

# dialogue

IDEAS FOR PACIFIC ECONOMIC COOPERATION

## How the Asia Pacific Can Drive the Global Recovery

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**THE TRANSITION** to a new, sustained global growth path is still precarious and will require concerted policy actions by many countries. Leadership by the G-20 will be essential for coordinating the global effort. But due to the central importance of the Asia Pacific in the world economy, regional institutions such as ASEAN+3, ASEAN+6, and APEC could also play large roles in the next phase of the recovery.

The policies that stopped the economic freefall—huge stimulus packages in China, the United States, and even small countries like Singapore, as well as massive financial bailouts in the West—were urgent, relatively easy to sell, and to a large extent forced

by circumstances (particularly the fall of Lehman Brothers). They were deployed under extraordinary time pressures and have proved remarkably successful.

But sustained recovery will require tackling different problems, including international imbalances between the United States, China, and other economies. U.S. consumers are not likely to drive world demand in the near future, and the slack will have to be taken up in part by Asian consumption and investment. The policies used to fight the crisis so far have not addressed these medium-term issues, and some are even counterproductive from that perspective.



The best outcomes—inclusive, balanced, sustained growth—require structural reforms that change economic relationships within countries and among them. The policy mixes will be complicated and varied, addressing household and government finances, investment, risk management, infrastructure, productivity, and other fundamental determinants of growth.

## FOUNDATIONS FOR SUSTAINED ASIA PACIFIC GROWTH

The term “rebalancing” is widely but imprecisely used to describe these issues. The central priority is to base growth on sustainable demand. Before the crisis, unsustainable borrowing supported high U.S. consumption, while unprecedented savings—including more than half of China’s national income—went into unsustainable investments in dollar assets and export industries. These internal imbalances in expenditures led to large international imbalances in capital flows between the United States and China, Japan, and other countries.

The inevitable reversal of such imbalances imposes high costs on firms, workers, and countries. Before the crisis, export industries thrived in Asia and languished in the United States. As the crisis progressed, Asian exports collapsed while incentives improved sharply for U.S. exports. In every such reversal, jobs, capital, skills, and institutional memory are lost in declining sectors and have to be built up anew in expanding ones.

Since the crisis began, the US current account deficit has declined to under 3 percent of GDP, a level widely considered sustainable. But will it remain there once economic activity picks up? Figure 1 plots the U.S. current account deficit (as a percentage of GDP) and world growth rates on two possible recovery paths.

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The central projection of the International Monetary Fund (IMF) indeed leads to the upper right corner, where imbalances remain sustainable and growth returns to roughly pre-crisis averages by 2011. But not all projections are so optimistic. For example, a simulation by William Cline, based on large U.S. fiscal deficits projected by the Congressional Budget Office, foresees much less growth and much higher imbalances. This would be a risky path. Once markets recognize that imbalances are growing again, currency and asset markets would likely become volatile, perhaps triggering another downturn.

Avoiding imbalances—driving growth into the upper right corner of figure 1—is increasingly important as growth revives. The good news is that the arithmetic of rebalancing is favorable. Even at its maximum before 2007, the “excessive” part of the U.S. deficit (the portion above 3 percent of GDP) amounted to little more than

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\$300 billion. This is a large number in an absolute sense, but it is manageable in the context of the Asia Pacific region's \$28.8 trillion economy.

