State of the Region

Introductions and Opening Remarks

Dr. Mark Borthwick

Good morning and welcome, everyone. I’d like to introduce you to the international co-chairs of the Pacific Economic Cooperation Council (PECC), who will formally launch the 20th General Meeting.

Mr. Jusuf Wanandi is one of the founders of PECC and one of the most important influences on its development from the organization’s inception to present day. If you are at all familiar with the history of Indonesia and his institution, the Centre for Strategic and International Studies in Jakarta, you know that he has played an important role in the history of his country.

Mr. Wanandi also has played an important role in the history of dialogues between Indonesia, ASEAN [Association of Southeast Asian Nations], and the Asia Pacific region with the rest of the world. Over the years, he’s been a founder of far more than just PECC, so it’s a real honor that he is here today in his capacity as international co-chair of this 20th General Meeting.

Dr. Charles E. Morrison has been president of the East West Center since 1998. While presiding over the Center the past 13 years, Dr. Morrison has developed it into an institution and resource for the region to use as an asset in education, dialogues, exchange, joint research, and generally, the development of the Asia Pacific community.

It was his initiative, for example, that created the US Asia-Pacific Council under East-West Center auspices, thereby enabling the Council as a US entity to engage with the region through PECC. Please join me in welcoming Dr. Morrison.

Dr. Charles E. Morrison

Thank you, Mark and welcome to the 20th General Meeting of the Pacific Economic Cooperation Council. In fact, the East West Center was a regional institution long before I was associated with it in 1966. A Japanese economist gave a conference at the East West Center, in which he presented a very interesting paper that proposed establishment of a trade and development organization for the Asia Pacific. I believe that was the first articulation of what has become APEC [Asia Pacific Economic Cooperation forum].

PECC is a 31-year-old network, which includes 26 member committees scattered around the region. We work on regional issues aimed at promoting the concept of Pacific economic cooperation, whether this is through our support of regional institutions like APEC, or through initiatives aimed at educating the general public about the importance of regional cooperation.

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Mark reminded us that my co-chair, Jusuf Wanandi, was one of the founders. We have more than one of the founders in this room today. For that generation, it was a very exciting concept to bring nations from both sides of the Pacific together for discussions aimed at fostering regional cooperation.

After 20 years of APEC, in which government leaders meet annually, trans-pacific cooperation seems to have become a less exciting and innovative concept. But we must continue to sustain these networks.

We have a new mission, which recognizes that Asia-Pacific cooperation is not just for the region. This is needed for global leadership at a time when leadership is lacking. We need a central axis for international cooperation to give people confidence that there is a steering group that can help to keep our global economy vibrant, thriving, and developing.

We named this conference, “State of the Region,” after a product we have produced for the past five years. The report not only provides a pulse of our region, but also describes what we’re doing to promote global leadership. We are very happy that you are all joined us and I think we’ll have a very rich program. Jusuf will now make a few remarks.

Mr. Jusuf Wanandi

Good morning. I’m very lucky to be here at the PECC 20th General Meeting. First, I would like to thank Mark [Borthwick] and Barbara [Wanner] for making this conference possible because just two years ago, the US Asia Pacific Council hosted the 18th General Meeting. We are grateful for USAPC’s generosity.

As Charles said, I think PECC has an even greater role to play in the region. There are always up and down periods in any organization, be it international, regional, or national. Through PECC, we hope to make you aware that the era we are facing is a critical one.

The Asia-Pacific region has become the most important part of the world. Especially as we prepare for the APEC Leaders Meeting in Honolulu, Hawaii, I hope that PECC can contribute some ideas aimed at enabling the region to shoulder its responsibility as an important force in the global economy. The topics we have chosen for the conference will delve into this, and the speakers represent the very best thinkers from the region.

I now would like to introduce Ambassador Zou Mingrong, who will moderate the first session, “Asia Pacific Regional Outlook.”

Ambassador Zou has been the Executive Vice Chairman of the China National Committee for Pacific Economic Cooperation since 2005. He has been a very enthusiastic leader for China and we have appreciated his participation and very positive attitude towards regional affairs.

Before joining the China National Committee for Pacific Economic Cooperation, Ambassador Zou had a long career as a diplomat, serving in Africa, Thailand, Australia, and finally in Europe, as ambassador to Estonia and Sweden. Ambassador Zou –

Amb. Zou Mingrong

Thank you very much Charles and Jusuf. I am very privileged to moderate the first session.

Three years ago, the world was gripped by one of the worst financial crises, prompting major economies to enact major stimulus packages. Three years later, the world is still plagued by an economic slowdown as Europe struggles to overcome the sovereign debt crisis.

How about the Asia-Pacific region? At a recent conference in Thailand, experts offered a mixed message. Some economists did not anticipate a double-dip recession. But others warned that unless major economies take forceful and effective measures, the world economy may slide into another recession. In contrast to the North Atlantic region, the Asia Pacific region has maintained robust growth in recent years.

China has been able to maintain a GDP growth rate of more than 9 percent. However, we face significant problems stemming from inflationary pressures. Japan still is recovering from the tsunami and nuclear crisis, but is slowly moving out of recession. ASEAN also is doing...
very well and has readjusted following the 1997 financial crisis.

