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Asia in the World Economy

A. Introduction:

Thank you Nik.

It is a great pleasure to be with you here at the Singapore Summit. This forum has become a prime event for discussing developments in Asia and beyond.

Singapore is an obvious place for this forum, a country at the very heart of Asia, strongly linked to the region through trade, finance and people. At the World Bank we are pleased to be a partner of Singapore with a growing office that focuses on infrastructure and urban development.

Many have predicted that the 21st century will be “the Asian century”.

Asian economies have done well in the past decades: first led by Japan, then by the Asian Tigers, and more recently by China and India.

With few exceptions, Asian economies have rebounded from the Asian financial crisis in the late 1990s and the recent global financial crisis - often faster and stronger than expected.

If measured in comparable prices, China will soon overtake the U.S. as the largest economy. And by 2050 it will constitute a quarter of the world economy. India will compete with the U.S. for second place, and Indonesia will be about to overtake Japan.

This success inspires others.

I just visited Tanzania and Ethiopia, both countries with high poverty and high growth rates in the last decade. Both are looking towards Asia to learn from its lessons and copy the region’s successes. This illustrates how dynamic this region is.

But despite these prospects, Asia faces challenges, and there is no reason for complacency. History is not destiny and the question is: are they ready to face new hurdles?

I believe more can be done. I believe if emerging economies in Asia manage a complex and intertwined set of challenges, success lies ahead. Today, I want highlight three areas in which Asian economies can influence their future:

B. Challenges:

First, Asia needs to balance its growth strategy by looking inward, not just outward.

A first challenge for many of the successful Asian economies is to change their economic model.

Asia, especially East Asia, has followed an export oriented model, which allowed for rapid growth, while OECD countries were happy to run trade deficits. After three decades of a successful export oriented model, the region is slow to adapt to the new situation.
But the global financial crisis and its aftermath require just that. The current outlook is mixed. To put it simply: global economic growth relies on the U.S. to continue its upturn, hopes for Japan to implement further reforms, and prays for Europe not to decline further.

Trade intensity has declined, in part because demand was led by governments as part of their counter-cyclical measures. External demand for Asian exports is therefore likely to be more lackluster than before the crisis.

In addition, normalization of monetary policies will lead to an increase in global interest rates. With more flexible exchange rates, ample reserves and stronger banking systems most Asian countries are now better prepared than a year ago to handle this. But higher interest rates will provide headwinds for investment demand.

Asia therefore needs to boost its domestic engines of growth through productivity.

In addition, governments can help domestic demand by addressing their infrastructure gap. But the fiscal space for some countries has become limited. India is one such example. They will need to select the right investments and govern them smartly to ensure that they will create demand and employment in the short run but also raise productivity in the long-term.

As Asia’s growing middle class will consume more, demand for services such as education, health services, housing and financial security is set to grow too. Policymakers should build financially sustainable services, and by doing so, support domestic demand.

But there are also countries who struggled to reform their social sectors, creating a negative effect on their productivity and even threatening the sustainability of their public finances. It will be wise to learn from their mistakes.

The second area where Asian economies can make a difference in guiding their future is productivity.

Despite the rapid growth that developing Asian economies experienced in recent decades, their productivity still lags behind.

China’s value added per employee is only 1/7th of the average OECD country and India is less than 1/10th.

Productivity will be critical for avoiding the middle income trap. And it is not just about volume, but also quality.

Mobilizing more capital and more human resources—something that most Asian countries have done well – is no guarantee for long term success. In fact, out of 100 middle income economies in 1960 only 13 graduated to high income level. The others got trapped in the middle.

Avoiding this trap means first and foremost changing the growth model and refocus from mobilizing productive resources to better using them.

But this can be challenging.

The transition to more productivity-driven growth requires investing in people, upgrading their skills and gradually building innovation systems.

It seems that several institutions need to be built concurrently to secure a continued reallocation of resources to the most productive sectors, even after economies reach middle income status:
First, countries need to be able to innovate, create and absorb new technologies. Korea achieved this through its universities that have strong ties to industries, a well-educated workforce and a flexible business climate. Countries such as China and Malaysia are actively building their own innovation system.

Second, they need labor market institutions that maintain flexibility in the labor force.

Third, they need financial institutions capable to channel money where it is most productive combined with a positive business climate that allows new firms to emerge and unproductive ones to exit.

And finally they need policies that increase competitiveness and openness to trade that forces companies to innovate and seek further productivity gains.

The most difficult part of productivity shifts is avoiding state capture. If the privileged few, the elites, protect state enterprises from competition and maintain exclusive access to productive resources, opportunities are wasted.

This is where leaders can make a difference: by tackling the structure of state-owned companies and by leveling the playing field, even if this comes at a political cost and the results are not immediate.

Mexico is a good example of a country that has tackled necessary but difficult reforms. But they have yet to pay off.

Further economic integration can be an engine of productivity gains.

East Asia’s close integration has allowed the region to become home to key production networks that supply the world.

ASEAN has played a central role by keeping external barriers low. We are now only 15 months away from the creation of its economic community, a much anticipated step for further integration.

