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G20 Meeting in Korea: Asian Agenda of Structural Reform for Strong, Sustainable and Balanced Growth of the Global Economy

A Framework Paper

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By

Peter Drysdale, Hadi Soesastro & Soogil Young¹

Executive Summary

The economies of Asia have been a positive and dynamic element in recovery from the crisis. Their national commitment to sustainable development in the long term will be increasingly important to the health and sustained recovery of the global economy. They have experience in carrying out the structural reforms to advance national growth strategies that will make an important contribution to achieving the G20's central medium-term goal of reducing global imbalances.

This paper proposes structural reform as a central pillar in the agenda for the G20 meeting to be held in Korea in November, 2010.

The agenda for the Korean meeting should have four main dimensions. The first two are the immediate priorities of macroeconomic stabilization and financial reform. The third is the medium-term priority of reducing international imbalances. The fourth priority is governance reforms in the international institutions for trade and finance.

The first two dimensions of the agenda require urgent follow up and completion of the agenda that developed through the G20 meetings in Pittsburgh and Canada.

The intermediate to longer term risks are focused on the third dimension of the G20 framework to do with structural reform. The achievement of strong, sustainable balanced growth as economies exit their stimulus packages will require commitment to a range of complex and varied structural reforms. Different economies have

¹ This paper has been jointly prepared by Peter Drysdale, Professor Emeritus, Australian National University and Director, East Asia Bureau of Economic Research (EABER) at ANU, Hadi Soesastro, Senior Fellow, Centre for Strategic and International Studies (CSIS), Indonesia, and Soogil Young, President, National Strategy Institute (NSI), Korea and Chair, Korea National Committee for Pacific Economic Cooperation (KOPEC). Preparation of the paper has been coordinated by KOPEC. The authors are indebted to Dr. Jusuf Wanandi, Vice-Chairman, CSIS Foundation and Publisher of *The Jakarta Post*, Indonesia, Prof. Yung-Chul Park, Distinguished Professor of Economics, Korea University, Prof. Yiping Huang of Beijing University, Dr. Fan Gang, Director, National Economic Research Institute, China Reform Foundation, Prof. Shujiro Urata, Waseda University, Japan, Dr. Rajiv Kumar, Director & CE, Indian Council for Research on International Economic Relations (ICRIER), India, Prof. Wendy Dobson, University of Toronto, Canada, and Mr. Richard Dobbs, Director, McKinsey Global Institute, for their valuable comments on the earlier drafts. This paper also draws on the draft report, 'From Crisis to Growth', prepared by the PECC Task Force led by Prof. Peter Petri of Brandeis University, United States.

different priorities in structural reform but their collective commitments need to target, and be consistent with, the objective of re-balancing global growth. This is helped by the need to re-balance national growth in many countries. This recommends initiating dialogue and consultation on programs of structural reform within the G20.

Structural reform is directly related to the generation of new engines of growth. New growth engines need to address the big challenges in the regional economy — population aging as well as social and environmental priorities—and use government expenditures and other incentives to stimulate productive investment.

Reform in the governance of international institutions needs to include: implementation of the IMF quota review; completion of the Doha Round and reform of the WTO architecture; and international cooperation at other levels, beyond the membership of the G20. The Asian G20 economies will want to include a broader constituency in the Asian and Asia-Pacific region that will make G20 more inclusive without adding to the number at the G20 table. The meeting in Korea will be an appropriate occasion on which to consider the modalities for engaging the broader regional and global constituencies.

Background

1. The global financial crisis, still in progress, had its cause not just in the pre-crisis global financial architecture and financial market management but, more broadly and fundamentally, in the pre-crisis policy choices and growth models of the world's major economies, now members of the G20 process.
2. Strong, sustained and balanced growth of the world economy over the longer term requires a new architecture and new principles for management of the international financial system – the development of which remains a top priority for the G20. But it also requires recalibration of national policy choices and models that will require ongoing national structural reform and institutional change.
3. This agenda of structural reform is central to balanced and sustainable growth of the global economy. It is an agenda that is the responsibility of all G20 economies and one that also needs to be inclusive of economies not represented at the G20 table but nonetheless with vital interests in the outcomes. Asia brings
4. The economies of Asia (East Asia, India and Australia) have been a positive and dynamic element in recovery from the crisis and their national commitment to sustainable development in the long term will be increasingly important to the long term health of the global economy. They bring a perspective that recognises the centrality of structural reform to successful national growth and a heightened awareness of the interdependence of national structural reform agendas to balanced and sustainable growth in the global economy.
5. The Asian G20 countries therefore see the G20 as a primary venue for leading the global effort to recalibrate national economic growth on a sustained, balanced and

