

ADB Working Paper Series on Regional Economic Integration



Asia's Contribution to Global Rebalancing

Charles Adams, Hoe Yun Jeong, and Cyn-Young Park
No. 58 | September 2010



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The paper was prepared initially to provide support for the Presidential Committee for the G-20 Summit, Republic of Korea. We thank Jong-Wha Lee, Srinivasa Madhur, Peter Morgan for their valuable insights and comments. Thanks also go to Rogelio Mercado and Theresa Robles for their excellent research assistance. All remaining errors are ours.

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September 2010
Publication Stock No.

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Abstract

Developing Asia remains at the core of global payment imbalances. While the geographical concentration of current account imbalances is rather significant, with the People's Republic of China accounting for the lion's share of the region's current account surplus, how Asia contributes to global rebalancing also depends critically on the NIEs and larger ASEAN economies. Given the region's huge diversity, the necessary national macroeconomic and structural policies will vary significantly across Asia's emerging economies. Whereas near-term rebalancing efforts will be driven primarily by macroeconomic and exchange rate policies, medium- to long-term measures will involve policies and structural reforms directed to boost domestic and regional demand as a source of economic growth. In this paper, we argue that regional rebalancing will depend critically on the adoption of deeper and more comprehensive structural reforms and further trade liberalization that promote domestic spending—thus reducing Asia's high dependence on extra regional demand. Priority policies should include infrastructure spending, competition, trade, financial development, investment, immigration, and other social policies to reduce national savings.

Keywords: global imbalances, Asia, rebalancing

JEL Classification: F42, F43, E61

1. Introduction

Developing Asia remains at the core of global payment imbalances.

Globally, its net current account surplus accounted for more than 30% of the world current account balance in 2008, while averaging about 50% of the global GDP during the past decade (Figure 1). As a result, the region also accumulated sizable—and in some cases excessive—foreign exchange reserves since the late 1990s.¹ The bulk of the remaining current account surpluses were in the Middle East and the Commonwealth of Independent States (CIS). On the other side of the ledger, the United States continues to be home for the lion's share of global current account deficits.²

The geographical concentration of current account imbalances is rather significant in developing Asia, with the People's Republic of China accounting for the lion's share of the region's current account surplus.

The most significant surpluses have been in the People's Republic of China (PRC), with its current account surpluses accounting for 61.2% of Asia's 2008 total. Excluding Japan, where surpluses have been large but stable, the PRC's share of the region's current account surplus is nearly 80%. The PRC's contribution to the region's reserve accumulation has been even larger—its reserves now account for over 50% of emerging Asia's total. Then follow the four newly industrializing economies (NIEs) of Hong Kong, China; Republic of Korea (Korea); Taipei, China; and Singapore, and other large Association of Southeast Asian Nations (ASEAN) economies.³ In contrast several emerging Asian economies—including India and Viet Nam—have been running current account deficits, while many others have been relatively balanced.

While how emerging Asia contributes to global rebalancing depends critically on the PRC, the NIEs and larger ASEAN economies will also have to contribute depending on the size of their surpluses.

The region's economic diversity requires a wide-ranging set of policy measures to tackle the problem of domestic, regional, and global imbalances. The PRC needs to play a critical role in the region's contribution to global rebalancing—given the increasing size of its economy and external imbalances.⁴ But, the NIEs and larger ASEAN economies will also have to contribute depending on the size of their surpluses. Many of the region's smaller economies also face country-specific external imbalances, even if their

¹ Gross reserves can be increased either through current account surpluses ("own" reserves) or through financial and capital account surpluses ("borrowed" reserves).

² Given international current account asymmetry, surpluses and deficits across economies do not add to zero.

³ ASEAN-4 comprises Indonesia, Malaysia, Philippines, and Thailand.

⁴ See ADB 2009.

contribution to the overall global imbalance remains negligible.⁵ Understanding these different policy requirements is essential to achieve more harmonious global, regional, and domestic rebalancing.

Ultimately, a concerted and coordinated regional approach will be key to an orderly global rebalancing process.

Concerted policy adjustments can potentially reinforce this process through two key channels. First and foremost, there are important positive spillovers when countries work together to boost demand while avoiding unnecessary adverse movements in intra-regional exchange rates. Second, enhancing intra-regional trade offers each of the region's economies a high degree of trade openness—with all associated benefits—even as the region as a whole becomes less dependent on extra-regional demand.

2. Global Imbalances and Asia

Although there is no single explanation for international payment imbalances, the underlying cause appears to be the stark differences in saving and investment behavior⁶ across economies.

The striking differences in national saving and investment behavior must reflect the different macroeconomic and exchange rate policies, along with structural factors (Figures 2 and 3). In Asia, large current account surpluses also derived from the success of outward-orientated growth strategies that supported high levels of extra-regional exports at the expense of bolstering domestic demand.

