b>	<b>90.0</b>

Notes: The table does not include the ASEAN Swap Arrangement (ASA), which totals US\$2 billion.

(a) The agreements are in local currencies and the amounts are US dollar equivalents.

(b) There is also a US\$2.5 billion commitment (made on 18 August 1999) under the New Miyazawa Initiative.

(c) Japan-South Korea BSA includes both US dollar swaps (US\$10 billion from Japan to South Korea and US\$5 billion from South Korea to Japan) and local currency swaps (US\$3 billion equivalent each from Japan to South Korea and from South Korea to Japan). The yen-won BSA was raised from US\$3 billion to US\$20 billion equivalent in December 2008 until the end of April 2009, which was later extended to the end of October 2009.

Source: Ministry of Finance Japan website

To develop regional capital markets, an Asian Bond Fund (ABF) was created by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) in June 2003. The Asian Bond Fund 1 (ABF1) pooled US\$1 billion of foreign reserves from the eleven central banks<sup>6</sup> and invested in US dollar bonds issued by eight EMEAP<sup>7</sup> sovereign and quasi-sovereign borrowers. To promote development of the local currency bond market in Asia, the second fund, the Asian Bond Fund 2 (ABF2) was launched in June 2006. Not only did the size of funds increase to US\$2 billion, but compared with ABF1, ABF2 was invested in local-currency-denominated sovereign and quasi-sovereign bonds (Fan, Wang and Huang 2010).

During the GFC, Asian countries further institutionalised regional financial co-operation. The idea of multilateral swap arrangements was first articulated in the ASEAN+3 finance ministers meeting in Istanbul in 2005 but progress was slow since it was not a high priority then. The GFC acted as a catalyst on the form of CMI multilateralisation (CMIM) in May 2009. Key features of CMIM include: (1) Japan and the People's Republic of China (PRC) each contribute 32 per cent of the total US\$120 billion fund, with Hong Kong contributing 3.5 per cent as part of the PRC's share;<sup>8</sup> (2) CMIM is still under IMF link, but the linked proportion is subject to review.<sup>9</sup> The progress, from a bilateral network CMI to a common institution CMIM, is a significant change in regional politics, particularly if the ASEAN+3 economies were to implement common decision-making fully (Henning 2011).

These regional liquidity arrangements and regional capital market developments in the wake of the Asian financial crisis are yet to bear fruit. None of the BSAs through CMI have been activated, not even during the GFC, and most of the accumulated surplus capital still flows to western countries. This is partly because the size of both ABF1 and ABF2 are too small and because there are major challenges that arise from the lack of required infrastructure, such as a credit rating and settlement systems, and the difficulty in determining the denomination of the proposed Asian basket currency bonds (McKibbin and Chanthapun 2009).

Finally, after the Asian financial crisis, economists and policy-makers started to work on potential currency integration. The importance of this was further highlighted by the risks associated with the US dollar being the dominant reserve currency, such as potential conflicts between national economic policy objectives and global reserve currency responsibility. This was an example of the Triffin dilemma, in which the widening of the US current account deficit conflicted with global investors' long-term confidence in the US dollar as a reserve asset.

Over the years, global central banks were diversifying their reserve investments away from the US dollar. The share of US dollar assets in total foreign exchange reserves declined from 71 per cent in 1999 to 62.2 per cent in 2009 (Table 5). The decline was even more profound among emerging and developing economies. Meanwhile, the share of euro assets in total reserves increased by almost 10 percentage points, from 17.9 per cent to 27.3 per cent.

6 Including the Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, the Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore and Bank of Thailand.

7 The three EMEAP countries in which the ABF1 (and also ABF2) will not invest are Australia, Japan and New Zealand.

8 The other shares were: Korea (16 per cent); Indonesia, Malaysia, Singapore and Thailand (4 per cent each); those of the remaining six south-east Asian members sum to 4 per cent. Overall, the three north-east Asian countries contributed 80 per cent and the ten ASEAN countries contributed 20 per cent.

9 Reducing the IMF-linked proportion depends on the development of a robust regional surveillance mechanism and the finance ministers committing to establishing an 'independent surveillance unit'.

