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Introduction and Overview

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Less than a decade ago, most economists and economic historians, looking at the nineteenth and twentieth centuries as a whole, or looking at the last decades of the twentieth century, still remarked that the process of global economic growth had been accompanied by a process of "divergence" of per capita incomes between a small group of rich countries and a large number of lower-income economies. The words of renowned growth theorist Elhanan Helpman are representative of most thought on the subject until quite recently: "Although the differences in income per capita among rich countries have declined in the post–World War II period, the disparity between rich and poor countries has widened. At the same time the number of middle income countries has dwindled. We now have two polarized economic clubs: one rich, the other poor" (Helpman 2004).

This "divergence" had been a puzzle for growth theorists, because essential aspects of growth theory, notably Robert Solow's neoclassical growth model, suggested that diminishing returns to capital deepening would lead to "convergence" of per capita incomes (Solow 1956; *Oxford Review of Economic Policy* 2007). These models suggested that for a while the developing countries with less capital per worker would grow more rapidly than the mature economies with their higher capital-labor ratios, as these richer countries were farther along in the process of diminishing returns to capital accumulation. The developing countries did not grow more rapidly, however, in the decades following World War II, when development economics became a subdiscipline within the economics

profession. Clearly the process of technological change that accompanied capital accumulation had been such that it more than compensated for the diminishing returns to capital in the advanced countries and allowed them to maintain their relative lead. Over the past two decades, and particularly since the turn of the twenty-first century, this has changed, with huge implications for the nature of the world economy, its growth dynamics, and the requirements for a system of global economic governance.

The global financial crisis of 2007–09 made the new convergence process due to more rapid growth in many emerging market economies very apparent. But the crisis merely underlined and accentuated a fundamental structural change in the world economy that had been taking place since the early 1990s. Convergence seems to have replaced the divergence referred to by Helpman. Emerging Asia is at the heart of the change, and the chapters in this book examine some of the key dimensions of this shift, which is continuing at full speed as we enter the second decade of the twenty-first century.

In the period following the Second World War, aggregate growth rates in the advanced industrial economies and growth rates in the rest of the world were not very far apart. Both groups saw much variation, with some countries and regions growing rapidly for certain subperiods and then far more slowly at other times. Parts of Latin America, for example, grew rapidly in the period from 1950 to 1980, and then stagnated during the 1980s and into the 1990s, before picking up new speed after the turn of the century. Many African countries experienced a few years of rapid growth after they gained independence, but soon most of them lost their growth momentum and many experienced negative per capita growth rates. Many developing countries also experienced high volatility, with good years followed by years of crisis and negative growth, often brought on by balance of payments difficulties.

Among the advanced countries, Japan grew spectacularly until 1990, and stagnated thereafter. From 1950 to 1970, Europe grew at a steady pace, even somewhat faster than the United States, but European growth slowed down significantly after the first oil crisis in the early 1970s. The United States also grew rapidly in the 1950s and 1960s, slowed down in the 1970s and 1980s, but picked up the pace in the 1990s. Overall, the period from 1950 to 1990 cannot be characterized as either a period of divergence or a period of convergence in per capita incomes, with the aggregate relative income gap between the advanced industrial economies and the emerging and developing countries neither widening nor narrowing significantly.

The picture started to change perceptibly in the 1990s, mainly because of the growth performance of the Asian countries. Growth in some Asian economies, such as Hong Kong, China; the Republic of Korea (henceforth, Korea); Taipei,China; and Singapore (the "Asian Tigers") had already reached relatively high levels in the mid-1960s.[1] Growth in the People's Republic of China (henceforth, PRC) picked up from the late 1970s onward, and in India it started in the 1980s. Nonetheless, since the four Asian Tiger economies had small populations and the PRC and India were still very low-income economies, the weight of Asia remained small in the world economy until the 1990s, and the rapid Asian growth did not compensate for the sluggish growth in many other developing countries in terms of impact on the aggregate relative per capita income gap between advanced and developing economies. By 1990, Asia had gained enough weight in relative GDP that its rapid growth started to lead to a narrowing of the aggregate income gap between advanced and developing economies, despite continuing slow growth in Latin America and Africa. This new "convergence trend" continued into the twenty-first century, after a brief interruption at the time of the Asian crisis in 1997 and 1998, reinforced after the turn of the century by substantially better performance, also in Latin America and Africa.