But the question remains whether the Asia-Pacific region can withstand the shock of the current economic slowdown. With this question in mind, we have invited two very distinguished speakers to offer their assessments.

The first speaker, Dr. Roberto Cardarelli, is a Senior Economist of the International Monetary Fund Research Department. He has contributed chapters on global imbalances, corporate savings, and the impact of financial systems on economic cycles to recent editions of the IMF’s World Economic Outlook report.

Before joining the research department, Dr. Cardarelli worked in IMF’s North American Division as well as the Asia Pacific Department. He also served as a research officer at the National Institute of Economic and Social Research in London. He will provide an economic forecast for the Asia Pacific region.

Our next speaker will be Mr. Yuen Pau Woo, who is president of Asia Pacific Foundation of Canada. He also is PECC Coordinator of the State of the Region report. In addition, Mr. Woo is on the management board of the National Center of Excellence in Immigration Research at the University of British Columbia and Simon Fraser University and is an advisor to the Shanghai WTO Affairs Consultation Center and Asian Development Bank.

In December 2008, Mr. Woo was appointed by the governor of British Columbia to the province’s Economic Advisory Board. He will discuss the findings of PECC’s 2011 State of the Region report.

So with these words, may I now welcome Dr. Cardarelli.

Dr. Roberto Cardarelli

Before I begin, I’d like to clarify something. I was in the IMF’s Research Department a couple of years ago, but currently I am Chief of the Regional Studies Division in the Asia Pacific Department.

My reason for noting that is because in mid-October, the Asia Pacific Department will formally unveil its Regional Economic Outlook for Asia and the Pacific at a special meeting in Tokyo. So I invite you to wait a couple of weeks for a clearer view of the IMF’s forecast. This also will include analytical chapters that delve more deeply into the main themes that I will touch on in today’s presentation.

[For Dr. Roberto Cardarelli’s complete Power Point presentation, please click here.]

In this presentation, the forecast that I will discuss is identical to the one included in the IMF’s World Economic Outlook report, which was released a week ago at the IMF/World Bank annual meeting. I will then go into more detail on the outlook and policy challenges for the Asian region.

Global growth has been revised down, although emerging economies will continue to lead

| Downward Revisions in Growth Forecasts since April 2011 WEO (In percentage points) |
|-------------------|-----------------|-----------------|-----------------|
| World             | Advanced economies | Emerging and Developing economies | Asia | ASEAN |
| 2010              | 0.1             | 0.3             | 0.6             | 0.8 |
| 2011              | 0.0             | 0.0             | 0.0             | 0.0 |
| 2012              | 0.0             | 0.0             | 0.0             | 0.0 |

| World GDP Growth (Year-over-year; in percent) |
|-----------------------------------------------|--------|--------|--------|
| 2010 | 2011 (proj.) | 2012 (proj.) |
| World | 5.1 | 4.0 | 4.0 |
| Advanced economies | 3.1 | 1.6 | 1.9 |
| Emerging and Developing economies | 7.3 | 6.4 | 6.1 |
| Asia | 8.3 | 6.3 | 6.7 |
| ASEAN | 7.6 | 5.3 | 5.5 |

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Global Growth – As you know by now, global economic growth has been revised down. The second quarter was weaker than the first for many economics across the globe. This stemmed from high commodity prices that affected domestic demand as well as the tragic events in Japan in March. The latter had a negative impact on the global manufacturing supply chain.

What happened over the summer was even worse than we anticipated in terms of the deterioration of confidence resulting from the downgrades of US sovereigns, French banks, and renewed turbulence in the Euro area. As the chart on the left shows, we have revised down our growth forecasts for advanced economies by .75 percent of GNP for 2011 and 2012, but by only about .5 percent for emerging and developing economies in Asia.

Baseline Forecast – As the table on the right shows, our baseline forecast is for growth to continue, but to be weak. There’s a lot of discussion about a double-dip recession, and we still don’t know whether or not this will occur. What we do know is that the recovery of the advanced economies is going to be weak and slow. As you can see on the second line, GDP growth in advanced economies was 3.1 percent in 2010, which was still the recovery year, but only 1.6 and 1.9 percent in 2011 and 2012, respectively.

Balance-Sheet Crisis – This is not surprising. We said from the beginning that this would be a long crisis. It’s a balance-sheet-type financial crisis. If you look at similar crises in the past, they lasted a long time. And if you compare the way this crisis has evolved to previous financial crises, we’re proceeding pretty much according to script in terms of GDP and other financial indicators, such as equity markets and credit.

This crisis is peculiar in that unemployment, especially in the United States, has been much slower to recover than in previous financial crises. But in all other respects, this crisis is proceeding along the lines of similar, earlier crises. This means that it will be a long time until all balance sheet restructuring is completed.

Emerging Economies Lead Growth – Emerging developing economies are going to lead world growth. This is because they have been growing more than advanced economies for a while because essentially they have a higher potential growth. The countries of ASEAN and Asian economies are still catching up in terms of economic development. Their contribution to global growth has been increasing over time and they are contributing more to the global recovery than in previous economic crises.

