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Session II – The State of the Region

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Market-led vs. policy-led integration

I'm going to talk about regional economic integration from the business perspective - in an APEC context.

I was at an APEC trade policy dialogue in Adelaide about ten days ago. This was on the question of strengthening regional, economic integration and one of the focuses was what we all think about the proposal for a free trade area for the Asia Pacific. Chris Findlay, Andrew Elek and others who were there talked about the big issues about whether the integration is market-led or policy-led. What concrete steps might we take to take us further down the track towards integration?

It did have a focus on the proposal for the FTAAP. The fundamental divide on this was: what is APEC's role? Is it an organization for capacity building, or is it an organization that is looking to take on a role of a negotiating institution? As you can imagine, the viewpoints on those two different branches reflect both economic thinking and often they reflect political thinking because some economies have a view on APEC's role that is determined as much from a political point of view as it is from an economic point of view.

There was analysis of the barriers to regional economic integration – particularly under the categories of the border barriers; beyond the border barriers and across the border barriers where reciprocity is required in two economies or more to achieve greater degrees of integration. What came out of that? That we have actually made good progress on tariffs with some obvious exceptions. In respect to the old-fashioned trade barriers such as licenses, quotas and so on, there has probably been very good progress.

There was general consensus, I believe, that integration so far in the APEC economies has been basically business-led, or primarily business-led; and the view that investment and services, trade and services, were growing faster than the trade of goods. Progress in investment across the region and investment liberalization is mixed and uneven; and similarly in the trade of services. It was recognized that there are very complex

beyond-the-border and across-the-border issues in further liberalization of investment and trade in services.

But what was particularly interesting were a number of the presentations, which could be summarized – and only touched upon very briefly – that the world can be viewed as one big factory. Business is fragmented and business models today are much more complex and rather different from the business models that might have existed when we were great trade warriors and looked at the border issues as the primary determinant of economic integration.

Globalised supply chains

There was some interesting analysis of what constitutes an American car. On the information we got in Adelaide, an American car has only got 37% US content and the rest is split up among Korea, Japan, Europe, and so on. Probably the easiest one to grasp is the Barbie doll example, where the Barbie doll is designed in California and the hair comes out of a Taiwanese oil refinery; it is sent to China to be assembled; the plastics come from Japan; the supply chain is driven out of China directly to end users in various markets around the world, bypassing warehouses.

The point that comes out of this is that information technology, intellectual property, logistics and the supply chains offer very important determinants of cost and product design; in taking a product and getting it finally to the market.

It has brought home the message that we are talking here about global issues with a regional dimension. The supply chains cover, potentially, the world. While the Chinese supply chain may at the moment be aimed primarily at the North American market, it is in fact of global capacity.

Hence, the IP, IT, logistics and software are regarded as very important and growing in

their significance in evaluation trading patterns. Services that can support supply chains are obviously also very important. Getting a product to market on time is often more important than traditional impediments such as the rules of origin. Multinational enterprises can often now be described as very complex partnerships that share information, share technology and share strategy, but the ownership of the whole supply chain may well be split amongst many participants.

This brings us to the role of the government – a shift to domestic policy. Because there is recognition that domestic input – education, regulation, competition, and so on – are vitally important to the structural adjustment process that is required to meet these changed dimensions of trading patterns. They are required continually – the supply chains, the product life, the evolution of particular industries are continually moving on, and so the role of government in facilitating domestic adjustment is a continuous one.

The behind-the-border issues are seen by business as being increasingly important, increasingly significant and difficult to get hold of. They are difficult to get hold of because they are often so specific to an industry, to a particular supply chain or to a particular product that finding the category or the umbrella description, or sometimes described as the bucket to put them in, is not easy.

So, those were some of the themes that came out. I tried to pull them together for what this means for the APEC region.