While the nineteenth and twentieth centuries were times of divergence, it appears that the twenty-first century will be a century of convergence in the world economy. Looking at the very long run, it now seems that the nineteenth and twentieth centuries, with their colonial empires and Western domination, may turn out to be a limited period, a kind of parenthesis in world history. As the twenty-first century unfolds, the world may become much less divided by income levels than it has been since the Industrial Revolution, returning to a structure—though at much higher levels of income and prosperity—that existed for centuries before the Industrial Revolution. Per capita income differences between the traditionally rich countries and the developing world will persist for decades, but they are likely to decline over time, while the overall size of the rich economies will soon be overtaken by the aggregate size of the developing country economies, even when measured at market prices. At purchasing

1. This book adopts the Asian Development Bank naming convention of referring to its member economies. The Brookings Institution takes no position on Taipei,China's legal status.

power parity prices, the emerging and developing countries have already caught up, in terms of aggregate size, with the advanced rich economies.

Climate and the environment may of course develop into new challenges, constraining growth for large parts of the world, advanced and developing; and there is unfortunately always the threat of devastating conflict that could create unforeseen upheaval. Some developing and emerging countries are particularly vulnerable to natural disasters. Moreover, some of the least-developed countries, where there is internal conflict and "state failure," are still "diverging," and extreme poverty remains a huge challenge, even in many middle-income countries. But looking at the world as a whole, a large percentage of the global population now lives in "emerging" countries that are closing the income gap that separates them from the mature advanced economies. Emerging Asia leads this process.

This volume analyzes the dynamics of growth in Asia comparatively and historically in a global context (chapter 2); appraises the scope for policy coordination among systemically important economies of the world (chapter 3); analyzes financial stability in Emerging Asia (chapter 4); and assesses the implications of the rise of Asia in the newly emerging global economic governance by focusing on the reform of the international monetary system (chapter 5). This introductory overview provides a brief summary of the topics analyzed in greater detail throughout the volume.

Structural Transformation in Asia and the World Economy

In chapter 2, Kemal Derviş and Karim Foda analyze the sources of the greatest structural transformation that the world economy has ever experienced in a three-decade period. Emerging Asia (EA), led by the PRC in terms of size and rate of growth, is very likely to reach close to one-quarter of world GDP at market prices by 2020, compared to 6.6 percent in 1990.[2] The weight of EA in the world economy approached 16 percent in 2010. These percentages are much higher when output is measured at purchasing power parity (PPP) prices. Barring any cataclysmic political events, it is likely that this group of countries will sustain its strong growth momentum through the next decade, at least from the supply side.

2. Emerging Asia includes Hong Kong, China; India; Indonesia; Korea; Malaysia; the PRC; Singapore; Taipei,China; Thailand; and Viet Nam.

To a degree, the rise of EA is in some ways similar to the rise of Japan during the postwar period. Over the three decades from 1960 to 1990, the share of Japanese GDP rose from 3.3 percent of world GDP to 13.3 percent. But the Japanese story involved about 120 million people, while the EA story involves close to 3 billion people—about 40 percent of the world's population. Japan's remarkable growth performance allowed it to join the club of the advanced economies. EA's growth performance is transforming in a very fundamental way the overall structure of the world economy and relocating its center of gravity.

In their analysis, Derviş and Foda point to two defining characteristics of the EA group: GDP growth rates and ratios of investment to GDP. In the aggregate, both investment rates and growth rates have been sufficiently high in EA countries to set them apart from most other countries. From 1999, the year after the Asian financial crisis, to 2008, EA growth was about three times as rapid as growth in the advanced economies and about twice the rate of growth in other emerging and developing economies. Over the same period, investment rates were high in EA countries, rising from about 29 percent of aggregate GDP in 1999 to about 38 percent in 2008, much higher than in any other part of the world.

Despite high investment rates, EA ran a significant current account surplus over the same period, indicating that the region has saved a higher proportion of income than the already high proportion it invests. This savings behavior has been providing the region with the ability to finance its own investments, and as EA's high growth rates indicate, the region has displayed the capacity and institutional effectiveness to translate investment into rapid economic growth.