## STRUCTURAL POLICIES

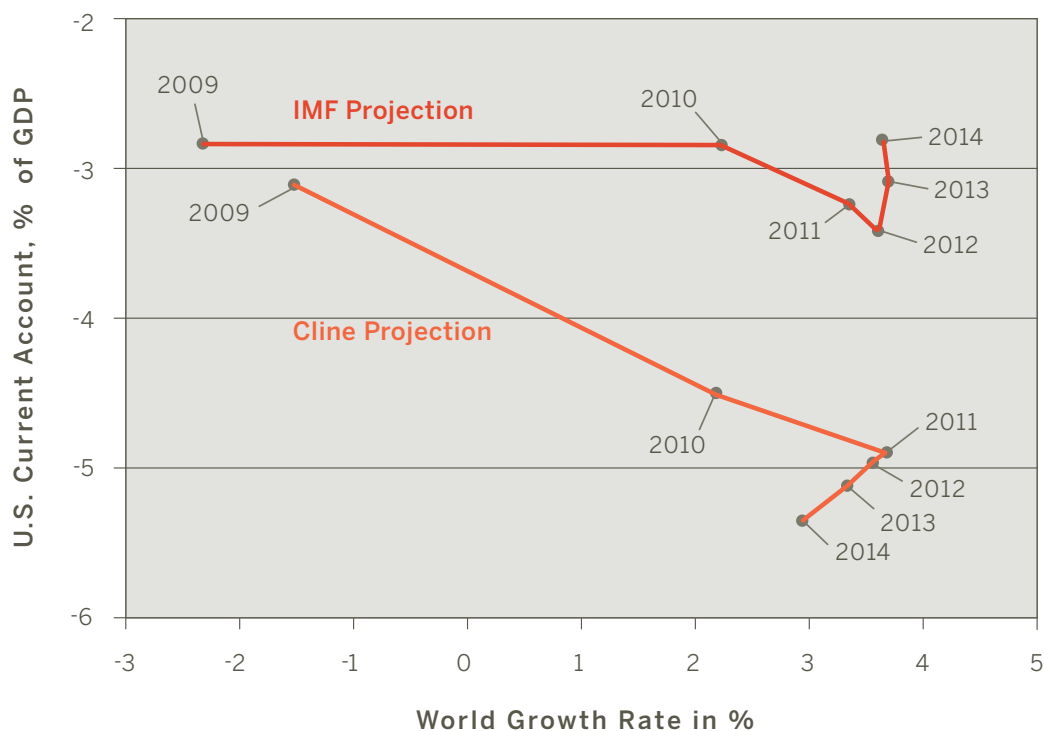
Achieving balance will require shifting from stimulus to varied structural policies. Since these adjustments will be difficult politically, international coordination and support—and pressure—could improve the prospects for implementation. For example:

- The U.S. policy mix will need to impose discipline on consumers and government to live within their budgets. The United States will also need to

improve its regulation of financial markets, and U.S. exporters will need to return to markets they abandoned in the past.

- China's policies will need to raise the incomes of households at the expense of the flush corporate sector, and create new safety nets, social services, and markets for labor and capital.
- Japan will need to free up services, energize consumption, and redirect its extraordinary technological capabilities toward growth markets, such as products and services for aging populations, and technologies for energy conservation.

Figure 1: **Some Projections Envision Sustained Recovery, Some Do Not**



DATA SOURCES:

International Monetary Fund. World Economic Outlook Database, October 2009; [www.imf.org/external/pubs/ft/weo/2009/02/index.htm](http://www.imf.org/external/pubs/ft/weo/2009/02/index.htm).

Cline, William R. Long-term fiscal imbalances, US external liabilities, and future living standards. In *The Long-Term International Economic Position of the United States*, ed. C. Fred Bergsten, 11–34. Special Report 20. Washington: Peterson Institute for International Economics, 2009.

Sustained growth will also require changes in supply—resource flows to tradable goods industries in the United States and to non-tradable sectors, especially services, in Asia. These compositional shifts, in turn, will also require relative price changes. Exchange rate flexibility (the appreciation of the currencies of Asian exporters and depreciation of the United States dollar) is the least disruptive way to achieve them.

Each Asia Pacific economy will face its own challenges. In some the top priority will involve household incomes or expenditures, in others investment or infrastructure, and in still others agriculture, resources, or services. But these changes are well within the framework of Asia’s extraordinarily successful development model. Asia does not need to “throw out the baby with the bathwater”: outward-oriented policies, efficient manufacturing, and high savings remain powerful assets for growth. The goal is to extend market-oriented reforms to more sectors within countries and to more transactions among them.

## GROWTH ENGINES

These demand-and-supply shifts could be accelerated with high profile Asia Pacific initiatives. Selected “growth engines” could address important trends—population aging and other social and environmental priorities—and use policy to stimulate investment. They could be backed by catalytic commitments from the Asian Development Bank and other international investors. Joint initiatives could emphasize projects in four areas:

*Economic integration*—new types of trade that build on Asia’s dynamic markets, new global and regional trade agreements, and strategic investments in connectivity.

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*Green economy*—investments in energy conservation, clean energy research and development, and energy efficient vehicles and transport systems.

*Investments in people*—programs in education, health care, and social safety nets.

Knowledge and productivity—investments in technology and reforms to drive gains in productivity.

Such regional initiatives could stimulate Asian demand, create markets for Asian manufactures, engage American resources and technology, and put Asian savings to productive use.

## A CHALLENGE FOR ASIA PACIFIC INSTITUTIONS

International cooperation is the common foundation for these policies. The G-20 (Group of Twenty Finance Ministers and Central Bank Governors) provides a “board of directors” for the global system, with substan-

tial Asia Pacific membership. But the plans of the “directors” will need to be translated into concrete initiatives and projects. Also, more inclusive forums will be needed to engage countries not in the G-20.

