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The Challenge of Structural Change

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Abstract

The Asia-Pacific region is a major force of global economic growth and a number of lower-income economies in the region have experienced impressive “catch-up” in recent decades. However, there is a growing appreciation that the APEC region is not realising the full potential of economic integration and improved living standards because of so-called “behind the border” or “structural” barriers to regional economic integration. The most appropriate institutional structures and policy responses will differ across economies and the reform of structural policies is an ongoing process and presents problems and challenges for all economies. This paper presents a framework for thinking about the challenges and strategies for managing structural change and identifies areas where the Economic Committee of APEC can add value to that process.

1. Goals of APEC

At the core of the Asia-Pacific Economic Cooperation’s (APEC) mission is the pursuit of economic integration in the Asia-Pacific region as a vehicle for improved living standards. APEC has tended to focus on trade and investment liberalisation and facilitation and technical cooperation. However, over time the agenda has broadened to include a complementary focus on “behind the border barriers” to regional economic integration (also commonly referred to as “structural policies” or “structural barriers”). Behind the border barriers refer to domestic policies and institutions which can impede the efficient operation of markets and the capacity of businesses to operate efficiently. These can take the shape of domestic regulatory systems, competition frameworks and governance structures.

In 1993, APEC economic leaders met for the first time in Blake Island, United States, and outlined APEC’s vision of “stability, security and prosperity for our people”. The following year APEC leaders adopted the Bogor goals, of “free and open trade and investment in the Asia-Pacific by 2010 for developed economies and 2020 for developing economies”¹.

In 2004 the Leaders Agenda to Implement Structural Reform (LAISR 2010) was adopted and identified the five priority areas of: regulatory reform, competition policy, public sector management, corporate governance, and strengthening economic and legal infrastructure. The following year the APEC Work Plan on LAISR towards 2010 was developed which outlined a road map for addressing structural reform issues in APEC. This work plan aimed to develop a “whole of APEC approach” for carrying out structural reform activities². LAISR 2010 gave the Economic Committee (EC) of APEC the responsibility for leading and coordinating APEC’s structural reform work programme³. LAISR 2010 recognises that structural reform in APEC economies is essential for realising the full benefits of trade and investment liberalisation thereby contributing to the achievement of the Bogor Goals.

A number of commentators are of the view that while benefits from trade and investment reform are far from being exhausted, a complementary focus in the APEC context should be given to behind the border barriers to economic integration⁴. This sentiment was reflected at

¹ Key APEC Milestones, http://www.apecsec.org.sg/content/apec/about_apec/history.html

² Refer Leaders’ Agenda to Implement Structural Reform (LAISR 2010), http://www.apec.org/apec/documents_reports/annual_ministerial_meetings/2004.html, and the APEC Work Plan on LAISR Towards 2010 (LAISR 2010), http://www.apec.org/apec/documents_reports/senior_officials_meetings/2005.html

³ There are a number of APEC fora that have a focus on structural reform issues including the Competition Policy and Deregulation Group (CPDG), Strengthening Economic Legal Infrastructure (SELI) Coordinating Group, the Finance Ministers’ Process (FMP), Small and Medium Enterprises Working Group (SMEWG) and the Investment Experts Group (IEG).

⁴ See for example presentations by Oxley (2006) and Parker (2006).

the first APEC Senior Officials' meeting in 2007. The APEC Business Advisory Council (ABAC) has also expressed strong support for the structural reform agenda, as a complement to the trade and investment liberalisation and facilitation agenda⁵.

Before discussing the challenge of structural change and the role of APEC and the EC in progressing structural reform in section 5, section 2 presents a conceptual framework to guide the discussion. To realise the full potential of economic integration and improved living standards in the region we would expect to see the enhancement of overall growth performance as well as the convergence of lower income economies toward the income levels of higher income economies. This paper draws on models of growth to provide a framework for thinking about how growth and convergence processes take place. Section 3 assesses where growth is occurring and whether convergence is taking place in the Asia-Pacific region in order to benchmark performance and section 4 discusses some possible impediments and possible future challenges to growth and convergence in the region. Section 6 draws out some general lessons from the discussion.

2. Process of Economic Growth and Income Convergence

2.1 Growth and convergence in neoclassical and endogenous growth theories

Growth models provide a framework for thinking about how growth processes and convergence takes place. A starting point for understanding growth processes tends to be neoclassical and endogenous growth theories.

A characteristic of traditional neoclassical growth models, as originally developed by Solow (1956) and Swan (1956), is that savings and physical and human capital investment influence the level of income per capita. In seeking the highest possible returns, capital moves from places where it is abundant to where it is scarce, bringing with it new products, processes and technologies. By operating across economies this process of economic integration can facilitate the convergence of incomes across economies.

As pointed out by Barro (1991), in neoclassical growth models an economy's per capita growth rate tends to be inversely related to its starting level of income per person. Low-income economies will tend to grow faster than high-income economies and consequently there is a force that promotes economic integration and convergence in the levels of per capita income across economies. It is of course possible, according to this model, that economies do not converge to the same level of per capita income because of impediments to convergence, such as ineffective structural policies. However, as highlighted by Rodrik (2003) a range of institutional settings can bring about growth and income convergence, and the most appropriate institutional settings will depend on local conditions.

By comparison to traditional models that focus on factor accumulation, the main driver of growth and convergence in modern endogenous growth theories is ideas. It is possible to construct endogenous growth models that exhibit convergence in per capita incomes. Barro and Sala-i-Martin (1997) for example develop an endogenous growth model in which long-term growth is driven by discoveries in new technology. In this model 'follower' economies catch up to 'leader' economies by copying technology. As the pool of un-copied ideas diminishes the cost of imitation increases and the growth rate of followers accordingly declines. A characteristic of endogenous growth models is that growth and convergence can occur for a number of reasons⁶.

⁵ Refer ABAC (2006)

⁶ See Baumol (1986) and De Long (1988) for other examples of endogenous growth models that also exhibit convergence.

2.2 *Convergence mechanisms*

Traditional and modern growth theories imply there are various forces that could bring about income convergence. Convergence in the neoclassical growth model is driven by capital flowing from places where it is abundant (high-income economies) to where it is scarce (low-income economies) to achieve the highest possible returns. In this way, economic integration can bring about growth and income convergence. However empirical evidence suggests that capital flows from high- to low-income economies are very modest and much less than predicted by the neoclassical growth model. Lucas (1990) canvasses theoretical explanations for these observed differences, including differences in economic fundamentals across economies that lower the rate of return on capital in low-income economies relative to high-income economies (such as technological differences, government policies and institutional structures) and capital market imperfections. Subsequent articles have attempted to test the relative importance of these explanations empirically. Alfaro, Kalemli-Ozcan and Volosovych (2005) for example, find that low institutional quality is the leading explanation for observed capital flows between low-income and high-income economies.