EA has achieved this through the combination of rapid capital accumulation, driven by sustained high investment rates and fairly rapid technological progress as measured by the growth of total factor productivity. This is in contrast to what happened in the Soviet Union, which also had very high investment rates but was unable to generate much total factor productivity growth. Much of the growth in total factor productivity in EA can be attributed to the importation and adaptation of frontier technology (catch-up growth facilitated by openness to the world economy), large-scale rural-urban migration (moving labor from low- to higher-productivity activities), and improved factor allocation within the "modern sector" across industries and firms. In addition, many indicators of human capital formation, such as years of education, enrollment rates, and gender parity, have significantly improved in EA. In the PRC and Korea, tertiary

school enrollment increased 16 and 18 percentage points, respectively, between 2000 and 2007.

The supply-side factors mentioned above will continue to be at work over the next decade at least, allowing growth at a pace similar to that of the recent past. The future sustainability of growth will also depend on the demand side. As a region with higher savings than investment, and thus a current account surplus, EA has shown that, in the aggregate, it does not need net foreign capital inflows to finance its high investment rates, but requires net foreign demand to ensure that potential growth is realized.

The debate over whether EA can sustain growth from the demand side centers on "global imbalances," where imbalances refer to current account surpluses or deficits. Most EA countries have run significant surpluses, with the PRC running the largest at $400 billion, or in the range of 10–12 percent of GDP, at its peak in 2007–08. On the other side of the Pacific, the United States runs very large current account deficits, which reached $800 billion, or 6 percent of GDP, at their peak in 2006.

In addition to EA running large current account surpluses, it has accumulated large volumes of foreign exchange reserves, a strategy that originated in the wake of the Asian financial crisis of 1997–98, partly, at least, as an attempt to self-insure against volatile international capital flows. Emerging countries more generally adopted this strategy, adding $4.7 trillion to their foreign exchange reserves between 1999 and 2008, with EA accounting for most of this accumulation. On the other hand, the United States experienced a current account deficit of $5.7 trillion over the same period. It is possible, to a certain extent, to view the EA surplus and the U.S. deficit as mirror images, although both the United States and Emerging Asia traded with a multitude of other countries in other regions as well.

Some argue that the existence of current account imbalances should not necessarily be considered a major problem, because globalization should be expected to reduce home bias in the allocation of savings. In a globalizing world, countries or regions should not be expected to balance their current accounts. However, in a world of sovereign nations, national currencies, herd behavior in markets, and volatile capital flows, not to mention national authorities that intervene in foreign exchange markets and accumulate foreign exchange reserves, the situation is much more complicated. A truly integrated world economy driven entirely by efficient markets does not exist.

Going forward, there is broad agreement that the United States cannot continue to run its pre-crisis current account deficits and that EA cannot continue its pre-crisis surpluses, because, among other reasons, the United States is unlikely to be able to sustain high domestic demand owing to the deleveraging process, large household debt, the need to rebuild household assets, high unemployment, and lack of investment demand. In other words, a rebalancing of supply and demand around the world is needed to help ensure sustainable growth in the long run. In particular, the high-surplus PRC should increase the share of its domestic demand in total growth, offsetting a desirable decline in domestic demand as a share of total U.S. demand. This "rebalancing" need not, and should not, however, involve only the United States and the PRC. Too rapid and too drastic a decline in the Chinese "structural" surplus might not be feasible in the short run without triggering a decline in the Chinese growth rate, which would hurt not only the PRC but world growth as a whole (on this, see also chapter 3 by Rajiv Kumar and Dony Alex).

There is also the special case of Germany, with a large surplus but a currency that could be dragged downward by weakness elsewhere in the euro zone, a paradoxical dilemma that poses a particular challenge to global (and intra-European) rebalancing. Moreover, many emerging and developing economies outside Asia have high returns to investment but relatively low savings rates. Given the huge need for infrastructure and other investments in these countries, and the much improved macroeconomic frameworks in many of them, it would seem reasonable that they be net capital importers and run a moderate current account deficit in the aggregate. This would help counter the tendency for "ex ante" world savings to exceed "ex ante" world investment and help rebalance the world economy.

