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ASEAN and G-20: Striking the Right Balance

The Strategic Balance in Asia: Cooperation and Competition

Boediono

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Indonesia has contributed to the development of ASEAN through important periods of its evolution and rapidly changing environment. This time the Chairmanship theme is "ASEAN Community in a Global Community of Nations". Mutual suspicions have continued to characterize relations among key powers in Asia and cooperation also has a strong undercurrent of competition. Indonesia and ASEAN believe that it is not in the region's best interest for any one power to become too dominant. ASEAN+1, ASEAN+3, ARF, EAS and other regional processes are mutually reinforcing. Indonesia places importance in identifying and ensuring the complementarities among these processes so that they will not only contribute to the strengthening of the ASEAN Community but also to peace and security in the region as a whole. In relation to the East Asia Summit (EAS), during Indonesia's chairmanship, one of our pre-occupations is in ensuring that the EAS, with enlarged participation, can contribute to the maintenance and promotion of a stable and peaceful regional environment. [Ed.]

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G-20: The Economic Perspective from Developing Asia

Iwan Jaya Azis

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From the Asian perspective, rebalancing translates into two strategic goals: increasing intraregional trade and stimulating domestic demand. For the first, it is important for the region to dismantle any barriers to intraregional trade and to maintain the stability of intraregional exchange rates. Along with rising inflows of portfolio investment that put a strong pressure on exchange rates, this warrants exchange rate cooperation. But Asia is likely to shy away from a strong form of cooperation or other forms that require strong institutions. For the second, spurring domestic consumption in PRC and investment in other Asian countries are the priority. But the fast growing financial sector that so far supports the region's economic growth needs to be made more inclusive. The overall macroeconomic policy should be consistent with other efforts to reverse the widespread trend of increased income inequality and

The Strategic Balance in Asia: Cooperation & Competition

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As you know, Indonesia is currently the chairman of ASEAN and will shortly be hosting the 18th ASEAN Summit in Jakarta. Indonesia has requested to bring its ASEAN chairmanship forward from 2011 to 2013, not only because in 2013 Indonesia will also be hosting the APEC leaders' meeting, but hopefully also to allow us sufficient time to ensure that all of the necessary preparations are put in place for the realization of the ASEAN Community in 2015 and beyond.

Indonesia has contributed to the development of ASEAN through important periods of its evolution and rapidly changing environment. You may remember that two key agreements, Bali Concord I of 1976 and Bali Concord II of 2003, were reached under Indonesia's chairmanship. Through the Bali Concord II the member states of ASEAN agreed to the development of an ASEAN Community with three pillars, an ASEAN Economic Community (AEC), an ASEAN Political and Security Community (APSC) and an ASEAN Social and Cultural Community (ASCC).

This time the Chairmanship theme is "ASEAN Community in a Global Community of Nations". In the chair Indonesia will Endeavour to strengthen ASEAN's position as part of the solution to global problems by addressing three levels of priorities which reinforce one another:

Boediono is the Vice President of the Republic of Indonesia.

This is an edited version of his keynote address at

The Asia News Network Seminar in Jakarta, April 26, 2011.

1. To ensure the achievement of significant progress towards the attainment of the ASEAN Community. We will do this by continuing and building upon past achievements, and by identifying and forging new areas of cooperation in the three pillars. We will also continue to address issues of particular concern for region;
2. To ensure the evolving regional architecture and environment remain conducive to the pursuit of development in the region. A part of this is to ensure that ASEAN remains in the driving seat in shaping an expanded East Asia Summit as well as strengthening ASEAN's other partnerships with dialogue partners.
3. To chart a post-2015 vision for ASEAN whereby there will be a more cohesive ASEAN role in addressing global issues.

Indonesia's first priority as Chair of ASEAN is to ensure that the member states of ASEAN meet the commitments that have been laid out in the three community blue prints. In particular we want to ensure that the development towards an ASEAN Community will continue to adhere to the spirits, norms and principles contained in the ASEAN Charter. The Preamble of the ASEAN Charter clearly stipulates: "Adhering to the principles of democracy, the rule of law and good governance, respect for and protection of human rights and fundamental freedoms".

The Indonesian government has made it a matter of national policy that the evolving ASEAN Community is truly people-centered and people-oriented. After all, what is a community without the people being at the centre? In assuming the chairmanship of ASEAN the Indonesian government has, therefore, actively encouraged and sought the participation of the business community, academics, the media, NGOs and the wider civil society in various ASEAN-related activities. If we are really serious about creating an ASEAN Community by 2015, we must all work hard to change the image of ASEAN as an elitist and mostly inter-governmental organization, to one which is truly owned and cared for by the larger community of ASEAN peoples.

Within the political-security pillar, Indonesia has brought its transition towards democracy to ASEAN. With the Bali Concord II in 2003 and its ASEAN Political-Security Community Blueprint, Indonesia puts the promotion of democracy in ASEAN's agenda. Indonesia's ef-

forts to promote democracy are also reflected in the wider region, such as with the biennial convening of the Bali Democracy Forum, which is consistently attended not only by most ASEAN member countries but also by many other Asia Pacific countries.

Indonesia has also continuously pushed for the promotion and protection of human rights. The ASEAN Charter has adopted human rights and humanitarian laws. With Indonesia's insistence, ASEAN has established the ASEAN Inter-Governmental Commission on Human Rights (AICHR), the first human rights commission in the Asia Pacific.

