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Economic and Social Commission for Asia and the Pacific

MACROECONOMIC POLICY BRIEF

VOLUME 1: FINANCIAL CRISIS

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The purpose of this policy brief series is to provide an analysis on macroeconomic policy challenges facing the ESCAP region. Some of these challenges may appear suddenly and confront policymakers unexpectedly. Other challenges may be long term or recurrent ones that suffer from inaction, policy fatigue, or the benign neglect of policymakers. Analyses and reliable statistics may be lagging behind or may not be available at all. This series aims at generating a forward-looking discussion among policy planners, researchers and other stakeholders that will build a regional consensus and forge political will on the policy actions and pressing reforms needed.

The first volume of the series is dedicated to the financial crisis: a crisis that over the past decade was predicted many times, by many, including ESCAP and other international organizations, eminent scholars, economists, policy decision makers and futurists. Less than a handful predicted its exact timing. None averted it. Much remains to be understood and done before regulatory policies and systems can be reformed.

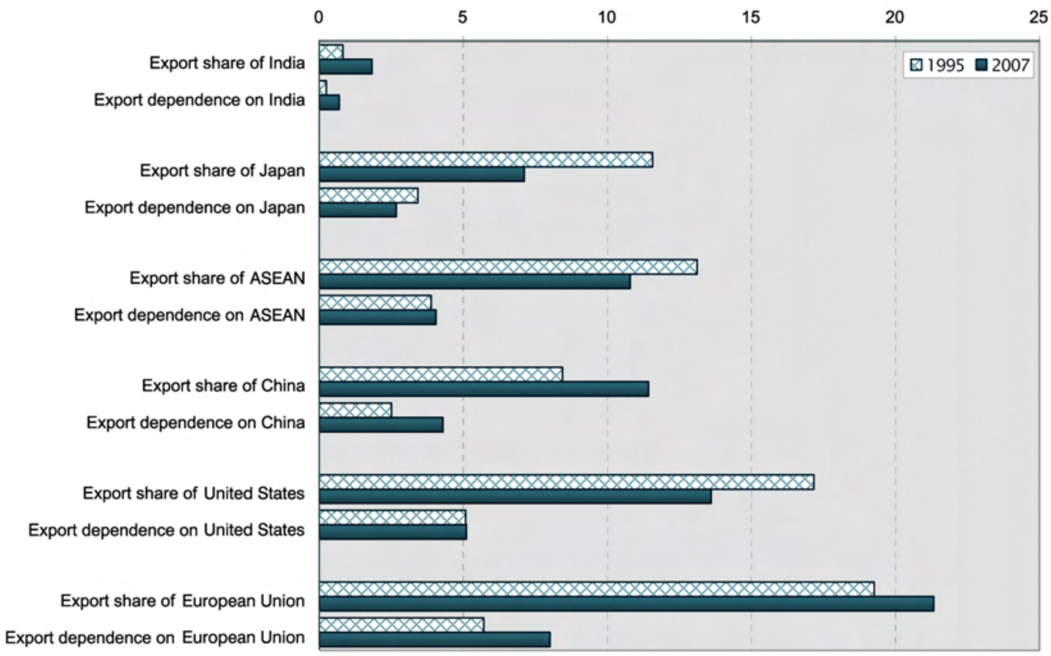
TRADE DECOUPLING IN TIMES OF FINANCIAL CRISIS: MYTH OR REALITY?

The development path of Asia and the Pacific has increasingly relied on economic growth led by rapid export growth. What does the financial crisis imply for the region's future development path? The second policy brief in this series on the financial crisis assesses the extent to which developing economies[1] are export dependent, and the extent to which their exports are dependent on developed markets that have been hit the hardest in the current crisis. Drawing from this assessment, it comments on the reality or myth of a "decoupling" process for Asia. Finally, it offers some policy options for the region.

TRADE AS AN ENGINE OF GROWTH, BUT WITH A DIFFERENT LOCOMOTIVE?