Derviş and Foda argue that it would be useful for policymakers to focus on the overall structure of savings and investment globally when trying to "rebalance" the world economy, as was tentatively agreed at the Seoul G-20 meeting in November of 2010. In this context it would be particularly desirable if more long-term capital could safely flow to capital-poor developing countries without creating the damaging "stop-and-go" cycles of the past. Besides private flows, official lending and guarantees from development banks can and should play an important role in reducing volatility and lengthening maturities. Official development finance remains relevant also in the context of resource transfers needed to fight climate change.

Looking to the next decade, Derviş and Foda argue that it is likely that the combination of high investment and savings rates, with continued technological diffusion and continued absorption of lower productivity labor by higher productivity sectors, as well as continued improvements in factor allocation within sectors, will allow emerging Asian countries to continue to grow at impressive rates, well above the world average. The ensuing structural transformation will be unprecedented and will need to be managed, including from a political economy perspective. If the transition is well managed, it will be compatible with growth in overall prosperity. It will, however, imply a serious shift in the economic and financial weight of countries and thereby in their political influence and power over the next decade. What lies beyond 2020 is surely more difficult to predict.

The Rise of Asia and Implications for International Economic Coordination

In chapter 3, Rajiv Kumar and Dony Alex examine first the nature and magnitude of the global macroeconomic imbalances, and then some possible scenarios for redressing them. In doing so, they focus on the role that Asian economies can play in achieving a more balanced and sustainable global economic growth and greater coordination of macroeconomic policies.

Kumar and Alex explain that macroeconomic imbalances have almost always been a feature of the modern global economy. They were seen to facilitate faster growth by permitting a creditor country, with a current account surplus, to park its excess savings in safe assets (such as U.S. Treasury bills) for possible use in financing a future external current account deficit. However, very large macroeconomic imbalances can be seen as a symptom of deeper underlying distortions in the financial and monetary systems of the economies concerned. They can be attributed to a number of factors, such as a shift in saving behavior, productivity changes, the accumulation of foreign exchange reserves, movements in commodity prices, and also a shift in investors' attitude toward risk.

Kumar and Alex review the two contrasting explanations that have been given for the present state of global imbalances. The first view (notably put forward by Barry Eichengreen) attributes imbalances to a savings deficit in the United States, which translates into a current account deficit that is met by an inflow of capital from the rest of the world. The

second view (supported by Ben Bernanke) argues that high savings rates in countries such as the PRC have made huge surpluses available; these surpluses, which lower the cost of borrowing, have contributed to huge current account deficits in countries such as the United States. In that view, the onus of correcting global imbalances falls also very much on surplus economies, which should be implementing policies to lower their domestic savings and raising their domestic consumption as a share of GDP.

Kumar and Alex argue that the global macroeconomic imbalances can be seen as the combined outcome of both explanations, with high U.S. current account deficits financed by rising savings in the PRC and the oil-exporting economies. To some degree, the imbalances are rooted in the Asian financial crisis of the late 1990s, which left the Asian economies bitter about not getting timely or adequate financial assistance from the IMF. In turn, this propelled them toward more contingent measures, such as achieving a degree of self-insurance against a future financial crisis through the raising of foreign exchange reserves (on this, see chapter 5 by Domenico Lombardi).

This process of accumulating reserves turned the current account of some countries from deficit to surplus. For countries such as the PRC, net exports also play an important role in sustaining high GDP growth rates. This has been achieved by keeping a fixed exchange rate with the U.S. dollar to maintain export competitiveness and, in turn, has led to a huge accumulation of reserves to prevent the currency from appreciating. However, the PRC is not the only country running a substantial current account surplus. Other countries, such as the oil-exporting economies, have perhaps been equally responsible. The case of Germany is more complicated, because it is part of the euro zone—but Germany too has had large surpluses in the current account.

