OECD Journal: Financial Market Trends
Volume 2012/2
© OECD 2013

The future of the Asian economic and financial community

by
Rintaro Tamaki*

From its beginning, Asia has been an important region for the OECD in terms of its members and partners. While the region's economic performance is still strong, structural reforms, underpinned by coherent macroeconomic polices, need to be put in place to maintain this positive momentum. This note focuses on three specific medium- to long-term issues that are important in shaping the future of the Asian economic and financial community: First, in the area of trade, the importance of measuring trade in value added terms; second, funding long-term investment, especially in infrastructure, and making these investments "greener"; third, regional financial cooperation in Asia that should become more solid and robust. Some further policy challenges are shortly addressed at the end where several areas of co-operation between the OECD and the Asian region are highlighted and further possibilities for joint work are briefly explored.

JEL Classification: F10, F20, F21, F30, F32, F33, F60, F65, G10

Keywords: Asian economies, international trade, Global Value Chains (GVCs), capital flows, regional economic and financial integration, globalisation.

* Rintaro Tamaki is Deputy Secretary-General of the OECD. This paper is based on a keynote address delivered at the 2nd OMFIF Asian Central Banks' Watchers Conference and 10th Bank Indonesia Annual International Seminar, held at Bank Indonesia, Jakarta, on Tuesday 13 November 2012. The author is grateful for comments from participants as well as OECD staff members. The author is solely responsible for any remaining errors. This work is published on the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein are the author's and do not necessarily reflect the official views of the Organisation or the governments of its member countries. This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

I. Asia in the world economy: "going global"

It is now more than 50 years that the OECD in 1961 emerged from the OEEC, the Organisation for European Economic Co-operation that arose from the Marshall Plan of the United States in 1948. The OECD, as Paris-based policy institution with 34 member countries mostly from the European and American continent, is often regarded as Western or Euro-centric. However, since its early days, Asia has been an important region for the organisation in terms of its members and partners. Japan became member three years after the OECD's creation, in 1964, Australia in 1971, New Zealand in 1973, and South Korea in 1996. Ever since, the Organisation has reached out to the Asian hemisphere, in particular with adopting China, India and Indonesia (along with Brazil and South Africa) as its "key partners", with whom we share our experiences, best practices and guidelines across a wide spectrum of economic policy making.

As a current example of our engagement in the region we have launched the 2013 Edition of the *Southeast Asian Economic Outlook*,[1] with perspectives on China and India and a thematic focus on narrowing development gaps. And this launch took place in the region itself, on the occasion of the ASEAN Business and Investment Summit in Phnom Penh, Cambodia, on 18 November 2012 (the European launch was celebrated in Paris on 13 December).

This outreach reflects the shift of growth-generating capacity from the advanced economies to emerging ones and growing importance of the Asian region in the global economy. Asia has fared relatively well throughout the global financial crisis, and, moreover, it has provided some stabilising force when economies in the western hemisphere came to a standstill. This came as a result of national and regional policy responses to the Asian Crisis of 1997/98: the soundness of banking systems in Southeast Asian economies has since improved and frameworks to deal with capital flows and to develop bond markets have been, and are being, put in place.[2]

While inflationary pressures have eased, macroeconomic policies and financial conditions remain accommodative and capital inflows have resumed, and growth is expected to pick up gradually going forward, keeping Asia ahead of the global growth average. According to the OECD *Southeast Asian Economic Outlook*, as opposed to most OECD economies, the region will enjoy solid growth until 2017 – and is projected to grow over the 2013-2017 period as strongly as during the pre-crisis period 2000-2007.

II. Common economic challenges in Asia: "going structural, and going regional"

But this positive growth performance is not a "done deal". In order to maintain the momentum, to build on past achievements and to consolidate this positive performance in the future, many of the Asian economies, in particular the emerging Southeast Asian economies, need to continue to engage in structural reforms.

These reforms will have to take into account – and make better use of – the various and heterogeneous natural resources, institutional settings, organisational capacities and socio-political background in each of the Asian economies, resulting in country-specific policy priorities and reform agendas. It goes without saying that strong macroeconomic policies to underpin such reforms are equally important.

In the following I will focus on three specific points that could relate, more or less, to the structural issues that Asian countries need to address.

- The first one is on trade: the importance of measuring trade in value added terms.
- The second one is on funding long-term investment, especially in infrastructure, and making these investments "greener".
- The third one is on regional financial cooperation: it has been on my mind for a long time that Asian financial cooperation should have a more solid and robust standing.

These three are medium- to long-term issues, and quite important ones in shaping the future of the Asian economic and financial community.

1. Measuring trade in value added terms and Global Value Chains

Global Value Chains (GVCs) have become a dominant feature of today's global economy, encompassing emerging as well as developed economies. This growing process of international fragmentation challenges our conventional wisdom on how we look at and interpret trade and, in particular, the policies that we develop around it.

