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A COMMERCIAL POLICY PACKAGE FOR REBALANCING THE GLOBAL ECONOMY? IMPLICATIONS FOR ASIA

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Abstract

This paper argues that if world leaders pursue an integrated strategy for commercial policy reform across goods and services sectors, this could help the rebalancing process and at the same time support the global economic recovery. As far as Asia is concerned, this would mean further opening to imports of goods and, more importantly, services, particularly in the context of extra-regional trade. Such a strategy would help reduce imbalances while at the same time contribute to the growth of potential output in the region.

1. Introduction

1. As the world economy emerges from the economic crisis of 2008-09, governments are exploring a range of policy options to avoid future crises and set the global economy on a more stable growth trajectory. While the crisis began with problems in financial markets in the United States, it then spread world-wide through financial and real channels, the origins of which were multi-layered and multi-dimensional. Economic developments in a number of areas—related to but separate from the financial sector—were deemed unsustainable in the years leading up to the crisis and were subsequently linked to the severity of the global "hard landing."

2. One prominent issue relates to the large current account surpluses and deficits that emerged in the years leading up to the crisis. Debate continues about the degree to which global imbalances were at the heart of the 2008-09 crisis and the extent to which they should be reduced to mitigate the risk of another crisis in the near future (see Bergsten, 2009; Krueger, 2009; and Frieden 2009). Nevertheless, the

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combination of trade surpluses in large emerging economies and persistent high unemployment in major industrialised countries has become a source of protectionist pressures (Freund, 2009; Evenett, 2009; and Baldwin, 2009). Asia, with its current account surplus accounting for more than 30% of world current account balances in 2009 and averaging about 50% of the global GDP during the past decade (Adams et al, 2010), is at the core of this debate. Any successful rebalancing package will thus have to include appropriate policy measures in the region.

3. While concerns about global imbalances are not new, the perceived need to "rebalance" by reducing these large surpluses and deficits has become more pronounced and accepted as a necessary feature of the reform to ensure stable, sustained growth in the recovery. Because of the polarising nature of the debate on bilateral trade imbalances, particularly in the US-China context, and fears of protectionism, much of the attention in the rebalancing debate has centred on how shifts in monetary and fiscal policies may affect national saving-investment imbalances. This has created the impression that rebalancing is solely an issue of expenditure-changing policies in countries with particularly large surpluses or deficits. While such policies have undoubtedly contributed significantly to the build-up of imbalances prior to the crisis (e.g. the debate on the appropriate value of the Chinese reminibi), this is not the only rebalancing option. As calls for unwinding global imbalances gain ground, policymakers in both surplus and deficit countries have a stake in better understanding the role of expenditure-switching policies, including commercial policies, in the global rebalancing process.

4. So far, calls for using commercial policy to reduce imbalances have focused primarily on trade-restricting measures. Some prominent economists have even called for the imposition of protectionism as a way to force rebalancing.[2] Others view such an approach as self-defeating and highly destructive (Evenett, 2010a). Indeed, current account imbalances can be reduced or even eliminated by significantly restricting international trade and investment, but protectionism is not the only way commercial policies can play a role in rebalancing the global economy.

5. This paper considers how trade and investment policies can facilitate the unwinding of global imbalances, with particular emphasis on Asia. Section 2 briefly surveys the basic theory of maintaining internal and external balance with the use of expenditure-changing and expenditure-switching policies in the context of the national savings-trade balance identity. Section 3 highlights the macroeconomic situation in Asia, major surplus economies, and deficit countries. Section 4 situates trade liberalisation in a broad palette of policies that can contribute to global rebalancing. Section 5 describes the evolution and structure of current account balances, characterises important differences and similarities among Asian economies, and identifies the most obvious areas of commercial policy reforms that could contribute to the rebalancing process. Section 6 offers some concluding remarks.

2. Role of macroeconomic and trade policies in facilitating internal and external balance

6. The economic crisis highlighted many types of imbalances world-wide as well as many complex and intertwined factors that may have led to the large current account deficits and surpluses that peaked in the run-up to the economic crisis. Indeed, current account imbalances may reflect, or may be connected to, national savings and investment imbalances, excess liquidity, asset price bubbles or exchange rate misalignments to name a few (see OECD, 2010a). This paper attempts to account for some of this

2 . Krugman (2010), for example, called for import tariffs to be imposed on Chinese imports to solve the problem of the United States' bilateral trade deficit with China. In addition, the temporary 1971 US import surcharge has been considered as a viable precedent in the current US-China currency dispute. Others judge a potential protectionist approach as self-defeating and highly destructive. See Evenett (2010a) for a summary of this debate and Evenett (2010b) for an analysis of the 1971 import surcharge.

complexity by studying the implications of the national saving-investment identity and focusing on policies that influence both the internal and external balance of a country.

7. The national saving-investment identity is derived from the Keynesian income accounting framework and states that national savings exceeds investment by an amount equal to the trade balance, which is the rate of accumulation of claims on the rest of the world (Equation 1).[3]

(1) $$(S-I)+(T-G)=X-M=TB$$

where *S* is the amount of disposable income consumers are willing to save, *I* is the private investment, *T* are taxes, *G* represents government consumption, *X* is exports, *M* represents imports, and *TB* signifies the trade balance.

8. It is worth emphasising that current account surpluses and deficits are not necessarily harmful; in fact, they can reflect economically beneficial developments. A trade deficit (surplus) means that the value of imported goods and services exceeds (is less than) the value of exported goods and services.[4] In a country's balance of payments a current account deficit or surplus is by definition matched by the sum of the financial account balance and changes in reserve assets. In other words, a current account deficit (surplus) must be matched by borrowing from (or lending to) the global economy. As a consequence, current account imbalances may reflect the fact that investors are channeling savings into its most productive use or that a country is running a current account deficit today to generate a current account surplus in the future.[5]

9. However, even if current account imbalances build up in the way predicted by the intertemporal trade hypothesis, they can still be quite harmful if they become unsustainable. An economy in a sustainable position cannot indefinitely import more than it exports by relying on financial flows from abroad; the liabilities built up in this way must eventually be paid back. In this context, how a country finances its current account deficit plays an important role in determining the sustainability of the deficit position. For example, current accounts financed by short-term capital flows are generally perceived as less sustainable than those financed with foreign direct investment, as they bear a higher possibility of financing reversal. This is what happened during the Asian financial crisis of 1997-98, when large current account deficits financed by an increasingly-short maturity structure made the countries vulnerable to a reversal of inflows. Moreover, deficits will only be sustainable if the investment that is being funded by foreign borrowing has a higher rate of return than the interest rate being paid on the borrowed funds.

10. Potentially harmful current account imbalances can also arise from underlying economic distortions that have pernicious effects throughout the economy. For instance, high savings rates can reflect low levels of government investment in social services, such as health and education, which provides incentives for households to save excessively. A strategy designed to promote exports at the expense of

3. Equation 1 can be interpreted as indicating that investment must be financed either by a nation's domestically generated savings or by funds made available for the use of the country by the rest of the world (Caves et al., 2002).

4. More precisely, the current account also includes net income (interest and dividends) and transfers from abroad, but these items are usually a fraction of the total (Ghosh and Ramakrishnan, 2006).

5. Ghosh and Ramakrishnan (2006), for instance, give a classic example of a capital-poor developing country in which investment potential exceeds national savings and in which this gap is typically matched by foreign investment, which is reflected in a current account deficit and capital inflows. Yet in practice, capital can also flow in the opposite direction; for example, some large emerging economies with a seemingly high investment potential such as China have been financing current account deficits in high-income countries, such as the United States.

other countries through undervalued exchange rates and policies designed to depress domestic demand can also lead to imbalances. One would expect developing countries, which by their very nature are capital scarce, to have relatively high rates of return and, therefore, to be capital importers. This would suggest that they should have current account deficits, not surpluses.[6] In addition, persistent overconsumption by households and/or governments (low or no savings) can clearly lead to the development of unsustainable imbalances.

11. Abstracting from the nature of factors underlying trade imbalances and assuming that their reduction is desirable, the national savings-investment identity (Equation 1) provides a convenient framework for studying the different possible rebalancing policy options. The identity implies that if national savings do not balance out with national investment then trade is not balanced either, but causality can work in either direction (i.e. national savings and trade balances are jointly determined). The causality does not necessarily run from national savings-investment to the trade balance as has been often assumed in recent discussions of rebalancing strategies.

12. This is best exemplified by the analysis of policy options to attain internal and external balance known as the Swan diagram of internal and external balance (Swan, 1955). Swan's analysis shows clearly that expenditure-reducing (increasing) and expenditure-switching policies are two alternative ways to reduce a trade deficit (surplus). Expenditure-reducing policies, such as increases in savings *S*, reductions in private investment *I*, increases in taxes *T* or reductions in government expenditures *G*, are measures to reduce overall expenditure. They also all work to reduce a trade deficit because some of the eliminated expenditure would be translated into lower imports.

13. Expenditure-switching policies, on the other hand, are those that, for any given level of expenditure, work to improve the trade balance by switching the expenditure away from foreign goods toward domestic goods in a deficit country or by switching the expenditure from domestic goods toward foreign goods in a surplus country. Some typical examples of expenditure-switching policies include devaluation of the real exchange rate either through price deflation or devaluation of the nominal exchange rate. Trade policy measures such as tariffs (or export subsidies), while not typically used to further macroeconomic purposes, can also act as expenditure-switching policy measures by raising import (export) prices and discouraging imports (encouraging exports).

14. Expenditure-switching policies have often been seen as beggar-thy-neighbour policies, especially in the context of external adjustment in deficit countries. This is because the expenditure is switched toward domestic products at the expense of trading partners. Additionally, many of the trade control types of expenditure-switching policies, despite their temporarily positive effect on output, have significant welfare costs. By the same token, the removal of pre-existing trade controls has positive welfare effects, and in some circumstances can help the country move closer to internal and/or external balance.

15. It can be demonstrated that expenditure-reducing and expenditure-switching policy options are equally valid ways of achieving external balance or, in the current context, eliminating a trade deficit (surplus).[7] The difference between the two options is that expenditure-reducing (increasing) policies accomplish this by reducing (increasing) income and employment while the expenditure-switching policies do so with the effect of raising (decreasing) income and employment. The Swan diagram emphasises the

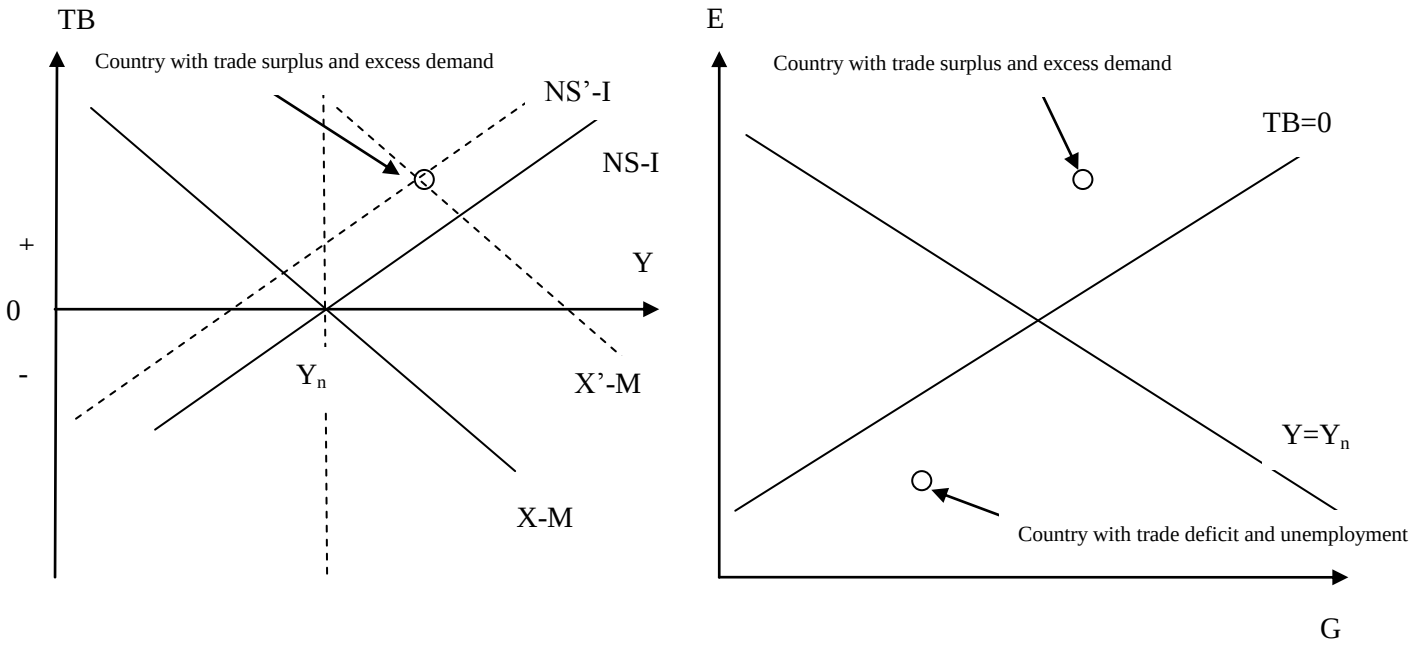
6 . Again, the Asian experience presents an interesting case. Prior to the Asian financial crisis in 1997-98, most crisis-affected economies had large current account deficits that were growing at very high rates. During the crisis, short-term finance dried up completely, causing these economies to run balanced trade. Since the crisis, they have generally posted large current account surpluses, with a much lower growth trajectory and a large drop in fixed investment.

