Asia: Ten Years On – Taking Stock and Looking Forward

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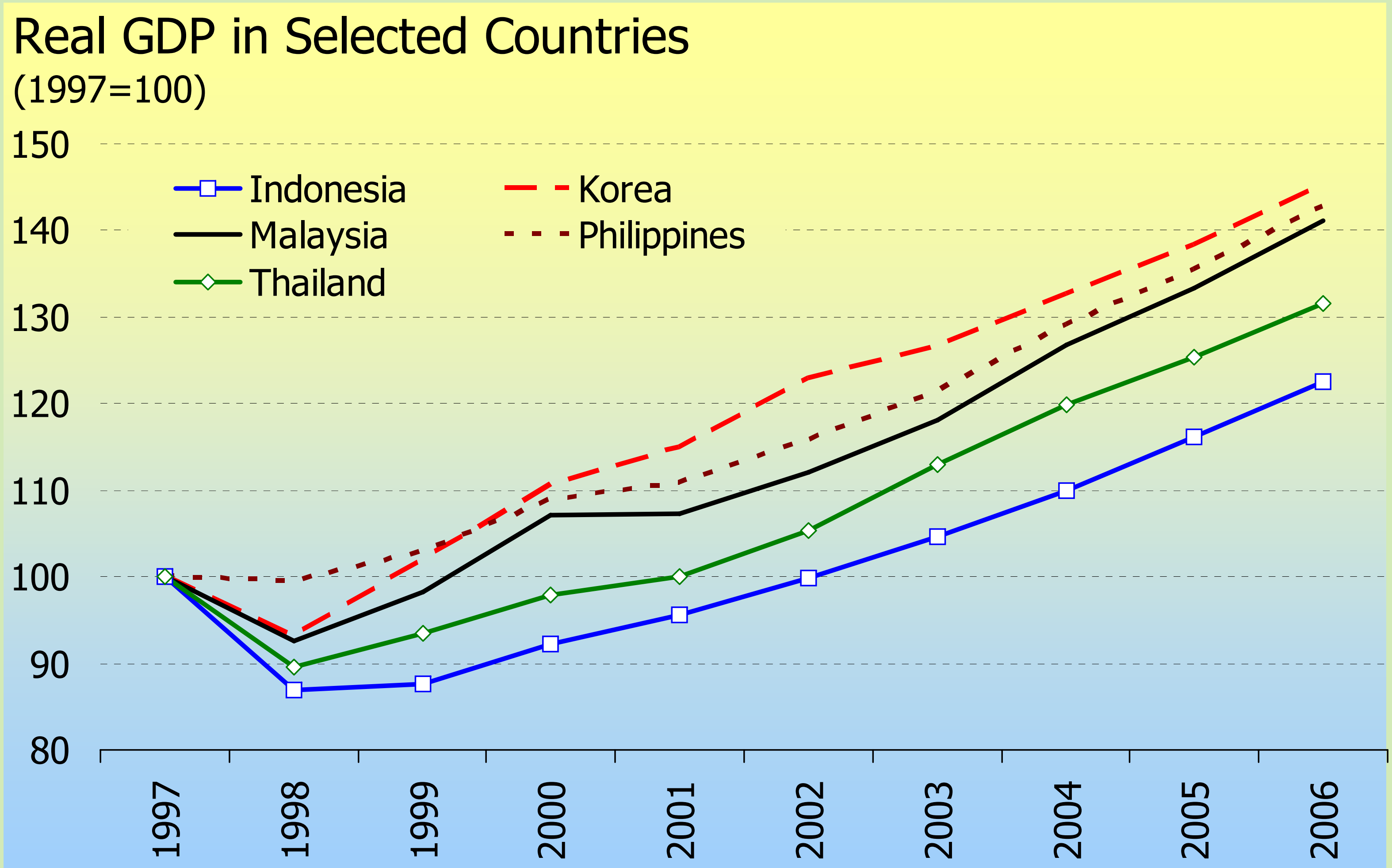
The Asia crisis left few countries in the region untouched.

- The roots of the crisis were in financial and corporate sector weaknesses, not in traditional macroeconomic imbalances; other ingredients were pegged exchange rates, inadequate reserves and a lack of transparency;
- Doubts about the soundness of financial institutions and corporates spread quickly across national borders;
- This set off a vicious circle of capital outflows, plummeting exchange rates and crippling balance sheet effects;
- Private demand and output contracted sharply;
- The international community acting through the IMF provided substantial financing.

Recoveries started relatively quickly, with the most determined reformers performing the strongest.



Source: IMF, *World Economic Outlook*.

Reforms in Asia since the crisis have been geared to equip the region to benefit from globalization.