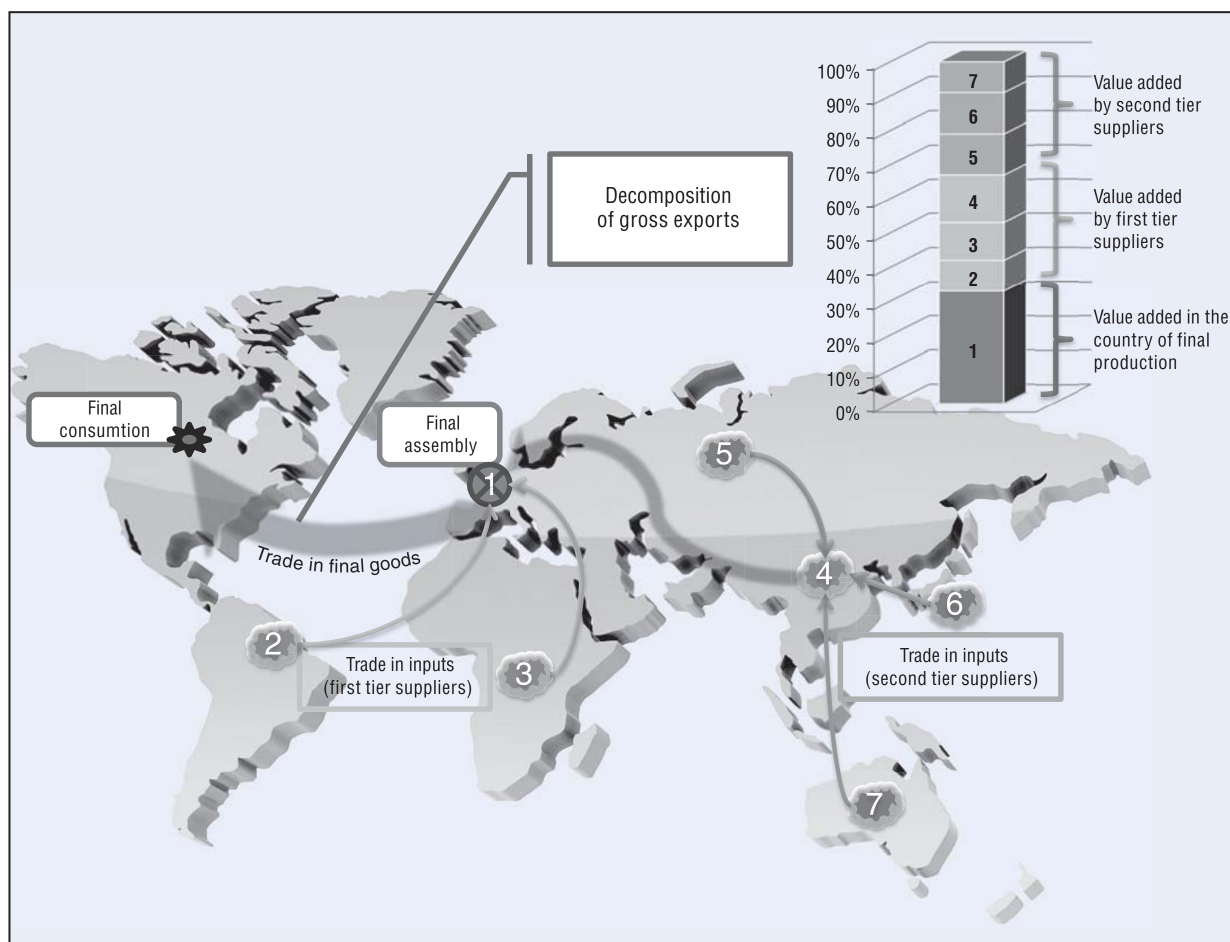
This is of particular relevance for Asian countries, which have to keep enhancing their productivity to remain competitive in export markets *vis-à-vis* lower-cost producers and adjust their production, in order to move up to higher levels in the global value chains. By contributing higher value added and upgrading from low-end processing to value-added manufacturing in the global production process these countries will eventually graduate into the ranks of high-income countries – and thus also avoid getting stuck in a "middle income trap".

Who makes what and who buys Asian countries' products seems to be an easy question. Conventional trade measures tell us about trade patterns between economies as well as trade surpluses and deficits. But these conventional measures only record the entire value of a product as it crosses borders, even if the product requires significant imports of intermediate inputs, as you can see in Figure 1.

The value added by the exporting economy in its stage of the production process may be significantly less than the value of the export. Therefore the priority for emerging economies is how to make sure that the value better "sticks" to the domestic economy, and which policies can be used to translate GVC integration into domestic economic benefits. Governments will have to look for new ways to better position their economic activities in these global networks of production and innovation in order to safeguard economic performance at home.

Figure 2 illustrates that the share of domestic value-added that is created per unit of exports is the highest in Japan and the US and lowest in Eastern Europe, but declined in all countries since 1995, as GVCs have grown, particularly in those economies that form part of European and Asian production hubs. Interestingly to note here is that the ratios rose in all economies in the wake of the recent financial crisis, indicating a higher sensitivity to demand shocks, the longer the GVCs. This also gives an idea how important it is to manage

Figure 1. **A simplified representation of a global value chain**



Source: OECD (2012a).

the risks of value chains as they can facilitate the spread of local risks into global risks. These issues have to be addressed not only at the firm level, but there is also a role for governments in this (while important, this issue will not be elaborated further in this paper).

