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Abstract

The recovery of the Asia-Pacific from the global economic crisis of 2008-09 is underway but incomplete. Despite encouraging progress, major risks remain, ranging from slow growth and persistent unemployment to reemerging global imbalances and renewed financial volatility. The policies that stopped the economic freefall—massive stimulus and financial bailout packages— were urgent, relatively easy to sell politically, and to a large extent forced by circumstances. This report argues that sustained recovery now requires tackling different problems, including international imbalances among the United States, China, and other economies. U.S. consumers are not likely to drive world demand in the medium term, and the slack will have to be taken up in part by Asian consumption and investment. The early policy responses, successful as they were in averting a larger calamity, were not designed to address longer-term issues, and some are even counterproductive from that perspective.

JEL: E63, R1

KEYWORDS: economic crisis, macroeconomic policy, stabilization

I. INCLUSIVE, BALANCED, SUSTAINED GROWTH IN THE ASIA-PACIFIC

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1. Introduction

The Asia-Pacific region is at the forefront of the recovery from the global economic crisis of 2008-09. But despite the region's strong economic fundamentals, major challenges lie ahead in exiting interventions adopted in the crisis and building solid foundations for future growth. There is still ample risk of slow growth and persistent unemployment, reemerging global imbalances, and financial volatility.

The policies that stopped the economic freefall—huge stimulus packages in China, Japan, the United States and even small economies like Singapore, and massive financial bailouts in the West—were urgent, relatively easy to sell politically, and to a large extent forced by circumstances (particularly the fall of Lehman Brothers). They were deployed under extraordinary time pressures and have proved remarkably successful.

But sustained recovery will require tackling different problems, including but not limited to current account imbalances among the United States, China, Japan and other economies. U.S. consumers are not likely to drive world demand in the near future and Asian consumption and investment will have to emerge as new engines of growth. The policies used to fight the crisis, successful as they were in averting a larger calamity, did not directly address this transition and some have been counterproductive from a long-term perspective.

The best outcomes—inclusive, balanced, sustained (IBS) growth—will require shifting the policy mix from crisis intervention to structural reforms. These will need to change economic relationships within economies and among them. The mix will be varied and complex, addressing household and government finances, investment incentives, risk management, infrastructure, productivity, and other fundamental determinants of growth.

The policy mix should also foster new engines of growth in the Asia-Pacific by focusing the region's entrepreneurship, innovation and resources on common priorities. Concerted regional initiatives could, for example, target cleaner and more reliable energy; energy-saving transport and new vehicles; more efficient irrigation; critical public services and social safety nets; and products and services to meet the needs of ageing populations.

This study argues that IBS growth is feasible in the Asia-Pacific. The region's dynamic, emerging economies have led the global recovery and the United States, despite its ailing financial sector, has also turned the corner. Global imbalances are, for now, at acceptable levels and can be kept so with forceful policies. Addressing the key threats to global recovery—weaknesses in financial oversight and limits to growth based on massive international capital

flows—are widely considered essential. If actions are now taken to address these threats, the crisis will have ultimately made the world economy stronger and more resilient.

International cooperation has been, and remains, central to the recovery. By articulating a shared strategy for growth, governments can enhance the consistency of policies and the stability of the business environment. They can signal common purpose and commit to holding each other accountable for keeping growth on track. Markets and investors critically depend on such signals in the uncertain aftermath of the crisis.

The G-20, now the premier global consultative mechanism, is a promising platform for cooperation and it gives the Asia-Pacific a voice commensurate with its economic importance. This global process needs to be complemented with regional cooperation. Asia-Pacific institutions—including ASEAN, ASEAN+3, the East Asian Summit, APEC and smaller groups—can add value by translating global goals into executable initiatives. This report, itself the product of region-wide collaboration, explores a coherent regional strategy both from the "top down" and from the "bottom up" in the economies that will have to implement it.

A successful post-crisis strategy calls for putting growth on a sustainable footing by changing the behavior of governments, firms and households. It calls for leadership, discipline and popular support. Not only academic, business and policy experts, but also citizens need to understand the issues and choices. Assisting such analysis and dialogue is the primary goal of this study.

2. A framework for post-crisis growth

The crisis required emergency interventions to prevent financial systems from collapsing and to halt the calamitous decline of economic activity that began in 2008. The post-crisis economy will require policies that prevent future financial meltdowns and sustain medium-term growth. Since the onset of the crisis, much progress has been made on containing the decline, but work on the foundations of sustained growth has just begun.

Policy challenges

The short-term challenge policy-makers faced in 2008 was to *manage the devastating impact of the crisis.* In days, or at most weeks, they had to deploy policies to rebuild confidence in financial markets and stop spiraling output, income, employment and asset price declines. Most economies met these challenges with remarkable success, but the solutions adopted—massive government expenditures, monetary easing, financial intervention, and bailouts of companies—increase risks for the longer term. The time to unwind these policies is at hand or approaching in most economies.

The long-term challenge economies face is to *achieve inclusive, balanced, sustained growth* consistent with economic potential. In many economies incomes are low and rapid growth remains a critical priority. But it is now widely accepted that income growth must be achieved alongside other goals—it must be inclusive and sustainable too, generating wide welfare gains and controlling negative environmental externalities. The drivers of growth—technological change, investment, and market-friendly economic policies—remain strong throughout the Asia-

Pacific. Indeed, some economies could achieve higher growth rates than they have seen since 1997-98. But all this will require policy changes that orient growth new directions.

The term "rebalancing" is widely but imprecisely used to describe this challenge. Before the crisis, unsustainable borrowing supported high U.S. consumption, while unprecedented savings—including more than half of China's national income—went into unsustainable investments in dollar assets and export industries. These *internal* imbalances in expenditures led to large *international* imbalances in capital flows between the United States and China, Japan and other economies.

Imbalances have shrunk considerably during the crisis, and consumption growth in the United States and Europe is likely to be restrained even in the intermediate term. Asia-Pacific growth will need to depend more on demand in Asia than before. We will argue that the arithmetic of this adjustment is manageable—the U.S. expenditures that need to be replaced by Asian expenditures amount to only around one percent of the region's approximately $30 trillion GDP—even though the necessary policy changes will reach deeply into economic structures and are likely to be politically contentious.

This study, including the sub-regional analyses of subsequent chapters, explores several solutions:

- Structural measures in the United States that encourage more prudent financial behavior throughout the economy—not only in the financial sector, but also in household and government finances.

- Structural measures in Asia that extend the region's highly productive economic environment to more sectors (such as services), to factor markets (including capital and labor), and to a wider range of transactions among regional economies.

- New "engines of growth" that address critical social and environmental priories.

Together, these approaches would shift demand from the United States to Asia, provide incentives for transferring resources between tradable and non-tradable sectors, and improve the quality of growth from a social and environmental perspective.

The medium-term challenge—which will dominate the coming months and years—is to *shift from crisis response to structural policies* for growth. This essential, complicated maneuver will require both negative and positive actions. Emergency measures will need to be unwound, but to maintain the recovery, new, structural policies will need to be introduced to promote growth. Among structural measures, those that can generate early gains in employment will need to receive priority.

Importantly, the transition will require coherent policy actions across economies. For example, the withdrawal of the U.S. stimulus needs to be matched by continuing expansion in surplus economies to sustain global demand. Similarly, changes in monetary policy should be

coordinated with policy changes in other currency zones in order to account for spillover effects and to minimize exchange rate and financial instability.

Reasons for confidence

Despite these complexities, there is reason to hope that the transition to structural policies will be managed successfully. Today's policy challenges have been more intensely studied and are arguably better understood than any other economic problem in history. The G-20 has focused high-level attention on coherent global policies. The macro-economic and financial fundamentals of many economies, especially in Asia, are strong. Asia's micro-economic fundamentals—entrepreneurial markets, robust innovation, and ample savings—have never been stronger.

Economies are also converging on key social priorities. These will help to resolve tensions that emerged in recent years: imbalances between North American and Asian net savings, between investment and consumption, between the production of public and private goods, between environmental quality and economic development, and among the incomes of different regions and population groups. These problems cannot be solved quickly, but there is more interest in finding solutions now than at any time in recent decades.

IBS growth does not require a significant—or possibly any—slowdown in the rate of growth. Evaluated by measures that account for externalities in production and welfare, the rate of growth could even accelerate. Deep recessions, such as the one the world has just experienced, tend to generate permanent losses in potential output, but they do not necessarily lower potential growth rates. Structural reforms and engines of growth associated with rebalancing can lead to new profit opportunities and spurts of innovation. This study argues that concerted Asia-Pacific initiatives can point governments and investors in directions that will sustain the recovery.

Reasons for vigilance

Yet major risks also lie ahead. Foremost is the politics of economic policy in difficult times. Pressures for intervention will tempt officials to follow the "siren song" of short-term relief at the cost of medium-term growth. These pressures will mount as the pain caused by the crisis, including unemployment, persists well into the recovery. The list of false solutions ranges from unrestrained spending and lending to overregulation and trade protectionism.

Other risks arise from inherent economic uncertainties. The 2008-09 shock is the world's largest in eighty years, and the time needed to repair the damage from such shocks to balance sheets and investor confidence is historically measured in years, not months. For some time, consumers and investors will remain cautious, financial institutions fragile, and markets volatile. Confidence could deteriorate again before the recovery is complete. And unrelated problems, from natural disasters and disease to political events, could also overwhelm the recovery. Of course, these possibilities do not change the need for purposeful action.

A final risk is posed by policy conflicts among economies, such as tensions over trade, or inconsistencies in fiscal, monetary or regulatory approaches. The G-20 provides welcome leadership and envisions building a new framework for coherent global decisions. The WTO and the World Bank have made major contributions by publicizing protectionist measures, and the

IMF and ADB have provided timely analysis and support for economies in trouble. So far, the world has avoided the disastrous policy anarchy of the 1930s. But much stronger cooperation is needed today to address the challenges that interdependence poses and to effect change in a setting no longer dominated by one or even a few countries.

3. Crisis and recovery: a drama in progress

The events of 2007-2009 were not supposed to happen: the world economy was thrust into its deepest crisis in a century by the failure of its largest and arguably most sophisticated financial system. An effort to build a sustainable post-crisis economy must begin with understanding the origins and propagation of the crisis, the interventions that followed, and its consequences for the future of the Asia-Pacific.

The antecedents of the crisis can be traced back at least to the Asian Financial Crisis of 1997-98 and the collapse of the Internet bubble in the United States in 2000. A combination of conditions that started to emerge then—in the United States, highly accommodative monetary policies, powerful incentives for home ownership and lax financial regulation, and worldwide, a wave of financial innovation and strong demand for dollar assets—led over the following years to a large, wide-ranging buildup of leverage by households and financial firms in the United States and some other economies.

When interest rates rose and some asset prices began to decline in 2007, the leverage took its toll. The first cracks appeared with the failure of U.S. firms that issued sub-prime mortgages and/or held securities built from them. These complex, unregulated, poorly-understood instruments attracted many investors reaching for high yield. The crisis simmered for months as markets learned about the true extent of exposure to these and other weak assets, and about interconnections among giant financial firms. In September 2008, the collapse of Lehman Brothers, a large U.S. investment bank established in 1850, delivered the *coup de grâce* to financial markets. Contagion spread swiftly across asset classes, institutions and borders. A precipitous fall in trade and production soon followed. Toward the end of 2008, the state of the world economy was widely described as "Great Depression II."

A second great depression didn't happen, but the crisis intensified with chilling speed. Its complexion changed markedly over time, unfolding as a drama in five distinct acts so far. Once the crisis became acute in the United States in September 2008, it engulfed the world, and some Asian economies became its worst casualties. But to the surprise of most forecasters the decline eased in mid-2009, and projections began to map a return to growth (Figure 1). The last act of the drama—recovery—is incomplete; much still depends on how policies are refocused on sustaining growth.

Figure 1. Deep V? Asia-Pacific growth, 2007-2014

Act I: Decoupling?

Early in the crisis it appeared that Asia might be spared the worst. The recession in the United States began in December 2007, but growth in the rest of the PECC area remained positive for

several months. The principal concern of most economies in the middle of 2008 was inflation, especially in oil and agricultural prices, and many ran monetary policy with a "foot on the brake." Until late 2008, Asian financial institutions largely escaped the problems plaguing U.S. and European banks. Chastened by the Asian financial crisis a decade earlier, Asian banks and regulators had maintained tighter reign on leverage and avoided many of the speculative investments that decimated U.S. and European balance sheets.

These developments led to the hypothesis that the Asia's economy had "decoupled" from North America. Of course, few would have argued that complete decoupling was possible, given close trade and financial ties. Asia's intra-regional trade had increased rapidly over the previous decade, but much of this trade reflected the fragmentation of production within Asia and not a redirection of ultimate final demand. A majority of Asian manufactured exports still ended up, directly or indirectly as components, in goods sold in North America. Nevertheless, Asia's stable finances and microeconomic dynamism offered hope that the region could ride out the U.S. recession by substituting replacing U.S. demand with regional and European sales.

