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**SESSION 5; GLOBAL CRISIS AND RESPONSES: IMPLICATIONS ON THE ASIA
PACIFIC REGION**

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'TRADE AND FINANCE: THE IMPACT OF THE RECESSION'

I am honoured to be invited to speak at this Conference and I thank the Singapore APEC Study Centre for inviting me.

The most recent World Bank forecast is that world GDP could fall by 2.9% in 2009; and growth could recover by around 2.0% in 2010. World trade volume is forecast to fall by 9.7% in 2009 and recover to grow by 3.8% in 2010.

Importantly, the World Bank notes that given the output losses already absorbed, and because GDP only reaches its potential growth rate by 2011 the output gap (the difference between GDP and its potential) unemployment, and disinflationary pressures are projected to build over 2009 to 2011.

As always with these kinds of projections, better or worse outcomes are both quite plausible. But that said, the outlook is somber indeed.

The World Bank also notes that the sharpest declines in economic activity (in the 4Q of 2008 and following through into the 1Q 2009) were concentrated among countries specialized in the production of durable and investment goods and in countries with serious pre-existing macroeconomic vulnerabilities.

As well as there being an unprecedented rapid fall in global demand for manufactured goods during the 4Q 2008 and the 1Q 2009, there have been widespread cutbacks in investment spending including in APEC economies, the US, Japan, Korea, Mexico and the Russian Federation. Investment spending fell by annualized rate of 16.5% in 27 of the 30 higher income countries in the 4Q 2008. There was a 13% fall in global industrial production between September 2008 and March 2009 and virtually every country that reports production data

witnessed a sharp fall in output. Many countries are reporting capacity utilization rates of below 70%.

Because consumer durables and investment goods are heavily traded the sharp fall investment spending (and the rise in household and firms' savings) has contributed significantly to the dramatic fall in the volume of world trade.

The World Bank observes that the very sharp contraction in trade volume has been amplified to an uncertain degree by a shortfall in trade finance.

The impact on countries specializing in producing durable and investment goods is relevant to the trade and financing issues I will develop further in this note. I should note that trade in services and in commodities are also being sharply impacted by the fall in global activity – as evidenced by falling commodity prices – but those developments are outside the scope of this paper.

A recent paper in the Asian Development Review, 2009 Asian Development Bank, contains an article “Trade Structure and the Transmission of Economic Distress in the High-Income OECD Countries to developing Asia” by Juthathip Jongwanich, William E. James, Peter J. Minor and Alexander Greenbaum.

A key point made by the authors is that the impact on developing Asia caused by the slow-down in high-income OECD economies is through the trade channel rather than through the meltdown of financial institutions.

By end 2008, exports from developing Asia to OECD had noticeably contracted. The drop of export growth averaged nearly 30% in East and South East Asia and approached double digits in South Asia, leading to a deceleration in GDP growth and significantly rising unemployment.

Of particular interest in the paper is a discussion on the evolution of trade patterns and that the rapid export growth in developing Asian economies has been underpinned by a pronounced shift in export structures away from primary commodities and towards manufactured goods.

Beginning in the early 1970's a notable shift toward manufacturing is observable across all countries at varying speeds and intensity. Since the early 1990's the share of manufactured exports in total exports in Southeast Asia (except Indonesia and the Philippines) has exceeded 70%. In the Philippines the share of manufactured exports in total exports increased

significantly from 50% during 1991-95 to more than 90% during 19996-2006. Manufactures remain a relatively lower proportion of total exports of Indonesia and Vietnam – around 50%.

Within manufacturing, machinery and transport equipment has become the key export component in developing Asia, rising from 36% in 1992 to 55% in 2006. Information and communications technology exports from developing Asia rose from 25% of total world exports in 1992 to 50% in 2006. The share of developing Asia in world electrical goods exports increased to 36% in 2006 from 17% in 1992.

Exports from developing Asian economies classified under the UN Standard International Trade Classification 7 – manufactures, including machinery and transport, ICT, electrical goods, parts and components –now dwarf the traditional labour intensive manufacturing exports of textiles, clothing and footwear which were major manufacturing exports in the mid-1980's. As a share of developing Asia's manufactured exports, textiles, clothing and footwear declined to only 11% of total exports in 2006, from 25% in 1992. That said, exports of TCF remains highly important to some Asian economies.

The paper also includes valuable analysis on changes in the direction of trade, supporting the view that Asia has become increasingly integrated through merchandise trade. The share of intraregional trade in total trade increased to 48% in 2005-06 from 40% in 1994-95. Intraregional trade was far higher than extra-regional trade with NAFTA economies, the EU-15 and Japan individually. However, there are notable differences in the degree of regional integration.