Tail Risks – As I said, the first line on the right-hand chart indicates the baseline. But in the IMF’s REO for Asia and the Pacific, we devote a good deal of attention...
to considering possible risks. What we thought were so-called “tail risks” are not “tail” anymore. “Tail risk,” as you know, refers to serious events that have a tiny probability of occurring.

Bi-Modal World – Now we move to the so-called bi-modal view of the world on the left [see slide on page 4]. You see the two peaks on the forecast, with the red one emerging recently. The blue one essentially is the baseline. So, across the community of forecasters, we all believed that global growth on average would be about 2-3 percent.

But an increasingly larger share of forecasters are now predicting a much lower rate of growth for advanced economies, at around 0 percent or lower. This is not a tail risk anymore.

The World Economic Outlook predicts a 10 percent probability of global growth at less than 2 percent, which meets the IMF’s definition of a global recession. Ten percent is not a small probability. Where is this bi-modal world? Where are these higher downside risks to growth? It’s coming from financial stress in the Euro area.

Europe’s Lehman? – If we compare what’s happening now in the financial markets to when Lehman Brothers went bankrupt in September 2008, we’re actually worse off in terms of risks on banks in the European area. You also will see that the sovereign CDS spreads are at a much higher level in the Euro area as compared to Lehman. It’s this risk of a negative feedback loop between sovereigns and banks that is driving the uncertainty about the recovery going forward.

Bullish on Asia – Now what about Asia? We expect growth in Asia to moderate only slightly [see slide below]. We are relatively bullish on Asia, I would say. We have revised down growth in 2011 by 0.5 overall for the region compared to our April World Economic Outlook, but this is mostly because the second quarter was weaker than we expected.

For 2012, only a 0.2 percent adjustment. We revised China down half a percentage point but it still will grow at 9 percent in 2012. India, we revisited down 0.3 percent in 2012, but it will continue to grow at in 2012 at 7.5 percent.

These are all economies that are growing in our baseline scenario at rates that are close to potential, if not, slightly above potential. And the main driver of growth is domestic demand.

There is no doubt that external demand is going to be weaker for Asia, but we are confident that the momentum in domestic demand we have seen for the past 2 years will continue. That is what the chart on the right indicates. The

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We expect growth in Asia to moderate only slightly
Domestic demand will remain strong

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<th>Asia: Projected GDP Growth (in percent; year over year)</th>
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<th>Selected Asia: Contributions to Projected Growth (in percentage points; year over year)</th>
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reason we are optimistic is because we are seeing strong markets, very low unemployment, and increasing wages. On the financial side, we are seeing cheap credit, which I will return to shortly, and high capacity utilization.

We are seeing government measures aimed at boosting demand. For example, a lot of Asian economies have launched ambitious efforts to increase investment in infrastructure. Examples might include the economic transformation project in Malaysia and the master plan in Indonesia.

In China, there is a large program of investment in social housing. In Australia, investment in mining has exploded because of still-high commodity prices. There are many idiosyncratic factors that will have the effect of boosting domestic demand in Asia over the next 2 years.

**Over-Heating Risks** – That is why we are relatively optimistic about our baseline scenario for the region, so much so that in the REO for Asia and the Pacific, we spent some time considering risks from over-heating pressures. We believe that over-heating pressures are not going to disappear.

The chart on the left [see above slide] is a combination of four indicators: CPI inflation, current account balances, equity prices, and real credit growth. Red indicates a high overheating risk, followed by moderate overheating risk in orange. Yellow indicates low overheating risk, and light green indicates least risk.

Inflation has probably peaked in 2011; it’s decreasing but only moderately in the region. But if you look at credit growth, it’s very high. Equity prices during mid-September took a bath, of course, but they also have been pretty strong.

If you put these factors together, you have a picture of many Asian economies dealing with this problem. Something we noted, which also appears in the IMF’s *Global Financial Stability* report, is a pick up in leverage in the certain sectors – not as much manufacturing as we see from the dashed red line – but in sectors like construction and real estate, where there is more of a concern about excess capacity.

**High Credit** – So credit is very high. Recent history has told us that when there are low interest rates for long periods of time, problems are going to arise somewhere in the economy. This is a history that Asia knows very well.

We are worried about the building up of balance-sheet risks over time. But the REO also notes that during the past decade, Asian countries have taken comprehensive reforms that have had the effect of strengthening their financial, corporate, and public-sector balance sheets. There is no cause for concern in the near term, but if an environment of very easy financial conditions continues, we may see problems down the road.

**Dependence on Non-Asian Demand** – Our immediate
concern is that Asia will pay the price for renewed tensions in the global economy. The chart on the left shows that Asia’s dependence on demand outside of the region actually has increased over time [see slide below].

What the IMF has stressed and will continue to stress in our REOs is that a lot of intra-regional trade is intermediate trade. There is quite a bit of vertical integration in the region, so a lot of the intra-regional trade is for parts that are exchanged across Asian economies.