Act II: Freefall

But U.S. and European imports did not merely slow, they swiftly collapsed. As sales plummeted, exporters halted purchases of intermediate inputs. For a while, economies engaged in assembly operations saw larger declines in imports (based on falling expectations) than in exports (based on past orders). The fragmentation of production into small steps carried out in several economies—a key innovation in manufacturing in recent decades—apparently speeded up and amplified the propagation of the trade shock. Sensitive "stocking decisions" appear to be an important characteristic of complex supply chains; in the downturn, de-stocking led to unexpected decline in demand, and in late 2009, re-stocking appears to be helping the recovery.

The effects of the crisis in the Asia-Pacific are summarized in Figure 2. Growth decelerated across the region by an average of 6 percentage points between 2007 and 2009 (Figure 2, panel A). A handful of economies, including Japan, Singapore, Chinese Taipei and others we classify as Advanced Asia, experienced much steeper declines due to their product mix. The impact also varied with the initial growth rates of economies—for example, China grew at nearly 13% in 2007, so even a 5% decline left it with an enviable 8% growth rate.

Figure 2. Dimensions of the crisis: no place to hide

Trade collapsed (Figure 2, Panel B) broadly, and especially so in certain subgroups of manufactured products. American consumers sharply reduced purchases of luxury goods such as autos, sophisticated electronics, and communications equipment. (Durables and luxuries are cyclical since households typically adjust these expenditures first.) Declining sales were amplified by the efforts of retailers and importers to reduce inventory. This generated declines in orders for sophisticated products and components, produced mainly by advanced Asian exporters such as Japan, Korea and Singapore, and by Mexico.

Financial markets also served to transmit the downturn. Equity markets fell by roughly one-half between December 2007, when markets were near their recent highs, and February 2009, when most appear to have reached lows (Figure 2, Panel C). The crash was similar everywhere—the

declines were only slightly larger in riskier markets such as China and Southeast Asia, and only slightly smaller in relatively sheltered markets such as New Zealand. As a result, wealth declined and economic forecasts turned sharply negative. These in turn took their toll on consumption and investment.

The downturn was further amplified by retrenchment in international lending. In late 2008, banks curtailed their international lending to consolidate capital positions at home (Figure 2, Panel D). For example, the Korean won fell sharply due to concerns about foreign currency debt, despite reasonable economic fundamentals. Several economies even experienced difficulties in accessing trade credit to maintain exports. Fortunately, the constraints on trade credit eased relatively quickly as markets improved and development banks and other institutions jumped in to provide targeted funding for trade.

The propagation of the crisis through the PECC region is illustrated in Figure 3 with reference to the evolution of GDP in four economies.

- *United States.* U.S. consumption began to decline in late 2007 with the sub-prime mortgage collapse and falling house prices. Investment contributions were stable in 2007 but became quite negative as the downturn gained momentum. Government expenditures contributed positively, but by a small margin, as state government cutbacks offset the impact of federal stabilizers. Net exports were also positive, as imports fell sharply, transmitting the crisis to other PECC economies.

- *Japan.* Consumption, government spending and net exports held up through much of 2008. But investment was slowing, perhaps anticipating a downturn, and the economy began to contract in 2008Q2. Then, as in other Advanced Asian exporters and Mexico, net exports fell very sharply in 2008Q4, reflecting falling U.S. demand. The decline was later reinforced by "knock-on effects" in domestic investment and consumption.

- *China.* Like Japan, China experienced a slow decline in demand through 2008, leading to a moderating growth rate. But this was enough to elicit a strong policy response, and by the time the export shock hit China (it came later and was smaller than for Japan) measures had been introduced to support investment. Consumption remained flat and investment rose in 2009Q1, moderating the decline.

- *Indonesia.* As some other ASEAN and Latin American economies, Indonesia survived the crisis relatively well. Its GDP components increased somewhat in 2008 (in some cases benefiting from rising primary goods prices), and the growth rate rose. The export shock hit in 2009Q1, but represented a smaller share of GDP and was partly offset by consumption. Growth slowed but stayed positive.

Figure 3. How the crisis spread from the U.S. to Asia

In short, powerful transmission mechanisms—operating through trade, financial markets, and financial flows—led to similar impacts in many economies, even those with the strongest fundamentals. Differences in effects were mostly due to differences in specialization: economies

producing advanced, durable goods fared worst. Some differences in the recovery were related to the speed and scale of policy reactions, and larger economies had more freedom to act. But on the whole, the crisis left "no place to hide." No policy could have insulated an economy from it, aside from the highly unattractive option of restricting specialization and trade. But exposures were amplified by high exports associated with current account surpluses.

Act III: Governments to the rescue

The policy reactions of the PECC region have been as remarkable as the crisis itself. Monetary easing began in the United States in 2007, but emergency financial operations in the United States and Europe dramatically intensified in the fall of 2008. Reactions in Asia and Latin America were more muted, since Asian financial firms were less exposed to "toxic assets." (More detailed assessments are provided in the subsequent sub-regional chapters.)

Monetary and financial measures included very low policy interest rates; central bank purchases of securities in asset classes such as long-term bonds, corporate securities and mortgage pools; wide-ranging guarantees of financial institutions and money-market mutual funds[1]; effective nationalization and government-managed mergers of vulnerable financial institutions; and lending against impaired assets. Between September and November 2008, the Federal Reserve System of the United States more than doubled its balance sheet and radically altered the composition of its assets from short-term government securities to a wide range of assets. The Bank of England took similar steps; the European Central Bank and the Bank of Japan also reacted.

Monetary easing was accompanied by large fiscal measures. Altogether, PECC economies adopted stimulus packages of $1.7 trillion, or 84% of the total world-wide discretionary stimulus, as estimated by the Khatiwada (2009). China announced a 4 trillion RMB stimulus package ($586 billion) on 9 November 2008, less than two months after the Lehman Brothers collapse, and the United States adopted the $787 billion American Recovery and Reinvestment Act on 17 February 2009.[2] Japan, despite high debt levels, mounted several packages. Significant packages were also adopted in Malaysia, Singapore, Mexico and other Asia-Pacific economies. European stimulus programs were not launched until later, although somewhat stronger stabilizers in Europe reacted to the crisis automatically as it deepened.

Policy responses in the PECC area are summarized in Figure 4. The announced fiscal policy packages are shown in Panel A (the package totals include expenditures planned for future years), while the actual deterioration in government balances in 2009 is shown in Panel B. Monetary policy is tracked in the next two panels. As Panel C shows that Japan, the United States and Korea forced policy rates to near zero, and Panel D indicates that all economies reduced policy rates by significant margins.

[1] Some of these programs, including the mutual fund guarantee program, were exited by the end of 2009.

[2] The line blurs between rescue efforts by central banks and fiscal programs. The IILS data do not include, for example, the $700 billion U.S. "troubled assets relief program" (TARP), signed into law on 3 October 2008. This is a government budget item, but initially involved only loans to financial institutions that are similar to those offered by central banks in the United States and elsewhere. In late 2009, however, President Obama proposed using leftover TARP funds for wider spending purposes.

The smaller PECC economies faced difficult choices. Most entered the crisis with strong fiscal balances and financial institutions, yet their thinly traded currencies, small financial markets and relatively open current accounts left them vulnerable. If they failed to act, or acted too aggressively, capital flows would undermine stability. In the end, most managed a middle course, adopting some stimulus and accepting some depreciation. Even larger economies like Indonesia and Korea faced challenges from currency speculation, and had to combine market adjustments with bilateral swap negotiations to manage the threat. In the end, depreciated currencies provided an extra boost to their exports and helped to support growth.

Figure 4. Policy: governments to the rescue

Domestic responses were supported by high-profile international meetings. The leaders of G-20 economies met on 15 November 2008 in Washington and—in contrast to the events of the Great Depression—launched a process of vigorous collaboration. Over the next year, they agreed to issue $250 billion in new SDRs through the IMF; turned the Financial Stability Forum into the more global Financial Stability Board; designated the G-20 summit as a continuing forum; established a detailed work plan[3] for cooperation on financial regulation and macroeconomics; and committed to reforming votes in the IMF and World Bank. In addition, important international support was also provided through *ad hoc* currency swap arrangements. More remains to be done, but the crisis has raised the state of play in global cooperation.

Act IV: Green shoots

The severity of the downturn in early 2009 dimmed expectations for a quick recovery. Studies of past crises indicated that the events of 2007-2009 followed an especially adverse course: the downturn was synchronized across the world and included a wide-ranging financial crisis that resulted in a large asset price collapse and substantially weakened major financial institutions (Claessens et al. 2009). Recovery is usually slow in such crises because of the challenges involved in restoring the health of the financial system and the balance sheets of households and firms. In the meantime, employment losses further depress economic activity. If the crisis is sufficiently long-lived, it can reduce potential output and even potential growth rates by removing factors of production or making them less effective. Thus, most forecasters envisioned at best a "U" shaped recovery with a long period of slow growth. The most frequently downloaded paper on a popular policy website showed that the current crisis and the Great Depression were following highly similar trajectories (Eichengreen 2009).

The first positive news came from China. The stimulus program there, combining government spending with aggressive credit growth by partly state-owned banks, had quick impact on economic activity. Falling exports had driven many export-oriented companies to the brink, and in 2009Q1 Chinese GDP slowed, to a still-respectable annual rate of 6.1%. As the effects of policy began to take hold, Chinese investment expanded rapidly and activity picked up. In 2009Q2 China grew by 7.9% and growth for 2009 eventually exceeded the 8% target.

In the middle of 2009, the export decline generally stopped and some economies began to register a rebound (Figure 5, Panel B). Combined with aggressive stimulus, the stabilization of

[3] The plan is contained in the leaders' statement: http://www.pittsburghsummit.gov/mediacenter/129639.htm.

exports led to surprising quarter-to-quarter increases in output in 2009Q2 in Hong Kong, Japan, Singapore and other economies. The United States joined the "green shoots" camp soon after the government managed to restore confidence in financial markets in March 2009. Unexpected improvements in housing markets and construction soon followed, and returning confidence led to a sharp rise in equity prices (Figure 5, Panel C). In the six month from the February lows to the end of August 2009, markets recovered roughly half of the losses experienced from the 2007 highs. With growing confidence, net lending by banks abroad also stabilized in the middle of 2009, and indeed recovered at a brisk pace to borrowers in Advanced Asia (Figure 5, Panel D).

Figure 5. Recovery: work in progress

Act V: Recovery

The outlook brightened in the summer of 2009. The IMF, which had revised its projections for global economic growth progressively downward from April 2008 to April 2009, increased its estimates in July and October 2009 (IMF 2009). IMF projections for the PECC region updated in October 2009 (Figure 5, Panel A) show growth rates over 2010-2014 to be similar to those in 2007 and the years prior to the crisis. For Asia's emerging economies, the consensus converged on a "V" shaped recovery.

The United States also resumed growth by the 2009Q3, and is expected to continue growing at a moderate pace in 2010. The only economy projected to have a significantly lower growth rate in the next five years than in 2007 is China—but it was growing unsustainably rapidly then (12.8%). Southeast Asia and Latin America, as well as Australia and New Zealand, escaped the crisis with less damage than other sub-regions, and should recover relatively quickly. Early fears of a collapse in remittances did not come to pass, a factor that proved important for the Philippines and Latin America.

But the recovery is not assured. Many forecasters expect anemic progress, as investment and especially employment recover slowly in the United States. Others even foresee a second downturn. Adverse scenarios typically assume that China and the United States are not be able to transition to new models of growth by 2011 or 2012. In the US, worries focus on government budget deficits, persistent unemployment and continued financial turmoil; in China the concerns relate to the heavy role of bank lending in stimulating investment, while household consumption continues to be too low.

Europe's contribution to world growth is projected to be modest in the near term. The European economy appears to be rebounding, but continuing consumer and investor caution, risks associated with exposure to Eastern European debt, and the real appreciation of the Euro point to sluggish economic activity. The IMF projects that Europe will recover more slowly than the United States. Thus, world growth in 2010 and 2011 will depend heavily on emerging markets.

Pessimistic scenarios incorporate some of the following elements:

- *Premature policy tightening.* Monetary or fiscal policies could be tightened too early, due to rising concerns about inflation, excessive growth in lending, or currency instability; or governments could encounter difficulties in financing deficits.

- *Insufficient private demand.* Private spending could remain depressed due to persistent unemployment, falling asset prices, uncertainty about growth, unrelated shocks (say, from disasters or disease) and, in the United States, high debt.