**Table 5: Currency Shares in Total Identified Foreign Exchange Reserves**  
Per cent

	1999	2002	2005	2008	2009
<b>All countries</b>					
US dollar	71.0	67.1	66.9	64.1	62.2
Euro	17.9	23.8	24.0	26.4	27.3
Japanese yen	6.4	4.4	3.6	3.1	3.0
Pound sterling	2.9	2.8	3.6	4.0	4.3
Swiss franc	0.2	0.4	0.1	0.1	0.1
Other currencies	1.6	1.6	1.7	2.2	3.1
<b>Emerging and developing economies</b>					
US dollar	74.2	68.6	62.7	60.7	58.5
Euro	17.5	25.3	29.2	30.0	30.1
Japanese yen	3.9	1.7	1.5	1.9	1.8
Pound sterling	2.6	2.8	5.1	5.4	5.9
Swiss franc	0.5	0.1	0.1	0.1	0.0
Other currencies	1.4	1.5	1.5	1.9	3.6

Source: IMF, *Annual Report 2010*

Balance of payment risks revealed by the Asian financial crisis and potential dollar problems highlighted by the GFC prompted economists to explore the appropriateness and rationale for Asia to form an optimal currency area (Alesina and Barro 2002; Barro and Lee 2009; McKibbin and Chanthapun 2009). Ogawa and Shimizu (2005, 2006) proposed to create an Asian Monetary Unit (AMU) as a weighted average of 13 east Asian currencies (ASEAN+3). At the same time, the Asian Development Bank (ADB) also planned to create an Asia Currency Unit (ACU), which was similar to the precursor to the euro, the European Currency Unit (ECU). To date, this idea has not gone very far even in policy discussion.

## 5. Prospects for Asia in the Coming Decade

What is going to happen in the coming decade? Much of the answer to this question depends on the sustainability of growth in the region. More importantly, many Asian economies are at important turning points in their development, in terms of both industrial structure and economic rebalancing. Therefore, some new trends may emerge.

### 5.1 Sustainability of Asian growth

The first issue we need to settle is the question of growth sustainability. The Japanese economy has been stagnating for almost two decades, although its income level is already among the highest in the world. Growth in the NIEs has been moderating as they quickly approach the economic frontier, but they will most likely be able to continue steady expansion in the coming



decade. Perhaps there are some uncertainties surrounding the growth prospects of China, India and south-east Asia.

For the past three decades, China has been the most successful economy in the region, maintaining an average annual GDP growth rate of 10 per cent. Alongside this economic miracle, risks have also increased significantly, including over-investment, high reliance on commodity consumption, large current account surpluses, low resource efficiency and income inequality. In other words, the current growth model is 'uncoordinated, unbalanced, inefficient and unsustainable' to use the phrase of Premier Wen. Since 2003, the Government has been making serious efforts to rebalance the economy and to improve the quality of growth. Most of the efforts, however, have failed so far. The 12th Five-Year Plan again highlighted the importance of transforming the pattern of economic development.

Whether or not the new Five-Year Plan will be successful depends on reform of the incentive structure for both the Government and companies. The performance assessment system for government officials needs to be improved by de-emphasising GDP growth. But this may require a certain degree of political reform. More importantly, the Government needs to remove the widespread distortions in the factor markets in order to correct the incentives for producers, investors and exporters. Some of these changes are already on the way, evidenced by rapid increases in wages, adjustments of resource prices and the expected introduction of market-based interest rates. If these reforms are implemented smoothly, then Chinese growth is likely to slow but be of higher quality and more sustainable.

Economic growth in India has been accelerating for the past decade or two, with its growth potential rising from around 7 per cent to 9 per cent currently. Given India's relatively low income level, it may grow even faster in the coming decades. India's biggest challenge, however, is how to let the general public, especially unskilled workers, benefit from economic growth. While India's rapid growth has been mainly service- and large machinery-orientated, it remains a serious challenge for it to develop labour-intensive manufacturing industries. So far, India has failed to do so despite its overall growth success. This may be related to a number of obstacles, including rigid labour laws, high manufacturing tax burdens and backward infrastructure. While it does not seem a problem for the Indian economy to keep growing at 7 per cent, more rapid and sustainable growth probably requires the participation of unskilled workers.