These include:

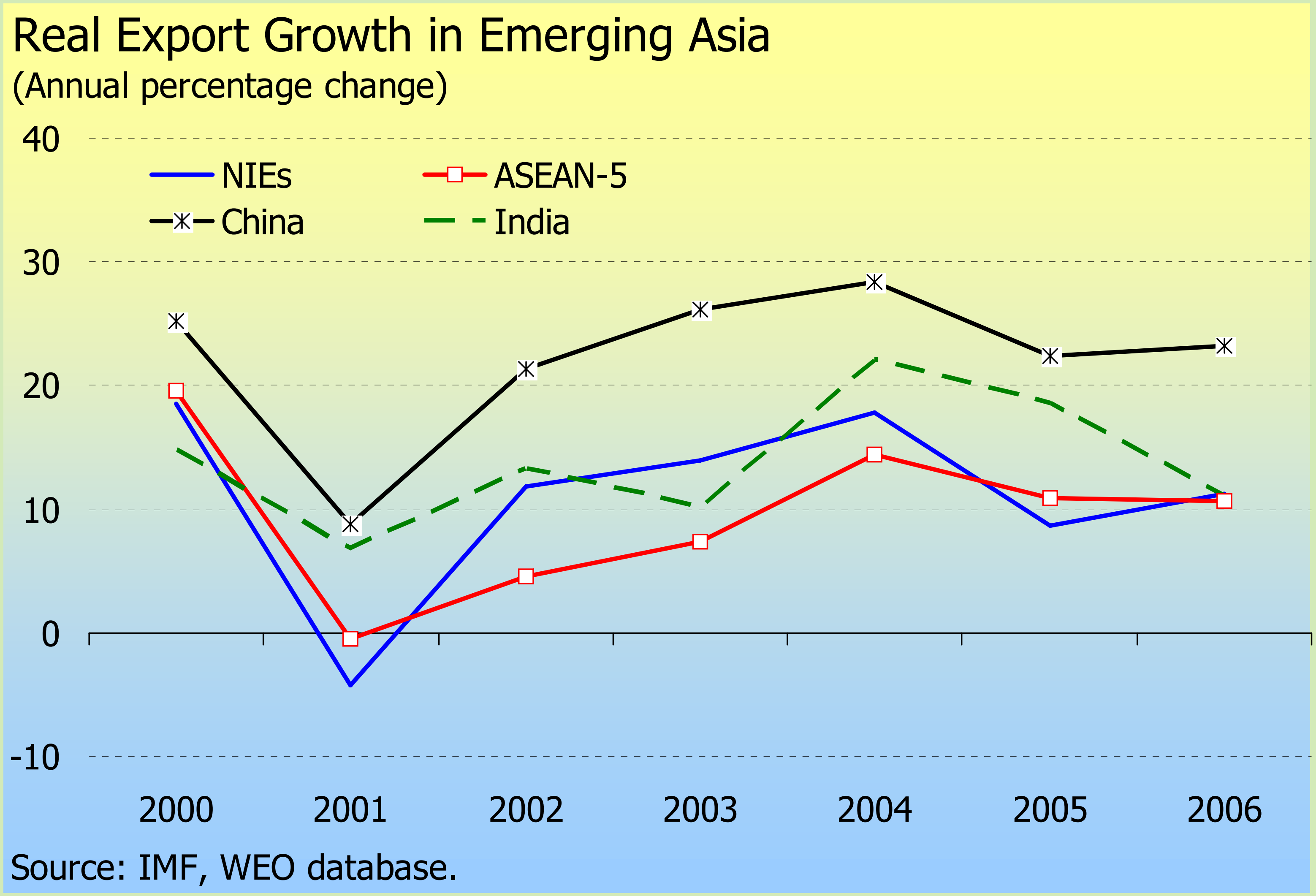
- More flexible macroeconomic frameworks, including more flexible exchange rate regimes;
- Comprehensive financial sector and corporate sector reforms, and greater transparency;
- Regional cooperation, including the Chang Mai Initiative and efforts to develop regional bond markets.

Although the outlook is favorable, the region must tackle a number of challenges to sustain strong performance over the medium term.

These include:

- Rebalancing growth;
- Coping with volatile capital flows;
- Adjusting to changing patterns of production and trade;
- Growing inequality.