The decomposition of manufacturing trade, including into final products and parts and components shows an intraregional concentration on parts and components trade. China's intraregional exports of parts and components has been relatively stable over the last decade but its imports from the region rose to 73% of its total imports of parts and components in 2005-06.

China has become a key export destination in parts and components for developing Asia exporters and this reflects the increasingly important role China plays as a final product assembler (for advanced country markets) using components procured from economies in the region. Another trend of note is that in contrast to other economies, the share of manufacturing exports from China to developing Asia dropped noticeably during the period 1994-2006 while exports to NAFTA and EU-15 became increasingly important to China.

China has become the assembler for final products and success in this is based on extra-regional demand. Through China, there is a reliance by other developing Asian economies on extra-regional markets for export-led growth.

In analyzing the impact of the crisis, the Asian Development Review points to the linkages in trade flows as the fall in demand by OECD countries and in particular the fall in import demand in the US on China's exports, but also on the impact on other developing Asian economies that export parts and components to China and which are assembled into final product. Of course, developing Asian economies exporting directly to the US and E-15 are also being impacted by falling demand in those regions.

Based on macroeconomic projections in the Asian Development Outlook for 2009, the ADB Review paper notes that over two-thirds of China's export declines are directly attributable to the decline in demand in the OECD countries for China's exports. It also notes that the majority of the trade impacts of the financial crisis in East Asian and Southeast Asian exports are channeled indirectly through third countries – most notably China, demonstrating the strong regional linkages between China and the rest of East and Southeast Asian.

Of interest in this conference and to this region is the response to the financial crisis and the impact of the crisis on trade and investment.

It is relevant to recall that when the G20 met in April this year, Leaders called for special action in the context of the extreme circumstances then prevailing, the like of which had not been seen since the depression of the late 1920's. The breakdown of confidence arising from the collapse of major western financial institutions led to a cessation of liquidity and credit with a marked impact on trade and investment finance. The transmission of these impacts was global – as a consequence of integrated financial markets and because of the reliance in some countries not directly affected by institutional failures of wholesale funding through US and European markets. (Australia being a case in point).

The G20 call was aimed at providing support for emerging markets and developing economies seriously affected by the crisis, and to support trade and investment flows. G20 Leaders also agreed to coordinate stimulatory fiscal action to underpin growth, to promote accommodative monetary action to underpin and grow liquidity and credit, to recapitalize banking systems and to address financial system regulatory and supervisory deficiencies.

Specifically, G20 Leaders agreed to develop effective responses to grow trade and investment flows during a period of serious credit and liquidity constraints. They clearly linked the massive

decline in global trade volume to the cessation or near cessation of credit and liquidity in global financial markets. They committed to expand the general financial base of the Multilateral Development Banks. The ADB announced that it would double its Trade Facilitation Program, and the IFC agreed to establish a Global Trade Liquidity Pool to provide up to \$US50 billion as part of an effort to make available funding of \$US250 billion over the next two years. The IMF agreed to implement a broad financial safety net to limit the spread of the crisis and is taking measures to enhance access to Fund resources and providing credit lines for strong-performing economies.

In addition to these actions by multilateral agencies, some economies agreed actions to support their import-export banks, including, the US and China (in a bilateral understanding), and South Korea and the US for general trade support.

Within APEC at the SFOM/SOM meeting in February, the issue of trade finance was recognized as important and Friends of the Chair established a Group to assess how individual economies are approaching the problem of trade and investment finance in this period of credit constraint. An information mechanism was established to share experiences. Reports on the situation should be forthcoming at the SFOM/SOM meetings scheduled later this week in Singapore.

It is now generally agreed that coordinated policy responses have so far succeeded in preventing a broader failure among financial institutions and avoided a much more severe collapse in production.

Bank lending is now growing although much less rapidly than in the past. However, public policy actions have led to sharply increased budget deficits and these will take years, likely many years to unwind, particularly in countries where deficits were relatively high before the crisis.

The World Bank points to several factors of continued weakness. Unemployment continues to rise globally, housing prices in many economies are still falling adding to negative wealth effects and bank balance sheets are fragile. Much more consolidation and recapitalization is required. Many countries are facing growing pressures on their currency and banking systems.

There are some favourable developments. Short-term liquidity has been restored in Europe and North America and interbank spreads have fallen in both regions. Spreads on developing country bonds have narrowed and some stock markets are showing signs of recovery. However, conditions remain tight, markets are nervous; interbank spreads remain above historic levels and the IMF estimates that only a third of all financial sector losses have been booked at this juncture.

In summary, there remain some critical impediments to financial system recovery and to confidence

It is relevant to focus on finance availability for trade and investment in the Asian region in the context of the growing interdependence on manufactured parts and component exports from the rest of developing Asia to China and the assembly of those goods into finished product which are then exported to the US and EU-15.

