

## **Recovery from the Global Recession - Adjusting the APEC Ambition.**

**Annual Conference of the APEC Study Center Network, Singapore, 13-15 July 2009**

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There is still great uncertainty about how the global financial crisis will impact on the global economy. The subsidiary question for APEC economies is how this will affect the APEC ambition to build an integrated Asian Pacific economy.

There are two determinants. One, the effect of decline of demand in the world's leading economies. And two, the condition of economies in the APEC region: will that hinder or advance the capacity of APEC economies to manage this change?

This analysis does not attempt to assess quantitatively the impact of the crisis. It merely observes the general direction of developments.

Nor does it predict the quantitative impacts on APEC economies; rather it focuses on the capacity of those economies to respond on those matters which will be affected by the global crisis.

Rather it proposes a broad program for APEC economies to follow to optimize recovery from the recession.

### **The APEC reference point**

For two decades APEC has mounted a continuous case for open markets in the Asian Pacific region. The goal of APEC is to foster an integrated market among APEC members.

The degree of openness of APEC economies varies. The most open sector is manufacturing, although on average manufacturing tariffs among APEC developing economies are a little higher than in developed economies.

APEC includes the most competitive manufacturing economies in the global economy. APEC has hosted the fastest growing manufacturing and traded sector in the global economy for the last decade – the IT and communications manufacturing sector.

APEC will not continue to remain the high growth region in the global economy if manufacturing remains its leading growth sector.

As labor costs rise in APEC, boosted by rising living standards, competitiveness in APEC economies increasingly depends upon efficient services sectors.

A feature of developed economies is large services sector. Successful industrialized economies have efficient services sectors. There is an important lesson here from the Japanese economy. A structural impediment to restoration of economic growth in Japan over the last decade and a half has been a poor performing services sector.

A key feature of a liberal services sector is an open investment regime.

Members of APEC have adopted programs to promote liberalization of both services and investment. The record of implementation is patchy.

Before the global economy went into recession, whether or not APEC economies with underperforming services sectors (and that includes most ASEAN economies) were willing to liberalize those sectors was arguably the single most important strategic question upon which the retention of global competitiveness across the board among APEC economies rested.

### **The impact of the global recession**

The global recession has impacted in different ways on APEC members. That impact is shaped by two things: the extent to which the financial sector was undermined by the sub-prime crisis; and the extent to which trade with leading economies, particularly in North America and Europe, fell as those economies contracted.

For example the global contraction of credit has influenced the availability of trade finance in a number of countries. The fall in demand is reflected in the heavy industry and related manufacturing sector. The US and Europe are major markets for these products and economies significantly dependent on them (Japan and South Korea) have found the collapse of growth in those industrialized markets has affected their own badly.

Global financial institutions are forecasting that the leading industrialized economies will contract by three to four percent this year. That will probably result in a decline in trade double that. It appears in the last 12 months that growth and trade in those economies declined by comparable amounts.

Singapore's economy appears to act as a real time measure of the health of global trade and growth in APEC. Its central function in trans-regional transport and logistics means its economy swings immediately with fluctuations in those industries. They are the first to react when trade rises or falls.

Recent reports suggest growth in Singapore next year may not be as much as initially forecast. Caution is called for when predicting the path out of this recession. As one leading economic analyst in Australia has warned, there is no precedent with which to measure the path of this crisis.

Mitigating influences for APEC economies exist for those which are significant exporters to China, where growth and demand for imports has fallen around 25 percent, but otherwise which is expected to be positive and remain reasonably buoyant. Measures to stimulate domestic demand in China are likely keep China's demand for imports healthy. Metal and commodities prices have fallen from record highs, but the inflationary spike which drove them so high appears to have passed and demand from China is expected to remain strong. So exporters of mineral and commodities to China, of whom there are several in APEC should expect demand to remain steady.

### **Systemic impacts on APEC economies**

Global recessions change paradigms. Businesses that are uncompetitive, or struggling to be competitive, and businesses denied access to finance, go under first.

The threat to survival of less competitive industries is why there is always an upsurge in anti-dumping actions during recession. The WTO is now reporting a record level of resort to contingent protection (anti-dumping, countervailing and safeguard measures) around the world. For the first time the most active are developing countries, although not in APEC – that dubious honor falls to Argentina and India.

