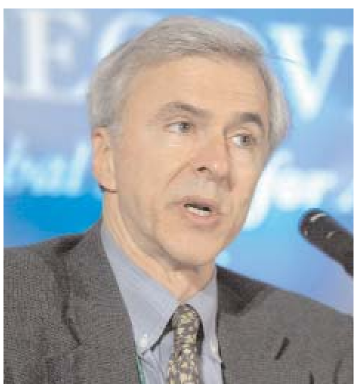
Pacific Economic Cooperation Council
Eighteenth General Meeting • May 12-13, 2009

Session 6: The Asia Pacific Path to Recovery: Toward a New Model for Growth
May 13, 2009

PAUL BLUSTEIN, Journalist-in-Residence, The Brookings Institution; former economics and Tokyo correspondent, *The Washington Post*—We all remember that some months ago the great debate was whether Asia had decoupled from the world economy, in general, and from the United States, in particular, and whether it mattered anymore how well the US economy was performing.

In think that debate has been pretty well resolved in favor of the skeptics of the decoupling theory. Just from this morning's paper one can see reports of 735 cargo ships idling in Singapore Harbor in the Strait of Majorca, China's exports having decreased 22.6 percent in April, which was worse than the March decline of 17 percent, and Japan's current account surplus having fallen 48 percent.



Mr. Paul Blustein, Journalist-in-Residence, The Brookings Institution; former economics and Tokyo correspondent, *The Washington Post*

There are lots of reasons for some pretty fundamental rethinking about where Asia's economy will receive sustenance in the future. Fortunately, we have some very knowledgeable panelists to present their thoughts on this subject.

We're going to begin with Prof. Peter Petri, who's a professor of international finance at the Brandeis University Business School. He will be followed by Prof. Eswar Prasad, who is a professor of trade policy at Cornell University and also a senior fellow at The Brookings Institution.

Following him will be Dr. Cyrillus Harinowo, who for many years was a central banker in Jakarta, Indonesia. And last but not least, Dr. Tan Khee Giap, who is associate dean at Nanyang Technological University in Singapore and also serves as Chairman of Singapore National Committee for Pacific Economic Cooperation.

I'll turn it over first to Prof. Petri for a presentation that will provide an overview of the issue and then we'll move on from there.

PETER PETRI, Carl J. Shapiro Professor of International Finance, Brandeis University: Thank you very much. Prof. Petri's PowerPoint presentation is available at http://www.pecc18.org/materials/petri_pecc.ppt

This discussion follows a very spirited,discussion yesterday by Prof. Yung Chul Park, Dr. Hiro Kawai and Dr. Fred Bergsten. They did something very clever, which is they managed to take what I thought was a common understanding of the problem and they managed to disguise that into a spirited disagreement and debate.

The point on which I felt they fundamentally agreed was that the imbalances that had preceded the crisis were instrumental in some way, whoever was the chicken and whoever was the egg. However caused, those imbalances were fundamental to the problems that we are now addressing and we must do our best to prevent them from being part of the recovery as it takes shape.

Shaping the Recovery

What I'm going to talk about is a kind of road map of where that recovery might go based on that fundamental understanding, that is, that the kinds of imbalances that had preceded the crisis should not be a part of it. The specific theme that I will pick up is that, in fact, the adjustments that need to happen have already mostly happened in a very short period of time in a very drastic way. The issue now in front of us is how to shape that recovery in

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such a way that they don't reemerge or they don't become much larger.

This approach can be advanced if you envision growth engines for the Asia-Pacific, which in many cases are parts of the policy packages that governments are adopting in their efforts to fight the crisis, and which, if appropriately strengthened and sustained, could pave the way to a much more sustainable future.

Here is a graph **[Slide 1]**. We have seen various versions of it. It's the export economy of the Asia-Pacific falling off the cliff. There have been huge decreases in exports and imports on the order of 40-50 percent in some countries.

U.S. Trade Deficit

But there is the other side of it. This is the U.S. imbalances. **[Slide 2]** The top line is imports, the green line is exports, and that bottom line, the red one, is the trade deficit, which came in this month at around somewhat under $20 billion. It's heading toward something on the order of $350 billion, perhaps, this year. It's less than half the number that it was a couple of years ago. Indeed, it's a number that is back to roughly the 2000-2001 levels, more or less like my pension funds. This extraordinary adjustment already has taken place.

China's Trade Surplus

China's trade surplus in the meantime also is falling very sharply. China's reserve accumulation during the first quarter of this year was $8 billion versus about $50 billion last year. That reflects not just the trade activity but also the fall off in investment flowing into China during that period. The U.S. trade deficit now is roughly 2.5 percent of the U.S. GNP, which probably is a bit high and ought to come down. But it is nothing like the $800 billion deficit that we saw only a couple of years ago.

Reducing Imbalances/Restoring Growth

So the issue in my mind is how to sustain and gradually reduce these imbalances while restoring economic activity, and it's that last part that much of my conversation today is about. We don't know what the shape of this recovery is going look like and we are seeing very early a very small piece of the puzzle. **[Slide 3]**

But I think it is very clear from the behavior of U.S. consumers, for example, that the adjustment is not just due to the crisis. It is reversing some imbalances that had built up over a long period of time. U.S. consumption is likely to stay sluggish.