But if we trace the origin of final demand – about 30 percent on average – it is coming from outside Asia. For the most open economies in the region Singapore, Malaysia, Taiwan, and Thailand – the dependence is 30-40 percent, which is pretty high.

**Export-Oriented Asia** – On the right, is another unsurprising but useful chart, which shows the relationship between private domestic demand and exports. We know that 40 percent of investment in Asia is in the export sector. Consumption, too, is related to exports in a way.

Our simplistic view of Asia is that if the export sector works, everything else is going to follow through. The tight correlation between private domestic demand and exports in Asia shows that if external demand heats up, domestic demand may be affected as well.

What we have seen in the crisis is a much stronger response by Asian policy-makers. China, for example, has become increasingly able to insulate the effect of external demand on domestic demand. It is unclear whether Chinese officials will be able to do this going forward. We are still confident that they have scope to boost domestic demand through their large fiscal space.

Concerning financial channels, what we have seen during mid-September is a reminder of how Asia is exposed to financial turmoil outside of the region. We have seen ups and downs in capital flows, in portfolio flows, and in equities and bonds. The green bar on the left-hand chart [see slide on page 8] represents what has been flowing out of the region, especially for countries that have rich bond markets, like Indonesia, Malaysia and Korea.

**Hedging Actions** – We have seen falling equity prices in Asian stock markets. Our view is that developments in mid-September represented the efforts of hedge funds to liquidate their positions in Asia. The real money investors, such as institutional funds and mutual funds, have been abandoning the region. They are hedging against risks from currency depreciation.

The IMF remains optimistic about the prospects for capital inflows in the region. Certainly, the Asia-Pacific region is going to be exposed to increased volatility. What

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**But another global recession would hit Asia hard through both trade channels**

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we’ve been seeing in Asia in early-to-mid-September is a correction.

If we are correct in saying that what we have been seeing is just a repositioning of leverage investors in the region, then we shouldn’t be worried about that. However, there is a risk that this repositioning will involve the real money, meaning the institutional investors and mutual funds.

So what are policy implications of this? The IMF’s April REO highlighted the need for Asian economies to normalize monetary and fiscal policy stances. However, we have been forced to change our view because of developments in recent months. My department now thinks there is a much differentiated story within the region.

Exposure to G-2 – As the chart on the left-hand side shows [see top slide on page 9] there are economies where over-heating pressures are relatively higher, such as India, China, Indonesia, or even Korea, and are less exposed to the slow down in the G2. The G2 refers to the Euro area and the United States.

The IMF believes that these economies should keep tightening. They may pause, but they should not lose track of the over-heating risks and the financial vulnerabilities building gradually in the region.

But there are economies where over-heating is less of a concern. Inflation has slowed down over the last few months and returned to levels within the central bank’s policy targets. They are going to be highly affected if the global economy deteriorates further. For Singapore, Thailand, Malaysia, there’s more room for them to pause in terms of monetary policy normalization.

In a way, it makes more sense to run monetary policy based on the risks and less on the baseline because of the lags that make running fiscal policy difficult. We think that fiscal normalization should continue, especially since the structure of aggregate adjusted fiscal balances is worse now than it was on average during the 2002-2007 period.

Of course, if the crisis comes, Asia has room to deploy a vast range of measures, as the economies demonstrated in 2008, to deal with the consequences. These include shifting aggressively to ease monetary policy or, for those with fiscal space, reversing fiscal consolidation. These measures can be used again to insulate economies from the recession.

Medium-Term Challenges – With respect to medium-term challenges, the chart on the left hand side shows [see lower slide on page 9] that we are still pessimistic that global current account imbalances will decrease world-wide.

But we are seeing progress in some Asian economies, notably Indonesia, Malaysia, and Thailand, owing to the investment projects I referred to earlier. There has
been less progress in China in terms of reducing current accounts surpluses.

The IMF also is concerned about the increase in income inequality in Asia. Poverty has been reduced because of fast growth. But if we look at the extent to which Asia has been able to reduce income inequality, that margin is much lower. We believe that is because there has been a relatively lower level of spending on social safety nets, health, and education as compared to other regions in the world.

To conclude, Asian economies are expected to continue

Medium-term challenges are to rebalance and shift to a more inclusive growth mode

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growing at a solid rate. We are bullish on the baseline but downside risks are very strong for the region. The region could be affected severely if the global economy worsens more than we expect.

That means that the pause in monetary tightening may be warranted in some countries though not in all, and fiscal policy normalization should continue. Policies in support of economic rebalancing are very much needed and as are policies aimed at making growth more inclusive.

Ambassador Zou

Thank you very much, Roberto, for your interesting presentation. Now we will give the floor to our second speaker, Mr. Yuen Pau Woo.

Mr. Yuen Pau Woo

Thank you Ambassador Zou. Good morning ladies and gentlemen. It’s a pleasure for me to share with you the results of this year’s State of the Region report, which we are releasing today in Washington, DC. First, let me thank and congratulate the US Asia Pacific Council, East West Center for putting together this terrific event.

I also want to remind all of you that we have students from a number of countries who joined PECC delegations at this meeting. I offer them a very special welcome and encourage them to enter into the discussions at this session and subsequent sessions.