A seamless economic space with 600 million people can be a powerful engine of growth for the region and the world. It could become an important market for global investors.

ASEAN can also be an alternative production base for China, which is becoming more expensive and will move away from low-skilled manufacturing and exports.

But for this to become reality, the new economic community must realize its vision. Too many exceptions in opening trade and too many limits on foreign direct investment will undermine its goals. It could undermine ASEAN’s attractiveness as a location of global supply chains.

Pursuing closer integration requires political leadership that can explain the benefits and cushion the impact on those that stand to lose in the short term.

It also requires more than signing agreements—but hard work in reforming institutions and taking on interest groups that have little interest in sharing the pie.

While the European Union has its own struggles, its success is based on the fact that its integration was very broad, even addressing competition and social policies. Its structure encourages high level political commitment to implement the Union’s policies at the country level.

We should learn from its success and mistakes.
And to succeed beyond middle income status, countries need to focus on macroeconomic stability.

In some countries in the region, credit growth has been rapid in recent years and leverage has been building up. The effects on growth of all this credit have been leveling off, and increasingly credit seems to be propping up asset prices rather than productivity and healthy growth.

Reduced pressures from capital inflows in the course of the FED’s tapering can help in reducing some of the risk that come along with that.

Nevertheless, the balance in some countries should shift from economic stimulus propped up by governments and central banks to containing the build-up in financial sector risks. Fiscal consolidation and monetary policies as well as macro-prudential policies should be used to achieve that balance.

The third challenge for Asian economies lies in the social fabric of their countries. There, policies need to be guided by what is good for most, not just a few people.

Fast growing countries in Asia, like countries elsewhere in the past, are experiencing rapid urbanization, rising income inequality and a fundamental reorganization of societies away from traditional structures.

In addition, their societies and labor force are aging. China’s labor force has already started to decline. While others such as India and Indonesia could still benefit from a demographic dividend in the decades ahead. Without generating sufficient jobs, they also could face rising tensions of growing youth unemployment.

Let me focus here on the challenge of rising inequality.

With rapid growth in Asia, the gap between the rich and the others has widened, notably in China and Indonesia, but also in India -- all traditionally egalitarian societies.

Cross-country analysis of inequality suggests that inequality first rises and then declines again, which has been a comforting thought for rapidly growing countries.

However, regardless of the debate around his data and methodology, the recent analysis of Piketty suggests otherwise. He finds that the top 10 percent of earners has considerably increased its share of total income. This is true also for Asia.

Some rise in inequality may be good for growth, as it provides the incentives for people to strive to succeed. Some inequality is also a reflection of people moving from traditional to modern sectors.

But as World Bank research shows, if inequality starts to affect equity of opportunity, inequality could threaten growth.

Further, high inequality could undermine the political consensus needed to implement policies and reforms that keep growth high.

So countries that strive to reach high income levels should care about three areas to promote a healthy income and wealth distribution.

First, managing inequality requires creating access to equal opportunities. Recent research suggests that many Asian countries still perform well in that respect: A child’s school performance is less dependent on its parents’ socio-economic position than in many other parts of the world.
One reason could be that most East Asian countries managed to maintain low cost public education with reasonable quality.

This is something Asia should protect and even improve.

Second, maintaining an open, competitive and meritocratic society and avoiding political capture by the privileged. To achieve this, countries need competition laws, access to finance, and business regulations with low barriers to entry.

They need inclusive political systems that ensure equal access to opportunity in society and can help avoid political capture by the privileged.

Third, establishing a tax system that is seen as just could be a further means to manage inequality. This not only requires sufficiently progressive tax laws, but also the investment in tax administration to make these laws work.

Many countries are struggling to design the right tax policy and set the right rates. The U.S. and France are just two examples where tax aversion and inversion can dilute the effectiveness of the system. This is why this issue needs a collective approach.

I’ve experienced firsthand how difficult it can be to overcome these challenges.

But we should remember that while taxes are important, the spending side is equally relevant to address inequality.

C. The Way Forward:

Asian countries have much to be proud of in the way they have managed their economies in the past decades. But they should not take success for granted: the challenging international environment, the need to rebalance growth and the challenges of productivity and social justice require continued vigilance of policymakers in the years and decades to come.

It is encouraging indeed that several countries in the region have revamped their efforts to reform in recent years. Japan’s Abenomics and China’s Third Plenum reforms are good examples of this, and the incoming governments in other countries, including India and Indonesia, have an opportunity to follow suit.

I think it is fair to say that we know a lot about what policies are needed to achieve high income levels, or at least which ones to avoid.

But maintaining reform momentum won’t be easy, and it is no surprise that reforms often accelerate in a crisis, when policymakers have no alternative.

Making good use of a crisis is one thing, sustaining the reforms over the decades that it takes to bring countries from middle to high income is altogether a different challenge for policymakers.

The most crucial ingredient for sustained reforms is unlikely to be economics.

In my view, it is social justice that maintains consensus for reforms and open and participatory political systems that avoids political capture and ensures that policies are set to benefit society as a whole rather than the privileged few. Investing in the institutions that can deliver on that is probably the best investment policymakers can make.

Thank you.