Chapter 1

Changing Global and Regional Economic Environment and Challenges Facing East Asia

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CHAPTER 1

Changing Global and Regional Economic Environment and Challenges Facing East Asia

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This overview paper analyses some key global and regional challenges to East Asia's continuing economic ascent. On the global front are the weakened growth engines of US-EU-Japan, threats to the open multilateral trading system from large trade imbalances and rise of protectionism, international financial instability and volatility, natural resource and environmental constraints threatening food and energy security, climate change and environmental deterioration and un-sustainability, and the challenge of global governance. On the regional (and national) front are the growing economic, political and social constraints of demographic ageing, rising inequality and weak national governance. East Asia has the tremendous opportunity and responsibility to be a global growth engine, contribute positively to governance of global economic and financial institutions, and assuring the world that it would facilitate global growth, stability and prosperity.

Keywords: East Asia, multilateral trading system, international finance, climate change, governance

JEL classification: F02, F13, F42, F62, J11, O53

1. Introduction

The East Asia region has experienced the fastest economic growth in the world for the past three decades, with the highest growth rate achieved by China.

In 1993 the World Bank published *The East Asian Miracle: Economic Growth and Public Policy* extolling the economic transformation of 8 East Asian economies. In 1998 East Asia was engulfed in the Asian financial crisis (AFC), which led to painful IMF bailouts and reforms for several countries, and led to critics questioning the East Asian development model. In the global financial crisis (GFC) one decade later, fingers were pointed at East Asia for its role in the global imbalances and its export-led growth model, requiring the region to rebalance towards domestic and regional demand. East Asia has survived both the AFC and GFC, and its economies are recovering from the latter, although the ongoing Eurozone crisis is again negatively impacting its highly export-dependent economies.

The ADB report on *Asia 2050* highlights the prospect of an "Asian Century". It argues that if Asian economies can maintain their momentum until 2050, adapting to the shifting global economic and technological environment by continually recreating their comparative advantages, Asia's GDP will rise by 2050 to account for half of global GDP (market exchange rate), and Asia's per capita GDP (in terms of purchasing power parity (PPP)) would reach $40,800, similar to that of Europe today. Seven economies would lead the march to Asian prosperity, namely PRC, India, Indonesia, Japan, South Korea, Malaysia and Thailand. However, to realize the Asian Century, Asia must tackle daunting policy, institutional and governance challenges, and the report proposed major changes at the national, regional and global levels.

This overview paper analyses some key global and regional economic challenges to East Asia's continuing ascent. Challenges that are domestic in origin with no cross-border spillover effects, and require domestic actions, are largely beyond the scope of the paper. Section 2 briefly examines East Asia's ascent and the challenges facing it. Subsequent sections focus on the key challenges to East Asia's ascent from the weakened western economies and global financial risks, threats to the open multilateral trading system, natural resource and environmental constraints, Asia's demographic ageing and rising inequality, and the challenge of global governance and national governance constraints. Section 10 concludes.

2. Global Growth Shift and an Asian Century

The world is currently witnessing a major shift in the balance of economic and financial power from the advanced industrialized countries to the emerging economies of Asia, particularly from US-EU-Japan to China-India. Over the past two decades, East Asia has become a growing force in global production, trade, investment and finance. And the region will become the biggest stakeholder in an open trading system, a stable financial system, and a sustainable environment.

Eichengreen (2011) argues that this shift could be usefully seen in the light of previous global shifts. First, there was the rise of the West from the 15th century and concomitant decline of China. Second, there was the industrial revolution, which led to Great Britain dominating the world by the end of the 19th century. Until then, China's economy was the largest in the world and the economies of developing East Asia together were larger than today's high income economies combined, in PPP terms. Over the following century, the share of global output of both China and developing East Asia declined dramatically. Third, there was the power shift from Great Britain to the US after the 1930s Great Depression. The aftermath of World War II was an era of hegemonic stability when the US as dominant power had the capacity to act unilaterally to stabilize the European and Japanese economies and manage the international financial system. The closing two decades of the 20th century was an era of hegemonic cooperation as the US could no longer act unilaterally but nonetheless led in organizing collective action. The advent of the 21st century saw the shift from US dominance toward a multi-polar world. If developing countries continue to grow at their current rate, their share of the global economy will rise to nearly half in current prices by 2030, as shown in **Table 1** below.

Table 1: Rising Percent Share of Developing Countries in Global GDP

	At 2010 prices		At 2030 current prices	
	2010	2030	Low	High
High income:	66.4	52.4	49.1	40
US	23.6	20.5	19.2	15.7
Other	42.8	31.9	29.9	24.4
Low & middle income:	33.6	47.6	50.9	60
China	9.5	17.1	18.8	23.6
India	2.3	4.6	5.1	6.7
Other	21.9	25.9	27	29.7

Source: World Bank EAP Update 2011 Vol.1, Table

Rapid growth in emerging Asia was facilitated by export-led growth, high domestic savings, foreign direct investment (FDI) inflows, growing human resource and infrastructure developments and economic and institutional reforms. Asian governments, learning from the experience of the 1997-1998 AFC, reduced their economic vulnerability by avoiding large current account deficits and real exchange rate overvaluation, strengthened the supervision and regulation of their banking systems, and accumulated foreign reserves as a buffer against external shocks. The process of Asian catch-up was further accelerated with the US sub-prime financial crisis and the EU sovereign debt crisis or recent years. In 2010 East Asia's share of global output was one third at market prices and half in PPP terms.