The State Of The Region [SOTR] report, as some of you know, is the flagship publication of the PECC. We produce it annually. In the last five years, we have developed a template for this publication that consists of an economic outlook, a survey of opinion leaders around the region, and finally, a unique index of Asia Pacific regional economic integration. I will be saying a bit about each of these.

This year, we also have an added feature, which is a special study on the Prospects for Asia Pacific Energy Trade. I’ll spend the second half of my presentation on that issue.

[For Mr. Woo’s complete Power Point presentation, please click here.]

Since we had such a terrific presentation from our IMF colleague, I won’t say anything about Chapter 1, which provides the economic outlook. I will spend most of my time on the perception survey and on the other elements of the report.

Survey of Opinion Leaders – As I mentioned, one of the key contributions of the SOTR is our poll of opinion leaders around the region. To refresh your memory, the way we do this is we go to our national committees and we ask them to identify between 20 and 30 opinion leaders and give them a score for how they expect the growth to change over the next year.
leaders in their economy. These could be senior business executives, senior government officials, scholars, people from the media, or those from civil society who have a very deep knowledge and involvement in Asia Pacific issues. We then compile the individual responses from our various national committees.

This year, we had about 430 responses from PECC’s 23 member economies. This is not a large number, but it was a very high-quality respondent set.

One of the questions that we pose every year is to gauge our respondent’s expectations for the growth outlook. We
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asked them how they see the next 12 months relative to the last year. This is the result for the Asia Pacific region as whole. The graph is self-explanatory [see slide on page 10].

Pessimism – Our opinion leaders were the most pessimistic they have been since 2008, when we had the last recession. These are responses from the different regions; there’s pessimism right across the board.

When we asked them about the expectations for specific countries or groups of countries, the pessimism was most pronounced, not surprisingly, with respect to the United States and the EU [see slides on page 11]. This survey was taken over the course of several weeks in July and August, so that was even before we received some of the more worrying news from the European Union.

In addition, this survey was conducted when the United States still was trying to work out a deal to raise the debt ceiling. In some ways, things have taken a turn for the worse, but even in mid-summer, some 80 percent of our respondents believed that the growth prospects for both the US and EU would be significantly worse.

You will note that even in the case of China, there’s a slight plurality of respondents who believed that the Chinese economy also would see less rosy growth prospects. This was not a prediction of recession, but simply that the growth outlook in China would be less positive in the next 12 months compared to the last year, which is consistent with the IMF’s forecast.

Surprisingly, the only economy where more respondents believed that growth will be higher in the next 12 months is India – this, by a margin of about 16 percentage points. For every other group, the balance of opinion was towards slower growth. So that’s the broad picture of expectations. We feel that this outlook has particular salience because it comes from a group of people who are particularly well-informed.

APEC Priorities – We also asked our respondents about the state of regional institutions, particularly APEC. In particular, we asked their opinions of what they think should be the priorities for the APEC leaders when they meet in Honolulu, Hawaii on November 12-13.

The top five issues they identified were: (1) the Free Trade Area of the Asia Pacific, which is an ongoing focus of APEC; (2) a green growth strategy for the region.; (3) the WTO Doha Development Round: (4) corruption; and (5) an APEC growth strategy, which basically means a more sustainable and inclusive strategy for the region.
Risks to Growth – When we asked respondents to identify the biggest risks to growth, not surprisingly, they identified the two engines of growth, if you will, as the sources of risk [see slide on page 12]. The US economy was at the very top as the greatest risk. Respondents also regarded the Euro-zone crisis as a very big source of risk. Other issues, such as energy security, the Chinese economy, bank crisis, and so forth followed. This is

Challenges to Doing Business

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Sustainable Growth – One topic that always interests us is the advice that respondents would give to APEC leaders and senior officials about policies on which APEC should focus to promote sustainable growth [see top slide on page 13]. The issues that were deemed as the most important were investment in new technologies and innovation systems, followed by two issues related to the rebalancing question.

Reducing both the US fiscal and current account deficits was regarded as very important. Likewise, respondents viewed the counterpart, involving the rebalancing of growth in East Asia, as an important policy priority for APEC leaders. For that matter, most of the other policy priorities identified by our experts also pertained to correcting both internal and external imbalances.

APEC always has placed a high priority on improving trade and investment in the region and facilitating commercial relations in the Asia Pacific. With this in mind, one question we have posed for a number of years concerns challenges to doing business in the region [see bottom slide on page 13].

Corruption – Corruption went to the very top of the list this year as the most significant obstacle to commercial relations. That was followed by regulatory impediments in overseas markets, which is in line with the work that APEC has focused on in 2011 aimed at realizing greater regulatory coherence and improvements in behind-the-border issues.

In fact, behind-the-border barriers to doing business dominate this list. By sub-region, our colleagues from Australia and to a lesser extent, South East Asia, placed the most emphasis on regulatory impediments, North America, a little less so, and likewise North East Asia.