South-east Asian economies still suffer from the consequences of the collapse in investment during the Asian financial crisis. Today, investment rates in these economies are, on average, 10 percentage points lower than their pre-Asian financial crisis levels. The governments of these countries have been trying for more than 10 years to raise investment rates without much success. More importantly, the economies of Malaysia and Thailand are quickly approaching middle-income levels. It is perhaps an even greater challenge for these economies to overcome the 'middle-income trap' by, for example, improving innovation capability, upgrading industrial structure or reducing income inequality.

Our general assessment is that Asian economies will probably be able to maintain strong economic growth. Growth potential should moderate in the coming decade with the exception of India and a few other south Asian economies, but this would still see Asian economies growing faster than the rest of the world and Asia's share of global GDP consequently rising.

## 5.2 Economic structural rebalancing

Global economic forums, such as the IMF and the G-20, have placed great emphasis on global rebalancing following the GFC. These organisations are even considering indicative requirements of external imbalances, such as current account surpluses or deficits that are larger than 4 per cent of GDP. For Asia, this could require a number of countries, particularly China and Japan, to further reduce their current account surpluses.

Rebalancing is consistent with the region's aim of achieving balanced, inclusive and sustained growth. Most Asian economies had large current account deficits in the mid 1990s, which led to concerns about currency depreciation and eventually caused the withdrawal of foreign capital from the region. Therefore, perceived difficulties servicing the current account deficits were closely related to the outbreak of the Asian financial crisis. During the past decade, most countries shifted to large current account surpluses. While a surplus contributes to GDP growth, it often becomes a source of trade tensions with trading partners, especially for large countries like China and Japan.

For most Asian economies, large current account surpluses are, at least partly, policy driven. After all, it is abnormal for low- and middle-income countries to export large volumes of capital. But how to go about rebalancing the economy remains a controversial issue for countries in Asia. Many Asian currencies have become much more flexible in the post-Asian financial crisis period, most clearly the Korean won, Indian rupee and Indonesian rupiah. Other currencies remain more inflexible, especially the Chinese renminbi, Malaysian ringgit, Taiwan dollar and Vietnamese dong. It would be ideal to fully utilise the exchange rate mechanism for external sector adjustment but so far Asian policy-makers remain cautious.

Perhaps the Chinese experience provides a good example. Since 2006 when the Government announced the 11th Five-Year Plan, China has been pursuing three separate objectives for its international economic policy: gradual appreciation of the currency; balance of the external accounts; and slower accumulation of foreign reserves. Unfortunately these policy objectives are contradictory among themselves. In the end, the only objective achieved was probably the gradual appreciation of the currency. External surpluses grew larger in the following years and foreign currency reserves surged.

The Chinese Government has placed so much emphasis on the currency because it was directly linked to exports, job creation and GDP growth. In the Chinese world of macroeconomic policy, the Government intends to achieve three key objectives: supporting growth; controlling inflation; and rebalancing the economy. Whenever there is a trade-off, however, the policy-makers always put growth and inflation ahead of rebalancing.

But this begs the question of what policy strategy China is likely to adopt to rebalance its economy. We expect to see a historical change in China's external economic policies in the coming years. In a Mundell-Fleming trilemma, a country can only achieve two of the three international economic policy objectives: free capital flows; a stable exchange rate; and independent monetary policy. With a rigid exchange rate and loose capital controls, China's monetary policy becomes increasingly challenging, illustrated by hot money inflows and difficulties managing liquidity conditions. While a gradual appreciation is probably better in terms of providing time for the real

sector to adjust, the problem is that it encourages expectations for future currency appreciation and induces more hot money flows.

