

*ASEAN's Need to Rebalance:
More Regional than Global?*

IWAN J. AZIS AND MARIO B. LAMBERTE

TRANSPACIFIC REBALANCING

*Implications for Trade and
Economic Growth*

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editors

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ASEAN's Need to Rebalance: More Regional than Global?

IWAN J. AZIS AND MARIO B. LAMBERTE

The Association of Southeast Asian Nations (ASEAN) is facing a large current account surplus.¹ To address the problem, member nations need to rebalance their economies not only to be in line with the goal of lowering the current imbalances in the global economy but, more important, for the region's own interests. What ultimately matters is the welfare of each country's population, and as has been observed in many countries, positive achievements in macro indicators, irrespective of the imbalances, do not guarantee a real welfare improvement. The relatively good macroeconomic performance of ASEAN has been accompanied by some undesirable trends, such as worsening income inequality and falling employment elasticity. These are far more serious problems than the imbalances per se, and they are a more important challenge than the current account surplus and excess savings.

The Golden Rule savings rate is the rate of savings which optimizes the level or growth of consumption. In a standard Golden Rule setting—which depicts an inverted U relationship between savings rate and consumption, the position of ASEAN as a group is generally on the right side of the curve, suggesting there is still room for transforming savings into consumption. The policy direction to

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1. The ten ASEAN member nations are Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam.

reach the Golden Rule equilibrium is therefore to increase spending (particularly in investments for most ASEAN countries) and to lower savings. Although exports exceed imports in some member countries and imports exceed exports in others, ASEAN as a group faces a current account surplus, consistent with the region's excess saving. Such a trend emerged particularly after the Asian financial crisis of 1997–98. Although the size of the region's imbalances is too small to make a significant contribution to the global imbalances, it is necessary for ASEAN to rebalance its economies for its own welfare improvement.

Trend in Imbalances and Capital Flows

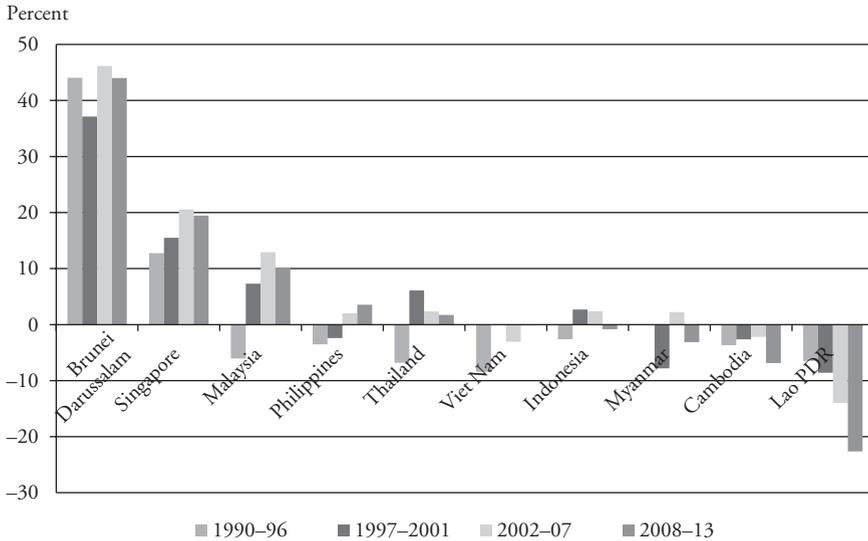
As a group, the ASEAN economies moved from a US\$8.7 billion current account deficit in 1990 to a US\$109.1 billion surplus in 2010—although it has since declined to reach an estimated \$55 billion surplus in 2013. This, however, is dwarfed by the rise in the People's Republic of China's (PRC) current account surplus, which, over the same period, rose from US\$12.0 billion to US\$237.8 billion in 2010, before declining to US\$182.8 billion by end-2013. From 1990 to 2010, the U.S. deficit worsened, moving from US\$79.0 billion to US\$470.9 billion, albeit narrowing since the onset of the global financial crisis (2007–08) and has settled at \$379.3 billion in 2013. Expressed as a percentage of gross domestic product, ASEAN's current account deficit before the Asian financial crisis (1997–98) was around 2 percent, and during the 1997–2001 period, the current account surplus reached 5.7 percent, higher than surpluses in the PRC and the newly industrializing economies. The current account balance slipped slightly after the global financial crisis, but it remained higher than other comparator regions (see figure 1-1 in chapter 1).

Most ASEAN countries underwent a transition from a current account deficit to a surplus, except Cambodia, the Lao People's Democratic Republic (Lao PDR), and Viet Nam, where the current account continues to register a deficit, and Singapore and Brunei Darussalam, where huge surpluses persist. In the post-global financial crisis period (2008–2013), the current account surplus as a percentage of GDP declined in Brunei Darussalam, Malaysia, Singapore, and Thailand; and shifted to a deficit in Indonesia and Myanmar; while the current account deficit worsened in Cambodia and the Lao PDR. Only the Philippines and Viet Nam saw an improvement in the current account balance (figure 8-1).

A similar trend is exhibited in the saving-investment (S-I) gap, with the ASEAN region as a whole generating excess savings after the Asian financial crisis at a rate higher than that of the newly industrializing economies, the PRC, Japan, the eurozone, and the United States. After the collapse of Lehman Brothers, however, the region's excess savings fell and were overtaken by the PRC.

Among ASEAN member countries, Singapore had the largest excess saving. Indonesia, Malaysia, the Philippines, and Thailand had negative S-I gaps before

Figure 8-1. *Current Account Balance as Share of GDP, ASEAN Member Countries, 1990–2013*^a



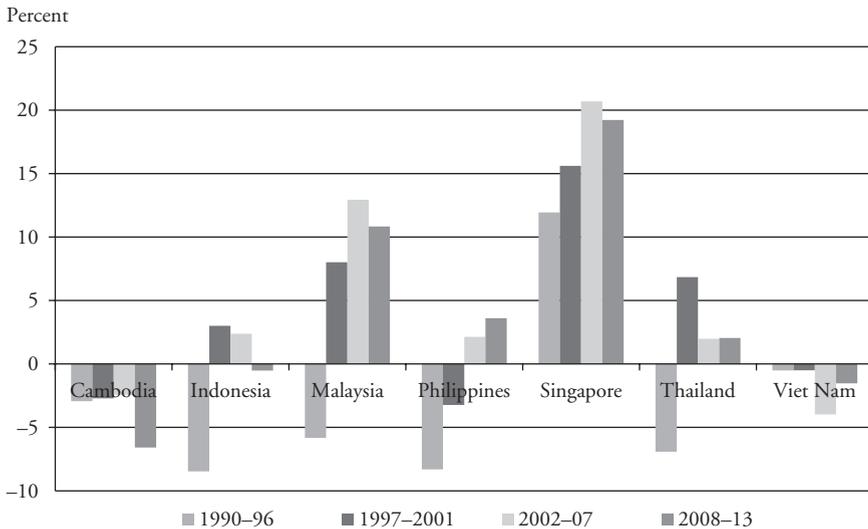
Source: International Monetary Fund (IMF), *World Economic Outlook* database, April 2014 (1990–2013).