Increasing trade dependence has characterized the nature of economic growth in developed and developing countries alike. Dependence on imports in the United States of America, the original locomotive of growth, jumped from 12.3 to 16.3 per cent between 1995 and now. Its merchandise export to gross domestic product (GDP) ratio increased only by half a percentage point, from 7.9 to 8.4 per cent. During that period, its GDP almost doubled (in current dollars). Similarly, Asian developing countries have become much more trade dependent, while their economic size grew even more

Figure 1. Export share and export dependence* index differences among ESCAP developing countries, 1995-2007 (percentage)



Source: Calculated on the basis of International Monetary Fund DOTS data.
Notes: "Export share" is defined as exports of ESCAP developing countries destined for a particular market as a percentage of ESCAP developing countries' total exports. "Export dependence" is defined as exports of ESCAP developing countries destined for a particular market as a percentage of ESCAP developing countries' GDP.

[1] ESCAP has 58 regional members and associate members, 3 of which are classified as developed (Australia, Japan and New Zealand).However, trade data is not available for most of the associate members or for some of the members. In total, 29 developing members and associate members are included in the "ESCAP developing countries" group observed in this Policy Brief.

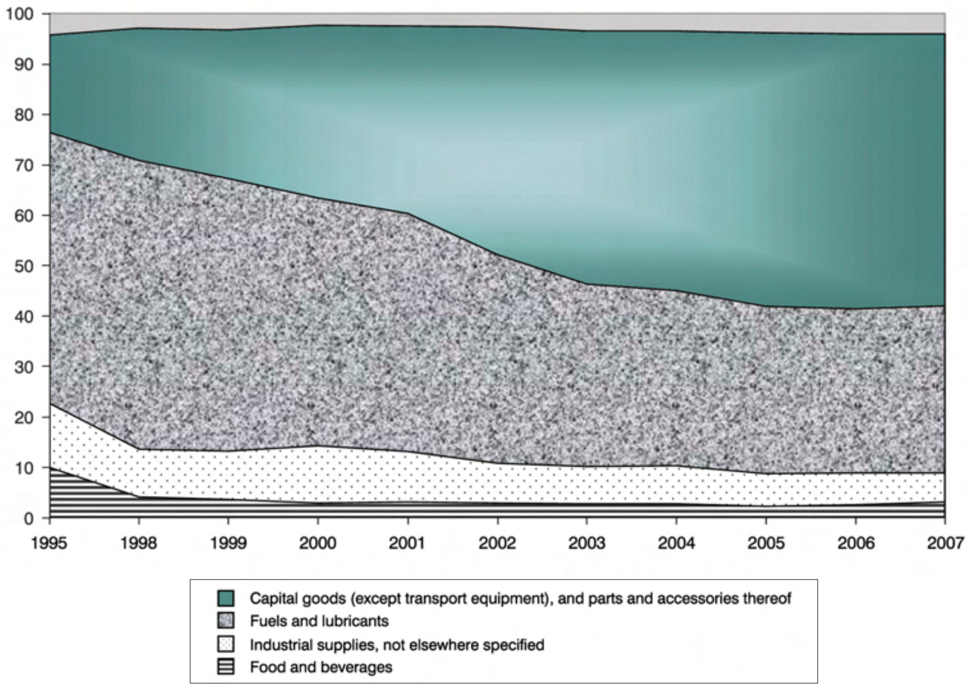
than that of developed economies. Total merchandise export share in GDP (so-called "export dependence") in Asian developing countries increased by almost 8 percentage points to reach 37.5 per cent, while their GDP increased almost three-fold.

At the same time, shares of exports destined to the United States and other developed markets fell by almost 6 per cent. From figure 1 it is clear that ESCAP developing economies as a group are reorienting their exports from the United States and Japanese markets towards the markets of China, India and the European Union. However, it is important to note that, while this reorientation has taken place, developing countries still rely greatly on exports to the United States, the European Union and Japan to generate GDP. As shown in figure 1, export dependence on the United States and the European Union markets expressed as the ratio of exports to GDP is either unchanged or increasing, signalling that a recession transmission channel is still open.