Chinese policy-makers may shift toward a freely floating exchange rate regime and even basic convertibility under the capital account, but it is likely to be a gradual process taking three to five years. The first step would be for the central bank to stop intervening in the foreign exchange market. The currency may appreciate at first, but only after that initial realignment would two-way fluctuation become possible. The Government could also use a stabilisation fund to prevent excessive exchange rate volatility. In the meantime, the authorities could also move to give up the remaining restrictions on FDI and cross-border debt financing. Restrictions on cross-border portfolio investment may continue in the initial period, but quotas for Qualified Foreign Institutional Investors (QFII) and Qualified Domestic Institutional Investors (QDII) could be significantly increased and their terms significantly eased.

If all these happen alongside domestic structural reforms, we are likely to see a significant reduction in the current account surplus in China and across the region. In the near term, however, we probably should not expect all countries in emerging Asia to run current account deficits, as policy adjustments may well be gradual in most countries.

### 5.3 Progress of regional integration

Asia has made important progress in designing and implementing regional co-operation mechanisms, from FTAs to the CMLs; however, real achievements have been limited. This may be because regional co-operation will take much longer to bear fruit. It may also be because political commitments to regional co-operation are still weak or lacking. ASEAN countries have been more advanced in economic integration, especially realising free trade between themselves, but any integration of the ASEAN economies without involving other large economies such as China, India or Japan is unlikely to be a significant event globally. Bringing together China, India and Japan, however, will be extremely difficult.

One of the key factors promoting active search for regional co-operation mechanisms was the region's feeling of being left out. The IMF's role during the Asian financial crisis was widely criticised in the region for being too slow and then too rigid in terms of policy conditionality. North America formed the North American Free Trade Agreement (NAFTA) and Western Europe had the European Union and then the euro area. Asian leaders felt the strong need to create something of their own for Asia. But the initiatives were either not creative enough or not large enough to have an impact. The pooled foreign reserves were not utilised during the GFC due to their link to the IMF conditionality requirements and the bond funds did not have a material impact on regional bond market development.

An important change after the GFC was the elevation of the G-20 summit, which includes a number of Asian countries such as China, India, Indonesia, Japan and Korea, for managing global economic affairs. While global liberalisation and regional integration are not exactly substitutes for each other, the G-20 is likely to absorb more time and energy of the key Asian policy-makers.

Asian economies are likely to continue to integrate among themselves and may become an important global economic block. If we make a simple extrapolation of the IMF PPP-based GDP

data, by the end the second decade of the 21st century, Asia's share of global GDP will be close to 40 per cent. This share would be greater than double that of the United States and the EU. Perhaps that is the time when we should expect true 'decoupling' of the Asian economies from the United States.

While regional policy co-ordination might be difficult, market forces could continue to drive economic integration in the region. This would happen in the areas of trade, investment and finance. For instance, some experts have been pushing for the creation of an Asian currency. This idea has not been well accepted across the region, given the wide divergence of countries in terms of economic development, culture, political institutions and different macroeconomic cycles.

But if currency integration is beneficial then it could happen even without political co-ordination among different countries. We summarise currency integration in today's world into two types: we call one the dollar model and the other the euro model. The euro model, in which countries adopt a common currency and many experts in Asia are promoting, is based on political commitment and requires individual countries to surrender their monetary sovereignty. The dollar model, in which countries link their currency to a major global currency, is based on market forces, without explicit agreement between governments. For instance, east Asia used to be a dollar block – this was a unilateral decision made by Asian governments.

The same could happen again in Asia, although it is unclear yet which currency would stand out. Some argue that the renminbi could be a potential candidate to join the US dollar and euro to be one of three global reserve currencies. Of course, this is dependent on many forthcoming reforms in China, including exchange rate flexibility, capital account convertibility, central banking and possibly even political reforms. According to Ito (2010), however, there is already a *de facto* renminbi block forming in Asia, as currently the renminbi is already at par with the dollar in Asia's exchange rate decisions (Table 6).

