

“Re-emerging Asia: Challenges and Opportunities”
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Thank you very much for your very kind words of introduction. Good morning, ladies and gentlemen, it is indeed a great privilege for me to take part in this very important San Francisco FRB conference on Asia along with a group of distinguished participants. I thank Mr. John Williams and his staff for inviting me. My remarks titled “Re-emerging Asia: Challenges and Opportunities” will look into the issue more from the medium to long term perspective.

Asia Re-emerging and Prospects

According to renowned economic historian Angus Maddison’s estimate, Asia’s GDP accounted for nearly 60% of the world GDP in 1820. China’s GDP alone was about 1/3 of the world total.

However, as we all know well, with the Industrial Revolution of the 19th century, the West grew faster and consequently Asia’s relative economic weight steadily declined. In 1950, Asia’s GDP share was down to well below 20%. Then Asia’s “re-emergence” began in the 1950s led by Japan and followed by Taiwan, Korea, Hong Kong and Singapore. In later years, the Southeast Asian economies of Malaysia, Thailand, and Indonesia, and then lately Vietnam started their rapid growth. Needless to say, the most dramatic turn of global economic scene came when Asia’s two giant economies of China and India started their re-emergence.

Currently, Asia accounts for about 30% of the global GDP (27% at market exchange rates). With this increased economic weight, the Asian economy has been playing a critical role in supporting the global growth since the Lehman Brothers’ bankruptcy in 2008 and the ensuing advanced economies’ devastating economic slump. It was the first time for the Asian economy spearheaded by China to lead the global economy exiting from a severe global recession in the modern world’s economic history. With 9.2% growth supported by a massive stimulus package “China saved the world” to the extent that the global economy was helped to suffer -0.7% growth only in 2009.

China continuously contributed to the global growth by 18.5% in 2010 and 24.8% in 2011, although the Chinese economy itself was affected by the global economic

slowdown. The Chinese growth was down to 9.6% in 2008 from 13% in 2007.

The most important factor which served as the foundation for the Asian economies' quick turnaround and robust recovery was their strong economic and financial fundamentals at all levels of government, business and financial institutions. In hindsight, the Asian financial crisis of the late 1990s was a blessing in disguise, although painful at the time, since the crisis-stricken countries implemented much-needed structural adjustments. In a way, one can say that they went through an externally forced shock treatment rather successfully.

With sounder economic and financial fundamentals, these countries were able to implement aggressive monetary and fiscal stimulus measures. For example, in case of Korea, the government made every effort to expedite the budgetary appropriation process for public projects, so that more than 60% of all public disbursements could be completed during the first half of 2009.

Then, how about future prospects for Asia? The ADB in its *Asia 2050* report foresees that Asia's growth momentum will likely be continued and Asia is expected to account for more than half of the global economy in 2050. In the meantime, Asia will certainly continue to be the most important engine of the global growth. The report predicts that Asia would contribute almost 60% of the global growth for 2010-2050 and 65% for 2040-2050.

Challenges for Asia and Opportunities for the World

Obviously, these predictions must assume Asia's successful adjustments to changing global environment and appropriately facing newly emerging challenges, both internal and external. Among others, the most urgent immediate challenge for Asia is how to implement its necessary domestic demand-led growth strategy switched from the primarily export-led outer-oriented strategy. At the same time, Asia must rely more on intra-regional trade and finance considering the necessity of rebalancing domestic and global imbalances on the part of both Asia and the rest of the world.

Broadly speaking, I suppose it can be said that the Asian re-emergence, especially in recent decades, was made possible by a tacit partnership between happy US consumers and the Asian workers with their States accommodating. The US consumers were happy to be stocked with plenty of goods they wanted at affordable prices, and the Asian workers were also happy to find jobs, albeit at relatively low wages to overcome their absolute poverty and improve their living standards.

I am sure some of you must have read a very interesting personal view in this regard, "A Year Without "Made in China"". Journalist Bongiorno illustrated well how US households cannot go by a day without purchasing goods made in China.

US consumers were even able to enjoy their consumption pattern going beyond their means! Obviously, this pattern was accommodated and facilitated by low interest rates and available liquidity, which, in turn, largely supported by Asian surpluses. States of both sides have been accommodating partners in this regard.