The literature on the measures that can be taken to tackle global imbalances identifies two approaches. The first approach argues that the imbalances are just a manifestation of a short-term disequilibrium and that this will automatically adjust itself over time. The second approach, on the other hand, insists that these imbalances are the result of severe economic distortions that have to be rectified with coordinated and conscious policy actions. In this vein, measures to correct the macroeconomic imbalances in the Asia-Pacific region and the United States have to focus on serious restructuring of the U.S. and Chinese economies.

The thirteen largest Asian economies have a total GDP of US$13.9 trillion, which is similar in size to the U.S. economy of about US$14.1 trillion

at 2009 prices. The economic crisis led to a decline in U.S. private sector demand. If the falloff in U.S. demand has to be compensated for by the thirteen largest Asian economies, Kumar and Alex argue that these would need to increase their aggregate demand by roughly a similar amount.

They say that there are three possible routes to raising aggregate demand in Asia. The first is to raise domestic private consumption, especially in the PRC and Japan, as well as in the ASEAN region. This would enable other countries, including the United States, to take greater advantage of external demand and to rebalance their own economies. While this would have some positive impact, especially in reducing the PRC's dependence on external demand to sustain its very rapid GDP growth, it is difficult for a country-by-country process of internal balancing alone to compensate for the weakness in demand-slowing growth in some of the advanced economies.

The second way forward would be for the oil-exporting economies to reduce their current account surpluses to push up aggregate world demand. The oil-exporting countries could be expected to spend more of their savings from sudden surges in oil prices, if they could be assured of more stable future income streams. This would be achieved through reforms in both the Asian and the oil producers' financial sectors to ensure that such savings could be suitably invested and would generate stable earning flows from Asia to the oil producers. A rise in domestic investment demand in these countries would help absorb skilled labor from labor-surplus Asian economies and also strengthen economic activity in general. However, the implementation of necessary reforms in the financial sectors will come about only in the medium to long term. As a result, the oil producers cannot be relied upon to substantially contribute to global rebalancing in the near future.

The third modality would be to boost regional economic activity in Asia even more, including in the lower-income Asian economies, by accelerating the process of pan-Asian economic integration and establishing institutional mechanisms for designing and financing regional infrastructure projects. One way to shore up regional demand would be to complete the process of trade and economic integration among the ASEAN+4—the ten ASEAN member states, the PRC, India, Japan, and Korea—so that it could contribute to greater dynamism in regional economic activity. Another option would be to establish an Asian Investment Bank (AIB), which would supplement the efforts of the Asian Development Bank (ADB) and other national development banks to finance infrastructure and connectivity in

Asia at levels comparable to those in Europe and the United States. The AIB could be managed independently of extra-regional interests and could focus on a more efficient utilization of savings generated within Asia. It could also help facilitate the development of Asian financial markets.

Kumar and Alex conclude that the strengthening of regional economic activity in Asia could contribute to the external demand stimulus for the U.S. economy and help both Asia and the United States achieve higher economic growth and employment. In their view and in the context of Asia-Pacific rebalancing, it is thus critical that intra-regional economic activity in Asia be bolstered through higher demand for regional public goods, supplemented by rising domestic demand in the economies with a current account surplus.

G-20 Financial Reforms and Emerging Asia's Challenges

In chapter 4, Masahiro Kawai underlines that the main lesson emerging from the crisis that began in 2007 is that a systemic financial crisis can be very costly in terms of fiscal resources as well as lost output and employment. In fact, the crisis severely affected the economies of the United States and Europe well beyond their respective financial systems. It then spilled over into Asia through the trade channel. The Asian financial system was largely spared, however, owing to the regulatory reforms that had been enacted in most Asian economies in the aftermath of the 1997–98 crisis, the ensuing reduction in short-term external debt and the accumulation of foreign reserves and, finally, a more conservative approach to risk-taking eschewing the widespread use of sophisticated structured products. Looking forward, the increasing globalization of financial activities, the sustained economic growth achieved by the region, and the new regulatory reforms on the agenda of the G-20 require Asian policymakers to upgrade their supervisory capabilities to continue to regulate and supervise financial firms and markets so as to promote financial innovation in a framework of systemic stability.