East Asia's successful export-led growth strategy was based largely on a relatively open global trading environment and on significant levels of foreign direct investment flows, and these were made possible by a framework of global rules and supporting institutions. However, Asia's continuing economic ascent will face a different global environment from that faced by the western advanced economies during their economic ascent after World War II. At that time there were closed capital accounts, limited flows of portfolio capital and fixed exchange rates. Today there is high volatility in capital accounts, capital flows, commodity prices and exchange rates, and there is the new issue of environmental sustainability. The global economic environment has also become less benign and more challenging as compared to the years of the "East Asian Miracle".

To realize the Asian Century scenario, the region must tackle daunting policy, institutional and governance challenges. At the global level there are the dysfunctional global trading system, global financial architecture and global governance institutions, as well as threats from climate change and global warming. In addition, there is intense competition for finite natural resources (energy, water and fertile land) unleashed by Asia's ascent, as the newly affluent Asians aspire to higher living standards. Further, East Asia also faces structural problems which could adversely affect its longer term growth prospects. These include demographic ageing; growing environmental degradation that necessitates shifting economic growth towards more sustainable models; and overcoming rising domestic discontent over growing inequality and corruption.

The growing economic weight of East Asia is accompanied by its aspirations for a greater voice in international affairs. So far East Asia's role in the governance of international economic institutions is far less than its rapidly growing economic weight, but this is beginning to change. Also, East Asia benefitted from global public goods in the past, but going forward the region must actively support them, for example, the international trading environment, international financial architecture, global economic governance and addressing the risks of climate change. There are great expectations of East Asia not only as an engine of global growth but also as a leader at a time of global economic volatility and fragility.

3. Challenge: Global Economic Fragility and Financial Instability

The global financial crisis (GFC) of 2008-2009, and its contagion effects, triggered the recent global recession, followed by the unfolding Eurozone sovereign debt and banking crisis engulfing several EU countries and dozens of European banks. East Asia was not badly affected by the GFC due to its reformed and robust financial systems and foreign exchange reserves, and timely fiscal stimulus packages. The GFC affected East Asian economic growth mainly through the export and investment channels. There was recovery in 2010 in response to stimulus packages. But the unfolding Eurozone sovereign debt crisis is once again threatening East Asia's growth, re-affirming that there has been no de-coupling of export-dependent East Asia from its major markets in the US and Europe. The global and regional financial markets have been see-sawing between pessimism and optimism over the possible resolution of the Eurozone crisis. Most analysts are agreed that the US and Eurozone problems cannot be resolved in the short term and will continue for some time to adversely impact the global economy and East Asia.

Financial instability is a challenge to the international financial system arising from the widespread presence of information asymmetries. Financial instability goes beyond budgetary considerations, affecting people's wealth, standard of living, investment and employment, and can trigger waves of bankruptcies and major recessions. International institutions involved in providing international financial stability include the IMF, the World Bank, the Bank for International Settlements (BIS) and the Basle Committee on Banking Supervision, but the problems of taking collective action have led so far to an under-provision of the international public good. The G7 was born out of early attempts to stabilize exchange rates following the end of the Bretton Woods system, and evolved into G8 (including Russia) as a broadly based mutual surveillance facility among the large developed economies. G8 has since been replaced by G20 which includes several large developing economies. The London G20 Summit in April 2009 agreed to strengthen global financial institutions, with additional funds to support growth in emerging markets and developing countries, increased resources for the IMF, and establishment of a new Financial Stability Board (FSB) to succeed the Financial Stability Forum. At the Los Cabos G20 Summit in June 2012, China, India and other emerging economies made commitments to a fund being set up by the IMF to help nations escape contagion. Following the Summit, the EU's Big 4 (Germany, Italy, France and Spain) pledged to cooperate on a growth plan amounting to 1% of EU GDP to restore financial stability, support growth and investment, and create jobs in the EU.

4. Challenge: Multilateral Trading System in Crisis, Rise in Protectionism, and the Need for Global Rebalancing

4.1. Whither the Doha Round?

The Doha Round is comatose, as World Trade Organization (WTO) members failed to reach agreement on any concluding package. The Round was launched in November 2001 and negotiations cover market access in agriculture, non-agriculture market access (NAMA) and services, and rules. Why has the Round failed so far? Reasons include:

- Complexity and huge scope of the negotiations: Earlier General Agreement on Trade and Tariffs (GATT) rounds were successful in considerably reducing tariffs on non-sensitive manufactures, leaving the most difficult issues and areas to be tackled in the Doha Round. These include agricultural export subsidies; domestic support for agriculture; agricultural tariff reductions; trade in services; anti-dumping duties and rules governing regional trading agreements (RTAs).

Complexity has been made worse by the necessity in Agriculture and NAMA negotiations of converting bound rate commitments to applied rate commitments. Also, the single undertaking meant that agreement would have to be reached on everything before conclusion.