To the extent that there is recovery, it will come from other parts. It will have to be driven by other engines of growth. Consumer durables are likely to lag especially. Those are the things that people give up first when they have an opportunity to adjust their consumption. And because of that, Japan and the NIE's will be especially hard hit. They are the economies at the very top, the upstream end of producing exactly those advanced consumer durables that have been hit hardest in this crisis.

Prof. Peter Petri, Carl J. Shapiro Professor of International Finance, Brandeis University

We don't know really all that much about how the impact of stimulus spending. Once we look through the econometrics and the structure of the spending, I suspect the stimulus spending has much smaller trade multipliers than the consumption boom that has driven economic growth in the United States in the past. There are a lot of questions in this discussion that will bear additional empirical study and I hope actually in the context of some research over the next few months to do just that.

Export Economy

So what will drive growth? **[Slide 4]** I think the export economy is not bad. One of the painful parts of the current discussion is the notion that somehow this very integrated, complex, and sophisticated fragmentation of the division of labor that we have developed over the last few years that has been so productive is somehow now gone.

That's not the case. What we really are looking at is just the tip of it, that is to say, that part of exports which supported over-consumption rather than the level of consumption. That is the part that needs adjustment.

And beneath that, some of the fundamental factors that drive the growth of the Asian economy are very much intact. These include savings and technology and the Asian financial systems. There also is a lot of room for expansionary government policy.

Removing Certain Incentives

This leads to the final point of my paper, which is that we need to work on the growth engines that will shift this economy into a new sustainable mode of recovery. These will need to operate in a policy context that facilitates the recovery. They need to remove incentives for export-oriented production. They need to abandon the view that somehow additional reserves by themselves will cushion the economy from future downturns. As we

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have seen, some of the economy's largest reserves—Singapore, Taiwan, and Japan—are facing some of the largest setbacks in this crisis.

And eventually, as conditions permit, there needs to be additional exchange rate adjustment in China and elsewhere. But beneath this is the notion that a new alternative economy can in fact take place and can in fact sustain the kinds of growth that we have seen in the past.

Here are some of the basic themes, and they have come up throughout this conference, and I won't spend too much time on emphasizing them:

Regional Integration

This has to do with closing gaps in productivity within countries such as China. It means closing gaps across countries in ASEAN and throughout the region. **[Slide 5]** It means infrastructure investments. Tremendous backlogs of transport power and other forms of infrastructure are needed in Indonesia and throughout the region. It means large adjustments in both production and consumption of energy in many countries. And then finally, we need to address important social priorities, such as health, aging, and human security.

Definition of Growth Engine

So how do these things become growth engines and what do I mean by growth engines? **[Slide 6]** A growth engine is something very big that induces large investments and results in rapid output growth. In addition, it is something that solves a coordination problem. In other words, it provides a signal for governments and private sectors about how to invest and move forward in a way that results in mutually reinforcing positive externalities of some sort.

Possible growth engines include projects with important international dimensions, such as those pertaining to climate change

What are possible growth engines? **[Slide 7]** I don't want to go through this list, but in each of the categories that I've identified, there are some very interesting and exciting projects showing up. We've heard about some of them today. They include both national and international projects, that is, projects that have very important international dimensions, such as those pertaining to climate change projects.

Let me turn finally to a top ten, from my point of view, and I've already received some comments that the U.S.-Korea Free Trade Agreement should be at the very top of the list. **[Slide 8]** Perhaps it does belong on that list, because some of the new regional integration initiatives and some of the commitments to sustained international trade in the region are critical.

Our job over the next few months will be to try to refine and quantify this list, picking up a lot of the work that is going on in specific areas of interest, such as the development of electric cars.

Difficult Transition

Finally, I think we need to worry a lot about what the transition is from here to there, because the transition process will be very difficult. In the short-term or even the intermediate run, it will be difficult to turn the U.S. $1 trillion deficit into a surplus. It will be difficult for China to raise its exchange rate at a time when it's struggling very hard to maintain its growth rate. But in time, as economic activity recovers and as hopefully these growth engines kick in, all of these can be important, supportive pieces of the new architecture.

So with all of that, I think we have an extraordinary amount of potential engines on the table ready to be turned on and ignited. The challenge to us at PECC and more generally in the policy community is to figure out exactly how to focus the kind of policy reactions that we are now making under tremendous pressure on these critical issues that will drive a more sustainable but still very solid growth path in the future. Thank you.

PAUL BLUSTEIN: Prof. Prasad.

ESWAR PRASAD, Tolani Senior Professor of Trade Policy, Cornell University; Senior Fellow, The Brookings Institution: Good morning. I'm going to talk about three issues. First, the tensions facing the world economy today, and there are a variety of these. Second, the implications of these tensions for the world economic recovery and global macroeconomic imbalances. And third, the possible resolutions for these tensions.

If one thinks about the various tensions facing the world economy, one can consider these within the context of systematically important economies like the United States and China. These two economies, in fact, will be my prime metaphors for the broader world economy.