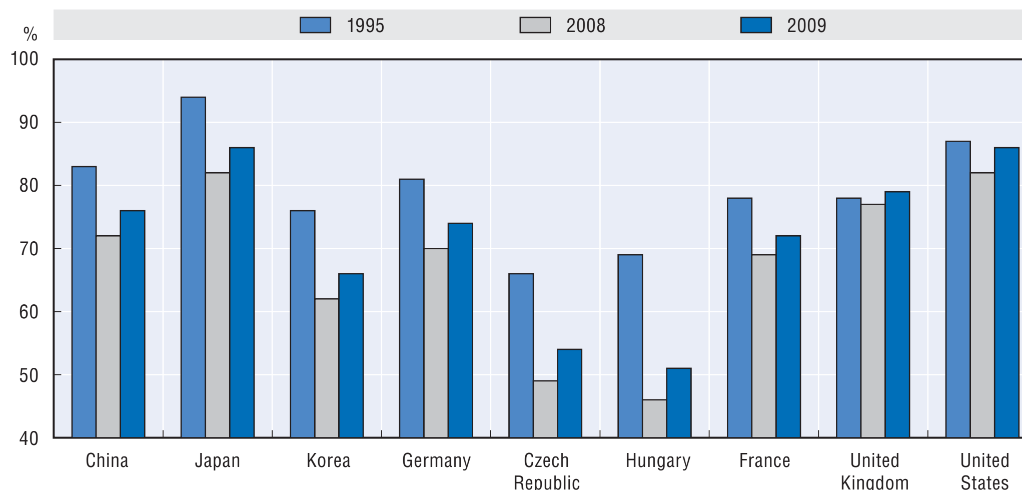
Another example of what added value figures could suggest is given in Figure 3. China's emergence as a leading production hub in GVCs is best illustrated by its exports of electronic products, which accounts for 35% of China's total gross export growth between 1995 and 2009. But much of this growth reflects increasing imports of intermediates. In 1995, nearly one-fifth of the values of Chinese exports of electronic goods were foreign content. By 2009 this had risen to one-third, with the increase being driven by most regions and industries providing the intermediate inputs.

The total share provided by European industries for example increased to nearly 5%. However, the total share of Japanese foreign content, at just under 6%, remained relatively stable. Part of this may be explained by an increase in Japan's FDI positions.

Table 1 also shows that the near doubling of value-added contributed by foreign electronic machinery industries between 1995 and 2009 coincided with a 7 percentage point fall in the value-added provided by Chinese electronic machinery manufacturers.

Figure 2. **Exported value-added**

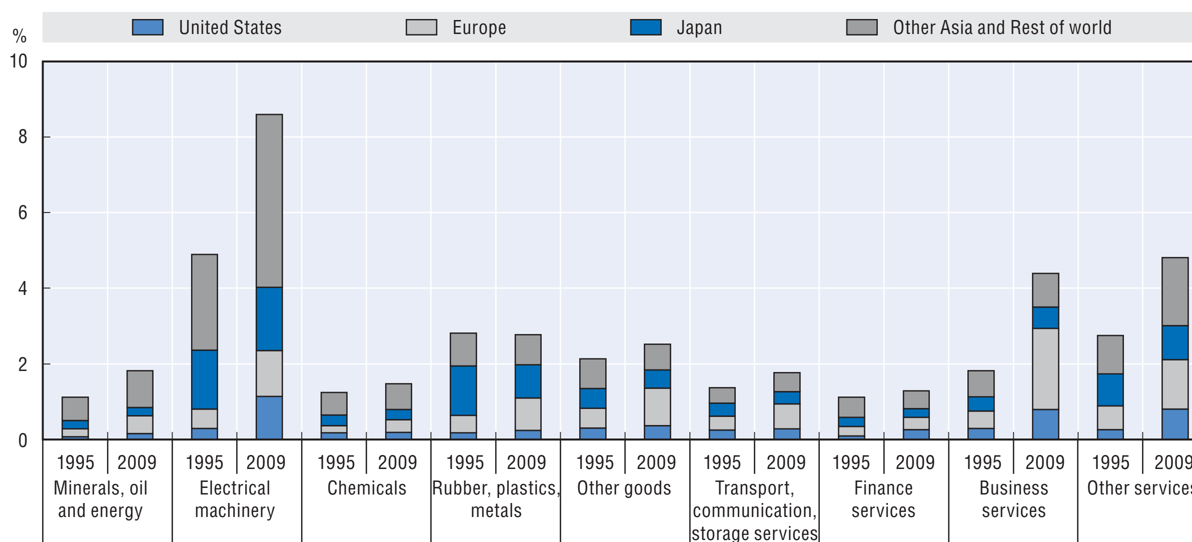
In per cent of gross exports



Source: OECD (2012a).

Figure 3. **Foreign content of Chinese electronic goods broken down by origin and activity**

In per cent of total value



Source: OECD (2012a).

