



11th Asia Europe Economic Forum

What can Asia learn from Economic Reforms in Europe?

Tokyo, Japan

5-6 December 2014

Summary of Proceedings

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Introduction

The 11th Asia Europe Economic Forum (AEEF) brought together leading scholars from Asia and Europe to discuss pressing issues from an Asian and European perspective. The theme of the conference was “What can Asia learn from economic reforms in Europe?” The conference was organized under the auspices of the Asian Development Bank Institute (ADBI). The other five AEEF members (Bertelsmann Foundation, Bruegel, CEPII, Chinese Academy of Social Sciences, and Korea University) contributed with speakers and panelists. The participants included active and former senior policymakers, recognized academic experts, and private sector specialists. Below is a summary of all sessions and keynote speeches of the 11th AEEF.

Session I: Macroeconomic and Financial Policy at a Crossroads

In the first session, the speakers discussed monetary policy decisions in Asia and Europe. Guntram Wolff (Director, Bruegel) began with an overview of the main characteristics of the current crisis in the eurozone, ruminating on the parallels with Japan’s Lost Decade. He pointed out that the specter of a European lost decade is already a *fait accompli*, as more than half a decade has already passed since the slowdown of economic growth in Europe, and even if the right remedies were implemented soon, a decade would have elapsed before seeing any hypothetical recovery. He further highlighted that European performance since the global recession followed Japan’s post-bubble trajectory very closely along various indicators. The financial sector continued to be frail, enfeebled by low profit and rising nonperforming loans. According to Mr. Wolff, the most worrisome factor was tentative indicators that Europe is falling into a disinflationary mood. Finally, Mr. Wolff said that the general contours of an appropriate policy response were well understood. The United States (US) had now mostly recovered from the Lehman crash, partly because of its swift and decisive macroeconomic and banking policies. By contrast, the response of eurozone authorities had been less focused, with the European Central Bank not accounting for deflationary risks, and so problems in the banking sector may be poised to resurface. In such an event, the recovery path would be considerably more daunting as the prospects of the world economy would likely be more uncertain.

Masahiro Kawai (Project Professor, Graduate School of Public Policy, University of Tokyo) gave an update on Abenomics as it reached its 2-year mark. He began by reviewing the necessity for Japan to return to nominal economic growth to avert a sovereign debt crisis. To this end, Abenomics was designed to slay the deflationary mindset and create a virtuous cycle of investment. According to Mr. Kawai, after 2 years, the first signs of success could be observed. Japan had already experienced several quarters of nominal growth as a result of inflation and increased corporate investment. In addition, the unemployment rate had been falling so that Japan was approaching full employment. He noted that in the viability of Abenomics had been called into question recent months, mostly due to the adverse impact of the consumption tax hike from 5% to 8% in April and to the negative effects of high import prices on import-intensive industries. Although the deleterious impact on the following quarter had been anticipated, data from the third quarter of 2014 subverted all expectations by showing continued contraction. Mr. Kawai admitted that with two consecutive quarters of negative growth, Japan was technically in recession. However, he emphasized that Japan should not back down but rather continue its commitment to Abenomics as the deflationary mindset was more deep-rooted than previously anticipated.

Guonan Ma (Non-Resident Scholar, Bruegel) made the case for monetary easing in the People's Republic of China (PRC) as growth began to slow in the PRC. He acknowledged that this was an unconventional standpoint as there were fears of overheating an economy that was expected to enjoy high growth rates for the foreseeable future. However, Mr. Ma listed several reasons that supported his idea: first, he noted that in contrast to its peers, the People's Bank of China has been far more restrained so far and that there was latitude for monetary easing. Second, he reminded that even if the PRC continued to grow at high rates, in relative terms, the drop in economic performance has been larger in scale than any of the other large economies. Third, he recalled that inflation was slowing down. The consumer price index (CPI) and producer price index (PPI) have dropped steeply over the past 2 years which was hurting Chinese competitiveness. Finally, according to Mr. Ma's application of the Taylor rule to the PRC economy, monetary easing was justified. According to his interpretation of current events, the People's Bank of China was already easing its monetary policy but in a stealthy manner by using nontraditional tools. All that remains was for the bank to clarify its intentions overtly.

