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Introduction: Toward a New Long-Term Growth Model for Asia

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There is a false sense of security among many Asian economic policymakers regarding their own and the region's growth prospects. This is to some degree understandable, because Asia overall has continued to enjoy high rates of economic growth since the global financial crisis in 2008–10. In fact, the region has become the main driver of global economic activity, accounting for some two-thirds of global growth. In contrast, economic recovery from the crisis in advanced economies outside Asia has entailed a decade of mostly subpar growth and persistent labor market slack, despite sustained loose monetary policy. This experience has motivated the revival of Alvin Hansen's secular stagnation hypothesis by Lawrence Summers (2013) and others, as well as more structural explanations (notably Gordon 2016), for the lasting downshift in trend productivity growth at the technological frontier. Given the continued contrast in growth rates and ample room for most countries to continue catch-up growth, the secular stagnation hypothesis usually is not associated with Asia, except for Japan with its aging population and high per capita income.

Nevertheless, the danger from secular stagnation to Asian economies of an extended and difficult-to-exit growth slowdown, as has arguably beset

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the G-7 economies, is real and approaching. This threat is not just the result of the difficulties experienced through trade and financial linkages with the advanced economies, their low growth and inflation, and the resultant very low interest rates. When considering the broader macroeconomic picture, several of the symptoms associated with secular stagnation are already prominent in several Asian economies. Growth, for example, while strong in cross-national comparison, has remained below the rates recorded before the global financial crisis in Asia as well as the West. More troublingly, average productivity growth has declined relative to precrisis rates in many countries in the region, as it has elsewhere. Rapid population aging and lower population growth are already shaping the demographics in many countries of the region; turning points toward rising dependency ratios and shrinking workforces will soon be a reality well beyond Japan. Inflation has been below target for an unusually long period in several countries in the region, while interest rates, nominal and real, have declined to very low levels in many economies, even in countries with still high real growth. Therefore, risks of nominal policy interest rates reaching the effective lower bound after a large shock and related problems of macroeconomic adjustment might be likely rather than tail risks.

For this reason, the Asia and Pacific Department of the International Monetary Fund (IMF) and the Peterson Institute for International Economics launched a joint research project to explore the relevance of the secular stagnation hypothesis for Asia and the policy implications. The papers published in this volume were presented at a conference organized jointly with the Korean Ministry of Strategy and Finance and the Bank of Korea in September 2017. The project combined research organized by economic themes and by countries. For the country case studies, the project distinguishes three groups of countries in Asia. The first category consists of Japan, a country in which symptoms of secular stagnation have already been present for some years. The second group includes Korea and other middle-income economies in which the reversal of the demographic dividend is imminent and which are already exhibiting some of the features of secular stagnation but not yet to an extent that would support wide recognition of the problem. In these transitionally threatened economies, fundamentals point to increasing risks of stagnation over the next few years but also some advance warning, meaning time to prepare and change policy. Finally, in many of the emerging and lower-income economies in Asia, the exposure to secular stagnation is primarily through international spillovers to date, but these spillovers are likely to last and to constrain growth and policy in an ongoing way.

Summary of Contributions to This Volume

In chapter 2 Joel Mokyr reminds us that secular stagnation was the rule rather than the exception until 1800. Negative demographic feedbacks, predatory rent-seeking institutions, and limitations on the accumulation of human knowledge made growth imperceptibly slow. Today, the economy is facing headwinds, but progress made in a year no longer melts away subsequently. A first headwind is the risk of growing old before becoming rich in parts of Asia. In chapter 3, Serkan Arslanalp et al. find that rapid aging is now set to create a demographic tax on growth that could subtract ½ to 1 percentage point from annual GDP growth over the next three decades in countries such as China and Japan. A second headwind is the slowdown in R&D productivity growth. Based on the experience of Japan, South Korea, and Taiwan, Lee Branstetter and Namho Kwon argue in chapter 4 that these countries' innovation systems have become a drag on productivity growth because of their pro-incremental and pro-incumbent biases.

Headwinds for the region are not only domestic. In fact, the concomitance of low growth and inflation in a large set of countries at different stages of development suggests a role for contagion. In chapter 5 Olivier Jeanne explores several possible channels of contagion but finds that post-crisis total factor productivity growth is surprisingly orthogonal to most measures of international economic integration. There is, however, evidence that the transmission of secular stagnation to emerging economies has been delayed, with rebalancing in current accounts happening against the backdrop of domestic credit booms.

When economists want to draw lessons from recent historical experience, they study Japan's two lost decades. The problem, writes Adam S. Posen in chapter 6, is that Japan had only one lost decade, not two. Since 2002, its per capita GDP growth and productivity growth have been decent. And its difficulty in generating inflation is not Japan specific. Explaining the empirical puzzles of the 21st century requires a more general rethinking of our understanding of macroeconomics, where factors other than just expectations can influence inflation. In chapter 7 Kyoji Fukao illustrates the importance of changes in workforce composition such as the increase in nonregular employment in the Japanese labor market to explain both inflation and productivity developments.