On the other hand, Asian workers were not bothered much by their relatively low wage level when there was a large pool of the unemployed or underemployed in their economies. In fact, this situation was a primary source of the region's international competitive edge in the past.

It is needless to say that the happy partnership or "arranged marriage" if you'd like to put it this way, between the US consumers and the Asian workers and the willing accommodating state level partnership cannot go on for long.

On the US side, households' deleveraging was expected to be inevitable and so, negative consumption adjustments. It's already happening. Some analysts even argue that the US consumers are in the early stage of a Japanese-like balance sheet recession by pointing to the fact that the US consumption grew only 0.6% on average from the 1st quarter of 2008 to the 1st quarter of 2012, for 17 consecutive quarters, as compared to 7.6% growth during the 1996-2007 period before the crisis.

Workers in Asia, too, are expected to demand higher real wages and a higher quality of life as their nations' development progresses. Once the acute problem of absolute poverty is lifted, the relative poverty concern becomes a critical socio-political issue for any society. As they overcame the misery of absolute poverty, Hirschmanian "tunnel effect" of growth must set in.

In addition, for a sustainable growth itself, policy-based real wage increases are necessary to boost domestic demand as currently done in China by purposefully increasing minimum wages. In fact, one of the main focuses of China's 12th 5-year plan from 2011 to 2015 is placed on pro-consumption growth strategy which puts much emphasis on appropriate level of wages and strengthened social safety nets which would reduce households' precautionary savings motive.

The current pattern of intra-regional trade in Asia, which is based on their past outer-oriented growth strategy, will also have to be changed in order to sustain the region's growth led by domestic demand.

As of now, intra-regional trade in Asia is much lower than that in the NAFTA or the euro area. With the rapidly increasing regional trade agreements since the Asian financial crisis of the late 1990s, it is expected that intra-regional trade will accelerate.

The newly increasing intra-regional trade will reflect both the prevailing current vertical regional trade and more horizontal regional trade which are expected for the region's rapidly increasing domestic demand rather than for accommodating foreign demand originating primarily from the US and the EU.

Let me now turn to vast opportunities to be provided by Asian domestic rebalancing towards more consumption for the rest of the world.

As of now Asian economies, prominently China has exceptionally low private consumption as a proportion of their GDP. With rising income and bulging middle class consumers in Asia, which is estimated to exceed 2 billion by 2021 according to the Brookings Institution, the domestic demand-led Asian growth will certainly provide huge new markets for the rest of the world, especially services markets where industrialized countries, especially the US, have strong competitive edges, e.g. distribution, logistics, transportation, communication, health care services, finance, and education. It is worth noting the China's 12th 5-year plan emphasizing higher national services consumption. The Chinese authority foresees those service sectors as a new source of growth and important source of high value-added job creation. As you know, services sectors usually have relatively higher job creation capacities. So, for the sake of job creation, most Asian economies need to open up and liberalize their services markets more actively. The problem is that this issue usually runs into sensitive political oppositions. Korea illustrates the point well.

It cannot be overemphasized for the sustainable Asian growth the necessity of putting a national priority on dealing with inequalities and disparities through inclusive growth strategy. As previously mentioned, the relative poverty issue, unless properly resolved, will become a serious socio-political problem in the course of economic development for most developing economies. Moreover, the current accelerating globalization trend and the deepening knowledge-based economy together will make economic inequalities and disparities more acute and urgent sociopolitical issues. So I am saying that unless these issues are resolved in a proactive manner, political repercussions may become serious enough to disturb regional or perhaps global peace and prosperity.

Asia in the World of Deepening Interdependence

The Lehman Brothers bankruptcy in 2008 and the ensuing severe financial crisis hit the whole world and Asia was no exception. There were often-heard claims of the Asian economic decoupling from the industrialized world until the initial stage of the crisis. With their strengthened economic and financial fundamentals after the Asian financial crisis in the late 1990s, these economies seemed to weather through the initial stage of the global financial crisis which began with the US sub-prime mortgage related trouble of 2007. So, the decoupling hypothesis seemed credible enough at the time.