In the economic pillar, ASEAN is establishing an ASEAN Economic Community that has four characteristics: a single market, a competitive economy, integration to the global economy and equitable development. The four characteristics must all receive equal attention.

The key point is that if we really want to create a cohesive community of ASEAN, our endeavors for trade liberalization and single market must be balanced by serious attention to equitable development. Therefore, among Indonesia's prioritized areas is the enhancement of development cooperation among ASEAN members, one such cooperation is between ASEAN's SMEs. At the same time, ASEAN's integration to the global economy suits well with the theme of the Chairmanship. ASEAN's representation in the G20 and the intention of the Chair of the G20 to meet with ASEAN Leaders are among the reflections of this trend.

Indonesia will continue the work to strengthen the caring and sharing community under the socio-cultural pillar. Among others, Indonesia is pushing for cooperation in education, health and disaster management. The establishment of the ASEAN Humanitarian Assistance (AHA) Centre in Jakarta is expected to increase the efficacy of the provision of humanitarian assistance by regional and international actors when disaster strikes.

Now I would like to turn to the second priority of the Indonesian chairmanship, namely to ensure a conducive regional environment and ASEAN's centrality in the evolving regional architecture. May I remind everyone here that this priority is not of Indonesia's own making, but is also mandated by the ASEAN Charter which states that one of the purposes of ASEAN is: "To maintain the centrality and proac-

tive role of ASEAN as the primary driving force in its relations and cooperation with its external partners in a regional architecture that is open, transparent and inclusive". Indonesia is firmly committed to ensuring that ASEAN will be in a position to play the kind of regional role that it aspires to, first by enhancing its capacity and credibility to act together, and second by skillfully managing its relations with major neighboring powers.

Asia is home to several large powers whose interests have collided in the past. With the Cold War well behind and the imperatives of globalization as well as the common transnational challenges now confronting all countries, many former enemies have increasingly developed close cooperation on many fields. Yet mutual suspicions have continued to characterize relations among key powers in Asia and cooperation also has a strong undercurrent of competition. Indonesia and ASEAN believe that it is not in the region's best interest for any one power to become too dominant.

A stable and peaceful regional environment is essential for the pursuit of economic development and social process. The Treaty of Amity and Cooperation in the Southeast Asia is the code of conduct for relations in the region. The TAC is gaining recognition from outside the region with some countries express its intention to accede to the TAC.

At the same time, the multifaceted, multidimensional and yet interlinked and constantly evolving nature of the security challenges in the wider East Asia Region defy national solutions. ASEAN must take a leading role in molding the wider region's response to the aforementioned security challenges through wider regional forums. In this regard, ASEAN+1, ASEAN+3, ARF, EAS and other regional processes are mutually reinforcing. Indonesia places importance in identifying and ensuring the complementarities among these processes so that they will not only contribute to the strengthening of the ASEAN Community but also to peace and security in the region as a whole.

In relation to the East Asia Summit (EAS), during Indonesia's chairmanship, one of our pre-occupations is in ensuring that the EAS, with enlarged participation, can contribute to the maintenance and promotion of a stable and peaceful regional environment. This can be achieved through the maintenance of a "dynamic equilibrium",

whereby emphasis is placed on win-win solutions and the absence of one or a few dominant actors. Further, Indonesia envisions the development of a sense of “community” among the EAS participants. The emphasis is placed on the notions of common security, common prosperity and common stability. With such notions and common vision in place, peace and stability are ensured.

Finally I would like to touch briefly on free trade agreements of FTAs. There are several reasons for the growing FTAs both between an individual ASEAN country and others or between ASEAN and another third country. These include (i) Deepening of production networks through FTA-led trade and investment liberalization; (ii) Need to improve international competitiveness through exploitation of scale economies; (iii) a Defensive response to European and North American economic regionalism to improve competitiveness and raise voice on global trade issues (iv) act as Insurance against the slow progress of Doha. I know there is still dispute in theoretical discourse, but in reality FTAs are seen as complementary building blocks to continued multilateral liberalization and WTO-plus scope.

The biggest challenge lies in political economy both domestically and regionally, as well as geopolitical considerations in moving forward on further and bigger economic cooperation like ASEAN+3/+6. Whichever road is taken, integration should be deepened and domestic reforms pursued.

No country can afford to remain isolated from the growing trend of economic interdependence and integration without suffering losses. On the other hand, we must also recognize the differences between countries and ensure that all necessary measures must be taken to prevent the growing gap between more competitive and less competitive economies. I must say that Indonesia in particular needs, and is resolved, to work much harder to improve our national competitiveness by eliminating bottlenecks, improving infrastructure, rooting out corruption and improving bureaucratic effectiveness, among others.

At the regional level as the economies of the ASEAN countries are becoming more integrated there is also a need to harmonize or introduce rules and laws on regional level. There are still a lot of works to be done in this area.

Once the ASEAN Community is realized in all the three pillars, or significantly so, then ASEAN will undoubtedly be able to make a much greater mark within the Global Community of Nations through its greater ability to take collective action based on a common regional platform.