In chapter 8 Dongchul Cho and Kyooho Kwon observe that developments in South Korea seem to mimic those of Japan with a 20-year lag. They project that potential output growth will fall further, given demographic trends and capital deepening, and call for bold structural reforms to raise TFP and to lower the risks of Korea experiencing the deflation pressures Japan has faced. In China, writes Ma Jun in chapter 9, the slow down in economic growth will be driven by demographics, environmental costs, and changing consumer preferences. Altogether, these factors are expected to slow annual growth by 2 percentage points in the coming decade. While ongoing technological innovations and reforms can partially cushion this deceleration, a further slowdown in growth appears inevitable over the medium term. This trend, together with the growing financial risks due to a high macro leverage ratio, calls urgently for a new macroeconomic management framework that is less growth-centric but focuses more on macro and financial stability.

In chapter 10 Prachi Mishra and Siddhartha Nath write that India's merchandise exports have undergone a quiet revolution with new-age engineering, electronic, and pharmaceutical exports gradually replacing India's traditional exports of leather, textiles, gems, and jewelry. But structural rigidities are still holding back diversification and thus make India vulnerable to global risks. The contrast with Indonesia is striking as it has progressively turned inward. This retrenchment, writes Mitali Das in chapter 11, has insulated Indonesia against the vicissitudes of global developments but at the price of a reduction in productivity-enhancing spillovers. In fact, potential output growth has declined in recent years despite strong demographic tailwinds and steady capital accumulation.

In reviewing the past 25 years of global imbalances, Maurice Obstfeld emphasizes in chapter 12 that excessive imbalances declined after the global financial crisis but are still present. Monocausal explanations for excessive global imbalances rarely apply. Instead, such imbalances usually reflect global forces and multiple distortions in many countries, notably diverse financial sector distortions. Notwithstanding the need for collective action, excess surplus countries still face little that would force them to adjust—outside of the threat of protectionist responses—whereas most deficit countries face the risk that lenders will withdraw. Reducing global imbalances should be a collective effort based on a shared appreciation of the roles individual countries need to play.

In chapter 13 Joseph Gagnon and Philip Turner study the implications of a slowdown in growth for monetary policy. A first implication is the importance of keeping core inflation at or above 2 percent. A second implication is that central banks should not shy away from using balance sheet policies. The view that central banks should stick to setting the overnight rate is unhistorical. If anything, balance sheet policies have more potential today than before given the increased size and importance of domestic Asian bond markets in influencing financial conditions. Rania Al-Mashat et al. make the case in chapter 14 for a risk avoidance approach to monetary policy that heavily penalizes large deviations of the target variables (output and inflation) from their preferred values. In a world of secular stagnation where the probability of entering low-inflation traps is higher, a prudent approach to a recessionary shock from a weak starting point is to take a more aggressive stance than usual. The authors of both chapters 13 and 14 argue that financial stability worries do not in general justify keeping the policy rate higher than warranted by macroeconomic conditions.

In chapter 15 Ana Corbacho et al. analyze the implications of subdued growth and rapid aging for fiscal sustainability and discuss options for fiscal policy to support growth potential. Left unchecked, age-related spending would be an overwhelming force driving up public debt in many countries in the region. A reversal of the favorable interest rate–growth differential that helped keep debt ratios in check in recent times would put debt dynamics at even further risk. This being said, model-based simulations show that many countries in Asia have scope to anchor drivers of growth potential by redirecting budgets to infrastructure, human capital, and R&D.

In chapter 16 Caroline Freund studies the relationship between global imbalances and trade. In the 1990s and early 2000s, increased borrowing from abroad allowed high-demand countries to import more than if they were constrained by their exports, stimulating trade growth. The relationship between trade imbalances and trade flows is especially strong for the United States and East Asia. In recent years, moderating imbalances have been associated with slowing trade growth, especially in the United States and East Asia. Going forward, even as global growth picks up, the new weaker relationship between trade and income may remain in place if global imbalances remain constrained.

In chapter 17 Subir Gokarn writes that the "Asian model" as we have come to recognize it is obsolete. Countries in the region have to recognize this and reorient their strategies for sustaining growth. Changing demand patterns in the advanced economies clearly indicate that these markets will become less and less important sources of demand for Asian products. But the key element of the "old" Asian model—the promotion of efficiency and competitiveness up the supply chain—provides the basis for a "new" model where the focus would be on meeting the needs of the growing markets in the region itself. Whether the "new" Asian model is a move toward mediocrity or renewed excellence depends on how effectively the countries in the region recognize and act on the opportunities and respond to the challenges.

Agreeing on the Need for a Forward-Looking Policy

There was broad agreement among conference participants that forward-looking adaptation of policy frameworks is needed to sustain growth in Asia for the medium term. So, even though the conference took place against the backdrop of an improved global outlook compared with the time when the research program was conceived, and the global expansion has continued in the months since, the best tradition of Asian economic policymaking to plan with a long time horizon was affirmed. In particular, the profound challenges from the impending demographic transitions in many Asian economies to rapidly aging populations and lower population growth resonated with participants. The demographic dividend has already started to reverse in many countries in the region, including in China, the engine of growth for the region and the world in the past two decades.