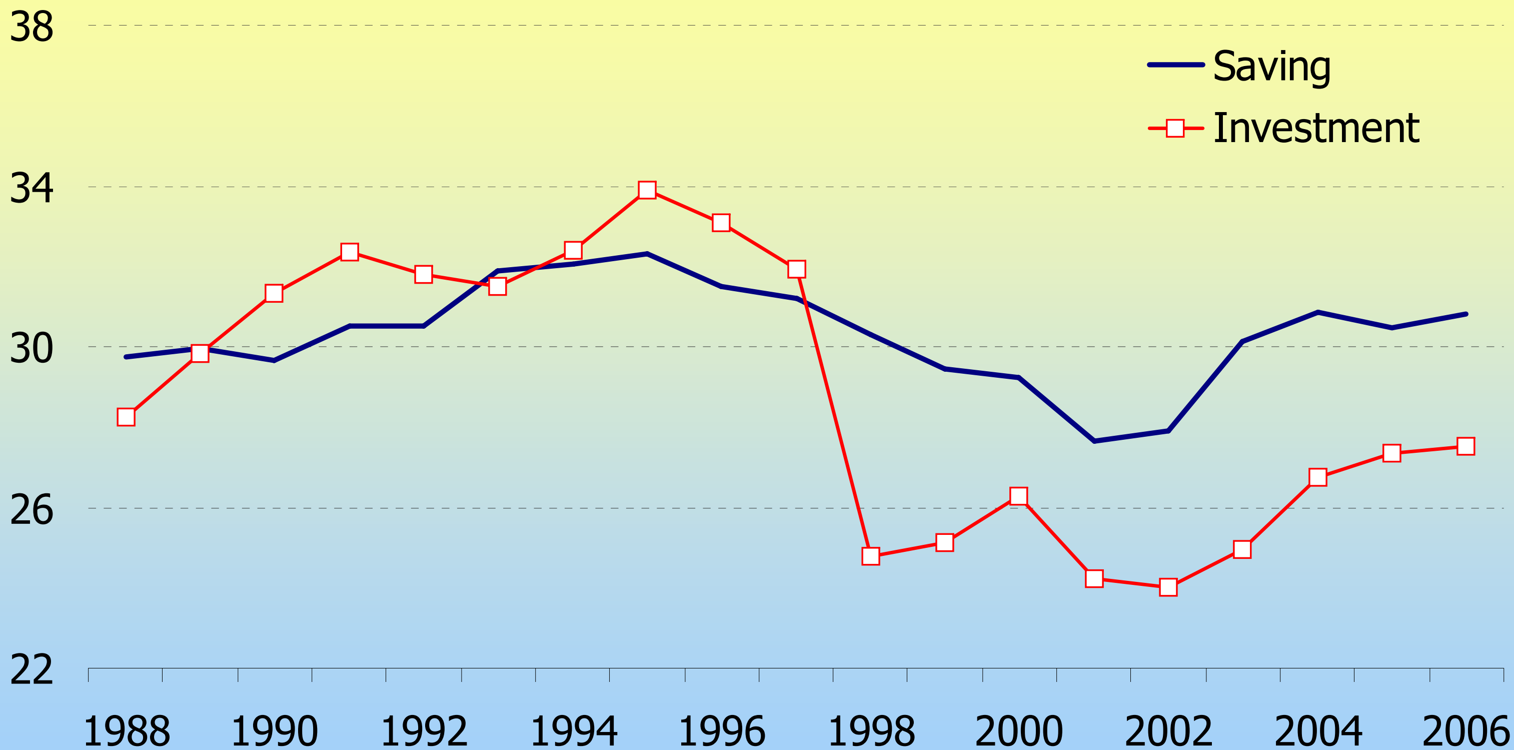
Asia continues to rely heavily on net exports as an engine of growth.



With the exception of China, weak investment lies behind the large current account surplus.

Saving and Investment in Emerging Asia[1]

(In percent of GDP)