G-20: The Economic Perspective from Developing Asia

Iwan J Azis

Global Imbalances

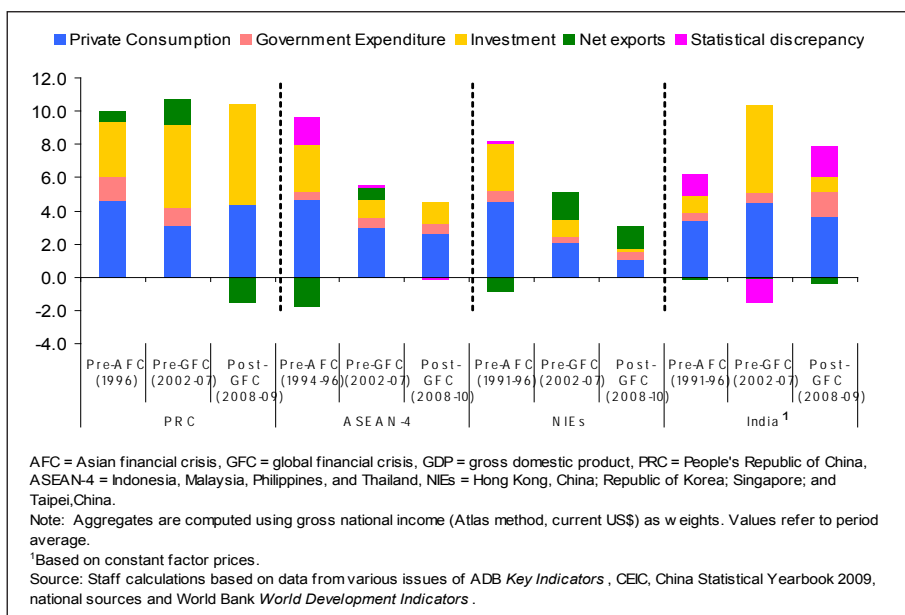
As the most dynamic region in the world, Asia has an important role to play in shaping the G-20 agenda for balanced and sustainable growth. This requires Asia to help provide global public goods and to rebalance the global economy. From the Asian perspective, rebalancing translates into two strategic goals: increasing intraregional trade and stimulating domestic demand.¹ This is particularly relevant for East Asian countries. In the last few years, the region's trade pattern has been characterized by increased intraregional trade of intermediate inputs, while trade of final goods is mostly with industrial countries. A production network has emerged in a big way, where multinational companies can lower the cost of production by taking advantage of the proliferating free trade agreements (FTAs) in the region.

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¹ Iwan J. Azis, *Crisis, Complexity, and Conflict* (London: Emerald, 2009).

After the recent crisis, such a trade pattern cannot be sustained; alternative markets need to be found as the demand prospect from industrial countries becomes more uncertain. The alternative that makes sense is the region itself. For export-oriented economies, shifting entirely from external to domestic demand does not make sense, while for other economies, strengthening domestic demand is critical. Raising consumption should be the priority for the PRC, and raising investment is the most important challenge for the rest of Asia. Since early 2000, a major source of growth in most countries except the PRC has been private consumption, not investment (Figure 1). This has caused the saving–investment imbalance to widen.

Figure 1: Sources of GDP Growth, Expenditure Approach—Emerging Asia
(percentage points)



Why the low investment? Since the Asian crisis, most investors in the region have turned cautious and more conservative. The “usual suspects” also persist, i.e., institutional constraints, a less than favorable investment climate, and limited infrastructure. On the other hand, saving remains high and growing. Households in developing economies have strong precautionary motives to save, for, among other rea-

sons, a lack of formal social safety nets. The corporate sector also has a high propensity to save because of various kinds of uncertainties. It is ironic that excess saving occurs when the region badly needs financing for new and improved infrastructure.²

Growing demand in industrial countries and low supply elasticity in the US mean a strong growth of exports and continued trade surplus in export-oriented economies. This contributes to the widening of global current account imbalances. In terms of size, the imbalance is largest between the US and the PRC. Trade of the PRC with other Asian countries is generally in deficit, while imbalances of Asia excluding the PRC with industrial countries and the US are relatively small. Thus, the role of PRC is critical as far as Asia's contribution to global imbalances is concerned.

An easy money environment was one of the important sources of global imbalances that fueled the recent crisis.³⁶ The fear of deflationary pressure associated with falling asset prices after the Asian financial crisis, the tech bust in 2000, and the looming Iraq war, prompted the Federal Reserve to adopt an accommodative fiscal and monetary policy that caused not only excessive spending and a credit boom, including one in the housing market, but also raised US imports, particularly from Asia (see Azis, 2009). This exacerbated the already large US current account deficit caused by the growing fiscal deficit, especially since early 2000. The resulting appreciation of Asian currencies—albeit not all are fully flexible—and lower returns in industrial countries brought most capital back to Asia. Hence, a round-tripping pattern was established with high transaction costs. Market intervention by most Asian authorities then caused further accumulation of foreign re-

² ADB (Asian Development Bank) and ADBI (Asian Development Bank Institute), *Infrastructure for a Seamless Asia* (Manila: Asian Development Bank, 2009).