- Enlarged WTO membership and large differences in policy stances: WTO membership has grown to over 150. Managing the negotiations became more difficult as the power relations among WTO members have changed dramatically. The US, and to a lesser extent the EU, which shaped the earlier negotiating rounds are now much less dominant in the world economy, while developing countries are no longer prepared to take a back seat. The US and other developed countries are looking to open markets in important advanced developing countries through major tariff reductions. Developing countries have different priorities and interests but insist that Doha delivers on the promised development agenda.
- Profound changes in the structure of the world economy and international trade: This makes the WTO and its negotiating agenda increasingly irrelevant. In particular, the emergence of FDI and related production networks as the main driver of global integration has challenged the assumption that the interests of countries and their multinational corporations (MNCs) are largely the same. In many developing countries, particularly in East Asia, the drives to attract FDI and to link deeply into global supply chains and production networks have provided an impetus for autonomous liberalization. On the other hand, in the industrialized countries, with high and structural unemployment, there is growing concern over their MNCs' moving production and jobs offshore.
- RTAs have proliferated: This is perceived by some as a viable and sometimes possibly as a preferable alternative, but perceived by others as a stumbling bloc for the multilateral trading system. Not all RTAs have subscribed to the principles laid out in GATT Article XXIV, particularly those between developing countries and notified to the WTO under the more lax enabling clause. The "substantially all trade" criterion has often been violated in the areas of agricultural and services liberalization. Also, the lack of a common template in negotiations has given rise to the "spaghetti bowl" effect of different and conflicting rules of origin, product standards, and formulae and time lines for removing tariffs and non-tariff barriers (NTBs). In East Asia, FTAs have proliferated since the first FTA was formed by Association of Southeast Asian Nations (ASEAN) in 1992. Reasons include: defensive reactions to RTA formation in North America and Europe which discriminated against East Asian exports; disappointment with the lack of progress of the Doha Round and an insurance against its breakdown; to achieve faster and deeper liberalization than possible multilaterally; and to achieve geopolitical objectives. The regional and bilateral FTAs in East Asia have so far been FTA-plus and WTO-plus, that is, going beyond the scope of a traditional FTA and beyond the mandate of the

WTO to include areas and issues such as investment, competition policy, government procurement, intellectual property rights, labor and environment, and wide ranging areas of economic cooperation.

Does it matter if the Doha Round is not completed? Some believe it is in the interest of all to complete the Doha Round as it would provide a signal to the international community on whether international obligations and commitments can be followed through, and whether global interests will be taken seriously. Others argue that the time is ripe to think strategically about a post-Doha agenda, with the goal of achieving results within a reasonable time period. For example, negotiating smaller sector-specific deals (in areas such as services and environmental goods similar to the IT and Government Procurement Agreements) could be more fruitful than a large-scale single undertaking.

4.2. Issue of Keeping Protectionism at Bay

It is important to keep markets open and resist protectionism in the challenging global economic environment. The *Asian Development Outlook 2009* noted that most of the world's major economies have put various forms of protectionism into effect, including the substantial amount of aid given to automobile manufacturers around the world in the aftermath of the GFC. In November 2008 the G20 Summit made a "no protectionism" pledge. However, a September 2009 report from Global Trade Alert (Evenett 2009) revealed that at least 121 protectionist measures had been implemented by G20 governments since November 2008 and another 134 measures were pending.

The Toronto G20 Summit in June 2010 renewed, until end-2013, commitments to refrain from raising barriers or imposing new barriers to investment or trade in goods and services, and imposing new export restrictions or implementing WTO export incentive measures. The Seoul Summit in November 2010 affirmed the Toronto commitments and further committed to roll back any new protectionist measures that may have risen, including export restrictions and WTO-inconsistent measures to stimulate exports. These were further affirmed at the Cannes Summit in

November 2011. However, the WTO reported[1] that from mid-October 2011 to mid-May 2012, 182 new measures that restrict or can potentially restrict or distort trade had been recorded. G20 restrictive measures put in place since October 2008 are estimated to apply to almost 4% of G20 trade. The main measures are trade remedy actions, tariff increases, import licenses and customs controls. The recent wave of trade restrictions smacks of industrial policy, including granting tax concessions, government subsidies, domestic preferential government procurement and local content requirements. There is also the growing threat of environmental trade protectionism, as the US and EU provide protection via subsidies and import restrictions to help their firms offset the higher production costs arising from carbon taxes and regulatory mandates.

The threat of protectionism looms large as recovery of the global economy remains weak and unemployment levels are high in the advanced industrialized economies. Governments need to make greater efforts to resist protectionist pressures and take active steps to keep markets open and advance trade liberalization. East Asia's trade-dependent economies are highly vulnerable to protectionism and need to keep multilateralism alive and open.

4.3. Issue of Global Imbalances

Global imbalances remain sizeable despite the narrowing of current account surpluses and deficits of major trading nations since 2007. By 2011, the external imbalances of the major economies had stabilized at about half their pre-crisis peak levels (relative to GDP). The US remained the largest deficit economy, with an estimated external deficit of about $450 billion (3% of GDP), while the external surpluses in China, Germany, Japan and a group of oil-exporting countries had fallen. China registered a surplus of about $250 billion (less than 4% of GDP), Japan's surplus was 2.5% of GDP, Germany's around 5% of GDP, while the current account for the Euro area was virtually in balance (Table 2). Large surpluses, relative to GDP, were still found in oil-exporting countries.

Table 2: Global imbalances

[1] WTO website, assessed 12 June 2012

	C/A balance	2005	2006	2007	2008	2009	2010
China:	US$ billion	160.8	253.3	371.8	426.1	371.5	451.2
	% of GDP	7.2	9.5	11	9.80	7.8	8.6
Germany	US$ billion	143.8	178.8	250.3	235.3	94.2	120.2
	% of GDP	5.1	6.1	7.5	6.4	2.9	3.6
Japan	US$ billion	165.7	170.4	211.0	157.1	96.9	105.6
	% of GDP	3.6	3.9	4.8	3.2	1.9	2.0
US	US$ billion	-748.7	-803.5	-726.6	-706.1	-369.8	-324.7
	% of GDP	-5.9	-6.0	-5.2	-4.9	-2.6	-2.2

Source: Jeffrey Schott in Il Sakong and Fred Bergsten (eds) 2009: The New Global Trading System in the Post-Crisis Era.

