The Asia Pacific Economies After September 11

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The Asia Pacific region is settling into a new pattern of growth following the financial crisis of 1997 and 1998, the American "tech wreck" of 2000 and 2001, and a series of inter-related security dislocations since 2001.

In the new pattern, East Asia is again the world's main locus of growth in output and trade, but now with the Chinese economy at its centre.

The United States continues to play a huge role in the region, but with its growth outlook more like the problematic 1980s, than the dynamic 1990s. The good news for the region is that the United States recession has definitely ended. The bad news is that the recession has definitely ended and there are serious doubts about whether strong growth can be sustained for long before there are investment-destroying adjustments in financial markets. In the meantime, the weaker dollar is switching United States expenditure from overseas goods and services and moderating the growth in imports.

The terrorist attacks on New York, Washington, Bali, Jakarta and elsewhere immediately and permanently raised costs of international economic transactions. The effects have been most severe in transactions involving movement of people, including tourism, education, other travel-related services, and direct foreign investment. In many countries, led by the United States, substantial increases in spending on security have been associated with rapidly rising budget deficits. Canny investors are contemplating the contribution that post-Cold War fiscal consolidation in the United States and elsewhere made to the prosperity of the 1990s.

The generally negative impacts of the security agenda on the economic outlook are balanced by one significant positive effect. The first year of the younger Bush administration in Washington was marked by tensions with China deriving from perceptions of strategic rivalry. The tensions represented a risk to security and prosperity in the Asia Pacific region. This risk has been greatly diminished by Sino-American cooperation in the "war on Terror" and Korean security issues since

September 11, 2001. Tensions over trade issues and Taiwan in November 2003 are less febrile than when these questions rose in the public agenda in earlier years.

Average growth rates in the Asia Pacific region were moderate in 2002 at 3.1 per cent. They are growing at a touch above that rate in 2003 — and it would have been higher still without the effects of SARS in Chinese Taipei, Hong Kong, Singapore, China and elsewhere.

East Asian growth has led the Asia Pacific region since 1997 and 1998 but not by the wide margins of the decade before the financial crisis. The East Asian average of 3.5 per cent in 2002 compared with 2.4 per cent in the United States. Slow positive growth — rising above 1 per cent only recently — and not recession, has been the Japanese story of the new millennium. This year is much stronger in Japan, and the momentum will continue into 2004. It will ease beyond that, because the demographic structures make 1 per cent a reasonable average for Japan. Korea was returning to high growth — 6.3 per cent in 2002 — but was dragged back for a while earlier this year by the intensification of security tensions on the peninsula. Southeast Asia has been growing reasonably strongly, if below the giddy heights which preceded the crisis — 4 to 5 per cent is the new norm for the larger, old ASEAN members. Vietnam is growing faster from a low base. Singapore is now growing within the tighter constraints of a developed economy.

China's growth provides the main impetus for contemporary East Asian expansion, and is likely to do so until well into the twenty first century. This prospect is underwritten by high rates of savings and investment, the productivity gains from increasing integration into the world economy and structural flexibility deriving from a rapidly expanding private sector.

Large-scale immigration, through easing demographic constraints, raises American growth potentially well above that of the other major developed regions. The Bush Senior-Clinton fiscal consolidation moderated the lift in long-term interest rates associated with high levels of private investment through the 1990s, and underwrote the long boom 1993-2000. The return to high budget deficits will cause capital intensification and sustainable economic growth to be lower in the decade ahead than during the long boom, with a norm of a bit below 3 per cent. The United States economy is temporarily exceeding the contemporary norm in late 2003, and will ease towards it through 2004.

SARS cut 2003 growth in East Asia by about a tenth. In China, it postponed until late in the year what had been emerging as a period of unsustainably rapid growth.

As in Japan in the 1990s, it will take some time for understanding of the new, lower speed limits on growth in the United States to be widely understood. Frustration at disappointing outcomes — waiting for new manifestations of a "recovery" that has already come — is a dangerous incubator for protectionist remedies of various kinds. Already we have seen the protectionist Farm Bill, steel import restrictions, action against Chinese imports, and priority for preferential over multilateral trade. The spectacularly but temporarily strong growth in the September quarter has not changed the mood. The political focus is still strongly on the employment reality — that, so far, this Bush junior term looks as if it may be the first to have experienced a loss of employment since the Hoover Presidency 1928-32.