³ ⁶ In its final report, the congressional commission of 10 members formed to investigate the causes of the crisis concludes that it was the result of "human action and inaction, not of Mother Nature or computer models gone haywire." The report clearly singles out the Federal Reserve for backing "30 years of deregulation." The report also points out that the IMF did appropriately stress the urgency of addressing large global current account imbalances that risked triggering a rapid and sharp decline in the dollar that could set off a global recession, although it failed to link these imbalances to the systemic risks building in financial systems (Source: FCIC (Financial Crisis Inquiry Commission), "Conclusions of the Financial Crisis Inquiry Commission," 2011, available at www.fcic.gov/report/conclusions).

serves.⁴ From this perspective, to deal with global imbalances, policies directed toward lowering the US fiscal deficit are as critical as other measures.

During the crisis, global current account imbalances actually narrowed as world trade volume also fell. Asia contributed to this encouraging trend: trade began to diversify, with intraregional trade expanding to include more Asian countries, while exports to non-Asian emerging markets increased as well. The current account surplus in many countries started to fall, and the largest source of growth was domestic demand. The PRC's 12th Five-Year Plan also put a strong emphasis on rebalancing demand toward domestic sources, particularly consumption. There is, however, no reason to believe that this trend of declining global imbalances will continue. The growth of global trade, which showed a V-shaped recovery in 2009–2010, has started to slow. Many forecasts also predict that global imbalances are likely to grow in the coming years.⁵ This is worrisome because the current recovery in many countries is fragile. From the recent crisis we have seen the severe damage that growing imbalances can create.

Rising oil prices raise further concerns, although G-20 can actually resolve this matter in a more coordinated way since its members include both the world's largest oil producer and world's largest consumer. During the past decades we have seen several episodes of oil price increase and their impact on the world economy. Unlike in the past, however, the surge of oil prices that began in the fall of 2004 did not result in a major economic slowdown; at least not in any of the G-20 countries. In oil-importing economies, the demand-driven nature of the oil price shock counteracted its adverse repercussions.⁶ But the impact of the current oil price increase may be different. It may be more serious because many economies have just started to recover

⁴ With rising costs of keeping a large amount of reserves, some Asian governments set up and use government-controlled investment companies to manage a portion of official foreign reserves to adjust portfolio composition.

⁵ IMF, "Global Economic Prospects and Policy Challenges," prepared for the Meeting of G-20 Finance Ministers and Central Bank Governors, 2010, available at <http://www.imf.org/external/np/G-20/pdf/060410.pdf>.

⁶ Most countries in Asia are net-oil importers, intensive in energy use, and are relatively inefficient in energy use; in some countries, however, the share of oil in total energy use is not that large.

from the most severe crisis since the Great Depression, and because the recovery in Europe and the US is still fragile.

For poor Asian countries, this adds to the seriousness of the problem, since they are also struggling to cope with the rising food prices that raise poverty and malnutrition rates. Ironically, in many agriculture-based economies, rising food prices do not necessarily translate into higher incomes of farmers, that is, the farmers' terms of trade does not improve. While there may not be much that can be done to deal with the supply-side shock (weather-related), a policy reform in food production and distribution that will ensure the pass-through of food price increases to farmers' income can be proposed as part of the G-20 development agenda.

Intraregional Trade and Exchange Rate Cooperation

The impact of a sharp fall in world trade during the crisis was particularly severe in export-oriented economies such as Japan, Korea, PRC, Malaysia, Singapore, and Thailand. Industrial countries including the US are important markets for their final goods exports, whereas intermediate goods are imported from other Asian countries. This pattern of trade has been one of the characteristics of the production network that has spread across East and Southeast Asia.⁷ Although industrial countries made assurances during the London G-20 Summit that they would keep their markets open, it would be ill-advised for Asia to continue relying on markets in industrial countries for their final goods exports. With demand falling from the slow-growing industrial countries, intraregional trade in final goods is expected to increase. It is therefore important for the region to dismantle any barriers to intraregional trade.

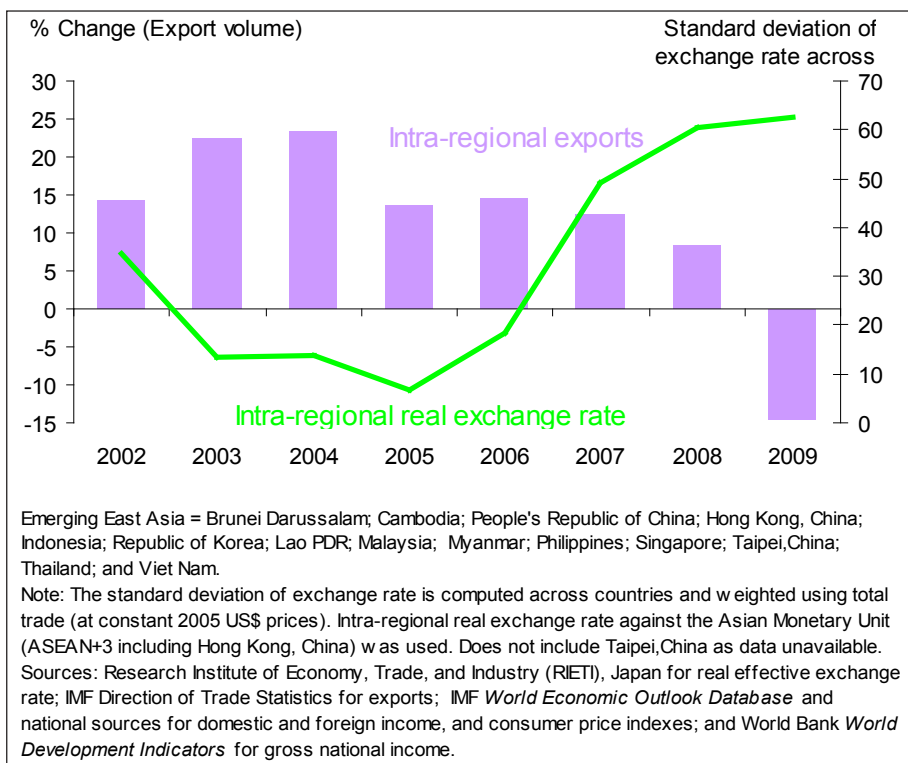
A scenario where PRC consumers can take up lost US demand for products from Asia is unlikely in the short run. Freer trade among Asian countries is the only reasonable solution that will simultaneously deal with the problems of global imbalances. Here, the proliferation of FTAs among Asian countries is helpful.⁸