In the Asia Pacific region, ASEAN+3 (the Association of Southeast Nations, plus China, Japan, and South Korea) and ASEAN+6 (also including Australia, New Zealand, and India) could help to coordinate the phasing out of stimulus programs and orchestrate a smooth realignment of Asian exchange rates relative to the dollar. APEC (Asia Pacific Economic Cooperation, in which North and South American countries also participate) is also poised to help. As a trans-Pacific forum, it spans critical dimensions of rebalancing. It has accumulated expertise on structural reforms and its non-binding format is suited to the complex cooperation required. APEC’s “pathfinder” approach, for example, could provide a platform for initiatives by groups of countries that support specific rebalancing objectives. APEC’s workplan could take on packages to address priority “behind the border” barriers to trade, and engines of growth focused on common social and environmental goals.

Interdependence in the Asia Pacific region is now often seen as a source of risk, but it also connects the most powerful technological, financial, and productive resources ever assembled in history. Asia Pacific institutions should not miss the opportunity to address the present crisis. By working together, Asia Pacific governments could send a powerful signal to markets that they intend to cooperate and will hold each other accountable for keeping growth on track.

## PECC'S TASKFORCE ON THE GLOBAL ECONOMIC CRISIS

This issue of the East-West Dialogue summarizes the findings of the Pacific Economic Cooperation Council's (PECC) Taskforce on the Global Economic Crisis. Taskforce members included Professors Yongfu Cao (Chinese Academy of Social Sciences), Wendy Dobson (University of Toronto), Yiping Huang (Peking University), Peter Petri (Brandeis University, Chair), Michael Plummer (Johns Hopkins University), Raimundo Soto (Pontificia Universidad Catolica de Chile), and Shinji Takagi (Osaka University). The Taskforce was advised by an international group of experts. The author bears responsibility for this summary.

The full report of this taskforce will become available from PECC during the first half of 2010. Further information is available on [www.pecc.org/economic-crisis/](http://www.pecc.org/economic-crisis/).



## A Note on North America



WENDY DOBSON

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North America's economic prospects depend heavily on those in the United States. Canada and Mexico were negatively impacted by the decline in U.S. imports and rising unemployment, and they are bearing much of the burden of U.S. dollar depreciation. Mexico, already reeling from swine flu, suffered the largest contraction in real GDP among the emerging market economies. But sound macroeconomic fundamentals helped cushion the impacts and provide room for structural changes to promote long term growth. No Canadian financial firm failed, and Canadian banks were rated as the world's soundest. Both countries are expected to weather the recession successfully and to return to sustainable growth paths in 2010.

U.S. policies and prospects are worrisome because of rising public indebtedness, job losses, and rising long-term unemployment. A credible plan is needed to rein in fiscal deficits and reduce large external imbalances. Political discord in Congress and U.S. dependence on foreign central banks and investors to fund the U.S. current account deficit are the Achilles heels in this recovery. For the United States to pay its own way, tax increases and expenditure compression are required,

and the dollar must depreciate. These adjustments will, however, take time to achieve.

In the meantime, China is helping to stabilize the U.S. recovery by continuing to finance public-sector borrowing. The major risk in this symbiosis is a collapse of the dollar, should the Chinese sell their holdings on any large scale—an unlikely eventuality because losses would hit Chinese balance sheets as well. Instead, as long as China retains confidence in the prospects for U.S. fiscal policy, inflation, and growth, Americans can continue to expect to hear from their largest creditor. At the same time, China could reduce its trade imbalance by shifting domestic growth toward consumption, allowing yuan appreciation and importing more. Because of the complex policy and institutional changes involved, China, too, will need time.

U.S. dollar depreciation will increase the price competitiveness in international markets of such sectors as aircraft, integrated circuits, capital equipment, parts and

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components, metals such as copper and aluminum, and agricultural commodities such as soybeans and cotton. Commercial services such as travel, transportation, and business and financial services will also benefit. Government incentives and public-sector spending has had some influence on short-term demand, although the impact has been watered down by the demands of influential interest groups. Initially American Recovery and Reinvestment Act expenditures, channeled to state governments for infrastructure and other public projects saved jobs from being lost; new jobs will be created only in 2010 and 2011.

Other initiatives encourage structural changes, such as expansion of renewable and cleaner energy supplies, automation of medical records, expansion of health care services and responses to the rising demand from older North Americans for health and personal services. These initiatives should include attention to drivers of long-term output growth, such as improving labor force quality through education and immigration. Financial reforms that reduce risk taking by the largest financial institutions may open avenues for growth of new, less risky but profitable commercial banks. In the energy sector, access to abundant new supplies of natural gas deposited in North American shale formations are impacting economic activity and jobs and are reducing natural gas prices. Entrepreneurs are pushing wind and solar power and generating “green collar jobs.”