The region's substantially large external imbalances also reflect its post 1997/98 crisis efforts to build strong international reserves.

In many of the region's economies, imbalances have also come from a determined effort to build large stockpiles of (gross) international reserves.⁷ In response to the 1997/98 Asian financial crisis, authorities sought self-insurance against the kinds of capital flow reversals that occurred then and during other episodes of systemic stress. This was also done with an eye to better manage stress in international financial markets.

Nonetheless, the aggregate Asia's picture masks important differences in external positions across the region and over time.

⁵ In some cases, for example, in Brunei Darussalam and Timor-Leste, current account surpluses have been over 50% of GDP. Given their small size and resource-based economies, the contribution of these economies to the region's overall current account surpluses has been negligible.

⁶ The current account for any country is approximately equal to the difference between its domestic saving and investment.

⁷ Reserves can be either owned or borrowed and it is only in the former case that their accumulation will require a current account surplus.

Even though Asia in aggregate has seen large current account surpluses since the 1997/98 financial crisis, it masks important differences in external positions across the region and over time (Figure 4).⁸ Meanwhile, most emerging Asian economies saw the pace of reserve accumulation accelerate during since the Asian financial crisis (Figure 5). The increase was largely due to a combination of sustained current account surpluses and persistent exchange market intervention. The exceptions are India and Viet Nam, where reserves were largely “borrowed” in the sense that the reserve buildup derived from large financial and capital account surpluses that exceeded the generally small current account deficits.

3. Domestic Rebalancing

Appropriate policy measures will inevitably differ across the region depending on the differences in individual economies' current account dynamics.

The region's current account dynamics during the 12 years since the 1997/98 Asian financial crisis can be grouped into five broad types. Each of these five sets of economies also exhibited similar underlying factors that drove their current account performance (Adams and Park 2009).⁹

The rapid build-up in the PRC current account surplus since 2002 comes from a surge in corporate savings, calling for effective mechanisms to enhance the worker's share in the corporate profits.

The PRC's domestic saving rate continues to rise even as investment has stabilized, if at relatively high levels. Government data show the large increase in PRC savings derives mainly from enterprises rather than households or the public sector—even though household savings has been relatively high over an extended period (Figure 6). Between 2002 and 2006, PRC enterprise savings rose 25.7% annually. This also could be the result of the recent shift in income distribution from wages to profits (due to the high investment profitability). Ineffective mechanisms for “releasing” enterprise savings to a firm's ultimate owners—especially in the case of state-owned enterprises—could account for the large impact of enterprise savings on the PRC's overall savings rate.

Sustained high savings rates in some of the region's high-income economies draw attention toward promoting investment in more advanced service and value-added sector reflecting the needs of these economies.

In the case of the small, open, high income, current account surplus economies—Hong Kong, China; Singapore; and Taipei, China—the upward trend in current account surpluses over the past decade from already high levels stems from sustained high savings rates (and increases in already high enterprise savings), and modest reductions

⁸ In the decade prior to the Asian financial crisis, the region—excluding Japan—ran current account deficits.

⁹ The marginal imbalances in many smaller economies in the region are not relevant to the following discussion.

in investment rates. The average savings rate for these economies has dropped marginally from 34.9% in 1997 to 33.9% in 2007, while the average investment rate fell from 31.3% to 21.8% over the same period. Possible reasons for high current account surpluses and savings rates include rapid GDP growth, increased uncertainty in the wake of the 1997/98 financial crisis, and demographic factors. Reflecting the demand power of these high-income economies, the policies need to focus on promoting more advanced service and value-added sector to unlock their consumption potential.

Economies where high savings are the cause of the imbalances need to carefully study the origins of such high savings—either public or private as well as either household or corporates—in order to design appropriate solutions.

Where the savings rate is sub-optimal from low public savings, the solution is relatively straightforward—budgetary expansion. However, when the problem lies with excessive private savings through either household or enterprise saving, the solution may be more complex. Robust social safety nets can help reduce the household need for precautionary savings. Financial development that improves household access to financial services can also contribute. Alternatively, where high enterprise savings is an important factor—in the PRC, Malaysia, and Singapore, for example—one can also consider various policy measures that unlock business opportunities.

For the five 1997/98 crisis-affected economies, the shift from current account deficit to surplus was due to a sharp and sustained reduction in investment from high pre-Asian crisis rates, requiring measures to bolster investment.

Investment in the five crisis-hit economies—Indonesia, Korea, Malaysia, Philippines, and Thailand—never regained their pre-crisis levels—with average investment rates falling to 23.7% in 2007 from 33.9% in 1997. National savings rates for these countries have remained mostly stable because of offsetting changes in household, enterprise, and government savings. The average savings rate dropped only 5.4% between 1997 and 2007. That is, current account surpluses largely derive from disappointingly weak domestic investment. Thus, resolving imbalances in these countries should be closely linked to bolstering investment.¹⁰

Beyond broad proposals to improve the business climate and address the risk factors that have been keeping investment weak, there are more specific measures that promote private investment—through infrastructure, non-tradable services, and small and medium enterprises (SMEs).

