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Globalisation and Global Financial Crises

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I am honoured to be invited to speak at this important workshop.

I will talk to four points:

- globalisation
- the present global financial crisis and managing future crises
- APEC and its role going forward
- conclusions relevant to this workshop

Globalisation has been a characteristic of human affairs for at least two and half thousand years, and probably much longer. Alexander the Great (356-323 BC) was an early and successful exponent of expanding influence, culture and economic power beyond Macedonia to Syria, Egypt, Mesopotamia, Persia. His troops limited his desire to the reach “the ends of the world and the Great Outer Sea” when they objected to his further exploits into India. Expansion and the desire to influence the “known” world has been a defining aspect of mankind since Alexander, and probably before Alexander. What it brought in an economic

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sense through the historic process was trade, modes of exchange, specialisation of products and services, market structures and market places and trade routes. Markets established centuries ago still exist, specialisation has deepened.

Globalisation in terms of open markets and payments systems blossomed until the First World War, after which nation states introduced trade barriers to protect domestic industry and employment. The period after the Second World War saw the creation of the Bretton Woods institutions and the General Agreement on Tariffs and Trade. They represented global efforts to reduce protectionism and to encourage capital flows. They promoted rules for cooperative international behaviour.

In the last thirty years or so the liberalisation of trade and investment and reforms to the international payments system have contributed to a massive rise in global activity, trade, payments and investment flows, rising living standards and a lowering of global poverty.

ASEAN and later APEC were formed. There were major achievements in removing barriers to trade through the WTO and to services through the GATs.

For a number of reasons the process of liberalisation through global efforts has stalled in recent years and we now confront problems in efforts to resuscitate the WTO Doha Development Round. Countries and regions have increasingly resorted to bilateral and regional trade and investment agreements to reduce barriers and to promote external trade and investment.

The value of trade in goods and services as a percentage of world GDP increased from 42 per cent in 1980 to 62 per cent in 2007.

Since APEC was created in 1989, average trade barriers in the region stood at around 16%; by 2004 they had been reduced by approximately 70% to 5.5% and intra-APEC merchandise trade grew from \$US1.7 trln to \$8.4 trln in 2007. APEC's trade with the rest of the world increased from \$US 3 trln to \$US 15 trln.

But perhaps the most important change in the last thirty years has been the movement to integrated global capital markets. Foreign direct investment has grown from around 7 per cent of world GDP in 1980 to 32 per cent in 2006. The stock of international claims – primarily bank loans – as a percentage of world GDP increased from 10 per cent in 1980 to nearly 30 in 2006.

The consequence of these massive changes in global economics has been a decline in the number of people living in extreme poverty. Those living on less than \$1 per day have been halved. Even so, there are still 1 billion people living on less than \$1 per day and 2.6 billion people living on less than \$2 per day.

Globalisation which can be defined “as increasing trade and financial openness” has contributed to momentous changes in international economic affairs, including those just mentioned but also to rising per capita incomes across almost all regions and including for the poorest segments of populations. Incomes for relatively well off people have increased at a faster pace than have incomes of the poorer.

Data based on consumption in groups of developing economies, show a striking inequality between the richest and the poorest in populations across different regions.

The World Economic Outlook 2007 noted that contrary to popular belief increased trade globalisation is associated with a decline in inequality. Technology, financial globalisation and in particular foreign direct investment have contributed to a rise in inequality by raising the demand for skilled labour and increasing the returns to skills in both developed and developing economies. Everyone benefits but skilled people benefit more.

World Bank studies show that in “globalising” countries in the developing world, income per person grew three and a half times faster than in the “non-globalising” countries during the 1990s.

Of course, when the analysis of the impact of the global financial crisis is completed – economic historians may point to some reversal in the favourable developments I have just noted as a consequence of globalisation.

I would suggest however that given the nature of the crisis with its major impact on lowering activity, rising deficits and wealth losses in developed economies, and the prospect of recovery coming more sharply and more quickly in developing economies that, relatively speaking, reversals in those favourable trends will not occur.

I would like to turn to *the global financial crisis and managing future crises*.

At the outset, history is replete with financial crises. More will come. Hopefully, we get a breathing space to adjust the major imbalances now present in the global economy and to put in place arrangements that will better prepare economies before the next crisis does occur. There are signs of improvements in current account imbalances.

Each of us will have his or her own way of understanding the genesis of the crisis. My own is that it reflected a failure in governance in both public policy agencies and in some financial institutions in major developed capital markets.

While deregulation, technological innovation, financial engineering and risk dispersion have contributed to spectacular growth in financial transactions and in supporting economic growth and risk taking, regulatory arrangements and regulatory knowledge were inadequate to capture the extent of leveraging in international capital markets.

The capital backing for financial transactions was seriously lacking, resulting in the need for massive bail outs of major institutions by governments.

Boards and management of some major investment banks and trading banks based their activities on inappropriate incentive systems, magnifying rewards for reckless risk taking and disclosure of a highly questionable and in some cases, fraudulent nature.

Policy makers and regulators failed to exercise their authority to bring a halt to extreme leveraging, or they lacked the authority to do so.

The damage wrought by these failures has cost global development dearly.

While the recent World Economic Outlook by the IMF points to a number of significant positive developments as a consequence of actions taken by both developed and developing economies in fiscal and monetary policies to ameliorate the impact of the crisis, it also notes that financial conditions remain more difficult than before the crisis, especially in advanced economies.