Tensions in U.S. Economy

In the United States, there are some very difficult tensions facing the economy right now. There is a desire to get the financial system revived and, at the same time, jump-start the economy through macroeconomic stimulus.

Naturally, monetary and fiscal stimulus are much less effective if the financial system is not working well. And, unless the stimulus leads to rapid macroeconomic recov-

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ery, it will be that much harder to get the financial system back on its feet. So these two will have to go together but this nexus also poses a serious risk to the recovery if either one falters.

Private Consumption

Ultimately, private consumption will be the key to a sustained recovery. The reality is that the government by itself cannot pull the economy along. Governments need private consumers to do what they previously admonished them for doing, which is consuming too much and saving too little.

Now, the U.S. private saving rate has gone from essentially zero percent of current disposable income to almost 5-6 percent. In terms of rebuilding private-sector balance sheets, we are making some progress. But, unfortunately, this process of balance sheet rebuilding is not easy to square with our hope that the American consumer will start consuming again and pull the economy up.

Looking for Export Markets

When one projects this on a global scale, things become more complicated. If one looks around the world for sources of strength—and given the fact that many markets in the world, including advanced countries such as Germany and Japan, plus many of the emerging markets, are still looking to exports as a driver of growth—the question then becomes which country is going to absorb these exports.

The United States seems to be the one economy that the world is still expecting will absorb these exports. This obviously creates a tension as reliance on U.S. imports to jump-start the world recovery would slow down recovery in the U.S. and could also raise trade tensions.

Chinese/Indian Growth

If one thinks about systematically important countries, such as China, India, and many of the other emerging markets in Asia, basically, they have been able to hold their own and maintain relatively good growth rates. The IMF is projecting negative growth in the advanced economies in 2009 and essentially zero growth in 2010. But the emerging markets, especially those in Asia, look quite good by comparison in terms of their prospects for output growth.

The Chinese stimulus package, for instance, has been effective at maintaining healthy GDP growth. The downside is that a lot of the stimulus has been through investment, which is still being financed through the banking system and, in my view, will ultimately lead to the buildup of a fair amount of excess capacity in industries where there is already excess capacity.

So in terms of pushing out this excess capacity, which the Chinese economy simply is not going to be able to absorb in the medium term, and generating employment growth, which even during the boom years of the 2000s was only about 1 percent, China will still need rapid growth in exports. This also creates a very fundamental global macroeconomic tension.

Reserve Accumulation

One other aspect of the export-led growth model concerns reserve accumulation, which has slowed recently. But if one regards reserve accumulation as a process of self-insurance, again, we have a tremendous paradox developing. Two trillion dollars of foreign exchange reserves in China, $300 billion in India, $500-600 billion in Russia-before the crisis hit, these seemed like staggering amounts based on standard notions of reserve adequacy-for instance, relative to the level of imports or short-term external debt.

Yet, within a period of about three months, India lost about a quarter of its reserves. Russia went from $600 billion to $480 billion in a similar period. All of a sudden, the notions of reserve adequacy have changed and emerging markets feel they need a lot more reserves to protect themselves from crises.

Prof. Eswar Prasad, Tolani Senior Professor of Trade Policy, Cornell University; Senior Fellow, The Brookings Institution

Changes in International Financial Markets

One could argue that an institution like the IMF [International Monetary Fund] should provide this insurance, and I'll come back to this issue. But there have been fundamental changes in international financial markets that affect the role of the IMF.

First, the amount of resources needed from the IMF has increased enormously. Second, money provided by the IMF used to be a signal to private investors. A country would receive money from the IMF and, based on the macroeconomic policy measures agreed to as part of the

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IMF loan, private capital inflows would soon follow. That has changed; private capital does not seem to follow IMF funding as surely anymore.

Thus, all of a sudden, even the ability of the IMF to insure countries, especially the very large countries, is in question. Consequently, we face this even more paradoxical situation in which countries that had built up large stocks of reserves have an incentive to accumulate even more reserves in order to self-insure.

Possible Worsening of Imbalances

Although some economists maintain that global imbalances already are adjusting, I do not see that as a certain outcome as we come out of this recession. In fact, I see a potential risk that once the recovery is underway, global imbalances could perpetuate or perhaps become even worse.

This is because the United States again will find itself becoming the consumer of last resort and the Asian economies will continue to rely on exports to a significant extent, not just to generate employment growth, but also to increase self-insurance. I see many of these tensions potentially becoming a great deal larger in the medium term.

One hopes that we have learned our lessons. Even with large global macroeconomic imbalances, perhaps we won't end up with another cataclysmic outcome like the one we are in the midst of right now. Perhaps with better financial market regulation and more coordinated international financial regulation, one can make progress in fortifying our economic systems against collapse. But the rules of the game are not clearly defined, either in terms of how to deal with macro imbalances or a more effective regulatory framework, so I remain far from sanguine.