These changes in competitiveness accelerate relocations of industries to more competitive economies. Before the recession began, there were clear indications that low cost manufacturing on China's southern seaboard was losing competitiveness.

The recession will accelerate the relocation of some of that industry to Vietnam. Will it go elsewhere in APEC? There may be a presumption that the traditional pattern of relocation of industry in APEC to lower wage cost economies, the "flying geese" pattern will continue. Under that model, manufacturing shifted from Japan to Korea, Singapore and Taiwan as wage costs in Japan rose, and from there to the rest of ASEAN as their costs rose.

This phenomenon was not an economic law or the result of the application of an economic theorem; it was response to changes in economic conditions. In the globalized economy, these changes have occurred outside the APEC region as well.

Consider the garment industry. In the late fifties and sixties, the mantle of most competitive manufacturer of rested in East and Southeast Asia. It is no longer the case. South Asia and Eastern Europe are now also competitive in that industry as well.

The recession is likely to accelerate the move of less competitive garment manufacturing out of developing APEC economies. It would be a mistake if APEC economies did not assume a similar process might occur in the electronic and IT manufacturing industry.

Developing APEC economies have been successful in attracting foreign investment. There has been a tendency to take for granted, although in most of these economies officials in Finance Departments have been well aware that this is a risk.

A number of APEC developing economies have been successful in attracting investment, despite significant controls on foreign investors. These typically include restrictions on what industries are open to foreign investors, the extent to which invested industries must export, as well as requirements for local shares of ownership. However the impact of the recession will make competition for foreign investment more intense.

ASEAN economies are aware of the risk and have agreed to liberalize constraints on foreign investors outside ASEAN under AFTA arrangements. Recently Thailand and Malaysia have announced removal of some restrictions on foreign investors.

This is just one more measure in ASEAN that global competitiveness, Vietnam and Singapore excepted, is declining.

### **The impact of the recession on global public policy**

In the last two decades, it has been orthodoxy in the leading industrialized economies that globalization is beneficial and that the open markets necessary to deliver its economic benefits are essential. There has been a common view that markets should dictate where investment should occur. By and large the public sector has retreated as an investor in national economies.

The settings for government policy have change massively as the leading economies acted to shore up their financial sectors and production and consumption in their economies. In the UK, the US and several other European economies, a very large part of the financial sector has been nationalized. Some industries, automobiles in particular, are now also under Government ownership or control. Others survive on government guarantees.

Following realization that failure to regulate exposure to risk was a key cause of the financial crisis and the recession, the leading economies have foreshadowed change in regulation of the financial sector. It may be sometime before the form of that is known.

However an event as far reaching as this economic crisis should also be expected to generate challenges to other policy settings or to create new grounds to advance others.

### *Opposition to globalization*

A push from interests in those advanced economies who have either disliked the open economy model or whose vested interests have been reduced by that system, such as organized labor, should be anticipated to exert pressure on governments not to return fully to the open economy public policy settings that have come to be regarded as the norm in a globalized economy.

In the industrialized world, particularly in Europe, civil society has been a constant critic of the open economy model, and it can be expected to ally with organized labor to press for these changes.

One area where civil society has had influence has been on the aid policies of donors. While it has campaigned for more aid, over the last decade it has in fact had more success campaigning to focus aid on issues high on the agendas of civil society agendas, such as human rights, environment and improved governance. The result is that the share of aid directed to support economic growth has fallen.

The greater impact on growth of opening the economy rather than by increasing aid has been amply demonstrated in APEC. However this has never been accepted by the leading global civil society NGOs based in the industrialized economies. Oxfam for example now advocates a managed trade model which is close to the import substitution development model which was discarded by international development agencies in the early 80's.

There is a distinct possibility that pressure will intensify on Western governments to step away from general economic policies that recognize globalization and foster integration of open economies.

### *Green restructuring of economies*

A related development which would support this tendency, if not lead it, is increasing elevation of environmental policy as a priority in national and international policy.

For some years now the EU has been retuning its regulations to secure compliance with environmental goals, in the process creating new hurdles for imports from the APEC region. The drive to intensify this trend seems to be strengthening.