At issue is whether the adjustment of the imbalances in major economies so far has been mainly cyclical or structural. Continued global imbalances are an issue that is expected to influence sustainability and patterns of trade and growth in the coming years. Rebalancing is necessary, if global growth is to be sustained. The economic prescription is fairly straightforward, but faces strong political resistance: the US needs fiscal consolidation with its large current account deficit and should consume less and save and export more; Germany as the main European surplus economy should stimulate domestic demand and lead structural reforms in the Eurozone.

The GFC has prompted a major rethink of East Asia's export-led growth model. In East Asia the two main surplus economies are Japan and China. Japan's yen has been appreciating vis-à-vis the US dollar and its trade surplus appears to be shrinking, especially with the production and export declines from the 2011 tsunami and nuclear fallout, continuing weak economic growth, and weak corporate balance sheets. China needs to implement domestic rebalancing goals to see a rise in household incomes and consumption as well as exchange rate appreciation. While China leadership is clear about relying more on domestic demand, it will take time and political capital to change institutions and incentives. A more flexible RMB is only one part of the package needed to rebalance demand and alter the pattern of growth in China. Other East Asian surplus countries should promote a similar shift toward domestic and regional demand, including services and infrastructure investments, and reduce reliance on exports to the West.

The central challenge in the G20 Summits in Pittsburgh in September 2009 and Toronto in June 2010 was to rebalance global growth and place the world economy on a sustainable long-term path. Reducing the imbalances has been the major focus of consultation among G20 Finance Ministers under the G20 Framework for Strong, Sustainable and Balanced Growth and the related Mutual Assessment Process (MAP) during 2011. Most developed economies (US, Europe and Japan), find themselves in a difficult economic bind. There are no simple solutions that would quickly win political support. Their economies have been growing too slowly for too long, making it more and more difficult to pay for the increasing costs of healthcare and pensions for ageing populations. In the short term, there is resistance to emergency measures, while over the longer term, there is resistance to the higher taxes and reduced benefits deemed necessary to return countries to financial stability. Developing countries find themselves in a different bind - they need to protect themselves against volatile commodity prices and external financial conditions, and also to step up investment to sustain higher growth and shift their economies towards faster poverty reduction and more sustainable production.

5. Challenge: Competition for Finite Natural Resources and Security of Food, Energy and Water Supplies

5.1. Competition for Finite Natural Resources

Asia's ascent and the addition of some 3 billion increasingly affluent Asians is leading to intense global and regional competition for natural resources such as agricultural land, energy, minerals, water, and forestry and marine resources.

Global known supply cannot readily accommodate huge changes in demand, especially for non-renewable raw materials. Reflective of this intense competition are rapidly rising prices of food and primary commodities in recent years. The spike in 2008 is comparable to previous commodity hikes during the Korean War in 1950/51 and the oil crisis of 1973. Since 2000, food prices are up almost 3-fold in real terms, oil prices almost 2-fold, and metal prices by more than half. Volatility in food prices is higher than before, and concern is increasing over an inevitable up-trend in food prices, given the rapid industrialization and urbanization taking place in East Asia, unless there is a repeat of the 1960s Green Revolution. International prices of oil and other primary commodities have seen reversals due to weaker global demand for commodities; positive supply shocks in a number of markets; a sell off in markets for financial commodity derivatives; and appreciation of the USD. Commodity price volatility is likely to remain high.

Underlying factors driving food prices, apart from the demands of a rising population, is the demand for bio-fuels. There is need to balance the dual priorities of using agricultural crops for food and for bio-fuel production. There is also a need for a comprehensive approach in tackling food security. This includes enhancing agricultural production, encouraging investment in agriculture (particularly in productivity-enhancing agricultural technologies and knowhow), balancing government policies in industrialization and agriculture, market-oriented policies in agricultural trade, international emergency grain reserves, and promoting harmonization of food safety standards.

The existing supply of global and regional energy sources is vulnerable to two primary threats. First is the threat to adequate and secure supplies of energy at affordable prices. The increasing volatility of energy supply has caused dramatic price changes, with serious implications for the availability and affordability of energy; this is due essentially to lack of alternative energy supplies. Second is the threat of environmental damage as a result of excessive energy consumption. World energy demand is forecast to grow by 53% from 2008 to 2035 due to continuing economic growth and the resulting higher living standards. Economic development is unsustainable in a scenario where no additional policy action is taken to counter global warming. Adjustments would call for price increases to reduce demand and increase supply; new technologies to produce more food, reduce unit consumption and/or substitute with more plentiful, renewable resources, and recycling to minimize waste. Action is needed to eliminate energy subsidies and to switch from fossil fuels to renewables. The solution is a combination of price increases (including removal of subsidies) more stringent green standards for buildings and transportation, adjustments in consumption patterns and green technology breakthroughs.

Rapid growth in East Asia's energy demand creates major concerns for the region and the world: First, growth in energy consumption implies an increasingly larger claim on global energy resources and higher dependence on imported energy, and triggers concern about the security of energy supplies, especially of oil and gas. Second, growth in energy consumption is accompanied by rapid increases in carbon emissions, with China, India and the ASEAN region projected to be the source of much of these emissions. The strong dependence on fossil fuels for economic development only exacerbates this threat, as it could serve to increase the level of carbon emissions. The increasing dependence of East Asian countries on fossil fuel imports is harmful to the environment and detrimental to their economic growth.

