Asia's recovery - 'Exit' to where?

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Developing Asia's rebound from the global economic crisis has taken hold. The Asian Development Bank predicts growth of 7.5 percent this year, up from a projected 5.2 percent in 2009 and exceeding 2008 growth.

Such robust expansion suggests authorities will "exit" accommodative policies adopted during the crisis earlier than the rest of the world. Indeed, monetary authorities in countries such as India and Malaysia have already pushed policy rates up a quarter-point, while many governments plan to reduce fiscal deficit targets this year.

But, the important question is: exit to where? As developing Asia exits this crisis, it must ensure it is not entering another. Authorities around the world have so far failed to deal with its underlying causes in a meaningful way. Structural problems, such as inadequate financial market regulation and excessive liquidity, remain despite constructive proposals on coordination of global macro-policy and financial regulatory reform. In developing Asia, large current account surpluses and reserve accumulation will continue to exacerbate the global imbalances that underpinned the current global crisis. Current account surpluses in the region, particularly in the People's Republic of China (PRC), declined only marginally during the crisis and are expected to reach even higher levels over the next few years.

The uneven pace of recovery between developing Asia and the advanced economies suggests that capital inflows to Asia will surge once more. Even without any major disruptions here, the region will remain vulnerable to large and potentially volatile capital movements, which could fuel inflation and asset price bubbles. As the 1997/98 Asian financial crisis demonstrated, rapid reversal of capital flows can have catastrophic economic effects. Excessive openness in international trade and financial transactions leave Asia susceptible to global financial turmoil.

The 1997/98 Asian crisis and the current global crisis exposed weaknesses in developing Asia's financial and real sectors. To avert the next crisis-that is, to choose the right exit-policy makers must learn the right lessons and follow a more balanced and sustainable growth path.

That requires consistent adjustments on the demand and supply sides of the economy over the long term. It means a broader monetary policy framework, more flexible exchange rates, continued fiscal discipline, greater domestic and regional demand, and better social protection.

First, leaders must implement a monetary policy framework that takes into account asset prices and financial market stability, and adopt a judicious mix of policies, including regulatory and direct capital control measures to manage volatile capital flows effectively. This also involves strengthening surveillance and regulatory regimes, including establishing an institutional framework for macro- and micro-prudential surveillance and regulation, ideally managed by a systemic stability regulator empowered with adequate enforcement tools and mandates.

Second, they should allow greater flexibility in exchange rates, and develop an institutional framework that accommodates a concerted appreciation of regional currencies, as well as increased intra-regional exchange rate stability. It is clear that developing Asian economies, especially the PRC, cannot keep exchange rates stable against the US dollar and continue to amass international reserves. Regional cooperation in foreign exchange reserve management-such as the multi-lateralized Chiang Mai Initiative (CMIM), a regional reserve pool of $120 billion-should also be strengthened to defend against future financial crises.

Third, developing Asia must maintain fiscal discipline. Authorities should avoid political pressure to spend more (when not needed), and give more weight to rules rather than discretion in determining fiscal policy. Sufficient fiscal space should be ensured during high-growth periods by keeping public debt levels low enough to leave room to adjust during crisis periods. Over the medium term, stronger institutional capacity and governance are needed to ensure effective fiscal policy and sustainability.

Fourth, leaders must encourage greater domestic and regional demand and reorient the supply side of the economy toward domestic demand. Export-led growth served Asian nations well. But it also increased economic vulnerability and introduced substantial economic distortions; its benefits now look much diminished, especially amid sluggish global demand. Asian authorities should also deregulate and encourage investment in growth areas of the service sector, including health, education, information, and telecommunications. In addition, small- and medium-sized enterprises can play an important role in supporting industrial clusters and creating domestic value-added.

Fifth, they should strengthen social protection in the areas of health insurance, unemployment insurance, and pensions to bolster social resilience. Effective social programs can encourage consumers to spend more, stimulating domestic demand and contributing to post-crisis rebalancing. Governments also need to increase public spending on education and health to support productivity growth. Targeted social assistance programs to address extreme poverty and basic nutrition and health needs are also needed.

Alongside these policy prescriptions, regional and global efforts must be enhanced to pursue policy cooperation and coordination. Key elements of regional efforts include: setting up an Independent Surveillance Unit for CMIM which can grow to be an Asian Monetary Fund and establishing a region-wide economic partnership agreement to encourage intra-regional trade in goods, services, and investment. On the global stage, developing Asia must actively participate in major international forums and policy dialogues to support strong and sustainable global growth.

This is the way out, and a stronger, balanced, and more resilient Asian economy can help lead the way.

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