Keynote Speech 1: Changyong Rhee (Director, Asia and Pacific Department, International Monetary Fund)

Changyong Rhee gave an overview of Asian economic prospects in the medium term. Mr. Rhee first noted that for all world regions, the International Monetary Fund (IMF) had to revise downward its growth forecasts with the exception of Asia and the Pacific which remained resilient on the whole. Nevertheless, Mr. Rhee raised potential risk factors at play. Economic activity was slowing down and financial volatility always constituted a risk in the region. These

conditions might be exacerbated by several other factors, according to Mr. Rhee. Although the recent precipitous decline in oil prices was a boon for the region overall, there was a risk for Asia's oil-producing countries as well as those seeking to escape deflationary pressures. Moreover, Mr. Rhee argued that while the economic slowdown in the PRC was a welcoming trend in that it put the country on a more sustainable path, the PRC's slowdown put pressure on the entire region to adjust as the country has been a traditional engine for regional growth. Furthermore, Mr. Rhee warned that an imminent normalization of US monetary policy presented another potential challenge.

Session II: Structural Reforms: How to Revive Growth in Asia and in Europe?

Lorenzo Codogno (Director General, Treasury Department, Ministry of Economy and Finance, Italy) began with an extensive recapitulation of the various problems facing nations in the eurozone. He told the audience that, with the exception of a few bright spots, most of the largest economies in the European Union (EU) were still struggling to find a path back to recovery with most not having yet recovered from the slump in 2008. He reminded the audience that public debt was still growing, which made fiscal consolidation a necessity. To permit the start of fiscal tightening, a restoration in finance and investment needed to take place but, for various reasons, this was not yet happening. In his opinion, the right structural reforms, in concert with good monetary policy, were necessary for a return to a growth path. Although structural reforms take time to bear fruit, the immediate impact of a successful program was that it boosted confidence and changed expectations. Reviewing his own national experience, Mr. Codogno examined the aspirations of Italian reformists. These included broad reforms of the government, tax system, and labor markets.

Jean Pisani-Ferry (General Commissioner, French Prime Minister's Policy Planning Staff and Professor, Hertie School of Governance) discussed the particulars of structural reform. He argued that the necessary structural reforms differed country by country. As he pointed out, structural reforms were meant to affect the supply curve which could eventually depress prices. In his view, this would be troubling because, while they needed structural reform, European countries also needed to escape disinflation. Therefore, in an environment where macroeconomic conditions were inauspicious, the best way to proceed was with reforms that were supply neutral, according to Mr. Pisani-Ferry. In practice, such reforms may be those that supported demand or were neutral on the supply side, such as establishing new rules on technology standards and increasing the retirement age. He concluded that governments needed to be judicious about their reform tactics in poor economic conditions.

Mr. Fan He (Deputy-Director, Chinese Academy of Social Sciences) had similar insights on the challenges of structural reform in the PRC. Because the PRC was currently exiting its export-based fast growth model, the need to find a new way forward was urgent. Mr. Fan argued

that in addition to being unsustainable, the extant model had proven unbalanced, leaving the PRC with a widening income gap and rampant environmental problems, among other things. He contended that the PRC needed to build an economy that depended more on consumption and less on investment. For Mr. Fan, the path forward rested on the shoulders of the services sector, which already accounted for the largest share of Chinese employment. He maintained that unlocking the potential of the services sector was the key to long-term prosperity. However, economic policies in the PRC tended to benefit infrastructure building and heavy industry, not those sectors that are labor intensive. To eliminate inefficiencies, Mr. Fan recommended that the PRC nurture the competitiveness of the services sector, even if it meant paring down part of the growth stimuli. To overcome this trilemma, he proposed that the PRC begin a course of reform in the health-care sector. He noted that health care must be reformed inevitably due to Chinese demographics. Pouring investment into this sector would not have the downside of overcapacity because the appetite for health care was, for all intents and purposes, limitless. Mr. Fan hoped that more health-care spending would create new job opportunities and open the pathway to more structural reform down the line. He concluded by stating that by targeting the health-care sector the government would increase its credibility and anchor public expectations in the long run.