a. Data for Myanmar start in 1998. IMF estimate for 2013 is used for Brunei Darussalam, Cambodia, the Lao PDR, Myanmar, and the Philippines.

the Asian financial crisis but improved their positions afterward. The S-I surplus continued during and after the global financial crisis for all ASEAN countries except Indonesia (figure 8-2). Of the four countries that transitioned from a negative S-I gap to a positive S-I gap after the Asian financial crisis, a rise in the saving rate characterizes the Philippines, while a fall in the investment rate is reported for Malaysia, Indonesia, and Thailand (figure 8-3). A prolonged fall in the investment rate has implications for a country's capacity utilization. For example, between 1997 and 2006, the capacity utilization in Thailand remained well below the precrisis level of about 75 percent (Azis 2008; Sussangkarn and Nikomborirak 2011). Because investment has long-term implications for future growth, such a trend may hamper the country's growth prospects. However, the case of Thailand is different since the fall in the investment rate reflects a trend back to normal, given the excessively high rate of investment (overinvestment) before the Asian financial crisis. In fact, Thailand's rate of investment after the Asian financial crisis and before the global crisis exceeded that of all other ASEAN countries with the exception of Viet Nam.

A look at the trade balance confirms the changing patterns within ASEAN since the dramatic events of 1997. From 1993 to 1996, the region was a net importer; after the Asian financial crisis it became a net exporter. Of the five

Figure 8-2. *Saving-Investment Gap as Share of GDP, ASEAN Member Countries, 1990–2013^a*



Source: International Monetary Fund, *World Economic Outlook* database, April 2014 (1990–2013).

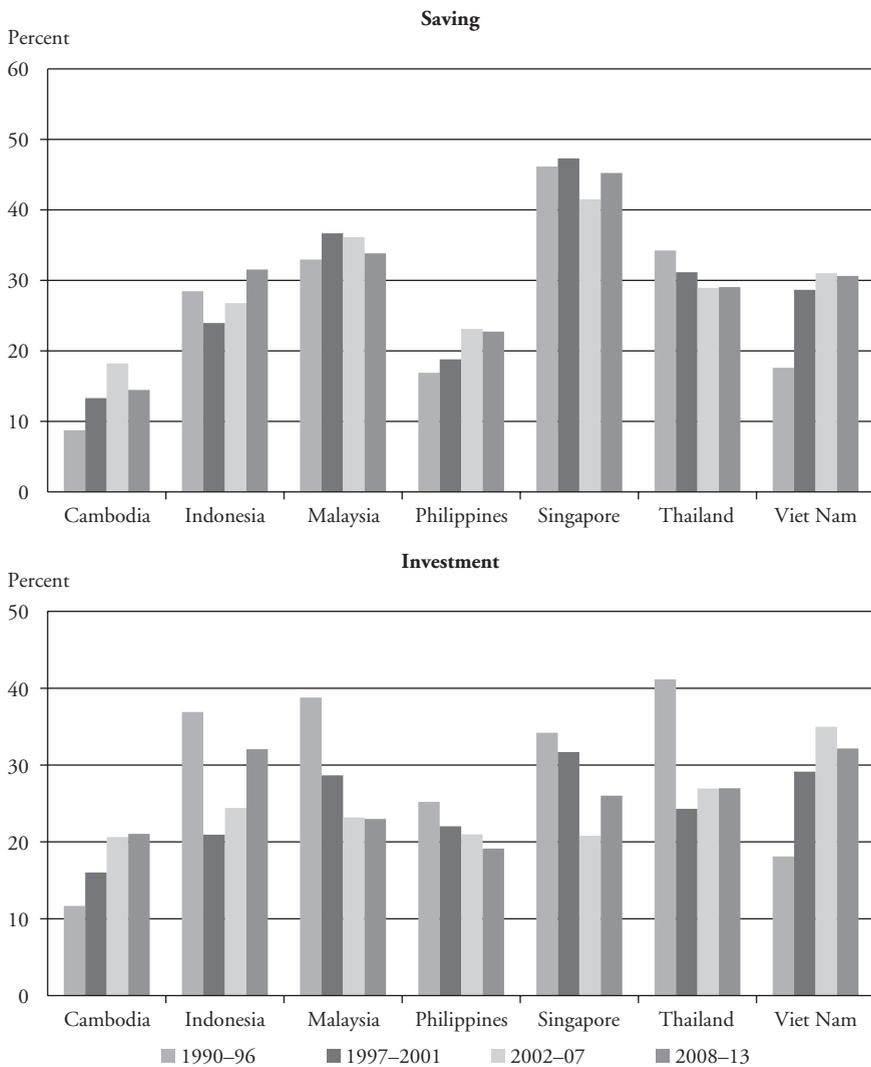
a. No historical data for Brunei Darussalam, the Lao PDR, and Myanmar. Saving-Investment gap is calculated as the difference between gross national saving and total investment, both as percent of GDP.

net exporters, Brunei Darussalam, Indonesia, and Malaysia are oil- and natural resource-exporting countries, while Singapore is a major entrepôt for the region. Cambodia, the Lao PDR, the Philippines, and Viet Nam register trade deficits (figure 8-4).