Endogenous growth models emphasise the spillover of ideas and technological knowledge as a key mechanism driving growth and income convergence. The transfer of scientific knowledge may occur through foreign direct investment (FDI) in low-income economies bringing with it the skills of investors, or through international trade. Economies may 'learn by exporting' by interacting with foreign customers and learning how to meet higher product standards, or through technology embodied in imports. Keller (2004) surveys the literature on the extent of international technology diffusion and the channels through which technology is spread. He concludes that there is no evidence that international learning is inevitable, or that it is easier for relatively undeveloped economies. Evidence suggests that importing is associated with technological spillovers, but evidence of benefits associated with exporting is weaker. The literature suggests that there can be spillovers from FDI but they do not occur everywhere to the same degree. Similar conclusions are drawn in the surveys by Greenaway and Kneller (2007) and Wagner (2007).

Migration from low-wage to high-wage economies could also bring about higher growth and income convergence. Migration will cause labour to become scarcer in low-income economies and more abundant in high-income economies and will tend to reduce wage differentials between economies. Restrictions in the movement of persons, rigid labour markets and generous and poorly designed welfare policies will limit the extent to which this mechanism is able to operate. Sinn (2007) assesses the impact of the emergence of 'Asian tigers' and ex-Communist economies in world trade on factor price convergence in Europe. He concludes that labour market rigidities and welfare policies in Western Europe are impeding adjustment and factor price convergence. These policies may be causing greater immigration and more capital-intensive exports from Western Europe than would otherwise be the case and could be contributing to unemployment and sluggish growth in Europe.

Trade and specialisation could drive growth and income convergence. Trade between high-income and low-income economies will allow high-income economies to specialise in capital-intensive production processes, and low-income economies to specialise in labour-intensive production processes. Both specialisation processes tend to reduce wage differentials as the demand for unskilled labour in high-income economies falls, while it rises in low-income economies. Estimating the effects of trade on economic growth is challenging because of the joint determination of empirical measures of economic growth and international trade. Frankel and Romer (1999) use instrumental variable estimation to help overcome some of these estimation problems, and find that trade has a large, positive (although only moderately significant) effect on income.

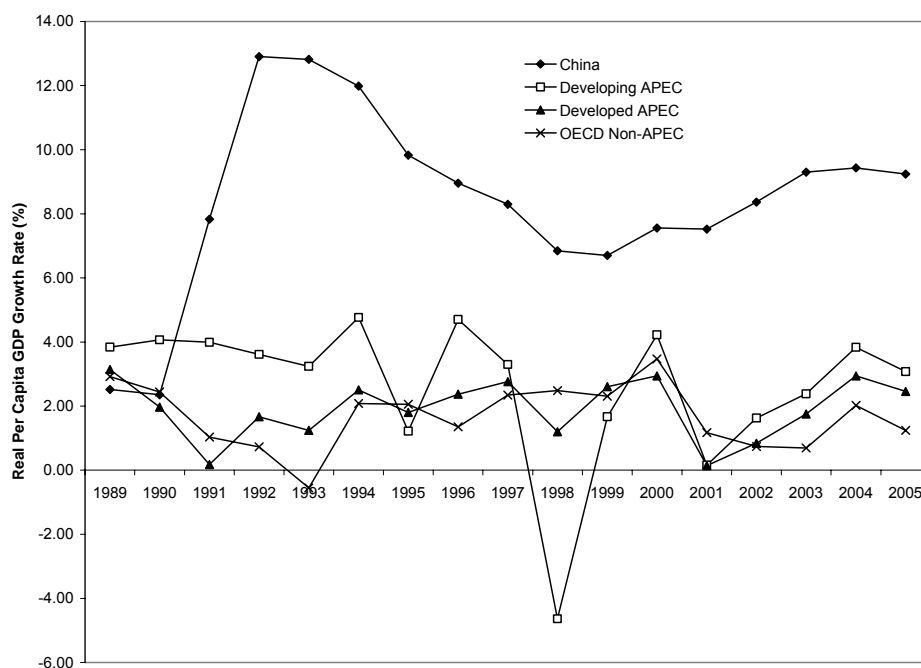
Theoretical growth models imply that there are potential benefits for all economies, not simply the lower-income economies, through specialisation, better allocation of skills and other resources, the dynamic interaction of learning, and the two-way spillover of knowledge. According to theoretical growth models, in the Asia-Pacific region, we would expect to find lower-income economies growing faster than higher-income economies, thereby bringing about the convergence of per capita incomes. The following section examines the growth and convergence performances across the APEC region. This is followed by a more detailed discussion of evidence drawn from the research literature of factors that may be impeding these processes.

3. Prospects of Economic Growth and Income Convergence in the Asia-Pacific

3.1 Where is growth occurring?

The growth performance of the Asia-Pacific region has been stronger on average than the OECD over the last two decades or so, although significant variation in economic performance exists within the Asia-Pacific region. The economic performances of East Asian economies and China in particular have been key drivers of growth in the Asia-Pacific region since the 1980s. Figure 1 shows the population weighted growth rates of China relative to APEC economies (developing and developed⁷) and OECD economies that are not in APEC, since APEC was formed in 1989.

Figure 1: Population Weighted Per Capita Growth Rates, 1989-2005



Source: United Nations Statistical Database

Note: Excludes Russia and Chinese Taipei due to data gaps; some recent data based on forecasts

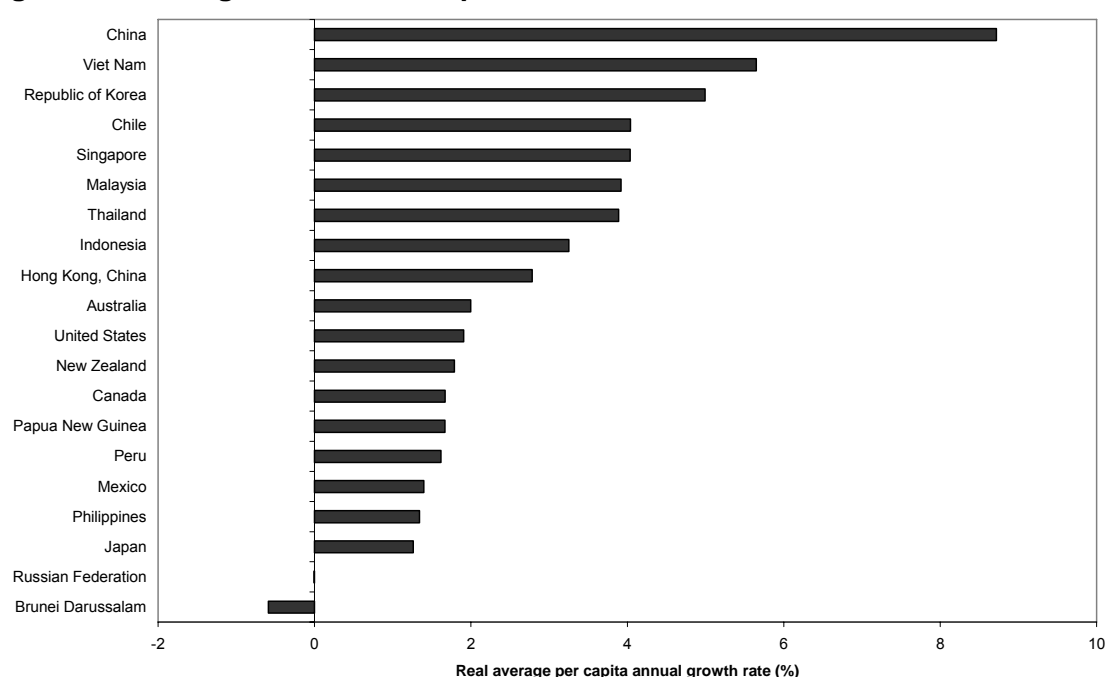
Growth rates in APEC economies have been higher on average than growth rates in OECD economies over the last two decades. The lower growth rates in 1997-98, particularly for developing APEC economies, reflects the impact of the 1997-98 Asian financial crisis on