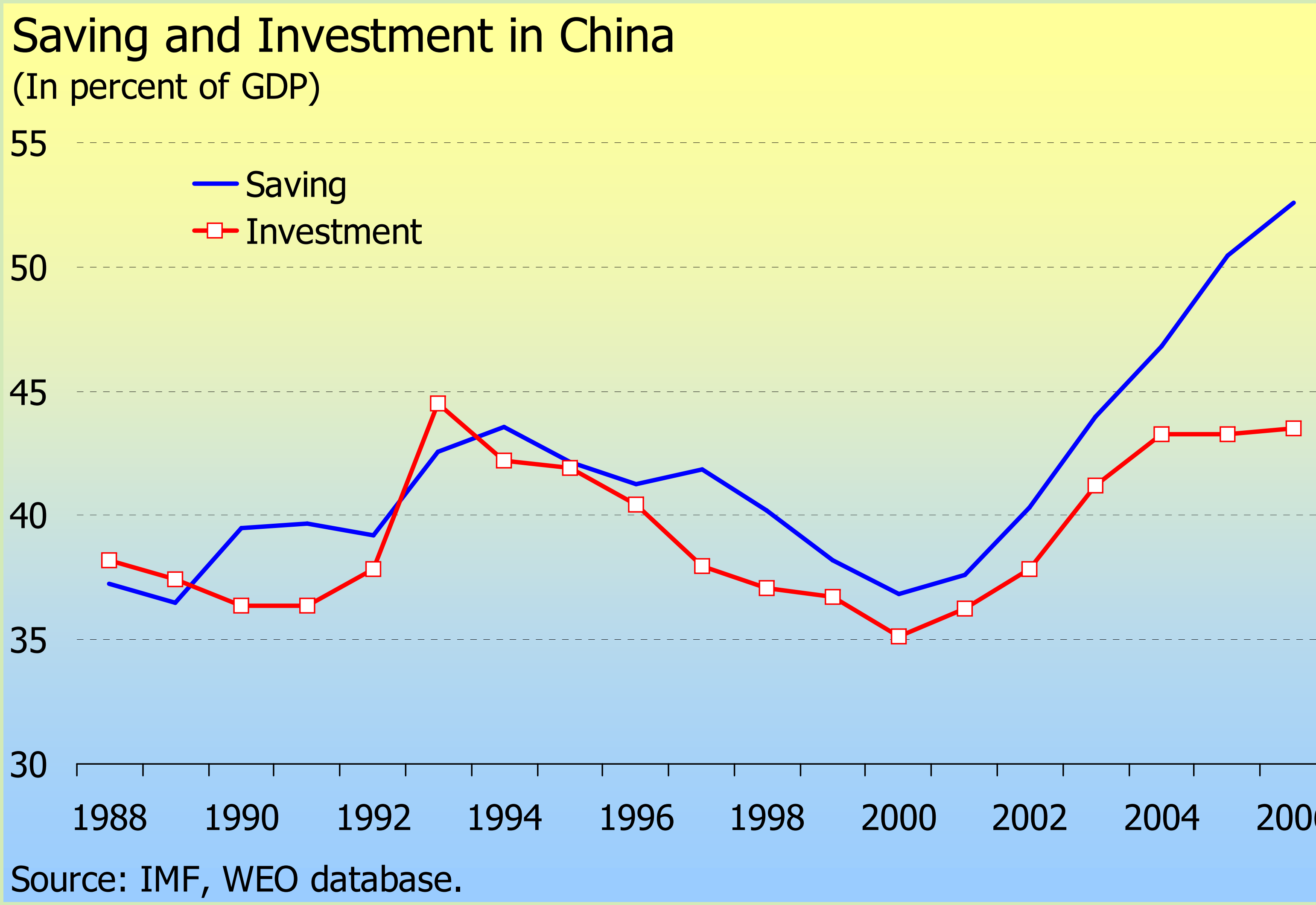
Source: IMF, WEO database.

[1] Excludes China.

Continued weak investment is not well understood.

- It is difficult to say what the "appropriate" level of investment should be, but the current levels seem to be lower than suggested by fundamentals;
- Post-crisis transitional difficulties – restructuring of banks and corporates – is largely completed;
- There is little empirical evidence that China is diverting investment from other countries;
- There is some evidence that investment has been affected by the *perception* of increased risk;
- The shift toward services may also be a factor.

In China, investment has grown rapidly but savings have increased even faster.