Aside from the generally high domestic saving rate, the high investment rate in the region has also been spurred by capital inflow and lending booms.² With a relatively low level of capital outflow in the early 1990s, net capital inflow as a percentage of GDP was close to double digits. A considerable portion of the inflows took the form of foreign debt, which was largely short term and unhedged and was used to finance many long-term and unproductive investments. It was precisely this double mismatch that eventually brought down the region into crisis in 1997–98, resulting in massive capital outflows. As figure 8-5 shows, the net capital inflow as a percentage of GDP plunged after the Asian financial crisis, and it did not return to positive levels until 2010, thirteen years after the crisis. It should be noted, however, that capital inflow actually began to recover in 1999 and continued to increase until it reached its peak right before the global financial crisis

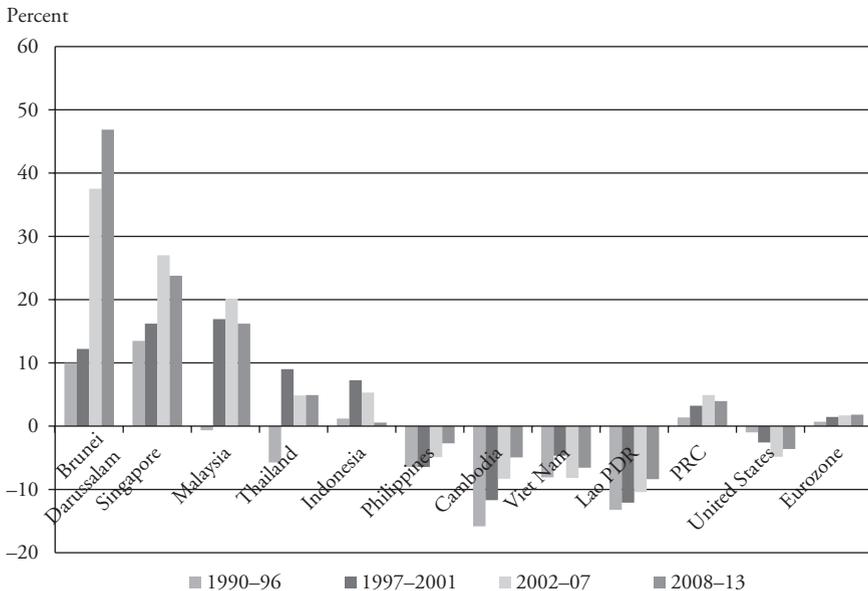
2. Note that ASEAN's investment rate before the Asian financial crisis was at par with the rate in the PRC and higher than in newly industrializing economies.

Figure 8-3. *Saving and Investment Rates as Share of GDP, ASEAN Member Countries, 1990–2013^a*



Source: International Monetary Fund, *World Economic Outlook* database, April 2014 (1990–2013).
 a. No historical data for Brunei Darussalam, the Lao PDR, and Myanmar.

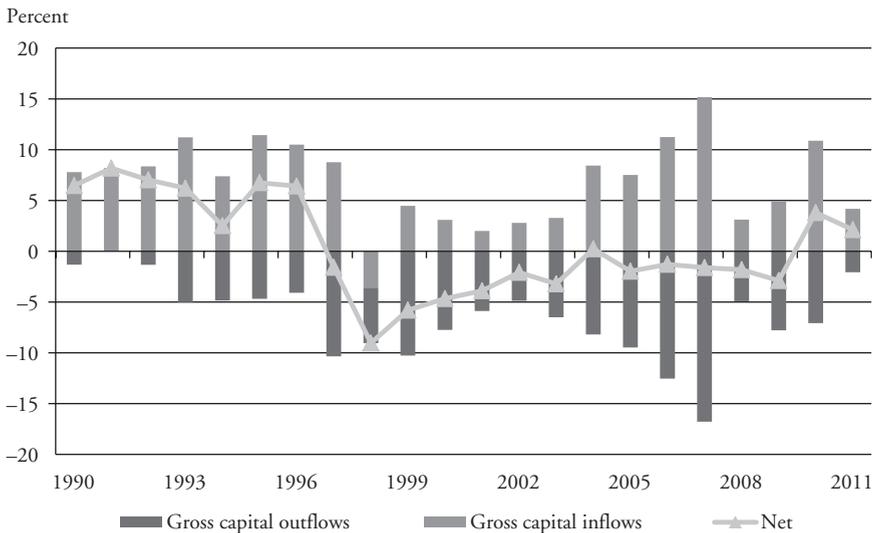
Figure 8-4. Trade Balance as Share of GDP, ASEAN Member Countries, PRC, United States, and Eurozone, 1990–2013^a



Source: World Bank, *World Development Indicators*, 1990–2013.

a. Data for Cambodia start in 1993 and end in 2011; for the United States and Viet Nam data end in 2012. Data for Myanmar are unavailable. Trade balance is computed as the difference between exports and imports of goods and services (as percent of GDP).

Figure 8-5. Financial Capital Flows as Share of GDP, ASEAN, 1990–2011^a



Source: International Monetary Fund, *International Financial Statistics* database and *World Economic Outlook* database, April 2014.

a. Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. Data for Viet Nam start in 1996. Malaysia not included in 2010 and 2011 as inflow-outflow breakdown for portfolio and other investment is unavailable. Singapore and Thailand not included in 2011 as data are unavailable.

began in 2008. Thus it was outflow exceeding inflow that occurred in ASEAN countries during the period.

Foreign direct investment in ASEAN remained strong during the first decade of this century. Early in the decade, other investments made up the greater share of outflow, while foreign direct investment made up the greater share of capital inflow. From about 2005 to 2008, before the Lehman Brothers collapse, capital inflow included large amounts of portfolio investments. The response of the capital markets to the global financial crisis came in the form of net outflow of portfolio investments immediately after the crisis. But beginning in late 2009, with the persistently low interest rate policy and the introduction of quantitative easing (QE) in the United States, the ASEAN countries as a group registered a net inflow of portfolio investments (Azis & Shin 2013).

Along with other emerging market economies, ASEAN has benefited from a windfall effect of the economic slowdown in the United States and Europe. The region has been perceived as the new safe haven. It is important to note, however, that relative to its economic size and situation before the Asian crisis, capital flow in the region remained low, especially in comparison with other economies such as the PRC, the United States, and countries in the eurozone.

Capital flow provide liquidity, but they can also create vulnerability. The current account can deteriorate owing to the resulting stronger currency, and a sudden stop phenomenon can occur caused by bubbles and asymmetric information.³ ASEAN policymakers faced this policy challenge during the period of strong capital inflow following the global financial crisis, prompting many of them to introduce various forms of prudential regulatory measures affecting capital flow and foreign exchange positions (Azis and Shin 2014; Kawai, Lamberte, and Takagi 2012). The lesson of the Asian financial crisis of 1997–98, however, has been instrumental in making the region's financial sector stronger and more resilient to shocks, and this has played an important role in the region's ability to avert crises.