⁷ Chile, Indonesia, Malaysia, Mexico, Papua New Guinea, Peru, Philippines, Thailand, and Viet Nam are classified as developing APEC economies and the remainder (excluding China, Russia and Chinese Taipei) are classified as developed APEC economies.

economic performance. This period was a harsh illustration of how weak institutions (in particular weak financial institutions) and poor governance structures can eventually impact on growth. While crisis-affected economies did rebound quickly from the financial crisis, growth rates in the post-crisis period have been running at around 2 percentage points less than two decades before the crisis (World Bank, 2007). The experience is still impacting on investment in the region and the effects are impacting on other economies in the APEC region.

Lower income APEC economies are growing more rapidly on average than higher income APEC economies, although the differences have been closing, especially since the Asian financial crisis. However these aggregate figures hide the great variation in economic performance across the APEC region. Figure 2 shows the average annual growth rate in APEC economies from 1989-2006. Average annual growth rates of per capita real incomes over the period range from -0.6% in Brunei Darussalam to 8.7% in China.

Figure 2: Average Annual Per Capita Growth Rates of APEC Economies, 1989-2005



Source: United Nations Statistical Database

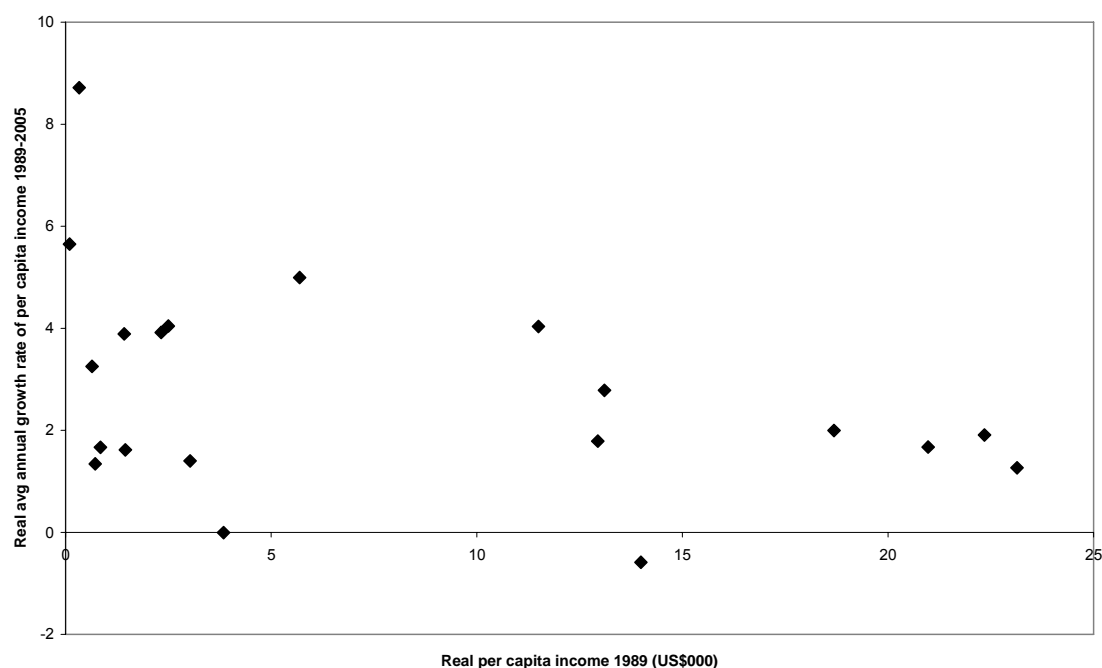
Note: Real average per capita annual growth of Russia calculated from 1990-2005 due to data gaps; excludes Chinese Taipei due to data gaps

3.2 Evidence of convergence

Evidence from the APEC region is somewhat consistent with the convergence hypothesis that under certain conditions low-income economies will tend to grow faster than high-income economies. However, evidence is mixed and some economies are converging while others are not.

If incomes of APEC economies were converging we would expect to see a negative correlation between initial income levels and subsequent growth rates. Figure 3 plots the per capita income level of APEC economies in 1989 against their average annual growth rate for the period 1989-2006. The figure shows some evidence of convergence in the region. However progress is patchy, and there is a cluster of economies with low initial incomes that are not 'catching up'.

Figure 3: Convergence of APEC Economies' Incomes, 1989-2005



Source: United Nations Statistical Database

Note: Data for Russia for period 1990-2005 due to data gaps; excludes Chinese Taipei due to data gaps

Engelbrecht and Kelsen (1999) formally empirically test whether there is evidence of convergence amongst APEC economies during the preceding 25 years (from 1965-1990). They find that APEC economies were indeed converging towards one another over the sample period. This result holds for both 'conditional β -convergence' (i.e. convergence conditional on institutional and structural characteristics) and 'unconditional β -convergence' and suggests that APEC constitutes a 'convergence club' similar to the OECD and the European Union. This result is of particular note, given the diversity of APEC economies. Figure 3 suggests that in general convergence has continued, but the process is characterised by some low income economies achieving very high growth, some merely matching the growth of higher income economies, and some economies falling behind.

3.3 *Impact of structural policies*

It is clear from figure 3 that while there is some evidence of income convergence there is still considerable scope to enhance standards of living in the region by both lifting growth in laggard economies and by lifting growth in general. Furthermore, even for the currently high growth economies there is evidently no assurance that the economic structures and processes that propelled their initial growth are necessarily the solution to ongoing convergence.

Recent thinking has suggested that what it takes to achieve growth at lower income levels may be different than what it takes to sustain growth at higher levels of income, and over the long-term (World Bank, 2007; Rodrik, 2003; Gill and Kharas, 2007). This implies that structural reform is an ongoing challenge, and raises the question of not only how to lift performance in the slower growing economies but also whether the recent impressive growth performances of many economies in the region can be sustained in the future. The World Bank (2007) identifies a number of transitions that economies may need to make to move from middle income toward higher income status, including: transition from being able to absorb knowledge to becoming a source of innovation; developing deeper financial systems; and managing greater urbanisation. There are many cases of economies

succeeding in reaching middle income status but not meeting the challenges of transitioning to high income levels (for example many economies in the Middle East and Latin America). However, there are examples of economies in the region that have made this transition successfully (for example Japan, Hong Kong China, Singapore and Chinese Taipei).

Evidence also suggests that convergence mechanisms may not be operating as well as expected in some economies due to barriers at and behind the border. Addressing these sorts of issues is the challenge of structural policy. The following section considers the implications of structural policies for the convergence mechanisms outlined in section 2.2: capital flows, technological spillovers, migration and the growth of intraregional trade and specialisation.

3.3.1 Capital flows and sluggish investment recovery

For most of the 1980s, emerging Asia was a net importer of capital, in line with the predictions of economic theory. However, since the 1997-98 Asian financial crisis emerging Asia has become a net capital exporter.