5.2. Issues of East Asian Food, Energy and Water Security

Can East Asia feed itself and if not, will the rest of the world provide enough food? How will East Asia's massive needs for energy and other natural resources be met? How will East Asia sustain its rapid growth with limits on carbon emissions and water supply? Food and energy price hikes pose challenges to, and affect, the region's socio-economic development. In particular, the surge in PRC's demand has led to its scramble to invest in resources in Australia, Africa and beyond.

5.2.1. Food Security

Food security includes accessibility, the availability, quality and safety of food. There is increasing anxiety about East Asia's food security that will impair its growth prospects, its progress in poverty reduction, and its strategic security. In addition, food price inflation gives rise to the specter of political-social unrest. East Asia is more vulnerable to higher food prices than other regions because of its huge and dense populations, its high levels of absolute poverty, and the higher weights of food in its consumer price index (CPI) baskets. Food price volatility and high prices are likely to continue and possibly increase in the near future, making farmers and consumers more vulnerable to poverty and food insecurity. Under ASEAN+3, the East Asia Emergency Rice Reserve should promote rice security in times of need in the region; the region needs to strengthen this mechanism to enable the scheme to respond effectively and promptly to emergencies caused by natural disasters such as flood, drought, cyclone, earthquake and tsunami.

5.2.2. Energy Security

East Asia's energy consumption increases with population growth, rising incomes, and energy intensity as a result of the changing structure of production and more energy-intensive consumer lifestyles. Overall East Asia contains some of the largest global energy consumers, although per capita energy consumption is still a small fraction of that of developed economies. Additionally, China and several other East Asian economies have made significant progress in reducing energy intensity.

East Asia faces the issue of energy security with its growing reliance on oil and gas imports. The region's dependence on oil as an energy source has declined over the past three decades (with significant variations among countries) and its dependence on natural gas as an energy source has increased. The high energy growth and energy mix has led to twin main energy challenges facing East Asia: supplying energy in an environmentally sustainable manner that does not adversely impact GDP growth; and improving the long term security of energy supplies. Concerns about energy, especially oil security is expected to heighten over coming decades because of further concentration of oil consumption in the transport sector, where the possibilities for fuel switching are limited, increases in import dependency on oil and the concentration of import sources. China has now become a large importer of oil. ASEAN countries, once major exporters of oil and gas, have now become net importers of oil and are likely to become net importers of gas in the next three decades.

To address these energy vulnerabilities, promoting energy conservation, improving energy efficiency and encouraging the adoption of renewable energy would be of utmost importance. Clearly new technologies are required to increase efficiency and reduce their environmental footprint. Countries need to reform institutions and policies to encourage efficient energy use and reduce pollution. Apart from domestic action, regional cooperation would address East Asia's two distinct energy security risks, namely a sudden interruption of energy flows and the risks in the long term availability of energy resources. Building strategic petroleum reserves and integrating gas and electricity networks are effective means of addressing the first risk, while recommendations for lowering energy intensity and diversification away from fossil fuels address the second risk.

Regional cooperation in energy promises a win-win outcome for all. Regional cooperation needed to ensure an uninterrupted and sustainable energy supply, enhance efficient functioning of markets, and strengthen greater collaboration to improve energy efficiency and conservation. A regional energy strategy and roadmap for the development of alternative and renewable energy sources, including bio-fuels and hydro power, are needed. Energy security should be a priority area of East Asian cooperation. Cooperation provides a policy alternative to addressing and overcoming conflict and reduces uncertainty. The regime complex for energy security comprises institutions that perform three types of function. These are rules and standards setting, correction of market failures and lowering of transaction costs.

5.2.3. Water Security

Water security is the ability to access sufficient quantities of clean water to maintain adequate food, goods production and health and sanitation. Water security will become a global priority in the coming decades. Water scarcity is an emerging critical challenge in East Asia. The water challenge has far-reaching adverse consequences on ecosystems and socio-economic development. Challenges related to water scarcity and management are complex.

Millions lack access to clean drinking water. The water challenge will be further exacerbated by urbanization. Ensuring access to water resources depends very much on good governance. In many countries, institutions involved in water management are fragmented. Agencies often lack necessary capacity and capabilities, and roles and responsibilities are often misaligned. Lack of long term strategic planning, poor financial management, and ineffective legislation often serve to worsen situations. Governments must take the lead in setting policies, regulations and standards to promote water management and ensure optimal water allocation and use. Governments should also be leading the efforts to generate awareness of water scarcity, and to educate the public about the importance of water conservation. The private sector can provide partial funding for water projects, technical innovations and training of personnel to ensure that they are equipped with the necessary skills to execute plans. Singapore provides a best practice example of water management, as its government has made substantial progress in the country's efforts to reduce the consumption of water, and to reuse and recycle it.

Regional cooperation in Southeast Asia on water security would focus on the Mekong Region. The Mekong River stretches from southwest China through 5

Southeast Asian countries. The river system is already under stress from multiple competing uses, particularly from the impact of dams, and pollution from industry, wastewater and agriculture.

6. Challenge: Environmental Risks from Climate Change and Urbanization

6.1. Environmental Risks from Climate Change and Mismanagement

Environmental risks include, first, natural phenomena such as persistent extreme weather, unprecedented geophysical destruction, and geo-magnetic storms that could disable critical communication and navigational systems. Second, they include also man-made and policy risks, such as a failure of climate change adaptation, a failure to reduce greenhouse gas emissions and expand carbon sinks, species overexploitation resulting in loss of biodiversity and ecosystem collapse, irreversible pollution (air, water and land) that threatens ecosystems, social stability, health outcomes, and economic development, the mismanagement of land and waterway use, and the mismanagement of urbanization.