⁷ This production network has played an important role in forging the region's productivity.

⁸ Although some agreements that cover all Asia are still elusive, and in some cases the pace of implementation remains questionable.

No less important is the stability of intraregional exchange rates. Evidence has shown that stable intraregional rates can help foster intraregional trade. After Lehman's collapse, intraregional rates started to become more volatile and intraregional trade fell (Figure 2).⁹ External forces that are also at play caused volatility to continue. The second round of quantitative easing by the US Federal Reserve, aimed at preventing a possible deflationary spiral at a time of fiscal policy paralysis, is adding more pressures for capital to flow out from the US. Even before this second round was announced, interest rates in the US and

**Figure 2: Intra-regional Exports and Exchange Rate—
Emerging East Asia**

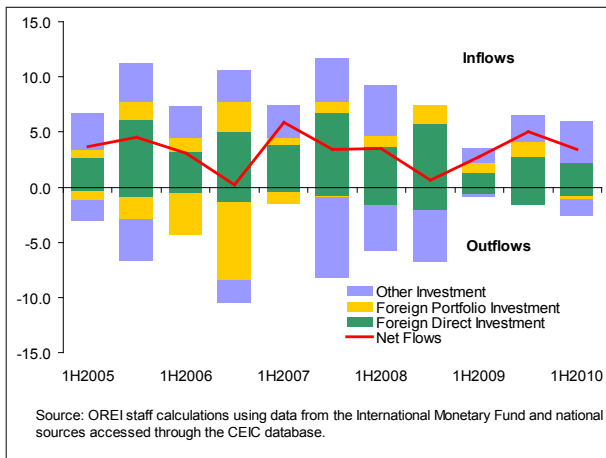


⁹ Greater intraregional exchange rate stability can also help reduce policy tension. It is, however, to the region's advantage if flexibility of their currencies against non-regional currencies is maintained. The flexibility is important for managing external shocks and further capital flows.

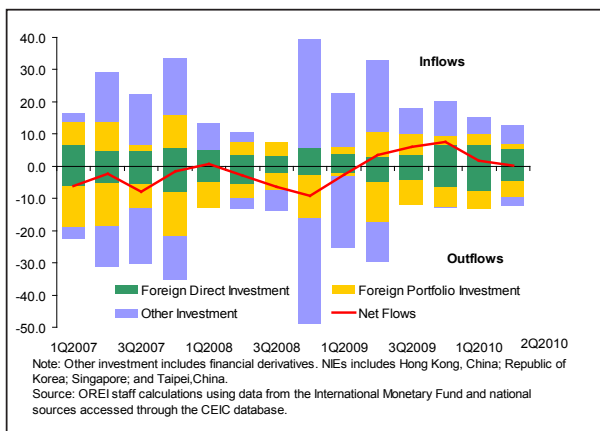
other industrial countries were already low, triggering a wave of capital outflows. A substantial amount of them flowed into emerging Asia with its high returns, robust growth, stable macroeconomic conditions, and strong currencies. As shown in Figures 3a, 3b, 3c, and 3d, after dipping sharply during the crisis, capital has returned to the region. Even in net terms, the trend in ASEAN-4, the newly industrialized economies, and India showed a marked increase of inflows right after the crisis.

Figure 3: Financial Account Flows
(% of GDP)