It seems to me that the financial system can be a mechanism for providing far more stability

Consideration of Reforms

What is the ultimate solution to many of these problems? The crisis provides an opportunity to think about fundamental reforms in a variety of dimensions. The big question in my mind is whether in the process of trying to get out of the crisis, we essentially use stop-gap solutions that solve the immediate problem but create bigger problems down the road. The scenario I've described is essentially one where the short-term problems are solved, that is to say, the United States begins growing again and the rest of the world breaths a sigh of relief and begin to grow again, too. But the fundamental tensions would remain festering.

Importance of the Financial System

Rebalancing growth in the Asian economies, especially China, is one important component of the eventual solution. So how does China rebalance its growth towards domestic demand and private consumption-led growth rather than relying on investment- and export-led growth? To me, the real core issue that ties all of this together is the financial system.

There is a notion that the western financial model has not worked very well, either in terms of innovation or regulation, and that has led us to where we are. However, I am very encouraged by the statements of the policymakers in China, India, and other emerging markets who, it seems to me, are dealing with this in a far more mature way.

They are saying things like, "This is not a sign that financial development should not go forward. Rather, we need a more back-to-basics approach to strengthen banking systems. We must make sure that our banking systems work more efficiently to intermediate both domestic and foreign capital into productive domestic investment. We must provide more insurance mechanisms within the country through the widening of the social safety net so households do not feel they need to increase precautionary savings to such a large extent." And, of course, diversifying financial income can be helpful in terms of stimulating consumption-led growth.

It seems to me that the financial system can be a mechanism for providing far more stability. But there is an international dimension to this, as well, as I alluded to earlier. We still need to think about how countries are going to insure against the risks of balance of payments and capital account crises through an institution like the IMF, rather than maintaining a tightly managed exchange rate in order to build up more reserves.

Reform of International Financial Architecture

This leads to another issue, which is fundamental reform of the international financial architecture. The G20 has expressed all the right sentiments about reforming an institution like the IMF so that it not only has more resources, but also has more legitimacy and credibility among the emerging market economies.

On the resource front, we have made significant progress, with a number of countries already having committed to contribute to a massive expansion of the IMF's resource base. However, the legitimacy issue, which would entail changing the governance structure of the IMF so that emerging markets feel they actually can use this institution to insure them against serious risks,

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remains an important concern.

Much of the discussion of macroeconomic reforms tends to focus on emerging markets with the notion that they have played an important part, perhaps not in the proximate causes of the crisis, but in helping to lead the crisis into a more explosive outcome. But there is a huge amount of reform that needs to be undertaken in the industrial countries, as well.

Reforms in Developed Economies

In fact, many of the mantras we were invoking before the crisis still remain relevant. There is a need for significant structural reforms in Europe, where this crisis seems to have turned into an opportunity for backsliding on many issues such as labor market flexibility and product market deregulation.

In the United States, which has been the epicenter of the crisis, it is encouraging that the Obama Administration seems to be engaging in more introspection and is willing to admit that there were issues related to U.S. regulatory and macroeconomic policies that need to be addressed. Tackling the exploding levels of public deficit and debt will have to be key priorities in the United States once the recovery is on track.

U.S. Leadership

It is likely to be a long and rocky road ahead—in terms of resolving these short-term growth concerns and managing medium-term tensions—towards achieving macroeconomic and financial stability. The United States has a critical role to play in all of this. Washington needs to serve as an important model leader in pulling other countries along, not by lecturing them about what to do, but essentially leading by example. Thank you.

PAUL BLUSTEIN: Next is Dr. Harinowo.

CYRILLUS HARINOWO, Commissioner of Bank Central Asia, Indonesia: Thank you, Paul. I would like to thank the host, East-West Center, for allowing me to substitute for Mr. Manggi Habir. The paper in your folders is by my colleague, Mr. Habir, and all credit should go to him.

There are a few points that can be derived from his paper. First, the myth is that Asia has been successful owing to its export-led growth strategy. But the fact is that there is no one growth model in Asia because the spectrum is quite broad. Some places, like Myanmar, have less that 1 percent trade to GDP ratio; Nepal is 12.1 percent, India, 21 percent, Singapore 23 percent, Indonesia 29.4 percent, and Hong Kong is 207 percent. This is the vast spectrum in Asia. It is certainly difficult to say that Asia, in general, has been successful because of the export-led growth. But no matter how small the export ratio, it remains very important for the Asian countries.

Reliance on Exports

Using Indonesia as an example, it has an export ratio of less than 30 percent, but many of these export products are from the outer islands other than Java. These exports contributed in a significant way to the improvement of the distribution of income. With the boom of exports a few years back, we also could see increased demand for cars, motorcycles, even ice cream.

The prosperity of Asian countries can be further enhanced if we can agree on region-wide infrastructure plans

Dr. Cyrillus Harinowo, Commissioner of Bank Central Asia, Indonesia

The second point is that with such variation, the impact to the global crisis is also quite different from one country to the next.

Interestingly, we have a number of countries that expected to post positive growth in 2009: China, Indonesia, India, Philippines, and Vietnam.

Why is that? I think the size of the population really matters. Those countries are having populations above 90 million people.