Against this backdrop, Kawai reviews recent progress on financial sector reforms in EA achieved as a result of the so-called G-20 process, focusing on the following issues: building stronger capital, liquidity, and leverage standards; addressing "too-big-to-fail" problems; designing macroprudential supervisory and regulatory frameworks; and strengthening international coordination of financial supervision and regulation. Such reforms are expected to strengthen the financial systems of the United

States and Europe, where the crisis originated in 2007. Yet, Kawai argues that Asian economies should not view them as relevant only to those advanced economies and that it is in their best interest to continue pursuing reform policies to further develop and deepen financial markets while preserving financial system stability.

A key aspect of the G-20 process has been the endorsement by the leaders of the Basel III capital and liquidity requirements. The aim is to introduce a fair amount of counter-cyclicality to the bank capital rules while increasing the provisioning against maturity mismatches that give rise to funding liquidity risks. EA banks will be less affected by the new supervisory framework thanks, to a large extent, to the reforms already enacted; they will benefit from the implementation of that framework in the United States and Europe. Similarly, because most EA banks are small internationally—although some are large in their domestic markets—they are unlikely to be affected by the emerging international regulation of systemically important financial institutions (SIFIs), although there is still merit in identifying and appropriately overseeing national SIFIs.

The 2007–09 crisis revealed that authorities in the United States and Europe had failed to accurately assess their financial system's ability to withstand systemic shocks owing to their traditional "bottom-up" approach of microprudential regulation and supervision of individual firms. Along similar lines, regulators tended to focus on specific areas of responsibility while no entity was in charge of assessing risk in the entire financial system or economy. In contrast, the aim of macroprudential regulation and supervision is exactly to remedy these shortcomings by providing a "top-down" framework for identifying risks in the financial system as a whole through a "systemic stability regulator." In Asia, many authorities have actively intervened in their respective financial systems in a macroprudential way without, however, a well-defined framework. At the international level, the prevention and detection of systemic crises will require concerted macroeconomic and financial surveillance as well as implementation of macroprudential policies through close cooperation between the IMF and the Financial Stability Board.

Following the 1997–98 crisis, Asian policymakers undertook significant reforms aimed at enhancing the quality of balance sheets and risk management practices of their banks. In this vein, financial firms have taken a conservative approach to risk, as reflected by their not relying on widespread use of structured products and by not expanding the securitization business. Partly as a result of national authority efforts, stock mar-

ket capitalization and the total stock of bonds have increased rapidly in Asia, reflecting a more balanced financial system than in the past. Despite these favorable developments, there is an urgent need to continue to strengthen microprudential regulation and supervision and to establish a full-fledged macroprudential supervisory framework that focuses on economywide systemic risks. An important lesson from the global financial crisis is that monetary and macroprudential policies should play complementary roles in addressing systemic risks. Accordingly, a mechanism should be established that allows central bankers, financial regulators, and finance ministry officials to share information about systemic risk and to coordinate policies so as to prevent the buildup of excessive risk. Whether a single entity or a council, a systemic stability regulator should be established at the national level for that purpose.

Kawai argues that, given the traditional predominance of banks in providing formal financial services, a balanced financial system would require deep local-currency bond markets as a means to enhance the allocation of large Asian savings to sustainable long-term investments. In the context of the Asian financial crisis, local-currency corporate bond markets would have, in fact, provided corporations with a greater opportunity to obtain longer-term financing for local projects, thereby removing both maturity and currency mismatches. Against this backdrop, finance ministers of ASEAN+3 launched the Asian Bond Markets Initiative with the aim of enhancing the market infrastructure for local-currency bond markets and facilitating access to a diverse issuer and investor base. Relatedly, the Asian Bond Fund, also launched by the region's central banks in 2003, aimed at removing impediments to the listing of local-currency bond funds through their inclusion in central bank foreign exchange reserves. Yet regional financial integration remains low. The bulk of the region's massive savings are still largely invested in low-yielding foreign exchange reserves and intermediated through financial centers outside the region.

In 2010, foreign capital resumed flowing back into the region, fueled by the expansion of the liquidity that advanced economies have injected to stabilize their financial systems and prop up their domestic demand. These flows will test macroeconomic management capacities, exchange rate policies, and financial supervision frameworks in Asia. As for the first aspect, sterilized intervention has been the favorite instrument applied by many EA economies to prevent nominal appreciation of their exchange rates. Given that interventions in foreign exchange markets have been mostly unidirectional, sterilization is becoming an increasingly costly

method of preventing the economy from overheating, while increasing the accumulation of net foreign reserves cannot be sustained indefinitely. Hence there is a need to allow greater flexibility in the exchange rates of EA countries.