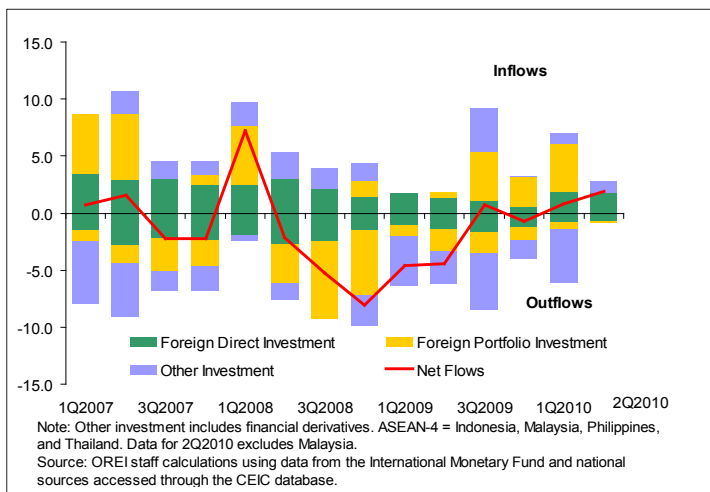
a) People’s Republic of China



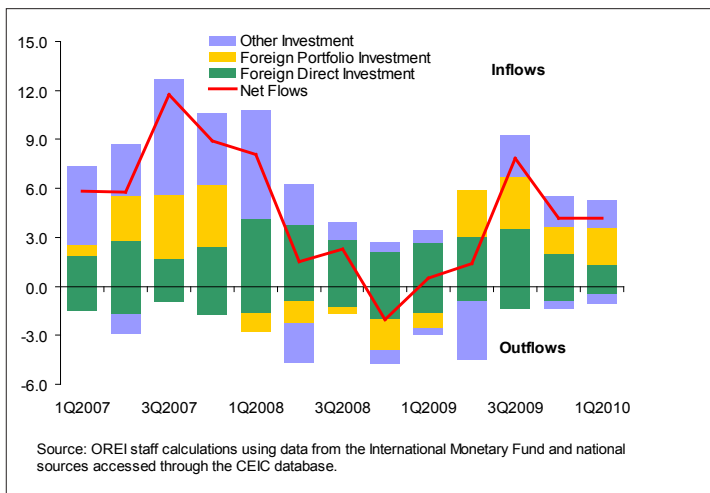
b) ASEAN-4



c) NIEs



d) India



While the composition of capital flows varies across countries, rising portfolio investment put a strong pressure on exchange rates. The resulting dollar depreciation (Asian currencies' appreciation) led many countries to respond by either imposing capital controls or conducting exchange rate intervention. This makes efforts to maintain stability of intraregional exchange rates more difficult, but at the same time it

opens up the possibility of policy coordination. Indeed, some countries in ASEAN+3, supported by the ADB, have initiated a series of discussions and policy dialogues on this issue.

The spillover effects of unilateral capital control, and awareness that it can potentially create distortion, also reinforce the need for cooperation. The fear of a sudden stop (as in 1997) is another source of concern. But the difficulty in finding an acceptable modality of cooperation due to the diversity of exchange regimes and associated political sensitivity may have put off any formal arrangement from emerging. A classic case of the prisoner's dilemma thus prevails.

Because the PRC's trade balance with most ASEAN countries is in deficit, a scenario of simultaneous exchange rate adjustment through cooperation will also make the realignment of the Yuan easier. It may be more effective than pressuring a country to adopt a particular exchange system. Indeed, economists are not always in agreement as to what exchange rate system is best to adopt. While globally there has been a trend of increasing number of floaters, it remains unclear how to determine the extent to which a currency deviates from its equilibrium level. Appropriateness of a particular regime depends on each country's conditions. The exchange rate system in Asia is diverse, ranging from a floating Japanese yen to a currency board system in Hong Kong, China (others are in between). Equally ambiguous is the precise definition and level of equilibrium exchange rate. While some currencies may be undervalued, the type and the extent of intervention considered acceptable remains a gray area. In the past, the IMF often supported efforts made by industrial countries to coordinate their monetary and fiscal policies that could alter the exchange rate in the name of maintaining global financial stability.¹⁰

While exchange rate cooperation is warranted, Asia is likely to shy away from a strong form of cooperation or other forms that require strong institutions (such as monetary union or common currency). The recent sovereign debt crisis in Europe made the benefit of having such arrangements doubtful. Also, Asia does not have a good track record

¹⁰ At least the IMF does not place any obligations on those countries when they conduct such efforts.

of institution-heavy economic cooperation.¹¹ But there is still a whole spectrum of options to select, ranging from a basket system that can be designed to avoid the “N-1” problem, to Bretton Woods–like systems where countries directly peg their currencies to each other and let them float jointly against other currencies, say, the US dollar (similar to what happened in Europe before a common currency was adopted and managed by a supranational body, the European Central Bank). The rates against a regional basket such as the Asian Monetary Unit (AMU) can also be used as a reference zone, certain deviations from which will trigger some policy measure. The lightest form of arrangement would be simply to enhance policy dialogue among member countries, for example through the existing Economic Review and Policy Dialogue forum. After the Chiang Mai Initiative was multilateralized in early 2010 (to become CMIM), finance ministers of ASEAN+3 made a decision to establish an independent surveillance unit, the ASEAN+3 Macroeconomic Research Office. This marks the region’s first step toward institutionalizing financial cooperation. It is likely that exchange rates and capital flows will be part of that office’s surveillance analysis, along with other macroeconomic issues.

Another related source of concern is the declining value of the US dollar. Many Asian countries worry that rising commodity prices and a soaring US deficit to pay for stimulus can lead to higher inflation that will undercut the value of their US dollar-denominated reserves. The PRC and Japan are the largest holders of US Treasury bills. No wonder on several occasions PRC officials questioned profligate US spending habits. It is in this context that ideas were floated that Asians either need their own currency or should adopt a currency basket to replace the dollar. Actually such a proposal was raised right after the Asian financial crisis, but the recent trend may have strengthened its rationale—and it may quicken the process. Looking at currency movements in selected Asian countries, over the last few years reliance on the dollar has been declining, and the role of other currencies, including the yen and Yuan, has increased. This occurred without any announcement about a basket system. But to move to the next step, closer policy coordination is obviously needed.

¹¹ Even during the recent crisis, the Chiang Mai Initiative was not used.