- *Persistent financial fragility.* Financial markets and intermediation could stay sluggish due to slow progress in isolating bad assets, regulatory interventions that increase risk aversion, or the renewal of imbalances that threaten stability.

- *Expanding imbalances.* The U.S. administration projects that the U.S. budget deficit will be reduced from well over 10% of GDP in 2009 to 3.1% in 2012. The spending cuts and tax increases needed to achieve this outcome will face heavy opposition. Similarly, Chinese surpluses could climb. These developments could create new turmoil in currency and asset markets.

Individually or in combination, these factors would restrain growth throughout the Asia-Pacific. Most likely, they would be then amplified by declines in asset prices. And since governments have pushed policy options hard in the crisis, they have less ammunition left for another battle. Thus, while a reasonable path to recovery is feasible, as reflected in IMF projections, policy mistakes or other adverse developments could easily lead to much worse outcomes.

4. Strategies for sustained growth

In 2010, policy makers face difficult decisions on exiting policies adopted at the height of the crisis and on building foundations for sustained post-crisis growth. The debate so far has focused more on the former than the latter. Yet the two types of decisions are linked: the sooner structural policies for medium-term growth begin to work, the sooner stimulus packages can be discontinued. Indeed, the risk in exiting the stimulus programs derives from not having effective structural initiatives in place. This section examines four types of structural measures:

- Demand-side measures to make spending sustainable in the principal expenditure categories of each economy.

- Supply-side measures to stimulate resources flows to and productivity growth in sectors neglected in the past.

- Initiatives to launch growth engines that generate new opportunities for investment, employment and output.

- Initiatives in international cooperation to generate global strategies and to help make national efforts consistent and effective.

We begin by reviewing structural threats to post-crisis growth and strategies to address them.

The threat of imbalances

Asia-Pacific growth prior to the crisis was spearheaded by consumption in the United States and to a lesser extent Europe. The exuberance of U.S. households spilled into U.S. current account deficits exceeding 6% of U.S. GDP in 2006, financed by the accumulation of financial assets by China, Japan and other advanced Asian economies (see Figure 6). In 2009, the imbalances fell sharply, partly because U.S. consumers returned to more typical savings rates. But while the IMF expects U.S. current account deficits to remain stable in the near future, it expects China's surpluses to rise, leading to a sharp overall increase the Asia-Pacific's surplus with the world.[4]

Figure 6. Imbalances change rapidly, remain unpredictable

Shifting demand from the United States to Asia and other surplus regions will require coherent, timely adjustments. If U.S. demand remains weak and no new demand takes its place, the recovery will stall. But if U.S. demand expands vigorously and generates new deficits, then the recovery will become unstable. The deficit scenario remains a serious concern, not so much due to excessive consumption, but due to the rapid increase of U.S. government spending and budget deficits. While there is no direct relationship between fiscal and current account deficits, the former tends to lead to the latter in a recovery, that is, when investment and consumption activity are relatively strong. In 2009, the U.S. fiscal deficit reached its highest level relative to GDP since World War II. If the government is unable to reduce the deficit rapidly, internal and external debt will rise, raising the prospects of inflation and instability. Sooner or later, these concerns will unnerve investors and lead to volatility in asset prices and exchange rates.

Forward-looking markets will tend to "balance" current accounts (even without policy changes) by penalizing the buildup of *ex ante* unsustainable imbalances. For example, markets may respond to projected imbalances with a sharp, early depreciation of the U.S. dollar and/or a sharp, early increase in interest rates on dollar-denominated loans. If some currencies fixed relative to the dollar, as was the case with the RMB during the crisis, adjustments take place with greater amplitude against other currencies that can move freely, imposing greater adjustment costs on those economies. In any case, the adjustments would slow U.S. spending by making it more expensive to borrow and more attractive to save, and by increasing the real cost of tradable products. Similar mechanisms would work in the opposite direction in surplus economies, unless they act to contain excessive savings.

But automatic feedback mechanisms would limit imbalances at the possibly high cost of exchange rate and asset price turmoil. If sustainability is left entirely to market adjustments, large and uneven price changes might result, due to uncertainty about policy and other factors. When imbalances rise, market participants cannot immediately tell whether this is due to excessive spending or other, transient factors. Markets could therefore permit imbalances to escalate until the forces driving them are clear—and much larger adjustments are needed. Whether or not such cycles develop, unsustainable policies increase uncertainty and diminish the efficiency of investment and consumption decisions.

[4] The IMF also projects a substantial increase in the world's "surplus." Although such a surplus is partly due to measurement errors, the IMF's projected increase more likely reflects inconsistencies in its several country projections.

This pattern of market corrections to Imbalances imposes costly stop-and-go patterns on the real economy. For example, in the pre-crisis period, export industries thrived in Asia and languished in the United States. As markets reacted, exports shrank in Asia and incentives improved for tradables in the United States. Such shifts impose permanent costs in both economies because they require capacity to be shut down in some industries and new capacity to be created in others. Capital, skills, knowledge and productivity are lost in declining sectors, and have to be built up anew in the expanding sectors.

For all of these reasons, policies that balance expenditures within and across economies are necessary to ensure stable growth. The relationship between global recovery and global imbalances is illustrated in Figure 6. Here the growth rate of the world economy is used as a proxy for recovery, and the U.S. current account deficit as a proxy for imbalances. The diagram indicates four possible outcomes, ranging from a worst scenario with a low world growth rate and high U.S. deficits (quadrant C) to the best scenario with a high world growth rate and low U.S. deficits (quadrant B).

Figure 7. The recovery needs to be sustainable

Prior to the crisis, global growth was adequate, but U.S. deficits were large (as illustrated by the pre-crisis point in quadrant D). During the crisis, the world economy moved to unacceptably low growth, but deficits shrank to an acceptable level (the post-crisis point in quadrant A). With recovery, the global economy is now moving along the solid arrow toward higher growth and larger deficits. But the future is uncertain, as represented in the diagram by three alternative dashed arrows. The eventual path of the world economy could approach balanced growth (ending up in quadrant B), but it could also lead to undesirable outcomes with unsustainable capital flows and/or low growth rates.

The IMF projections envision a sustainable growth path, as illustrated in Figure 8. The IMF expects world growth to return to near 4% (above the 3.1% average for the 1997-2007 decade) and U.S. deficits to remain under 3%, an arbitrary but widely used target for sustainability. The IMF trajectory reflects a relatively sluggish recovery of U.S. consumer spending and investment, and steady unwinding of the fiscal stimulus.

In the medium term, while the U.S. dollar remains the world's principal reserve currency, the United States is likely to run a current account deficit, or equivalently, other economies are likely to accumulate dollar assets. The 3% target rate corresponds, roughly, to the potential long-term growth rate of the U.S. economy. Even if U.S. external debt were to expand at this rate forever, it would eventually stabilize at 100% of GDP. The rate is probably best viewed as acceptable only in the medium term, facilitating global reserve accumulation and measured adjustment in both surplus and deficit economies. The rate is consistent with much larger surplus percentages in other, smaller economies. For example, if the 3% U.S. capital inflows were to come entirely from China, they would represent 8% of Chinese GDP.

Figure 8. Not all paths lead to balanced recovery

Some forecasts of future imbalances are less optimistic than those of the IMF. William Cline (2009) projects lower world growth rates and higher imbalances; he sees U.S. current account

deficits growing to 4.9% of U.S. GDP by 2011 and remaining close to that level thereafter. In a still more adverse scenario, Cline assumes larger budget deficits, which push the U.S. current account deficit to 5.2% GDP by 2015 and to 16% of GDP by 2030. Cline incorporates two plausible—but hopefully too pessimistic—assumptions: that the U.S. will fail to reduce government deficits, and that foreign investors (especially China) will continue to demand U.S. assets with only modest increases in interest rates. Due to these assumptions, neither of Cline's scenarios enters the desirable quadrant B in Figure 8.

Rebalancing demand

To reduce net external surpluses and deficits of an economy, two kinds of adjustments are needed: (i) in the overall level of demand and (ii) in the composition of demand between tradable and non-tradable sectors. In the United States, the deficit economy, rebalancing the current account requires a reduction in overall demand relative to income, and a shift in demand from non-tradables to tradables. In surplus Asia, rebalancing requires an increase in overall demand and a shift in demand from tradables to non-tradables (especially services).

Shifts in an economy's domestic demand may result from changes in consumption or investment (and hence deeper determinants such as wealth, taxes, and credit and business conditions) or from policy changes that affect government spending. Shifts in the composition of demand typically reflect price changes, and specifically movements in the real exchange rate.[5] For example, the currencies of deficit economies can be expected to depreciate in the process of rebalancing, because declining domestic demand will reduce the prices of the economy's non-traded goods and drive resources into industries that sever external (export) demand.

Flexible exchange rates normally facilitate the currency adjustments required to achieve expenditure switching and rebalancing. But since China and some other economies manage their exchange rates, these adjustments also require policy decisions. After appreciating by 17% in nominal terms against the dollar between 2005 and 2008, the Chinese RMB has remained constant relative to the dollar through 2009. Since the dollar depreciated against other currencies in 2009, this has also meant that the RMB has depreciated in trade-weighted terms, particularly against the Japanese yen. In effect, the RMB has moved in a direction opposite to that required for expenditure switching.

Future adjustments will require renewed flexibility against the U.S. dollar. Of course, exchange rate changes cannot work except as part of a package of policy measures that drive the necessary expenditure shifts. Moreover, given the Asia-Pacific's complex, fragmented production system, several currencies would have to move against the dollar (BIS 2009) in order to change the overall price of goods exported to the United States. These complicate policy and argue for greater regional cooperation in policy changes. But decisions about real exchange rates cannot be avoided. In the absence of flexibility in nominal exchange rates, market mechanisms may

[5] Real exchange rate movements may be achieved through nominal exchange rate movements or changes in price levels. For example, a deficit economy could depreciate its currency, or keep its nominal exchange rate fixed and undergo deflation to reduce the prices of its tradable goods. If nominal exchange rates are permitted to move, they tend to adjust more rapidly, and with lower adjustment cost, than price levels.

result in more costly adjustments in real exchange rates, namely through price level changes that involve deflation in deficit economies and inflation in surplus economies.

To provide insight into the magnitudes involved in rebalancing, Table 1 presents an overview of expenditures and imbalances in the PECC area in 2007, the last "normal" year before the crisis. The largest current account imbalances in the region consisted of the U.S. deficit of $727 billion and China's surplus of $372 billion. Other important surplus economies included Japan and other Advanced Asian economies; other deficit economies include Australia and New Zealand. Overall, the region ran a deficit of $127 billion with the rest of the world. Europe had a slight current account surplus (netting out substantial surpluses and deficits), while the Middle East and the Rest of the World had surpluses, as did the world as a whole (due to statistical inconsistencies). The table also shows significant differences in the pattern of expenditures; while the United States produced 49% of the Asia-Pacific's GDP, it accounted for 56% of the area's consumption and only 35% of its investment.

Table 1. Pre-crisis expenditures were not sustainable

What would it have taken to eliminate excessive imbalances in the Asia-Pacific in 2007? A hypothetical recalculation of Table 1 can help to assess the scale of the adjustments that might be required. We anchor this scenario by assuming that the United States deficit is reduced to 3% of GDP ($422 billion), or by $304 billion, for reasons explained above. The scenario requires further assumptions on how adjustments are distributed across other economies and how they are allocated to expenditures within them.

A second set of assumptions involves the allocation of the $304 billion reduction in the U.S. deficit to other economies with current account surpluses. This was accomplished by allocating the reduction to each surplus economy in proportion to its share of the sum of all global surpluses in 2007. This implies, for example, that China would absorb 33% of the U.S. deficit reduction, reducing its surplus by $102 billion. (This allocation is simple but essentially arbitrary—for example, a case could be made for alternative approaches that allocate more- or less-than-proportional reductions to other economies such as Japan and the Middle East.)

A third set of assumptions involves the allocation of changes in overall national expenditures within each economy to specific expenditure categories. This was based on country-specific assumptions that commonly appear in discussions of rebalancing. For example, overall 60% of the expenditure adjustments were allocated to consumption in the United States and China (where consumption rates are widely considered to be too high and too low, respectively) and to investment in Southeast Asia (where investment rates are considered too low, especially compared to levels achieved before 1997-98). In all cases, 20% of adjustment was allocated to each of the other two expenditure categories.

The goal of the exercise is to offer insight into the size of adjustments associated with eliminating the excess imbalances of 2007 (Figure 9). In China, for example, the recalculation implies consumption 5% above its actual 2007 level. This is equivalent to the growth in consumption that normally takes place in 8 months given China's rapid development. Put another way, China's consumption growth would have to exceed the rate of growth of GDP by 1.67% per year over a three year period (say, it would have to grow at a nominal rate of 11.7%

per year rather than 10% per year). It is a matter of judgment, of course, whether such acceleration is considered "small" or "large," since significant policy measures have to be taken. But a detailed study of consumption-increasing policies by the McKinsey Global Institute suggests that with the right initiatives even greater increases in consumption could be achieved (Woetzel et al. 2009).