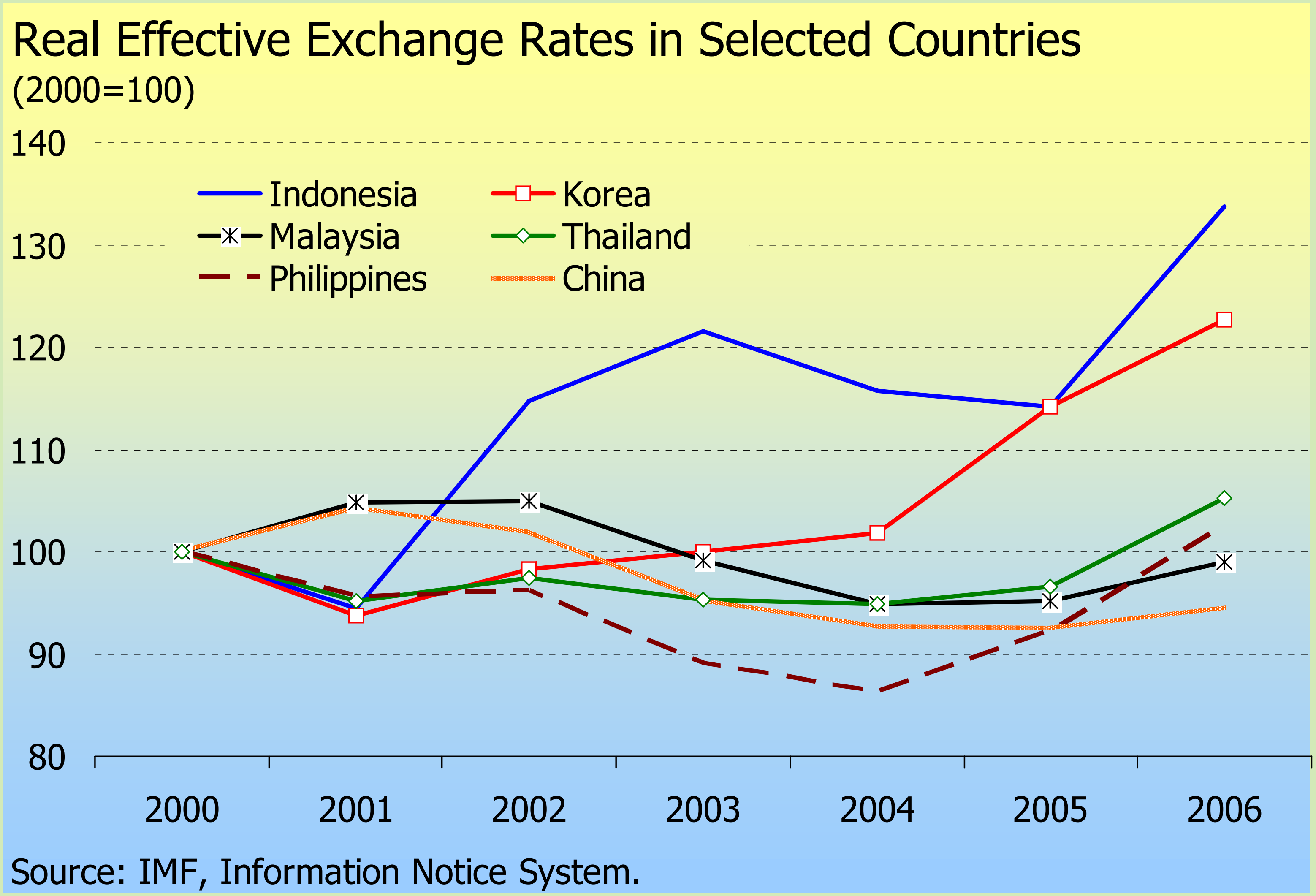


China needs to rebalance growth away from investment and net exports toward consumption.

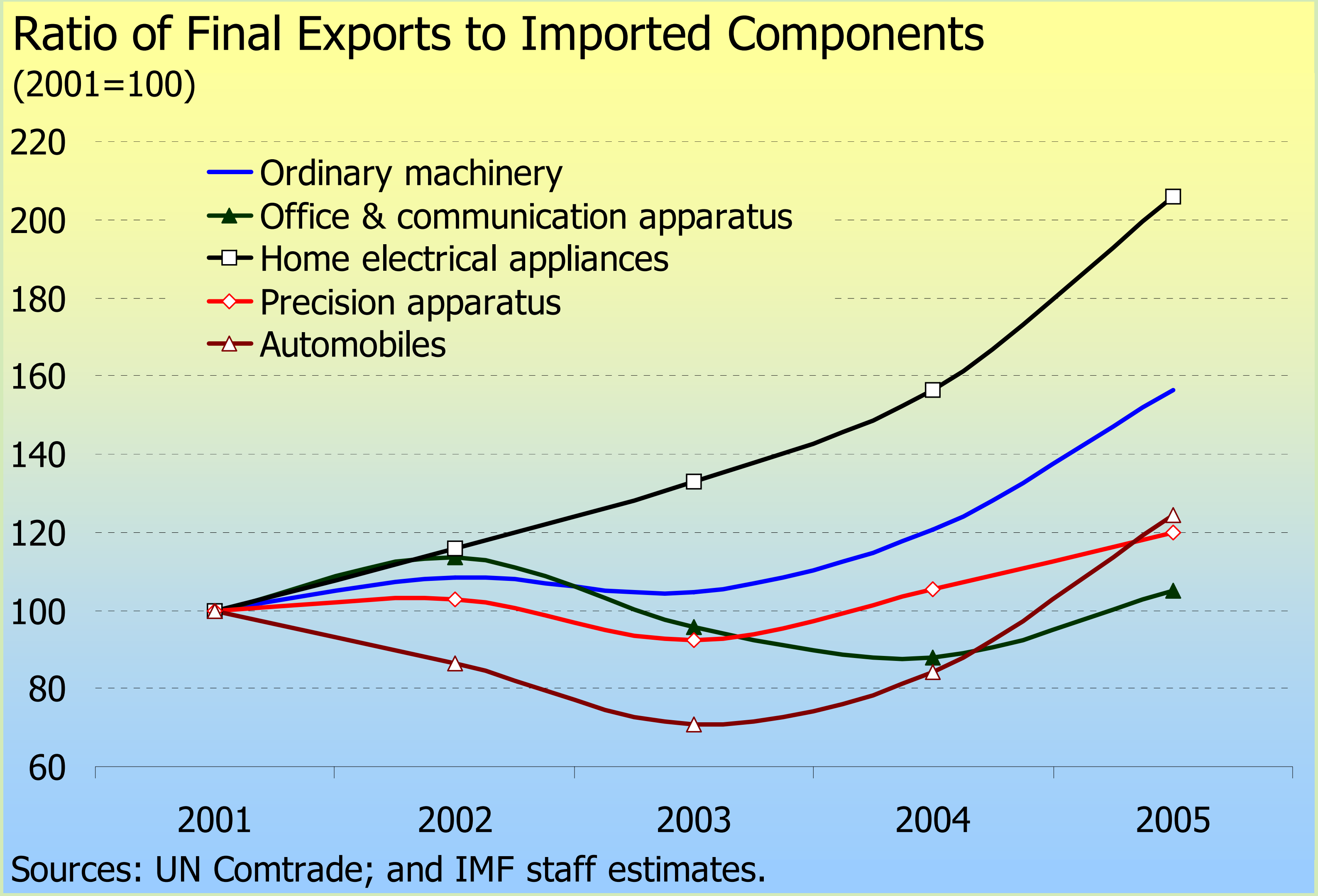
This requires:

- Reforms to strengthen social safety nets and re-orient public spending;
- Greater exchange rate flexibility to give monetary policy more scope to operate;
- Reforms to increase the quality of investment.

Flexible exchange rates will help rebalance growth, but still limited flexibility in China is a constraint.



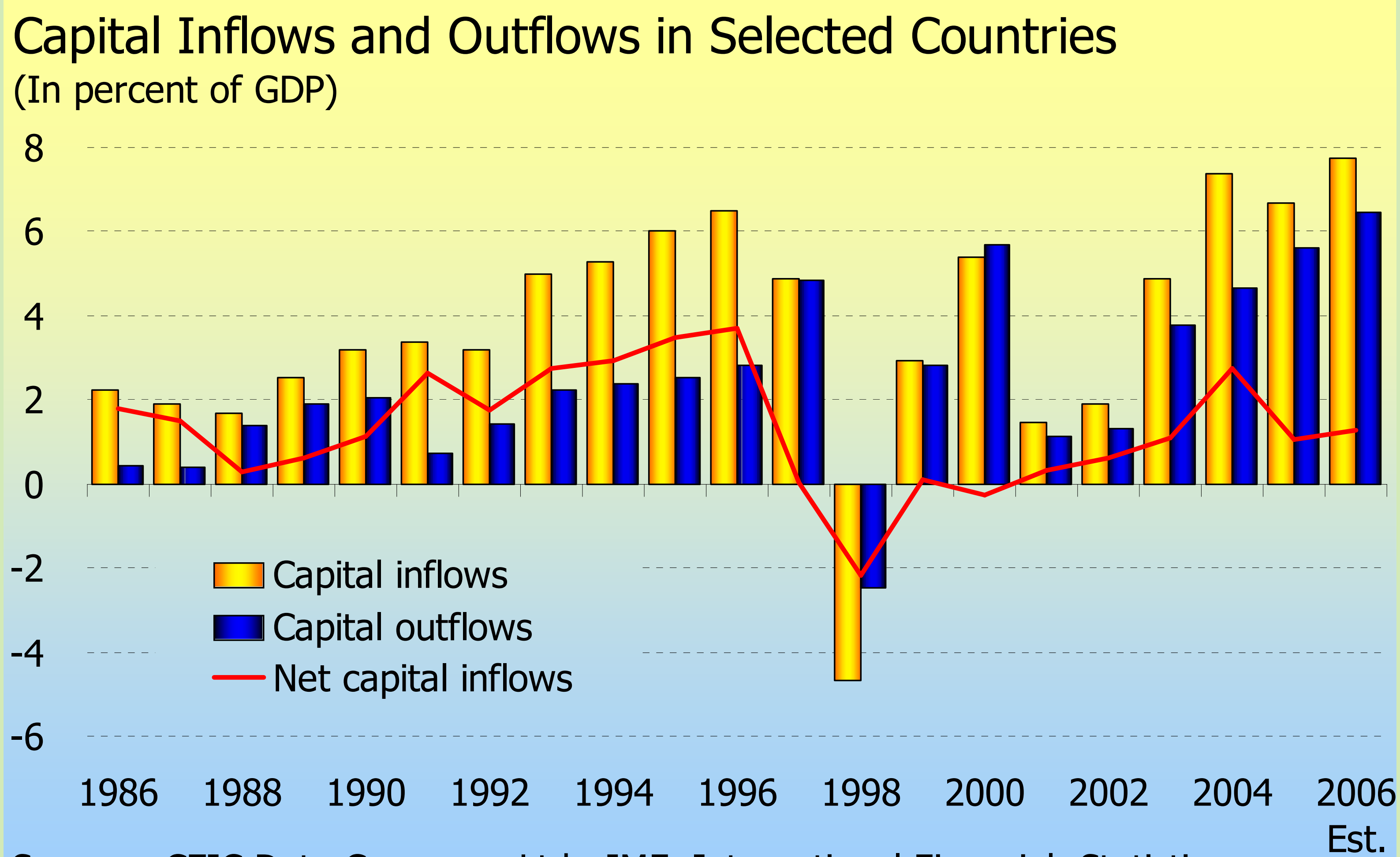
The supply chain is evolving with China increasingly using domestically sourced intermediate imports.