Evolving Models

A third point is that the growth model of Asian economies continues to evolve in a distinct way depending on how pressing the situation is and the capacity to affect change. The more closed the economy, the less the pressure to restructure. The more open the economies, just like Singapore and Hong Kong, the more likely they are to push domestic demand.

Fourth, the scope for rebalancing growth to our domestic economy is big, especially for countries with a relatively low consumption ratio. Just to take an example, China was 37.1 percent in 2007; Malaysia was 45.6 percent in the same year. The rest of Asia have consumption ratios of more than 50 percent. And those countries that significantly less consumption ratios certainly can use fiscal stimulus as a kind of temporary measure.

Fifth, to rebalance the growth sources, there have been a number of enabling factors. One is the government policy of loosening the liquidity of the banking systems.

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Health of Asian Banking System

Also the Asian banking system is relatively in better shape after the Asian crisis in 1997. You can see from their profitability level and also from their capital level. Just to inform you, at BCA [Bank Central Asia], which is the bank where I work, the first quarter of this year we enjoyed loan growth of around 30 percent annually and a profit growth of 41 percent. This is a sign of the soundness of our banking system.

The stimulus packages adopted by various governments also are an enabling factor in responding to the export growth as is the rise of the middle classes in Asia. Indonesia now has around 30 million peoples that can be classified as middle class. Thirty million is larger than the entire population of Malaysia and Taiwan.

For instance, last year, Australia closed 61 out of 84 Starbucks stores. In Indonesia, in comparison, we increased from around 65 stores to around 80 stores. That indicates the vibrancy of the middle class.

The conclusion from this analysis is that certainly countries have to choose their own right balance in the years ahead, but certainly there is still scope for them to pursue further development of domestic demand as part of their rebalancing strategy.

Region-Wide Infrastructure Plans

Finally, the prosperity of Asian countries can be further enhanced if we can agree on, say for instance, region-wide infrastructure plans. Just to give an example, Japan some years back proposed a kind of a project called the Trans Asia Pacific Gas Pipeline. It was a brilliant idea, but I have not heard anything more about it since.

At the same time, Indonesia started to develop our own gas pipelines connecting Java, Sumatra, and Singapore. Following these lines, I think it would be very interesting to have a Trans-Asia highway system or Trans-Asia railway system.

For example, Japan will have a fiscal stimulus package amounting to about 10 percent of GDP. I do not know how that money will be put to use because I am sure the Japanese infrastructure is in very excellent shape.

But just one percent of GDP of that fiscal stimulus of Japan, around $50 billion, would build a highway from Bali to Singapore. Just by widening up the focus of official stimulus would potentially make a significant change to the region. Thank you very much.

PAUL BLUSTEIN: Thank you. Dr. Tan, please.

TAN KHEE GIAP, Associate Dean, Graduate Studies Office and Co-Director, Asia Research Center, Nanyang Technological University, Singapore: Good morning, ladies and gentlemen. I have three broad observations to make. First, we should recognize the shifting economic dominance between East and West. We want to look at the long-term implications of massive fiscal stimulus.

We also should think in terms of inclusive development to overcome widening income disparity and potential structural unemployment, which can be destabilizing socially, especially in China and India.

Dr. Tan Khee Giap, Associate Dean, Graduate Studies Office and Co-Director, Asia Research Center, Nanyang Technological University, Singapore

The second observation I would like to make concerns the potential and challenges ahead for East Asian economy. Is the external demand-driven growth model obsolete? We want to know why Asian surpluses are escalating and how to ensure long-term the innovation-led development.

Then I will discuss public policies and structural reform that we need to fine tune. We don't need to invent a new model, but we need to strengthen other societies and further enhance the quality of life. I think now the role of the government is no longer a dirty word. There must be a correct role of the government to ensure more equitable distribution of wealth and also to strengthen areas where market forces are weak.

Fine-Tuning the Asia Model

Now, where is the growth coming from? By 2015, for the first time, the GDP by PPP of China, India, Japan for the first time will be 36.3 percent, which exceeds the 33.9 percent level of Europe and the United States. There is, indeed, huge potential ways to fine tune the East Asia model.

What is clear is that massive unemployment is unacceptable. The failure of corporations is unacceptable as is protectionism. The United States has been very busy, especially in October and November in Singapore, and we look towards U.S. leadership with respect to the importance of globalization and open trade.

Potential Structural Unemployment

Also, we want to talk about the worsening of income disparity within East Asian economies, lopsided, unsustainable growth, and a mismatch of skills. We are seeing this potentially as the new source of structural unemployment. We should call for urgent public policy responses with the correct role of the government.

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Now, this is where government must play an important role with respect to fiscal stimulus. It is good that at least President Obama actually said that he is committed to reducing the deficit to 2 percent of GDP by 2013. We therefore expect governments elsewhere to explicitly state the timetable to install fiscal discipline. We have to talk about the IMF and sovereign wealth funds as an important source of financing.

Why question the East Asian growth model now? I think because they saw the simultaneous contraction in major markets, such as Europe, North America, and Japan. This is unusual. China, Korea, Taiwan, Hong Kong, Singapore, and Malaysia, Thailand, were all affected.