TPP vs. ASEAN-Plus – In Washington and elsewhere in the region there has been a great deal of focus on utilizing different pathways to realize deeper regional integration, whether this be through sub-regional agreements or through an Asia Pacific wide-arrangement, such as the Free Trade Area of the Asia Pacific [FTAAP] or a Trans-Pacific Partnership [TPP].

We asked our respondents whether they thought the TPP and/or the so-called ASEAN-plus agreements, which would include the ASEAN+3 [ASEAN plus China, Japan, and Korea] and ASEAN+6 [ASEAN Australia, China, India, Japan, New Zealand, and South Korea] arrangement, might be a suitable pathways to broader regional integration.

Generally speaking, our respondents were quite ecumenical about how we get to regional integration. There was some variation from our respondents from different regions but broadly speaking, they regarded...
these agreements as ways to realize deeper regional integration.

Of course, if you look more carefully at the results, you see the obvious insider-outsider phenomenon. Economies that are not part of ASEAN-plus agreements, such as those in North America, were less enthusiastic about this as a pathway because they are not part of it. Likewise, those economies that are not currently involved in the TPP negotiations were less positive about that agreement.
But generally speaking, there was a willingness among our respondents to not take overly strong positions on the best way to Asia-Pacific integration. They were quite willing to let different experiments take place and hope that they can somehow lead to integration for the region as a whole.

**APEC vs. EAS** – APEC is always being compared to other organizations. A couple of years ago, there was a major review of the performance of APEC in light of the so-called Bogor goals coming due. These goals refer to a pledge by APEC leaders in 1994 when they convened in Bogor, Indonesia to achieve free and open trade and investment by 2010 for industrialized economies and by 2020 for developing economies.

We therefore asked our respondents to assess APEC’s performance, both in and of itself as well as compared to the East Asian Summit [EAS] and other regional forums [see top slide on page 15]. You will see that APEC generally fares better than the EAS in terms of its effectiveness and usefulness to the business and policy communities.

Looking specifically at the areas of work in which APEC is involved, our respondents generally gave quite high marks to the organization’s the work aimed at achieving free and open trade, supporting the global trade regime, reducing trade transaction costs, and so forth. All these areas easily earned a greater than 60 percent satisfaction level.

**Regional Economic Integration** – The other standard feature of our *State Of The Region* report is a unique index of Asia-Pacific Regional Economic Integration [REI]. We developed this by combining a number of measures to develop a composite index. One set of indicators involves direct measures of intra-regional trade, intra-regional investment, intra-regional people flows.

We then match that with another set of indicators that deal with what we call convergence, meaning that if the region is coming more closely together, one would expect that regional members will start to look a bit more like each other. So we combine these two sets of indicators into the composite index, which you see here shown in the red line. At first glance, you can see that this convergence has fallen for the most recent year, 2008.

Although a bit out of date, it nevertheless is noteworthy that 2008 was the first time our index of regional economic integration fell since we developed the index. When you look at the component parts of the index, you will see that it fell with respect to intra-regional trade, intra-regional FDI and intra-regional people movements [see bottom slide on page 15]. Of course, 2008 also was a recession year.

**Convergence Decreasing** – Also important, is the continued divergence in the indicator measures of how closely the regional members resemble each other [see above slide]. In previous years, the convergence indicator was diverging but not enough to cause a fall in the overall composite indicator, primarily because the
trade measure, the investment measure and the tourism measure were increasing. In other words, the trade, investment, and people flows measures overwhelmed the convergence measure so that the composite measure continued to increase.

But in 2008, because there was a decrease in intra-regional trade, investment and people flows – combined with a continued decline in the convergence indicator – there was a decrease in the overall composite index. This is not a value statement about whether it’s a good thing or bad thing. But in my view, it draws attention to continued
divergence in the region, which is something that APEC leaders and the PECC community should think about.

Over the long term, the region cannot reasonably aspire to coming together if, in fact, members of the region are growing apart in terms of their wealth and income levels.

Energy Security – One new set of questions we introduced this year related to energy issues. This has always been a major concern for our respondents, who have regarded energy security as one of the key risks to the economic outlook. You see here [see top slide on page 17] that respondents from different regions assign greater or lesser importance to the question of energy security.

Respondents from energy-exporting countries seemed less concerned, but those from Northeast Asia and even Southeast Asia, indicated a very high level of concern. As many of you know, Indonesia and Malaysia are beginning to transition from being net energy exporters to becoming net energy importers.

When we asked respondents about the role of different energy sources to address the energy security question, renewables ranked very high, so there is a strong awareness of the need to move away from fossil fuels [see bottom slide on page 17].

In terms of specific actions to promote energy security, it is no surprise nuclear energy has fallen to the bottom of this list, significantly below measures to increase energy efficiency and conservation and other issues. I should note that this poll was taken 3 or 4 months after the Fukushima nuclear crisis in Japan.

Energy Subsidies – You may know that APEC leaders have pledged to eliminate fossil fuel subsidies. Our respondents apparent shared that view; more than 50 percent, but varying among different regions [see slide below]. Respondents from Northeast Asia, for example, seemed to be the least supportive of eliminating fossil fuel subsidies.