**Table 6: Estimated Currency Basket Weights for Asian Currencies**

	US dollar	Euro	Japanese yen	Chinese renminbi
Indian rupee	0.56	0.12	-0.01	0.33
Indonesian rupiah	0.47	0.08	-0.01	0.46
Malaysian ringgit	0.45	0.15	-0.03	0.43
Philippine peso	0.73	0.16	-0.04	0.14
Singapore dollar	0.25	0.29	-0.03	0.49
South Korean won	0.48	0.48	-0.24	0.28
Thailand baht	0.49	0.13	0.01	0.37
Vietnamese dong	1.04	0.00	0.00	-0.03

Source: Ito (2010)

## 6. Concluding Remarks

Asian economies have changed significantly during the past decade. Ten years ago, Asian economies were mainly low-cost exporters of labour-intensive products. Today, they are a part of integrated supply chains across the region and the most dominant consumers of global commodities. Ten years ago, Asian economies ran current account deficits, faced pressure for currency depreciation and imported capital. Today, most of them have large current account surpluses, probably undervalued currencies and massive capital exports. Ten years ago, Asian economies opted for a unilateral approach in economic liberalisation. Today, they focus much more on regional co-operation in areas of trade, finance and macroeconomic policies.

All these changes have had a significant impact on the world economy. Asia has been a key driver of the super-cycle of the global commodity market, which was a direct contributor to strong growth of the Australian economy. Asian economies were also important players in determining global liquidity conditions and costs of capital. Some even blamed Asia for causing the sub-prime crisis in the United States by supplying too much liquidity to the world market. While there were many policy initiatives trying to promote regional co-operation, there was little concrete achievement in terms of real economic impact.

Asian economies are at an important juncture in terms of economic development and structural reform. China faces an important task of transforming its economic development pattern, without which its growth trajectory may be disrupted. Some south-east Asian economies are faced with 'middle-income traps', while at the same time trying very hard to revive investment. Most regional economies have to accommodate the rebalancing agenda adopted by the G-20.

These and other events will likely lead to some important changes in Asia's economic trends. First, by 2020, Asian economies will account for 40 per cent of world GDP measured in PPP terms and will not only be prominent producers but also major consumers of finished goods. Conditional on successful implementation of the needed structural reforms, Asian economies are likely to be able to continue their steady expansion, although their pace of growth might moderate further, with the possible exception of India. This might eventually decouple the Asian economies from the advanced economies.

Second, Asia's demand for commodities will probably remain strong, but the pace of growth should slow somewhat. There are still very strong fundamentals supporting commodity consumption in Asia, driven by continued industrialisation and urbanisation across the region. Alongside the moderation of economic growth across the region, investment growth may also slow, particularly in China. More importantly, as China strives to transform its economic structure, the resource intensity of its economic activities may decline over time.

Third, capital outflows from Asia may shrink in the coming years but may concentrate more in cross-border portfolio investment and FDI. Following worldwide rebalancing efforts, Asia is likely to make gradual progress in reducing its current account surpluses in most countries. This will probably be done through currency appreciation and other structural reforms. Asia as a whole will probably remain a surplus region but the magnitude could be much smaller. Foreign assets will likely be held more by the private sector, rather than as foreign exchange reserves.

Fourth, with rising costs at home, China and India could become a new source of global inflationary pressures in the coming decade. China and India were key contributors to global disinflationary pressures in the past, due to the rapid shift to extremely low-cost production locations from relatively high-cost locations. Even though there are countries with even lower costs, they may not be big enough to replace China or India.

Fifth, while Asian countries will probably continue to push ahead with regional integration efforts, we are sceptical about real progress outside of trade and FDI. Also, many of the initiatives in the areas of finance and macroeconomic policy involve economic sovereignty and require political commitment. Historical and institutional differences among the regional economies mean that this cannot be achieved quickly. It is possible, however, that Asian leaders will now re-emphasise the global framework, especially since key players are part of the G-20 process. In addition, some market-driven processes may also move ahead, such as voluntary currency integration.

Finally, if Asian policy-makers struggle with the structural issues, it might be difficult to completely avoid a crisis in the coming decade, which could start off the world's next recession. The experiences of Asian economies during the GFC suggested that they had made little progress in limiting financial and macroeconomic risks. While Chinese policy-makers used fiscal and monetary policies to boost economic growth during the GFC, these policies have backfired in terms of high inflation, high local government debts and possibly large non-performing loans. Further, it is almost impossible for the Chinese Government to repeat what it did during the GFC. It is quite possible that Asia or China will experience a new financial crisis in the coming decade or two.

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