7 . See Caves et al. (2002) for a textbook exposition of this argument.

trade-offs inherent in the pursuit of internal policy goals, such as maintaining income and employment at an equilibrium level, and external policy goals such as maintaining balanced trade or reducing the size of a trade deficit or surplus. The diagram shows that attaining the two policy goals generally requires both expenditure-reducing and expenditure-switching policies.

16. For example, contractionary fiscal policy helps to achieve external balance, but this is at the expense of output and employment. In contrast, expansionary fiscal policy may help improve internal balance, but would worsen the trade deficit. An expenditure-switching policy such as a devaluation of the exchange rate or an imposition of a tariff would raise output while also worsening the trade balance. This is illustrated in Figure 1, which presents the Swan diagram with two sets of equilibria.

Figure 1. The Meade/Swan Diagram of Internal and External balance



Source: based on Caves et al. (2002)

where the TB=0 line represents the combinations of expenditure-switching policies (an increase in E represents devaluation) and expenditure-changing policies (an increase in G represents an increase in government spending) that imply external balance. The $Y=Y_n$ line represents the combinations that imply internal balance (i.e. when the output is at its equilibrium level).

17. Figure 1 shows that, except by chance, a country seeking to improve external balance will typically have to use a combination of expenditure-reducing and expenditure-switching policies if it wants to avoid compromising the internal balance. The diagram, while highly stylized, seems quite relevant to the current discussion of global rebalancing strategies especially in the context of the stark differences in the macroeconomic situations of some of the deficit and surplus countries in the aftermath of the 2008-09 crisis. For example, recommendations to increase expenditure in China and to reduce expenditure in the United States in order to fix external imbalances stand somewhat in contrast to the immediate policy concerns about potential overheating in the case of China and the weak recovery from the 2008-09 crisis in the case of the United States.

18. Indeed, the United States ran a sizable trade deficit before the 2008-09 crisis that unsurprisingly shrank significantly during the crisis when expenditures fell dramatically. During the sluggish recovery of 2009-10, expenditure and, to a lesser extent, employment picked up, but did not recover fully and the trade deficit increased (but remained well below the pre-crisis levels). Thus, the case of the United States suggests the existence of an internal imbalance reflected in slower growth and persistent unemployment as well as an external imbalance reflected in the deficit that re-emerged during the recovery. China, on the other hand, ran a large surplus before the crisis which was subsequently reduced as a result of weaker external demand, but the economy grew by approximately 10% in 2010 and displayed signs of inflationary pressures. This hints at the existence in China of internal imbalance (i.e. excess demand) and an external imbalance reflected in significant and persistent trade surpluses.

19. The contrasting situations of the two countries at the heart of the global imbalances debate suggest that some type of expenditure-switching policies may be needed to rebalance the global economy. Indeed, expenditure-switching policies do not necessarily have to take the form of contentious beggar-thy-neighbor policies such as exchange rate adjustments or protectionism, but can instead take the form of completing unfinished trade and trade-related policy reforms (see Sections 4 and 5). The next section considers the current macroeconomic situation in Asia, the other major surplus economies, and deficit countries, with a view to devising policy implications appropriate in the current economic environment.

3. The macroeconomic situation

20. At the onset of the economic crisis (2007), 5 out of the top 10 surplus countries world-wide were in Asia, with China representing the lion's share of world current account surpluses.[8] Five other Asian economies round out the top 20. While not every Asian economy ran a current account surplus in 2007 (India and Vietnam both posted deficits), the majority of Asian economies tended toward surpluses. A better understanding of the current macroeconomic situation in Asia, other large surplus economies, as well as in the economies with the largest deficits, is critical to assessing trade-related policy prescriptions for global rebalancing.

Growth fell during the crisis, but it is staging a recovery, particularly in Asia

21. The consequences of the global economic crisis are clear (Table 1). None of the economies surveyed grew more in 2009 than at the onset of the global economic crisis. The crisis has been particularly pronounced in the deficit countries, with all economies except Australia contracting in 2009. Some of the surplus economies were also hard-hit, particularly those that are relatively more dependent on exports (e.g., Malaysia, Singapore, and Thailand). This is in part due to the rise of vertical integration and product fragmentation, which increased the trade and investment linkages with other economies, particularly in Asia, and multiplied the impact of the trade collapse. China (9.1 percent), and to a lesser extent India (7.7 percent) and Vietnam (5.3 percent), have managed impressive rates of growth, albeit down from their peaks in 2007.

8 . This ranking excludes large net oil exporters. 2007 rankings: China (1), Japan (3), Singapore (7), Chinese Taipei (8), Malaysia (10), Hong Kong, China (11), Thailand (12), Indonesia (14), the Philippines (19), and Korea (20).

Table 1. Nominal GDP growth

(percent change from previous period)

Panel A. Asian and surplus economies

	1990-1996	1997-2003	2004	2005	2006	2007	2008	2009
China	10.7	8.6	10.1	11.3	12.7	14.2	9.6	9.1
Germany	2.5	1.4	1.2	0.8	3.4	2.7	1.0	-4.7
Hong Kong, China	4.9	2.1	8.5	7.1	7.0	6.4	2.4	*n/a*
India	5.5	5.6	8.3	9.3	9.4	9.6	5.1	7.7
Indonesia	8.0	1.5	5.0	5.7	5.5	6.3	6.0	4.5
Japan	2.2	0.6	2.7	1.9	2.0	2.4	-1.2	-5.2
Korea	7.9	4.2	4.6	4.0	5.2	5.1	2.3	0.2
Malaysia	9.5	3.8	6.8	5.3	5.8	6.5	4.7	-1.7
Netherlands	2.7	2.7	2.2	2.0	3.4	3.6	2.0	-4.0
Philippines	2.8	3.6	6.4	5.0	5.3	7.0	3.7	1.1
Singapore[A]	8.7	4.2	9.2	7.4	8.6	8.5	1.8	-1.3
Sweden	0.9	3.2	4.2	3.2	4.3	3.3	-0.4	-5.1
Switzerland	0.7	1.6	2.5	2.6	3.6	3.6	1.9	-1.9
Thailand	8.6	1.7	6.3	4.6	5.1	4.9	2.5	-2.2
Vietnam	7.9	6.7	7.8	8.4	8.2	8.5	6.3	5.3

Panel B. Deficit economies

	1990-2006	1997-2003	2004	2005	2006	2007	2008	2009
Australia	2.8	3.8	4.1	2.8	3.1	3.8	3.7	1.3
France	1.4	2.4	2.5	1.9	2.2	2.4	0.2	-2.6
Greece	1.2	4.1	4.6	2.2	4.5	4.5	2.0	-2.0
Italy	1.4	1.5	1.5	0.7	2.0	1.5	-1.3	-5.0
Portugal	2.3	2.7	1.6	0.8	1.4	2.4	0.0	-2.6
Romania	-1.5	0.9	8.4	4.2	7.9	6.0	9.4	-8.5
Spain	2.0	3.9	3.3	3.6	4.0	3.6	0.9	-3.6
Turkey	4.8	2.7	9.4	8.4	6.9	4.7	0.7	-4.7
United Kingdom	1.7	3.1	3.0	2.2	2.9	2.6	0.5	-4.9
United States	2.6	3.3	3.6	3.1	2.7	1.9	0.0	-2.6

Source: World Bank Development Indicators.
[A] Data for Singapore comes from the Singapore Department of Statistics.

22. In response to the significant stresses of the global economic crisis in 2008-09, many economies introduced unprecedented stimulus packages to help blunt the impact of the crisis on the real sector. In China, the stimulus programme was a mix of government spending and a large-scale increase in credit by banks partly owned by the State (Cao et al, 2010).[9] In the United States, the United Kingdom, and Japan, monetary easing was combined with large fiscal stimulus. In 2008, the United States adopted a USD 787 billion stimulus programme (1.9 percent of GDP); all together, economies in the Asia-Pacific implemented stimulus programmes worth USD 1.7 trillion (Khatiwada, 2009).

9 . China's stimulus programme amounted to USD 586 billion in 2008, or 2.1 percent of GDP.

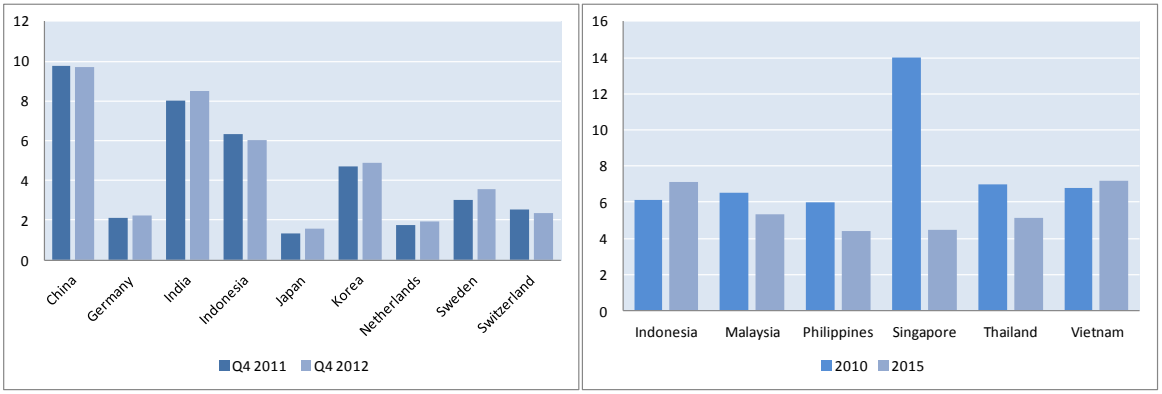
23. Some economies in Southeast Asia, in particular Singapore and Malaysia, also implemented major stimulus programs to alleviate the effect of the crisis on the domestic economy. The smaller Southeast Asian economies faced a somewhat more difficult dilemma, given the combination of positive current account balances and relatively small financial markets, open current accounts, and currencies that are not heavily traded (Cao et al, 2010). The potential for capital outflows in the direction of hard currencies meant that these economies needed to strike the right balance between stimulus and currency depreciation.

24. Growth appears to have picked up in the recovery period, particularly in Asia. The OECD forecasts China's GDP to grow over 9 percent in 2011 and 2012; India's projected growth rate is around 8 percent for the same period (OECD, 2010b). Other Asian economies are also expected to grow in the short- and medium-term (Figure 2, Panel A). At a little over 7 percent each, Indonesia's and Vietnam's GDP growth rates are robust (OECD, 2010c). Growth in Singapore in 2010 is also predicted to increase by 14 percent and by around 4 percent in 2015 (OECD, 2010c). Stronger growth in 2010 in some Asian economies, including China, Singapore, and Malaysia, is in part a response to the significant stimulus packages that were implemented to combat the effects of the crisis. Notwithstanding the fact that the effects of the stimulus programs will taper off, the medium-term outlook is bright for the largest economies in developing Asia.

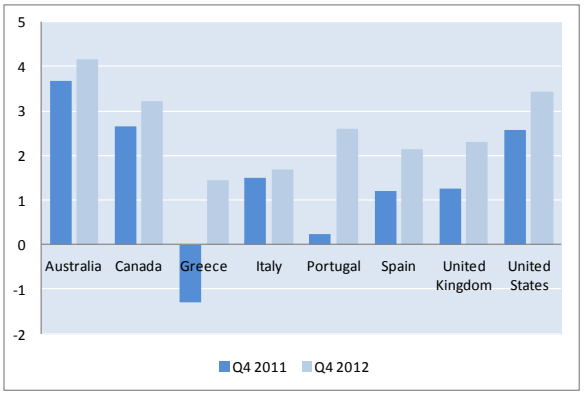
Figure 2. Real GDP growth, projections

(percent change from previous period)

Panel A. Select Asian and surplus economies



Panel B. Deficit economies



Source: *2010 OECD Economic Outlook* for projections in 2011 and 2012; *2010 OECD Southeast Asian Outlook* for projections in 2010 and 2015.

25. China and India stand out as the most dynamic and fast-growing economies in Asia. The short- and medium-term growth forecasts for the largest Southeast Asian countries are higher than in most OECD economies, but they are nevertheless lower than China and India. The OECD countries are experiencing a more tepid recovery, and growth rates are expected to remain somewhat lower than trend at least in the short-term for most of the OECD area.[10] One of the implications of slower growth in the OECD area is that Asian economies must become less reliant on exports to OECD countries (e.g. Japan, the United States, and Europe).

26. Inflation is another area of concern to policymakers in the rebalancing debate, and the pace of recovery in each economy is reflected in the inflation figures (Table 2).