Moving quickly through the rest of the presentation, you will see that this graphic simply shows the pattern of trade in the Asia Pacific region [see top slide on page 19.]. Much of what we think of as Asia-Pacific trade is really dominated by trade within sub-regions and particularly trade within the Americas, on the one hand, and trade within Asia on the other hand.

There’s virtually no trans-pacific energy trade today. The chart shows the nature of trade in oil; there are no trans-pacific arrows going in any direction [see bottom slide on page 19]. The same holds for global gas trade.

But now we believe there is the potential for a trans-pacific energy market because of some extraordinary discoveries in North America of shale gas. This development raises the possibility of the United States
becoming energy independent if can capture or utilize all of this shale gas.

**Natural Gas Trade** – This new prospect for trans-pacific energy trade, particularly from North America to Asia, relates to the segmentation of markets where there are huge price differentials. This chart [see chart on page 21] depicts the price differential for natural gas.

If you look at the very bottom of the orange and the blue lines, these are essentially the prices paid in North America for natural gas. This dotted line is the price that
Japan paid most recently for long-term contracts from Qatar – and that margin is in the order of $16.

Data indicates that there is an intriguing possibility of a more integrated and therefore more transparent and competitive market. Obviously, there are a range of geo-political implications if this kind of trade can be established.

The economic welfare gains, certainly for Asia, would be huge. There would be export benefits for North American producers. This would be something that the Asia-Pacific community would be pleased to see develop in that it would, in fact, bring the region closer together. Thank you very much.

**Ambassador Zou**

Thank you very much, Mr. Woo, for this very interesting presentation. Now we will take questions from the audience. And we will take a number of questions together so that the speakers can either respond to them individually or give a comprehensive reply.

**Question #1**

I would like to ask Dr. Cardarelli about the income inequality that is growing in East Asia and how worrying that is. Having worked on Latin America, one of the reasons cited for all the bad things that plague that region, such as crime, gangs, drug trafficking, and so forth, has been the huge income inequality there and the inability of the region to reduce this.

Thus, I think this trend in Asia is quite worrying. In China, there are two different countries, one in the East and one in the West. And in India, there is urban India and rural India. How can we make China and India into one country? What are the policy tools to deal with this in East Asia?

**Question #2**

My question is for Mr. Woo. What are the major obstacles to trans-pacific energy trade? Is there a lack of infrastructure in North America or even if infrastructure is addressed, will we see the development of local objections to exporting energy resources from North America to Asia?

**Question #3**

On the convergence index, I was looking at your book and the big negative is GDP per capita, but that’s not necessarily bad news. It simply means that, say China, is growing at 9 percent, Malaysia is growing, let’s say, at 6 percent.
So, when you consider the first question about income inequality, you have to look at not only the inequality, but what the absolute improvement is in all other countries. I don’t know quite how you’re going to deal with that in your convergence index but it’s something that one might want to think about.

**Dr. Cardarelli**

**Incoming Inequality** – Concerning income inequality, to be honest with you, we started thinking about this after what happened in the Middle Eastern economies. We are the IMF; we’re not the World Bank. In a way, we’re not comparing advantages in the macro-financial, but it became obvious that when this kind of issue becomes significant enough, it will have macro implications that we cannot ignore.

The IMF prepared a working paper, which also will be a chapter of the *REO* for Asia and the Pacific. It shows that one percentage point of extra growth has the capacity of reducing income inequality in Asian economies relative to Latin American economies.

It’s a pretty robust result. We considered whether there was some fiction to the data but it actually was pretty strong. There are so many policies that affect income inequality, but we also show that Asia is under-spending on things like health, education, social safety nets relative to what is should be.

We did some modeling of what the spending should be based on some variable like GDP per capita. As it turns out, Asia is under-spending relative to what this model would predict. There are examples in Latin America involving conditional cash transfers. This approach has proved to be pretty successful in Brazil and Mexico. But is has been successful in reducing poverty rather than income inequality.

It’s true but there are successful experiences in many Asian economies, especially China and India. Certainly, this is an issue the IMF is going to continue looking at it. Again, for further details, I encourage you to read that chapter and the IMF working paper that will be issue in mid-October in Tokyo.

**Mr. Woo**

**North American Energy Exports** – There are many issues around the prospects for North American exports of energy to Asia, and the first and foremost is political. I don’t think Americans are used to the idea that they could be either energy self-sufficient or an energy-exporting country. There’s so much focus on energy dependence and energy security and getting energy from safe and secure sources.

That shift in mind-set has not taken place yet. It is compounded by the very real concerns that many Americans and Canadians have about the technologies that are required to extract so-called unconventional gas, unconventional oil.

The term that’s been used is “fracking” and there are many controversies around the chemicals that are used for fracking, the consequences for the water table, for farms, and for the general environmental. So those issues have to be overcome. Plus, there must be a general willingness to be an exporter of energy, which might be seen as detrimental to US national security interests.

There are also more parochial obstacles. US industries and utilities that would like to have natural gas at a very low price – that is, $4 per million British thermal units rather than at a price closer or somewhere in between what the Japanese or Koreans are paying. So there are the usual push and pull factors caused by interest groups that are an obstacle to the political ability to export.