robust long term path. They are also committed, through dialogues in regional forums and institutions, to engaging the participation of all the Asian economies in these efforts.

Objectives

6. The G20 Summits in Pittsburgh and Canada will have developed a substantial program of work directed at building a more resilient international financial system and reducing development imbalances.

7. The key undertakings are:

- US and EU commitments on
 - common requirements for bank capital and liquidity ratios to permanently reduce the leverage in the system and
 - common approaches to the resolution of future insolvent ('too big to fail') financial institutions; and
- G20 commitments to reducing international imbalances.

8. Asian countries have an important contribution to make in articulating the path towards reducing global imbalances and that is the key challenge addressed in this framework for action through the G20 meetings in Korea.

9. This paper sets out a framework for addressing these challenges in the lead-up to, and through, the G20 Summit in Korea.

Main Issues

10. In Pittsburgh, the G20 committed to a new framework for strong, sustainable and balanced growth and to ensuring that collectively, monetary, fiscal, trade and structural policies are consistent with more sustainable and balanced growth trajectories. This includes taking into account the social and environmental dimension of economic development. In November Finance Ministers launch a process for mutual assessment of these policy frameworks and their implications for the sustainability of global growth. The G20 Summit in Canada is charged with reviewing and evaluating progress with this process in June.

11. The framework set out in Pittsburgh and guiding the work program in Canada includes:

- implementing responsible fiscal policies, attentive to short-term flexibility considerations and longer-run sustainability requirements
- strengthening financial supervision to prevent the re-emergence in the financial system of excess credit growth and excess leverage and undertake macro prudential and regulatory policies to help prevent credit and asset price cycles from becoming forces of destabilization
- promoting more sustainable current accounts and support open trade and investment to advance global prosperity and growth sustainability, while actively rejecting protectionist measures

- undertaking monetary policies consistent with price stability in the context of market oriented exchange rates that reflect underlying economic fundamentals
- undertaking structural reforms to increase our potential growth rates and, where needed, improving social safety nets
- promoting balanced and sustainable economic development in order to narrow development gaps and reduce poverty.

12. There are four broad dimensions of this work program, some of which is already well under way. The first has to do with macroeconomic cooperation. The second seeks to deal with the amelioration of excessive financial risk. The third involves tackling the problems of structural reform. The fourth is the reform of governance in the international institutions for finance and trade.

13. The swift implementation of programs of fiscal monetary expansion has served to staunch the effects of the economic crisis and signs of recovery are now evident in many economies around the world. In Asia, despite sharp declines in production and trade, China, Indonesia and India continued positive growth throughout the crisis and, among advanced countries, Australia maintained positive growth avoiding the worst of the global recession while Korea is making the fastest recovery among the other OECD economies. Recovery seems firmly entrenched in these and other Asian economies.

14. Although the Asian economies appear to have emerged strongly from the crisis, a full and sustained recovery of the global economy is far from assured. Adverse outcomes are especially likely if the emerging and advanced economies are unable to effect the transition to ‘balanced’ growth. The problem for the US would arise if there were continued weakness in the financial sector and large government deficits; in China and other emerging economies, it might be caused by excessive and continued bank lending for investment in the tradable goods sector. Poor outcomes could also result from premature tightening of monetary or fiscal policies; insufficient demand due to entrenched unemployment and other structural problems; persistent financial fragility due to the drag of bad assets on the financial sector; and expanding ‘international imbalances’ that trigger asset price or currency volatility.