The view, I think, that came out from most of the participants – with which I certainly agree - is that APEC is primarily a capacity building organization and the real politics is that it is not yet ready to be a negotiation organization. Certainly, a number of the major economies that participate in APEC are not prepared to see it as a negotiation organization. So, its role is essentially to

harmonize, cooperate and to provide a means for the interchange of information rather than to negotiate.

There are many aspects to consider for the FTAAP proposal, but this is clearly one of those. If the FTAAP proposal is to go forward, it would require APEC to evolve the ability to negotiate, and to enforce. APEC is not ready for that yet, so if the FTAAP proposal proceeds, it will have to be in some form outside of APEC.

Domestic policy intervention

But the big issue that I think comes out of this for regional economic integration in the near term is the importance of domestic policy interventions. Here, I think we have to think very seriously about the particular role of APEC because the issue of domestic policy intervention is not really in the WTO agenda. We don't get this from a successful conclusion of Doha. Domestic policy interventions can take place in very prescriptive fashion, presumably in the EU, and we are all familiar with the OECD models. Neither of those models is appropriate for APEC at its present stage. So the domestic policy interventions e.g. to provide the reforms to facilitate the application of IT, IP; to facilitate the greater liberalization of investment, to facilitate the trade in services – all of which are so significant now in the support in the trade of goods – are seen as a critical role for the APEC economies.

The question really is: how do I continue to reform my domestic institutions, so that my economy can share in the regional growth? Well, what was the outcome of this discussion? Some participants in the discussion expressed themselves to be underwhelmed with this agenda or they saw it as lukewarm. Where was the big idea that could get APEC economies unified; governments and leaders galvanized to moving ahead and get the business community to engender support and enthusiasm for progress? There wasn't

an obvious big idea and FTAAP doesn't appear to be the big idea in the near term.

However, I think this brings us to something we need to recognize very clearly, and that is, that from the viewpoint of the business community, trade-focused policies are no longer enough to engage their full support. The world for many businesses is seen to have other issues, other impediments and other opportunities that need to be dealt with outside of the traditional trade agenda and essentially, the border issues.

I have not developed this proposal yet and in a room full of eminent economists, it is very dangerous to put forward inadequately prepared propositions. One of the big subjects you are going to talk about tomorrow is the fiscal imbalances across the region. You can look at that and say when trade reaches a certain level, which it obviously has today, economic integration may be better accelerated through financial market integration rather than trade market integration. What we are really talking about there is dealing with those imbalances through economic reform that allows exchange rate movements to facilitate the integration rather than tariff levels or the traditional trade measures.

OECD framework

The dimensions of this whole thing are getting bigger and more complicated, but there are obviously very large gains available. How do we deal with them? Well, I'll come to some specific proposals, but before I do that, I would like to just move on to another dialogue held recently in Melbourne at the end of last week, which was a high-level dialogue on the policy framework for investment – which is really the OECD policy framework for investment - and this group was examining that policy framework to determine how useful it could be and what its applicability might be across the APEC region.

It is the OECD framework that has been developed for some time – really, I think the big publications started to emerge a few years ago, around 2000 and 2002. Essentially it has ten policy domains and in those domains, rather than prescribing necessarily the best practices – although they have got appendices of the best practices – they pose a whole series of questions; have you got this, have you done that; what is your state of your development in x? The idea is to provide a checklist against best practice for an individual economy so it can determine whether it has got to the appropriate level to stimulate investment. It's investment – it's not foreign direct investment. The basis of the analysis is a level playing field for domestic investors as well as international investors.

The ten policy domains are pretty much – when you think of it – what you'd expect. They cover investment, they cover trade, they cover competition policy, they cover tax, and they cover governance and so on. When you do think about it, it looks simple like a lot of good ideas, but it seems to me to be a fairly all encompassing description of the big policy domains that will affect investment.

So, this was discussed and one of the very interesting things of this particular gathering was that the representative from Vietnam came to talk about their experience, and submitted themselves as a case study to show where they started from, how far they had progressed using this framework and what they felt were the priorities to advance.