Table 2. Consumer Price Index

(percent change from previous period)

Panel A. Asian and surplus economies

	1990-1996	1997-2003	2004	2005	2006	2007	2008	2009
China	11.0	0.3	3.9	1.8	1.5	4.8	5.9	-0.7
Germany	2.2	1.3	1.7	1.6	1.6	2.3	2.6	0.3
Hong Kong, China	9.1	-0.9	-0.4	0.9	2.1	2.0	4.3	0.6
India	10.1	5.9	3.8	4.2	5.8	6.4	8.4	10.9
Indonesia	8.6	17.0	6.2	10.5	13.1	6.3	10.1	6.4
Japan	1.4	-0.1	0.0	-0.3	0.2	0.1	1.4	-1.4
Korea	6.4	3.6	3.6	2.8	2.2	2.5	4.7	2.8
Malaysia	3.7	2.3	1.5	3.0	3.6	2.0	5.4	0.6
Netherlands	2.6	2.6	1.2	1.7	1.1	1.6	2.5	1.2
Philippines	9.9	5.4	6.0	7.6	6.2	2.8	9.3	3.2
Singapore	2.5	0.6	1.7	0.4	1.0	2.1	6.5	0.6
Sweden	4.6	1.2	0.4	0.5	1.4	2.2	3.4	-0.3
Switzerland	3.1	0.7	0.8	1.2	1.1	0.7	2.4	-0.5
Thailand	5.1	2.8	2.8	4.5	4.6	2.2	5.5	-0.8
Vietnam	0.8	2.8	7.8	8.3	7.4	8.3	23.1	7.1

Panel B. Deficit economies

	1990-1996	1997-2003	2004	2005	2006	2007	2008	2009
Australia	3.2	2.5	2.3	2.7	3.5	2.3	4.4	1.8
Canada	2.5	2.1	1.9	2.2	2.0	2.1	2.4	0.3
Greece	14.0	3.8	2.9	3.5	3.2	2.9	4.2	1.2
Italy	5.1	2.3	2.2	2.0	2.1	1.8	3.3	0.8
Portugal	7.5	3.0	2.4	2.3	2.7	2.8	2.6	-0.8
Romania	129.3	53.9	11.9	9.0	6.6	4.8	7.8	5.6
Spain	5.2	2.7	3.0	3.4	3.5	2.8	4.1	-0.4
Turkey	76.7	59.3	10.6	10.1	10.5	8.8	10.4	6.3
United Kingdom	4.1	2.5	3.0	2.8	3.2	4.3	4.0	-0.6
United States	3.4	2.3	2.7	3.4	3.2	2.9	3.8	-0.4

Source: IMF's International Financial Statistics (IFS).

10 . The United States is an exception; it is expected to grow at almost 3.5 percent in 2012.

27. While Table 2 shows moderate deflation in China in 2009, the OECD forecasts consumer price inflation to increase slightly from 3.1 percent in 2010 to 3.3 percent in 2011 and 3.0 percent in 2012 (over the previous period) (OECD, 2010b). India is also expected to see higher inflation in 2011 (5.8 percent) and 2012 (5.2 percent), reflecting rising food and commodity prices in both countries. Indonesia is also expected to see higher consumer prices (5.1 percent in 2010, 6.4 percent in 2011, and 5.3 percent in 2012) (OECD, 2010b). In contrast, the deficit countries (apart from Turkey) are not currently experiencing (nor are they forecast to experience) inflationary pressures. In fact, the data points to modest deflation in many of the deficit countries (including the United States).

External imbalances emerged pre-crisis and persist in the recovery

28. When analysing the current account balances of the 10 countries with the largest current account surpluses and deficits in 2007 – the year preceding the economic crisis – one observes a marked shift toward Asia (Table 3).[11] Only two of the economies with a current account surplus in 2007 are not high-income – China and Malaysia. But half of the surplus countries are Asian – China, Japan, Singapore, Chinese Taipei and Malaysia. This is a marked contrast from 1996 – the year when current account imbalances began to increase significantly – when only China (9) and Chinese Taipei (8) made it into the top 10.

Table 3. Top 10 surplus and deficit economies

Surplus economies			Deficit economies		
1996	2007		1996	2007	
9	1	China	1	1	United States
102	2	Germany	26	2	Spain
1	3	Japan	7	3	United Kingdom
3	4	Netherlands	4	4	Australia
5	5	Switzerland	118	5	Italy
10	6	Sweden	15	6	Greece
6	7	Singapore	25	7	Turkey
8	8	Chinese Taipei	116	8	France
12	9	Canada	23	9	Romania
92	10	Malaysia	12	10	Portugal

Source: Authors' calculations based on IMF BOPs.

Note: In 1996, Germany and Malaysia both ran deficits, while Italy and France posted surpluses.

29. All of the major Asian economies recorded current account surpluses in 2007 except for India and Vietnam, and all improved their external positions (either by increasing a surplus or decreasing a deficit) since the 1990s. In some Asian countries such as Singapore; China; Malaysia; and Hong Kong, China, the surpluses exceeded 10% of their national GDPs in 2007, while in Thailand, the Philippines, and Japan the surpluses hovered around 5% of GDP. This pattern reveals both the shift of economic clout from West to East as well as some of the aftershocks of the Asian financial crisis of 1997-98, when balance of payments problems induced countries to pursue economic policies aimed at achieving current account surpluses.

30. On the deficit side, all of the countries are high- or middle-income countries (and all OECD members except Romania). The opposite trend appears here, as developing and largely Asian countries[12]

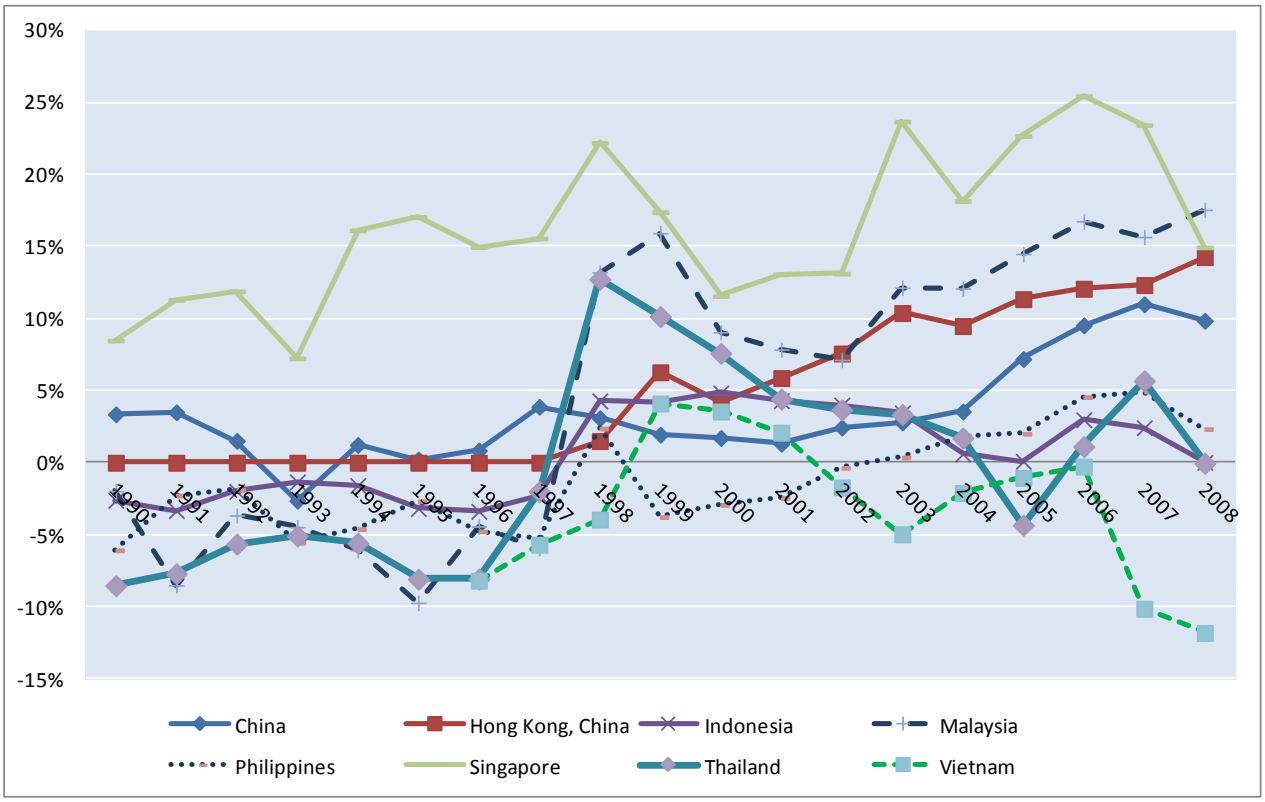
11 . This ranking excludes large net oil exporters.

12 . Brazil (2), Korea (3), Thailand (5), Indonesia (8), Argentina (9), and India (10).

moved out of the top 10 deficit countries in the 11-year period (1996-2007) and more high-income, largely European countries[13] moved in.

Figure 3. Selected Asian economies' current account balance as a share of GDP

(1990-2008)



Source: IMF BOPS and World Bank Development Indicators.

31. Apart from Singapore and to some extent Thailand, Asia went from persistent current account deficits (net borrowers) prior to 1997 to consistently high current account surpluses (net creditors) after the crisis abated. But this average masks large differences among countries. For example, Vietnam (-11.8 percent in 2008) has run persistent current account deficits during the entire period, while Singapore (19 percent in 2009) and Malaysia (16.5 percent in 2009) have run persistently large surpluses.[14] A strong appetite for imports, driven by tariff cuts, robust growth rates, and significant investment in infrastructure, has led to persistent current account deficits in Vietnam. The single largest component of the Philippines' current account is a new (positive) balance of current transfers (remittances); Thailand also has a notably large negative net income component in its current account.

32. The current account balances as a share of GDP in all of the Asian, other surplus, and deficit economies is included in Figure 4. What is striking about this figure is the degree to which current account deficits and surpluses have grown since 1990. Concerns in financial markets about the ability of many of the deficit countries to finance these large deficits has since manifested itself (e.g. Greece and Portugal in 2010) and looks set to continue into 2011. It is precisely because of these concerns that policymakers are

13 . Spain, Italy, Greece, Turkey, France, Romania, and Portugal all moved into the top 10 during this time.

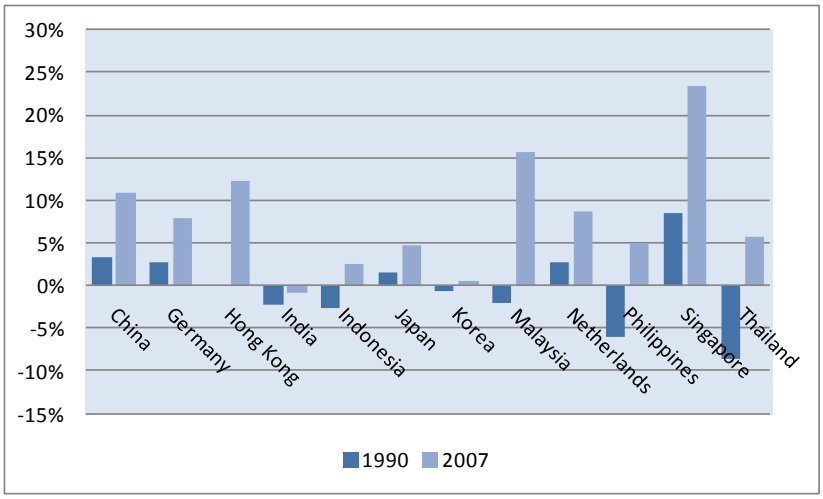
14 . Data come from the Asian Development Bank.

putting 'rebalancing' high on the agenda both nationally and in the context of regional groupings (e.g. G-20).

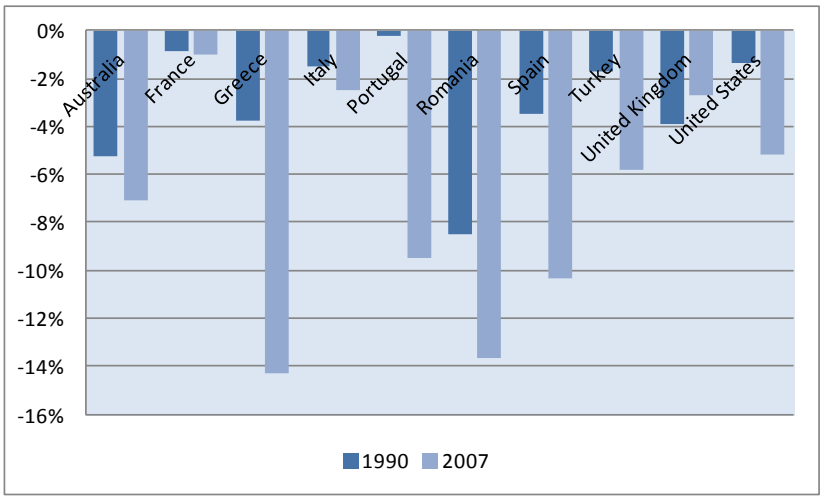
Figure 4. Current account balances as a share of national GDP

(1990 and 2007)

Panel A. Selected Asian and surplus economies



Panel B. Deficit economies



Source: IMF BOPS and World Bank Development Indicators.