15. The term ‘rebalancing’ is widely applied to policies that address some of these risks, and especially global imbalances. Before the crisis, unsustainable borrowing supported high US consumption, while unprecedented savings—including more than half of China’s national income—went into investments in export industries and dollar assets. These internal imbalances in expenditures led to large international imbalances in capital flows between the United States and Asia, among other countries.

16. These risks underline the importance of the first two dimensions of the G20 framework in the immediate term. Correcting these imbalances in the medium to longer term is not a matter that can be dealt with by macroeconomic or exchange rate adjustments but one that requires fundamental structural changes and reforms.

Macroeconomic policy cooperation

17. On the issue of macroeconomic policy cooperation, the G20 has tasked the IMF with providing analytical support for macroeconomic assessments. National policies affect global balances and risks and call for surveillance and consultation among the global economies. Shared analysis enables policymakers to set consistent targets for fiscal and monetary policies and to minimize the volatility of variables (such as long-term real interest rates and real exchange rates) that affect investment and production decisions. A rigorous framework for analysis and discussion of conditions in all economies, including the largest, has to be the basis for this process within the G20 process.

18. Similar processes of macroeconomic monitoring and surveillance would be of value in Asian frameworks, and Asian G20 members should move to put them in place.

Managing financial risk

19. On the issue of financial risk, whatever the difficulties making progress, there is urgency in effective regulation of financial markets to reduce a major source of market uncertainty. Macro-prudential risk—the tendency for risk appetites to rise at the peak of the business cycle and to decline at the trough—has become better understood as a result of the crisis, and some governments can now move to adopt policies (such as reserve requirement adjustments) to countervail fluctuations in risk appetites. Micro-prudential risks, managed through the regulation of individual financial institutions, are also better understood. This requires improved oversight of systemically important institutions (institutions ‘too big to fail’) and the extension of prudential regulations to all significant financial transactions. The Financial Stability Board (FSB) is designed to address issues related to regulatory cooperation and to foster the close cooperation among national governments that is needed among regulators from different countries on the oversight of institutions that operate in multiple markets. The objective is to help national authorities apply best regulatory best practices that address the problem of leverage and financial market connectedness. While Asian economies escaped the worst of the global financial crisis because they were less leveraged in the wake of the Asian financial crisis, governments have a significant task in modernising and diversifying, and deepening the quality of oversight of, their financial systems their financial systems to world’s best practice standards, including through cooperation among national authorities.

20. There is need to improve monitoring, surveillance, and regulation at a regional level, drawing on capacities through the FSB and the IMF as well as building complementary capacities in the region, around the Chiang Mai Initiative or other regional institutions: Regional authorities can improve the regulatory oversight of domestic and cross-border financial systems to enhance their resilience. From this perspective, Asian economies can consider consolidating—or where appropriate strengthening coordination across—various financial regulatory agencies. This would make it easier to gain a coherent picture of financial developments in their markets, and would simplify the process of regional coordination, especially when a systemic financial crisis develops. This would also help to avoid regulatory gaps in systems in which regulation is divided along functional or institutional lines.

21. Asian G20 members could also move, through the relevant regional frameworks, to put in place regular consultations among the regulatory and supervisory agencies in Asia with a view both to sharing policy experience and building capacity for policy cooperation.

Undertaking structural reform

22. The intermediate to longer term risks underline the importance of the third dimension of the G20 framework, focused on structural reform. Structural reform includes measures that improve institutions and incentives for efficient and sustainable production, investment and employment, and facilitate fundamental, productivity-increasing changes in economic structure. This is a complex task to which the Asian members of G20, because of their experience with rapid economic transformation and reform, bring a particular and important perspective. Now that the more urgent tasks of macroeconomic stabilisation and financial system reconstruction are in hand through Pittsburgh and Canada, it is a task that has priority.

23. There is clear recognition that recovery in Asia is not sustainable on the pre-crisis growth model which has resulted in over-investment in the traded-goods sector. Unless urgent attention is given to fundamental structural problems in national economies, international imbalances will intensify in the course of global recovery and choke off growth in the medium and long term and what now looks like robust recovery is unlikely to last more than a year or two. These structural problems have to be dealt with by national governments but they will be made more tractable through international cooperation and understanding of what is at stake.