Onto some implications of this – it's actually very consistent, in my opinion, with the APEC approach. It is self examination – you recognize the ability of various economies at different stages of the development curve to apply the best practices, but they can apply it against their own economic requirements. It does,

however, encourage policy integration because ultimately it is leading to best practice for everybody across the region. Given the previous meeting where we failed to come up with a grand idea, this kind of framework looked to me to be something that was much more interesting. Now, I haven't got a grand idea out of this – in fact, it's really hard to find a sensible simile. The closest I've been able to come to is a sort of Wankel engine – those stationary engines where in a traditional engine, the crankshaft goes round and round; and in one of the rotary engines, the engine goes around the crankshaft. The point being here is that you've got these 10 policy domains of which trade is only one. One of the points I think I'm trying to make is that we have focused primarily on trade and trade reform as our engine for economic liberalization through the APEC region.

Business is now saying it's not quite as simple as that - there are a whole lot of these other things that we got to deal with and they're probably there in those 10 policy domains. Those 10 policy domains will apply to a different degree in every economy in the region because everybody is at a different stage of economic development and has different priorities.

But this PFI framework seemed to me to offer at least a conceptual tool that you could twist and dial to see what you needed to do in your own economy to keep up with the reform process, which, I think everybody has agreed to, is an essential part of facilitating competition and improved economic integration. I was quite impressed by this.

Cooperation and finding niches

Now, business is essentially, and I think very deeply, a very cooperative animal, organism, call it what you will. It must be cooperative - it's got to cooperate with suppliers; it's got to cooperate with distributors; it's got to cooperate with

customers and so on. Right at the moment, business is extremely robust. Fifteen or twenty years of the best economic conditions we have ever seen has made business very robust - occasionally triumphal, but certainly genuinely robust.

It's Darwinian in the sense that they're finding niches. I don't mean Darwinian in the sense of absolute, bloody competition, but it is always finding niches and the economies that provide the greater number of niches will get the greatest business growth. Big reforms, which open up bigger areas and remove the need for niches will progress faster.

It's also Schumpeterian - I have to acknowledge that, I think, in this gathering - look what's happening, for example to the world's steel industry and contemplate what might happen to the world automobile industry when industries reach maturity.

So those are the characteristics of business that still prevail and look likely to prevail for some time. What does business want now for improved regional integration? Business is business. It's also like *Oliver Twist*, Charles Dickens - business always wants more. When would it like more? It's a bit like the street protesters, it wants more and we want it now or we want it very soon. But, it's got a global perspective, as I've tried to mention - the supply chains that have been built up are global and so what we would really like is more, we would like Doha, we would like Doha now because multilateral is better, the world is better so that remains the first priority.

If we don't get Doha, I don't think there's any clear consensus of what might happen, but the regional arrangements are, I think, seen as distinctly second best to multilateral liberalization.

Facilitation is very important against the supply chain and manufacturing paradigm that I've tried to describe. Behind the

border reforms are very important as well. Capacity building, which is a touch tone of APEC, continues, obviously, to be required on an increasing scale to deal with the behind the border reforms.

So, those are some of the business perspectives, that I think, come to bare on regional economic integration. So, what can APEC policy makers do for business? Somewhere, I think we're groping towards a view of integrated APEC markets. The markets may be services markets, they may be investment markets, they may be product markets, but increasingly, any market is seen to require any inputs from many sectors; from many skills and from, often, many other economies. The markets are essentially quite complex, but they will integrate and reach an optimal level if the right framework is provided for them.

So, we're looking at, as I said, the behind the border reforms and then continued application of governments and leaders of the relevant economies to continue domestic reforms. Domestic adjustment policies are, I believe, very important part of achieving this economic integration.