World trade growth (measured in constant United States dollars) was negative in 2001 and 2002. This cessation of the powerful momentum of "globalisation" had its origins in the United States recession, but was greatly exacerbated by increased perceptions of risk and other sources of higher transactions costs of international movement of people, capital, services and goods after September 11, 2001. East Asia was affected less than other world regions, with both exports and imports growing reasonably strongly in 2002. The 10 per cent expansion from East Asia caused total Asia Pacific export growth in 2002 to be positive, despite substantial declines in exports from the United States and Australia.

Imports for the Asia Pacific region grew faster than exports in 2002, with East Asia leading the way for both imports and exports. East Asia is again becoming increasingly interdependent in trade and growth. This resumes the tendency of the decade from the mid-1980s, which had been broken temporarily by booming United

States markets in the mid- and late-1990s. The earlier period of growing East Asian interdependence had been driven by economic growth and structural change in Japan, supported by mutually reinforcing economic growth and trade liberalisation throughout the Western Pacific. The contemporary period of growing interdependence is built around growth, trade liberalisation and import expansion in China. China is now the most rapidly growing export market for the rest of the Asia Pacific, and has recently overtaken the United States as the largest market for other Northeast Asian economies.

There has been considerable relocation of the increment in production capacity to China from other economies which are losing competitiveness in labour-intensive and standard technology manufacturing. This leads to rapid growth in intermediate as well as final product exports to China. Most analysts in East Asia see this positive effect as being larger than the negative economic impact of increased Chinese competition. However, for the benefits to outweigh the costs requires competing economies to be open and flexible in response to changing international opportunities.

Risks to the Outlook

There are two main risks to the mostly favourable if unexciting medium-term outlook in the Asia Pacific. The first is uncertainty about financial market and political responses to the United States' budget and current account deficits. The second is the danger of widening fractures in the international trading system, further increasing the costs of international trade and investment.

The threat of deflation requires some comment, following global excitement earlier in the year at remarks from the Governor of the US Federal Reserve. Deflation (sustained falls in the general price level) has been present for some recent periods in Japan, China, Chinese Taipei and Singapore.

Inflation for the Asia Pacific region as a whole is expected to change little. Average rates in East Asia are rising, but only slowly. Rates around the Pacific are converging towards 2 per cent in 2003. This is a common mid-point in the bands of central banks which adopt an inflation target.

United States inflation is expected to rise as growth is temporarily high and then settles for a while in the 3 to 4 per cent band. Accelerating inflation in 2004 will lead to a return to rising interest rates in the United States. Revival of the economy and dollar depreciation can be expected to diminish the concerns about deflation in the United States, but also to lead to large adjustments in financial markets.

Fears of deflation damaging growth in the Asia Pacific generally have no foundation. Deflation is a real issue only in a couple of high-income East Asian economies, and with stronger economic performance in Japan, not even there for long.

Of more concern are developments in current account imbalances. Asia Pacific economies' combined deficits were in the order of US$200 billion in both 2000 and 2001. By the end of 2004, they will be more than twice as big.

The main action has been in the United States. The US current account deficit fell to about US$380 billion with the downturn in 2001. It rose to nearly US$600 billion or over five and a half per cent of GDP in 2003, and is expected to rise again in absolute terms in 2004. At the same time, the East Asian surplus is expected to fall from US$223 billion in 2002 to a bit below US$200 billion this year and next. The combined deficit for the Asia Pacific is therefore expected to rise from about US$200 billion in 2000 to nearly US$450 billion in 2004. This implies an immense draw on funds from the rest of the world — principally Western Europe and the Middle East (alongside East Asia).

This outlook is premised on a large depreciation of the US dollar against other major currencies over 2003 and 2004. Much of this has already occurred. If it continues in an orderly manner, this would moderately and temporarily enhance output growth in the United States and correspondingly reduce prospects for its trading partners.

The rapidly increasing and now unprecedentedly large US current account deficit is associated with historically low levels of private savings and above all with the rapid movement in the Federal budget, from substantial surplus to huge deficit. The latter reflects tax cuts and increases in expenditure on defence and homeland security.

Following a decade of restraint after the end of the Cold War, Federal expenditure on defence rose by 5 per cent in 2001 and 11.2 per cent in 2002. It is expected to rise by 19.6 per cent this year, and to continue to rise in 2004 and 2005. The budget deficit is expected to exceed US$450 billion in 2003.

There is a sense in which part of the deficit deriving from tax cuts is attributable to the new security environment. The post-September 11 political milieu facilitated passage of the tax reduction through the Congress.