Composition of domestic demand impacts rebalancing strategies

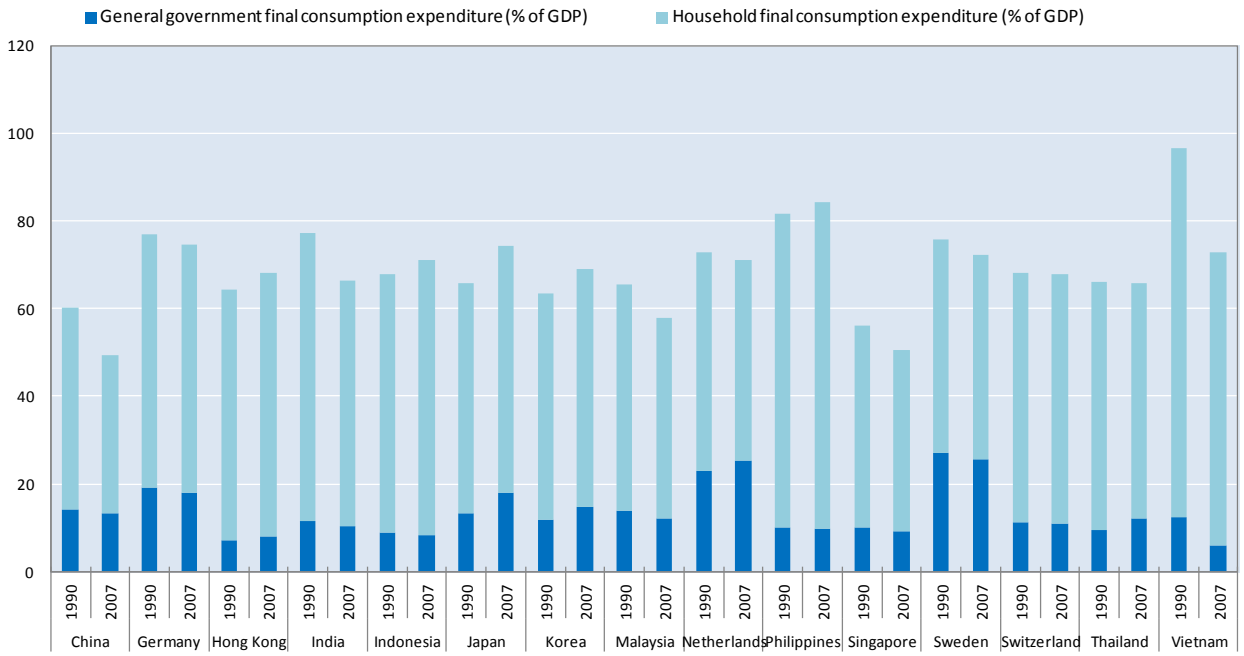
33. To a large extent, reducing global imbalances will require shifts in domestic demand, which can take place through changes in investment, consumption, and policies that affect government spending. In particular, as governments find less space for fiscal stimulus, private domestic demand must pick up the slack. Indeed, some economies that fared better during and since the global financial crisis tended to have a higher share of domestic consumption in GDP in 2007, the year immediately preceding the crisis (Figure 5). Vietnam, for example, represents a country with a relatively high share, and it posted impressive

growth of 5.3 percent in 2009. The Philippines show a similar pattern. In contrast, economies with lower shares of domestic consumption in GDP have been harder hit (e.g. Singapore and Malaysia). Relatively lower rates of domestic consumption put more of a burden on governments during economic contractions because households are less inclined to drive growth.

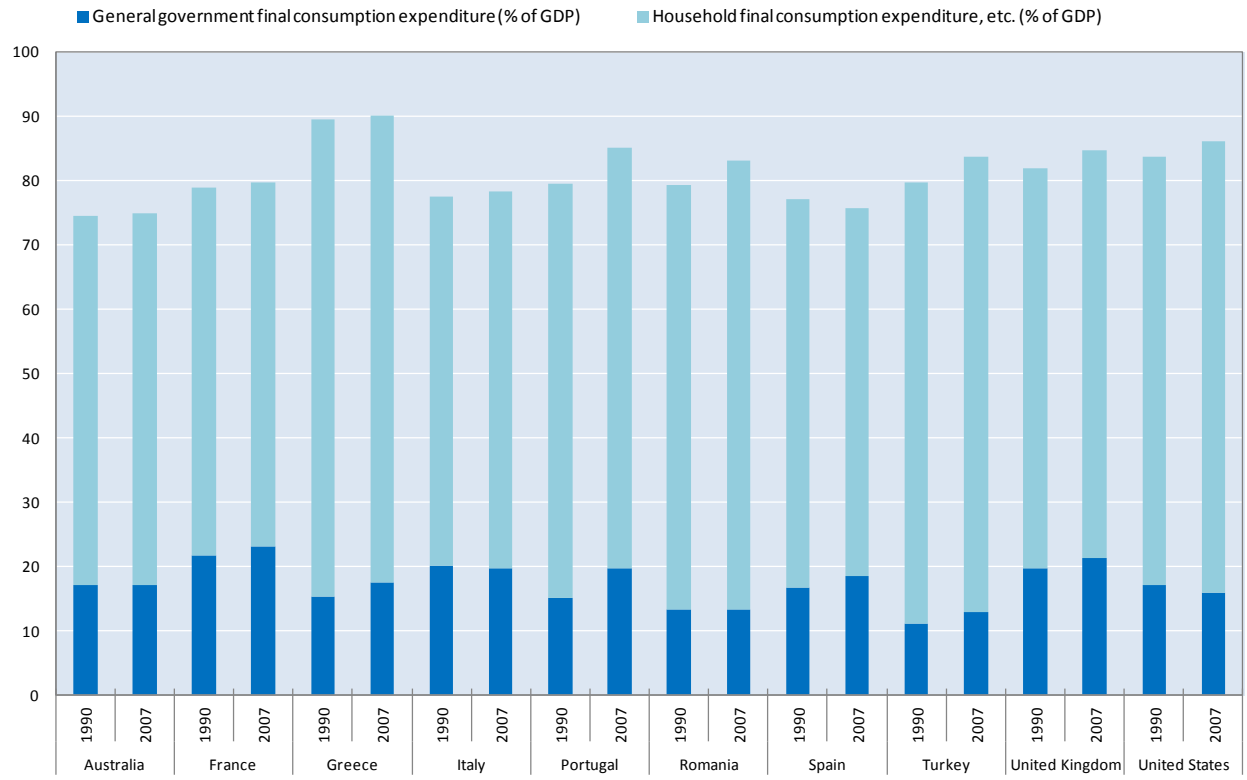
Figure 5. Consumption

(as a share of GDP)

Panel A. Asian and surplus economies



Panel B. Deficit economies



Source: World Bank Development Indicators.

34. Investment is another mechanism for shifting the composition of domestic demand, and foreign direct investment (FDI) plays a pivotal role in increasing domestic productivity through technology transfer Table 4 presents FDI as a share of GDP in the Asian, surplus, and deficit economies. FDI generally declined over the 2008-09 period for most countries, particularly the more open economies of Singapore, Thailand, and Malaysia. Singapore, one of the hardest hit Southeast Asian economies in the most recent crisis, posted a substantial decline in FDI as a share of GDP between 2007-08. However, FDI in India, Indonesia, and Vietnam increased.

Table 4. Foreign direct investment

(net inflows as a share of GDP)

Panel A. Asian and surplus economies

	1990-1996	1997-2003	2004	2005	2006	2007	2008
China	3.8	3.6	2.8	3.5	2.9	4.0	3.3
Germany	0.2	2.9	-0.4	1.7	1.9	2.3	0.7
Hong Kong	*n/a*	12.8	20.5	18.9	23.7	26.3	27.7
India	0.3	0.8	0.8	0.9	2.1	2.0	3.4
Indonesia	1.5	-0.6	0.7	2.9	1.3	1.6	1.8
Japan	0.0	0.2	0.2	0.1	-0.2	0.5	0.5
Korea	0.3	1.1	1.3	0.7	0.4	0.2	0.4
Malaysia	6.5	3.3	3.7	2.9	3.9	4.5	3.3
Netherlands	2.6	8.7	0.7	7.4	1.0	15.5	0.7
Philippines	1.6	1.8	0.8	1.9	2.5	2.0	0.9
Singapore	10.7	14.1	19.2	12.3	20.0	20.2	5.6
Sweden	2.3	7.9	3.0	2.7	6.7	5.9	8.0
Switzerland	1.3	4.3	0.5	-0.1	8.3	10.3	2.5
Thailand	1.7	3.9	3.6	4.6	4.6	4.6	3.1
Vietnam	7.0	5.0	3.5	3.7	4.0	9.8	11.8

Panel B. Deficit economies

	1990-1996	1997-2003	2004	2005	2006	2007	2008
Australia	1.9	2.2	6.0	-5.1	3.5	4.8	4.5
Canada	1.2	3.7	-0.1	2.3	4.7	8.3	3.7
Greece	0.9	0.6	0.9	0.3	2.0	0.6	1.5
Italy	0.3	0.8	1.0	1.1	2.1	1.9	0.7
Portugal	1.8	3.2	0.9	2.1	5.5	1.3	1.9
Romania	0.6	3.2	8.5	6.6	9.3	5.9	6.9
Spain	2.0	3.9	2.4	2.2	2.5	4.6	4.7
Turkey	0.5	0.6	0.7	2.1	3.8	3.4	2.5
United Kingdom	1.9	4.1	2.6	7.8	6.3	7.2	3.5
United States	0.7	1.8	1.2	0.9	1.8	1.9	2.3

Source: World Bank Development Indicators.

35. Policies designed to boost investment – particularly FDI, which has been shown to have positive spillovers in the domestic economy – may represent one component of the rebalancing package for some Asian countries.

4. Commercial policies as a tool for rebalancing the global economy

36. Much of the attention in the rebalancing debate has centred on how shifts in monetary and fiscal policies may affect national saving-investment imbalances (i.e. on the expenditure-changing side of the national net savings-current account identity). Macroeconomic policies have undoubtedly been one of the

key contributors to the build-up of imbalances prior to the economic crisis and they will thus have to be an integral part of rebalancing. However, as we argued in Section 1, expenditure-changing policies are unlikely to be sufficient and may in fact be problematic to implement given the nature of existing internal imbalances in countries with the largest deficits or surpluses. Expenditure-switching through appreciation of real exchange rates by surplus countries would help, but exchange rate shifts are perceived to be of a win-lose nature and thus bear the risk of triggering a wave of competitive devaluations. Additionally, the world's largest surplus country – China – pursues a fixed exchange rate policy and it is uncertain whether this will change dramatically at least in the short-term.

37. Trade controls represent another type of expenditure-switching measure that can be used for rebalancing. Indeed, global imbalances could in principle be reduced or even eliminated by restricting trade and investment flows. However, moving toward protectionism or putting off further liberalisation efforts are most likely not the best strategies to pursue. This is simply because such strategies imply a risky and highly uncertain trade-off. First, since some current account imbalances can be desirable, it is hard to know how much imbalances should be reduced in general. Desirability and sustainability might even be hard to assess on a country-by-country basis. In this context, the uncertainty surrounding the benefits of reducing imbalances must be weighed against the benefits of trade and investment, including efficiency gains related to specialisation according to comparative advantage, economies of scale, access to a wide variety of intermediate and final products, and technology transfer associated with international commerce.

38. But protectionism is not the only way commercial policies can contribute to the rebalancing process. Indeed, while a real exchange rate appreciation by surplus countries or protectionism in deficit countries could bring about external rebalancing, so would the removal of trade controls that impede imports in surplus countries, or the removal of impediments to exports in deficit countries. Moreover, the latter type of scenario, as trade theory and empirics clearly demonstrate, would have the 'win-win' benefit of increased welfare in the liberalising countries and their trading partners.

39. Deardorff (2010), for example, uses a simple two-country model of trade based on comparative advantage and demonstrates that implicit or explicit subsidisation can lead to the accumulation of trade surpluses and deficits that work against a country's comparative advantage. The distortions cause trade imbalances to be welfare-reducing and flow in the 'wrong' direction – that is, distortions divert capital flows toward the country that does not have a comparative advantage in future production. Removing such subsidies would both enhance welfare and reduce imbalances.

40. Barattieri (2010) presents an alternative inter-temporal trade model in which current account imbalances emerge as a result of asymmetric liberalisation of goods and services. He shows that a country specialised in the production of services, whose products suffer from higher trade barriers now and are to be liberalised in the future, accumulates net foreign liabilities in anticipation of a future improvement of the relative price of its products and higher incomes. By the same token, the anticipation of a future reduction of impediments to trade in services generates an increase in savings in the service-importing countries.

41. Inter-temporal consistency of trade flows and payments is an important consideration in both Deardorff (2010) and Barattieri (2010), but there is scope for its further elaboration. In Deardorff (2010), for example, there is an implicit assumption that financial markets would be willing to finance the welfare-reducing imbalances that flow in the 'wrong' direction. In Barattieri (2010), on the other hand, the inter-temporal consistency implies that the emergence of current account deficits and surpluses is optimal and sustainable, but the welfare costs of asymmetric trade barriers are not taken into account.

42. It is perhaps difficult to capture all the real and financial aspects of imbalances in a formal inter-temporal model that would also be capable of accounting for welfare costs of trade distortions.