24. The Asian economies have been growth success stories in the past because of the pro-market, export-oriented reforms that they have undertaken. This has encouraged strong economic growth based on the export sector and stimulated by very high rates of investment. Over time, this growth path has become unbalanced, inefficient and unsustainable because market reforms that have encouraged it are incomplete. Goods markets have been liberalized but other markets are still heavily distorted.

25. There is need to improve the quality of economic growth and to achieve the principles of sustainability. A central step in achieving this must be achieved through the liberalization of the factor markets: markets for labour, capital, land, energy and the environment. This requires market institutions appropriate to settings in national economies that will ensure the efficient and equitable operation of these markets as well as the markets for goods.

26. Some of these distortions, such as state control of energy prices, are the result of deliberate policy decisions. Others, such as restrictions on capital markets and on the movement of labour, result from transitions in the process of reform. But they all share common features. They generally depress factor prices and lower production costs, subsidising producers in the tradable goods sector. This model has been successful in the past, judging from the rapid rates of economic growth. The producer subsidy equivalents have increased industrial profits, raised investment returns and

improved international competitiveness, artificially lifting these economies to income levels that would otherwise not be possible.

27. But the pre-crisis growth model was not without costs and it is no longer sustainable. The most obvious problems are the structural imbalance resulting from the overdependence of the economy on exports, and the high rates of investment and resource consumption. The result has commonly been a decline in the household income share of GDP, depressed consumption, very high rates of net savings and the continuing accumulation of external reserves. This model of economic growth cannot be sustained in the longer term because consumption in advanced country markets has to fall. There will not be the same capacity to absorb exports from emerging markets as there was in the past. Advanced countries have to cut their current account deficits and rely less heavily in future on external borrowings.

Agenda of Cooperation in Korea

Financial reform

28. Much has been achieved in reforming financial institutions and markets to improve global financial stability. **There is still a hefty and complex implementation program to deliver by the end of 2010 on strengthening capital standards and dealing with systemically important financial institutions set at previous Summits.** The meeting in Korea provides the opportunity to make and set out progress in this work. **The review of progress on measures to reduce financial risk should include reports on best practice in executive compensation.**

Dialogue on structural reform

29. **The achievement of strong, sustainable balanced growth as economies exit their stimulus packages will require commitment to a range of complex and varied structural reforms.** Different economies have different priorities in structural reform but their collective commitments need to target, and be consistent with, the objective of re-balancing global growth. **This recommends initiating dialogue and consultation on programs of structural reform within the G20 as the meeting in Korea delivers on the outcomes of the Pittsburgh meetings.**

30. Emerging economy policies will need to raise the incomes of households relative to incomes in the corporate sector, create new safety nets, and expand public spending on a wide range of social services, in order to achieve more equitable and balanced growth domestically and contribute to the reduction of global savings imbalances. These changes will require improvements in the operation of factor markets—financial markets and labour markets—that enable workers to command higher wages that are more closely aligned to their productivity and small firms to access capital markets for investment funds in a wider range of economic activities including the provision of services to the domestic economy.

31. **The challenge of structural change to support balanced and equitable growth in emerging economies, therefore, is not separable from the challenge of building resilient and more open financial systems in the major emerging market economies, and more effective intermediation of the vast savings potential, for**

example, within the Asian region. At the same time, the financial system risks that were exposed in North America and Europe through the global financial crisis need to be avoided. It is crucial that Asia not be the source of the next global financial crisis as its financial markets are transformed on a globally competitive scale.

Asian contribution on structural reform

32. Asian G20 economies can commit to setting out and discussing their priorities in national financial market reform directed at:

- **making national savings accessible on equitable terms to enterprise, including small, medium scale and agricultural enterprise, right across the whole economy**
- **increasing opportunities for the diversification of the financial sector to serve a wider range of borrowers, including households**
- **mobilising capacities from the international market for strengthening the competitiveness and efficiency of domestic institutions in partnership and competition with foreign financial firms**
- **reform of state-owned banks through privatisation or increasing the scope for competition in the market with the private banking sector**
- **identifying prudential risks and gaps in prudential regulation of their financial sectors.**

Engines of long term growth

33. Structural reform can directly support new engines of long term growth. Asian G20 economies should work together to headline the future engines of growth in the region and set out a vision for growth and development in the Asia-Pacific economy at the Korea meeting. Growth engines can address the big trends—population aging and other social and environmental priorities—that are underway in the regional economy and use government expenditures and other incentives to stimulate investment. They can be supported by commitments from the Asian Development Bank and other international investors.