Current account deficits at current US levels can be sustained only if agents in other countries are willing to accumulate more and more dollar-denominated assets. The recent dollar depreciation reflects reduced willingness to accumulate dollars without limit. The danger is that this inevitable process may at some point become concentrated into a short period, leading to overshooting in a downward direction, more general financial market volatility, and reduced investment everywhere.

Some Asia Pacific currencies especially of economies which are major exporters of resource-based products, have appreciated by a third and more against the United States dollar since the latter began to weaken. As a result, Canada, Australia and New Zealand are finding that recent slow export growth has been exacerbated.

Dollar depreciation is less immediately challenging for the economies whose currencies are formally linked to the dollar — notably China, Hong Kong and Malaysia. The dollar pegs, however — and also the Central Bank interventions to slow appreciation against the dollar in Japan, Chinese Taipei and elsewhere in East Asia — are generating negative political reactions in the United States.

These reactions are misdirected — the East Asian surpluses are part of the process of financing sharply increased public and private deficits in the United States. Much of the political interest has focussed on perceived undervaluation of the yuan. The Chinese currency has now been pegged against the United States dollar for almost a decade. For some of this period, the peg was associated with current account deficits and the yuan was perceived to be undervalued. Both reality and perception have turned around rapidly in recent years, with strong productivity growth in export industries and low or negative inflation. However, the Chinese current account surpluses have not been large on a global scale — in 2002, US$20.9 billion or 1.6 per cent of GDP. Imports have been expanding rapidly with rising domestic expenditure and trade liberalisation. In 2002, real imports rose by 20.6 per cent and real exports by 20.4 per cent. In the first ten months of 2003, the dollar value of imports rose by 40 per cent and of exports by 30 per cent. It is desirable for China and its trading partners that Chinese import growth exceeds export growth in the period ahead. This outcome may be secured by rapid expansion of domestic demand. If further policy intervention were required, the acceleration of import liberalisation would be likely to confer larger benefits on the Chinese, Asian and global economies than institutionally premature deregulation of foreign exchange markets.

International Transaction Costs

Two sources of rising international transactions costs are currently important — the security agenda and the proliferation of preferential trading arrangements. There are important links between the two.

While the nature and level of the "security tax" on international transactions is still emerging, it is already apparent that it is large. It includes higher insurance costs, more intensive vetting processes, and increased private perceptions of risk. It affects some relationships, countries, types of transactions, sectors and modes of transport more than others. It has, for example, substantially reduced US imports and exports of tourism and exports of education services. Australian but not New Zealand tourist arrivals have fallen. There has been a larger effect on North American intercontinental than intra-regional trade in manufactures. Direct foreign investment everywhere has been affected negatively, but less to China than to destinations which are seen to carry higher levels of security risk. It is to a considerable extent unavoidable, and alone would cause the rate of expansion of international trade and investment in the early twenty first century to be significantly lower than in the later years of the twentieth.

There is, however, an avoidable exacerbation of this increase in international transactions costs. The exacerbation is coming through the proliferation of preferential trading arrangements, many of them artificially favouring trade amongst countries with compatible political, cultural or strategic outlooks. Discrimination in favour of one partner is discrimination against others, so that the proliferation of preferential arrangements can have the effect of deepening and entrenching the divide between members of what have been crudely called "civilisations".

The breakdown of the multilateral trading system into preferential areas is most pronounced in the Asia Pacific region, especially East Asia and the Western Pacific. This is significant, because this was once the region most free of trade discrimination.

Trade discrimination within NAFTA provided the first impetetus to the contemporary explosion of interest in small-group FTAs in the Western Pacific. The rush into preferential trade was accelerated by the trade policy agenda of the younger Bush administration. The adoption of a preferential approach to negotiation of trade agreements now seems firmly established as an idea in the Asia Pacific region, although not much has yet happened in practice since NAFTA. The reality will quickly catch up with the talk if there is continued malaise in the multilateral trading system, and no firm action to stop the drift towards FTAs.

Within the Western Pacific region, the Japan-Singapore Agreement of 2002 marked the beginning of a new era in preferential trade. Singapore has since signed agreements with New Zealand, Australia and the United States. China-ASEAN remains at the stage of negotiations, but an "early harvest' of tariff-free access for some agricultural products commenced in October 1, 2003, and will be extended on January 1, 2004. China-Hong Kong and Thailand-Australia were completed in 2003. Japan-Korea, Japan-Mexico, Korea-Chile, Japan-ASEAN, Korea-ASEAN, US-ASEAN, Japan-Korea-China, New Zealand-Thailand and Australia-China, amongst others, are at various stages of discussion.