Nevertheless, intuitively the comparative advantage principle can also be a useful guide in thinking about global imbalances in a more traditional, static sense. Quite simply, a welfare-reducing trade imbalance could arise between two countries if the levels of trade protection are asymmetric and if, for some reason, there is appetite in financial markets to finance such trade.[15] If one country (say China) has a comparative advantage in the production of labour-intensive products (goods), and the other country (say United States) has a comparative advantage in the production of human capital- or technology-intensive products (services), then any asymmetries in the structure of trade barriers could result in the build-up of unsustainable (and welfare-reducing) imbalances. This would be the case if import barriers are persistently higher in services than in goods in both countries, or if one of the countries has higher import barriers on both products. A liberalisation scenario that alleviates this asymmetry would result in both the reduction of imbalances as well as welfare gains.

5. Trade solutions to the rebalancing problem must involve Asia

43. Whether trade and other related policy reforms can usefully contribute to the rebalancing process is an empirical question, although *a priori* theory and some analysis suggests that the macroeconomic rebalancing process could be helped with appropriate trade policies that would at the same time support the global economic recovery (Claessens *et. al*., 2010). The principal purpose of this section is to investigate in greater detail whether changes to trade-related policies in Asia may contribute to the rebalancing process. This section analyses the structure of trade and trade protection with a view to understanding the mechanisms whereby trade policy reform in Asia could help in rebalancing the global economy.

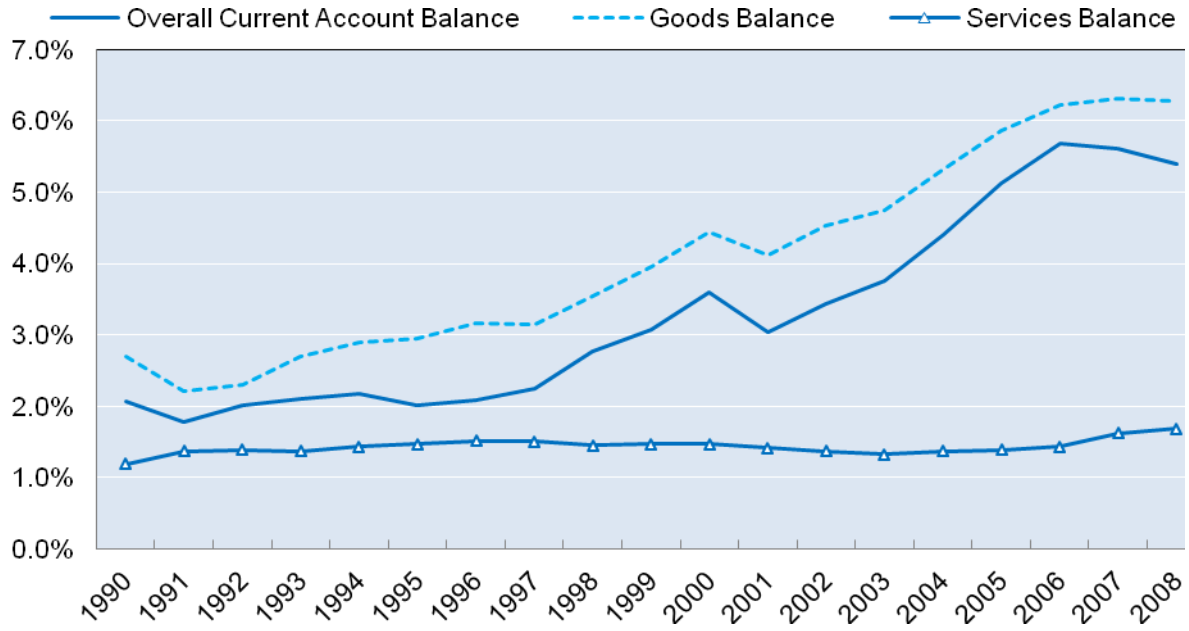
The build-up of global current account balances was driven by goods

44. First, we consider whether the evolution and structure of global imbalances in the run-up to the economic crisis point to welfare-reducing and imbalance-enhancing distortions. Strikingly, the build-up of global current account balances – measured as the sum of the absolute value of world current account balances divided by world GDP – that began in the mid-1990s was driven by the goods side of the trade account (that is, imbalances related to trade in goods have contributed the most to global imbalances since the mid-1990s) (Figure 6). In fact, the contribution of the goods sector to imbalances doubled from below 3% of world GDP in mid-1990s to above 6% in the late 2000s.

[15] Presumably, such a model would have to assume some kind of disequilibrium or asymmetric information to be consistent with financing of such welfare-reducing trade flows.

Figure 6. Composition of Current Account Balances, 1990-2008

Absolute values of respective imbalances divided by world GDP



Source: Authors' calculations based on IMF Balance of Payments data. For presentational purposes, net income and transfers, the other two components of the Current Account, are omitted.

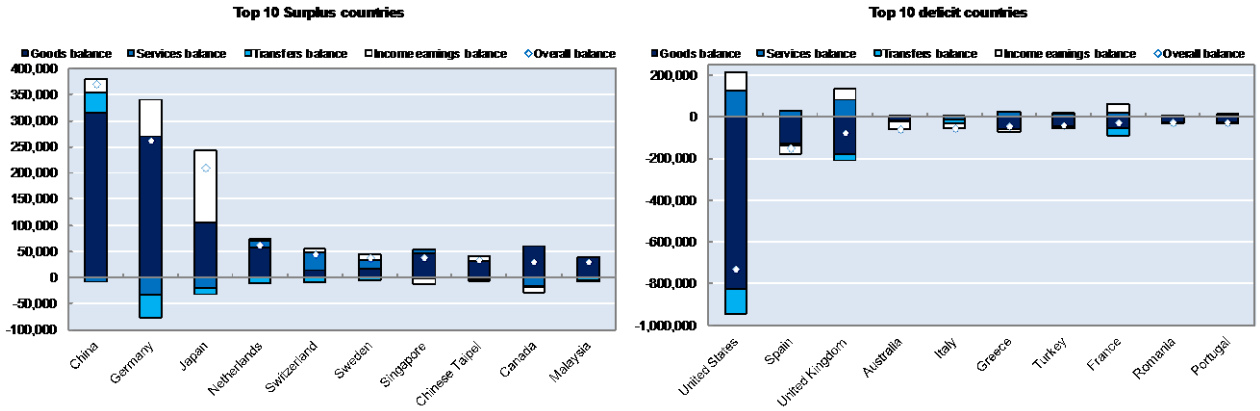
45. In contrast, the contribution of services trade to global imbalances has remained relatively constant at around 1.5% of world GDP over the period, albeit with a slight upturn in 2007-08. Of course, the current account does not capture all of the channels through which services are traded,[16] but this potential bias would not be expected to increase over time. It is also hard to resist comparing the timing of the emergence of this disparity (the mid-1990s) and the conclusion of the Uruguay Round of trade negotiations (1994), especially since the commitments in goods have been reported to deliver more actual trade liberalisation than those in services.[17] Thus, these trends may be suggestive of a growing divergence in the structure of trade protection for goods and services, especially given the fact that the countries that account for the bulk of the large deficits in goods are relatively specialised in the services sector.

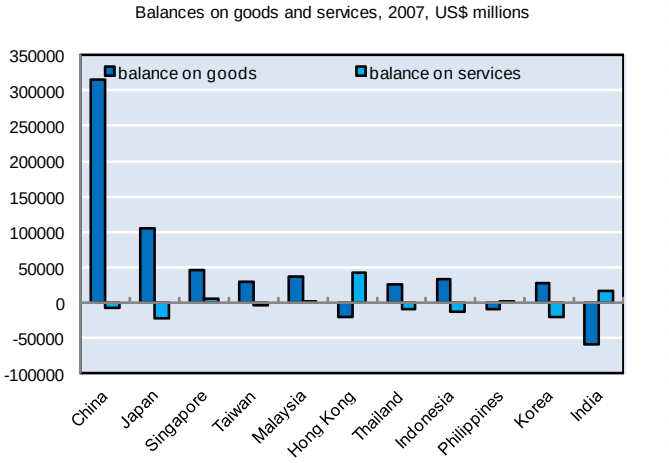
16 . The services category in the current account does not cover two important modes of services delivery (mode 3 services trade (commercial presence) and mode 4 services trade (temporary migration of labour)). Mode 4 is captured in the capital account; Mode 3 is not included in the Balance of Payments, but rather in statistics on sales of foreign affiliates.

17 . Hoekman (1995), for example, provides an assessment of the Uruguay Round Agreement commitments on services and their failure in terms of generating liberalisation. Recently, Barattieri (2010) finds an asymmetry in the liberalisation of goods trade versus service trade using the concept of the constructed home bias index. While the index for manufacturing trade, available from 1994, has been declining since the mid-1990s, the index for services has been virtually flat.

Figure 7. Structure of the current accounts in Asia, and top 10 deficit and surplus countries

(2007)





Source: Authors' calculations based on IMF Balance of Payments data.

46. Remarkably, in 2007 9 out of the 10 countries with the largest current account deficits recorded negative balances on goods trade and, at the same time, positive balances on services trade (Figure 7). All surplus countries recorded a positive balance on goods trade and the three countries with the largest surpluses (China, Germany, and Japan) as well as Chinese Taipei and Canada had at the same time a negative services trade balance (Figure 7). Among the major Asian economies, only India; Hong Kong, China; and the Philippines had a negative balance on goods and these countries, together with Malaysia, posted positive balances on services trade. In all of the Asian countries with large current account surpluses such as China, Singapore, and Malaysia, positive balances on goods trade dwarfed small deficits on services trade. This general pattern is consistent with the 'Kuznets' development trajectory of less developed countries concentrating in manufacturing exports and the higher income countries moving toward greater exports of services.

which was related to the prevailing structure of comparative advantage and trade barriers

47. We now turn to an analysis of whether differences in the structure of the current account between surplus and deficit countries are related to the prevailing structure of comparative advantage and trade barriers. Table 5 presents the average applied MFN tariffs in the Asian economies. While Singapore and Hong Kong, China, represent very open economies (almost zero tariffs across all product categories), in other economies there exists scope for further reducing barriers to goods trade. In some product categories,

China, Malaysia, Thailand, and Vietnam in particular can reduce tariffs further. On average, tariffs in the surplus Asian economies are higher than in the deficit countries.

Table 5. Average MFN applied tariffs in select Asian economies

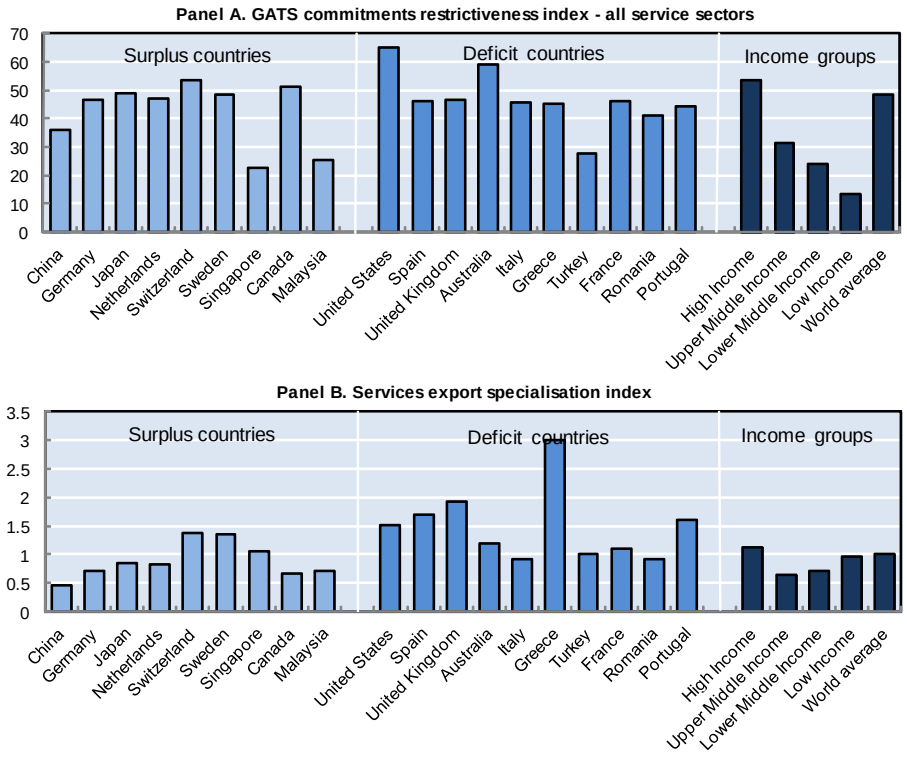
	China	Hong Kong, China	India	Indonesia	Japan	Korea	Malaysia	Philippines	Singapore	Thailand	Vietnam
		2009	2009	2009	2009	2009	2009	2009	2009	2009	2009
Animal products	14.8	0	33.1	4.4	12.3	22.1	3.9	21	0	28.7	14.6
Dairy products	12	0	33.7	5.5	147.5	67.5	2.3	3.9	0	24.8	12.8
Fruit, vegetables, plants	14.8	0	30.4	5.9	12.2	57.7	3.6	9.8	0	30.5	24.4
Coffee, tea	14.7	0	56.3	8.3	15.6	53.9	5.7	15.7	0	28.3	29.8
Cereals & preparations	24.2	0	32.2	5.8	60.8	134.5	4.5	10.9	0	18.1	21.6
Oilseeds, fats & oils	10.9	0	18.2	3.9	10.6	37.5	1.8	5.6	0	10	8.6
Sugars and confectionery	27.4	0	34.4	8	23.5	17.1	2.5	16	0	22.3	15.8
Beverages & tobacco	22.9	0	70.8	51.8	14.2	31.7	155.2	8.2	2.5	41.9	50
Cotton	15.2	0	12	4	0	0	0	2.6	0	0	6
Other agricultural products	11.5	0	21.7	4.3	5.7	16.1	0.6	3.4	0	9.4	6.8
Fish & fish products	10.7	0	29.8	5.8	5.5	16	1.2	8.1	0	11.7	25.7
Minerals & metals	7.4	0	7.5	6.4	1	4.6	11.2	4.9	0	6	8.6
Petroleum	4.4	0	3.8	0.3	0.6	4.1	0.7	2.9	0	6	13.5
Chemicals	6.6	0	7.9	5.2	2.2	5.7	2.9	3.8	0	3.1	4.2
Wood, paper, etc.	4.4	0	9.1	5	0.8	2.2	10.1	6.6	0	6.9	13.5
Textiles	9.6	0	13.6	9.3	5.5	9.1	10.3	9.1	0	8	10
Clothing	16	0	16.1	14.4	9.2	12.6	15.9	14.9	0	29.8	19.7
Leather, footwear, etc.	13.4	0	10.2	9	9.7	7.8	13.9	6.6	0	12.4	15.4
Non-electrical machinery	7.8	0	7.3	2.3	0	6	3.6	2.3	0	4.1	4
Electrical machinery	8	0	7.2	5.8	0.2	6.2	4.3	4	0	7.5	10.9
Transport equipment	11.5	0	20.7	10.6	0	5.5	11.6	9.1	0	20.3	18.9
Manufactures, n.e.s.	11.9	0	8.9	6.9	1.2	6.7	4.8	4.9	0	10.2	12.1