But Asian economies had been hit most severely since the Lehman Brothers bankruptcy in September 2008. It is well documented that Asian economies immediately had to suffer the worst economic slump in the last quarter of 2008 and the first quarter of 2009 since their economic take-off.

In fact, Asian economies' exports dropped by 70 percent in the same period and the decline was almost 3 times more than during the Asian financial crisis of the late 1990s.

Why, then, Asian economies had to suffer so drastically from the global financial crisis? Obviously, the Asian economies' high trade dependency and rapidly progressing global financial integration made these economies more vulnerable to external shocks in general.

It is worth noting that the rapid expansion of the intra-regional trade in Asia during the last couple of decades was a critical factor for the synchronized region-wide trade and production growth. The Asian intra-regional trade is primarily based on the vertically integrated production networks of the region. The vertically integrated production networks were to produce final products for exports to mostly industrially advanced nations, i.e. the US and the EU. Consequently, the immediate impact of the economic slump in these economies on Asia is rather obvious and fully expected.

How about impacts through financial channels? Since the Asian financial crisis of the late 1990s, Asian financial institutions in general had been better capitalized and supervised. Fortunately or unfortunately, their limited financial sophistication was a blessing in disguise as their direct exposure to the US sub-prime mortgages or else was rather negligible. Consequently, Asian financial institutions were able to avoid the brunt of direct negative spillovers from the global financial crisis.

However, Asian economies had to suffer subsequently from indirect impacts through financial channels. As financial institutions of industrialized world try to adjust their portfolios or deleveraging, Asian financial markets became subject to sudden reversal of capital flows.

In addition, some of the emerging Asian economies, Korea for example, which exports high-valued industrial products, e.g. plants and ships, are adversely affected further by the credit crunch in industrialized countries.

Asia's New Role in the Global Governance System

So far, the discussion has mostly been on the national policy agenda. However, Asia should be ready to exert its global leadership commensurate with its economic weight and influence. Asian nations up till now have been perceived as passive

followers rather than active leaders in the global arena. But needless to say, with their growing economic prowess, they deserve enhanced representation and voices in multilateral forums. At the same time, Asians themselves need to take strong ownership in them.

In fact, as I will further discuss in a minute, Asia should exert its leadership in making the existing multilateral institutions, e.g. the Bretton Woods Institutions, more legitimate and credible and then utilizing them with ownership. In this regard, I want to emphasize the fact that any regional level cooperative arrangement should be complementary and supplementary, not necessarily competitive, to the existing multilateral institutions.

Given the current global power constellation, it can be easily seen that the global community level decision making, especially in the provision of global public goods, would be difficult, if not impossible. So, Asian nations should pro-actively participate in the global community level decision making process and exert its full potential leadership.

At this juncture, I would like to just remind all of us that no individual country or region alone can prosper in this highly integrated and globalized world. I must tell you the fact that even ordinary Korean housewives wake up in the morning and pick up morning papers to see what's happening in Europe because they own some financial savings in Korean banks, not necessarily in European banks. Then, why bother? It is because the Korean banks are all linked to the European banks in one way or another. It is therefore critically important to make special efforts to have closer economic cooperation and policy coordination at both regional and global community level.

I cannot proceed without bringing your attention to the G20 in this connection. Today we live in, in a way, a no-polar world, not even a multi-polar world, or a G-zero world. For this reason, as I said, the global decision making process is rather complicated and easily protracted. Collective leadership is always difficult to maintain at any level.

As you know, the G20 Summit process which was initiated in the midst of serious global financial crisis in the making in November 2008 is supposed to be the premier forum for international economic cooperation. The G20 has been quite successful as crisis management committee for the 2008 global financial crisis by averting another Great Depression. With all the modesty, I must say that Korea did contribute much to the G20 Summit process, particularly in 2010 when Korea held the G20 presidency.

However, the G20 is yet to prove itself as functioning crisis committee for helping

resolve the current euro zone crisis. In that regard, the forthcoming Mexican Los Cabos G20 Summit, June 18-19, is critical.

I have been advocating to further institutionalize the G20 process and strengthen its own governance to make the G20 functioning, not just as crisis committee but as steering committee for global economic cooperation and policy coordination. I would like to see the G20 more closely involved in resolving the current euro crisis. After all, the G20's ultimate objective is to achieve strong, sustainable and balanced growth of the global economy. The current euro zone crisis is the most serious threat to this global goal. So, unless the G20 acts properly on this, the G20 cannot claim to be the premier forum for international economic cooperation.