Recent analysis suggests the explanation lies with investment performance rather than necessarily excess saving. Kramer (2006) notes that, excluding China, savings have been relatively stable over the past 10-15 years and according to some studies, broadly consistent with economic fundamentals. By contrast private investment declined sharply after the financial crisis and some recent studies suggest that investment in emerging Asian economies is low relative to fundamental determinants (See for example Chinn & Ito, 2005; Eichengreen, 2006; and IMF, 2005).

Kramer considers three possible reasons for the investment decline in emerging Asia: financial and corporate sector restructuring following the 1997-98 financial crisis, competition from China, and changes in perceptions of risk. He concludes that financial and corporate sector stresses and restructuring following the financial crisis impacted on investment, but these effects would not be enduring. China's success in attracting FDI has raised questions as to whether China may be attracting capital inflows at the expense of other economies. However recent studies have not found any evidence of China diverting FDI from other Asian economies.

Perceived risks in emerging Asia are higher than in the pre-crisis period and could explain the sluggish recovery of investment in the region. The perceived increase in risk, despite moves to reduce vulnerabilities after the crisis (for example by making exchange rates more flexible, strengthening banking and corporate sectors, and the accumulation of large foreign exchange reserves) could reflect more realistic perceptions by investors in the post-crisis period. For example, a World Bank study finds that the perceived ranking of the governance environment is weaker now than in the pre-crisis period across the six dimensions of voice and accountability, political stability, governance effectiveness, regulatory quality, the rule of law, and control of corruption (Kaufmann, Kraay and Mastruzzi, 2005).

Kramer concludes that while it is impossible to identify the "right level" of investment with any precision, investment may be enhanced by moves to increase certainty, such as implementing prudent monetary and fiscal policies, structural improvements in the investment environment at the microeconomic level, notably in governance frameworks, and by broadening and deepening financial systems.

The World Bank (2007) notes that cyclical explanations for the slower growth in investment among East Asian economies (excluding China) in the post-crisis period have become less convincing as the time elapsed since the crisis has increased. Analysts have identified

increased uncertainty and the quality of the investment environment as likely to have played an important role. This suggests that the investment climate and governance reforms to reduce the scope for uncertainty about policies and laws are likely to have payoffs for investment and growth in the region.

Consumption levels in China are low, and levels of investment high relative to international comparisons and economic fundamentals. In a recent IMF Working Paper Aziz (2006) uses a standard neoclassical growth model to investigate these compositional issues and finds that the low cost of capital is an important explanatory factor, and could be caused by nonperforming loans, borrowing constraints, and uncertainty over changes in government guidance in bank lending. Aziz concludes that if China wants to 'rebalance' toward greater levels of consumption, then banking sector reforms and financial market development are likely to be important. The 11th five year plan approved in March 2006 placed the broad long-term challenge of rebalancing of the pattern of growth on the government's agenda (World Bank, 2007).

3.3.2 Technological spillovers and migration

Case studies on East Asian economies since the early 1960s have strongly emphasised technological spillovers from learning-by-exporting (see for example Rhee, Ross-Larson, and Pursell, 1984). However, these results do not seem to be supported by international evidence from econometric panel studies which find little evidence of learning-by-exporting effects (Keller, 2004; Greenway and Kneller, 2007; Wagner, 2007).

Migration could cause income convergence as workers from low-income economies migrate to higher-income economies to take advantage of higher wage levels, thereby increasing the supply of labour in high-income economies and reducing the supply of labour in low-income economies and reducing income differentials. Taylor (1995) examines the relationship between trade, openness and migration in the Asia-Pacific region since the 1970s and finds that migration played little part as a determinant of growth or income convergence. This result is unsurprising given restrictions on migration during this period. The World Bank (2007) identifies the facilitation of migration within economies as having the potential to contribute to a more flexible business environment and to encourage greater equity within economies. There are a number of factors that inhibit internal migration including restrictions on the movement of people across regions, and the poor access to services (for example education, housing, health) for migrants in destination areas.

3.3.3 Intraregional trade and specialisation

Increased intraregional trade and vertical specialisation of production processes have increased the importance of economies having markets that are flexible enough to adjust in line with their evolving comparative advantage.

In a recent IMF Policy Discussion Paper, Zebregs (2004) examines trends in intraregional trade in emerging Asian economies. The share of emerging Asian economies in world exports has increased substantially over the past 25 years (from 8% to 19% between 1978 and 2002). This is in large part due to increased intraregional trade of intermediate goods, which in turn seems to be driven by greater geographical dispersion of production processes and vertical specialisation. This intra-industry trade has been closely associated with flows of FDI and the establishment of regional production networks (World Bank, 2007).

The integration of China into the world economy has had a major impact on trade flows, and has played a large part in the rise of intraregional trade. Between 1995 and 2005 all of the increase in emerging East Asia's share of world exports (15.5% to 17.9%) came from China (World Bank, 2007). This raises both challenges and opportunities for economies in the

region. Those economies with competing trade structures will need to have the flexibility to reorganise away from sectors in which China has a comparative advantage. The ongoing relocation of production processes across borders highlights the importance for economies in the region making further progress with structural reforms, particularly in corporate and finance sectors and taking other steps to create a good business and investment environment.

4. Impediments to Growth and Convergence in the Asia-Pacific

Impediments to enhancing growth and convergence in the Asia-Pacific region lie both at and behind the border. Significant progress in tariff reduction has been achieved. Exports of goods and services now make up 18.5% of GDP for APEC economies compared with 13.8% in 1989, and average applied tariffs in APEC economies have been reduced from 16.6% in 1988 to 6.4% in 2004⁸. However significant tariff peaks still exist in some areas, such as agriculture.

A number of commentators are of the view that while benefits from trade and investment reform are far from being exhausted, a complementary focus in the APEC context should be given to behind the border barriers to economic integration. For example Oxley (2006) maintains that the importance of trade liberalisation to growth in APEC region is diminishing and the core mission of APEC should be to ensure economies are structured to maintain growth.