In the sense that Asian banks have been much less exposed to capital write-downs and to the need to consolidate their financial structures as a consequence of the global financial crisis, it may be reasonable to conclude that the Asian banking system has the capacity to provide trade finance, at least to that part of trade that is based on intraregional transactions.

If that is the case, then arguably, the major fall in import demand in North America and Europe for exports from China and from Asia more generally, is attributable to just that, the fall in demand in major consumer markets, and not to liquidity constraints faced by banks in the region (unless they are strongly reliant on wholesale funding from markets in other regions).

Referring back to the World Bank observation that world trade contraction has been amplified to an uncertain degree by a shortfall in trade credit, to what degree would this apply for Asian intraregional trade?

This leads on to other questions. For example, within the region, is the banking system supporting intraregional trade with guarantees to their exporting- based customers and are banks and financial institutions routinely issuing and accepting letters of credit for importers from within the region during this period of global slow-down? Or, as is possible, have regional banks followed banks in other regions by seriously tightening access to credit for their trade-based corporate customers and have they also tightened the risk premiums on credit lines? Have banks done this in the absence of the underlying dire causes that confront major internationally operating banks in Europe and North America, and if so, why?

Clearly, there could be some deep concerns in regional banks arising from the failure and the cessation of the interbank markets but was/is access to those markets in Europe and North America a critical aspect of Asian banks' financing?

Other questions relate to the role of official export and investment guarantee agencies during this crisis. Have these agencies increased their financing and guarantee role in supporting trade and investment activity in this period, or have they become more risk averse?

These questions are less about the cause of the sharp retraction in global trade – is that due to falling demand or a serious contraction in trade credit, or both – but more about enhancing understanding of the role and the linkages in the financing system in the region during this period. More importantly, the questions lead to consideration of whether private and public financing arrangements and practices in the APEC region are sufficient to support trade and investment during this global crisis.

On the reasonable assumption that trade will remain at much lower levels over the period at least through end 2011, and possibly well beyond that, a serious review of the role of trade finance, including private and public, for the region would seem eminently justified.

Another important reason for such a review is to consider the impact of the public policy measures being promoted by the international agencies and referred to earlier above. Some of them are likely to take some time to put in place and while it is important that multilateral and regional banks do have the capital base to support their activities, perhaps of more importance at this time of seriously declining global trade volume, is the appropriateness or otherwise of short-term measures to support trade finance.

As unemployment rises across the region and as trade struggles to revive to become a serious agent of economic performance and dynamism, there is a need for analysis and knowledge on critical financing aspects of trade and investment and the role of both the banking system and public agencies in finance availability. In a region much less seriously impacted by the direct consequences of the massive financial system failures that have impacted the US and Europe, APEC policy makers should be as certain as they can be that public and private financial arrangements are serving the Asian Pacific region in this crisis period.

The Australian APEC Study Centre has proposed a study of these matters. If we are successful in launching this work, we would seek the support of private institutions and public agencies in the region in completing the work and in providing advice and framing recommendations to Trade and Finance Ministers and to Leaders for their consideration later in the year.

On a broader front, the failure of the global financial system raises critical questions about the veracity of the system as we know it (or rather knew it), the massive failure in governance in the international financial system both in public agencies and in internationally operating private

financial institutions and it has also raised the need for deeper regulatory cooperation across national borders. These matters pose another set of questions that APEC Leaders and policy makers might wish to consider.

In essence they relate to ways to raise awareness in the region and globally of the value of Asian regional perspectives on changing regulatory developments and in changes that are under consideration in global standard setting bodies that formulate standards and best practices for financial sector management and prudential supervision. For example, should Asian policy makers and banking regulators have a well formulated view on the amount of leveraging that would be permitted by banks operating in this region? Should there be a regional perspective on capital needed by regional banks to support riskier counter-party risks undertaken by banks operating in the region? Should the region consider an early warning system where central banks and other public policy bodies would share information with markets particularly in cases of excessive exposure to short-term capital flows?

The underlying point is that it is opportune for APEC to consider a mechanism to develop regional perspectives on these important matters and to reflect them in international standards setting bodies.

Some changes are occurring in the governance of global institutions to better reflect Asian weighting in global economic and financial affairs. But inevitably as proposals emerge to effect regulatory and supervisory changes in banking and other areas of the financial system they will reflect the influence of North America and Europe and that is to be expected as those regions do contain the major market makers.

But as savings, output and trade become the physical manifestation of global economic activity, Asia's positioning and influence and its interests in ensuring financial and economic stability should be as equally an important influence on the rules for banking and financial markets.

Shaping Asian views and positioning as financial markets develop from this point in time is a major and important challenge for this region. It is time now for APEC to engage in developing the structures to do this effectively.

9th July 2009