However, when the eurozone crisis emerged in the summer of 2011, fear of another crisis surfaced as a considerable size of capital outflow occurred in some of the region's countries. The huge fluctuations of flow had some adverse effects on the region's economy as financial indicators, including the exchange rate, became volatile. In countries such as Indonesia and Malaysia, where the share of foreign capital in the domestic capital market is large, the effect of the pullout of capital resulting from deleveraging by European banks has been quite significant, exposing these countries' vulnerability to external shock. Fortunately, the impact on the credit market through the banking sector has not been severe, owing to ASEAN's limited exposure to bank credits from the United States and Europe. By mid-2011, the percentage of bank loans from these countries in total domestic

3. The sudden stop phenomenon is characterized by large reversal of capital inflows and current accounts, deep recessions, and collapses in asset prices (Mendoza and Smith 2002).

credit was around 4 and 11 percent, respectively. There has been also an increase of lending to the region by Japanese and Australian banks.

Looking ahead, as far as ASEAN's imbalances and the associated capital flow are concerned, we expect that the size of imbalances will continue to narrow down but the net capital inflow will continue to rise, at least as long as the economic growth and interest rates differential with advanced economies remain low. Although the region is less likely to face a serious liquidity problem, however, it will continue to face the major challenge of how to convert the liquidity into real investments and more productive infrastructure, which the region badly needs. Volatility may also return if the interest rates in the US reverse and the QE policy ends. This link between imbalances and development issues is taken up later when we use flow-of-funds data to analyze the use of the excess savings in ASEAN countries.

Rebalancing and the Role of Exchange Rates

Measured by the ratio of trade to GDP, many ASEAN countries are trade dependent, with ratios greater than 50 percent, while in Singapore, Malaysia, Viet Nam, Thailand, and Cambodia, the ratio exceeds 100 percent. Combined with the low but positive net exports to GDP, the region's trade is clearly heavily import dependent. The evidence from 1997 cannot be overemphasized: during the Asian financial crisis, exports grew only slowly, despite a sharp fall in the exchange rates in many countries during the time. The region's dependence on imports continues to be strong, if not stronger, especially since many of its countries became involved in the growing production network in Asia.

One can also look at the contribution of net exports to GDP growth to evaluate the region's efforts to rebalance. In particular, a small (or large) contribution indicates a large (or small) role of domestic demand. The latter is of course an important component of rebalancing. Looking at the trend, the contribution of net exports to GDP growth in most ASEAN countries is low. It is only substantial in some countries in some years, such as Brunei Darussalam and Singapore in 1996 and 1997, while for the rest of the region, the share of net export falls below 1 percentage point. Taking the case of the ASEAN4 (Indonesia, Malaysia, the Philippines, and Thailand), for example, net exports contributed only 0.5 percentage points toward the 5.1 percent average growth in GDP from 2006 to 2013. Exports alone contributed 2.9 percentage points, higher than the share of consumption (2.6 percentage points), but imports accounted for 2.4 percentage points. This is a sign of import-dependent countries, and the ASEAN4 depends particularly on imports of high-technology capital goods.

The low contribution of net exports to GDP growth indicates that domestic demand has been the primary driver in the region's growth. This is unlikely to change in the current global economic climate, where external demand in

Table 8-1. *Share in Total Exports, 2000, 2010, and 2013*

Percent

| <i>Exporter</i> | <i>Destination</i> | | | | | |
|-----------------|--------------------|------------|--------------|--------------|-----------------------|----------------------|
| | <i>ASEAN</i> | <i>PRC</i> | <i>India</i> | <i>Japan</i> | <i>European Union</i> | <i>United States</i> |
| <i>2000</i> | | | | | | |
| ASEAN | 23.1 | 3.9 | 1.5 | 13.4 | 13.9 | 19.2 |
| PRC | 7.0 | — | 0.6 | 16.7 | 15.4 | 20.9 |
| India | 6.3 | 1.7 | — | 4.3 | 20.7 | 22.0 |
| Japan | 14.3 | 6.3 | 0.5 | — | 15.6 | 29.7 |
| European Union | 1.7 | 1.0 | 0.4 | 1.8 | 57.4 | 9.5 |
| United States | 6.1 | 2.1 | 0.5 | 8.4 | 19.6 | — |
| <i>2010</i> | | | | | | |
| ASEAN | 25.1 | 10.8 | 3.5 | 9.5 | 10.0 | 9.6 |
| PRC | 8.8 | — | 2.6 | 7.7 | 18.2 | 18.0 |
| India | 10.4 | 7.9 | — | 2.2 | 16.4 | 10.7 |
| Japan | 14.7 | 19.4 | 1.2 | — | 10.1 | 15.6 |
| European Union | 1.7 | 3.2 | 0.8 | 1.2 | 53.6 | 6.7 |
| United States | 5.5 | 7.2 | 1.5 | 4.7 | 16.6 | — |
| <i>2013</i> | | | | | | |
| ASEAN | 27.2 | 12.1 | 3.4 | 9.7 | 8.0 | 8.1 |
| PRC | 11.0 | — | 2.2 | 6.8 | 14.1 | 16.7 |
| India | 11.3 | 4.9 | — | 2.2 | 14.5 | 12.5 |
| Japan | 15.5 | 18.1 | 1.2 | — | 9.0 | 18.8 |
| European Union | 1.9 | 3.5 | 0.7 | 1.3 | 51.0 | 6.8 |
| United States | 5.0 | 7.7 | 1.4 | 4.1 | 14.4 | — |

Source: Data from United Nations Commodity Trade (UN Comtrade) database.

major trade partners like the United States, Europe, and Japan is weak. Pursuing an export-led growth strategy as a way out of addressing any external imbalances will be difficult unless alternative markets for exports are found. What is the trend so far?

A look into trade statistics shows that trade among ASEAN countries as well as trade with other emerging markets has been gaining ground. From US\$96.3 billion in 2000, intra-ASEAN trade rose to US\$305.3 billion in 2013. It also rose in terms of share of total trade, from 23.1 percent to 27.2 percent (table 8-1). In terms of ASEAN's exports to its major trading partners, the PRC showed the biggest increase, from 3.9 percent in 2000 to 12.1 percent in 2013; but ASEAN's exports to Japan declined from 13.4 percent to 9.7 percent during the same period. Since 2000, the ASEAN region has been in a trade deficit with the PRC, Japan, and the Republic of Korea and in trade surplus with India, the European Union, and the United States. As of 2013, this trade structure has not changed