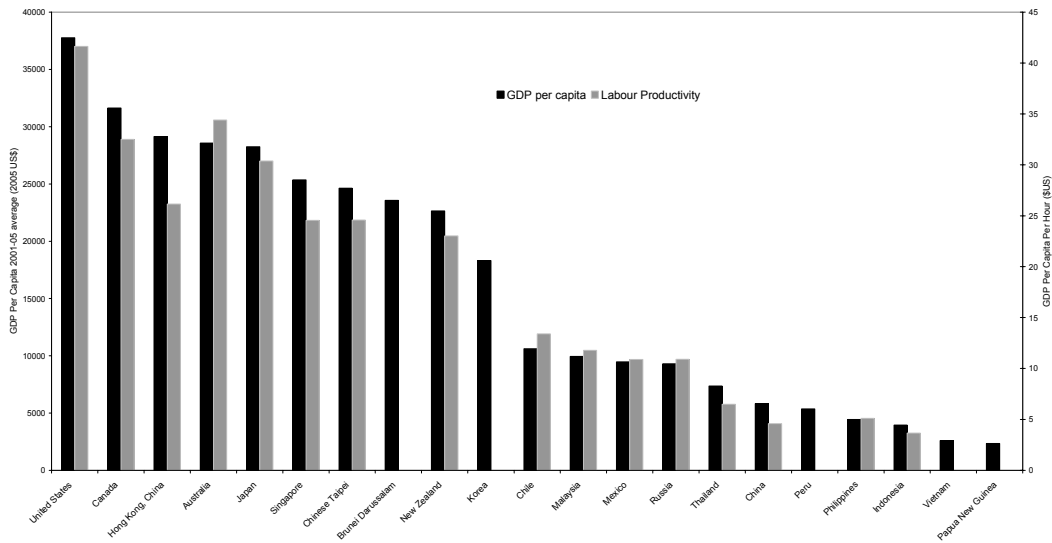
Research indicates that there are large potential gains from structural reform. Dee (2005) for example empirically examines the payoffs from three scenarios: a regional preferential trade agreement, the successful completion of the Doha round of World Trade Organisation negotiations, and unilateral regulatory reform. Dee's estimates show that preferential reform of regulations that discriminate against foreigners adds negligibly to gains from preferential trade liberalisation (US\$2 billion per annum relative to US\$16.6 billion per annum). The successful completion of the Doha round would result in much larger gains of over US\$30 billion per annum. However, by far the largest gains result from unilateral regulatory reform which is estimated to result in gains of over US\$100 billion per annum for the region.

The variation in levels of GDP per capita is closely related to labour productivity levels across the region. Figure 4 shows the close relationship between average per capita levels of GDP and the level of labour productivity in APEC economies. An implication of this is that convergence mechanisms that increase labour productivity levels will be potentially important.

(see Figure 4 overleaf)

⁸ APEC Secretariat (2005)

Figure 4: GDP Per Capita and Labour Productivity of APEC Economies, 2001-2005

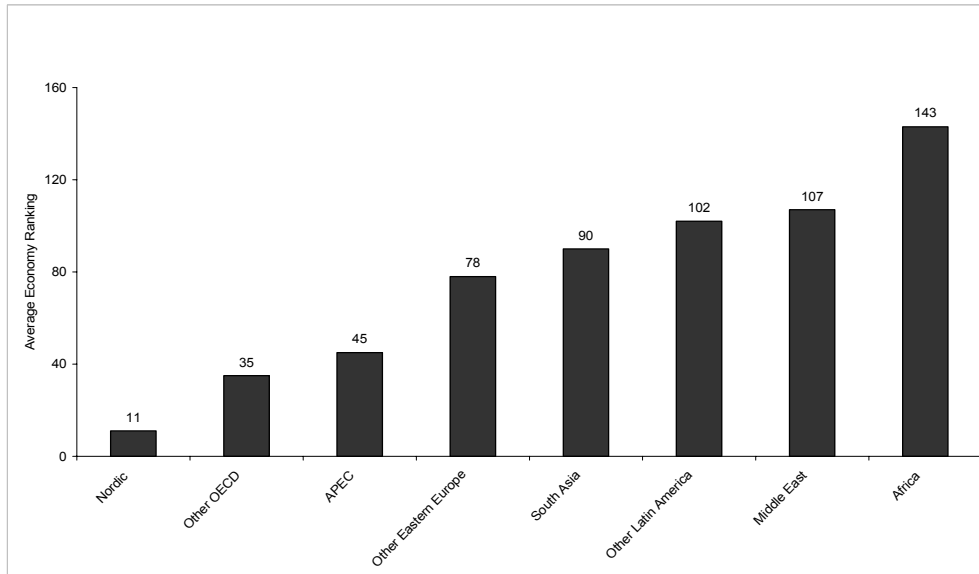


Source: World Economic Outlook Database, International Monetary Fund
 Note: Some recent data based on forecasts

This argument is also supported by various indicators. World Bank “Doing Business Indicators” provide internationally comparable measures of business regulation and enforcement across 175 economies. For example it provides international comparisons of the number of days to register a business, the number of days to close a business and the ease of enforcing contracts.⁹

Figure 5 shows the average ranking of the costs of doing business in the various regional groupings and Figure 6 shows the ranking of individual APEC economies. APEC performs quite well on average as a group, but in general the costs of doing business are higher than in the OECD. There is also significant variation in rankings across APEC economies, ranging from 1st to 135th out of 175 economies sampled in 2006.

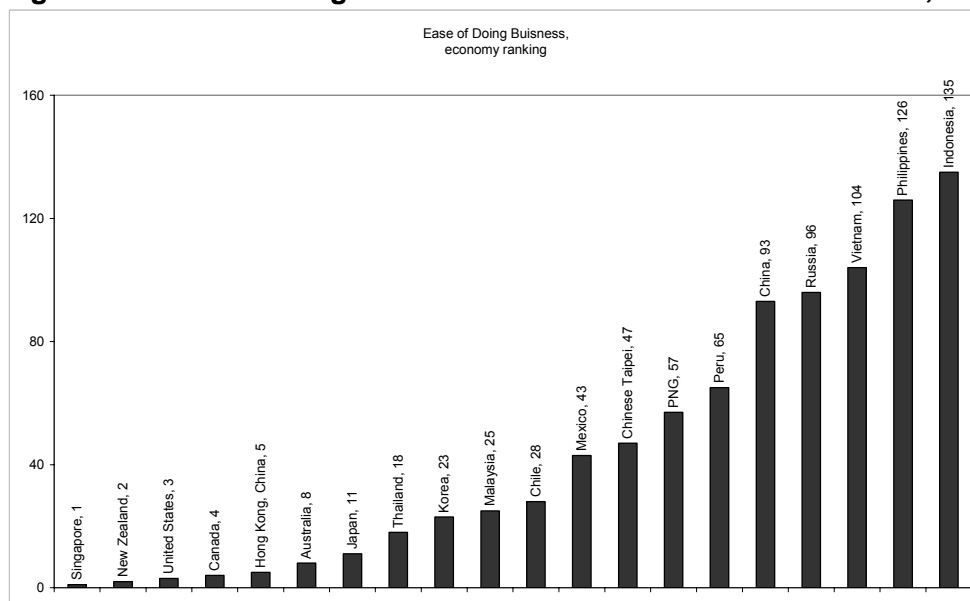
Figure 5: Cost of Doing Business Indicators of Regional Groupings, 2006



Source: Doing Business Database, World Bank

⁹ For more information on the World Bank Cost of Doing Business Indicators refer to <http://www.doingbusiness.org/>

Figure 6: Cost of Doing Business Indicators of APEC Economies, 2006



Source: Doing Business Database, World Bank

As discussed in the previous section, the business environment is likely to impact on how well convergence mechanisms operate. For example, the relative attractiveness of an economy as an investment destination and its ability to absorb new technologies will typically depend on the business and investment environment. The following section outlines general lessons from the literature on the challenge of bringing about structural change and the role of APEC and the EC in progressing structural reform across the APEC region.

5. The Challenge of Structural Change

The importance of barriers both at and behind the border to regional integration, growth and stability has been recognised by APEC Leaders and the business community, and shown by empirical studies. For reasons already discussed, they can be expected to impact on convergence mechanisms outlined above and the long-term growth prospects in the Asia-Pacific region.