Innovation is America’s great source of strength. As sophisticated services and manufacturing industries—such as advanced materials, semi-conductors, computing, energy supply, electrical displays, and autos—invest in basic and applied research, their dynamism will continue, as it has in the past, to contribute to North America’s productivity growth and economic resilience.

# How to Rebalance China’s Economy?



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China’s thirty-year economic reform has yielded what Justin Lin, Chief Economist at the World Bank, has called the “China Miracle.” When the economic reform began in the late 1970s, China was still a closed agrarian economy. Today, it is already a significant global economic power. Real GDP growth averaged 10 percent, and hundreds of millions of the population were lifted out of poverty.

Accompanying this “China Miracle,” however, is the “China Puzzle.” There appears to be a disconnection between China’s per capita income of \$3,000 (ranking China 105 among 180 countries covered by IMF data) and its impressive global influence in international markets, including global markets for commodities, consumer goods, and even foreign exchange. Urban development is also much more advanced than it is in many countries with even higher income levels. At the same time, there is always a sharp contrast between the optimism and the pessimism about the Chinese economy. Optimists would dub the twenty-first century as the “China Century.” Pessimists constantly anticipate the system’s imminent collapse.

Such seemingly contradictory phenomena are in fact the results of China’s unique approach during the reform



period: complete liberalization of markets for goods and services but significant distortions in the factor markets (markets where the factors of production—like labor, capital, and land—are traded).

Perhaps the single most important term to describe the Chinese economic reform is “reintroduction of free markets.” However, a closer examination of the process would reveal that this “reintroduction” task is only half done. Today, more than 95 percent of the goods and services transactions are through the free market mechanism. This is the basis of what Justin Lin calls the “comparative advantage development strategy” during the reform period, i.e., resources are allocated according to market demand and the country’s factor endowment. However, factor markets remain heavily distorted. The labor market is still highly segmented, mainly because of the household registration system. This system was introduced during the pre-reform period in order to restrict labor mobility. Today it can no longer prevent farmers from coming to the cities to seek employment, but it is still an important instrument of institutional discrimination against farmers. Migrant workers normally receive only about half or even one-third of what their urban cousins receive for performing the same job functions.

The capital markets are still tightly managed by the authorities. Capital account restrictions are more stringent for outflows than for inflows, and for long-term investment than for short-term investment. Interest rates remain highly regulated by the central bank, while the currency is most likely undervalued. Perhaps the most important evidence of underpriced capital is the unusually large gap between long-term government bond yields (roughly 3–4 percent currently) and the long-term nominal growth potential (probably around 12 percent).

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Land is owned by collectives in the countryside and by the state in the cities. With the exception of property development, land is often given to investors at very cheap rates or even for free in order to attract investment. The government also exercises tight controls over energy prices in order to minimize the shocks that high energy prices would have on production and consumption. For instance, when crude oil prices peaked at \$150 per barrel in 2008, domestic prices were only \$80. Lax implementation of the environment protection policy means that producers pollute the environment without obligations to provide compensation.

These factor market distortions generally lower input costs, increase production profits, raise investment returns, and improve the international competitiveness of Chinese exports. They are equivalent to a producer subsidy, which was estimated at 7.2 percent of GDP in 2008. These boost GDP growth but boost investment



and exports even more, giving rise to imbalance problems such as over-investment and over-exporting. Also as a result, household income as a share of GDP has declined over time, causing sluggish consumption.

Factor market distortions are the fundamental cause of the “China Puzzle”: a disproportion of activities in the outward-oriented economy (therefore exceptional international influence) and in investment (therefore very advanced urban development). Optimists tend to focus on the success of economic growth while pessimists pay more attention to the imbalance problems. But they are two sides of the same coin.

The government began to deal with the imbalance and growth-quality problems in 2003 but has achieved very limited results. In fact, these problems deteriorated continuously in the years following 2003. Economists have put forward recommendations for dealing with these problems: mainly currency appreciation and social welfare systems. But these will be effective only if they are a part of the broad policy-adjustment effort.

The fundamental approach must lie in liberalization of the factor markets, including abolishing the household registration system (which heavily restricts migration between rural and urban areas), developing the social welfare system, establishing market-based interest rates and exchange rates, and liberalizing energy prices. These reforms should be given top priority in the Chinese government’s policy agenda.