Through the G-20, Asia can learn from the experience of other G-20 countries—in Europe in particular—in policy coordination and exchange rate cooperation. By realizing the differences between the two sets of economies, lessons can be learned as to what policy direction to take, what not to take, and what needs to be done. The speed and nature of each stage and the components of cooperation can be studied, and when found relevant to the Asian context, they can be emulated.

Domestic Demand and Interactions with Development Issues

From Asia's perspective, giving a more prominent role to development issues in the G-20 agenda, as decided at the Seoul Summit, is commendable. One of the G-20 development initiatives highly relevant for Asia is financial inclusion. Through the Financial Inclusion Experts Group, nine Principles for Innovative Financial Inclusion were announced at the Toronto G-20 Summit. The principles, from leadership to regulatory framework, are intended to form the basis of a concrete action plan for improving access to financial services for the poor, details of which were released at the Seoul Summit. Two broad agenda have been selected: access through innovation, and finance for small and medium-sized enterprises.

But G-20 also covers other development issues, many of which are relevant for Asia as well. Most governments in Asia realize the need to strengthen social safety nets, including pension and health insurance programs; speed up the development of physical infrastructure to reduce supply bottlenecks; and raise investment for more sustainable long-term growth, such as energy efficiency, renewable and clean energies, green transportation, and quality-of-life services (health care and sanitation). All these are not inconsistent with rebalancing. Strategies have been discussed and designed, measures have been taken, and some may not be the most optimal and their implementation may face many bottlenecks, especially when macro and fiscal policy is inconsistent with more development-oriented measures such as these. Still, any strategies and policy measures (including those directed toward lowering global imbalances and mitigating their impact) ought to be linked with the ultimate goal of welfare improvement. The effectiveness of those policies needs to be evaluated based on indicators that go beyond the narrow macroeconomic and financial sector.

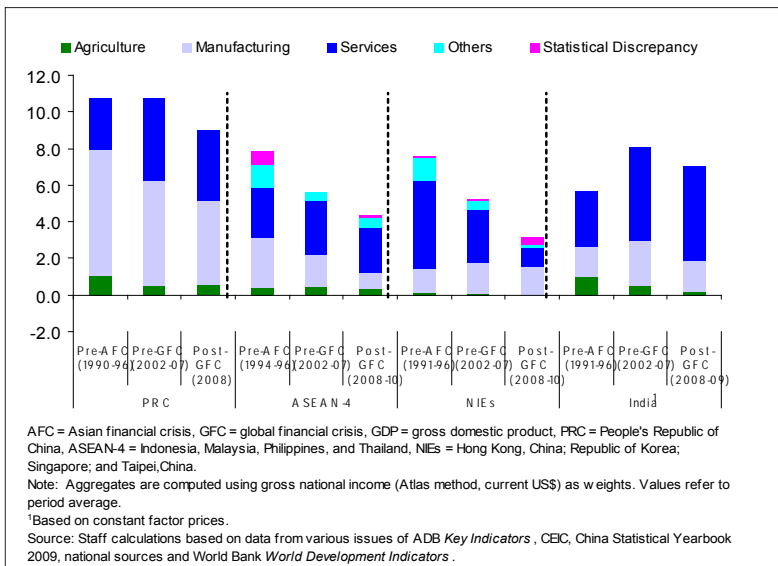
Indeed, while development issues are diverse and by themselves deserve attention, little has been done to understand the interactions between these issues and macro-financial-trade measures in the context of Asia's efforts to rebalance. Thus, exclusion of the poor and small and medium-sized enterprises from financial services, issues of the environment and climate change, income inequality and poverty—all of which are so critical in many G-20 countries—should not be seen only as the consequential impact of macro-financial measures that will be subsequently countered by some compensating policies (such as financial inclusion). Yet this practice is common, instead of attempts to reassess the respective macro-financial policy and explore an alternative that will ensure inclusion.

Interactions imply two-way directions. A proactive rather than reactive approach suggested above is not only preferable in terms of cost-effectiveness, but it can also preclude any possible negative feedback effects. For example, a deteriorating environment due to an unsustainable pattern of development in many Asian countries can have an adverse impact on the supply and productivity of many sectors in the economy, and it can contribute to the increase of food prices, commodity prices, and inflation in general. Rising inequality across any country in Asia is likely to have an adverse impact on growth, hence its sustainability. The mechanisms of this can work through at least three channels: uncertainty caused by greater social instability, insecurity due to lack of property rights, and rent-seeking practices that can raise transaction costs and so dampen growth. Although the impact may not be felt in the short run, when output growth falls, so will household income, including those in the low-income bracket. When inflation rises and a food crisis looms, poverty incidence tends to increase.

Excess saving and the link between financial sector development and broader development issues is another noted example. According to flow-of-funds data, most countries in Asia have excess saving in the sense that total saving exceeds actual investment in the real sector. This excess largely goes to financial assets, both abroad (foreign reserves in US treasuries) and at home (equity, bonds, and other securities). As a result, economic growth is strongly supported by a growing financial market. This is also consistent with the information from national income accounts where the financial sector is recorded as one of the

major sources of growth, along with domestic trade and other services (Figure 4). Except during the Asian financial crisis, this pattern has been persistent and self-reinforcing, as incentives to invest in financial assets continue to exceed those to invest in the real sector. Although this may foster overall growth and financial sector development, it fails to provide sufficient employment opportunities. This can spell trouble in some countries in Asia where the labor force is growing fast. Consequently, an unchanged rate of output growth creates much less employment now than in the past (declining employment elasticity). The same applies to poverty reduction (declining poverty elasticity).