The importance of looking at the value-added as it flows around the system is also central to understanding how supply shocks transmit through the GVC and also whose final domestic demand drives production.

One simple way of illustrating this is to compare shares of an economy's trade on a gross basis with the shares on a value-added basis. Figure 4 shows that in 2009 Japanese gross exports to Asia (53%) were nearly twice as large as those to Europe and the United States (28%), but on a value-added basis the share of exports to Europe and the United States (41%) were marginally higher than those to Asia (40%).

Table 1. **Chinese content of Chinese electronic goods broken down by activity**

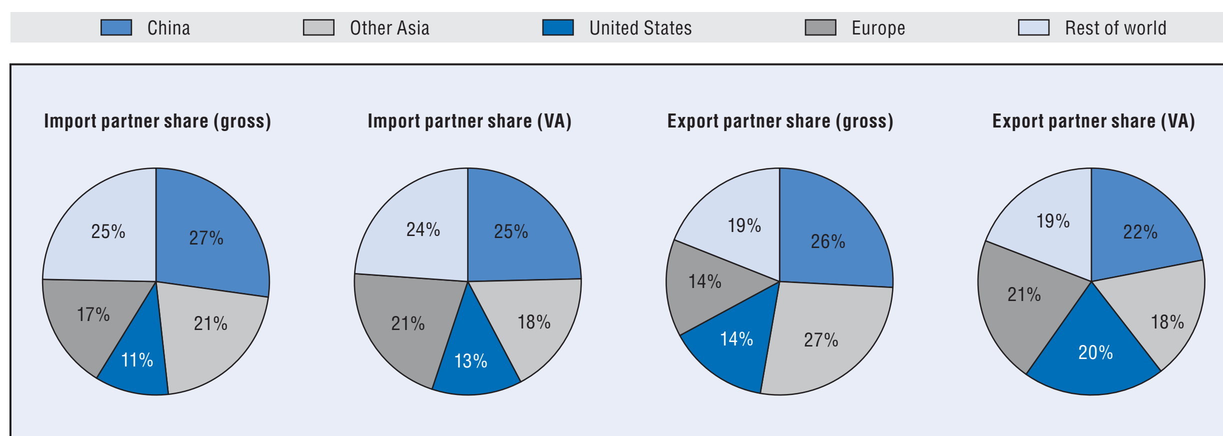
In per cent of total value

Minerals, oil and energy		Electrical machinery		Chemicals		Rubber, plastics, metals		Other goods		Transport, communication, storage services		Finance services		Business services		Other services	
1995	2009 %	1995 %	2009 %	1995 %	2009	1995	2009	1995	2009	1995	2009	1995	2009	1995	2009	1995	2009
6%	6%	31%	24%	3%	3%	13%	9%	8%	6%	4%	3%	4%	4%	2%	4%	7%	7%

Source: OECD (2012a).

Figure 4. **Japan's imports and exports by region**

In 2009



Source: *OECD-WTO TiVA Database*, January 2013.

The rise of GVCs has also changed the notion of what economies do and what they produce: important are tasks and stages of production, and it is upon this notion that competitiveness should be assessed, and also what GVCs mean in terms of jobs and skills. For example, between 1995 and 2009 increased demand from Chinese consumers supported nearly 1 000 000 jobs in the United States, accounting for almost 7% of the increase in total US employment growth over that period. But there are also additional jobs created like those that rely on income flows that compensate for intellectual property such as brands as well as retail jobs to sell the products made abroad. But these may not be recorded in the conventional trade statistics.

Therefore, the OECD has plans to capture these flows too by building a new statistical information system that brings together and links official national statistics under an international umbrella, with national input-output tables as key building blocks.

While GVCs are not a new phenomenon, their scale, speed and complexity raise several policy issues that the OECD is trying to identify and address. Besides measurement issues, GVCs concern trade policy, national competitiveness and industrial policies (including those fostering innovation), and as mentioned before, also raise issues of management of global systemic risks. The OECD is preparing a report on all these issues for its May 2013 Ministerial meeting.

But let us now move on to the next issue, funding infrastructure investments and making them greener.

2. Funding infrastructure investments and making them greener

Achieving greener, low-carbon and more resource efficient development is a policy goal of many governments today. A major part of the infrastructure required to meet development goals is still to be built in the fields of energy, environment, water, urban development, transportation and agriculture. We estimate that global infrastructure investment requirements are in the order of USD 50 trillion to 2030, or an investment flow of roughly USD 2 trillion per year.