Source: WTO Statistics Database.

48. Moreover, barriers in services in the surplus economies tend to be higher in surplus economies than in the deficit economies (Figure 8, Panel A). Deficit countries tend to be more (less) specialised in exports of services (goods) than surplus countries (Panel B),[18] which suggests that their exports could be hampered disproportionately by relatively higher services trade barriers. Interestingly, this line of thinking possibly generalises beyond the top 10 surplus and deficit countries as a strong tendency can be observed for barriers to services trade to decrease as income levels rise (Panel A, Income Groups), while the share of services in value added and specialisation in exports of services tend to increase with income (Panel B, Income Groups).

18 . This is based on the Word Bank index of GATS commitments reported in the World Trade Indicators database. This is an imperfect measure of services trade restrictiveness but so far this is the only index that offers a broad sectoral coverage and comparability across countries. Other sources of information on services trade barriers such as Dihel and Shepherd (2007) and Wölfl et al. (2009) confirm the general finding that barriers to services trade tend to be higher in developing and emerging economies, as compared to the OECD area. The OECD is currently developing services restrictiveness indexes at the sector level: http://www.oecd.org/trade/stri.

Figure 8. GATS commitments restrictiveness index - all service sectors



Source: Authors' calculations based on World Trade Indicators and World Development Indicators (World Bank).Notes: In Panel A, the GATS Index score for these countries is on a scale of 0-100, with 100 meaning fully liberal. Panel B represents the ratio of a share of a country in world service exports (current USD) and a share of a country in world exports of goods and services (current USD).

49. To explore whether this hypothesis might be helpful in identifying policies that would be particularly useful for rebalancing in Asia, we take a more detailed look at import and export specialisation in countries with largest surpluses and deficits, and then consider separately the major economies in Asia. To do so, we employ the classical Revealed Comparative Advantage (RCA) indices (Balassa, 1965) which help identify product categories in which a country's exports or imports are more concentrated compared to a reference country group.[19] Indices above 1 indicate a relative[20] concentration of either exports or imports in the considered category of products in the given country.

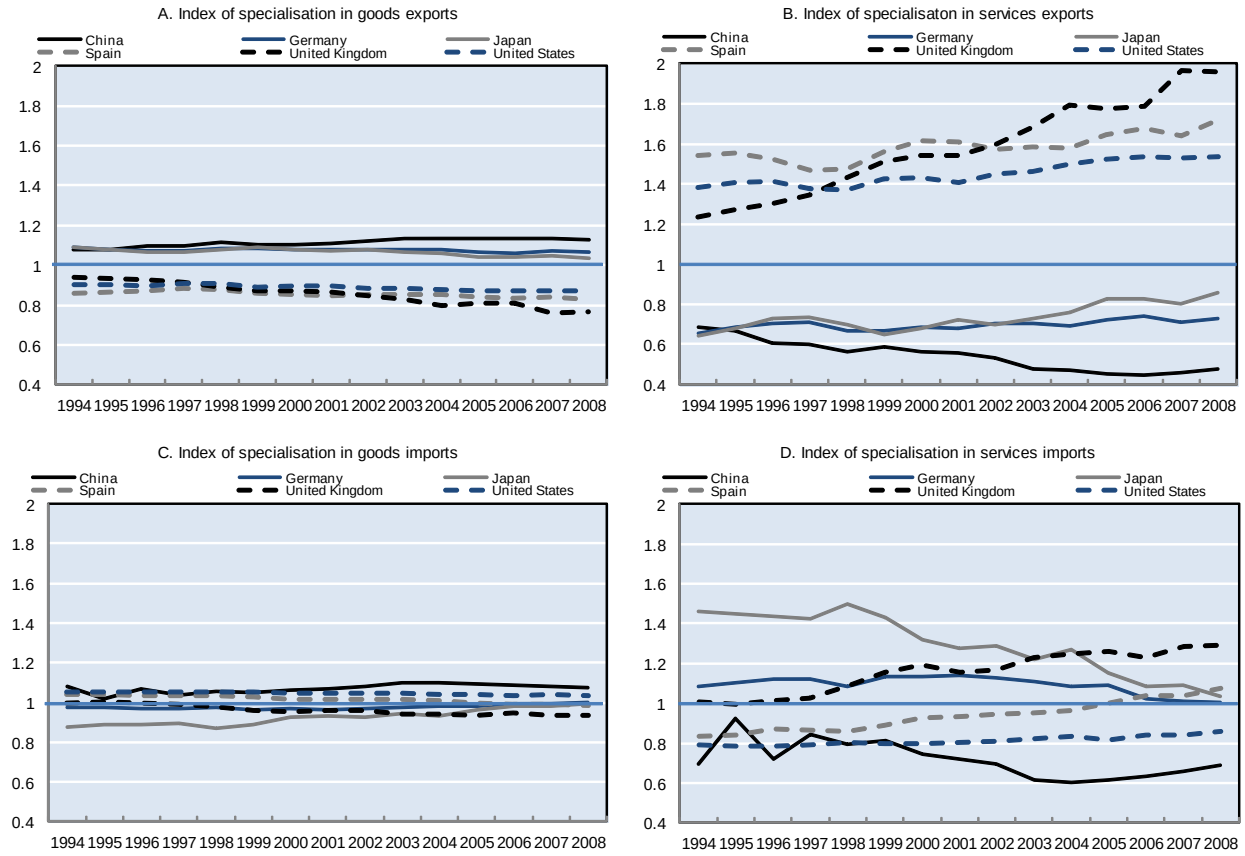
50. Figure 9 indicates that all of the top three surplus countries' exports are relatively concentrated in goods (indices above 1), while all the top three deficit countries' exports are relatively concentrated in services (Figure 9, Panels A and B). Interestingly, the disparities in specialisation indices are larger for exports of services (Panel B) as compared to exports of goods (Panel A), indicating that a given world-

19 . The index is based on trade flows and as such is influenced by a multitude of factors, including country's technology and natural characteristics as well as economic policies which may benefit certain sectors more than others (e.g. infrastructure or R&D expenditures), irrespective of whether such policies are welfare enhancing or sustainable in the long term. As long as this is borne in mind, however, the index provides a good insight into trends that can be studied further using additional country, industry or policy-specific information.

20 . Relative to the world.

wide marginal increase in services trade barriers could create larger payment imbalances as compared to a comparable marginal increase in goods trade barriers.

Figure 9. Exports and imports specialisation in goods and services in top 3 surplus and deficit economies



Source: Authors' calculations based on IMF Balance of Payments data.

51. Differences in imports specialisation indices are smaller, especially as far as goods are concerned (Figure 9, Panel C), indicating that surplus and deficit economies import goods in similar proportions. Differences in services import concentration ratios (Panel D) suggest some interesting trends with all three deficit countries gradually increasing their relative shares in services imports and all three surplus countries decreasing their shares.

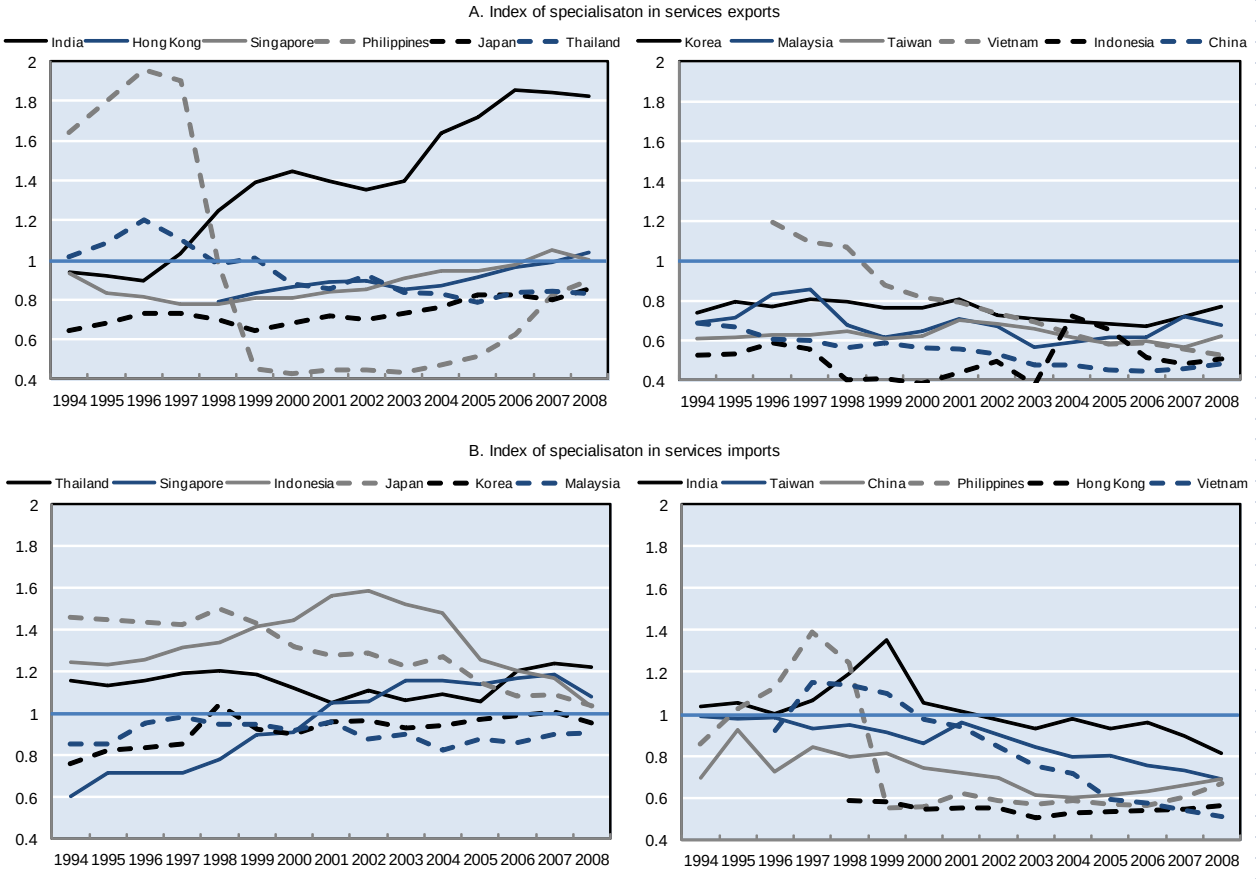
52. In China in the mid-1990s, for example, the share of services in overall imports of goods and services was approximately 20 percent lower compared to the reference group and the gap deepened further by mid-2000s before bouncing back to approximately 30 percent in the late 2000s. Japan's share of services imports was approximately 50 percent higher in mid-1990s, but after a gradual decline Japan's imports of services moved closer to a typical share at the end of 2000s. Importantly, in the case of Japan this was accompanied by increasing specialisation in services exports (Panel B) that was presumably driven by a gradual development of competitive domestic services industries. This was not the case in China, however, where services shares declined on both the export and the import side (Panels B and D).

53. Figure 10 focuses solely on services trade and takes a closer look at export and import specialisation trends in major Asian economies. In the left-hand side of Panel A, India; Hong Kong, China; Singapore; Philippines; Japan; and Thailand all show signs of the development of a competitive services export sector, albeit to a different degree. India's exports in particular have become strongly services-

oriented and this was driven by new services, such as computer and selected professional services (e.g. Kowalski and Dihel, 2009). The right-hand side of Panel A shows the countries with low concentrations of services in overall exports, and in many of these countries services specialisation indices have been declining since the mid-1990s.