Table 8-2. *Intermediate Goods Exports, 2000, 2010, and 2013^a*

Billions of US\$

| <i>Exporter</i> | <i>Destination</i> | | | | | |
|-----------------|--------------------|------------|--------------|--------------|-----------------------|----------------------|
| | <i>ASEAN</i> | <i>PRC</i> | <i>India</i> | <i>Japan</i> | <i>European Union</i> | <i>United States</i> |
| <i>2000</i> | | | | | | |
| ASEAN | 73.4 | 13.4 | 5.0 | 37.3 | 31.5 | 38.2 |
| PRC | 10.5 | — | 1.3 | 14.0 | 12.5 | 13.3 |
| India | 1.9 | 0.6 | — | 1.0 | 3.5 | 4.6 |
| Japan | 46.7 | 22.3 | 1.8 | — | 32.2 | 59.1 |
| European Union | 22.0 | 12.2 | 6.5 | 15.7 | 619.0 | 101.6 |
| United States | 34.1 | 9.6 | 2.2 | 35.9 | 87.0 | — |
| <i>2010</i> | | | | | | |
| ASEAN | 192.0 | 89.7 | 29.5 | 69.9 | 57.2 | 41.3 |
| PRC | 74.9 | — | 26.4 | 48.0 | 101.7 | 78.6 |
| India | 16.1 | 16.8 | — | 4.0 | 20.8 | 12.3 |
| Japan | 79.6 | 99.4 | 6.0 | — | 40.3 | 53.5 |
| European Union | 44.6 | 78.7 | 22.1 | 24.5 | — | 162.3 |
| United States | 46.2 | 64.5 | 13.7 | 32.3 | 105.7 | — |

Source: Data from United Nations Commodity Trade (UN Comtrade) database.

a. Intermediate goods include primary goods, parts and components, and processed goods for industry. Data are based on UN Comtrade's Broad Economic Categories classification.

except with the European Union, which turned into a trade deficit in 2013. If anything, with the slowing down of growth in the United States and Europe, intraregional trade in Asia and trade among emerging markets in general are likely to intensify.

It is important to note, however, that the increase in intraregional trade has mostly been from trade in intermediate goods. Of the US\$120 billion increase in goods exports to the PRC from 2000 to 2013, for example, US\$100 billion (over 80 percent) came from intermediate goods (tables 8-2 and 8-3). The bulk of the increase in exports within ASEAN, and to India, Japan, and the European Union, are also in the form of intermediate goods. In the United States, the main source of increase is final goods until 2012, despite the economic slowdown in the United States. In 2013, however, this has shifted to intermediate goods, given the fact that the share of Asian trade with the United States has declined since the Asian financial crisis, and the fall has intensified since the global financial crisis in 2008.

In 2000 ASEAN trade in intermediate goods was in surplus with the PRC, India, the European Union, and the United States and in deficit with Japan. By 2013, it was in deficit with the PRC, the European Union, and the United States; and turned into a surplus with Japan. In terms of final goods, ASEAN was in

Table 8-3. *Final Goods Exports, 2000 and 2010*^a

Billions of US\$

| <i>Exporter</i> | <i>Destination</i> | | | | | |
|-----------------|--------------------|------------|--------------|--------------|-----------------------|----------------------|
| | <i>ASEAN</i> | <i>PRC</i> | <i>India</i> | <i>Japan</i> | <i>European Union</i> | <i>United States</i> |
| <i>2000</i> | | | | | | |
| ASEAN | 22.0 | 2.6 | 1.3 | 18.2 | 26.2 | 41.3 |
| PRC | 6.8 | — | 0.3 | 27.6 | 25.8 | 38.9 |
| India | 0.7 | 0.2 | — | 0.8 | 5.0 | 4.3 |
| Japan | 18.7 | 7.3 | 0.6 | — | 40.0 | 77.9 |
| European Union | 12.0 | 8.3 | 2.1 | 22.0 | 573.2 | 95.5 |
| United States | 11.8 | 5.7 | 1.3 | 27.5 | 60.2 | — |
| <i>2010</i> | | | | | | |
| ASEAN | 60.1 | 20.3 | 6.6 | 26.7 | 40.3 | 57.0 |
| PRC | 62.9 | — | 14.4 | 71.9 | 185.3 | 205.1 |
| India | 6.1 | 0.6 | — | 0.8 | 15.1 | 11.1 |
| Japan | 28.2 | 42.5 | 2.7 | — | 32.8 | 61.1 |
| European Union | 30.7 | 64.0 | 11.7 | 28.8 | 1,046.6 | 134.5 |
| United States | 15.0 | 20.3 | 4.0 | 21.5 | 73.1 | — |
| <i>2013</i> | | | | | | |
| ASEAN | 71.1 | 21.0 | 5.1 | 26.6 | 34.7 | 46.7 |
| PRC | 110.4 | — | 18.7 | 92.5 | 208.3 | 260.0 |
| India | 10.7 | 1.1 | — | 1.3 | 20.0 | 17.7 |
| Japan | 28.2 | 33.6 | 2.1 | — | 26.3 | 68.5 |
| European Union | 43.3 | 85.5 | 12.0 | 38.5 | 1,150.5 | 170.4 |
| United States | 18.5 | 31.9 | 5.4 | 24.7 | 79.6 | — |

Source: Data from United Nations Commodity Trade (UN Comtrade) database.

a. Final goods include capital goods and consumption goods. Data are based on UN Comtrade's Broad Economic Categories classification.

deficit with the PRC and Japan and in surplus with India, the European Union and the United States in 2000. By 2013, it shifted into a deficit with India and the European Union.⁴ Along with the growing production network and the trend of capital flows, the development of the exchange rate explains the above trade patterns as well as the development of the intraregional trade.

The exchange rate in ASEAN countries in the period following the Asian financial crisis has been more market determined than in the period preceding it. Yet authorities in the trade-dependent region tend to intervene in the foreign exchange market when the movements of the exchange rate affect their countries'

4. The United States remains the largest importer of final goods from ASEAN, though its share in total ASEAN final goods exports slid by half from 2000 to 2013.

export competitiveness. The current account is quite sensitive to the exchange rate.⁵ However, the sensitivity of the region's exchange rate to the movements of major currencies has also changed, shifting away from sole reliance on the U.S. dollar toward reliance on a basket of currencies, especially after the Asian and global financial crises.

The sensitivity of the region's exchange rate to movements of major currencies after 1998 has been discussed in great detail by Azis and Puttanapong (2008). Here, we want to highlight the changing sensitivity in the more recent period by using the global financial crisis as the reference point. Before the crisis hit, the Brunei dollar, the Korean won, the Singapore dollar, the NT dollar, and the Thai baht were more sensitive to the yen, but in the postcrisis period, most ASEAN currencies became more sensitive to the movements of the euro. This is most evident in the case of the Brunei dollar and Singapore dollar and, to a certain extent, the Malaysian ringgit, the Philippine peso, and the Thai baht.