Similar percentage changes would be involved in investment and government expenditures in Southeast Asia and Latin America. The demand effects in the United States would be smaller, amounting to around 2% reductions in various U.S. expenditures. The scale of these results suggests that the adjustments are manageable—and indeed considerably smaller than some market-driven changes that have taken place in recent months.

Figure 10 reports the trade impacts of these same recalculations. This requires a fourth set of assumption, in which we allocate ½ of the change in the net exports to exports, and ½ to imports. This would lead to around 5% change in U.S. trade (including a larger increase in exports, and a smaller decrease in imports), and around 2-4% changes in trade in other sub-regions. Given relatively modest expenditure changes, it is not surprising that other studies find that the sectoral impacts of rebalancing are also manageable (Kawai and Zhai, 2009 and Petri, 2009). Thus, the arithmetic of rebalancing is generally favorable: imbalances that exert great stress on global financial relations are relatively small when compared to broad classes of domestic expenditures within large economies. Shifting expenditures, although politically difficult, will likely cause relatively small structural dislocations within the region's economies.

Nevertheless, quantitatively modest adjustments may involve deep policy changes and significant political effort. The details of these policies are discussed in the sub-regional essays. For example, increasing consumption in China is likely to require a redistribution of income from the corporate sector to households, as well as improvements in social safety nets. These changes would require substantial improvements in the operation of factor markets—labor and capital markets—that enable workers to command higher wages that are more closely aligned with their productivity, and give small firms better access to finance. And those changes, in turn, might require adjustments in the incentive systems used within the government bureaucracy.

Similarly, a balanced growth path will require difficult political decisions in the United States. The U.S. current account deficit has declined to around 3% of GDP in 2009, due to a remarkable increase in net private savings to 10% of GDP, which in turn reflects declines in investment and consumption spending. But the U.S. government budget deficit, already large before the crisis due to tax cuts and military expenditures, has risen dramatically. Many new priorities, such as expanded health insurance coverage, have also emerged with the change in administrations in 2009. The U.S. budget deficit is now at levels not seen since World War II. Although there is no one-to-one relationship between the fiscal and external deficits, the two are likely to move together once U.S. investment recovers. Massive fiscal consolidation would then be needed to keep U.S. external balances stable, possibly in the context of high unemployment. Solutions are likely to require major political changes; for example, Bergsten (2009) proposes that the United States add a “balanced budget amendment” to its constitution.

Figure 9. Modest expenditure changes are sufficient for rebalancing

Figure 10. Modest trade changes are sufficient for rebalancing

Box 1. Rebalancing China's Economy

Rebalancing supply

If demand patterns change, supply patterns will also need to adjust, requiring resource movements between tradable and non-tradable production. In the US, where rebalancing will require increased net exports, resources will need to move from non-tradable sectors into tradable ones. Such transfers require price signals, which typically reflect exchange rate adjustments.

In the years before the crisis, the U.S. dollar had begun to depreciate, helping to invigorate the U.S. export sector and reduce the current account deficit. Cline (2009) finds that U.S. net exports increase by 1% of GDP for each 7% depreciation of the dollar (real, trade-weighted). Thus, rebalancing of 2007 demand (that is, increasing net exports by 2.2% of GDP) would require an approximately 15% depreciation of the dollar from 2007, when the U.S. dollar was around 140 Euro. After briefly appreciating during the crisis, the U.S. dollar returned to approximately 150 Euro at the end of 2009, or about half-way to what Cline projects would be sufficient for the necessary expenditure shifts.

In Asia, where rebalancing will require lower net exports, resources would have to move from tradable sectors to non-tradable ones, and especially to services. Asian economies have performed less well in service production than in manufacturing. (There are important exceptions, such as the business and financial services in Singapore.) Restrictions on competition—from large and/or foreign firms—are often cited as a cause. In addition to exchange rate flexibility, the following strategies can also promote the development of non-tradable supply:

- *Eliminating incentives to export.* Asian export industries have at times benefited from special access to finance, investments in trade-related infrastructure, and favorable tax treatment. Non-tradables have typically lacked such support.

- *Removing barriers to competition.* Service sectors in many Asian economies face wide-ranging regulations and restrictions on entry, especially by larger companies and foreign competitors.

- *Expanding the provision of public goods and services.* Unmet needs are growing for public goods and services in health, education, environmental conservation and infrastructure development. Substantial shares of such expenditures are non-tradable.

Box 2. Logistics reform as an engine of growth

Box 3. Promoting labor mobility

A history of remarkable tradable growth—and a body of academic literature—suggest that giving preference to tradable sectors is advantageous in the early stages of development. Yet macroeconomic conditions today argue against over-reliance on tradable sectors for growth. Leveling the playing field for non-tradable sectors, in turn, could generate productivity gains that will remain important drivers of growth as Asia's economies move to higher income levels.

Growth engines to drive recovery

Some sectors and growth processes invariably stand out as "growth engines"[6] in times of rapid expansion. These reflect unusual productivity or demand changes and create new opportunities for investment and employment. Until 2008, U.S. consumption demand was arguably *the* engine of world growth, supported by others that included foreign direct investment in China, Vietnam and other economies; real estate booms in Singapore, Indonesia and Thailand; and agricultural and mining investments in Australia and New Zealand. In addition to direct economic effects, growth engines contribute to investor psychology by making economic development comprehensible and palpable.

A growth engine is any *significant profit opportunity that leads to robust investment and economic activity.* A growth engine may generate further profit opportunities in the process of its operations, but at a minimum it is sufficiently large and long-lived to affect macroeconomic results. In this discussion, we focus on a substantial number of activities that could generate global investments of $100 billion or more in five years. Growth engines may be launched by technological breakthroughs, such as the diffusion of the internet in the 1990s, or by new trends, such as the ageing of populations in Asia. Some are created by policy changes.

Rebalancing global demand and supply will itself create new engines of growth. Demand and price incentives for net exports in the deficit economies, including depreciated real exchange rates, will expand export and import-competing industries. For example, U.S. exports could increase rapidly—as in the years prior to the crisis when the dollar was depreciating—in industries such as medical technology, high-technology manufacturing, and services from communications and entertainment to finance. Demand from rapidly growing Asia could drive growth in agriculture and primary goods production in Southeast Asia, Australia, New Zealand and even Latin America and the United States. New opportunities will emerge to establish centers to serve Asia's rapidly growing markets for financial, education, health and entertainment services.

[6] A staple of growth theory, growth engines attempt to single out the main drivers of growth from the many factors at play. For example, Schumpeter (1942) saw entrepreneurial innovation as an engine; Kaldor (1957) focused on investment in industry; Hirschman (1959) and Nurske (1953) emphasized economies of scale and sectoral imbalances; and Kravis (1970) focused on trade. Contemporary endogenous growth theory (Romer, 1986) emphasizes accumulated knowledge and the related processes of research and innovation.

In addition, a wide range of possible engines could directly promote balanced growth. The triggers might include freeing up competition and investment, as in Asia's logistics and other service industries. It could be also launched by new regulations in environmental protection, energy conservation and safety. Governments might also solve various "coordination problems" to generate growth, for example, by concluding major trade agreements, or setting standards that integrate domestic markets. Governments can also directly stimulate production by mandating, funding or subsidizing activities such as education and health services.

Despite the great diversity of the Asia-Pacific, recent years have seen convergence on economic and social priorities. Virtually all economies have policy initiatives in four areas:

- Economic integration: investments in connectivity and trade agreements that strengthen Asia-Pacific markets.

- Green economy: investments in energy conservation, research and development, efficient irrigation, and energy-saving vehicles and transport systems.

- Social priorities: investments in education, health care, pensions and social safety nets.

- Knowledge and productivity: investments in research and development and technology, and reforms to drive productivity.

Box 4. Green growth: South Korea's strategy

Regional and domestic initiatives on these priorities could reinforce each other and generate new poles of growth. They would also support rebalancing by stimulating Asian demand, opening new markets for Asian manufactures, and cushioning the impact of declining consumption in the United States. Table 2 identifies sectors targeted in the regional policy discussions. Many of these initiatives have been already extensively researched and action plans are available; in some cases, there also exist good models to be emulated. In other words, blueprints often exist, providing a basis for early action.

Table 2. Social priorities suggest promising growth engines

Creating new engines of growth was, at best, a side-effect of stimulus packages introduced during the crisis. Stimulus spending did sometimes target relevant initiatives, but was not designed to address long-term, structural objectives. Indeed, governments typically sought to make policies timely, targeted (on direct spending), and temporary (the "three Ts" enunciated in the United States). This approach maximized impact, but sacrificed long-term productivity.

In contrast, forward-looking, structural initiatives need to be prioritized, productive, and persistent ("three Ps"). This report cannot do justice to their promise or complexity, but argues that they should rise on the international cooperation agenda. International policy discussions can help to forge consensus—among governments, investors, and the public—about economic priorities and directions. Common goals could stimulate innovation and investment, and strengthen domestic commitments to coherent reforms.

International cooperation

The crisis has intensified the need for international cooperation, including managing the exit from stimulus policies and deploying structural policies. It has also established emerging economies as full partners in these decisions, due to their weight in the global economy and especially the post-crisis recovery. Credible international mechanisms for cooperation are necessary to reduce uncertainty about policy, which in turn is a prerequisite for vigorous private investments.

Several areas of cooperation are urgent and some appear to require new or substantially restructured institutions. The system of global cooperation is in flux, and will most likely evolve into a "layered" structure, with higher-level global institutions setting broad strategy and regional or bilateral institutions handling the implementation of concrete initiatives. In the following, we sketch priorities for the Asia-Pacific.

Macro-economic cooperation. Domestic policies affect global balances and risks and call for surveillance and consultation. Shared analysis enables policy makers to set consistent targets for fiscal and monetary policies and to minimize the volatility of variables (such as long-term real interest rates and real exchange rates) that affect investment and production. A rigorous framework for analysis and discussion of conditions in all economies, including the largest, has to be the basis for this process. Capital flows represent an especially difficult challenge. While the rebalancing issues discussed in this report are especially urgent, excessive surges of capital flows present other problems and need continuing attention. The G-20 has tasked the IMF, which already conducts regular consultations with member economies, with providing analytical support for macroeconomic assessments. Similar processes might be of value also in Asian frameworks, including the Chiang Mai Initiative Multilateralized (CMIM).

Financial risk. Coherent regulation of global financial markets would reduce a major source of market uncertainty, but will be difficult to achieve. Macro-prudential risk—the tendency for risk appetites to rise at the peak of the business cycle and to decline at the through—has become better understood as a result of the crisis, and some governments are now likely to adopt policies (such as counter-cyclical reserve requirement adjustments) to countervail fluctuations in risk appetites. Micro-prudential risks, managed through the regulation of individual financial institutions, are also better understood. The key challenge is to improve oversight of systemically important institutions (institutions "too big to fail") and to extend regulations to all significant financial institutions and transactions. This in turn requires close cooperation among regulators from different economies in overseeing institutions that operate in multiple markets. The Financial Stability Board may help to address issues related to regulatory cooperation.

Liquidity support. Economies facing shocks have urgent financial needs. The IMF normally meets such needs in order to provide resources for adjustment, and to contain international contagion. In the wake of the 1997-98 crisis, however, borrowing from the IMF became politically unacceptable to many Asian economies. Liquidity support is central to rebalancing demand, since the perceived lack of such insurance is one reason why some Asian economies have built large foreign exchange reserves. Some new options are now emerging. In 2008-2009, bilateral swaps with the U.S. Treasury and the central banks of China and Japan provided emergency support for Korea, Indonesia and other economies. Recent steps to multilateralize

and strengthen the Chiang Mai Initiative represent a further addition to the toolkit. Also important are global Initiatives to strengthen the IMF (including through new SDR allocations), to reform its governance structure, and through these and other measures to make engagement with the IMF more acceptable politically.

Trade. Some protectionist measures have emerged in recent months, including a significant rise in administrative actions, such as the U.S. decision in September 2009 to impose safeguard tariffs on tire imports from China. But on the whole, the measures have affected a small share of trade and have remained within the bounds of WTO disciplines. In fact, some observers have noted the absence of major protectionist surge despite the severity of the economic downturn—the "dog that didn't bark"—and argue that restraint has so far avoided the mistakes that led to disaster in the 1930s (Baldwin and Evenett 2009). Arguably, the WTO has provided a legal framework for managing the pressures that inevitably arise in serious recessions. WTO and World Bank monitoring have been instrumental in keeping protectionism at bay. But it is too soon to declare victory against protectionism, and avoiding severe disruptions in trade is any case too modest a goal. The completion of the Doha Round and/or broad, inclusive regional FTAs could substantially improve the long-term prospects of the world economy and thus contribute immediately to the recovery.