54. Panel B of Figure 10 presents indices of specialisation in services imports and its left-hand portion indicates that the shares of services in overall imports of Thailand, Singapore, Indonesia, Japan, Korea, and Malaysia are generally higher than the average world share. Finally, the right-hand portion of Panel B shows the countries with relatively low shares of services in imports. This group includes countries such as India; Hong Kong, China; and the Philippines, where low import shares may be related to the existence of competitive domestic services industries. However, this is not the case for Chinese Taipei, Vietnam and, in particular China, as these countries have very low import and export services concentration ratios, suggesting relatively less competitive domestic industries on the one hand and the existence of barriers to services imports on the other hand.

Figure 10. Export and import specialisation in goods and services in top three surplus and deficit economies

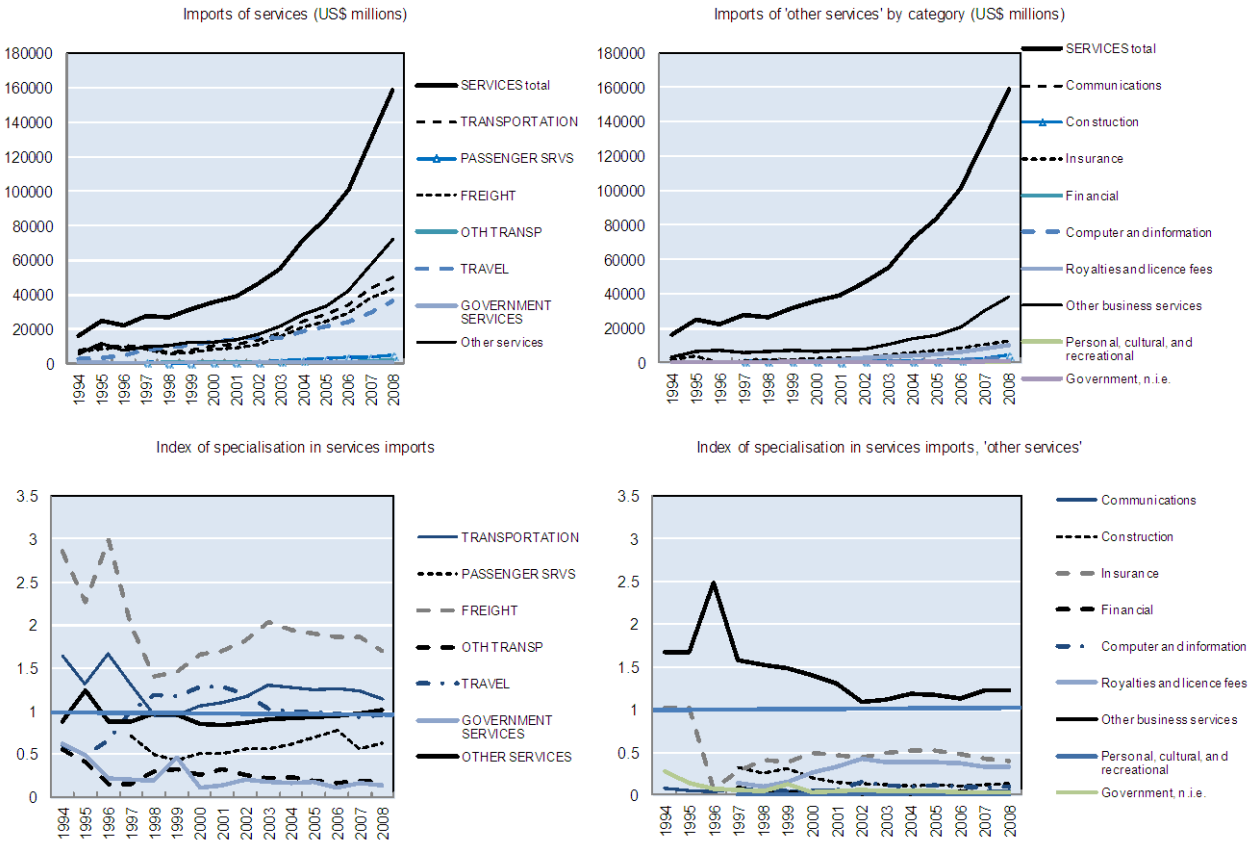


Source: Authors' calculations based on IMF Balance of Payments data.

55. Detailed balance of payments data on imports by category of services do not exist for Chinese Taipei and Vietnam, but they exist for China and are subject of further analysis in Figure 11. The figure shows that China's appetite for some services has been growing robustly, reflecting the rapid growth of the economy. This is particularly evident when considering both the value of imports and indices of imports specialisation of travel, transportation and freight services. Indeed, these categories of services imports are significant in terms of values and specialisation indices above 1, indicating that shares of these services

categories in China's imports of services are higher than a typical share. Trends in transportation and freight are undoubtedly connected to developments in China's manufacturing trade, which underscores important feedback mechanisms between services and manufacturing sectors (see also Lesher and Nordås, 2006). Trends in imports of travel services, on the other hand, are likely linked to the growth of disposable incomes of Chinese citizens, a growing share of which is spent on international travel and tourism.

Figure 11. China's imports of services



Source: Authors' calculations based on IMF Balance of Payments data.

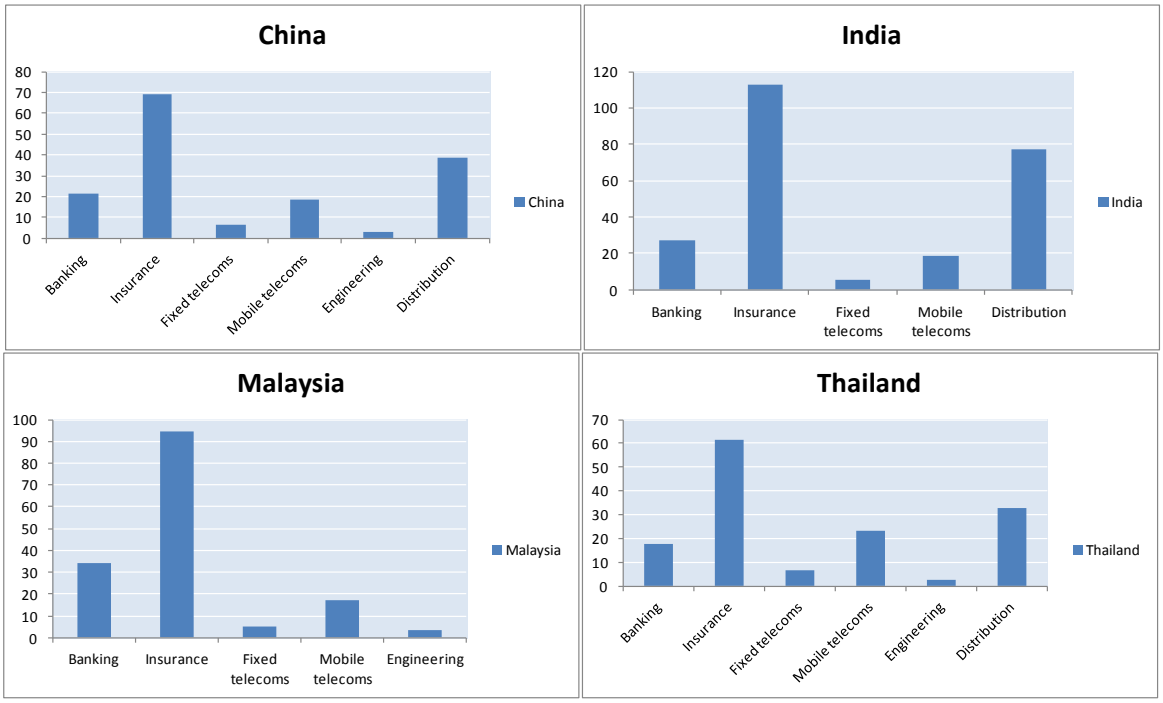
56. 'Other services' is another import category which has recorded robust growth. This composite category collects several important business services as well as construction and its share in China's services imports is close to a typical share in the reference group. Yet, within the composite category, there are stark differences between individual business services categories that suggest important differences in regulations and barriers to services trade. Royalties and licence fees and insurance are the only two service categories that indicate a more significant importing activity but even there specialisation indices suggest that China's imports are only 50% of the typical imports of the reference group. By the same metric, communications, financial, computer and information and personal, cultural and recreational services are almost not imported by China at all. It is possible that some of these services are included in the residual category 'other business services', which collects all the services not classified elsewhere, but the imports specialisation index of this category has been declining steadily since mid 1990s. This likely reflects a high level of public ownership and important regulatory barriers in the services sectors (see e.g. Greene et al., 2006), the issue that is developed further below.

Further liberalisation of services trade in Asia could help rebalance

57. Assessing services trade barriers is an imprecise science, but there have been some efforts to quantify barriers to services trade beyond GATS commitments. And while most of these efforts have focused on developed economies, some estimates exist for developing countries as well. Figure 12 presents estimates of services barriers in four Asian economies, two of which are in the top 10 surplus economies world-wide (China and Malaysia).

Figure 12. Services barriers in select Asian economies: Estimated tax equivalents, 2004

(percent on price)



Source: OECD, 2005.

58. While not all services sectors are covered and only a sub-set of the surplus Asian economies are surveyed, it is clear that among the sectors studied, barriers are highest in insurance (particularly on mode 1) and distribution services. Banking also appears to be more heavily protected (especially mode 3), while fixed telecommunications and engineering are relatively open in this analysis. This pattern holds across India and Thailand (although India is not a surplus economy).

59. Another study (McGuire, 2008) calculates services trade restrictiveness indexes for select economies in the Asia-Pacific region. The results suggest that of the 14 economies analysed,[21] Indonesia, Malaysia, and the Philippines had the most restrictive banking sectors in 2001, stemming from restrictions on foreign firms entering the domestic market and foreign equity participation, in addition to prohibitions on expanding operations. Singapore, Korea, and Thailand scored moderately, and barriers in the area of licensing, foreign equity participation, and on-going operations seem to be of particular importance. In the

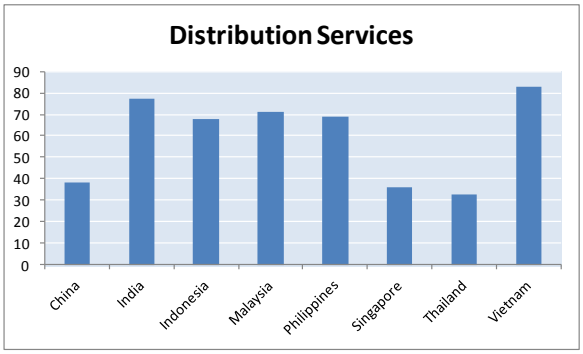
21 . Economies studied in the banking services sector include: Australia; Canada; Chile; Hong Kong, China; Indonesia; Japan; Korea; Malaysia; Mexico; New Zealand; the Philippines; Singapore; Thailand; and the United States.

banking sector, the analysis suggests very high price effects in Indonesia, Malaysia, the Philippines, and Thailand.[22] In Malaysia, for instance, the study indicates that the price of banking services is around 60 percent higher than in the absence of these restrictions.

60. In distribution services, more countries were surveyed by the OECD (Figure 13).[23] In distribution services, Vietnam emerges as the most restrictive country in the sector, although India, Indonesia, Malaysia, and the Philippines are not far behind. China, Thailand, and Vietnam are relatively less restrictive. Across all of the economies surveyed, modes 1 and 4 are the most restrictive in this sector, although some important restrictions were also noted on mode 2.

Figure 13. Services barriers in distributions services in select Asian economies: Estimated tax equivalents, 2004

(percent on price)



Source: OECD, 2005.

61. This pattern is consistent with results from McGuire (2008), which shows that Malaysia, Indonesia, and the Philippines have the most restrictive score in 1999, with Thailand following closely.[24] The primary barriers identified include outright bans from entering the sector, quotas on the import licenses granted to foreign firms, and restrictions on foreign equity participation in the form of limitations and performance requirements. In contrast, Singapore and Hong Kong, China have very low (i.e. less restrictive) scores.

62. The OECD (2005) work points to relatively smaller barriers in the telecommunications and engineering sectors. In the area of professional services, analysis by McGuire (2008) suggests relatively less variation among the economies surveyed, implying less asymmetric liberalisation patterns. Nevertheless, the same three economies top the restrictiveness score: Malaysia, Indonesia, and the Philippines, with Thailand not far behind. In assessing the effect of these restrictions on the economic

22 . McGuire (2008) uses the services trade restrictiveness indexes in an econometric model to estimate the effect of barriers on the prices, costs, and price-cost margins faced by firms.

23 . China; Hong Kong, China; India; Indonesia; Malaysia, the Philippines; Singapore; and Thailand.

24 . Economies studied in the distribution services sector include: Australia; Canada; Chile; Hong Kong, China; Indonesia; Japan; Korea; Malaysia; Mexico; New Zealand; the Philippines; Singapore; Thailand; and the United States.