Another way to deal with the current surge in capital flows would be to impose capital controls along the lines of the Chilean experience. But evidence on the effectiveness of capital inflow controls is mixed and, in any case, their impact tends to weaken over time as agents learn how to circumvent them while producing distortions and inefficient allocations.

In the absence of definitive measures at the national level to effectively manage capital flows, Kawai concludes that regional collective action can be an attractive alternative, as it expands the menu of options available to individual countries. By stepping up regional financial market surveillance, policymakers can mitigate the impact of investor herd behavior and financial contagion. A country's adoption of tighter prudential policies and capital inflow controls could push capital toward other countries. The establishment of a new high-level Asian Financial Stability Dialogue (AFSD) would bring together all responsible authorities—including finance ministry officials, central banks, and financial supervisors—to address regional financial market vulnerabilities and make efforts at regional financial integration through greater harmonization of standards and market practices. Regional collective action would also be needed in respect of exchange rate policies. In fact, if the fear of loss of international price competitiveness prevents a country from allowing its currency to appreciate, it could cooperate with its regional competitors to take action simultaneously. Collective currency appreciation would have the benefit of contributing to financial and macroeconomic stability in the region while minimizing the loss of price competitiveness, at least within the region.

Reforming the International Monetary System through the Lens of Emerging Asia

In chapter 5, Domenico Lombardi focuses on the asymmetry between the sustained globalization of economic and financial activities driven by the integration into the world economy of emerging economies, many of which are in Asia, and the capacity shown by the international monetary system (IMS) and the global economic governance institutions to adapt accordingly. Despite some changes that have occurred since the late 1960s, when,

for instance, special drawing rights (SDRs) were introduced, the current IMS has maintained key asymmetric features. These features, in the face of their increasing integration into the global economy, have produced a pattern of reserve accumulation by several emerging and developing economies that cannot simply be traced to traditional mercantilistic motives.

According to Lombardi, the first structural asymmetry of the IMS relates to the well-known feature whereby pressure to adjust their external accounts is much stronger for deficit countries than it is for those in surplus. This feature was strongly noted by Lord Keynes in his preparatory work for the Bretton Woods Conference in 1944. He pointed out at that time that the fundamental asymmetry in the global monetary system would generate a global deflationary bias in the absence of any corrective measures. In the past, the lack of an authentic multilateral forum to discuss and formulate policy responses to these weaknesses and asymmetries in the global monetary system had left developing and emerging economies more vulnerable in an increasingly interdependent world. Policymakers from emerging economies have often complained that advanced countries do not adequately consider how their policy spillovers will affect the rest of the global economy.

The G-20, with its stronger representation of emerging economies, especially from Asia, and its recent elevation to the leaders' level, may finally be able to become a relevant forum where emerging economies can voice their concerns and constructively channel their criticisms. In September 2009, leaders at the G-20 summit in Pittsburgh agreed to the so-called "Framework for Strong, Sustainable, and Balanced Growth" proposed by the United States. Through this framework, they pledged to devise a method for setting objectives, developing policies to support such objectives, and mutually assessing outcomes. The IMF's involvement has been sought in providing analysis on various national or regional policy frameworks and how they fit together.

Lombardi underscores that this is the first relevant multilateral surveillance exercise on a global scale in recent history. There are, however, strong challenges for the G-20-led multilateral surveillance. First, the exercise appears, so far, mainly geared toward making national authorities aware of the international spillover effects of their policies and providing a context in which policymakers can exercise mutual pressure. The G-20 countries have committed to a peer-review process for their economic policies and to a broadly defined policy objective. This is not the same as committing to quantitative policy targets to which they can be held accountable

in a multilateral forum. The effectiveness of this multilateral exercise will also hinge on the extent to which emerging Asian countries are willing to fully articulate their vision of how international economic coordination should work in practice.