34. Regional initiatives could emphasize achieving a:

- **connected Asia: through strategic investment in the infrastructure for connectivity** generating new trade that builds on Asia's dynamic markets and is facilitated by open regional and global trade and investment agreements
- **greener Asia: through investment in that infrastructure for adaptation to climate change** and the green economy: investments in energy conservation, clean energy research and development, and energy efficient vehicles and transport systems
- **secure Asia: through building programs in education, health care, and social safety nets**
- **productive Asia: through investment in technology and reforms to drive gains in productivity.**

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

35. Asian G20 economies need to free up their service sectors, energize consumption, and redirect their technological capabilities toward growth markets, such as products and services for aging populations and technologies for energy conservation. These changes will depend on government success in launching substantial reforms in the service sector and in reassuring investors about future carbon trade and tax regimes. Korea and Japan are well placed to bring their strategies for reform and green growth to the table and to begin the needed dialogue on the impact of demographic transition on structural and macroeconomic problems.

International governance

36. The Korea meeting will immediately precede the IMF quota review in January 2011 through which there is commitment to a 5 per cent increase in emerging market economies' voting share. **The meeting in Korea will also provide opportunity to review progress and deliver the implementation of these and earlier commitments to increase emerging market voting share and set out views on the future governance structures of the Fund and the Bank .**

37. Asian G20 economies have a deep and abiding interest in the openness and robustness of the international trading regime. **The timing of the Korea meeting recommends re-visiting closure on the Doha Round of trade negotiations.** This will be a time in the international political cycle at which this goal can be reached, after the mid-term elections in the United States. **It will also be a time, after settlement on the Round, to initiate a thorough-going review of the world trade architecture and the modalities of the WTO as they impact on future global negotiations and the relationship between regional and bilateral trade agreements and the multilateral trade rules.**

38. An IMF and World Bank review of international financial architecture and how global and regional institutions fit together, can provide the opportunity for Asian G20 economies to set out and report on efforts in the region to improve the efficiency and safety of regional financial markets through the development of regional bond markets and regional currency swaps (including through the CMI).

39. **The implementation of these agendas requires international cooperation at other levels, beyond the membership of the G20.** The G20 now serves as the 'premier forum' for managing the global system, with substantial Asia Pacific membership. To undertake its role effectively, more inclusive forums will be required in order to engage countries not at the G20 table. **The Asian G20 economies will want to include a broader constituency in the Asian and Asia-Pacific region in developing these responses to global economic challenges, explicitly including their partners in Asia and communicating the substance of these regional dialogues to the G20 and the substance of G20 dialogues to regional endeavours. This will make G20 more inclusive without adding to the number at the G20 table. The meeting in Korea might be an appropriate occasion on which to consider the modalities for engaging the broader regional and global constituencies.**

40. Interdependence in the Asia Pacific region is sometimes viewed as a source of risk, but it also a tremendous asset: it connects the most powerful technological, financial, and productive resources ever assembled in human history. In the Asia Pacific region, East Asian arrangements (ASEAN+3 and ASEAN+6) can play a useful role in orchestrating a smooth realignment of Asian exchange rates relative to the dollar. The agenda of deep and continuing structural reform is a critical element in this. APEC is also well-positioned to help. As a trans-Pacific forum, it spans critical countries and dimensions of rebalancing the regional and global economy. It has accumulated expertise on structural reforms and its non-binding mode of operation is suited to the complex cooperation required. APEC's 'pathfinder' approach, for example, could provide a platform for initiatives by groups of countries that support specific rebalancing objectives. APEC's work plan could take on packages to address priority 'behind the border' barriers to trade, and engines of growth focused on common social and environmental goals.