The new FTAs so far have long transition times and are incomplete in their industry coverage. They have different rules of origin across industries, and the rules of origin are widely inconsistent and incompatible across agreements.

The Western Pacific region is well on the way to becoming the tangled "spaghetti bowl" of incompatible preferential trading agreements against which eminent American trade economist Professor Jagdish Bhagwati has warned so eloquently.

Amongst much else, the modern "globalised" pattern of production, in which economies contribute only moderate proportions of the value added in any product, and draw inputs from globally efficient sources, will be excluded from the FTAs which accounts for an increasing proportion of international trade.

Preferential arrangements add to the cost of doing business, because of the complexities they introduce, for example through rules or origin. They can undermine the domestic political interest in general trade liberalisation. The costs of trade and investment diversion are significant. The enthusiasm for FTAs was one factor denying energy to the multilateral trade negotiations that were initiated at Doha in late 2001, and which stalled at the Cancun ministerial meeting of the WTO two months ago.

Singapore's FTAs with a number of Asia Pacific economies are unimportant in themselves, but exemplify the way that preferential arrangements add to the costs of doing business. Singapore's businesses were once uninhibited in their global search for the most cost-effective inputs into production. Now they must be careful that there is not too much Malaysian or Thai value-added in many sectors. If inputs are cost-effectively sourced from Indonesia, businesses must be careful of their place of origin within Indonesia, since the US rules of origin allow inputs from some parts of Indonesia, but not others. Australia's proposed FTA with the United States illustrates the same problem. It would cut across the Closer Economic Relations Agreement with New Zealand, with Australian businesses needing to monitor the level of New Zealand and other Western Pacific inputs if they were to remain eligible for preferred access to the United States.

The potential effects of FTAs on trade with third countries is illustrated by the Canadian experience since NAFTA. Canada roughly held its share of the rapidly expanding North American import market between 1995 and 2002. However, it became a much less valuable trading partner for the rest of the world between these years. Its share of East Asian imports fell be one third, and of European imports by one sixth.

The scene has been set for the comprehensive breakdown of the Asia Pacific trading system into discriminatory trading blocs. In the worst case, the trading fault lines will correspond significantly with political and strategic interests and alliances. This would cut across the shared interest in truly global expansion of trade and investment, and in truly global cooperation in the effort to combat terrorism in all of its forms.

Of course, the new trading blocs would not be tidily built around strategic alliances. For example, the Japanese alliance with the United States would not have the weight in the Japanese political contest to overcome the resistance of domestic agricultural interests. New tensions will be built into established strategic relations as old partners discriminate against each other's exports.

A Way Forward

The Asia Pacific policy challenge is to avoid compounding the inevitable costs from the security agenda with additional transaction costs from the fracturing of the international trading system.

In November, 2003, this compounding of transaction costs seems difficult to avoid, given the momentum behind the proliferation of preferential trading arrangements. What hope there is of avoiding the worst outcomes lies in restoring credibility and strength to the multilateral trading system, and in staunching the flow of bilateral and regional FTAs.

Here the news is not all bad, despite the failure of the WTO ministerial meeting on the Doha Round of multilateral trade negotiations in Cancun two months ago. It is now clear that the Cancun failure was as much the result of poor preparation and diplomacy, itself resulting from the low priority attached to the multilateral negotiations in a number of important countries, as of irreconcilable differences on key issues.

Only a few weeks later, APEC Leaders in the Bangkok Declaration unanimously endorsed a return to Doha Round negotiations on the basis of the Cancun Chairman's text. This is of considerable importance, because APEC members had not previously been supporters of this course of action and have substantial weight in the international system. Five APEC countries (Malaysia, Indonesia, Thailand, the Philippines and China) had been prominent in the rejection of the Chairman's text that had precipitated the Cancun collapse. Three (the US, Thailand and Australia) had made major statements immediately after the Cancun collapse, that they would give priority to bilateral over multilateral negotiations.

Another positive sign for the prospects of the multilateral trading system, is in the suggestions in recent days that the United States will respect the WTO's ruling against the Bush administration's protectionist measures against steel imports.

Historians record that a terrorist's shot in Sarajevo in 1914 marked the end of a great era of globalisation, that had sponsored a long period of rapid expansion of international trade and investment, and rising incomes in much of the world. It would be another tragic consequence of Osama bin Laden if September 2001 were to mark the end of the modern world's second major period of globalisation and expanding prosperity. The avoidance of this consequence is worth a large international effort.