Social priorities. Convergence of priorities on social concerns across issues such as health, environment and poverty, enables economies to pursue political goals more effectively in the framework of regional cooperation. As argued below, such cooperation could also advance economic objectives by focusing public and private investments on new engines of growth.

These five areas of cooperation define a complex agenda, spanning many governments and institutions. Not all issues have to be addressed at once, but early, concrete actions could help to restore confidence in Asia-Pacific integration, and thus energize private investment and entrepreneurship. Such discussions inevitably lead to a call for political will and leadership, but circumstances today make this call more urgent than ever.

5. Time for decisions

The crisis of the 2008-2009 has not become Great Depression II, but has been severe and continues to pose risks. It also represents a watershed in economic history. It offers an opportunity to address weaknesses in the global economy, to reinvent the institutions to manage interdependence, and to establish the foundations for inclusive, balanced, sustained growth. Achieving these will require:

- Adopting policies (especially in China, Japan and the United States) to keep current account imbalances across the Pacific under 3 percent of U.S. GDP;

- Intensifying macroeconomic cooperation to chart clear policy directions and to create a predictable framework for currency and asset markets;

- Intensifying microeconomic cooperation to launch effective structural measures on financial regulation, trade liberalization, and productivity growth;

- Identifying common social priorities and fostering engines of growth to stimulate innovation, investment and employment, in the spirit of deeper regional cooperation.

The costs of failure are large. Given the damage they have already suffered, people across the region cannot afford another crisis or even a prolonged slowdown. The gains from IBS growth are equally large: the Asia-Pacific's dynamism, diversity and resources are primed to lead global growth for decades to come.

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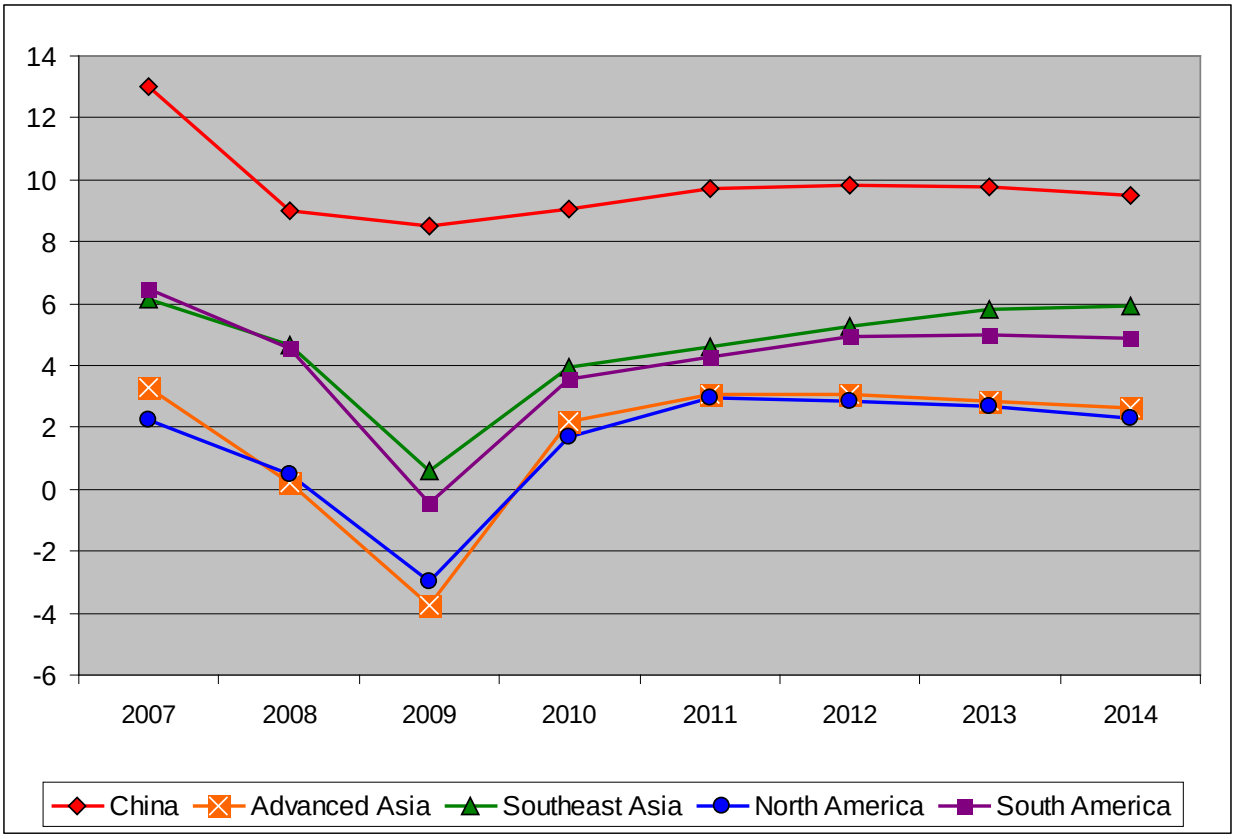
ANNEX. DEFINITION OF SUB-REGIONS

The report covers data for the 22 economies that are members of the Pacific Economic Cooperation Council. These economies are grouped into five sub-regions as shown in the table below.

Group	Economies
China	China exc. Hong Kong SAR; Hong Kong SAR
Advanced Asia	Australia; Chinese Taipei; Japan; Korea; New Zealand; Singapore
Southeast Asia Developing Economies	Brunei Darussalam; Indonesia; Malaysia; Philippines; Thailand; Vietnam
North America	Canada; Mexico; United States
South America	Chile; Colombia; Ecuador; Peru

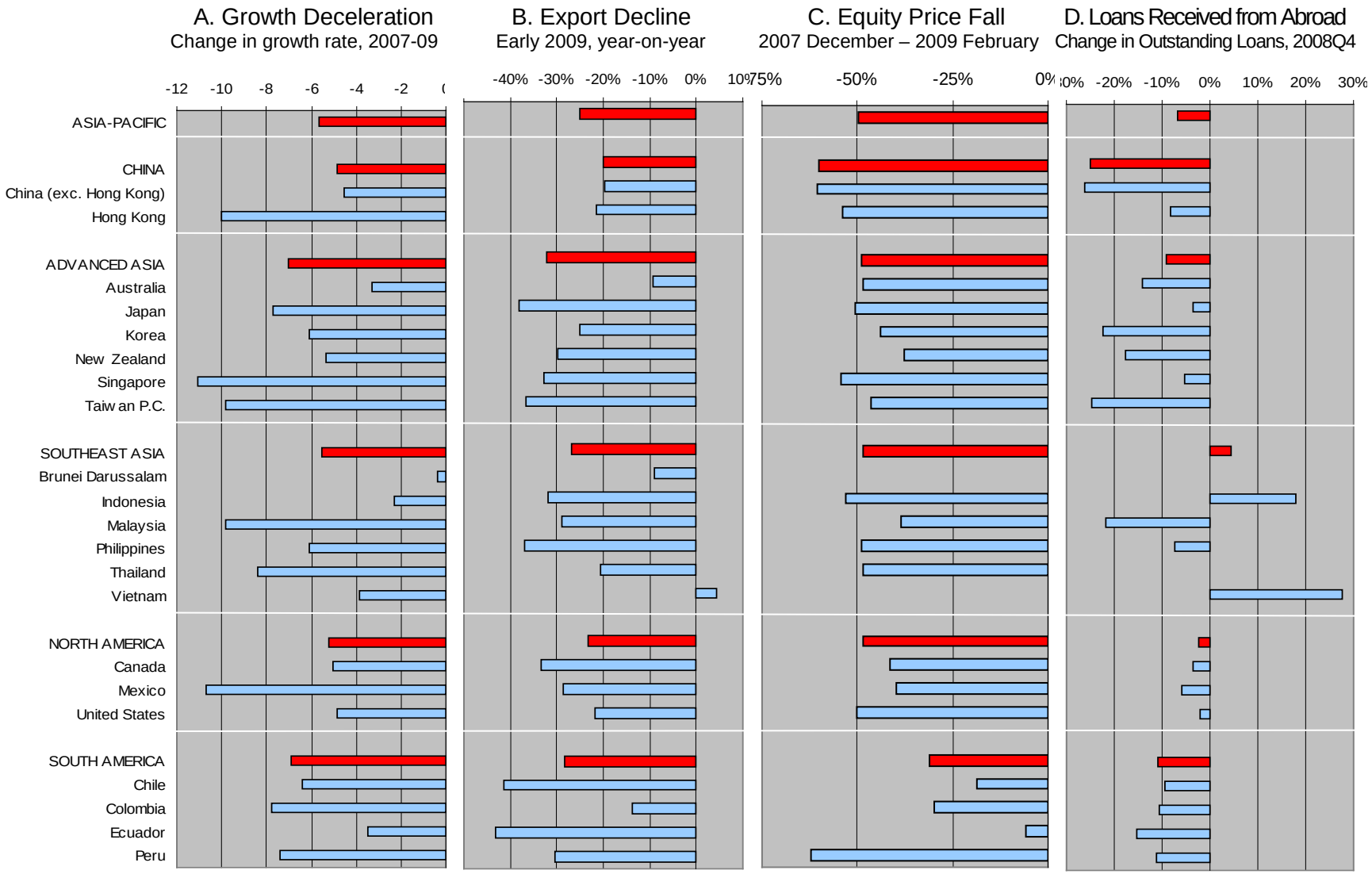
FIGURES AND TABLES

Figure 1
Deep V? Asia-Pacific GDP growth projections, 2007-2014



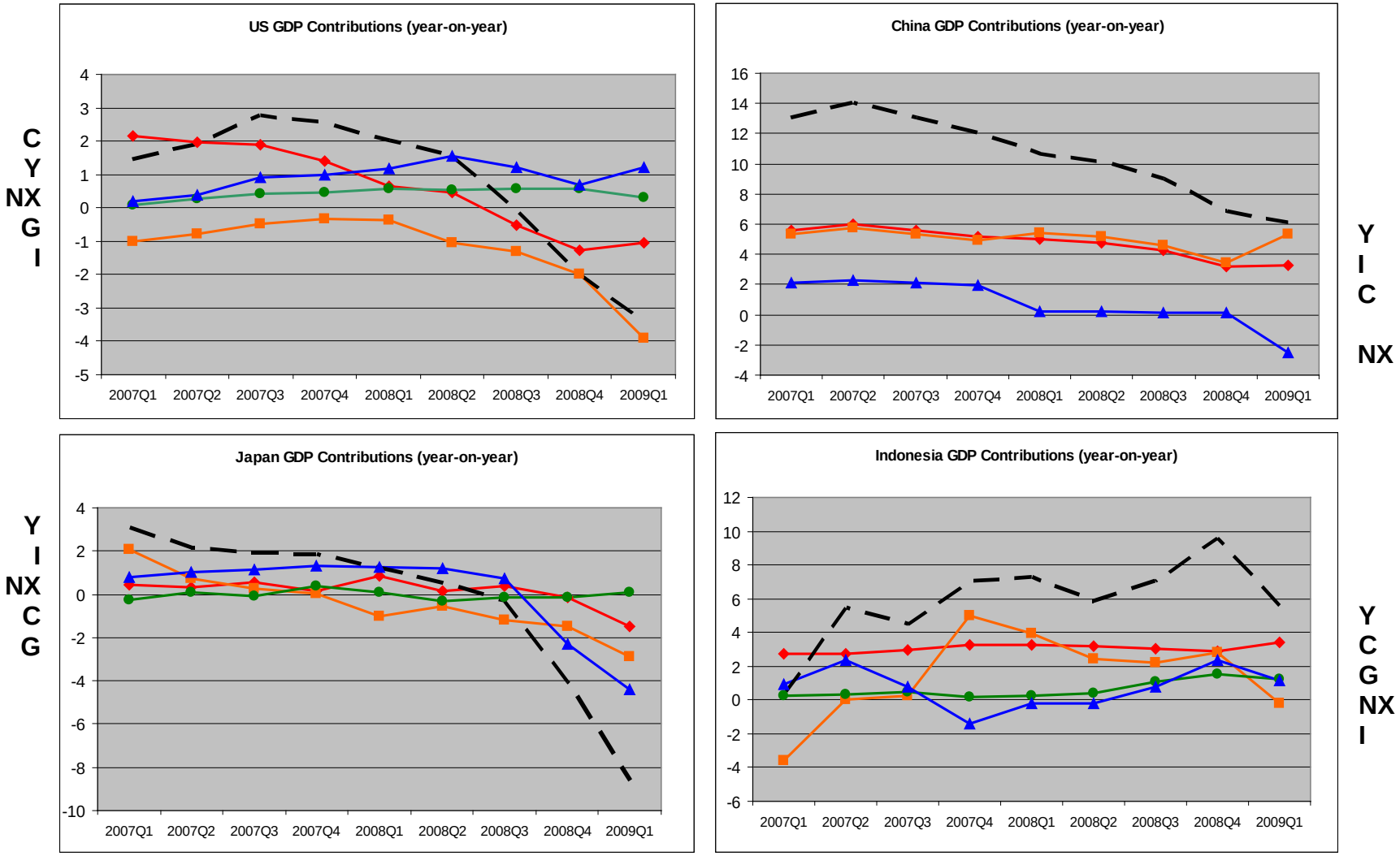
Source: IMF WEO (October 2009).