The yuan is also rising as an international medium of exchange.⁶ Given the region's increasing trade with the PRC, the yuan's impact on regional currency has risen, particularly in the postcrisis period. The Cambodian riel, the Myanmar kyat and the Vietnamese dong remain predominantly driven by the U.S. dollar, whereas the Indonesian rupiah, the Malaysian ringgit, the Philippine peso, the Singapore dollar, and the Thai baht have become more sensitive to the yuan since 2007.

This tells us that when looking at the exchange-rate volatility, one needs to take into account the fluctuations of ASEAN exchange rates with respect to a basket of currencies and not just the U.S. dollar. This prompts the question, what basket of currencies should be used? Adopting the concept of a currency basket based on the Asian currency unit to examine the link between exchange-rate stability (both over time and with respect to Asian currency units) and intraregional trade, Azis and Puttanapong (2008) found a negative relationship between the two variables. As the volatility of the exchange rate increases, intraregional exports decline. Although this calculation is based on a large number of economies in Asia, we believe that a similar pattern holds for the ASEAN region as well.⁷ To the extent that a growing intraregional trade is to be pursued in response to the decline in demand from the United States and Europe, and that diversifying the

5. Thorbecke and Komoto (2010) found that the exchange-rate elasticity of Thailand's imports, estimated at 0.38, is much smaller than that of exports, which is estimated to be 0.69. Thus a real depreciation of the baht in response to a balance of payments pressure leads to a significant improvement in the current account balance.

6. Malaysian companies, for example, now have the option to settle their trade transactions with their counterparts in the PRC in yuan.

7. Tang (2011) found the same negative relationship between intraregional exchange-rate volatility and intraregional exports in Asia, where the adverse impact of volatility is pronounced in the subregion of the ASEAN plus the PRC; Hong Kong, China; Japan; the Republic of Korea; and Taipei, China, and especially among intermediate and equipment exports. This impact is further magnified if smaller ASEAN economies are excluded from the subgroup.

direction of trade is an important part of the rebalancing process, maintaining stability of the intraregional exchange rate should be pursued. Whether or not this stability will be secured through formal exchange-rate cooperation depends on how leaders of ASEAN perceive the need for such cooperation.

Uses of Excess Saving and Implications

We have been arguing that for ASEAN, rebalancing is important for the region's own interests, even though its share in the global imbalances is small. For any policy and strategy, ultimately one needs to look at the implications of rebalancing for overall welfare. For this purpose, one needs a better understanding of the complex transmission mechanisms that relate imbalances to welfare indicators. We attempt to do this by looking at the breakdown of the excess saving according to institutions and account types and trace where these excess savings go. This can be done only by using information from the flow-of-funds data.⁸ In particular, we focus on the saving and investment behaviors of three institutions: firms or the nonfinancial corporate sector, financial institutions, and households. Owing to data limitations, however, we look at the case of only three ASEAN countries: the Philippines, Thailand, and Indonesia.

Based on these countries' flow-of-funds data, household saving in the Philippines constitutes the bulk of domestic saving, whereas corporate saving makes up the biggest share of Thailand's total domestic saving.⁹ In the case of Indonesia, saving went up for the household and business sectors but fell for the public and financial sectors in the period following the Asian financial crisis (figure 8-6). In the Philippines, the average household saving rate continued to increase throughout the 1990s to 2011 (the last year for which we have data). Nonfinancial corporations also increased their savings in response to the crisis, whereas financial corporations reduced their saving. Similar to the case of Indonesia, the government sector in the Philippines responded to the crisis by raising government spending, which effectively reduced government saving. In the case of Thailand, households saved less after the Asian financial crisis, and the same is true with the financial and public sectors. Only the nonfinancial corporations increased their savings. Hence in general, the response of household saving to the crisis was mixed, whereas the financial and government sectors responded by reducing their savings.

8. The International Monetary Fund's *International Financial Statistics* presents a number of accounts commonly used in macroeconomic and financial analysis, for example, the balance of payments, the banking sectors, and the government sector. All these accounts can be arranged into a flow-of-funds system, whereby the saving and investment allocation of each sector (institution) in different financial instruments is presented in a fairly detailed way.

9. Similar analysis for Indonesia is not possible because there is no disaggregation of saving between households and businesses.

Figure 8-6. *Savings by Institution as Share of GDP, Indonesia, Philippines, and Thailand (1990–2012)^a*