I think the business community has limited, if indeed any concept, of just what the APEC structure is really like. Because, most business men, when you actually show them a simplified organization chart of APEC, almost turn pale. They don't recognize that APEC has come from a historic background that has shaped it - the very basis of APEC; voluntary, consensual, non-binding and so on was the political possibility that allowed APEC to emerge. It now encompasses a whole range of diverse economies at very different points in their development life. Politically, it is still the only basis which is acceptable to all the members and on which it must therefore proceed.

But, as David Spencer noted, it's also dominated - to this point - by the Trade and Foreign Affairs Ministers. One of the

things that I've plagiarized from David and his colleagues is a very nice organizational chart of APEC. So you see this nice pyramid proceeding up through the Trade and Foreign Affairs Ministries with a recommendation to the leaders. That's fine – businessmen can understand that because most businesses sort of end up in a pyramid getting to the boss. Underneath this, David's chart has got various committees – I forget how many; 14 working groups, 8 fora whatever it is, and a series of committees reporting to the Senior Officials who do all the work.

But, what's really interesting about this is off to one side are the Finance Ministers process, and they proceed up on their own process and don't actually report to anybody. The contact between the Finance Ministers process and the Leaders process is based on goodwill, I suppose. There is absolutely no formal requirement that they should interact at all. It's only because of common sense that interaction takes place.

Similar structures apply to Health Ministers, to Transport Ministers, to Communication Ministers, who may meet on an annual cycle, or they may meet on another cycle, and they might interact with the Senior Officials or they may not. Hence, the structure is, to a businessman, highly uncoordinated and very inefficient. That leads often to business making totally unrealistic demands on APEC. But what I believe it does reinforce very much, is that business requires the fundamental reforms of APEC that David touched upon. They are exceedingly modest. The appointment of a chief operative officer with a term of three to five years to give the organization a limited degree of continuity and corporate memory is a very minor step. The formation of a policy support unit to work under the Economic Committee to provide skills which are available to member economies should they wish to pursue domestic structural reform is really, in scale, a minor reform.

Bring in the Finance Ministers

In APEC, there are attempts to increase convergence to bring the Finance Ministers process – the economic input - into the Trade and Finance Ministers process. That should be encouraged by business because to allow the continuation of the financial stream as a totally support stream is clearly, highly ineffective. So, business, I believe, when it thinks about it, really wants, really strong, these reforms of APEC to allow APEC to respond to the increasingly diverse requirements that the business community will place on APEC.

We've had harmonization and cooperation – that's the essential structure of APEC; we've agreed that we are not involved in negotiation or enforcement mode for the foreseeable future. Approaches to facilitate adjustment and integration and particularly to implement the APEC reforms are totally consistent with what business wants for closer economic integration. Thank you.

Questions

Mark Borthwick: I would just like to ask a very short question on how you feel ABAC is doing in reference to APEC itself. That is, how receptive do you feel APEC is at this point, to business input through the instrument or vehicle of ABAC?

Mark Johnson: The last two or three years, I think, the relationship has changed quite materially, led by a couple of our previous ABAC chairs – Hernán Somerville from Chile and so on. We in ABAC have realized that we've been given this position, potentially, of immense leverage. That position of immense leverage is the ability once a year to say to the leaders, the bureaucrats are doing this well or they're not doing enough of that. Now, if we're really going to exploit that leverage, we've got to know what the bureaucrats are doing. So, we need to know how the whole APEC process is proceeding and to have an

informed opinion if we are to fulfill our role. So, I think we set out quite seriously to try and develop that informed opinion and we're doing that at both the Senior Officials process and the Finance Ministers process. The reciprocal of that is that I think we've been welcomed by these bureaucrats. Business input is seen as being valuable and valid to the bureaucrats.