Figure 2. Dimensions of the crisis: no place to hide



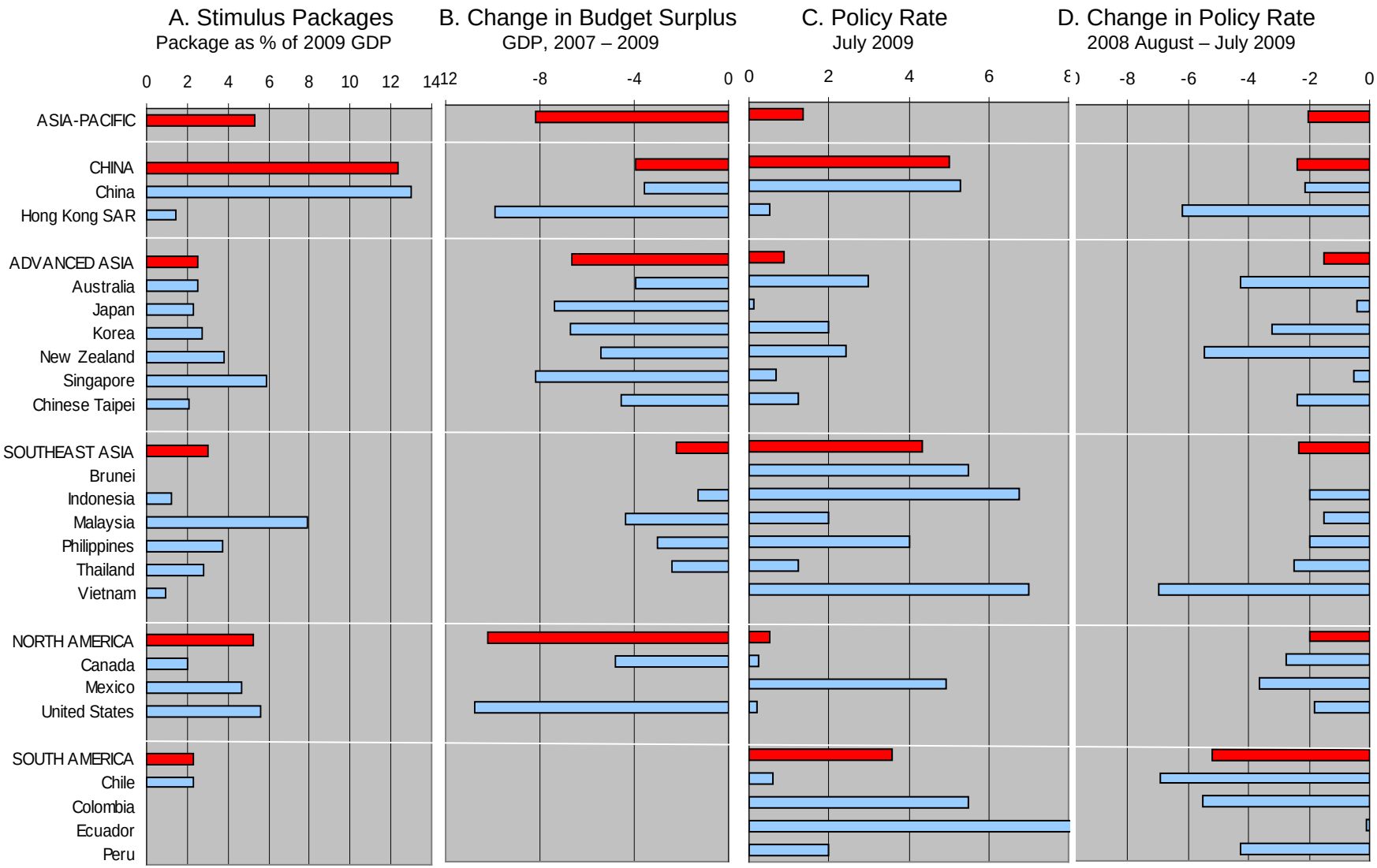
Sources: BIS, CEIC, Yahoo Finance.

Figure 3. How the crisis spread from the United States to Asia



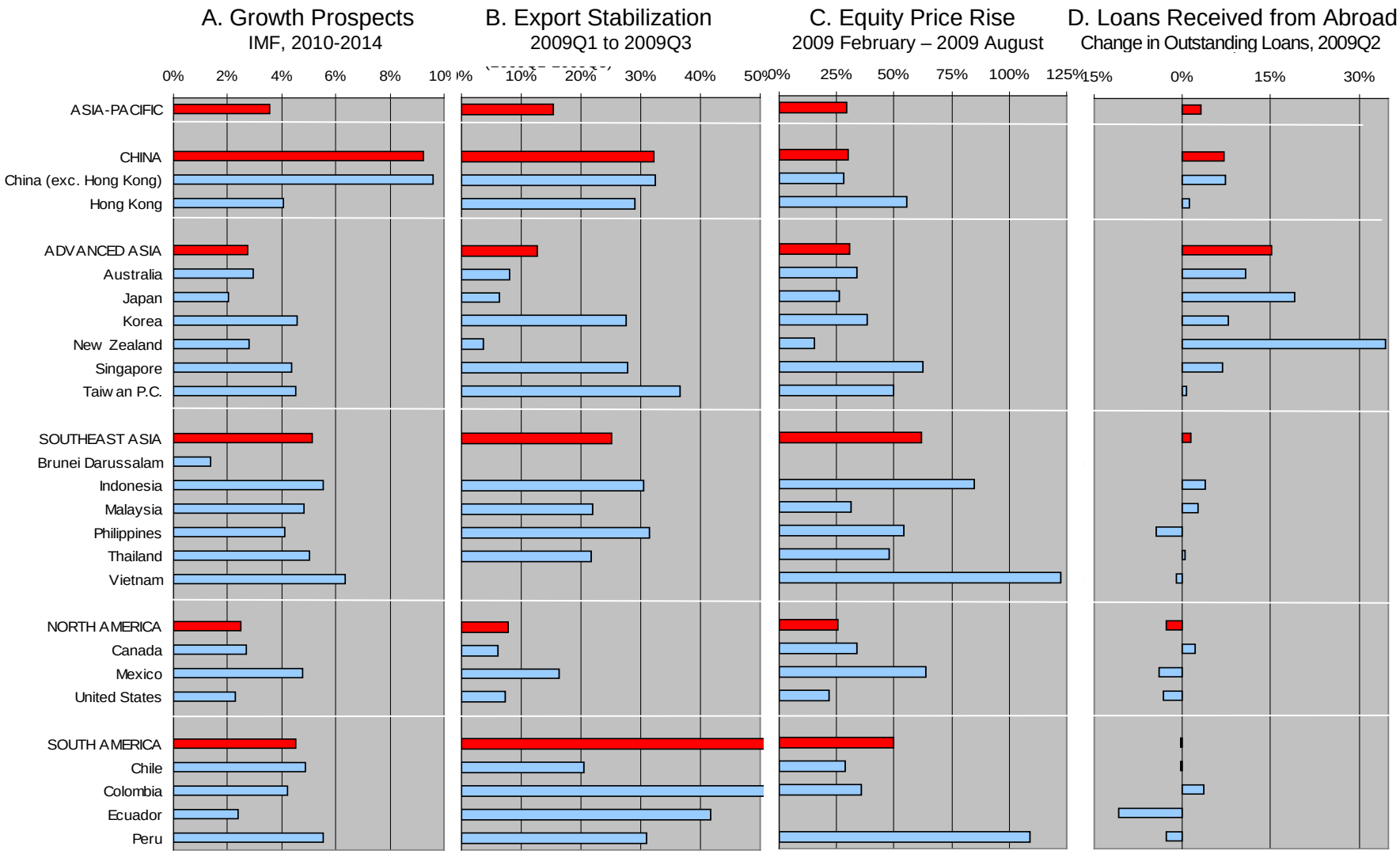
Source: calculations based on CEIC data.

Figure 4. Policy: massive responses across the region



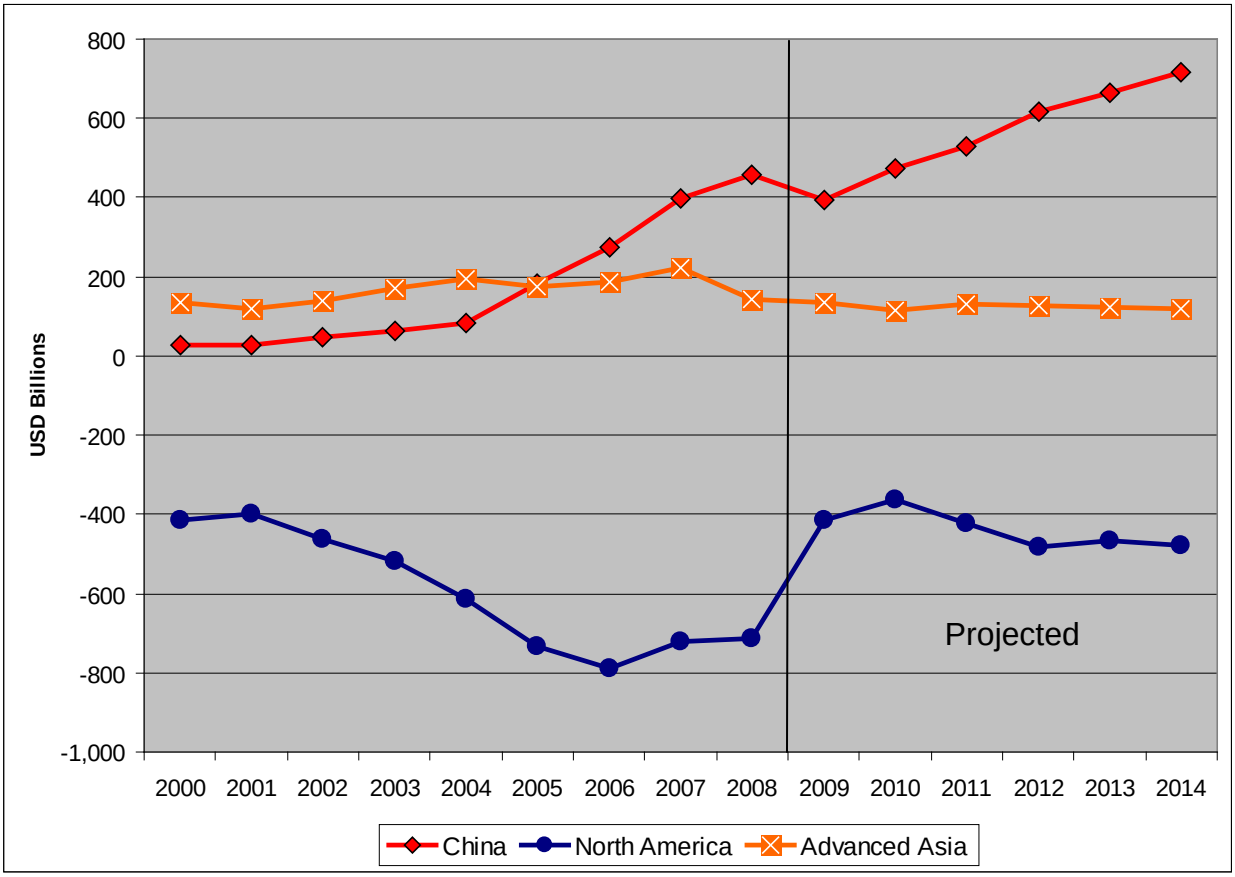
Sources: Khatiwada (2009), AEM (June 2009), CEIC.

Figure 5. Recovery: work in progress



Sources: IMF WEO (October 2009), CEIC, Yahoo Finance, BIS (December 2009).

Figure 6.
Imbalances change rapidly
Current account, USD billions



Source: IMF WEO Database, October 2009.