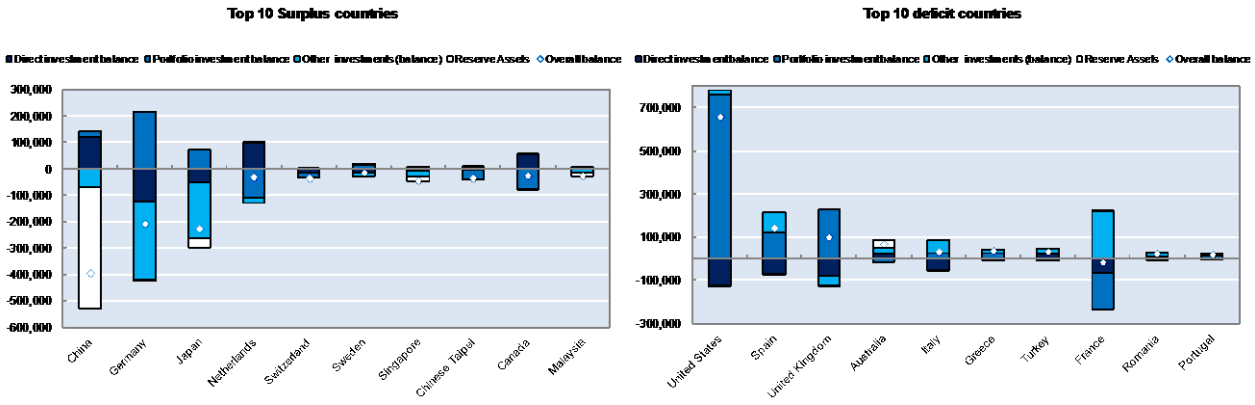
performance of service suppliers (i.e. price and cost effects on firms), the analysis suggests that most restrictions impact more on price than on cost for the Asia-Pacific economies studied.[25]

63. The value of both of these studies is not in a particular tax equivalent or score *per se*; rather, it is in the relative ranking of countries and an identification of the policies that may be contributing the most to restrictiveness. This helps policymakers prioritise liberalisation efforts and target the most distorting services trade barriers.

FDI, which has been shown to have positive spillovers in the domestic economy and facilitates services trade, may represent an important component of the rebalancing package

64. In the deficit economies (apart from Turkey), the portfolio and other investments elements – not FDI – contribute the most to the overall financial account balances (Figure 14). This pattern has not changed much over the 11-year period. Given that current account imbalances are more sustainable in the medium-term if they are financed by FDI, which is less subject to sudden reversals, it appears that the largest deficit countries may have difficulties continuing to run deficits with the current structure of their balance of payments. As a result, encouraging FDI (or mode 3 trade in services) is an important element of any policy package designed to help reduce unsustainable imbalances.

Figure 14. Structure of the Financial Accounts of the top 10 deficit and surplus countries in 2007



Source: Authors' calculations based on IMF Balance of Payments data.

65. Asian countries, particularly developing Asian countries, are playing a larger role in financing other countries' deficits, and that this has come in the form of portfolio and other investments, as well as reserve assets in the case of China, which is less sustainable than FDI. These developing countries generally have more restrictive services policies than the high-income countries on the deficit side. This suggests that surplus countries are not choosing to invest via portfolio and other means in deficit countries because they face overly burdensome restrictions to direct investment. Indeed, their World Bank *Doing Business* scores all rank quite well (apart from Greece and to some extent Turkey) (Table 6).

25 . This perhaps because many of the restrictions limit entry and competition, which tends to increase prices rather than raise costs.

Table 6. The business environment

(2010)

Panel A. Asian and surplus economies

	Ease of Doing Business Rank ▲	Starting a Business	Dealing with Construction Permits	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business[A]
Singapore	1	4	2	15	6	2	4	1	13	2
Hong Kong, China	2	6	1	56	2	3	3	2	2	15
Sweden	14	39	20	15	72	28	39	7	52	18
Korea	16	60	22	74	15	74	49	8	5	13
Japan	18	98	44	59	15	16	112	24	19	1
Thailand	19	95	12	19	72	12	91	12	25	46
Malaysia	21	113	108	60	1	4	23	37	59	55
Germany	22	88	18	67	15	93	88	14	6	35
Switzerland	27	80	37	14	15	167	16	43	28	41
Netherlands	30	71	105	46	46	109	27	13	29	11
Spain	49	147	49	54	46	93	71	54	52	19
Vietnam	78	100	62	43	15	173	124	63	31	124
China	79	151	181	38	65	93	114	50	15	68
Indonesia	121	155	60	98	116	44	130	47	154	142
India	134	165	177	94	32	44	164	100	182	134
Philippines	148	156	156	102	128	132	124	61	118	153

Panel B. Deficit economies

	Ease of Doing Business Rank ▲	Starting a Business	Dealing with Construction Permits	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
United Kingdom	4	17	16	22	2	10	16	15	23	7
United States	5	9	27	12	6	5	62	20	8	14
Australia	10	2	63	35	6	59	48	29	16	12
France	26	21	19	142	46	74	55	26	7	44
Portugal	31	59	111	31	89	44	73	27	24	21
Spain	49	147	49	54	46	93	71	54	52	19
Romania	56	44	84	92	15	44	151	47	54	102
Turkey	65	63	137	38	72	59	75	76	26	115
Italy	80	68	92	95	89	59	128	59	157	30
Greece	109	149	51	153	89	154	74	84	88	49

[A] The ranking for this component ranges from 1-156; the remaining economies share a rank of 183 because they have no practice in closing a business.Source: World Bank Doing Business Indicators.Note: Rankings are out of 183 economies. The lower the rank, the easier it is for a local firm to conduct business operations. The overall index represents an average of the economy's percentile ranking in the underlying components, with equal weights for each component. The data come from *Doing Business 2011*, which covers the period June 2009-May 2010.

66. If it is essential to encourage FDI, at least in some of the surplus economies, then policymakers must understand how restrictive services policies are in the countries that contribute the most to global imbalances. Based on the currently available data, it does not appear that the countries that are on the deficit side have particularly restrictive policies toward trade in services. Using either the FDI component of the OECD's measure of product market regulation (Table 7) or the World Bank's GATS Commitments Restrictiveness Index (Figure 3, Panel B), it does not appear that the deficit countries (apart from Turkey) have overly restrictive services regimes. However, these measures are imperfect and more robust measures covering a wide variety of developed and developing economies are needed.[26]

[27] High entry barriers, excessive state involvement, opaque regulatory process and overly burdensome licensing and operating requirements.

Table 7. FDI Restrictiveness Index

(2009)

Panel A. Asian and surplus economies

	CANADA	CHINA	GERMANY	JAPAN	INDIA	INDONESIA	NETHERLANDS	SWEDEN	SWITZERLAND
Agriculture & Forestry	0.00	0.55	0.00	1.00	0.00	0.05	0.00	0.00	0.00
Fishing	0.60	1.00	0.28	1.00	0.00	0.05	0.25	0.55	0.00
Mining (incl. Oil extr.)	0.15	0.39	0.00	1.00	0.00	0.05	0.00	0.00	0.00
Manufacturing	0.10	0.25	0.00	0.08	0.00	0.05	0.00	0.00	0.00
Electricity	0.10	0.61	0.00	0.00	0.00	0.05	0.00	0.00	0.50
Construction	0.10	0.27	0.00	0.00	0.00	0.05	0.00	0.00	0.00
Distribution	0.10	0.24	0.00	0.00	0.00	0.05	0.00	0.00	0.00
Transport	0.27	0.67	0.20	0.67	0.03	0.05	0.08	0.29	0.25
Hotels & restaurants	0.10	0.25	0.00	0.00	0.00	0.05	0.00	0.00	0.00
Media	0.70	1.00	0.03	0.00	0.00	0.05	0.00	0.20	0.47
Communications	0.60	0.80	0.00	0.50	0.08	0.05	0.00	0.20	0.00
Financial services	0.07	0.61	0.01	0.00	0.03	0.05	0.00	0.00	0.07
Business services	0.10	0.14	0.00	0.00	0.00	0.10	0.00	0.05	0.00
FDI INDEX TOTAL	0.16	0.46	0.02	0.26	0.01	0.05	0.02	0.06	0.08

Panel B. Deficit economies

	AUSTRALIA	FRANCE	GREECE	ITALY	PORTUGAL	SPAIN	TURKEY	UNITED KINGDOM	UNITED STATES	ROMANIA
Agriculture & Forestry	0.08	0.23	0.08	0.00	0.00	0.00	0.00	0.02	0.00	0.00
Fishing	0.08	0.15	0.24	0.50	0.02	0.00	0.00	0.57	0.55	0.00
Mining (incl. Oil extr.)	0.09	0.01	0.11	0.02	0.00	0.05	0.05	0.02	0.10	0.00
Manufacturing	0.08	0.00	0.02	0.00	0.00	0.00	0.00	0.02	0.00	0.00
Electricity	0.08	0.00	0.02	0.00	0.00	0.00	0.00	0.02	0.22	0.00
Construction	0.08	0.00	0.02	0.00	0.00	0.00	0.00	0.02	0.00	0.00
Distribution	0.08	0.00	0.02	0.00	0.00	0.00	0.00	0.02	0.00	0.00
Transport	0.23	0.15	0.17	0.15	0.08	0.08	0.21	0.11	0.55	0.17
Hotels & restaurants	0.08	0.00	0.03	0.02	0.01	0.00	0.00	0.02	0.00	0.00
Media	0.20	0.05	0.13	0.36	0.00	0.23	0.25	0.25	0.30	0.00
Communications	0.40	0.00	0.02	0.00	0.00	0.00	0.00	0.02	0.01	0.00
Financial services	0.13	0.05	0.04	0.02	0.02	0.00	0.00	0.02	0.04	0.00
Business services	0.10	0.00	0.07	0.00	0.00	0.11	0.13	0.02	0.00	0.00
FDI INDEX TOTAL	0.13	0.04	0.06	0.05	0.01	0.02	0.07	0.06	0.08	0.01

Source: OECD.

Conclusions

67. Slower growth in the OECD area means that Asian economies would be well-served to become less reliant on exports to OECD countries (e.g. Japan, the US, and Europe). Such a strategy would typically involve rebalancing demand toward domestic and intra-regional sources through increases in domestic investment and consumption, particularly if these changes do not threaten macroeconomic stability and boost potential output in the longer term. Differences in the structure of current and financial accounts, the pattern of post-Uruguay Round barriers to trade in goods and services, together with broad patterns of trade specialisation, all suggest that a policy package designed to rebalance the global economy can also usefully include trade liberalisation, particularly in the area of services, as one important element. Since many of the deficit countries specialise in services, they are at a disadvantage when trying to rebalance their economies because they face higher barriers to exporting in the sectors in which they have a comparative advantage. Similar reasoning may also apply to remaining protection within goods sectors. High concentration of current account surpluses in Asia and deficits in North America and Europe suggest also that such further trade liberalisation efforts should go well beyond regional integration.

68. Indeed, it makes sense to liberalise services from the perspective of the surplus economies, particularly those in developing Asia where barriers are highest. Crucially, services liberalisation would help the surplus countries by providing access to a greater variety and quality of services. The associated services productivity boost would encourage domestic consumption, thus putting these countries on a more

sustainable growth trajectory. Moreover, there can be important feedback mechanisms between services liberalisation and productivity in manufacturing, the sector in which many of the surplus economies have a comparative advantage, with positive welfare implications (Lesher and Nordås, 2006).

69. Analysis suggests that restrictions on establishment contribute the most to increasing both the price and the cost of services (McGuire, 2008). This means that reducing these barriers – such as restrictions on licensing of new firms, mode 3 services trade (FDI), and requirements for joint ventures – could be useful. Policymakers should consider which mode of supply is most restrictive in a given services sector in prioritising the liberalisation agenda. In addition, it may be best to remove non-discriminatory restrictions on all service suppliers first before turning to a reduction in those measures that just discriminate against foreign firms (See Dee, 2002). This is because targeting foreigners (only) first may actually reduce the level of services supplied in the domestic economy.

70. Some existing commentary suggests that this policy prescription could indeed be a viable option for the two countries with the largest current account imbalances – China and the US. (Greene et al., 2006), for example, describe the duality in China's economy where the opening up of trade and FDI in goods coexists with a high level of public ownership and important regulatory barriers in the services sectors.[27] Indeed, this is independently acknowledged in internal discussions on China's 11th Five-Year Plan (2006-2010) which for the first time emphasises development of services as a means of improving the overall structure of industry, job opportunities and comprehensive competitiveness.[28] More recently, Godement (2010) argues that greater access to China's capital market and services sector and public procurement ("second opening") would be a better solution to the US-China currency dispute than currency revaluation.

71. Analysis in this paper supports these arguments but, by showing potentially harmful asymmetries in the levels of protection across the goods and services sectors and countries at different levels of economic development, it also advocates for a wider and a more transparent services liberalisation agenda (e.g. in the context of the DDA negotiations in the WTO or through free trade agreements). Commercial policies can usefully contribute to global rebalancing and support the global economic recovery, and policymakers would be well-served to incorporate them in their policy agenda.

[27] High entry barriers, excessive state involvement, opaque regulatory process and overly burdensome licensing and operating requirements.

[28] See e.g. http://www.china.org.cn/english/2006/Mar/160397.htm.

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