APEC's cooperative, voluntary and informal manner of operations means that it is a good place to start a discussion on economic policy challenges facing the Asia-Pacific region. APEC is not a negotiating forum, but rather a voluntary process of cooperation and support. This suits the discussion of structural policies because they are behind the border, and cannot be easily negotiated between economies. Where the APEC adds value to this process is by providing a forum for economies to discuss and share experiences on good principles, practical lessons on implementation as well as technical support as required.

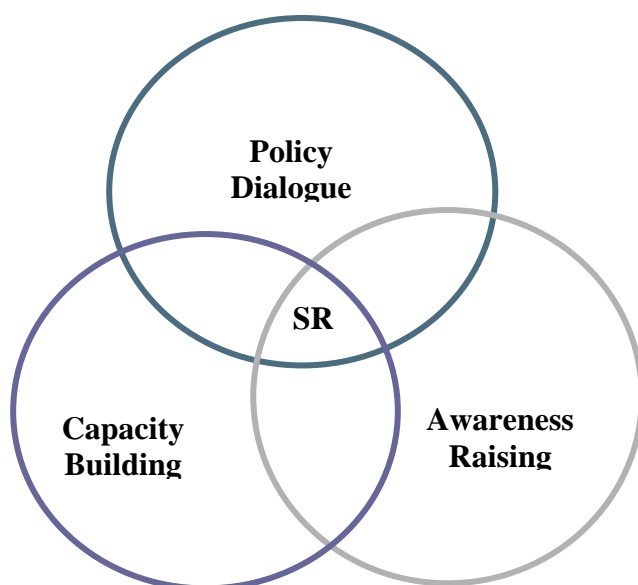
There are a number of APEC fora that have a focus on structural reform issues, including the Competition Policy and Deregulation Group (CPDG), Strengthening Economic Legal Infrastructure (SELI) Coordinating Group, the Finance Ministers' Process (FMP), Small and Medium Enterprises Working Group (SMEWG) and the Investment Experts Group (IEG). The EC has the mandate to lead and coordinate APEC's structural reform work to ensure consistency and the elimination of unnecessary overlap across APEC fora.

Structural change is an ongoing process and presents problems and challenges for all APEC economies. While the benefits of structural change are becoming increasingly clear, reforms often involve quite fundamental changes to how markets operate, and as such can face resistance from groups that have a vested interest in the status quo. Reform can also

involve transitional dislocations. Hence there are potentially significant social and political tensions and challenges involved in undertaking structural reform.

The literature identifies a number of challenges and strategies for managing structural change. Figure 7 illustrates a framework for thinking about how the set of desirable and feasible structural policies (zone “SR”) can be expanded by making improvements across the three dimensions of policy dialogue, capacity building and awareness raising. This section provides an overview of lessons from the literature and the role of the EC in providing tools to manage structural change.

Figure 7: Framework: Increasing the Set of Feasible Structural Policy Improvements



Source: Adapted from World Development Report (2005)

5.1 Policy dialogue

The pervasiveness of structural policies makes identifying and setting priorities a key challenge of structural reform. Given the diversity of situations there is no standard formula for identifying priorities. However, the World Development Report (2005) suggests that government may wish to start by:

- *Assessing current conditions:* Comparing performance with other economies (for example by using the World Bank Doing Business indicators)
- *Assessing potential benefits from improvement:* There may be a greater impact from addressing constraints that affect a large share of economic activity (for example macroeconomic stability)
- *Implementation constraints:* Take into account administrative and political constraints when setting priorities (for example a high level commitment and process for managing change may be necessary)

At the EC’s meeting in January of this year, Australia in conjunction with co-sponsor New Zealand hosted a ‘Seminar on Priorities in Structural Reform in APEC Economies’. The seminar aimed to understand the national and common regional priorities in structural reform across APEC member economies to help inform the focus of the EC’s detailed work programme and also provide a basis for assessments of capacity-building needs in member

economies. It was evident from the discussion at the seminar that economies are able to identify specific priority areas in their local contexts. Where the EC can add value is by providing a forum for discussion and sharing of experiences on tools to assess and implement reforms.

The EC is currently in the process of developing a detailed forward programme to report to APEC Ministers on during September of this year. The work programme is being progressed by the establishment of 'Friends of the Chair' (FotC) groups (groups of between 3-10 interested economies) across the five LAISR themes of regulatory reform, competition policy, public sector management, corporate governance, and strengthening economic and legal infrastructure. The majority of APEC economies have signed up to at least one group. The FotC mechanism is designed to ensure that the work programme of the Committee reflects the priorities of member economies and guides the work of the EC going forward.

5.2 Capacity building

Economies need the financial resources and technical expertise to drive structural change. The World Development Report 2005 suggests that government may wish to start strengthening capacity by improving the expertise of the civil service and the quality of information available to guide and administer reforms.

The Report identifies the importance of economies creating a skilled, professional and accountable civil service and drawing on specialist expertise where necessary. Some economies have established more autonomous administrative structures to recruit and retain staff and have tried contracting out specific functions to outside experts.

The Report also highlights the importance of economies improving processes for ongoing learning from within economies and from overseas experiences. This can be achieved through greater access to reliable data, introducing consultation processes or by introducing or improving enterprise surveys to gather information on factors such as productivity and job creation.

The work of the EC has a capacity building dimension. For example the APEC Study Centre is running a five day training course in May on 'Strategies to Promote Structural Reform by Focusing on the Drivers of Economic Growth in APEC', which is endorsed by the EC. This course aims to enhance the capacity of participants to appreciate the key drivers that improve productivity and to devise policy responses to improve economic performance.

Another activity that has a capacity building aspect is the APEC-OECD Integrated Checklist on Regulatory Reform. The Checklist is a voluntary tool that member economies may use to evaluate their regulatory reform efforts. The Checklist highlights key issues that should be considered during the process of development and implementation of regulatory policy, while recognizing the diversity of member economies. This year Australia and the Republic of Korea are undertaking a self-assessment using the Checklist. The results of the self-assessments will be reported and discussed at a joint EC-CPDG-SELI Roundtable session during the second EC meeting in June of this year. In 2006 the United States, Chinese Taipei, and Hong Kong, China undertook a self-assessment using the Checklist, the results of which were discussed at a Roundtable session at the second EC meeting last year.

A seminar is also being held in Indonesia in early June on 'Utilizing APEC-OECD Integrated Checklist on Regulatory Reform in Competition and Deregulation Aspects'. This seminar will be attended primarily by officials from Indonesia and other member economies that are considering undertaking the self-assessment exercise in future years.

5.3 Awareness raising

The benefits of structural reform are not generally well understood by the public. For reforms to be successful it is important that the costs and benefits of policy approaches are well communicated and understood by key stakeholders.

While recognising that the appropriate awareness raising strategies will differ across economies, the World Development Report 2005 identifies some practical steps economies can take to raise awareness about structural reform:

- *Communicating to build support:* Raise public awareness and mobilise a broader range of support (for example by using tools like World Bank Doing Business indicators to benchmark performance)
- *Maintaining momentum:* Establish institutions to sustain progress of reform. Institutions can facilitate consultation and coordination and review existing and proposed policies (for example institutions such as Mexico's Economic Deregulation Unit and the Australian Productivity Commission).