In the impact of the current crisis, two additional factors play an important role. First, Asian exports are more dependent on the European Union, which, as expected, has not been immune to the economic crisis. As is clear from figure 1, both in terms of export share and export dependence, the European Union now plays a larger role than it did in 1995, with the result that a recession in the European Union will magnify the adverse impacts of a reduction in the United States aggregate demand. Second, rapid increases in intraregional and intra-industry trade among ESCAP economies are the hallmark of this region's trading panorama. However, intraregional trade has grown asymmetrically, with the result that China, largely through the hub of Hong Kong, China, has become a dominant importer of intermediate products, parts and components produced elsewhere in the region. In 2007, China sourced about 30 per cent of total merchandise imports from ESCAP developing economies. ESCAP estimates that about one third of total Chinese imports of intermediate goods used for final Chinese exports come from the region.[2] Figure 2 shows that the commodity structure of China's imports from the members of the Association of Southeast Asian Nations (ASEAN), India and the Republic of Korea (accounting for 24 per cent of total imports) has changed over the last decade in favour of capital goods and industrial supplies, which now absorb 87 per cent of total imports from these countries. If exports from China (to the United States and European Union) should contract significantly, its slower economic growth and the associated contraction in imports of parts and components from the rest of Asia would spread throughout the regional supply chain through weakened demand for imports of these goods. Preliminary ESCAP forecasts of the impact of the United States recession[3] on merchandise export growth in 2009 as regards Asian economies indicate declines in China from 13.4 to 4.5 per cent, in India from 9.9 to 2.6 per cent, in Thailand from 8.2 to 1.5 per cent, and in the Republic of Korea from 8.2 to -0.3 per cent. Import demand in the United States further declines from -2.6 to -3.0 per cent.

The fact that intraregional trade is inextricably linked to developed country demand for final products makes the prospects for decoupling from developed markets more difficult to realize. Table 1 shows that about 30 per cent of total imports of both China and India come from the developing countries of the ESCAP region. Using intraregional trade as a cushion against the contraction of exports to developed countries will depend on strengthening domestic demand and restructuring it to support intraregional trade.

Figure 2. Commodity structure of Chinese imports from ASEAN, India and the Republic of Korea (percentage, based on broad economic categories for classification of goods)



Source: Calculated based on Commodity Trade Database (COMTRADE) data.

[2] Yilmaz Akyüz, "The Current Global Financial Turmoil and Asian Developing Countries" ESCAP Series on Inclusive and Sustainable Development : 2, 2008.
[3] Set as a 2 percentage point reduction of the base-line growth rate. For more details, see *Economic and Social Survey of Asia and the Pacific 2009* (forthcoming).

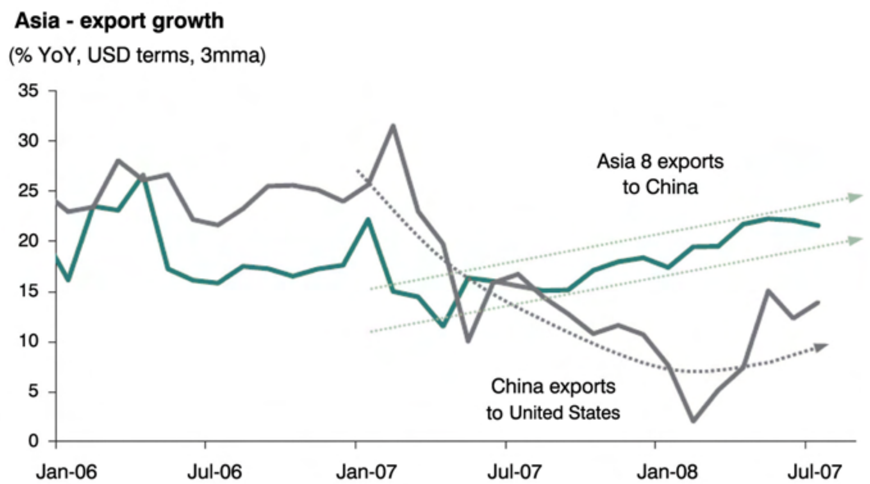
Table 1. Share of China's and India's imports from the ESCAP region and its subregions, 2007

	Total ESCAP region	Developing ESCAP economies	Developed ESCAP economies	East and North-East Asia	South-East Asia	South and South-West Asia	North and Central Asia	Pacific island economies
China	46.6	29.8	16.9	12.4	11.3	3.2	2.8	0.1
India	35.6	29.4	6.3	15.4	10.8	1.4	1.7	0.1

Source: Calculated on the basis of International Monetary Fund DOTS, 2007 data.