Increasing flexibility of economies is key to remaining competitive and responsive.

- Labor market flexibility will help labor to move to new growth industries;
- Improving the business climate will facilitate new investment and innovation;
- Education policies can upgrade skills and knowledge base.

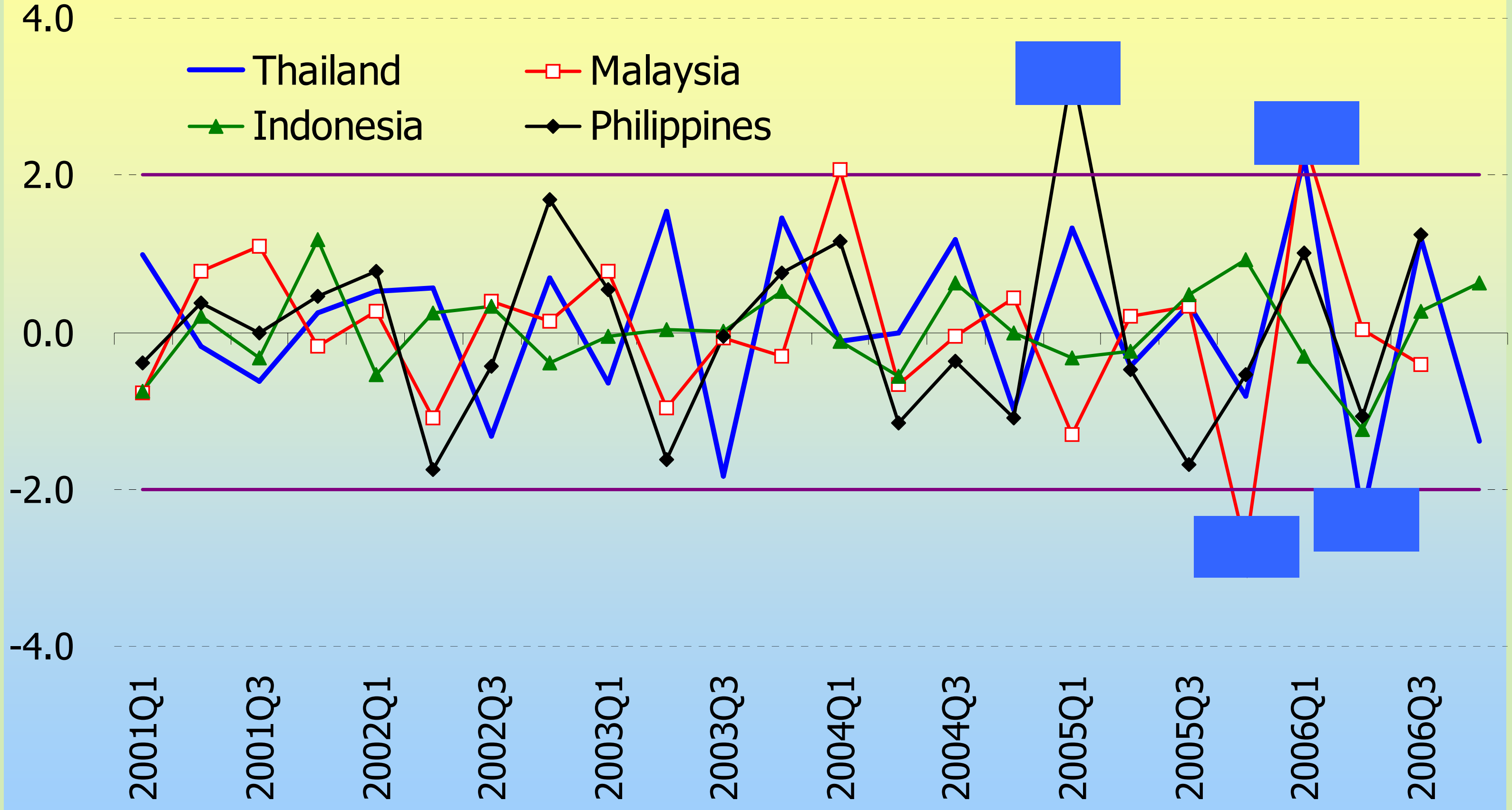
Net capital inflows are near their historical average, but gross inflows and outflows have increased.



Sources: CEIC Data Company, Ltd.; IMF, International Financial Statistics; WEO database; and staff estimates.

Surges in capital flows have become a concern.