There are many developing economies in the region that continue to suffer problems of chronic underinvestment. For example, these economies can introduce a set of tax and subsidy schemes to promote investment and adopt policies that develop the supporting infrastructure and ensure adequate financing—particularly for SMEs. Efforts are also

¹⁰ The *Asian Development Outlook* (2009) cited three major reasons for continued investment weakness in the five 1997/98 crisis-affected economies: lingering effects from the crisis itself; unsuccessful competition for foreign direct investment (FDI) between the PRC and the rest of the region; and a poor investment climate. While none of these explanations is sufficient to explain the weakness, each was found to have influenced the fall in investment among the five countries.

underway to encourage more foreign direct investment (FDI)—not just to raise foreign investment but also to stimulate complimentary domestic investment. Key is to enhance the investment climate by implementing more comprehensive structural reforms in areas like (i) minimizing unnecessary regulatory barriers in business activities, (ii) encouraging private incentives and market discipline, (iii) creating a level playing field across all sectors, and (iv) fostering competition to upgrade institutional capacity (Schou-Zibell and Madhur 2010).

Some current account deficit economies in the region, notably India and Viet Nam, face huge infrastructure needs and may have little to contribute to global rebalancing.

Among most low-income countries in the region, poor savings coupled with high investment combined to produce persistent current account deficits. Thus, these economies cannot be expected to play a major role in the rebalancing process. In the future, they will likely prefer smaller deficits, cognizant of the risks associated with large external imbalances evident during the recent crisis. Both India and Viet Nam face huge infrastructure investment needs to maintain rapid, sustained economic growth. But with relatively low domestic savings rates a key policy priority will be increasing rather than reducing savings.

4. Regional Rebalancing

Reducing emerging Asia's current account surpluses and high dependence on extra-regional demand are the key elements of the rebalancing challenge.

Asia's rebalancing will require efforts at both national and regional levels: First, at the national level, surplus countries in emerging Asia need to increase domestic demand relative to trend output, with more spending directed toward imports—both externally and intra-regionally, either through increasing private consumption demand or investment spending. Second, at the regional level, promoting greater intra-regional trade in final goods and services is key. This will require further trade liberalization and facilitation with particular emphasis on reducing behind the border barriers to trade and investments that promote intra-regional connectivity.

In aggregate, emerging Asia's high export dependence may be another reason for current account imbalances.

The region's outward-orientated growth model involves both export promotion and the containment of domestic demand. Thus, one would expect a strong link between export dependence and current account surpluses (Figure 7). Empirical findings also show a closely knit relationship between the region's export dependence and increases in current account surpluses since the 1997/98 financial crisis (ADB 2009). The increases in current account surpluses have generally been accompanied by increases in the ratio of exports to GDP—with the exceptions of India and Viet Nam.

With the growing importance of the regional economy and intra-regional trade, however, emerging Asia's own domestic spending could become a major source of increased demand within the region.

The close relationship between export dependence and the size of current account surpluses makes an interesting point in terms of the final sources of demand for the region's exports. Much intra-regional trade in emerging Asia continues to be in intermediate goods and components—ultimately as components for goods consumed outside the region (ADB 2007 and Kim, Lee, and Park 2009). Thus, the region continues to depend on extra-regional rather than intra-regional demand. Growing intra-regional trade does not imply significantly less dependence on extra-regional demand.

Rebalancing efforts will be driven initially by macroeconomic and exchange rate policies, but ultimately trade and structural policies will need to take the lead afterward.

Given the region's vast diversity, the macroeconomic and structural policies needed to meet these challenges will vary significantly across economies. The near-term focus of rebalancing will inevitably be centered on increasing macroeconomic expenditure and switching to policies favoring imports. This will require monetary and fiscal policies primarily, supported by greater exchange rate flexibility where appropriate. When employing macroeconomic policy tools, it is important to support private demand. For example, ongoing fiscal support in surplus economies will need to be carefully calibrated to have maximum impact on private spending, with public spending programs geared toward promoting the private spending. Also, allowing currencies of surplus economies to appreciate will support global rebalancing, as it helps induce expenditure switching. It can also help ease the risk of overheating, thus avoiding the need to tighten monetary policy too fast. Thus, it would help narrow the global payment imbalances while containing inflationary pressures.

Beyond the near term, rebalancing will depend on the adoption of deep-seated structural and trade reforms to reduce the impediments that have held back domestic spending and contributed to Asia's high dependence on extra-regional demand.

Ultimately, the medium-term structural reform agenda will require several components aimed at increasing spending relative to output, encouraging consumption not only in home goods but also in imports, bolstering intra-regional trade, and improving economic efficiency in general. Two areas require particular attention in this regard:

4.1 Increasing Spending in Both Home Goods and Imports

For the region as a whole, three broad areas require policy attention.