It will often be important for policy makers to clearly communicate to key stakeholders why structural changes are necessary. While the most appropriate form of communication will vary among economies, a good example of the use of communication to build support is the New Zealand reform experience of the 1980s. New Zealand went through radical reforms in the 1980s that transformed its economy from one of the most regulated to one of the least regulated in the OECD in a matter of a few years. The incoming administration extensively publicised why regulatory changes were necessary, what the goals of reforms were, and what the strategy was. While strong debate existed, most of the reforms have not been repealed.

History also tells us that programs of structural change often involve taking advantage of opportunities as they present themselves. New Zealand's 1980s structural reforms for example were implemented when the New Zealand economy was on the verge of severe financial stress, following a decade of very poor economic growth.

The main publication of the EC, the APEC Economic Policy Report, is a tool for raising awareness of the benefits of structural reform. Last year's report focused on the importance of structural reform and captured member economy's experiences with structural reform over the last 10 years. The report is provided to APEC Leaders and is available to the public on the APEC website. The 2007 report will focus on the LAISR priority area of public sector governance and capture general principles of good public sector governance and economy experiences with public sector governance reforms over the last 10 years. Future reports will focus in on other LAISR priority areas, such as competition policy, regulatory reform, corporate governance and economic and legal infrastructure.

6. Summary

The Asia-Pacific region is a major force of global growth, comprising 57% of world GDP (US\$20.7 trillion) and 45.8% of world trade (US\$7 trillion)¹⁰. However there is a growing body of evidence which suggests that the APEC region is not realising the full benefits of convergence due to remaining barriers at the border and behind the border barriers to regional economic integration. While outward-orientation and strong growth performances have resulted in a catch-up process in some economies, progress across the APEC region

¹⁰ APEC Secretariat (2005)

has been patchy. Consequently there is a growing consensus that as a complement to the trade and investment liberalisation and facilitation agenda, focus in the APEC context should be given to structural policies.

While the benefits of structural reform are becoming increasingly well-understood there are of course significant challenges to undertaking structural reform. While the most appropriate policy responses will differ across economies, the literature identifies a number of challenges and strategies for managing structural change. These can be conceptualised as increasing the set of desirable and feasible reforms across the three dimensions of policy dialogue, capacity building and awareness raising. Where APEC and the EC can add value is by providing a forum for the discussion and sharing of experiences on good practice principles and practical lessons on implementation, as well as technical assistance where necessary. Structural change is a long term process, which complements the trade and investment liberalisation and facilitation agenda. It will take sustained high-level support to progress this work programme across APEC.

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The Challenge of Structural Change

Prepared for:

APEC 2007 Annual Conference of APEC Centres
Melbourne, Australia, 20 April 2007

Presented by: Bob Buckle

Chair, APEC Economic Committee
Principal Advisor, New Zealand Treasury
Adjunct Professor, Victoria University of Wellington

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Presentation outline

- **Goals of APEC:**

- Trade and investment liberalisation and facilitation (1994 Bogor Goals)
- Complementary focus on structural reform (2004 LAISR)

- **In this presentation:**

- Growth and convergence in APEC
- Structural impediments
- Framework for identifying and managing challenges of structural change

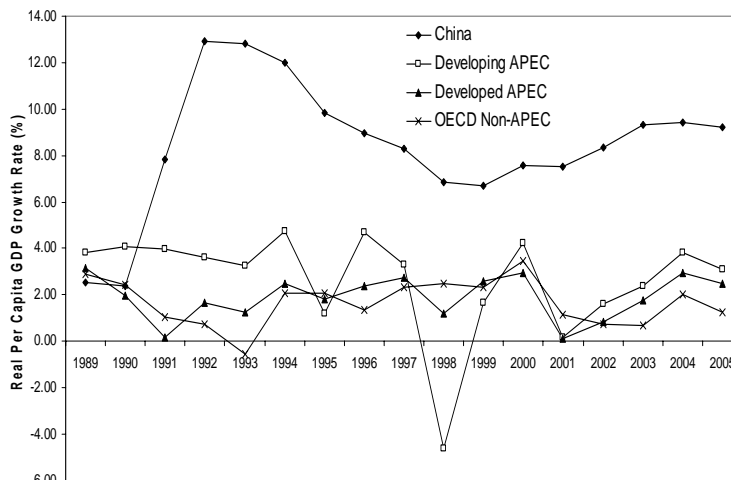
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Growth and convergence in APEC

- Traditional and modern growth theories identify (proximate) reasons for growth:
 - Factor accumulation (given technology growth)
 - Ideas and technology
- Convergence of incomes can be driven by:
 - Capital flows between economies
 - Technological imitation
- Slowdown results from diminishing returns

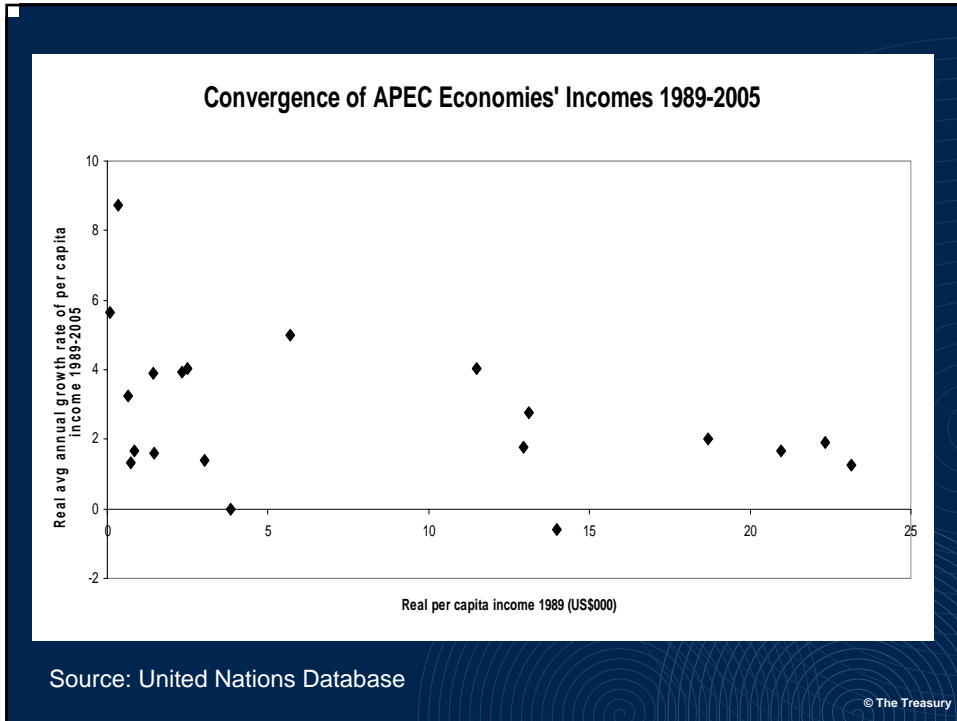
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Population Weighted Per Capita Real Growth Rates 1989-2005