Lombardi supports the view that a key structural source of instability in the IMS is the central position that the U.S. dollar enjoys as a global reserve asset. The reliance on the domestic currency of a single country as the principal international reserve asset makes it difficult for U.S. policymakers to reconcile, in the long run, their domestic macroeconomic goals with the (increasing) need for a net supply of dollar-denominated international assets, leaving the IMS vulnerable to unilateral adjustments in the economic policies of the reserve currency country. In this regard, the IMS has been remarkably resistant to change. In contrast to the obligation set forth in Article VIII of the IMF Charter about "making the special drawing right the principal reserve asset in the international monetary system," SDRs have played a marginal role as international reserves.

As the 2007–09 crisis unfolded and developing countries' economies increasingly needed to bolster their reserve asset position, the G-20 supported a general allocation of SDRs equivalent to $250 billion, and the IMF quickly implemented this in August 2009. Many experts, including a UN Commission, have called for expanding the role of the SDR through its regular or cyclically adjusted issuance, as a way of managing international economic risks posed for countries that do not issue hard currencies. Because SDRs are an artificial unit of account with limited scope for use within the existing parameters, the head of the Chinese central bank has proposed a significant overhaul to increase the role of the SDR. This proposal envisages a political bargain between structural reforms of the IMS and the restoration of the IMF's centrality in it. In the interim, the managing director of the IMF, the executive board, as well as the institution's governors have expressed interest in proposals for strengthening the role of the SDR, and the 2011 French presidency of the G-20 has made it an agenda item.

In Lombardi's analysis, a third asymmetric element of the IMS has been associated with the governance of the institution charged with the regulatory task of overseeing it. The distribution of voting power within the IMF has been heavily biased toward Western countries and has pointed to a serious legitimacy gap. Since many emerging Asian countries have carried inadequate weight in Fund decisionmaking, their positions, even on matters in which they may have the most relevant and immediate experience or

knowledge, were less likely to be incorporated in the IMF's own policies and programs, as when, for instance, the Fund intervened in Asia in the late 1990s.

Another example of how the IMF's governance has affected the asymmetries of the IMS is the fact that, against the need for increased reserves, the issuance of "synthetic" assets such as SDRs requires approval of 85 percent of the voting power of the IMF membership. Besides the potential veto power that such a large supermajority affords to a few countries or groupings, the governance arrangements underpinning the creation of SDRs have reduced the IMF's ability to be responsive to the liquidity needs experienced by some segments of its membership. At the same time, it embeds a tension in the institutional mandate to pursue systemic stability, as it leaves decisions on regulating global liquidity in the hands of those countries issuing the hard currencies used as international reserve assets.

At the G-20 meeting in Gyeongju in October of 2010, the finance ministers agreed on a package of reforms that went beyond most expectations at the time by endorsing a shift of about 6 percent of voting power to dynamic and underrepresented economies. According to this agreement, approved by the IMF Executive Board on November 5, and endorsed by the leaders at the Seoul G-20 Summit, the PRC will become the IMF's third shareholder, while Brazil and India will be among the top ten members on the basis of their revised quotas. Moreover, the quota review, to take effect by the time of the IMF's Annual Meetings in 2012, will be linked to a recomposition of the board itself, with Western Europeans giving up two seats at any given time. The practical details of how this broad package will be implemented remain to be worked out but, in Seoul, G-20 leaders expressed a clear commitment in this respect, making it very likely that such reforms will be enacted within the envisaged time frame.

These latest developments would have not materialized without the political impetus provided by the G-20 with the presence of the large Asian economies. As long as countries with large stocks of reserves, like emerging Asian economies, perceived a gap between their relative international economic status and their position within the IMF's membership, they had an incentive to break away from the IMF and set up regional or plurilateral pooling facilities. Only by linking IMF reforms to structural changes in the IMS will the IMF gain strong support from emerging Asian countries for the Fund's role as the central institution in a reformed and truly global monetary system.

Looking forward, Lombardi concludes that, given Asia's increasing weight in the world economy, the region's support for the IMF, replacing the suspicion and disappointment rooted in the crisis of the 1990s will be key for the effectiveness of the institution in discharging its own mandate and for delivering better prospects for global economic policy cooperation.

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