Climate change is a global challenge. Environment global risks could devastate the earth's vital resources and inhabitants, destabilize economies and societies, and trigger geopolitical conflict. Mitigation of climate change and global warming risks would affect every economy and way of life. It might include increasing the efficiency of energy use, reducing dependence on fossil fuels, changing modes of transportation, changing the design of buildings and cities, care of forests and green areas, and the need to shift to an economic growth model that is more eco-friendly and sustainable. Reducing emissions of greenhouse gases requires substantial and sustained efforts by all. Developed countries need to take the lead by committing to drastic cuts in greenhouse gas emissions and providing technical and financial assistance to developing countries to support and expand the latter's ability to introduce green technologies that will help them meet the global need to reduce greenhouse gases.

East Asia is more vulnerable to environmental risks than many other regions, due to its huge populations, population concentrations in low lying areas in danger of rising sea level, and the past rapid destruction of forests and land and marine species that endangers biodiversity. East Asia has paid a heavy environmental price for its economic growth achievements. It relies heavily on coal combustion and fossil-fueled vehicles, and these emissions are the main polluters. As a result East Asia has many of the world's worst-polluted cities, especially in China. Further environmental risks for East Asia in the coming decades would arise from climate change and global warming, especially the rising sea levels affecting coastal areas and the increased incidence of droughts and floods affecting agricultural production.

6.2. Managing East Asia's Rapid Urbanization

East Asia's high economic growth has been accompanied by rapid urbanization brought on by industrialization, population growth and rural-urban migration. The urban population is expected to increase by 50% between 2000 and 2030. In many East Asian countries, a substantial proportion of the urban population comprises migrant labor and those working in the urban informal sector. Most of the world's mega-cities are in Asia, as well as more than half the world's slum-dwelling population. Many cities are poorly managed, with inefficiency and inadequate supplies of power and clean water, insufficient treatment of waste water before being discharged into local waterways, flooding due to poor drainage, and uncollected garbage. Poor sanitation leads to poor health conditions. Urban slum problems have been exacerbated by disputes over land titles, lack of functioning land markets, and unrealistic zoning.

Well-run cities (with quality amenities such as education, health, finance, infrastructure, recreational facilities and proper sanitation and good air quality) are drivers of economic growth and economic and social welfare. Thus the urban transformation could be an unparalleled opportunity for increased productivity and an improved quality of life for all. In East Asia, the city-states of Hong Kong and Singapore are thriving hubs enjoying the highest per capita GDP and living standards. Singapore also offers an example of a well managed East Asian city in its successful urban planning, transportation management, and water and waste management.

7. Challenge: East Asia's Rapid Demographic Ageing

The demographic bonus has been a major contributor to East Asia's high growth performance in recent decades. It takes the form of a high proportion of working age population and low dependency ratios, providing the workforce in the labor-intensive phase of industrialization and contributing to the region's high savings and investment rates. The demographic bonus can be realized only if the economy is able to productively employ the additional workers. In the case of the Philippines, low labor absorption due to anemic economic growth has resulted in large numbers having to seek employment abroad.

The demographic bonus in East Asia is coming to an end, as declining fertility rates and rising life expectancies have resulted in rapid demographic ageing. There is considerable heterogeneity, with countries at different stages of the demographic transition. Countries with rapidly ageing societies, where the demographic window has already closed or is about to close, include high income Japan, South Korea, Taiwan, Hong Kong and Singapore. Lower income countries in ASEAN, with a more recent demographic transition, can still benefit from their demographic dividend for another one to two decades. But China will suffer rapid demographic ageing before it becomes rich, reflective of its one-child policy enforced for decades.

The demographic bonus will be giving way to the demographic onus in much of East Asia. Inflexion points of ageing indicate the demographic dividends that countries could exploit to their advantage. For the major East Asian economies, these inflexion points are: Japan (2005), South Korea (2024), PRC (2032), Thailand (2039), Indonesia (2050), Vietnam (after 2050). Other things being equal, a fall in the share of working population will lead to lower economic output. Population ageing will negatively impact labor supply, although policies such as encouraging immigration, encouraging higher female labor force participation rates, and raising retirement age can compensate. Also population ageing will have important implications for savings and capital formation and the sustainability of publicly funded pension and healthcare systems. The concern is that a country might become too old before it becomes rich.

Demographic ageing gives rise to two fundamental challenges for East Asia in the medium to long term. These are sustaining strong growth in the face of demographic ageing, and developing socioeconomic systems that can provide economic security to the growing number of elderly. First, with high old-age dependency ratios, economic structures, institutions and policies will have to adjust to accommodate the rising numbers of elderly. As the labor force shrinks and wages rise, labor intensive industries will become uncompetitive and will disappear. The economic structure will have to upgrade towards technology- and innovation-intensive manufacturing and services and depend on rising productivity to drive economic growth. Accelerated human resource development thus becomes critical for economic upgrading and avoiding the middle income trap. Second, meeting the needs of a growing elderly population will entail building the costly economic and social institutions that are needed to achieve income security and provide adequate healthcare and other needs. Healthcare and related regulations will have to be adjusted to the special needs of the elderly. Older people are often more conservative and more resistant to change and this in turn will impact on governance and require wide-ranging institutional adjustments.