**Infrastructure Challenges** – In addition, there are a range of more commercial or physical challenges. Infrastructure is not in place. The United States has a number of LNG plants on the East Coast that are inbound, receiving terminals. Some of them are now being repurposed for export.

There are proposals to build LNG terminals and liquefaction plants on the West Coast, both of the United States and in Canada. This will require massive investment, and much of this investment likely would have to come from Asian countries including Asian state-owned enterprises.

*continued on page 22*
SOE Challenge – That’s another category of challenge that Americans and Canadians will have to deal with. Are they willing to accept, for example, Chinese national oil companies or Korean or Thai or Japanese, Malaysian state-owned oil companies?

So those are just some of the obstacles that are blocking progress. But the economic logic is very, very powerful and I think the more that policy-makers and the general public understand the economic logic and the environment logic – particularly in the case of natural gas, which is a cleaner fossil fuel than coal – the better.

The only way that China, for example, can go from 60 percent dependence on coal to even 50 percent dependence is by using more natural gas. It is the best environmental option for them.

Convergence – If I could turn to the question concerning convergence, the measure that we use is the absolute deviation of the member economies of the Asia Pacific from the mean GDP per capita. I do understand, of course, that a widening convergence doesn’t necessarily mean a bad thing if everybody’s GDP per capita is going up. The very crude hypothesis we have is that over the long run, if there is more integration, there will be some narrowing of the differential.

Now it could be a narrowing because the richest countries are becoming poorer and that’s probably not a good thing. But again, we’re not trying to impose too much of a value judgment. We do think, however, that over the long run, if integration really is happening as theory would suggest, then there should be some narrowing of the GDP per capita differentials and we’re not seeing that at all in our measure.

Dr. Cardarelli

By the way, if I can say something on this one, we have a chapter in the REO on regional financial integration. It indicates that Asia hasn’t realized a lot of progress in terms of regional financial integration – not as much as one would expect based on trade integration.

Regional Financial Integration – There’s a correlation between the two. So we also show that there’s room for a higher degree of financial integration in the region. In addition, we show that there are pros and cons for regional financial integration. The pros are that you are able to do risk-sharing, to diversify external shock across Asian economies.

There’s also the negative, which is contagion. The more you’re integrated with other economies, the more you risk suffering if one of these economies is hit by a shock.

We show that there’s a trade-off between the two, and Asia is below the the optimal frontier. So there is room for Asia to increase financial integration and gain more risk-sharing benefits paying the same cost in terms of the risk of contagion.

It’s completely shocking to me to see that divergence across the region is actually increasing while trade integration has increased. It may have something to do with the lack of progress in the area of financial integration, but we’re going to think about that in the future.

Ambassador Zou

Thank you Roberto and Pau. Let’s thank our speakers. ♦
The United States Asia Pacific Council (USAPC)

The United States Asia Pacific Council was founded in April 2003 by the East-West Center (EWC). It is a non-partisan organization composed of prominent American experts and opinion leaders, whose aim is to promote and facilitate greater US engagement with the Asia Pacific region through human networks and institutional partnerships. The Council also serves as the US secretariat for the PECC. In addition, it supports and strengthens the US National Consortium of APEC Study Centers and is available to facilitate other regional cooperation processes.

The Pacific Economic Cooperation Council (PECC)

PECC is a track-two, tripartite organization in the Asia-Pacific region composed of senior individuals from business and industry, government, academic, and other intellectual circles. All participate in their private capacity, and thoughtfully discuss and consider areas of cooperation and policy coordination aimed at promoting economic growth and development in the Asia Pacific region.

PECC was founded in 1980 because of the need to facilitate policy dialogues among the economies of this region, which were becoming increasingly interdependent. There currently are 26 Member Committees, including two institutional members, the Pacific Trade and Development Conference (PAFTAD) and the Pacific Basin Economic Council (PBEC), and one associate member, the France Pacific Territories National Committee for Pacific Economic Cooperation (FPTPEC). PECC’s regional community-building efforts led to the establishment of the official APEC process in 1989. The Council is one of the three official observers of the APEC process. PECC has provided information and analytical support to APEC ministerial meetings and working groups. Also it channels and facilitates private sector participation in the formal process.

PECC Full Member Committees include:

Australia
Brunei Darussalam
Canada
Chile
China
Colombia
Ecuador
Hong Kong, China
Indonesia
Japan
Korea
Malaysia
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New Zealand
Peru
Philippines
Singapore
Pacific Islands Forum
Chinese Taipei
Thailand
United States of America
Vietnam

The East-West Center

The East-West Center promotes better relations and understanding among the people and nations of the United States, Asia and the Pacific through cooperative study, research, and dialogue. Established by the US Congress in 1960, the Center serves as a resource for information and analysis on critical issues of common concern, bringing people together to exchange views, build expertise, and develop policy options. The Center’s 21-acre Honolulu campus, adjacent to the University of Hawai’i at Manoa, is located midway between Asia and the US mainland and features research, residential, and international conference facilities. The Center’s Washington, DC office focuses on preparing the United States for an era of growing Asia Pacific prominence.

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