Source: United Nations Database

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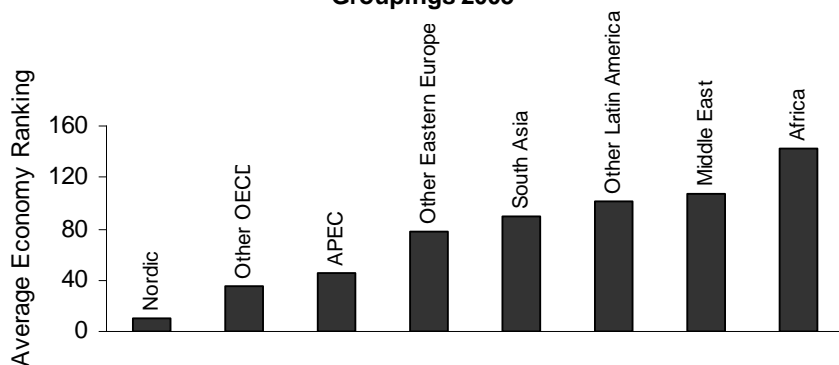
- ## Impediments to growth and convergence
- Progress in tariff reduction, but barriers behind the border still significant
 - Research indicates large gains from structural reform
 - ‘Middle income economy challenge’
 - Sluggish investment recovery post 1997-98 financial crisis
 - China’s ‘rebalancing’
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... Impediments (cont.)

- Technological spillovers
- Migration – between and within economies
- Intra-regional trade and specialisation
- Business environment e.g. World Bank 'Costs of Doing Business' indicators

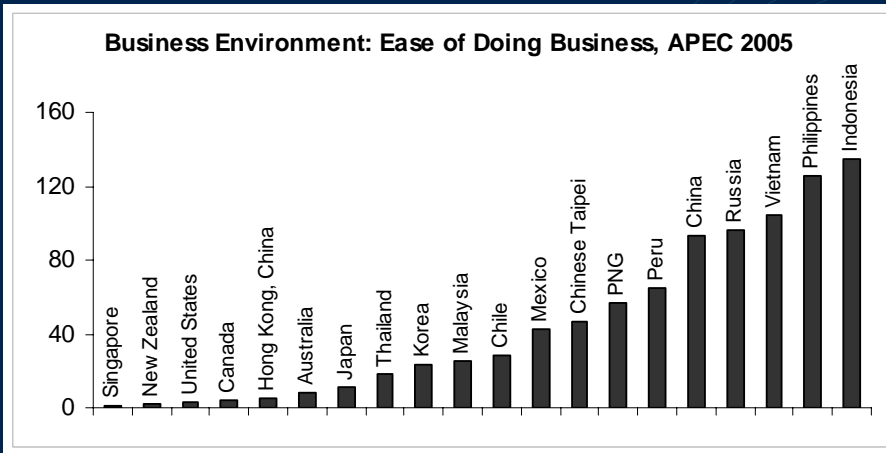
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Business Environment: East of Doing Business, Regional Groupings 2005



Source: World Bank Doing Business Database

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Source: World Bank Doing Business Database

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The challenge of structural change

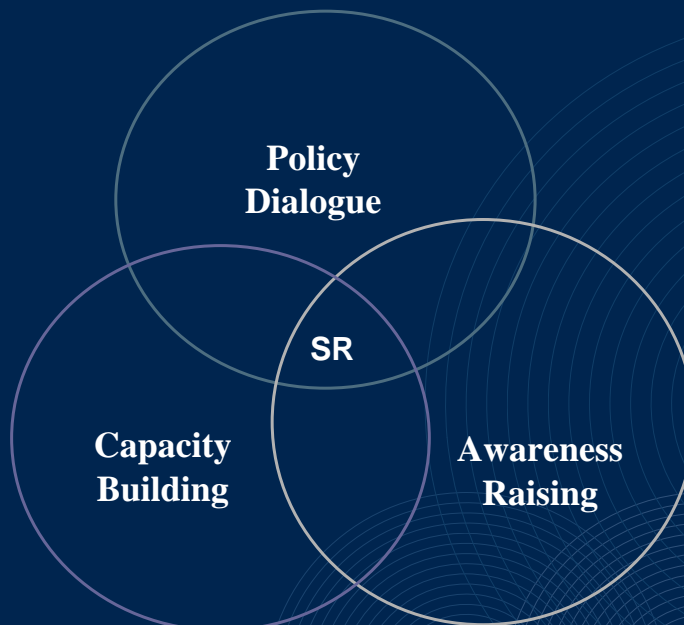
- APEC is a good place to start discussions on economic policy challenges
 - Voluntary process of cooperation and support
 - Structural policies not easily negotiated between economies
 - Can provide a forum to share experiences on good principles, practical lessons and technical support

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... The challenge (cont.)

- Many economies still grappling with design and implementation of effective regulation, competition and governance systems
- Framework for identifying and managing challenges of structural change built on three dimensions:
 - Policy dialogue
 - Capacity building
 - Awareness raising
- Increase set of feasible policy improvements

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Source: Adapted from World Development Report (2005)

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.....The challenge (cont.): Policy dialogue

- Setting priorities is a key challenge
- No standard formula
- Suggestions from World Development Report (2005):
 - Assessing current conditions
 - Assessing potential benefits from improvements
 - Implementation constraints

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.....The challenge (cont.): Policy dialogue

Role of the Economic Committee

- Seminar on Priorities in Structural Reform in APEC Economies, January 2007
- Forward work programme for LAISR
- ‘Friends of the Chair’ process

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.... The challenge (cont.): Capacity building

Economies need financial resources and technical expertise to drive structural change

- Suggestions from World Development Report (2005):
 - Improve expertise of civil service
 - Improve quality of information available to guide and administer reforms

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.... The challenge (cont.): Capacity building

Role of the Economic Committee

- APEC Study Centre training course on 'Strategies to Promote Structural Reform by Focusing on the Drivers of Economic Growth in APEC', May 2007
- APEC-OECD Integrated Checklist on Regulatory Reform
- Seminar on 'Utilising the APEC-OECD Integrated Checklist on Regulatory Reform in Competition and Deregulation Aspects'

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.... The challenge (cont.): Awareness raising

- Benefits of structural reform generally not well understood
- Important that costs and benefits of policies are well known
- World Bank Development Report (2005) suggests some practical steps:
 - Communicating to build support
 - Maintaining momentum

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.... The challenge (cont.): Awareness raising

- **Case Study: New Zealand's 1980s Reform Experience**
- Reforms transformed economy from one of the most regulated to one of the least regulated in the OECD in a matter of a few years
- Incoming administration publicised:
 - why regulatory changes were necessary
 - what the goals of reforms were
 - what the strategy was
- Strong debate existed but most reforms have not been repealed

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.... The challenge (cont.): Awareness raising

Role of the Economic Committee

- APEC Economic Policy Report
 - 2006 Report on importance of structural reform
 - 2007 Report on Public Sector Governance
 - Future reports on other LAISR priority areas (e.g. competition policy, regulatory reform, corporate governance, economic and legal infrastructure)

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Summary

- Asia-Pacific region a major force driving global growth
- Region may not be realising full growth potential and rates of convergence due to 'behind the border barriers'
- Some 'catch-up', but progress has been patchy
- More focus in APEC should be placed on structural policies
- APEC Economic Committee provides forum to promote and support structural reform

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