This in turn has sharpened up ABAC because sometimes you would sit in an ABAC meeting and you'd think of a toy ship, or somebody shooting a pop gun; because someone would say 'really, we ought to get them to do this'. I remember a conversation, particularly about perfecting legal title to moveable objects. Basically it was how you'd get back leased airplanes that had been seized around the region. People spent a lot of time talking about this. That's structural reform – we have got to get proper legal systems throughout the region. What this process has done is force ABAC to focus on the policy issues rather more and stop debating the little irritations to business.

Peter Thompson: You concentrated quite a bit on - you mentioned a number of times – the potential of role of APEC and capacity building. What capacity building did you have in mind? I was left wondering on that score.

Mark Johnson: Well, capacity building will start at the level of a specific economy. As I said, in this investment seminar in Melbourne, Vietnam submitted itself as a case study. Now, what they need in Vietnam, since they are starting from a pretty low base, they need capacity developing programs in a lot areas, but they can sort out their priorities. Do they need regulators, do they need statisticians, or do they need other bureaucrats, more importantly to get it going? Where are there priorities?

Peter Thompson: What might APEC do if, for example, Vietnam decided that statisticians were a priority?

Mark Johnson: Well, APEC could look around its own membership and identify those economies with a high level of skills in statistics and presumably to see what they could do to facilitate the transfer of that knowledge to the other economy.

Peter Thompson: So, play a broking role or more than a broking role?

Mark Johnson: A broking role and often, particularly in the financial sector, I think it is not just a broking role; it is running training programs. For example, if we want to integrate our financial systems, you need regulators, you need supervisors. Who is going to train the regulators and the supervisors? APEC is in a very good position to put together those kinds of training programs; those kinds of interchanges between people who've already got it and those who need it, at various stages of the development cycle.

Soogil Young: Thank you, Mark, for your very thoughtful and even provocative presentation on the need to reform the APEC. The way that I heard you is that you are recommending benchmarking the OECD for the reform of the APEC because the kind of missions you're assigning to a reformed APEC seemed to be best carried out by an organization like the OECD. Would that be a correct reading of your presentation?

Mark Johnson: No, not at this stage, Soogil. I think the OECD PFI policy documents represent best practice, but as I said, part of their attraction is that they are user-friendly. Any economy can look at them, analyze its own economy against them and decide what their priorities might be. I don't think that APEC is ready for the OECD mandatory examination. Under that model, of course, OECD officials are entitled to access information

and will make a report. Under the PFI style approach, if you want it, you can have it and other economies will help you with it. But it will remain voluntary.

Hadi Soesastro: Thank you for the opportunity. I thought the presentation was very balanced and thoughtful. You sort of said that business would like to see APEC being reformed now and you want to see more. My question is, how patient can you be, as a business person? One wonders whether the steps that have been suggested, as the beginning, would be sufficient, unless you do have a kind of a vision as to where APEC should be going. I thought that Soogil Young's question may have sort of indicated that perhaps we do need an idea on as to where we are going.

Mark Johnson: Yes, I think from the viewpoint of business – and I hope this doesn't sound triumphal because when business sounds triumphal it's normally just before a crash – business is impatient, it is getting on with it; it is feeling niches; and it will do whatever it can do to fulfill all the available opportunities. Business is

well ahead of APEC. That was certainly the consensus of the discussion that I was in because everybody agreed that the integration was more market-led, much more business-led, than it was policy-led. I think it also follows from what David Spencer was saying about the mission to reinvigorate APEC is a degree of recognition that that is required. The convergence that we're actually getting in a limited away between the business and APEC is also symptomatic of that. It's symptomatic of greater complexity, it's symptomatic of greater understanding and so the moves together are much more in parallel. They are confined by the history and the structure of APEC and they are confined, in my opinion, very much by this problem of complexity. We've got 1001 issues to deal with and we can't solve it by putting up big grand ideas. Even the Bogor Goals are not a grand idea. Do you think there are actually 10,000 people in the world who know the Bogor Goals? You certainly don't get out of the bed in the morning and say, 'wow, I'm going to move one step closer to the Bogor Goals'.