Figure 4: Sources of GDP Growth, By Sector—Emerging Asia
(percentage points)



Thus the challenge for Asia is how to channel the excess saving toward more productive investment in a manufacturing sector that will generate jobs, since this is generally more employment-creating than services in general. This is why improvements in the business and investment climate are so important. From this perspective, efforts to raise domestic demand are not only necessary for lowering global

imbalances, but for many Asian countries they are also warranted to make development and growth more inclusive.¹²

Indeed, the growth pattern in many Asian countries has been far from being inclusive. While the region has done relatively well in terms of output growth and macroeconomic management, even during the recent crisis, the development and welfare outcome has not been good. In many countries environmental conditions have worsened, resource depletion has become alarming, unemployment (especially among youth and the educated segment of the labor force) has increased sharply, and income inequality has risen almost across the board. To be credible and accepted by the global community, G-20 needs to assume leadership in this area. It should encourage policy makers to seriously reassess the development pattern that has produced unfavorable outcomes. In particular, focus ought to be directed toward the interactions of these issues with the strategy and policy approach needed to lower and mitigate global imbalances. This is the only way to achieve “strong, sustainable, and balanced growth,” the stated goal of G-20.

Global Role and Governance

In Chinese, the word “crisis” is made up of the characters for “danger” and “opportunity”. From Asia’s perspective, the G-20 should see the recent crisis as these two things. The fact that the global recovery is “strengthening, but is still uneven” and that the international monetary system has proven “resilient, but vulnerabilities remain” indicate that the work is only half done. Emerging economies have become important forces in helping the world to weather the crisis, and this highlights the importance of the G-20. Indeed, the G-20 has done remarkably well in helping the global economy to recover. It has emerged as the leading forum for coping with the crisis. But the unevenness of the recovery and the persistent vulnerability in the global financial system remain serious challenges. Financial regulations have been strengthened but are still far from sufficient to avert a similar shock in the future, especially when “too big to fail” problems remain. Many components need further structural changes, especially those related to the least regu-

¹² J. Zhuang (ed.), *Poverty, Inequality, and Inclusive Growth in Asia: Measurement, Policy Issues, and Country Studies* (Manila: Asian Development Bank, 2009).

lated financial instruments. For Asian countries, the lesson of the Asian financial crisis is clear—that a too liberalized financial sector not supported by proper regulation and supervision is a recipe for disaster. Whether the world economic structure of the past, as characterized by liberalization and deregulation, can realize a smooth transformation of the global economy to achieve more sustainable and balanced growth with minimum risk of crisis, depends on how far the G-20 can help to push reforms of the international monetary system. The recent crisis should be seen as an opportunity to push such moves.

The unevenness of growth and the difficulties in achieving more significant financial sector reform present another difficult challenge as it touches on the issue of power influence. The role of the IMF in reporting the vulnerabilities prior to the crisis is a notable example. Despite the Fund's warning, officials from powerful industrial countries concealed such important information and put pressure on the Fund to tone down warnings before the crisis. Often the IMF wilts in the face of officials' demands to water down criticisms.¹³¹⁴ One cannot imagine that being true for developing and emerging countries. The extent to which the G-20 can balance the influence between the developed world and emerging economies is a major test for the future development of this global forum. Another critical test is whether it can properly handle its relationship with non-G-20 countries.¹⁴ Unless it listens and caters to their claims and respects their interests, its legitimacy—and perhaps its existence—will be seriously questioned.

Asians are coming of age. In formulating the strategy to support its agenda, the G-20 can absorb the experience in Asia that may provide lessons to be shared, both good and bad, on macroeconomic and development policies. In addition to providing financial resources, Asian members of the G-20 can also play a greater role in helping to set the vision and ambitions for global rebalancing, and to share Asia's

^{13 14} Revealed in a report by the IMF's Independent Evaluation Office (IEO) in January 2011. In some cases, according to the report, so intimidated were the IMF staff that they did not challenge the officials' arguments. See IMF, "IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004-2007," Prepared by IMF's Independent Evaluation Office, 2011, available at www.ieo-imf.org/eval/complete/pdf/01102011/Crisis_Report_English.pdf.

¹⁴ G-20 member countries only account for 10% of more than 200 states that engage in global economic activity.

unique experience in areas such as establishing international production networks, and using the government and public sector to play a vital role in supporting these networks.¹⁵ In the global financial reform, Asia should no longer be content to leave it to powerful industrial nations to decide; it must join in setting new standards for global financial institutions and in regulating risk. Regional or subregional arrangements can be used to facilitate Asia's stronger voice and sense of ownership.

The new global economic governance structure will need to be based on representative institutions that reflect the changing economic weight of emerging economies in the global economy. Asia should and will play a greater role on the global stage.

¹⁵ The way the region looks at the importance of investment and the necessary infrastructure, beyond just trade, by establishing international production networks is acknowledged by many countries and institutions, including the Inter-American Development Bank. It suggests that Asia has a unique track record in establishing such production networks. Asia also has much to offer in terms of resources management, innovative financing, technical expertise on engineering and design, to project management.