First, efforts to broaden the access to financial services and credit can help increase investment and consumption rates, thereby contributing to the rebalancing process.

The region's predominantly bank-based financial systems have made considerable progress expanding financial services and their breadth of clientele since the 1997/98 Asian financial crisis (Ghosh 2006). In many economies, however, the access of consumers and SMEs to formal credit remains limited. While efforts that continue to strengthen banking systems and broaden public access to more diverse financial services can play an important role in middle-income economies, low-income economies may need support to increase micro-credit facilities. Local currency bond market development can also provide alternative funding for firms—unlocking vast investment potential.

Second, expanding infrastructure is not just urgently needed across emerging Asia, but it can be a critically important contribution to raising domestic demand.

ADB estimates that the region will need to spend about \$750 billion a year for infrastructure over the next decade—close to \$8 trillion. Although infrastructure needs vary significantly across the region, there is large potential demand for investments in cross-border infrastructure to promote intra-regional trade. Innovative approaches to finance infrastructure investment must be explored further as well. In addition to bolstering public-private partnerships (PPPs), ADB has been reviewing a range of options for special infrastructure financing investment vehicles—to tap the region's vast pool of savings and support required levels of the region's infrastructure spending needs.

Finally, economic policies that promote market efficiency and flexibility can help promote spending toward domestic markets.

These will include policies that allow prices to better reflect market signals and improve the flexibility of resource allocation when market demand shifts. Greater exchange rate flexibility will also contribute to cross-border reallocation of demand and needed production adjustments. These often involve painful adjustments and social costs. Thus, social safety nets should be designed accordingly to balance the competing objectives of “security” and “flexibility” during the rebalancing process.

4.2 Trade and Investment Facilitation/Liberalization

Regional cooperation is an important aspect, as it can better address specific regional trade issues while remaining aligned with global requirements under the World Trade Organization.

Emerging Asia needs to establish a comprehensive trade liberalization and facilitation program emphasizing agriculture and services. It should address distortions and impediments to trade—including behind the border restrictions—associated with labor mobility and capital flows. The program should be directed toward promoting growth of intra-regional trade and investment through close regional cooperation. Cooperation in eventually forging a region-wide free trade agreement (FTA) should be further pursued—consolidating the current “noodle bowl” of FTAs.

While the greatest progress to date for many of the region’s economies has been on “at the border” liberalization, reducing restrictions on trade in manufactures, the focus now should shift to the removal of “behind the border” impediments to trade in goods and, importantly, services—by allowing freer flow of labor and capital.

There are huge benefits in improving regional connectivity through upgrading and extending the region’s infrastructure networks. Potential benefits include increased market access, reduced trade costs, and more efficient energy usage. This will not only boost intra-regional trade, but it can contribute to more efficient supply chains and production networks, and allow more consumers from within the region greater cost-efficient access to final products produced in Asia. More proactively, easing trade should aim at reducing the costs of doing business across the region by reducing red tape, simplifying and harmonizing customs procedures, and agreeing on product standards, among others.

Accelerating liberalization of agricultural and services trade and easing impediments freer cross border flow of labor and capital should be prioritized.

Under its 2015 ASEAN Economic Community roadmap, ASEAN has built a comprehensive framework for substantial trade liberalization covering goods, services, labor, and investment. Using the ASEAN+1 approach¹¹ or through other processes, these frameworks can be extended to cover the removal of impediments to cross-border flows of labor, capital, and services—thus promoting growth in intra-regional trade. It is important to ensure the region’s trade rules are consistent with international rules, guidelines, and best practices.¹²

Even though trade liberalization should cover a broad range of services, key focus should be on providing support to investments in manufacturing, construction, and infrastructure.

Of particular importance are basic infrastructure services including business, financial, and freight services as along with information technology and communication. Liberalization will indirectly benefit other sectors of an economy by making transactions more efficient. There are also large potential benefits in liberalizing service trade more broadly—to tourism, education, and medical services, for example. Several economies in South East Asia, including Malaysia, Singapore, and Thailand have already taken

¹¹ ASEAN+1 approach refers to agreements between ASEAN and a single partner economy.

¹² The role of services and investment liberalization in the promotion of intra-regional trade is recognized by the ASEAN Framework Agreement on Services (AFAS). AFAS provides broad guidelines for ASEAN members to progressively improve market access and ensure equal national treatment for service suppliers within ASEAN. Under AFAS, Mutual Recognition Arrangements (MRAs) have also been created to allow professional service providers who are registered or certified in one signatory member country to be recognized in another signatory member. In principle, these agreements can be extended beyond ASEAN. The rules of AFAS are consistent with international rules for trade in services as provided by the General Agreement on Trade in Services of the World Trade Organization. This implies that AFAS can serve as an important multilateral template for other economies in the region.

steps in this direction. Given the region's heterogeneity, different economies will benefit more from different kinds of liberalization. Some will gain more from liberalizing one particular service than another. Thus, regional support for trade liberalization must ensure that national approaches to trade liberalization are broad and comprehensive, with enough room to eventually bring about a region-wide FTA.