We should focus on sharing experience, peer review, and coordinated discourse to adapt structural reform and to integrate East Asian economies harmoniously

Recognizing Comparative Advantage

But I think that the argument about the excessive reliance on trade-oriented policies due to the undervaluation of local currencies is becoming less valid. This is because since 1997, Asian economies increasingly have moved to a more managed, market oriented regime.

It is certainly true that many governments consciously built up currency reserves as an insurance against speculation. But we must not forget that the ability to diligently and efficiently organize factors of production, significantly improve transportation, telecommunication, logistics and port infrastructure based on comparative advantages are keys to a comparative and successful East Asian export sector. So don't blame out good export performance. A lot of effort has been put into this based on basic economic comparative advantage and we do not apologize for it.

New Forces at Work

We are convinced that we need fine tuning, but not because of the accumulation of foreign exchange reserves. Rather, we need to reformulate a new growth model for East Asia to take into account new forces in the region.

On one hand, we want to address the transpacific trade imbalance and also increase insufficient domestic consumption. But on the other hand, you cannot stimulate domestic demand without first realizing external demand. External demand is a means to achieve an end. And the end is eventually to have the purchasing power to deepen the economy and increase consumption.

In fact, we recognize there are four major economies over the last 20 years whose consumption has been declining—China, India, Malaysia, and Singapore. The decline in the U.S. dollar is more or less made up by the increasing value of the Euro and British sterling. Half of the foreign exchange reserves of East Asian countries are invested in U.S. Treasury bonds. According to latest statistics, long-term government bonds actually are reducing but the amount is now being invested in the short-term (less than one year) U.S. Treasury bonds.

There is some rethinking about plans and a desire to see how the U.S. dollar is going to move. But I think the U.S. dollar will continue to be a very important reserve currency given that the capital account of China is unlikely to be liberalized in the medium term.

Social Security System

I would like to quickly talk about quantitative, qualitative, and equitable growth. East Asia now must be aware that quantitative, itself, is not important. We must look at the comprehensive social security system and adapt to local conditions, which inevitably must cover affordable retirement benefits, health care, public housing, education and skill upgrading.

Unfortunately, explosive population growth for poor economies and declining populations among wealthy economies in Asia would not be beneficial to economic integration and would lead to a deteriorating quality of life and worsening income disparity in East Asia. So the vision here must be sharing experience, peer review, and coordinated discourse to focus on efforts to adapt structural reform and to integrate East Asian economy harmoniously.

Focus on SMEs

What are the potential engines of growth—rising private domestic consumption. We are now beginning to look at the small and medium enterprises (SME) very seriously. This is because in most East Asian economies, including China, SMEs contribute to at least half of the employment and one-third of the GDP.

Because of a contraction in the external market, it is important that SME's play an important role in mitigating the pain of structural unemployment. A more robust inclusive development will ensure a more green sustainable quality and equitable growth. Therefore, I think we must focus on the expansion of soft infrastructure plus energy efficient and environmental development. Thank you.

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QUESTION & ANSWER PERIOD

PAUL BLUSTEIN: We'll take some questions from the audience.

IAN BUCHANAN, Australian Pacific Economic Cooperation Committee: I have questions for Prof. Petri and Dr. Harinowo. Prof. Petri talked about growth themes and one was a pan-Asian infrastructure. Prof. Petri mentioned rail and highway and Dr. Harinowo extended that to gas.

The Asian Development Bank two or three years ago estimated there was at least a $1 trillion infrastructure requirement in the region. Last year, Indonesia hosted a major fair for infrastructure investments in Indonesia. The fact is, the ability to invest is hindered by certain institutional factors, such as land rights and corruption.

I would argue that the biggest constraint to being able to roll out an infrastructure-focused stimulus package even within a country—let alone across countries—relates to institutional capacity. So I would invite the panel to share your thoughts about what collectively PECC can do to help to accelerate the building of institutional capacity in order to allow the stimulus package to be effective.

PAUL BLUSTEIN: Dr. Harinowo, I see you nodding.

CYRILLUS HARINOWO: It is true that institutional factors sometimes hinder this kind of development. But lately there has been some progress. For instance, the development of a 10,000 megawatt electricity capacity just became operable. Also, we are beginning to make progress in developing a better road system.

Recently, Unilever Global decided to build a skincare products factory in Asia, and Thailand and Indonesia appeared on the short list. Finally, the decision was made to make the investment in Indonesia because the market is just too big to ignore and it can be used as a kind of springboard for the Asian region. With this as a start, hopefully more large-scale regional infrastructure projects can be developed. Thank you.

SOOGIL YOUNG, President, National Strategy Institute of Korea: I think there are certain clarifications to be made about some aspects of so-called rebalancing growth or about our notion of an export-led growth strategy. Since yesterday, Prof. Park Yung Chul, Dr. Fred Bergsten, and everybody else has been associating export-led growth strategy with chronic imbalances leading to the accumulation of foreign reserves. And then we were wondering if everybody exports, who imports.

I think this line of questioning assumes a number of specific conditions. Korea, of course, is well known for having pursued an export-led economic growth strategy from the 1960s through the 1980s. But up to 1985, Korea was pursuing export-led growth, but at the same time suffering from chronic current account deficits. What does this mean?