The touchstone for this now of course is climate change. The declared aim of several governments in the industrialized world is to "restructure" their economies so they generate less greenhouse gases.

There are no readily available sources of energy to replace carbon-based energy at the same price, so if these strategies succeed, producers in these economies will become less competitive compared to producers in others. This has already led to calls in Europe and in the US Congress for carbon tariffs to restrict the entry into their markets of more competitive imports.

Environmental groups are now arguing that financial assistance and other government programs to support recovery from the recession should be targeted to promote the restructuring of economies to make them low carbon consumers.

Most developing economies, and particularly key member of APEC, do not see things this way. They perceive correctly that the strategies to reduce greenhouse gases being promoted in Europe and the US will reduce economic growth and hinder national goals to raise living standards and reduce poverty.

Economics supports their case. The conventional view among development economists is that measures to address climate change should be very long term, and not begin with onerous increases in energy costs, but instead with measures that do not inhibit the capacity of developing countries to continue to raise living standards.

It is also pertinent that argument that drastic and immediate action to reduce greenhouse gases is necessary to avert significant environmental damage is not supported by the scientific analysis of the IPCC, the UN expert body on climate change.

In the very short term, say the next two years, the economic crisis will diminish public interest in industrialized economies in costly programs on climate change because of the more immediate economic problems created by the recession. This is clearly altering the framework in which climate change policies are being written in Washington and Bonn. However, once economic recovery is perceived to be underway, the climate change environmental agenda can be expected to have a major influence on policy on economic growth and development.

### **Adapting the APEC Strategy**

The Bogor Declaration has decreed industrialized APEC economies will remove all barriers to trade and investment by 2010 and all developing APEC economies by 2020.

The 2010 target will be broadly met, although significant restrictions to trade in agriculture will remain in the US and Japan and Japan's the services sector will remain heavily constrained.

The 2020 target will probably be met in most manufacturing industries by developing economies, although this will require acceleration of liberalization programs in China and Vietnam.

As noted, the bigger challenge will be in services and investment. If the target is to be met, developing APEC economies have 11 years to institute programs to liberalize those two areas.

However the recession demonstrates the importance of APEC's reinforcing its strategy to foster economic integration for its own sake, and rather more quickly than the timetable of the Bogor Declaration.

*The need to accelerate Asian Pacific Economic integration*

First, APEC economies need not only to restate the essentiality of promoting global growth on the basis of fostering open economies, they need to demonstrate their own commitment to doing so to ensure the concept is taken seriously and is not just another set of words produce by yet another meeting of Leaders.

Second, they need to engage in collective economic risk management. This means not just advancing the implementation of programs to accelerate liberalization of services and investment, it means acting concretely to secure, restore and re-establish the global competitiveness of economies in the APEC region.

APEC was founded on the idea that trade liberalization was key to promoting economic growth and integration of APEC economies. There is an inclination for the measure of success in reaching this goal is the extent to which trade barriers are reduced.

It takes more than that. The key is domestic economic policy which fosters the competitiveness which enables industries in open economies to trade on their comparative advantage. The commitment to reduce the trade barrier is testimony to recognition of that principle. But the implementation depends on sound domestic economic policy.

APEC has recognized this indirectly and implicitly – such as through the trade facilitation programs to reduce the transaction costs of trade and to tackle the ‘beyond the border’ impediments to increased growth. APEC has established an economic structural change program and created a forum for Economic Affairs Ministers to advance it.

What is missing is a statement of the primary goal these activities are to achieve. It is not economic integration itself; it is the condition which achieves it. And that, simply put, is to achieve global competitiveness in each APEC economy.

The lesson of the changes generated by the global financial crisis and the economic crisis for APEC is that its members need to act urgently to alter their national policies to imbed new standards of global competitiveness in their national economies, in recognition that the circumstances which obtained in the global economy before the recession will not continue afterwards.

The impact of the recession elevates the importance of taking action to liberalize those sectors. This is no longer a matter of achieving an ideal goal which would deliver economic benefit; it is a matter of acting to restore the level of competitiveness APEC economies need in order to continue to pursue the national goals of raising living standards.