Recent experience in Japan and in Western Europe suggests that aging and lower population growth could reduce growth in per capita incomes and productivity, not just aggregate growth in output and investment. There are strong hypotheses suggested by Japan and Western Europe as well that there might even be negative feedback loops from demographics to technical progress: Lower rates of innovation in the frontier economies and eroding intellectual property rights could interact with aging to slow diffusion of progress within and across countries (Posen 2012); aging could change the structure of household demand toward less capital-intensive services, providing yet another reason for lower investment, thus limiting positive productivity spillovers; structural reforms are needed to strengthen domestic innovation capacity and productivity in service sectors.

The reversal of the demographic dividend would therefore likely result in more than just persistent even if small declines in aggregate demand. So, even absent macroeconomic imbalances, which arguably made the problems more acute in the G-7 economies, Asian policymakers are right to be concerned about the negative impact of the demographic transition on productivity and medium-term growth. The conference participants emphasized that the transition reinforced the need to change the Asian growth paradigm.

Similarly, the international dimension of the challenges facing Asia for sustaining growth go well beyond the cyclical and direct immediate spillovers from insufficient demand and low growth in advanced economies since the global financial crisis. After a decade of very low growth since the global financial crisis, external demand growth from advanced economies outside Asia is unlikely to return to providing the momentum it had before the global financial crisis. An implication is that manufacturing exports are unlikely to be the motor for growth and development that they were over the past few decades. This development intensifies the phenomenon of "premature deindustrialization" identified by Dani Rodrik (2016). Moreover, the trade tensions taking shape between the United States and many of its largest trading partners in Asia and elsewhere are further eroding the room for export-led growth. Even if these conflicts are resolved or at least stepped down, legitimate doubts about the wisdom of relying on access to advanced economies' markets for large-scale exports will remain. If so, the highly successful Asian growth model of the past few decades is unlikely to remain the blueprint for future growth and convergence in emerging and developing economies in the region.

A third major theme is that macroeconomic policy frameworks in Asia had to be prepared for the possibility of policy rates hitting the lower bound on nominal interest rates after contractionary or deflationary shocks, even if the source of shock or of the low level of interest rates going in was external, and the domestic macroeconomy appeared well-balanced. This means that in the case of a downturn, there is a need for determined aggressive macroeconomic policy responses, given higher risks of protracted adjustment to shocks. Many conference participants were concerned about the risks to financial stability from such policy responses, noting the possible limited effectiveness of prudential policies to offset those side effects.

This scenario is relevant for Asian policymakers, even if not induced by their own economies' actions. Admittedly, there is no easy answer to the tradeoff between demand stimulus and financial stability, though to some degree the risks from financial side effects can be exaggerated during recovery phases. As argued in Summers (2013), such a situation presents the risk not only of more severe downturns but also of getting stuck in a trap of extended need for still lower rates and substantial fiscal stimulus. Just as for their counterparts in the advanced economies, the risk of getting trapped in secular stagnation with only monetary policy to get the economy out is that it will be ineffective as well as distortionary. Thus, it is important that Asian policymakers get ahead of the curve to build fiscal space ahead of such situations and be prepared to use that fiscal space in productive as well as stimulative ways (such as ready infrastructure projects). The failure of US and European policymakers to do so, and apparent benefits with hindsight of such aggressive fiscal action in Japan, is an object lesson.

Asia remains the most vibrant, the most diverse, and the largest economic region of the world economy. Its citizens' economic well-being remains largely in the hands of their own markets and governments. The economic policymakers of the region could take solace from their economies' relatively good performance compared with their counterparts in other parts of the world, even as their growth rates of income and productivity have slowed. They could even blame those slowdowns on the spillovers from the advanced economies' own crises and policy mistakes. That, however, would be a mistaken approach. Significant unfavorable demographic trends, a less open and slower-growing rest of the world to trade with, and ongoing risks of falling into stagnation from persistently low levels of nominal interest rates and growth in the major economies combine to demand a new growth model for Asia.

The broad outlines of such a model for sustaining growth are applicable for all Asian economies and should be put in place without undue delay.

- Undertake a structural reform agenda—including making better use of the female labor force, promoting innovation and technological diffusion internally, and encouraging productivity gains in service sectors—that can robustly offset some of the predictable forces of demographic change.
- Pursue international economic integration within the Asian region, and openness to South-South trade and investment more broadly, to maintain the benefits for productivity and steady demand that go with export competition.
- Prepare macroeconomic frameworks to be ready to undertake aggressive stabilizing stimulus when needed in the likely-to-persist global low interest rate environment. This preparation requires a recognition both of the risks of excessively anti-inflationary monetary policy and of the need to build up fiscal space in advance of problems.

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