5. Conclusion

Regional rebalancing will depend importantly on the adoption of deeper and more comprehensive structural reforms.

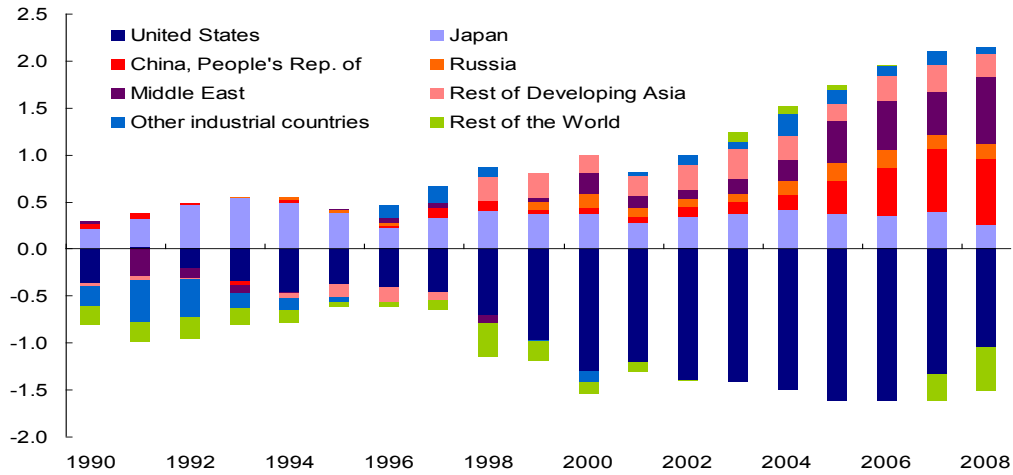
The longer-term reforms should aim not only to facilitate needed private expenditure increases and shifting expenditures across sectors, but also to make economies less dependent on external demand. As a result, reforms can contribute to improving the region's resilience to external shocks. A check list of reforms would include but not be limited to the following areas and issues:

- **Infrastructure Spending.** Adequate infrastructure is mandatory—not only for trade but also to accelerate growth in the non-tradable sector and internal distribution networks. Policies that focus mainly on infrastructure for special export zones, for example, should be paired with greater attention to industries and sectors that can potentially serve domestic as well as foreign markets. Given the huge infrastructure needs across the region, infrastructure investment can potentially be useful for applying Asian savings toward Asian investment.
- **Competition Policy.** While the international market is highly competitive, domestic sectors of many economies in the region are not characterized by high levels of competition and, in several cases, have monopolistic or oligopolistic structures. National authorities could usefully explore competition policies for the non-tradable domestic sector—retailing, construction, financial services, and telecoms, among others—including breaking down monopolistic structures and/or expanding international trade in services. In principle, a level playing field across the domestic economy and for exports needs to be built in an economy. Using tax and subsidy schemes can be one way. These measures should be broadly neutral and not provide artificial incentives for exports over production for the domestic market.
- **Financial Development Policy.** The region's bank-dominated financial systems have made considerable progress in strengthening risk management and broadening credit allocation beyond traditional business (Adams 2008). During the past decade, there has also been significant progress developing regional capital markets and, in particular, local currency bond markets. Less progress has been made, however, in ensuring access of SMEs outside the export sector to bank or nonbank financing—or in consumer credit. National

authorities could usefully identify and address impediments to this type of finance as part of the effort to achieve better balanced economic structures.

