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Asia's economic challenges and policy choices

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The global economy is fundamentally changing, and the centre of global economic gravity is returning to the East. Over the past decade, Asia accounted for around 55 per cent of global growth. Based on UN population projections and plausible assumptions about the gradual convergence of productivity growth rates, Australian Treasury projections suggest that Asia will continue to account for more than half of world growth in the coming decade, surpassing the advanced economies in purchasing power parity terms to become the world's largest economic region by 2020.

Yet while Asia's share of the global economy [1] will continue to rise in the coming decade, the rate of economic growth in the region is projected to slow. This reflects a range of factors, including slower population growth and less rapid convergence or 'catch-up'. Crucially, to achieve even this 'baseline scenario' of a gradual easing in growth, Asian economies will need to overcome a range of substantial challenges in trade policy; demographic change; capital account and financial market liberalisation; and environmental degradation, including dealing with climate change over the longer term.

The export-led growth model has served Asia's development well. This is not because mercantilism is good economic policy but because the external discipline and technological transfer that comes from trade helps drive productivity growth. Economies of scale in exports can help growth, but the import of world-class institutions and ideas from integrating with the rest of the world is crucial. Singapore, which has been consistently 'open to trade' for decades, is the canonical example of how an economy with few natural endowments can become rich as part of the global trading network.

Trade arrangements must remain inclusive. Both the Regional Comprehensive Economic Partnership [2] (RCEP) and the Trans-Pacific Partnership (TPP) will contribute to promoting a rules-based trading system in the region. The TPP is the economic centrepiece [3] of the US 'rebalance' to Asia, but it doesn't yet include some of the big players in Asia including China, India and Indonesia. RCEP, which is built around ASEAN, may be less ambitious than the TPP in the standards it is trying to achieve, but is potentially more inclusive and potentially harmonises some of the underlying free trade agreement rules. Looking ahead, a challenge for the region will be to ensure that the TPP and RCEP converge over time to a more open regional market.

The gains from trade tend to be the greatest between economies with different factor endowments. Asia's most significant endowment is its labour, but the picture across Asia is very different. Much of Northeast Asia is facing a period of demographic ageing. China, Japan and South Korea are already rapidly ageing societies, which in China's case is a direct consequence of its one-child policy. This will detract from future growth, yet Northeast Asia has been unwilling or unable to adopt more open immigration policies like those that enabled Australia and the United States to partially replace ageing working age populations.

Demographic ageing will be a significant drag on growth in Asia over the coming decades. Annual trend economic growth in Asia this decade is projected to be approximately 6 per cent, falling to just under 3 per cent by the 2030s. As a consequence, those countries with rapidly ageing populations face immense challenges in pension systems, labour markets and health care. By 2050, Japan is expected to have 40 per cent of its population over 60 years [4] of age and 19 million fewer citizens than today, contributing to a pronounced decline in Japan's share of world output.

At the other end of the spectrum, countries like India and Indonesia are facing a demographic bulge. Indonesia, with a population currently increasing by 2.5 million per year, has one of the world's youngest demographic profiles with around 46 per cent of the population younger than 25 years of age in 2010. This could potentially provide a demographic dividend for Indonesia. But if a large cohort of these young people cannot find employment and earn satisfactory income, Indonesia's youth could instead become a source of social and political instability.

To take advantage of favourable demographics, countries like Indonesia need to address relatively low rates of participation in the labour force, particularly among women, and a gap between the supply and demand for skilled labour. The World Economic Forum recently released its 2013 Global Gender Gap Report, which measures the magnitude and scope of gender based inequalities. According to the report, 53 per cent of females are now in the Indonesian labour force, compared to 86 per cent of males. The gap in participation rates is only exacerbated by the disparity in estimated earnings and wages for similar work.

A large gender gap represents a significant under-utilisation of available economic resources. Closing the gender gap, particularly in economic participation, is a second powerful demographic dividend that policymakers should focus on to secure strong medium term growth.

One of the consequences of shifting demographics is pressure on aggregate capital flows. In theory, differing country demands for saving and investment would be mediated through global financial markets to ensure that excess savings flow to countries that can invest them most productively, to the mutual benefit of recipient and source countries alike. But Asia still has many barriers in place that contribute to excess savings flowing into financial instruments like almost zero-return US Treasury bills, rather than productive investments in the region. So perhaps even more significant than regional integration on trade and more risky than managing changing demographic profiles is handling the opening of the region to freer flows of capital without overwhelming what in most Asian economies have been sheltered financial markets.

As an example, the financial opening of China presents huge opportunities but also large risks. Despite China accounting for approximately 15 per cent of world output in purchasing power parity terms, the renminbi accounts for only 2.2 per cent of global foreign exchange turnover. Further, China's stock markets account for 7 per cent of global stock market capitalisation, while China's bond market accounts for 4 per cent of global bonds outstanding. This means financial flows to and from China could grow very fast if it does open up, exposing the domestic financial system to outside market forces in a way that China has not experienced before. Careful consideration should thus be given to what outcomes are desired from regional financial integration. In this context, a cautious, measured and prudent integration may be preferable to 'big bang' style reforms.

Environmental challenges are a significant issue for much of Asia, particularly for China, imposing a real constraint not just on the quality of life of ordinary Chinese but their potential productivity and longevity. The World Bank's China 2030 report [5] estimated that the cost of natural resource degradation and depletion at China's level of development in 2008 was approximately 9 per cent of gross national income, which is more than 10 times the corresponding figures for South Korea and Japan. Over 70 per cent of China's lakes and waterways are seriously polluted and 50 per cent of the Yellow River is biologically dead. As a consequence, an estimated 400 Chinese cities [6] are facing sometimes severe water shortages according to the UN Development Programme and the Chinese Academy of Social Sciences. The Lancet's *Global Burden of Disease Study* [7] estimated that outdoor air pollution contributed to 1.2 million deaths in China in 2010. These are stark environmental challenges, and that is before addressing the long-term challenges of climate change.

Given the economic challenges currently facing other parts of the world, particularly Europe, it may seem strange to focus on the challenges facing Asia. But it is precisely those other parts of the world that offer a powerful lesson for Asia: it is far easier to deal with economic challenges while growth is robust than when it is weak or non-existent.

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[1] the global economy:
http://www.eastasiaforum.org/2012/02/02/can-asia-save-the-sinking-world-economy/

[2] Regional Comprehensive Economic Partnership:
http://www.eastasiaforum.org/2013/05/15/why-the-rcep-matters-for-asia-and-the-world/

[3] TPP is the economic centrepiece:
http://www.eastasiaforum.org/2013/06/08/the-trans-pacific-partnership-as-a-tool-to-contain-china-myth-or-reality/

[4] 40 per cent of its population over 60 years:
http://www.eastasiaforum.org/2013/07/21/drastic-change-in-immigration-policy-off-the-japanese-election-agenda/

[5] China 2030 report:
http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf

[6] an estimated 400 Chinese cities:
http://www.cn.undp.org/content/dam/china/docs/Publications/UNDP-CH_2013 NHDR_EN.pdf

[7] *Global Burden of Disease Study*:
http://www.thelancet.com/themed/global-burden-of-disease