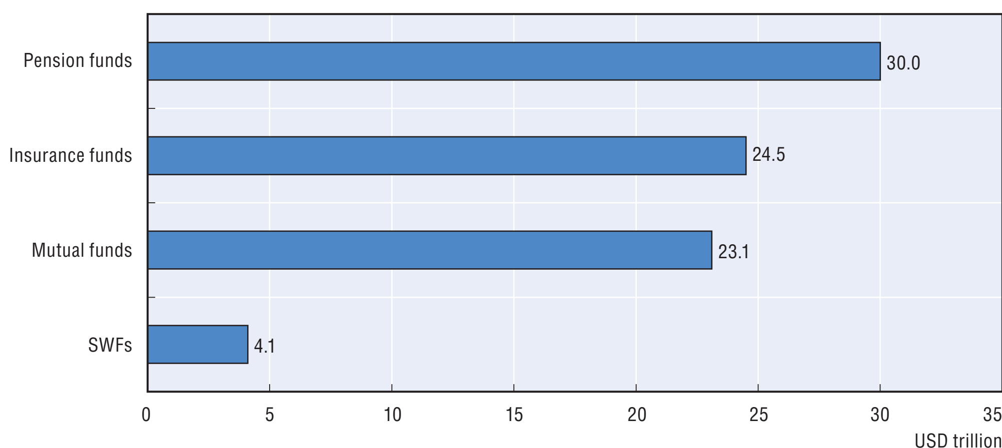
But at the same time, we have identified a USD 1 trillion investment gap that becomes even harder to close given the current state of government finances and the on-going deleveraging in the private financial sector in the aftermath of the current crisis. For example, some of the traditional sources of private capital have become scarcer as in key parts of the banking sector provision of long-term financing has become tighter; Basel III regulations are also expected to have a negative impact on project financing.

So where should the funds come from that are necessary to achieve the policy goal of greener, low-carbon and more resource efficient development that requires further investment in the energy, transport, water and building infrastructure? A recently launched OECD project on long-term investment helps to determine and promote policies and instruments (including public-private partnerships, PPPs) that encourage institutional investors to engage in long-term projects such as infrastructure.[3]

To illustrate some of the possibilities in store, note that the global institutional investors – pension funds, insurance companies and mutual funds – held over USD 77 trillion in assets at the end of 2011 as shown in Figure 5. Given the long-term nature of some of their liabilities, investments with a long-term perspective such as infrastructure, innovation and green technologies, should be a 'perfect match' of maturities.

Figure 5. **Institutional investors and SWFs can be tapped for green growth and other long-term investments**

Global assets under management (AuM), 2011



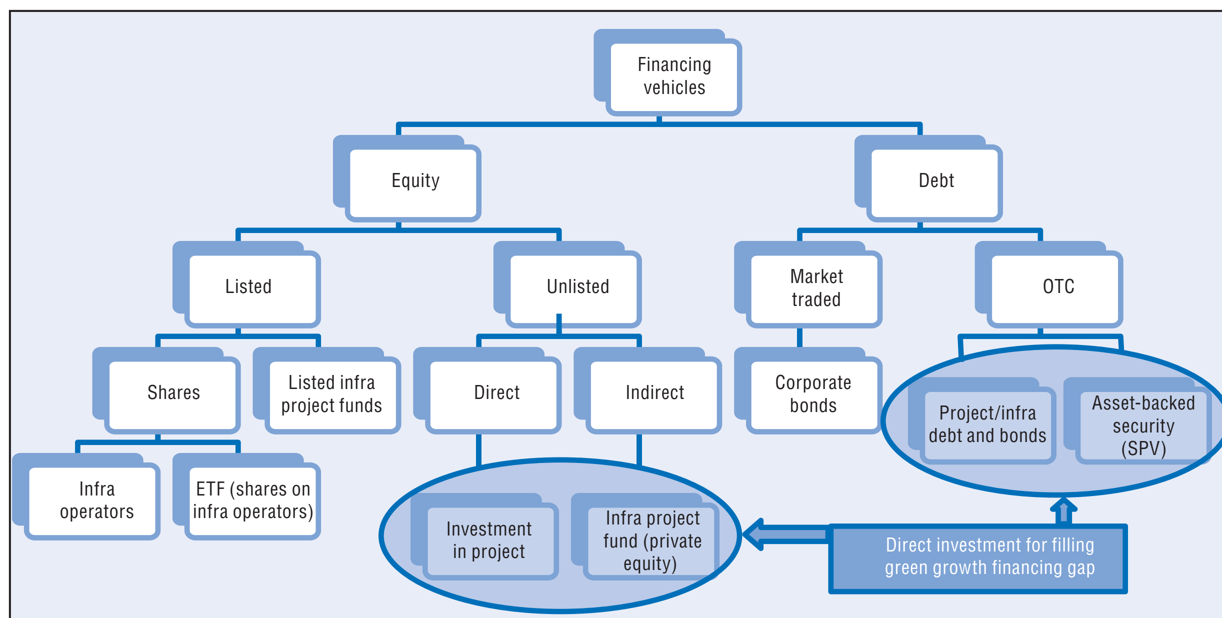
Source: The City UK, Financial Market Series: *Sovereign Wealth Funds 2012*, DB Global Markets Research.

Outside the OECD, in Asia in particular, Sovereign Wealth Funds (SWFs) have recently emerged as major players in capital markets, with assets over to USD 4 trillion at the end of 2011 and a long-term, strategic orientation in their investments.