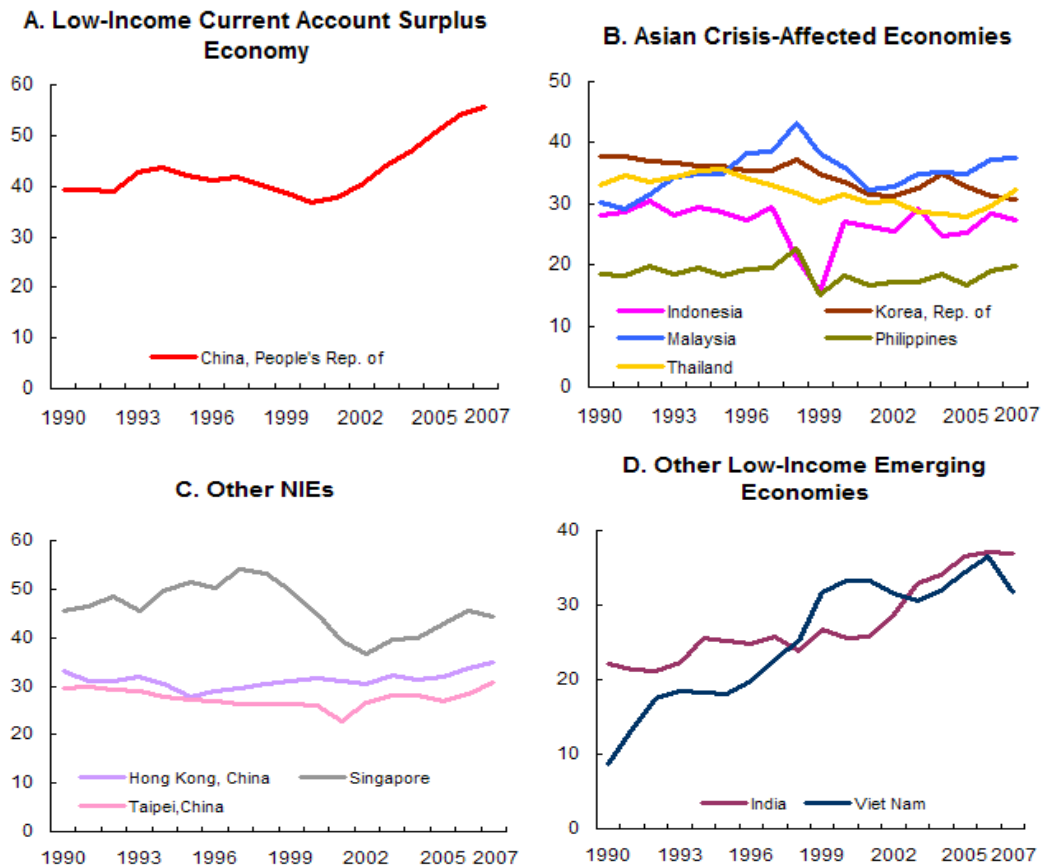
- **Trade Policy.** Continued behind the border restrictions on trade in goods and services also contribute to unbalanced economic structures. Prudent liberalization of formal or informal restrictions on trade can play a potentially important role in encouraging competition in local markets and improve economic efficiency. As part of a broad-based regional strategy, this liberalization will also open up other markets for the more efficient provision of goods and service across the region.
- **Investment Policy.** Foreign or local investment geared toward local markets would have important payoffs and play an increasingly important role as economies mature. With growing income and expanding middle classes across the region, the demand curve for final consumer goods will naturally shift over time, bringing growth to domestic markets, especially for higher-end consumer goods and services. Efforts should also be made to identify and address factors that weaken investment in the five 1997/98 crisis-affected countries.
- **Immigration Policy.** Further relaxation of the relatively tight immigration policies in several countries in the region could play a role in rebalancing. Initially, this might involve allowing only short-term employment, but in increasing cases it could involve longer-term contracts. In addition to allowing countries to get the labor required for new sectors, liberalizing immigration accelerates growth of services such as tourism and expands the range of potentially tradable goods and services.
- **Other Social Policies to Reduce National Savings.** Authorities should identify the factors contributing to the very high national savings rates beyond what's considered optimal in several countries—including savings rates in households and businesses. Where high personal savings reflect high precautionary saving, policies to ensure adequate social insurance or, alternatively, private insurance could be strengthened. Thus, when surges in corporate savings lie behind very high national savings rates, consideration could be given to corporate governance and related reforms to help ensure that corporate profits can spillover into the households to support private consumption.

Figure 1: World Current Account Balance (% of world GDP)



Source: Asian Development Outlook 2009

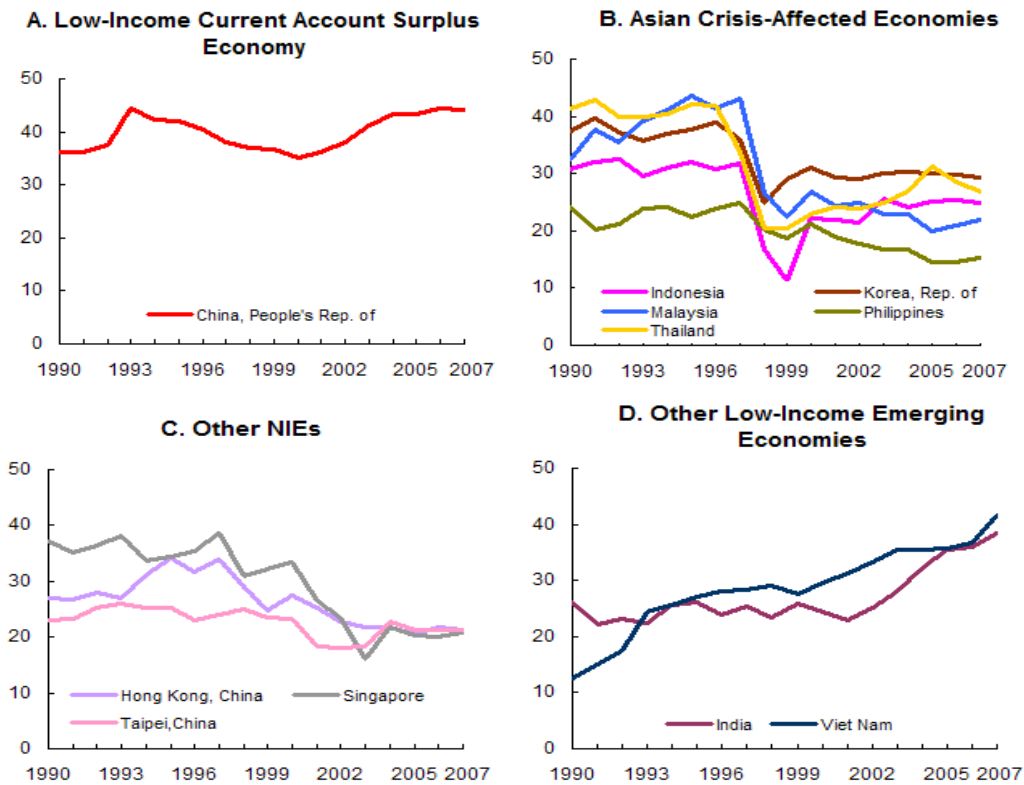
Figure 2: Savings Rates of Individual Asian Economies