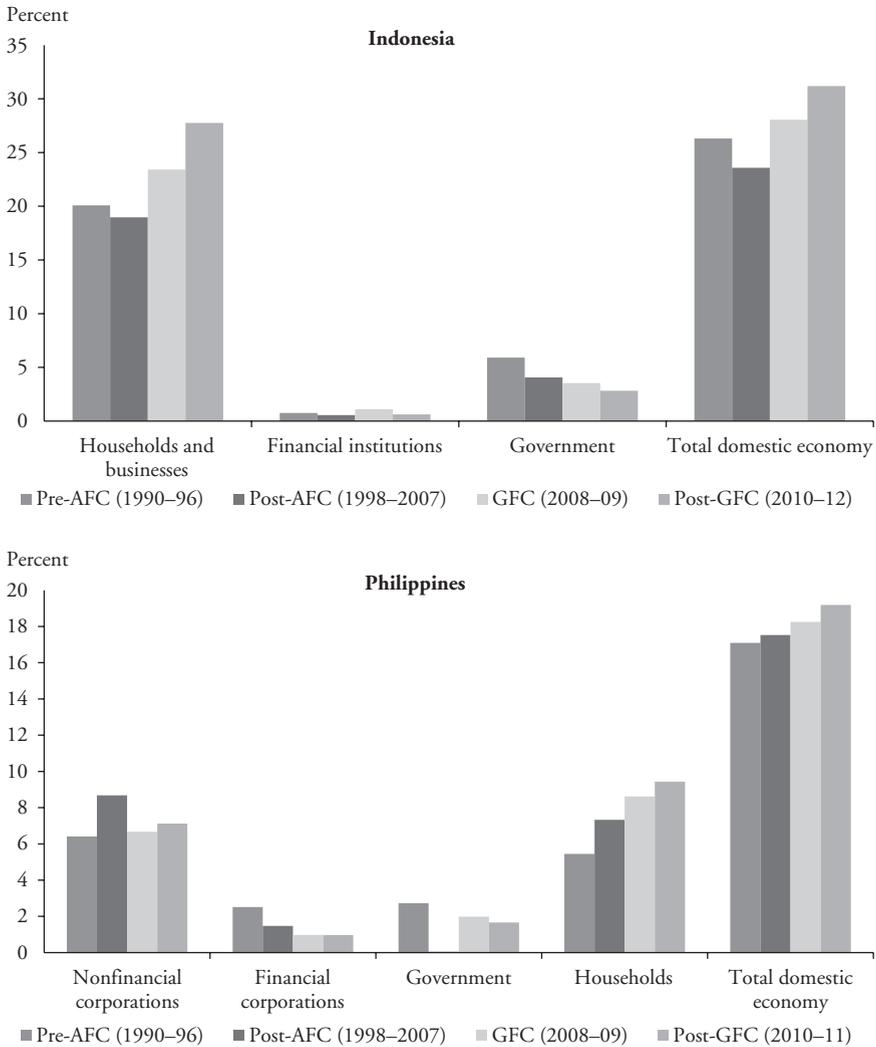
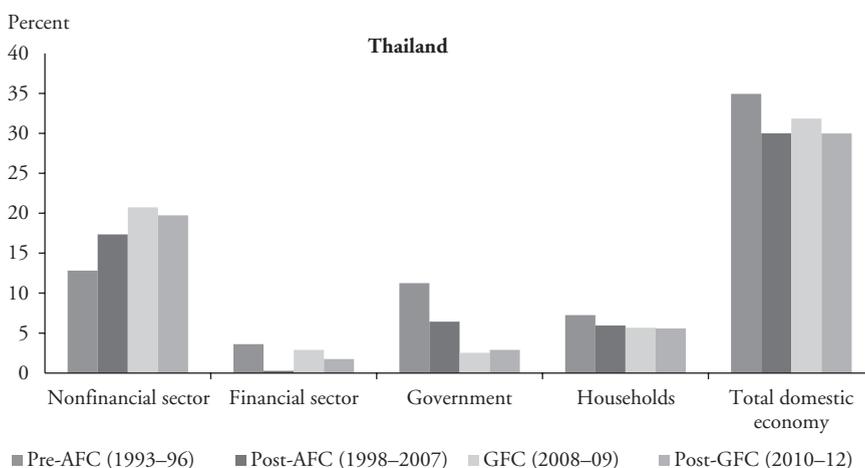


Figure 8-6. (Continued)



Source: Flow of Funds data from Statistics Indonesia, Bankgo Sentral ng Pilipinas, and Bank Negara Malaysia; and International Monetary Fund, *World Economic Outlook* database, April 2014, for GDP data.

a. AFC = Asian financial crisis, GFC = global financial crisis. Financial institutions consist of the central bank and domestic money banks. Pre-AFC pertains to 1996 data only for government and total domestic economy.

ASEAN corporate savings are relatively high for a number of reasons, one of which is the economic and financial structure that lowers the costs of inputs and permits oligopolistic profit. Inaccessibility of funds and various forms of uncertainty drive firms to rely more on retained earnings for their current and future investments and thereby increase their savings. Household saving generally responds more to demographic factors.¹⁰ However, what is more important for our analysis is where the excess savings go.

Philippines

In the Philippines, excess saving in the financial sector fell from an annual average of Php693 billion in 1995-96 to Php504 billion in 2002-07, before making a strong recovery following the global financial crisis, as the sector's total resources reached Php1,605 billion by 2010-11. This was financed mainly by currency and deposits. Shares, other equity, and claims constituted the second major source of

10. The age of household head and the retirement age can determine the saving rate (Bersales and Mapa 2006; Prasad 2012). Horioka and Terada-Hagiwara (2010) argue that generally demographic transition matters in developing Asia, where the aging of population will play an important role in determining future domestic saving. For further explanations on the region's excess savings, see Azis and Yarcia (2014).

excess savings before the Asian financial crisis but were subsequently replaced by securities, other shares, and other accounts payable during and after the global financial crisis. Before the Asian financial crisis, the financial sector used its excess saving mainly to issue loans, but by 2008–09 it was used primarily to issue securities and cash, although loans and other accounts receivable also received a fair share. Excess saving in the Philippines' corporate (nonfinancial) sector fell from Php415 billion in 1995–96 to Php258 billion in 2002–07 and then rose back up to Php513 billion in 2008–09. Before the Asian crisis, the Philippines' corporate sector sourced most of its funds from securities and other shares. Its major source of financing was other accounts payable during the period 2002–09, followed by shares, other equity, and claims between 2002 and 2007 and by loans and securities, other than shares, during and after the global financial crisis. Before the Asian financial crisis, the corporate sector divided its funds almost equally among five financial assets, but by 2002–07 this was largely spent on other accounts receivable and currencies, and by 2008–09 on other accounts receivable, loans, and shares other than equity and claims. And by 2010–11 the corporate sector kept most of its funds as currencies while loans turned negative.

In the household sector, loans were the major source of funds. Accounts payable also provided funds for households before the Asian crisis, although this was reduced by some unclassified items. We also observe that households in the Philippines had a high level of investment in securities before the crisis, which were greatly reduced after the Asian financial crisis had passed; but later on increased after the global crisis. In the latter period, the sector instead increased investments on some unclassified items and insurance technical reserves.

Thailand

The excess saving in Thailand's financial corporation went down from an annual average of B934 billion in 1993–96 to B572 billion in 2002–07 before rising again to B947 billion in 2008–09 and to B2,771 billion in 2010–12. This was financed mainly by currency and deposits, while loans and securities were the other major sources of financing before the Asian financial crisis. However, other accounts payable, insurance technical reserves, and shares and other equity became the other major sources of financing immediately after the crisis, while securities had a negative contribution to financial assets.

The financial sector invested its financial assets mainly in loans and securities, with the latter having the biggest share in the period before the global financial crisis. After the global financial crisis, the financial sector divested itself of its currency and deposits and increased its loan issuances.

Financial assets of the Bank of Thailand before the Asian crisis came almost solely from currency and deposits, but in 2002–07 securities became the biggest source of financing, while loans dominated in 2008–09. Post-GFC, securities returned as the biggest source of financing, while loans turned to negative.