But given the often fiduciary nature of these assets, and the long time horizons and risks involved in infrastructure investments (including regulatory risk and environmental and climate policy risk), some obstacles need to be overcome to tap these resources. To make the point, note that currently less than 1% of pension funds' assets are allocated to infrastructure investment, let alone to green projects. The key to increasing institutional investor allocation to green infrastructure is to make sure that green investments are competitive on a risk-return basis. Investors with fiduciary responsibilities will not make an investment just because it is green – it also has to deliver financially.

This can be achieved by designing appropriate instruments, as indicated in Figure 6, also involving Public-Private Partnerships (PPPs) or other forms of guarantees that provide the risk/return profile that institutional investors need to manage the risks specific to clean energy projects.

Figure 6. **Main vehicles for filling the green growth financing gap**

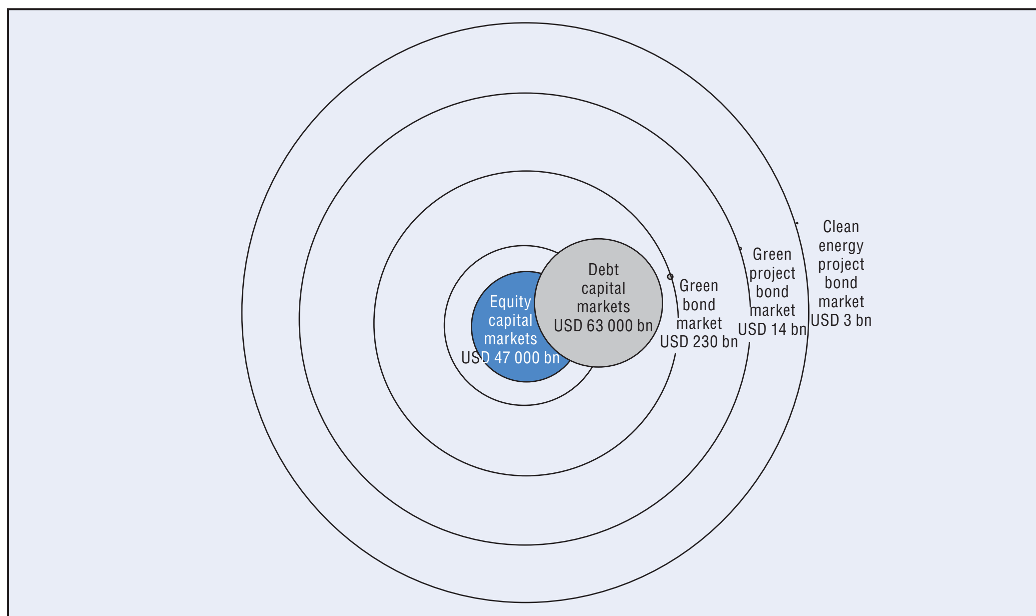


As one can see in Figure 7, the current size of the "green bond" market is very small as compared to the overall market. But at the same time this also means that there is a lot of potential for scaling up green bond issuance – and, in fact, it needs to be radically expanded if we are to meet climate change mitigation and green growth goals. But progress is being made – with investor groups coming together to use their scale and build their expertise in clean energy investment. From the public and private sectors, actions are underway to scale up green bond offerings, create risk-mitigating public finance mechanisms, green investment banks and co-investment funding structures. These initiatives need to be encouraged, carefully monitored, and expanded where successful.

A few specific areas were the OECD is engaged fostering long-term, green investments in the Asian region should be mentioned. First, in co-operation with the Indonesian government under the auspices of the APEC (Asian Pacific Economic Cooperation) Presidency, the OECD plans to hold a conference in this country in 2013 on "Infrastructure Financing in Indonesia" with participants from the Indonesian government and central

Figure 7. **Global capital market sizes in perspective**

In USD billion



Source: Bloomberg New Energy Finance, Bank for International Settlements, Citi.

bank as well as local and international investors. This is an important initiative, given the infrastructure needs not only of Indonesia but in Asia more generally. In 2012 ASEAN set up an Infrastructure Fund that will help finance the development of road, rail, power, water and other critical infrastructure needs which are estimated at about USD 60 billion a year.

The OECD has also partnered with ASEAN in undertaking Investment Policy Reviews (IPRs) of its members. Past reviews include Viet Nam (2009) and Indonesia (2010), while Malaysia and Myanmar are currently undertaking IPRs. This contributes to strengthening the regional dialogue on investment policy, and in our context it is noteworthy that both the Malaysia and Myanmar IPR will include a chapter on the investment framework in support of green growth. Integrating such green investment chapters can benefit host governments of all developing and emerging economies, by encouraging better investment policy coherence in the area of green growth.

Moving forward work on investment in clean energy infrastructure we are currently developing a "Policy Guidance for Investment in Clean Energy Infrastructure" that identifies key policy issues for consideration by governments throughout the design and implementation of policy measures for clean-energy investment. The Policy Guidance draws on the OECD Policy Framework for Investment (PFI), the most comprehensive multilaterally-backed instrument to date for improving investment conditions.[4] Elaborated in 2006, the PFI addresses some 82 questions to governments in 10 policy areas to help them design and implement sound policy measures to create a truly attractive, robust and competitive environment for domestic and foreign investment. Support to host governments based on the Guidance can take the form of country-level Investment Policy Reviews, but also for instance of capacity-building programmes for infrastructure investment.