NIEs = newly industrialized economies.

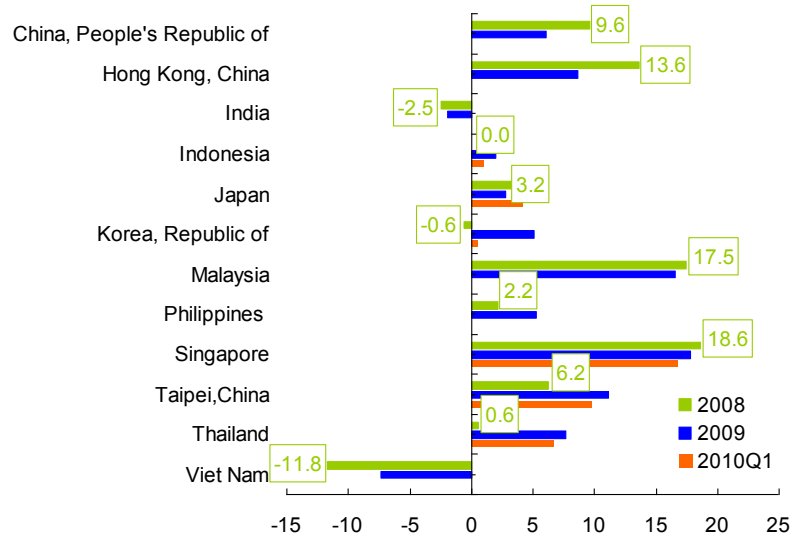
Source: Asian Development Outlook 2009.

Figure 3: Investment Rates of Individual Asian Economies



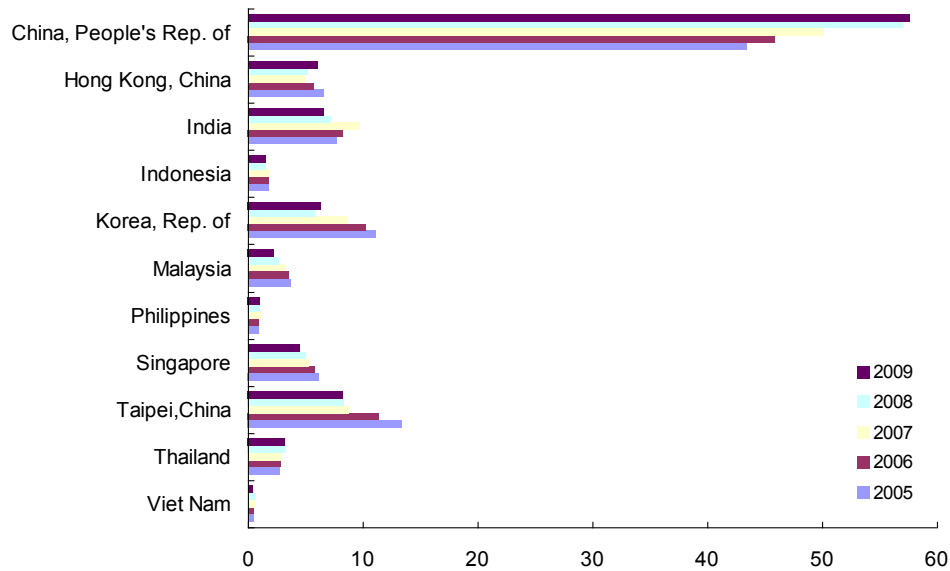
NIEs = newly industrialized economies.
Source: *Asian Development Outlook 2009*.