This, in turn, hinges not only on the ability of fast-growing economies, such as China and India, to readjust the mix between consumption, investment and exports, but also on a policy choice to fulfil this role in the Asia-Pacific region. Figure 3 shows, based on trade data, that de facto China has started to play this role and that it can be expected to continue along this trend. Furthermore, it seems that other countries in the region are joining this strategy. Other countries of the ASEAN+3 grouping as well as India have all announced "New Deal" type stimulatory fiscal packages. While the components of these packages differ, these countries are all sending signals that they have the fiscal space and they are prepared to use it. They are, in effect, positioning themselves as new locomotives of growth, albeit not in a decoupled but rather a complementary role that supports the faltering locomotives which hitherto had performed that role.

Figure 3. New locomotive of growth for Asia and the Pacific?



Source: DBS Group research, p. 6.
Note: Asia 8 comprises Hong Kong, China; Taiwan Province of China, Republic of Korea, Singapore, Malaysia, Indonesia, Thailand and Philippines.

GUARDING AGAINST A RISE IN PROTECTIONISM

What is more worrisome is that, in a climate of severe economic slowdown, some countries may be tempted to increase tariffs or take other protectionist measures in an effort to shield ailing domestic industries from competitive imports.

This risk is not abstract, nor is an increase in protectionism infeasible, despite World Trade Organization (WTO) rules and commitments that countries have made to liberalize. As can be seen in figure 4, there is ample "building material" to erect protectionist walls without breaking current WTO rules. In terms of averages, there is a gap of 14 percentage points between applied and bound rates (the upper limit to which WTO members commit themselves). This gap gives plenty of leeway to countries that choose tariff protection as a means of insulating domestic producers from competitive imports. Taking the current average applied tariff of 8.7 per cent as an example, there is space to increase the tariff by 250 per cent before the 14 percentage point gap between applied and bound rates is reached.

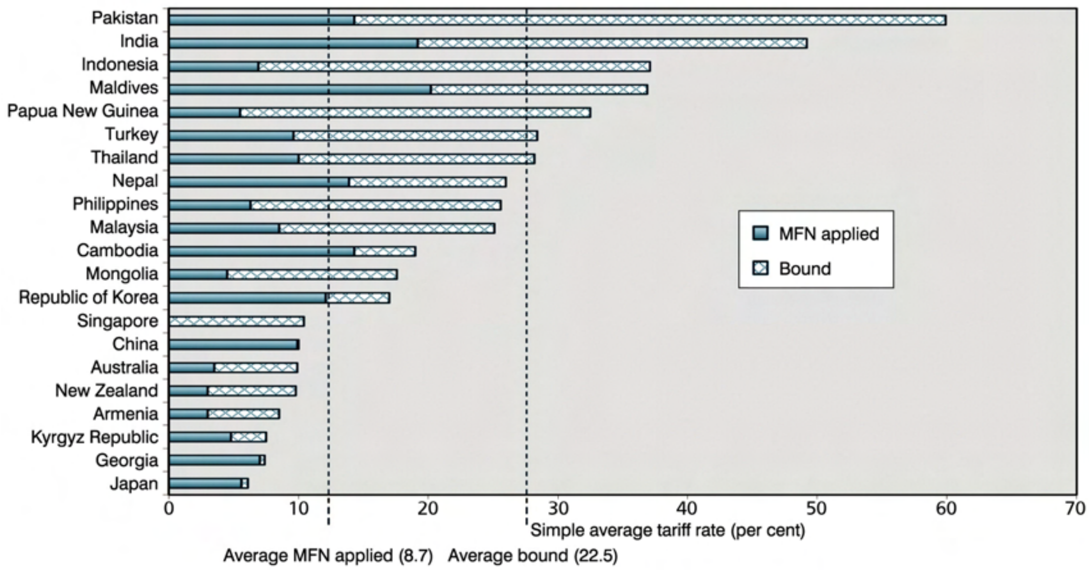
Furthermore, there are many other ways in which countries may engage in increased protectionism. Typically, they take the route of contingency measures, such as additional tariffs imposed as safeguards and anti-dumping measures. With many Governments now actively seeking to support domestic producers, and with the difficulties in making a clear distinction between non-tradable and tradable products and services, there will likely be an increased use of all such measures.