Exports were growing very rapidly but imports were also growing at about the same speed or at a higher speed. So this illustrates the fact that export-led growth

From left, Prof. Peter Petri, Carl J. Shapiro Professor of International Finance, Brandeis University; Prof. Eswar Prasad, Tolani Senior Professor of Trade Policy, Cornell University and Senior Fellow, The Brookings Institution; Dr. Cyrillus Harinowo, Commissioner of Bank Central Asia, Indonesia; and Dr. Tan Khee Giap, Associate Dean, Graduate Studies Office and Co-Director, Asia Research Center, Nanyang Technological University, Singapore

doesn't have to mean chronic surpluses or continued increases in foreign reserves.

Even under those circumstances, Korea was able to benefit by pursuing export-led growth for the purpose of maintaining a high economic growth rate because even if imports were increasing at about the same speed as exports, the fact that we were exporting allowed us to take advantage of economies of scale by selling for the global markets.

It introduced the efficiency of competitive pressure on domestic producers. So I'm saying that export-led growth doesn't necessarily lead to continued amassing of foreign reserves, and so on.

We have to ask, then, when can we have export-led growth accompanied by chronic surpluses and continuing accumulation of foreign reserves when imports are not allowed to increase concurrently. This would mean that either the imports are restricted by protective barriers or that the capital market is closed so that interest rates are high and you have a chronic inflow of foreign capital which would keep the exchange rate undervalued.

There are a certain number of conditions under which export-led growth doesn't have to give rise to the problems that we are worrying about or when it can be benign. I think this makes us think about this concept of rebalancing growth in a different way.

PAUL BLUSTEIN: I'm going to ask Prof. Prasad also to take a swing at it.

PETER PETRI: If I may, I agree that the fundamental logic of the global export economy and the very important role of Asia in it haven't been changed by what has

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happened. The imbalances have to change. But that does not alter the fact that a very large part of world production and manufacturing will be done in Asia.

Since you've raised it, I want to spend a second on this issue reserves as insurance. I think the question we have to ask is what is it that they are insuring against? They're certainly insuring against currency attacks. But that hasn't been the effect of the crisis on East Asia. Frankly, I worry about what level of insurance Russia would have to have in order to make it a safe place in which to invest.

The pressures to find demand these days are very high. And to the extent that the American consumer will provide that demand to anybody, I'm sure that countries will be delighted to take advantage of it. But I don't see it. Look at the U.S. savings rate, which had been driven lower by rising housing prices. However, housing prices have been falling now for more than a year and will continue to fall as best as we can tell. All of this is now working in reverse and instead, the U.S. government is stepping in with very large fiscal policy measures to compensate.

The imbalance we need to worry about concerns the ability of the financial systems to intermediate capital and absorb foreign capital in many of the emerging market economies

The kind of consumer demand that would give us an easy way out of this crisis is not likely to emerge very soon. That's why some of these other initiatives pertaining to infrastructure, social investments, and improvements in consumer income in Asia are very important to the recovery.

SOOGIL YOUNG: My point was that all the Asian nations can continue to pursue export-led growth—if only they also would import from each other and create an open market between themselves. In other words, we could be pursing trade and then growth instead of an export-only strategy and everyone would be happy.

PETER PETRI: Right, and regional integration within Asia is a very important potential engine for trade-led growth.

PAUL BLUSTEIN: Eswar, do you want to add to this?

ESWAR PRASAD: That was a very useful clarification. It is true that it is not trade or exports as a ratio to GDP or export growth to be concerned about, but the overall surpluses. And the concern, of course, has been that if you look at the Asian region as a whole, with China being a prime mover, it has been relying on final markets. Even though Korea is running a more balanced trade account than China, much of that is intra-Asia trade and final markets still seem to be outside the region.

It is difficult to resolve this because, as Prof. Petri pointed out, in the short-term the U.S. consumer has a very limited ability to step up. The crisis that many of us had anticipated, which was a dollar crisis with U.S. imbalances leading to a decline in the value of the dollar, has not happened. Paradoxically, the country at the epicenter has had money flowing in because it's still seen as a safe haven, plus the dollar had in fact strengthened a little bit even in the latter half of last year.

But to me, those are reflections not about U.S. strength, but about relative weakness of the financial systems in the rest of the world. Even though the U.S. system seems to be imploding, there is still this miraculous faith in the U.S. government and, at some level, in the U.S. financial system. Ultimately, the U.S. financial system will revive and will be the place to park money.

That is the imbalance we need to worry about—the fact that there is this imbalance in the ability of the financial systems to intermediate capital and to absorb foreign capital in many of the emerging market economies. That is a fundamental problem that we will have to solve in order to deal with global imbalances as well as imbalances within each of these countries.

PAUL BLUSTEIN: Dr. Tan?

TAN KHEE GIAP: I just want to quickly add that not only Korea, but also Singapore in the early 1980s had a balance of payment deficit. In addition, if we want to increase consumption and trading within Asia, we cannot expect the market forces to lead because you must release this consumption purchasing power through reforming the public social security system. In that regard, it is relevant to explore the appropriate role of government in helping to foster trading between East Asian economies. Thank you.