Asia's Region-wide Cooperation and Policy Coordination

Let me now turn to the region-wide cooperation and policy coordination in Asia. Since a lot has been happening in Asia, particularly in East Asia in this regard, and as they will have significant global impacts, let me spend some time on the subject.

The Asian financial crisis of the late 1990s triggered regional initiatives for cooperation in East Asia, Northeast Asia in particular.

Only since the Asian financial crisis of the late 1990s, East Asia, Northeast Asia in particular, awakened to the necessity of a closer regional economic and financial cooperation and integration. In fact, the Chiang Mai Initiative was first initiated in 2000 as a network of bilateral swap arrangements among the ASEAN+3 countries. By the way, leaders of the three Northeast Asian countries, China, Korea and Japan, started to meet at the time of the ASEAN+3 Summit from 1998 for the first time. Until then, due to the still lingering negative historical legacies, the heads of the three countries never had a summit meeting on their own.

They eventually agreed to have a regular three country summit outside the ASEAN+3 summit process in 2008. The Trilateral Cooperation Secretariat was established in September last year. I would say it is a rather significant historical step forward.

Recently in Beijing, May 14, leaders of the three countries at their summit took a number of historically significant actions geared toward accelerating the East Asian economic cooperation and thus integration. First of all, they signed a trilateral investment agreement which is the "first important legal document for the three neighboring countries". In fact, the three countries' economic integration rather rapidly achieved so far has been wholly "market-driven" without *de jure* actions at the three governments' level. At the same time, they agreed to begin the three-country free trade negotiations before the end of 2012. If successfully concluded, albeit not expected to be comprehensive and rigorous enough and the negotiation process

may be protracted, it would be the largest FTA only after the NAFTA and the EU as a free trade zone.

It is quite certain that with numerous new *de jure* integration initiatives, the Asian integration will further accelerate.

As previously mentioned, immediately after the Asian financial crisis, the ASEAN+3 countries agreed to launch bilateral swap arrangements, the Chiang Mai Initiative (CMI), in 2000. The CMI later was expanded and multilateralized. I for one from the very beginning have been advocating the multilateralization of the CMI. Going forward, I have been voicing throughout to develop it into an Asia region-wide monetary facility, provided its mode of operation is consistent with the IMF and other multilateral facilities.

In May this year, the ASEAN+3 agreed to double the CMIM to US\$240 billion which is about 1.7% of Asia's GDP as of 2010. By the way, the European Stability Mechanism (ESM) of 500 billion euro (equivalent to US\$620 billion) is about 4.7% of the euro zone GDP of 2011. They also decided to increase the IMF delinked portion to 30% from 20%, along with introducing the CMIM precautionary line to make the CMIM not just a crisis resolution but a crisis preventative mechanism.

The ASEAN+3 Macroeconomic Research Office (AMRO) was also launched as an independent regional surveillance unit to support effective decision making of the CMIM. However, there are a number of hurdles for the AMRO to effectively play its supposed role as a regional economic and financial surveillance body. For instance, the AMRO is registered as a private limited company in Singapore where it is located. So, it is a step in the right direction that the ASEAN+3 finance ministers discussed how to strengthen its organizational capacity.

Given this, I would like to see much expedited progress toward establishing a regional monetary facility, as indicated, provided its mode of operation is consistent with that of the IMF. In fact, this regional facility should work closely with the IMF and rely on the immense bastion of knowledge and experience of the IMF, particularly in the area of surveillance and early warning exercises. In this connection, I would also like to say a word on the IMF delinked portion of the CMIM. Since the Asian financial crisis of the late 1990s, Asians, too, along with Latin Americans, have had a rather negative perception of the IMF. So, there are strong voices among the ASEAN+3 policy making circle to increase the discretionary portion detached from the IMF. I don't think that should be the key priority and don't see it as a desirable option, either. Rather, I would like to see Asia to have stronger ownership in the IMF. Asians should not take the passive attitude of looking at the IMF with the "us" versus "them" sort of approach. Obviously, the IMF's governance itself needs to be reformed to reflect the current global economic reality.