When individuals accumulate pension funds or personal savings during their working years, they rely on asset income and/or liquidation of those assets during their retirement. In high income economies, the elderly are taken care of through pension and social security payments and medical care programs. However, these measures have taxed the fiscal resources of the countries concerned, and contribute to rising fiscal deficits in countries such as the US and Japan. In most developing countries of East Asia, including China and India, pension funds and social security systems are underdeveloped and the aged usually depend on private transfers through the family and community. Governments are under pressure to provide public transfers to prevent poverty among the elderly. Some public transfers are required, but the challenge for East Asian governments is how to avoid over-generous public transfers that need to be funded by higher tax burdens, which could hamper long run economic growth.

8. Challenge: East Asia's Growing Inequality, and the Case for Inclusive Growth

In recent decades East Asia has lifted millions out of poverty at unprecedented rates, but inequality is also on the rise. From the early 1990s to the late 2000s, the *Gini* coefficient worsened from 32 to 43 in PRC, 33 to 37 in India, and 29 to 39 in Indonesia.

Why does inequality matter? First, rising inequality can lessen the poverty impact of economic growth. If inequality had remained stable while the Asian economies grew, the same growth in 1990-2010 would have lifted 240 million more people out of poverty, or 6.5% of developing Asia's population in 2010 and 8.0% of those countries with rising inequality. Second, inequality can weaken the basis of growth itself. High and rising inequality can curb medium-term growth by reducing social cohesion, undermining the quality of governance, and increasing pressure for inefficient populist policies.

What are the drivers of income inequality? Technological progress, globalization and market-oriented reform (the primary drivers of the region's growth) are also behind the rise in inequality, as the new opportunities for economies to prosper have not benefited all people equally. These forces affect income differences through three biases. These are the capital, skills, and location biases. The bias towards physical capital reduces labor's share of national income. Labor's share of total income is falling in many economies in the region. Between the mid-1990s and the mid-2000s labor income as a share of manufacturing output in the formal sector fell from 48% to 42% in PRC and from 37% to 22% in India. The employment intensity of growth in Asia is lower than the global average, and has declined in recent decades. Likewise, the growing demand for skills raises the premium on the earnings of skilled workers and the earnings premium for skills and tertiary education has increased in recent years. And locations with superior infrastructure, market access, and scale economies such as urban centers (for example Singapore, Hong Kong, Jakarta, Bangkok, Tokyo, Shanghai) and coastal areas (for example coastal Thailand and coastal PRC), are better able to benefit from changing circumstances.

Inequality of opportunity is a crucial factor in widening income inequality in East Asia. Disparities in the means to raise living standards, such as physical assets, human capital (education and health) and market access (labor and finance) are common. Unequal access to public services, especially education and health, generates inequality of opportunity. These inequalities can lead to vicious circles as unequal opportunities create income disparities, which in turn lead to differences in future opportunities for individuals and households. These forces require policy makers to redouble their efforts to generate more productive jobs, equalize opportunities in employment, education, and health, and address spatial inequality. Inclusive growth needs policies to ensure that all can participate in the development process productively and benefit equitably from the opportunities generated by economic growth. Because the forces behind rising inequality are also the engines of productivity and income growth, policy makers should not hinder their progress but emphasize equal access to opportunities and mitigate vulnerability and risks and prevent extreme poverty. More Asian developing countries are embracing inclusive growth at the heart of their development policy, as reflected in their recent medium-term development plans.

Governments can address rising inequalities through several policy channels, including three below:

- Efficient fiscal policies: these include spending more on education and health, especially for poorer households; spending more on better targeted social protection schemes including cash transfers for the poorest and incentives for human capital development; minimizing price subsidies (such as on fuel) and compensating the impact on the poor by targeted transfers; and broadening the tax base and strengthening tax administration for larger and more equitable revenue mobilization.
- Policies to make growth more employment-friendly: these include encouraging structural transformation to create a greater number of productive jobs, and maintaining a balanced sectoral composition of growth between manufacturing, services and agriculture; supporting the development of SMEs which are more job-creating than big enterprises; removing factor market distortions that favor capital-intensity over labor use, including strengthening labor market institutions; and as a temporary measure to address unemployment and underemployment, using public employment schemes as a temporary bridge.
- Policies to improve regional balance within a country: including improving connectivity through transport and communications networks between the more

developed and less developed regions, creating new growth poles in lagging regions; using fiscal transfers to accelerate investment in human capital and improve access to public services in poor regions; and removing barriers to within-country migration, such as the household registration system in PRC.

Growing inter-country inequalities could also pose potential concerns to political-social stability in East Asia. Instabilities within countries can spill over to richer neighboring countries, including rises in illegal and legal cross-border migrations. In ASEAN, wide disparities in income and economic growth prospects would also hinder the objective of economic integration, as poorer countries resist economic opening up to larger trade and investment flows. Hence the ASEAN Economic Community has as one of its primary goals the narrowing of the development gap between the more developed and less developed members. Measures include special and differential treatment for the less developed members (Cambodia, Lao PDR, Myanmar and Vietnam) in meeting the integration commitments and timelines, and special programs under the Integration for ASEAN Initiative to promote infrastructure development and human resource development in the CLMV countries.

9. Challenge: Improving Global Governance –the IMF and the G20

9.1. East Asia and Reforming the IMF

Mohsin Khan (2011) suggests that given the size and strength of Asia in the global economy, the region clearly still ‘punches below its weight’ in the global financial institutions like the IMF. There have been calls for IMF reforms to reflect the changing economic power shift towards emerging market economies. These include:

- A doubling of quotas, with a corresponding rollback of the New Arrangements to Borrow (NAB) preserving relative shares, when the quota increase becomes effective. Comprehensive review of the quota formula by January 2013 to better reflect economic weights. Completion of the next general review of quotas by January 2014.