Figure 7.
The recovery needs to be sustainable

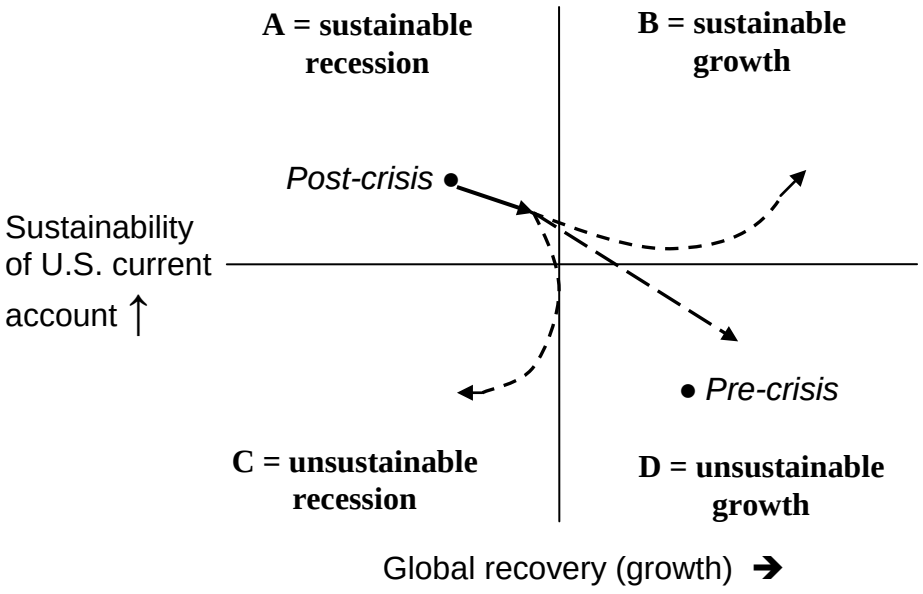
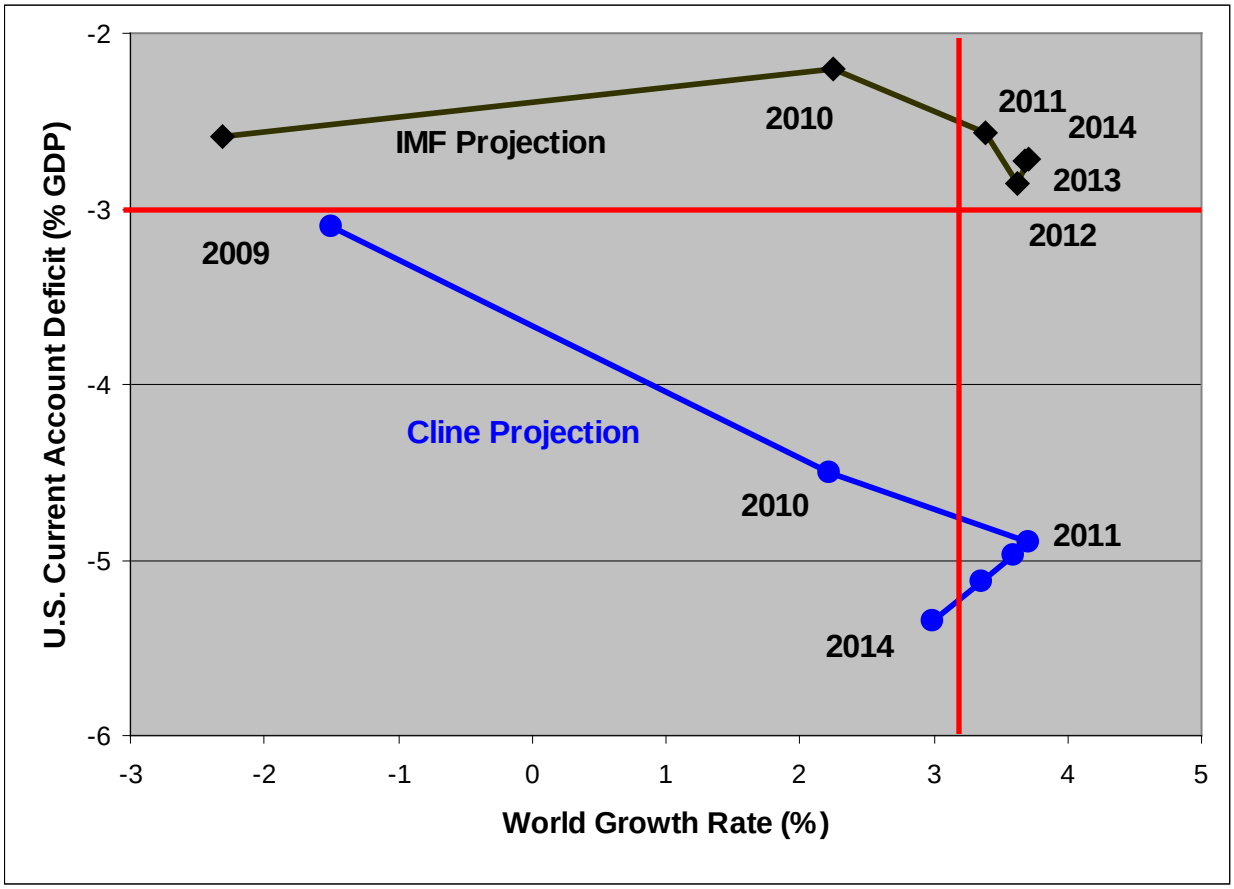
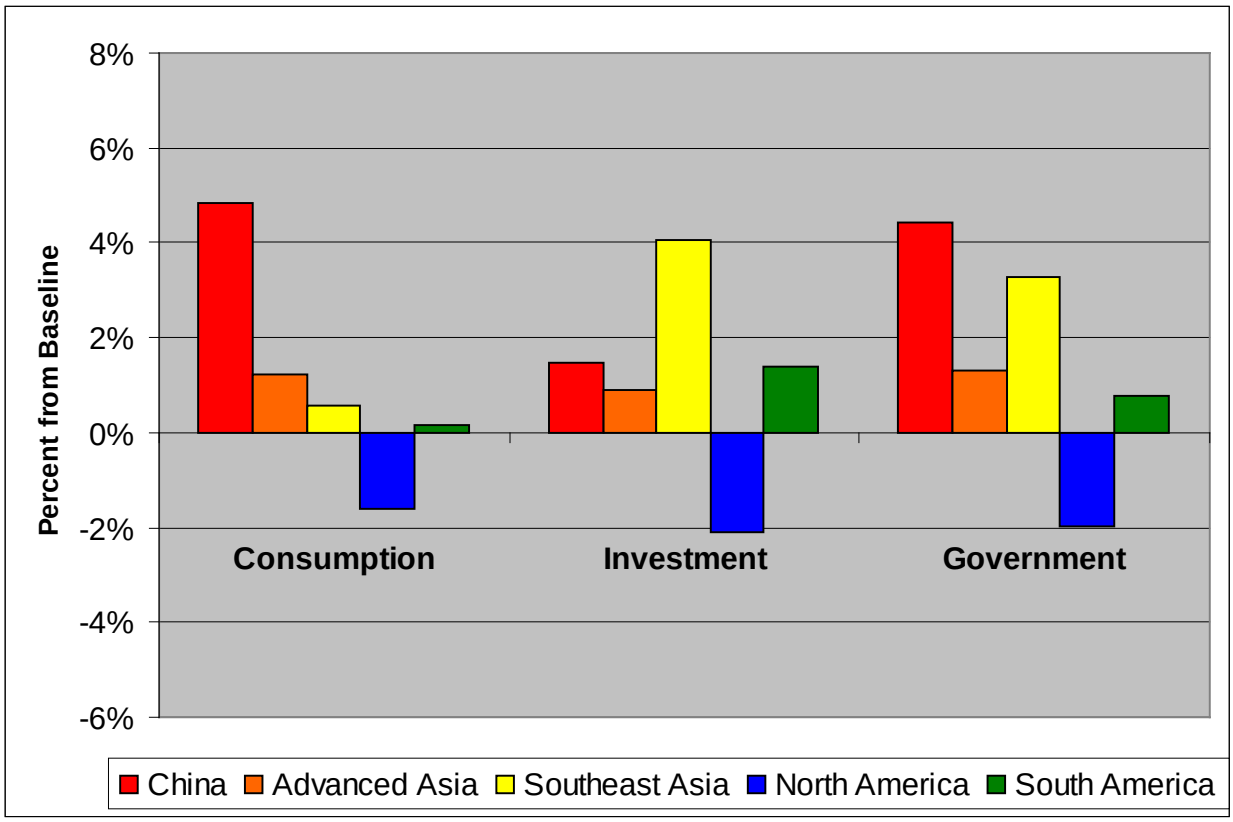


Figure 8
Some projections envision balanced recovery, some not



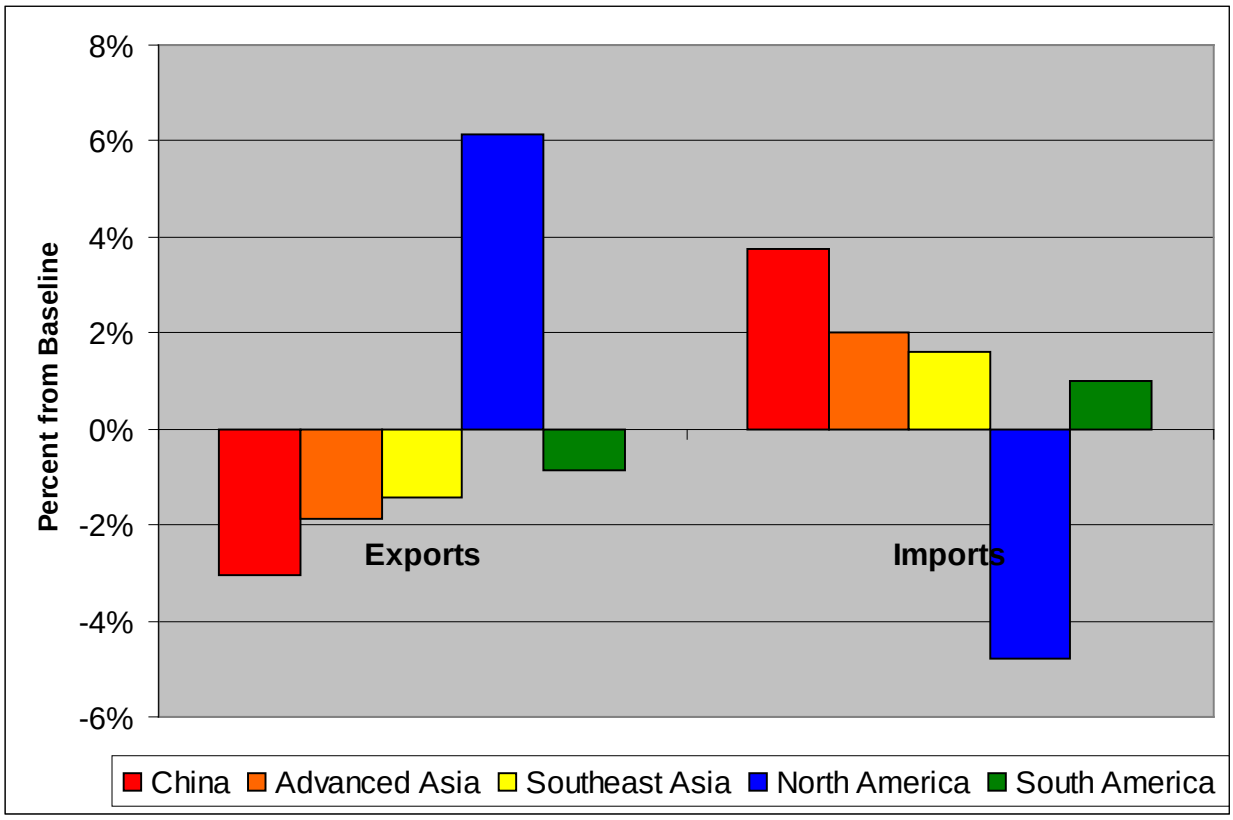
Source: IMF WEO (October 2009), Cline (2009).

Figure 9.
Rebalancing requires moderate expenditure changes
(% change from 2007 baseline)



Source: calculations explained in text.

Figure 10.
Rebalancing requires moderate trade changes
(% change from 2007 baseline)



Source: calculations explained in text.