The OECD will also continue to lead work on defining and understanding the potential for green bonds and other vehicles suitable for long-term institutional investors, and investigate and highlight market distortions which hamper international investment in green energy, including FDI restrictions in the energy sector.

The OECD also intends to expand international consultation on policy recommendations for improving regulatory and policy incentives, as well as corporate governance, for institutional investments in Green Growth.

3. Financial market development and co-operation in Asia

Among many regional initiatives in Asia, financial cooperation has very much developed since the Asian crisis in 1997/98.

In 2000, the Chiang Mai Initiative was established under the ASEAN+3 (ASEAN plus China, Japan and South Korea) framework. This currency swap arrangement among East Asian countries was set up by finance ministers and central bank governors to deal with short-term foreign currency liquidity problems and to supplement the existing international facilities. As these bilateral swaps have grown in terms of nominal value, in May 2009 (effective 24 March 2010), this arrangement was upgraded to the Chiang Mai Initiative Multilateralization (CMIM) through which the swap arrangements have been multilateralised. The total value had risen to USD 240 billion in 2012.

To further strengthen the CMIM, it is essential to enhance the organisational capacity of the ASEAN+3 Macroeconomic Research Office (AMRO), established in Singapore in 2011 as an independent surveillance unit to contribute to effective monitoring and analysis of regional economies, early detection of risks, and effective decision-making of the CMIM.

As one of the projects implemented under the new OECD Strategy on Development, in September 2012 the OECD Development Centre organised the first Roundtable with AMRO in Singapore. We invited around 100 participants from Asian countries to discuss the impact of euro area uncertainty on Asian economies and new growth models in Asia. Enhancing such collaboration with regional mechanisms in Asia could be an important contribution of the OECD to the region.

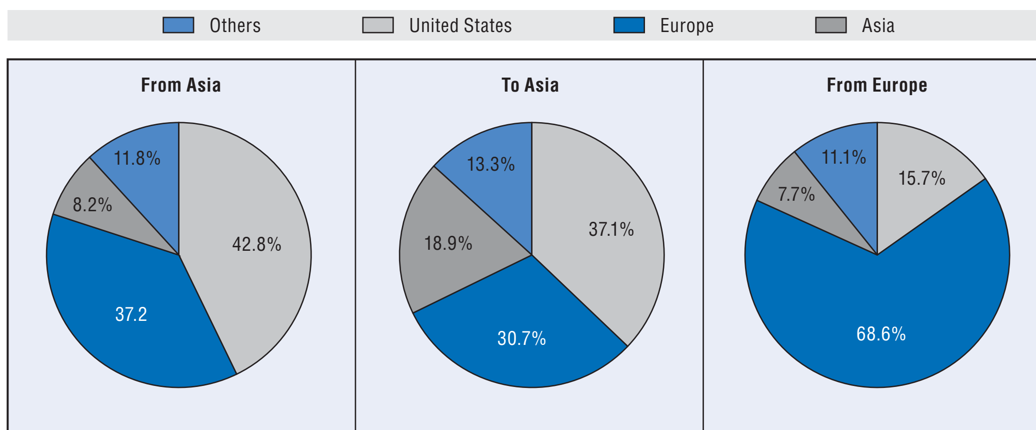
In fact, our engagement in the region has been long-standing. For example, in the aftermath of the Asian financial crisis, the OECD, jointly with the Asian Development Bank Institute (ADBI), established the OECD/ADBI Roundtable on Capital Market Reform in Asia ("Tokyo Roundtable") which has been held annually since 1999. By providing a forum for discussion for experts and policy makers the Roundtable also supports the development of local capital markets. This is important as still only less than 10% of the high Asian savings are invested in the region (Figure 8) and financial intermediation in Asia remains bank-dominated (Figure 9).

III. Concluding remarks: "going forward"

So where do we go from here? Let me just share a few further thoughts to conclude. As pointed out in the introduction, Asia is providing lots of opportunities for the OECD as well as the global economy. The OECD plans to continue and extend its long-standing co-operation with the region; not only with key partners; but also regional organisations like the ADB and ASEAN. We have recently (on 27 September 2012) signed a Framework Agreement with the Indonesian government for co-operation in various policy areas and to establish an OECD liaison office in Jakarta.