PAUL BLUSTEIN: And Dr. Harinowo?

CYRILLUS HARINOWO: Yes. The likelihood for intra-regional trade is very high because the size of the middle class is expanding rapidly. For instance, a product of Korea may be sent to the United States, but then the final consumers can be in Malaysia, Indonesia, Singapore, and other countries. That could be a short-cut to intra-regional trade.

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CHRISTOPHER FINDLAY, University of Adelaide, Australia: I had a follow-up Ian Buchanan's question about the regulatory or policy environment. To the extent that there is a reallocation of resources into the non-trading sector, I think there's another set of questions to those that Ian raised.

He talked about the institutional setting in which investment decisions are made. A lot of the sectors identified by the panel as possible areas of new investment and therefore growth are themselves highly regulated, but potentially open to investment. But in many of those sectors, there are significant barriers to trade and investment.

My concern is that resources would go to an already distorted sector. My suggestion would be that alongside consideration of the top-ten most interesting and exciting new areas for investment and sources of growth, there should be some sort of cross-cutting exercise that looked at the risks associated with the distortions in those sectors.

To illustrate, PECC is about to release a report in which we benchmarked education policy across the region. There are significant variations in policy and many countries have significant barriers to trade and investment in that sector. And while investment appears quite often on the lists of the really good things to do, I think another positive contribution would be to make sure the policy regime is right.

PAUL BLUSTEIN: That didn't sound like a question, but it was a very insightful observation. Thank you.

RICHARD CRONIN, Henry L. Stimson Center, Washington, D.C.: It seems to me that we've all been tiptoeing around one big issue that's kind of what we call the elephant in the living room—that being China and how China is going to generate domestic growth.

Experts on China point out that something like 80 percent of the Chinese people, including small and medium-sized businesses, don't have access to bank credit primarily because they don't have collateral. Peasants don't own their land and therefore can't borrow against it. The same goes for businesses. You must have property to borrow money to buy property. How does China get moving without this really fundamental change?

PAUL BLUSTEIN: Dr. Tan, do you want to address that first?

TAN KHEE GIAP: Yes. If you come to Singapore in October 2009 for the PECC meeting, one concurrent session will address trade financing for SMEs and credit rating in the small and medium-sized enterprises by sector. The kind of a model being tried in Europe should help the Chinese banks in assessing the credit worthiness of SMEs. Thank you.

PAUL BLUSTEIN: Eswar, you have the bat now.

ESWAR PRASAD: It's not that we haven't recognized the elephant in the room. In fact, we're trying to grapple with it. The problem is getting the damn beast to move around. There are multiple distortions in the economy and we've talked about some of these issues in the context of other economies, such as a weak legal system, property rights, and so on.

So how does one get the financial system to move? There are macro angles, as well, to this. If you think of monetary policy within the framework of being a relatively tightly managed exchange rate, that gives you much less flexibility with monetary policy. This means that you cannot use price signals to direct the financial system to issue credit. So you have a problem there.

Even if one deals with all of these systems, there is a broader issue of how you change incentives in the system. There are aspects that need to be dealt with outside the banks.

For instance, developing a corporate bond market, which is an important priority of the Chinese authorities, would be a good way of creating more competition for the banking system. It would give smaller enterprises potentially more room to start generating their own funds and perhaps increase the level of transparency in the system, complimentary to what is occurring through the stock market.

Developing a corporate bond market would be a good way of creating more competition within China's banking system

It is also important to move forward with very basic derivatives. Currency derivatives are not exotic instruments, but exporters, importers, and firms ultimately need them. In addition, there is the aspect of financial inclusion, which is becoming an important issue in many emerging markets and lower-income developing economies.

The goal would be to get more of the population encompassed by the formal financial system to improve their access to credit mechanisms, insurance mechanisms, and so forth. This is all understood quite well, but it becomes very difficult to figure out where exactly to move first. But there is movement and I am encouraged by it.

PAUL BLUSTEIN: One more question . . .

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RONNIE SUSMAN NATAWIDJAJA, University of Indonesia: I'd like to ask Dr. Harinowo a question. During the last 5-10 years, Asian growth has been relying more on domestic demand because of the restructuring process of forward mobilization, especially for agricultural products. The role of financial sector throughout our region is very small. Businesses rely more on their family savings.

In Indonesia , do you think that local specific resources can be used as a competitive advantage and enable a shift to a non-trading strategy in such a way that this crisis becomes an opportunity for Indonesia to become more competitive in the Asian region?

CYRILLUS HARINOWO: Yes. It is true that there has been progress in the last few years and the development of a credit culture is part of this. If you look more carefully at the Indonesian banking system, it also has quite a significant share in the agricultural sector through its support of the plantations as well as food farming. Just to give an example, my own bank has already devoted a lot of shares in this activity, but basically government intervention is needed in this respect.

PAUL BLUSTEIN: Well, thank you very much to our panel. Please join me in expressing appreciation for the contributions of the panelists. ♦