Table 1
Pre-crisis imbalances were not sustainable
(2007 Data, USD Billions)

		Expenditures						Current
	GDP	Cons	Inv	Gov	Exp	Imp	Net Exp	Acct
World	**54,841**	**31,835**	**12,810**	**9,810**	**17,149**	**16,763**	**386**	**299**
European Union(EU15)	15,724	8,998	3,359	3,227	6,147	6,006	141	9
Middle East	1,394	589	347	203	811	556	255	265
Rest of the World	8,895	4,742	2,575	1,462	3,076	2,959	117	63
Asia-Pacific	**28,827**	**17,506**	**6,529**	**4,919**	**7,115**	**7,242**	**-127**	**-38**
China	**3,652**	**1,340**	**1,493**	**488**	**1,773**	**1,443**	**330**	**397**
China (exc. Hong Kong)	3,445	1,216	1,450	472	1,342	1,035	308	372
Hong Kong	207	125	43	17	431	408	22	26
Advanced Asia	**7,028**	**3,915**	**1,772**	**1,188**	**2,100**	**1,947**	**153**	**221**
Australia	910	508	257	161	183	199	-17	-57
Japan	4,384	2,469	1,057	786	772	699	73	211
Korea	1,049	571	309	154	440	424	16	6
New Zealand	131	76	32	25	38	39	-1	-11
Singapore	168	64	35	16	384	332	53	39
Chinese Taipei	385	227	83	47	283	254	29	33
Southeast Asia	**1,089**	**640**	**268**	**111**	**637**	**567**	**70**	**60**
Brunei Darussalam	12	2	2	3	8	3	5	6
Indonesia	436	275	108	36	127	110	17	10
Malaysia	187	85	41	23	206	168	38	29
Philippines	137	100	22	14	62	61	1	7
Thailand	247	132	66	31	180	161	19	14
Vietnam	70	46	30	4	55	64	-10	-7
North America	**16,533**	**11,294**	**2,880**	**3,060**	**2,446**	**3,147**	**-701**	**-720**
Canada	1,432	799	326	279	500	471	29	15
Mexico	1,023	669	266	105	290	306	-17	-8
United States	14,078	9,826	2,289	2,676	1,656	2,370	-714	-727
South America	**525**	**316**	**117**	**71**	**160**	**138**	**21**	**4**
Chile	164	89	34	18	77	55	23	7
Colombia	208	132	51	34	35	44	-9	-6
Ecuador	46	29	11	5	16	16	0	2
Peru	107	66	21	13	31	24	7	1

Source: CEIC Oct 2009.

Table 2.
Priorities and growth engines

Priorities	Growth Engines	Project Examples
Economic integration	• New frameworks for trade and investment • Investments in transport and communications infrastructure	• Doha Development Agenda • Chiang Mai Initiative Multilateralized • Regional FTAs • Pan-Asian railway network • Immigration
Green economy	• Clean energy • Energy conservation • Safe air and water	• Intelligent power grid • Electric car • Efficient irrigation • Energy efficiency (achieving Japanese standards)
Social priorities	• Affordable health care • Improved access to education • Income security • Services for the aged	• Rural health care • Free education • US health reform • Pension reform
Knowhow and productivity	• Financial sector development • Service sector reform • Investments in science and technology	• Information systems for health care • New green revolution

BOXES

Box 1. Rebalancing China's economy*

After three decades of remarkable reforms, more than 95 percent of China's goods and services transactions are now conducted in free markets. But factor markets remain distorted and create a "China Puzzle:" disproportionate success in the outward-oriented sectors of the economy and investment, but more sluggish growth of household incomes and consumption. Factor market liberalization is now needed to complete the reforms and to drive the next wave of Chinese development.

Labor markets are still highly segmented because of the household registration system (HRS), which was originally introduced to restrict labor mobility. Today it no longer prevents farmers from moving to cities, but remains an important form of discrimination against them. Migrant workers receive only half or less compensation than their urban cousins receive for similar jobs. Capital markets are also tightly managed. Capital account restrictions are more stringent for outflows than for inflows, and for long-term than for short-term investment. Interest rates remain regulated by the central bank and the currency appears undervalued. One indicator of these distortions is the large gap between long-term government bond yields (3-4 percent in 2009) and the nominal growth potential (around 12 percent).

Land is owned by collectives in the countryside and by the state in cities. With the exception of property development, investors often get land at low rents or even for free in order to attract investment. The government also controls energy prices: when crude oil prices peaked at $150 per barrel in 2008, domestic prices only rose to $80. Lax implementation of environmental regulations leads to widespread environmental damage.

These distortions generally lower input costs, increase profits and investment returns, and improve the competitiveness of Chinese exports. They are equivalent to a producer subsidy, which we estimated at 7.2 percent of GDP in 2008. They boost GDP but restrain the growth of wages and household income.

The government began to address these issues in 2003 but has had limited success so far. Solutions such as currency appreciation and social welfare systems can be effective only as part of a broad policy strategy. The fundamental focus must be the liberalization of the factor markets, including abolishing the HRS, developing the social welfare system, establishing market-based interest rates and exchange rates, and liberalizing energy prices.

* Contributed by Professor Yiping Huang of Peking University and the Australian National University. Additional detail is provided in Yiping Huang, "China's Great Ascendancy and Structural Risks: Consequences of Asymmetric Market Liberalization", Working Paper No. 2009003, China Center for Economic Research, Peking University, 2009.

Box 2. Logistics reform as an engine of growth*

Logistics activities manage the flow of goods from point of origin to destination, as well as the associated information flows and storage. They add value by helping producers to meet customer requirements better and at lower cost. A competitive, efficient logistics sector can generate wide-ranging benefits as a source of productivity growth, economic integration and employment.

Logistics is a relatively new sector and its composition continues to evolve. It is not listed in the classification of services used in the WTO-GATS. Its original activities focused on transport and storage, but now logistics providers also offer varied management services. WTO members wanting to make commitments on logistics still have to check a list of activities rather than one code for the whole sector.

Logistics generates productivity growth in two stages. In the first, specialists emerge to provide logistical services in larger scale operations, allowing contracting firms to concentrate on their own area of competitiveness and thus become more productive. The services provided by logistics firms also lower wastage rates and inventory costs. In a second stage, contracting becomes more extensive, with greater coordination and sharing of data along the supply chain. The activities along the chain come to be regarded as integrated sets rather than independent sequential events. Exploiting efficiencies in reorganising these processes can add to productivity.

Logistics services have important contributions to make in connecting the rest of the economy to world markets. Logistics providers help lower transport costs and accelerate integration. In agriculture, these benefits may transfer directly to the incomes of small producers.

The logistics sector is itself an important source of employment; a recent report suggests that logistics might account for 13% of GDP in a developing country, trailing off to 8% in higher income countries such as the United States. As industrialisation proceeds and more transactions take place in urban markets, there are advantages to reorganising production into supply chains. Inputs employed in logistics then tend to grow faster than GDP. But as productivity grows in the logistics sector and complementary inputs such as IT services and telecommunications become more extensive, input growth in logistics may slow and its share of GDP fall.

The shape of this "upside down U" is likely to be flatter the greater the reform of domestic regulation in infrastructure sectors and the greater the openness of the logistics sector itself. There is evidence that in many economies logistical services remain significantly restricted and that these restrictions adversely affect the performance of the logistics sector as measured by the World Bank Index. Not only infrastructure policy matters but also government processes such as customs. The significance of logistics is increasingly appreciated in developing countries, where for example ASEAN has identified that sector as an integration priority.

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* Contributed by Professor Christopher Findlay of the University of Adelaide. Further information is provided by De Souza, R., M. Goh, S. Gupta and L. Lei (2007). "An Investigation into the Measures Affecting the Integration of ASEAN's Priority Sectors: Phase 2: The Case of Logistics", REPSF Project No. 06/001d, and by Hollweg, Claire and Marn-Heong Wong, Measuring Regulatory Restrictions in Logistics Services, ERIA Discussion Paper Series, ERIA-DP-2009-14 May.

Box 3. Promoting labor mobility*

Several high income economies in the Asia Pacific are experiencing low or even negative population growth because of an extended period of low fertility. Thus, an increasingly small working age population needs to support an increasingly large non-working age population ("population aging"). In contrast, low income countries have experienced fertility declines more recently and are still enjoying a "demographic dividend" as high fertility cohorts enter the workforce while the number of dependent children and aged persons remains small. Labor mobility between these groups of countries could raise productivity and growth in the region as a whole.

Considerable cross-border migration is already taking place. Some countries have seen significant emigration (e.g., Mexico and the Philippines) while others have received significant numbers of immigrants (e.g. Australia, Canada and the United States). Some record emigration and immigration (e.g. Malaysia and Thailand). But others (e.g. Korea and Japan) remain less open to accepting significant numbers of foreign workers.

There are benefits and costs to cross-border migration. Economic theory suggests that labor mobility improves the allocation of resources (though free trade in goods and services to some extent substitutes). This does not mean that each country benefits equally. Labor migration could dampen the demographic dividend of an emigration country, especially when the emigrants are highly skilled ("brain drain"). At the same time, emigrant workers will send remittances home and may encourage foreign investment from host countries. And when they return, they will bring back technical skills, entrepreneurships, and the working culture of an industrial society.

Japan and other East Asian countries will experience rapid aging of their populations over the coming years and would benefit from receiving a substantial number of foreign workers, both as immigrants and as temporary workers. Declining populations mean a shrinking domestic market, which discourages domestic investment. Labor constraints may also directly limit the expansion of production at home. All this would leave the stock of productive infrastructure in high income countries underutilized. To be sure, there are costs that the host society must pay to accommodate foreign workers and their families who may bring different a cultural heritage.

There is increasing awareness of both opportunities and challenges from greater labor migration. Regional cooperation is important for ensuring that foreign workers' rights are protected, that migration channels are kept open when recession hits the host countries, and that pension benefits and health protection are provided to foreign workers. If well managed, international labor mobility can serve as an engine of growth and help spread prosperity across the region.

* Contributed by Professor Shinji Takagi of Osaka University. Further information may be found in Asian Development Bank, 2009, "Maximizing the Benefits of Labor Flows," *Asian Development Outlook 2009 Update: Broadening Openness for a Resilient Asia*, 2009, 67-72, and Graeme Hugo and Soogil Young (eds.), 2008, *Labour Mobility in the Asia-Pacific Region: Dynamics, Issues and a New APEC Agenda*, PECC, Singapore: ISEAS.

Box 4. Green growth: South Korea's Strategy*

At the 60th anniversary of the founding of the Republic of Korea on August 15, 2008, President Lee Myung-bak proclaimed 'low carbon green growth' as the country's new long-term vision for economic growth. Using less and cleaner energy, green growth aims to pursue three objectives simultaneously: (1) to create a synergistic relationship between environmental protection and economic growth, (2) to enhance the quality of life for the people, and (3) to contribute to global efforts to fight climate change. The National Assembly is expected to enact shortly a Framework Law on Green Growth to provide the legal and institutional basis for aligning all national and local rules with this overarching vision. The legislation will provide for an emission trading system and carbon taxes, among other things.

The government's 'National Strategy for Green Growth' covers the period 2009-2050 and articulates ten objectives:

(1) Mitigate greenhouse gas emissions;
(2) Enhance energy independence by reducing dependence on fossil fuels;
(3) Strengthen the capacity to adapt to climate change;
(4) Develop green technologies to create new growth engines;
(5) 'Green' the existing industries and promote green industries;
(6) Upgrade the industrial structure for higher value-added;
(7) Create the infrastructures for a green economy;
(8) 'Green' the land and the transportation system;
(9) Bring a green revolution into daily living; and,
(10) Become a role model internationally as a leader of green growth.

Under these objectives, the National Strategy proposes 50 specific action agendas. For example, under strategy (4) Korea intends to promote new energy sources such as fuel cell, clean coal, and hydrogen, as well as renewable sources such as solar (photovoltaic and thermal), bio, wind, hydraulic, ocean, wastes, and geothermal.

To ensure implementation, the government has revived the developmental-era tradition of planning and formulated a Five-Year Plan for Green Growth for 2009-2013. Under this plan, the government will spend about 2 percent of annual GDP, double the amount recommended by the UN Environmental Program, on the construction of green physical infrastructures and on research and development of new and renewable energy technologies. Initially, large infrastructure investments are planned, including a project to restore four major rivers. As the economy recovers, however, the R&D portion will be increased. According to projections, the green growth plan will add 1.5-1.8% to Korea's 2009 GDP and will generate employment equivalent to 26.0-32.4% of the total unemployed labor force in the first quarter of 2009.

To drive this vision, President Lee has announced an emissions reduction target of 30% relative to 2020 emissions, the maximum recommended by the UNFCCC for the developing countries. It

* Contributed by Dr. Soogil Young. The author serves on Korea's Presidential Commission on Green Growth and is Chairman of the Korea National Committee for Pacific Economic Cooperation (KOPEC).

intends to pursue this voluntary and unilateral target independently of the outcome of the Copenhagen conference. Korea has also launched efforts to contribute to green growth in developing countries. Its ODA will increase from 0.09% of income in 2009 to 0.25% in 2015, with the green growth component rising from 14% to 20%. Further, Korea has launched an East Asian Climate Partnership Program with a commitment of USD 1 billion, and intends to provide leadership for an APEC Climate Center, an Asian Forestry Cooperation Organization, and the OECD project on green growth, among other initiatives.