## Indonesia and Sustained Asia Pacific Growth



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As a member of the G-20, Indonesia should seek greater coordination of its economic policies in the framework of regional cooperation arrangements in the Asia Pacific region. As this region increasingly assumes a central role in the world economy, the countries of the region are expected to make a significant contribution to strong, sustainable, and balanced growth of the world economy following the 2008 global financial crisis. As suggested by Peter Petri, tackling international imbalances is an important agenda for the region.

Indonesia’s contribution to the global imbalance is small. Indonesia’s current account even became negative during some quarters of 2008–09. Private consumption is relatively strong and investment is moderate, compared with Indonesia’s neighbors. Indonesia is not a surplus country like China, which has an urgent need to rectify internal imbalances, including unsustainable investments in export industries, mounting dollar assets, and low pri-

vate consumption. In fact, the Indonesian case may be an anomaly. What Indonesia needs, for continued growth, is to strengthen its export competitiveness and maintain strong private consumption and investment.

Reductions in unemployment, poverty, and inequality are needed to strengthen private consumption. Reductions in poverty and inequality are likewise needed to improve public welfare and maintain macroeconomic stability. Such changes have yet to be reflected in the reality of the Indonesian people's lives. The good macroeconomic performance over the past years has not resulted in major improvements in public welfare. Unemployment remains at around 10 percent, and poverty as well as inequality remains very high in many districts in Indonesia. The reasons for this are debatable, but many observers point to the need for further and sustained economic reforms. Indeed, structural reforms as well as institutional reforms, including regulatory reforms, could play important roles in achieving these objectives.

Indonesia's successful "first generation" reforms began about two decades ago and removed a web of heavy regulations affecting the country's international trade and foreign investment activities. Now, Indonesia must clearly undertake "second generation" reforms to strengthen institutional frameworks, regulations, and government policies, with the aim of making markets within Indonesia's borders function more efficiently. The 1997–98 financial crisis, which hit Indonesia the hardest, led to reforms in the financial sector, resulting in greater resilience during the 2008 global financial crisis.

Indonesia's banking sector, like that of some other countries hit by the earlier crisis, has become more financially risk-averse with less financial leverage. With

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“Indonesia’s low  
level of public  
debt and small  
budget deficit  
provided support  
during the  
2008 crisis.”

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the adoption of inflation targeting, inflation has become relatively stable. International reserves also ensure the stability of the Indonesian rupiah. Investment and private consumption remain strong, constituting about 23 percent and 60 percent of GDP, respectively. Beginning with the third quarter of 1998, Indonesia's current account registered surpluses, with a resulting increase in dependence on exports. For some quarters in 2008–09 Indonesia's current account was in deficit, when exports dropped due to the crisis. However, unlike countries such as India, Indonesia's low levels of public debt and the small budget deficit provided support for the government's plan to bolster the economy through a fiscal stimulus during the 2008 crisis. Moreover, Indonesia's interest rate stands well above the zero-limit and allows for monetary expansion.

Despite the macroeconomic stability that has been achieved, there are still weaknesses in the Indonesian economy.

The country's export depends on volatile world markets for mineral and agricultural commodities. . . . Exports of textiles, electronics, footwear, pulp, paper, and wood products have stagnated even as the world market expanded, suggesting that Indonesia is becoming less competitive.

*Asian Development Outlook 2009: Rebalancing Asia's Growth.*  
Manila: Asian Development Bank, 2009.

Structural problems have become significant bottlenecks in Indonesia's trade. Logistical weaknesses, including infrastructure, reduce Indonesia's competitiveness in the world market. Power shortages due to underinvestment also hinder factory output in many cities. The real (nonfinancial) sector has not seen much improvement since the 1997–98 crisis. Indonesia has lagged behind its neighbors in its involvement in regional production networks.

Like other East Asian countries, Indonesia may need to reorient its exports of intermediate and final goods

to other East Asian countries. Regional arrangements such as the ASEAN+3 and ASEAN+6 as well as APEC can help facilitate this reorientation. ASEAN+3 and ASEAN+6 have recently agreed to establish working groups on rules of origin, tariff nomenclature, customs-related issues, and economic cooperation to harmonize ASEAN's trade and investment agreements with individual countries. Structural reform has become a main agenda item in APEC.

In this context, Indonesia urgently needs to take measures to increase the competitiveness of its exports. It is important that the increase in domestic demand does not erode net exports so much that the national currency comes under pressure. A depreciation of the rupiah would increase the liabilities of banks and other firms that have high levels of debt in foreign currencies, and these "balance sheet effects" might lead to reductions in investment and credit, with consequent negative impacts on economic growth and welfare.

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