Sectors that have only limited access to capital markets, consumers and small and medium sized enterprises are likely to continue to face tight limits on borrowing.

The noteworthy development of the crisis has been the efforts at global coordination by the G20, the Financial Stability Board and other groupings in finding resolutions to the crisis and in developing reforms to financial system regulatory standards and practices to minimise the prospect of further crises.

The arrangements involve:

- new and higher capital charges for banking institutions
- investment banks to be brought under more intensive regulation
- stress testing and macro-prudential measures to strengthen financial institutions and reduce systemic risk
- the inclusion of systemically important non-financial institutions in an economy's financial regulatory systems
- compensation arrangements for banking executives aimed at rewarding prudent risk managers
- capital charges as a measure to safeguard against liquidity risk
- enhanced disclosure requirements to enforce market discipline
- capital charges to cover potential exposure to activities of non-bank subsidiaries of a banking group

- arrangements for closer cooperation between national regulators where institutions they supervise operate across borders

These measures will involve higher capital charges for banks and other financial intermediaries and require them to take greater precautions in their lending functions. This will slow credit growth, lead to higher risk premiums on borrowers and slow economic activity. These are some of the costs that societies must bear for the crisis.

The mix of policy and regulatory responses proposed by G20 and the financial standard setting bodies will have far reaching implications for Asian economies. They will certainly impact on the Asia Pacific region.

A future challenges in financial system affairs for APEC and for regional economies is the need to review the relevance and potential impact of major proposed regulatory reforms on the economies of the region. And to better understand changing financial conditions that will determine systemic stability in the Asian region.

Managing future crises imposes responsibilities on economies of the region and regional forums – and APEC is perhaps the most logical forum – to propose ways to coordinate regional policies and management approaches.

Issues to be considered with the objective of minimising turbulence in finance systems could include:

- the impact on regional economies of changes in investor sentiment to any rise in concerns of sovereign debt in major western economies
- ways in which trade credit and investment flows can be maintained if global liquidity becomes more constrained than it is presently
- sustaining demand and investment in regional economies if recovery in advanced economies is protracted

- assess the appropriateness of compensation systems and governance arrangements proposed by the Basel Group of Banking Supervisors and others, to institutional practices and standards in the region and to consider whether some differentiation is relevant
- measures to ameliorate any break out in trade and financial system protection
- the relevance of proposed capital charges to regional financial institutions

These are just some policy issues that could and should be the subject of enhanced cooperation within the region to focus on. By starting work now on such matters, confidence in the region could evolve to place regional economies as equal and substantial partners with major western economies and other regional groupings in the formulation and determination of public policies in financial affairs that impact globally and regionally.

The longer term financial challenges that confront the region are massive and deserving of high quality review. They include:

- deepening financial structures and markets
- meeting the financing gaps in economic and social infrastructure
- financing the health and education needs of the region
- handling the impact of ageing populations and retirement needs

In promoting liberalisation and openness in the region APEC has become a major forum in regional and global economic affairs. It does provide a coherent set of policy frameworks for its members to evaluate and facilitates trade and investment across borders and behind borders. It is working within the LAISR framework to support structural reform in regional economies. The establishment of the Policy Support Unit has provided APEC with a major resource for analysis and research to promote the social and economic goals of APEC.

By focusing on the issues I have outlined, APEC would complement its existing structures and work programs. It would contribute to a financially stronger region and to regional economic and social integration. It would contribute to bringing an authoritative Asian perspective into global deliberations and policy formulation.

Conclusions

APEC regional economies have achieved strong growth rates in trade in goods and services and in investment flows over the recent past. Growth in Asian output is forecast to increase faster than that of any other region in the period ahead.

Participating in the globalisation process has brought and continues to bring significant benefits to the region. APEC's various forums which focus on opening markets and investment flows, structural reforms are contributing to the growth momentum in the region.

The global financial crisis poses threats to growth and development and demonstrates some serious weaknesses in major economic relationships and in governance and risk management in global financial institutions. The crisis has impacted on the Asian region, but it has not thrown regional development seriously off course.

Concerns early in the crisis that serious liquidity constraints would impede credit and trade credit in particular, were cause for concern in the Asian region. That concern has eased as the impact of the crisis lessens but credit growth may be again slowing down.

Serious challenges remain – essentially the major causes reside in the major developed economies – but handling the consequence is relevant for all countries and certainly for developing economies of APEC.

Any further crisis in Europe for example, following the Greek crisis – a crisis far removed, in time at least, from Alexander the Great – could have serious repercussions for the Euro and international financial and economic stability.

International coordination has worked well in response to the global financial crisis. It is to be hoped that European support for Greece and other vulnerable countries in the monetary union will hold and will stabilise that region's economies and build confidence in the region and in the global system.

However, outcomes in Europe and indeed in the global economic system are far from certain. But there are promising signs that economic coordination is working.

The issues I have outlined have implications for SMEs, as indeed they do for all economic sectors. SMEs are affected by financial system stability, or the lack of it, fluctuations in the availability of credit, factors causing major currency fluctuations, interest rate increases and rises in sovereign debt around the world. These are some of the consequence of a world in which capital markets are integrated and part of the globalisation process.

The establishment of the SME Crisis Monitor is an important and additional development in APEC's structures. It does reflect concerns that APEC should coordinate in a specialised way to monitor and propose actions to ameliorate potential threats to SMEs as a major and fundamental component of all our economies.

THANK YOU.