As the attention of world leaders remains squarely on financial rescues and fiscal stimulatory packages, it becomes even more important to keep the long-term perspective in mind. A conclusion of the negotiations on the Doha Development Agenda (DDA) agreement in 2009 is prominently on the list of necessary actions in all crisis policy action documents (for example, the G20 and APEC leaders' summit). A conclusion would provide insurance against a resurgence of "beggar-thy-neighbour" policies of the type seen in the 1930s. Furthermore, in the Asia-Pacific region, accelerated implementation of South-South regional trade agreements would promote trade and deepen economic cooperation through increased investments and regional production networks.

OPTIONS FOR THE CONSIDERATION OF POLICYMAKERS

Liberalized trade in goods and services and easier movements of capital and financial flows have made the economies of the world ever more interdependent. Tracking economic developments since

Figure 4. Differences between applied and bound tariffs, selected ESCAP member



the last global downturn, in 2001, points to the growing dependence of Asia-Pacific economies on the economic growth of China and to a lesser, but still important, dependence on sound United States growth. The Asia-Pacific region has experienced and can be expected to continue to experience the negative impact of the widening global economic recession. Complacency is therefore something that the region, especially its smaller economies, cannot afford; and even though there are a number of actions that each country can take independently, no country can ride this crisis out on its own. Coordinated action for greater regional prosperity is required in order to build resilience and ensure that the region can minimize the negative impact of the current crisis.

With a view to promoting intraregional trade and narrowing the channels along which a recession is transmitted while, at the same time, recognizing that the Asia-Pacific region is inextricably integrated with the world economy and will depend on a rapid resumption of world economic growth for its continued prosperity, the following policy actions are proposed:

- First, do no harm.[4] In other words, Governments should not resort to protectionist policies focused on narrowly defined nationalistic interests that would harm trading partners. For example, even though developing countries in the Asia-Pacific region have gaps between applied and bound tariffs that are sufficient to allow significant tariff increases without running afoul of WTO rules, they should refrain from doing so. Anything less would stymie the potential of South-South trade as a shock absorber.
- Second, a revitalization of efforts is needed to push through with conclusion of the negotiations under the Doha Development Agenda, both as a confidence booster and as a bulwark against possible slippages back into protectionism. Even though developed countries have little space to increase tariffs, there is a range of tariff and non-tariff forms of contingent protection at their disposal. A conclusion of the Doha Round would strengthen disciplines on their use.[5]
- Third, special attention should be given to trade and investment agreements, many of which fragment the regional market by imposing rules of origin that are costly to comply with and other trade procedures that increase cost of trading. A conscious effort should be made to opt for regional trade agreements that could contribute to trade facilitation and a deepening of South-South economic cooperation.
- Fourth, South-South investment should be supported by extending foreign direct investment incentives to other developing countries, as there is scope for active encouragement of such flows as well as enhanced South-South transfer of technology and technical knowledge.
- Finally, Aid for Trade should be promoted and channelled particularly into building the supply-side responses of developing countries so that they can make more effective use of the market access opportunities that will arise in future. Tackling bottlenecks in transit, transport and trade facilitation is an important area of work that will need attention in future.

This issue of the *Macroeconomic Policy Brief* has been prepared with substantive contributions from the Trade Policy Section, Trade and Investment Division, and the Macroeconomic Policy and Analysis Section, Macroeconomic Policy and Development Division, ESCAP.

For further information on the *Policy Brief*, please contact the Director, Macroeconomic Policy and Development Division, ESCAP, e-mail: escap-mpdd@un.org

[4] Jeffrey J. Schott, "First, Do No Harm", available at http://www.petersoninstitutte.org/realtime/?p=210, 3 November 2008.

[5] Strengthened multilateral rules and principles are needed not only in trade, but also in improving the tracking and regulation of international financial flows. The Asia-Pacific region should not miss the opportunity to contribute to new ideas and solutions that would put forward the interests of developing countries and remove asymmetries in the global financial system.