Figure 8. **Asian portfolio investment is still largely non-regional**

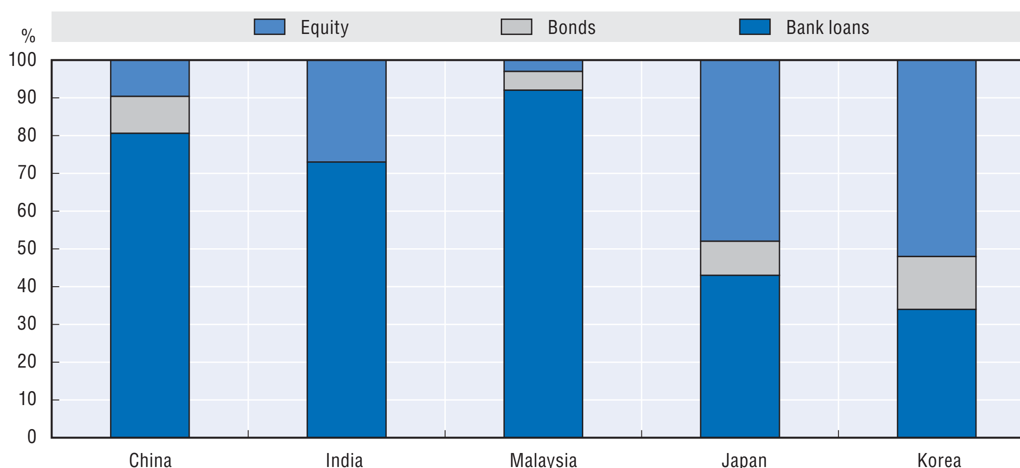
Direction of portfolio investment



Source: IMF, Coordinated Portfolio Investment Survey (CIPS), as cited in Yoshino (2012).

Figure 9. **Financial intermediation in Asia remains bank-dominated**

Equity, bonds and bank loans, as shares of total



Source: Shigesuke Kashiwagi, Nomura Holdings Inc., FSA Financial Research Center International Conference, Japan, Tokyo, February 2011, as cited in Yoshino (2012).

Policy co-operation is especially important given the various long-term economic, demographic and societal challenges that Asian policy makers need to address. As societies grow older (China will face the ageing problem sooner than others) the need to provide care for the elderly increases, and continued strong growth may widen income disparities.

At the same time, growth in income and production will increase the "carbon footprint" of these societies. Thus, growth will need to become more inclusive and "green", and the investment policies that are necessary for this are outlined above. Green growth is the only option we have if economies are to advance at a global level and emerging economies are to catch up to advanced levels.

All this will require implementing effective medium-term reforms in a wide range of areas such as agriculture, health care, education and skills, infrastructure, taxation, and support for small and medium-sized enterprises (SMEs).

The question then is also in how far, in a globalised world, should challenges for the region be addressed by a regional approach? As Europe has shown, regional trade integration can help to foster not only valuable regional trade links, but can also help countries to better exploit and develop their comparative advantages and raise productivity by competing and trading with their peers. Furthermore, regional integration both requires and underpins liberalisation of domestic markets. Economic liberalisation and tariff reductions in ASEAN and APEC in the past have been driven by competitive pressures for regional economic integration and enhanced regional trade.

Intra-regional integration in ASEAN has gradually strengthened and interregional inflows of foreign direct investment (FDI) have increased dramatically. Such integration can be reinforced by further harmonising rules and regulations, while tendencies of a "wrong convergence" towards more regional protectionism need to be curbed.

In short, the challenges are manifold, but I am optimistic that Asian policy maker will tackle them. The OECD has been offering advice in many of the policy areas concerned, and the OECD stands ready to enhance its cooperation with the region.

Notes

1. OECD (2012b).
2. See, for example, Shimada and Yang (2010).
3. See *www.oecd.org/finance/lti*, also for some background papers, e.g. Della Croce (2011) and Della Croce et al. (2011).
4. See *www.oecd.org/daf/investment/pfi*.

References

Della Croce, R. (2011), "Pension Funds Investment in Infrastructure: Policy Actions", *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 13, OECD Publishing; *http://dx.doi.org/10.1787/5kg272f9bnmx-en*.

Della Croce, R., C. Kaminker and F. Stewart (2011), "The Role of Pension Funds in Financing Green Growth Initiatives", *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 10, OECD Publishing; *http://dx.doi.org/10.1787/5kg58j1lwdjd-en*.

Della Croce, R., F. Stewart and J. Yermo (2011), "Promoting Longer-term Investment by Institutional Investors: Selected Issues and Policies", *OECD Journal: Financial Market Trends*, Vol. 2011/1.

OECD (2010), "Financing Transport Infrastructure Development", *Southeast Asian Economic Outlook 2010*, Chapter 6, prepared by Naoyuki Yoshino; OECD Publishing, *http://dx.doi.org/10.1787/9789264096004-en*.

OECD (2012a), *Global Value Chains: OECD Work on Measuring Trade in Value-Added and Beyond*, note prepared for the conference Global Value Chains in the 21st Century, Beijing, September (mimeo).

OECD (2012b), *Southeast Asian Economic Outlook* 2013; OECD Publishing, Paris; *http://dx.doi.org/10.1787/saeo-2013-en*.

OECD (2013), *Measuring Trade in Value Added: An OECD-WTO joint initiative*, and OECD-WTO TiVA Database, at *www.oecd.org/trade/valueadded*.

Shimada, T. and T. Yang (2010), "Challenges and Developments in the Financial Systems of the Southeast Asian Economies", *OECD Journal: Financial Market Trends,* Vol. 2010/2.

Yoshino, N. (2012), "Global imbalances and the development of capital flows among Asian countries", *OECD Journal: Financial Market Trends*, Vol. 2012/1.