Figure 4: Current Account Balance (% of GDP)



GDP = gross domestic product.
¹Excludes China, People's Republic of; Hong Kong, China; India; Malaysia; Philippines; and Viet Nam for 2010Q1.
 Source: *Asian Development Outlook 2010*, ADB; *International Financial Statistics*, International Monetary Fund; CEIC; and national sources.

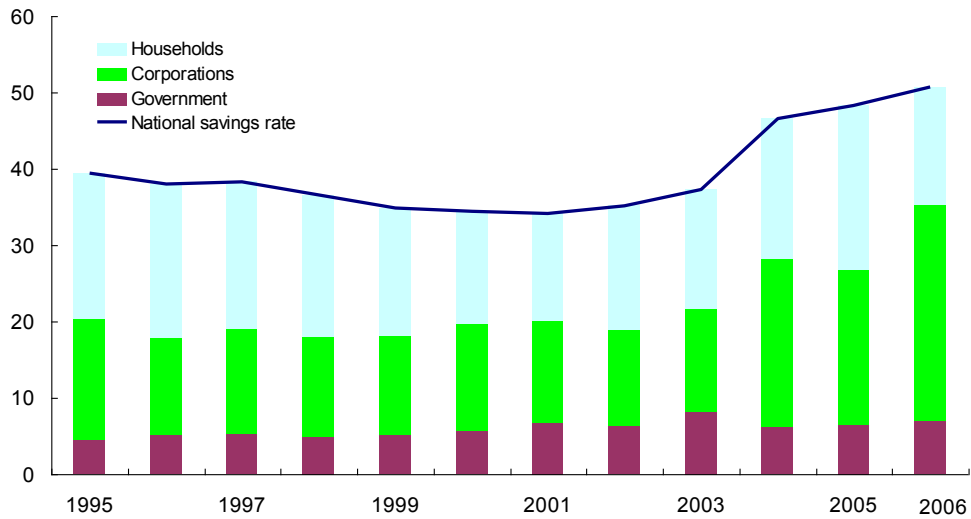
Figure 5: Gross International Reserves (% of regional total)



Note: Gross international reserves include US dollar value of foreign exchange reserves, special drawing rights, reserve position in the International Monetary Fund, and gold at the end of a given period.

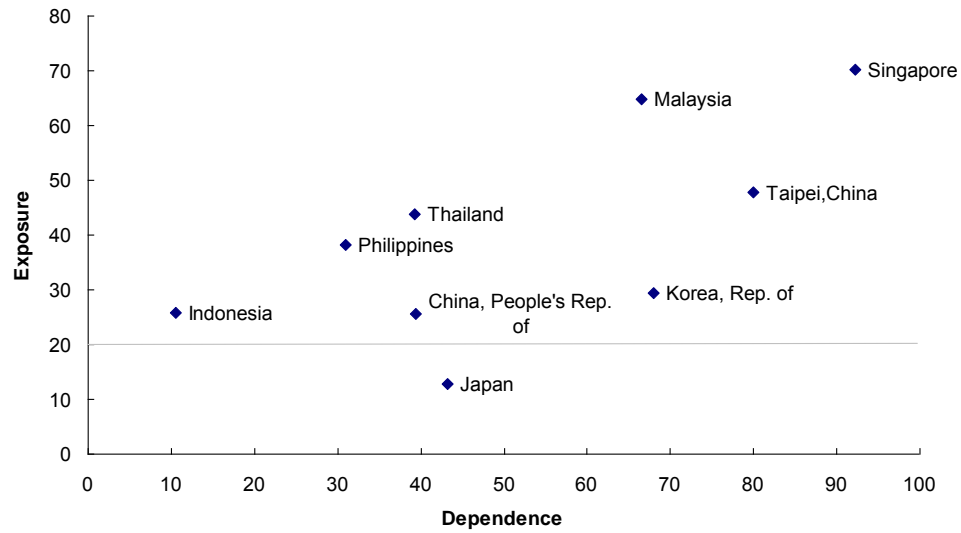
Source: *Asian Development Outlook 2010*.

Figure 6: Composition of Savings—People's Rep. of China (% of GDP)



Source: *Asian Development Outlook 2009*.

Figure 7: Export Dependence and Exposure (%)



Note: Export exposure is defined as the share of exported value-added in total value-added; export dependence is the contribution of export value-added to growth. The gray line indicates the OECD average for export exposure.
 Source: *Regional Economic Outlook: Asia and the Pacific 2010*, International Monetary Fund.

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Asia's Contribution to Global Rebalancing

Emerging East Asia remains at the core of global payment imbalances. While the People's Republic of China accounts for a substantial share of the region's current account surplus, Asia's contribution to global rebalancing also depends on how the NIEs and larger ASEAN economies respond to the crisis. In this paper, the authors argue that regional rebalancing will depend critically on the adoption of deeper and more comprehensive structural reforms with further trade liberalization that promote domestic and regional spending.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

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