- Greater representation for emerging market and developing countries at the Executive Board through two fewer advanced European chairs and the possibility of a second alternative for all multi-country constituencies. Moving to an all-elected Board, along with a commitment by IMF membership to maintaining the Board size at 24 chairs and a review of the Board's composition every 8 years.
- Advanced economies, the IMF and other international organizations should provide capacity-building programs for emerging market economies on the formulation and implementation of new major regulations, consistent with international standards.

Eichengreen (2011) argues that design flaws can be fixed. The articles of the IMF, for example, could be amended to provide for automatic penalties for chronic surplus countries; the composition of the executive board could be changed to further enhance the representation of emerging market countries. Nonetheless, the US has shown foresight in advocating reform of IMF quotas and executive board representation, while Europe has been less forthcoming in this regard. East Asia, partly reflecting its unhappy memories of the IMF's role in the AFC, instead of pushing for a larger voice in the IMF, has chosen to develop its own regional arrangements such as the Chiang Mai Initiative Multilateralisation (CMIM) the ASEAN+3 Macroeconomic Research Office (AMRO) and the Asian Bond Market Initiative (ABMI).

9.2. East Asia and the G20

The G8 has evolved into the G20. The 2008 global financial crisis has forced the leading economic powers to confront the need to integrate the emerging economies more effectively into international economic decision making. The latter includes the G8 countries (Canada, France, Germany, Italy, Japan, Russia, United Kingdom and United States) as well as the European Union, Australia and the emerging economies of Brazil, China, India, Indonesia, Mexico, Saudi Arabia, South Africa, South Korea and Turkey. It is a grouping that comprises 85% of world GDP. The inclusion of emerging economies is a positive development for global governance. But the G20 has a legitimacy problem, in that it has no written constitution, its membership is arbitrary and it has no enforcement power.

Asia is represented by 6 countries, developed (Japan, Australia) and developing (China, India, Indonesia, South Korea). But is Asia up to the task? Asia has to play a more active role in G20. The G3 (US-Europe-Japan) face serious risk of double-dip recession, and the Eurozone countries are mired in sovereign debt. In contrast, the East Asian economies are in relatively good health. The countries have huge foreign reserves, healthy public finances and low debt ratios; their banking systems and corporate balance sheets are healthy, economic growth is still satisfactory and unemployment rates are nowhere alarming, and trade is being restructured to reduce dependence on the US-EU markets. Hence Asia has the economic and financial power to be co-driving the agenda and actions of G20. As Asia's weight in the world economy grows, its interests will also be served by a strong commitment to global institutions.

The first G20 Summit in November 2008 proposed immediate actions to focus on standard setting and strengthening collaboration:

- Enhancement of efforts to better integrate regulatory and supervisory responses into the macro-prudential policy framework and conduct early warning exercises.
- Reviewing the adequacy of the resources of the IMF, the World Bank Group and other multilateral development banks and standing ready to increase them where necessary. Revising their lending role in the light of the ongoing financial crisis.

Looking at the agendas of various G20 Summits since November 2008, some analysts have cited the "hijacking" of G20 summit agendas by the need to respond to current crises as an inherent weakness of the G20 approach. A related question is whether these agendas should continue to deal primarily with systemic financial/economic matters or whether they should be expanded to include consideration of other related topics. Agenda hijacking and agenda broadening are both reflections of the nature of G20 summitry itself. There is a clear expectation that they will deal with the most important issues of the day, and as other large issues come to the fore, G20 leaders will want to expand the range of issues they discuss for understandable political reasons.

Once established, the G20 did a creditable job of framing solutions to the financial crisis. Decisions taken at the 2009 London Summit and confirmed at the 2010 Seoul Summit laid out a constructive agenda. Unfortunately, much of that work program remains incomplete. For the moment at least, the political will among G20 leaders to deal with underlying systemic issues seems limited. Going forward, G20 should strive to handle not only the short-term problems of the global economy but also address the longer term rebuilding the global economic order.

10. Conclusion

Asia is on the ascent. The US, Europe and much of the world looks to East Asia as the driver and engine of growth of the world economy and to provide growth in import demand. East Asia's economic rise has changed the world economy, and is shaping world trade, financial markets, commodity markets and consumer markets. The Asian middle class will quintuple in size and spending in the next 20 years. East Asian growth will generate demand for imports of primary products, manufactures and services from the rest of the world, as well as attracting investment capital from the advanced economies for agricultural, industrial, services, infrastructure and human resource development.

But Asia's continuing ascent to realize the Asian Century is complicated by the less benign global economic environment, and domestic economic, political and social constraints. On the global environment, there are the trade imbalances and threats of protectionism, and the need to rebalance away from export-led growth towards domestic and regional demand; there is international financial instability and volatility; and there is increasing concern over food and energy security and climate change, and environmental deterioration and un-sustainability. On the domestic front, East Asia is confronted with growing economic, political and social constraints that could lead to the middle income trap and political-social instabilities. Unless the constraints are resolved, the Asian Century will not materialize and large parts of East Asia will remain low and middle income economies.

Nonetheless, East Asia has already become a global economic and financial power to be reckoned with. In particular, it has the opportunity to play a larger role in decision making in the international economic and financial institutions such as the WTO, IMF, World Bank and G20. East Asia has to bear in mind its increased responsibility to act as a cooperative global power so that its continuing prosperity would not be a threat to the rest of the world but would facilitate global growth, stability and prosperity.

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