The bank used this excess saving on monetary gold and special drawing rights (SDRs), cutting back its loan issuances in 2008–09. Monetary gold and SDRs, however, declined sharply in 2010–12 while loans increased.¹¹

Excess saving in the business sector dropped from B1.2 trillion in 1993–96 and settled at an average of around B680 billion from 2002–09, and increased further to B1.4 trillion in 2010–12. Most of the excess saving before the crisis in Asia had been funded by loans and some shares and securities. Businesses used it to lend, to buy securities, and to hold cash. In the period between the Asian and global financial crises, their financial assets had been funded by shares, equity, and securities. Investment on other accounts payable rose after the Asian financial crisis, along with higher levels of loans, securities, and shares. The country's business sector kept a significant share of cash throughout the period, presumably as a precautionary measure. The extent to which the financial and business sector in Thailand has been active in the securities market is also demonstrated by the fact that in addition to using currency and deposits they are holding, the country's financial sector has been drawing from shares and other equity sources, as well as insurance reserves, to finance lending and to purchase securities and shares.

Thai households received some funds from securities during the same period. Similar to the case of the Philippines, households in Thailand also reduced their saving after the Asian crisis, albeit not by as much. The saving rate picked up during the global financial crisis. The household sectors in both countries maintained a substantial amount of currency on hand, although Thai households were more conservative, keeping a greater part of their excess saving in the form of currency in 2008–12. They also had a relatively higher investment in shares and other equity. In short, as was the case in the Philippines, funding for Thai households came largely from loans, presumably from the banking sector, and a substantial portion of it was stored in the form of currency and also invested in securities and shares and other equity.

Indonesia

Excess saving of monetary authorities in Indonesia rose sharply from Rp4.0 trillion in 1996 to Rp68.8 trillion in 2009–12, primarily driven by the increase in interbank claims, which they used mainly in acquiring foreign exchange reserves and other foreign claims. Bank assets, on the other hand, were mostly funded by currency and deposits, except in 2002–07, when miscellaneous accounts became a substantial source of funding and negative equity significantly pulled down net financing. Before the Asian financial crisis, banks used their assets mainly in lending activities, but afterward, they also used them to pay off interbank claims.

11. Sussangkarn and Nikomborirak (2011) note that gross official reserves rose sharply from US\$39 billion at the end of 1996 to US\$143 billion at the end of 2009.

Securities made a negative contribution to bank investments in 2002–07, but turned positive during 2009–12.

To summarize, though the saving and investment behaviors of the corporate, financial, and business sectors from the three countries differ, the following common trend stands out:

—Currency and deposits remain the biggest source of financing in the financial sector, but there is an increasing dependence on accounts payable and securities.

—Despite having large saving, the region's corporate sector tends to borrow to finance further lending activities.

—Investment in securities has been on the rise.

In the case of households, their excess savings in recent years have been spent mostly on lending, but they are also increasingly investing in financial assets such as securities, shares, and equity.

Investing a considerable amount of saving in financial assets and investing the excess liquidity in much-needed productive infrastructure clearly have different impacts on a region's economy. Aside from the macroeconomic repercussions, we argue that the region's excess savings also produce a negative effect on the region's socioeconomic conditions.

Although the financial sector in ASEAN countries remains underdeveloped compared with that of industrial countries and other emerging economies, it has been developing relatively quickly after being substantially liberalized. This has contributed to a growing middle class that has access to the growing financial sector. This segment of society is able to accumulate wealth through consuming and saving more by riding on the continued growth of the financial sector, but the bulk of the population has limited or no access to financial services and cannot enjoy the gains of financial development. As a result, income inequality widens. This situation is worse when analyzed in a dynamic context, because the lack of investment in the real sector curtails the capacity of the economy to generate employment, hence aggravating the problem of income disparity over time.

Indeed, income inequality across many countries has worsened, not only in the ASEAN region but also in many economies across Asia. Declining capacity of the economy to generate employment (falling employment elasticity) is also observed across countries, despite the fast growth rate of the financial sector, which is even exceeding the GDP growth rate.

To the extent that the effect of massive capital inflows on the domestic economy has not always been positive, owing to the negative repercussions on the exchange rate and other vulnerabilities, our analysis reinforces the following argument: from the perspective of the saving-investment gap, the region's efforts to rebalance are necessary not primarily to help resolve the problems of global imbalances but to improve overall development in the region.

Concluding Remarks and Policy Implications

ASEAN's imbalances in the current account and saving-investment rates are too small to have a meaningful effect on the global imbalances. The collective current account surplus and excess saving are declining, growth has been driven by domestic demand, and trade among ASEAN countries as well as with other Asian and emerging markets is gaining ground, compensating for the slow demand from the United States and Europe. The resulting net capital flows, however, have been strong owing to the region's healthy growth prospect, open capital account, and low interest rates in advanced economies. We are inclined to believe that the ASEAN imbalances will continue to shrink, while portfolio inflows will continue to increase, albeit they will be more volatile. FDI flows are likely to go up, especially from other Asian countries such as the PRC, Japan, and the Republic of Korea. The region will be less likely to face a serious liquidity problem in the years to come.

The major challenge, though, is to convert the liquidity into productive investment and infrastructure, which the region badly needs. This will be necessary to sustain growth as well as to help improve the overall welfare by lowering income inequality and strengthening the capacity to generate employment. It is in this context that rebalancing should be seen as an important policy to pursue for ASEAN's own interest. For this to happen, the overall business climate ought to be improved to alter the incentive structure. The service sector, in particular, needs to be exposed to greater competition by opening up the sector to foreign players and by formulating and enforcing competition law.

Furthermore, regional liberalization of trade in final goods will open up vast market opportunities for member countries. Thus it is important for ASEAN to exert greater effort to achieve the aims of transforming the region into a highly competitive, single market and production base as detailed in the ASEAN Economic Community Blueprint (ASEAN Secretariat 2008). To enhance the intra-regional trade and cross-border capital flows, the region needs to strengthen harmonization, standardization, and technical infrastructure such as trade facilitation, customs clearance, and payments and settlement systems. In addition, it needs to remove other remaining impediments that reflect behind-the-border obstacles, as well as to ensure intraregional exchange-rate stability.

The supply-side factors are no less important. The quality of human resources holds the key to improving product quality for both intermediate and final goods, which is critical for developing a global-production value chain and for maximizing the benefits of regional free trade agreements. High product standards can also help to differentiate domestic products from lower-quality imports, providing domestic companies with an opportunity to maintain their domestic market share while capturing a global market share.

By strengthening these demand- and supply-side factors, the role of domestic demand in driving ASEAN growth will be further enhanced, while intraregional

trade and the production network with other Asian countries are likely to be strengthened as goods and services being traded are higher in both value and quality. Stimulating domestic demand and intraregional trade that will ensure welfare improvement is the essence of rebalancing for the ASEAN region.

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*The Asian Development Bank recognizes China by the name People's Republic of China.