By observing what's happening in the euro zone today, regional financial cooperation is critically important to supplement the multilateral facilities. I don't want to get into details of the CMIM any further. But there still are a number of critical issues to be resolved, for example how to do away with the so-called "stigma effect" of the first user of the facility. In this regard, I was glad that the ASEAN+3 finance ministers agreed to introduce the precautionary line similar to the IMF's which was introduced at the suggestion of the G20.

Although Asia has a large pool of savings, the region still relies heavily on financial intermediation outside the region, namely, in London, New York and Frankfurt. Realizing this, there have been various initiatives to develop efficient and liquid local currency bond markets with such programs as the Asian Bond Markets Initiatives (ABMI). It is needless to say that the prerequisite for the financial market development is the establishment of sound and prudent financial supervisory infrastructure at both national and regional level.

Towards the Asian financial development, I personally have endorsed Barry Eichengreen's suggestion of establishing an "Asian Financial Institute" for doing research and training for financial sector personnel for the region. Going one step further, I would suggest making the Institute eventually a part of the research and training arm of the regional monetary facility in the future. I would also like to suggest again for the region to seriously consider the establishment of a Northeast Asian Development Bank to supplement the ADB and the World Bank. The reason I mention this at this juncture is because that there is a vast room for policy coordination in Northeast Asia in the sphere of development in general, development and cooperation in the natural resources and energy sector and environmental preservation.

At this point, I also want to remind you of a significant action taken by China and Japan. China and Japan agreed in December last year at the Beijing bilateral summit to establish a foreign exchange market in both Tokyo and Shanghai in June this year to directly trade their currencies, yen and renminbi, without converting them into the US dollars. Needless to say, this will save huge transaction costs, promote trade between the two countries, and help the Chinese effort to internationalize renminbi.

Closing Remarks

In ending my remarks today, I just want to share with you my rather optimistic view of the Asia's future. Why am I bullish on Asia's future?

There still remains unpicked low hanging fruit for late comers, in this case most Asian economies, until they move out of the production possibility front. Especially

those transition economies, namely China and Vietnam, can gain further by enhancing their systemic efficiency through structural reforms for enhanced private initiatives, privatization of state owned enterprises and financial sector reform. Asian economies as a group still has a large room for increased intra-regional trade as previously indicated and relying more on domestic demand. With their closer region-wide cooperation and policy coordination Asian economies can benefit further through increased availability of public goods, i.e. a freer trade environment and enhanced financial stability of the region.

In addition to these favorable factors, I just want to bring your attention on an Asian cultural heritage of high value attached on education. In the tradition of neo-classical economics, cultural factors are not often considered in causal analyses. However, the Asian value drew heightened attention at the time when the so-called Asian tiger economies started doing well.

Long ago, the late development economist, Paul Rosenstein-Rodan, was rather cynical about economists' attitude of bringing cultural factors into causal analysis by saying "When doctors don't know what caused an illness, they call it psychosomatic: when economists cannot explain a phenomenon, they call it social or cultural." However, 2006 Nobel laureate Edmond Phelps not only brought renewed attention on a few studies which established "culture as a causal factor that makes market work better" but also attempted to explain the gap between the American and European economic performances with culture-bound choice of economic system.

The reason I wanted to bring your attention to it at this point is because it will become more relevant to talk about Asia's future now. Today we are living in the age of knowledge-based economy where knowledge is the most critical strategic factor for growth and development. The knowledge can be inculcated and promoted through education. Consequently, education is more important than ever before for growth and development in this era. So, Asians have initial competitive advantages since education is on top of their societal values. Whether or not they will be able to take full advantage of the initial competitive edge will depend on their education system which may or may not accommodate or facilitate the society's high zeal for education. I emphasize the education system simply because I am not fully satisfied with the education system we have in my country, for instance. Even then, educational services gap for the nation has been closed largely by the private households with a high zeal for their children's education. In this regard, I want to remind you of the fact that Korean households spend more money for their children's private educational services than their counterparts in any other OECD member countries.

With this optimistic personal view of Asia's future, I would like to end my remarks this morning and am looking forward to hearing the views of the distinguished panels.