Change in Portfolio and Other Investment Flows in Selected Countries: Deviation from Trend

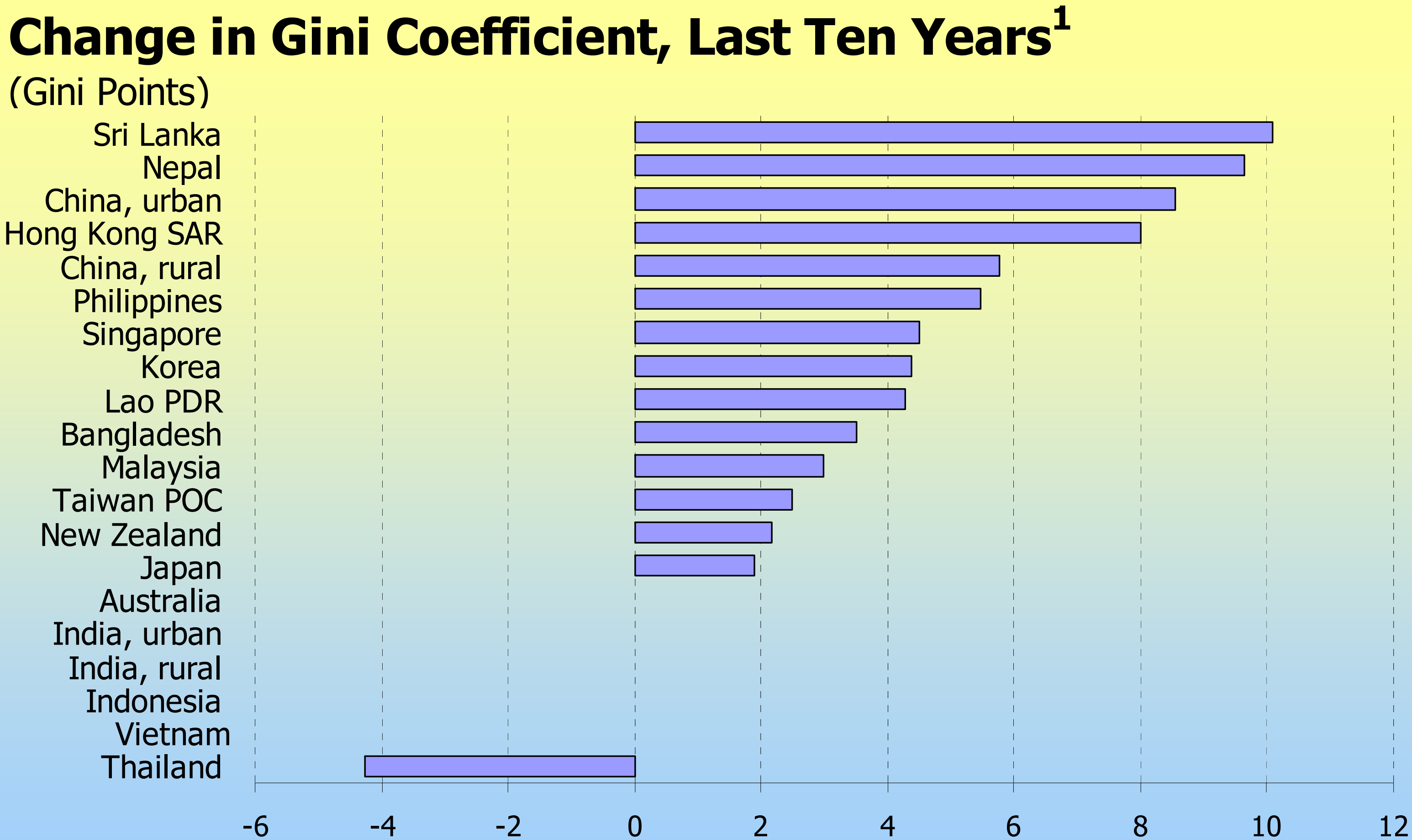


Sources: CEIC Data Company Ltd; IMF, International Financial Statistics; and staff estimates.

Coping with surges in capital inflows is challenging.

- Re-imposing capital controls can be problematic;
- The most promising policy response appears to be:
  - Exchange rate flexibility, with some sterilized intervention;
  - Strong macroeconomic and monetary frameworks;
  - Cautious further easing of remaining outflow restrictions;
  - Reforms to deepen financial markets.

Inequality has been rising across the region.



Sources: World Bank, PovCalNet database; WIDER World Income Inequality Database; OECD (2005); Australian and Korean authorities.

[1] Zero values indicate no discernable trend.

The causes of growing disparities are complex.

- Skill-based technical progress and the transition from agriculture to industry in low-income countries have been important forces;
- Policy options include better spending on education and infrastructure, as well as labor market and financial sector and social safety net reforms. Preparing for fiscal impact of aging will also be important.

Concluding Comments

- Asia is well positioned to be an ever greater force in the global economy;
- But continuous reform will be needed to fulfill this promise;
- The IMF will continue to work closely with Asian economies to achieve this goal.

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