Session III: The Interplay between SME Development and the Financial Sector in Asia and Europe

Junghan Koo (Director, Consumer Finance and Protection Division, Korea Institute of Finance) opened the session with a review of how small and medium-sized enterprises (SMEs) were financed in the Republic of Korea. He reminded the audience that although SMEs have played a prominent role in national employment and in the total number of firms, they were nearly inactive in the capital markets and their contribution to the economy was falling. In 2001–2011, the export share of SMEs fell by half. Moreover, he showed that the equity-to-asset ratio of SMEs was lagging compared to large enterprise peers. Mr. Koo explained that, although the primary finance channel remained lending from financial institutions, reliance on government support had been on the rise since the global economic and financial crisis, reflecting the struggle to overcome the resultant deterioration of SME credit. Mr. Koo showed that in the Republic of Korea government support for SMEs as a percentage of gross domestic product (GDP) was the third highest among member countries of the Organisation for Economic Co-operation and Development (OECD). In Mr. Koo's opinion, government support was justified because SMEs were critical to employment but faced unfavorable lending conditions as a result of low collateral and short business histories. Mr. Koo admitted, however, that there had been several downsides to this volume of government intervention. For example, excessive support had crowded out market-based lending, as SMEs increasingly relied on government guarantees. Furthermore, it discouraged the restructuring of inefficient SMEs by keeping them alive with interest rates below

free market value. SMEs also lost the incentive to grow as they would no longer qualify for government support once they reached a certain size.

Federico Galizia (Deputy Director, Head of Risk and Portfolio Management, European Investment Fund) delivered an overview of the European Investment Fund (EIF), a multilateral institution of the EU that accounted for the majority of SME finance in Europe. In addition to the provision of finance, Mr. Galizia outlined how the EIF played many other roles shepherding SMEs from their inception throughout their growth (to which the EIF currently contributes 20%). He explained how the EIF was able to perform these functions because it worked beyond its own resources as a coordinator that mobilized many actors across the entire economy. For example, to support SME innovation, the EIF worked with corporations, the European Commission, and other relevant authorities to help shape and develop SME business concepts. To expand its own lending capacity, the EIF worked with many banks and other financial institutions, he explained. By vetting firm ideas from the start, SMEs were better prepared to apply for loans. Mr. Galizia elaborated how the EIF was currently attempting to widen the range of the products it had on offer, as well as developing more partner relations to carry out its mission, targeting the support of 100,000 SMEs every year.

Naoyuki Yoshino (Dean, Asian Development Bank Institute) shared some of his ideas for improving the lending situation for SMEs. He noted that for the entire Asian region, SMEs were critical and essential to the economy. He reminded that SMEs were, however, usually forced to resort to risk-averse banks for lending, which generally meant that the potential for SME contributions to the economy was depressed by access to finance. Mr. Yoshino then described several potential ways to circumvent this problem. A longstanding bugbear for would-be SME lenders was the lack of reliable performance data. Mr. Yoshino explained that the typical SME did not keep accounts in a sophisticated manner because of a lack of understanding or resources. Without good records, it became very difficult for SMEs to borrow. Mr. Yoshino elaborated on how policymakers in Japan were able to establish a credit risk database of SMEs and to promote financial education among SMEs, thus leading to improved bookkeeping. Mr. Yoshino suggested that such measures would probably be very effective elsewhere and thus improve access to credit for SMEs. He further detailed that for the category of riskier borrowers, alternative investment funds were necessary. One such innovation, deployed in the aftermath of the Great East Japan Earthquake, was the hometown investment trust fund. Mr. Yoshino explained that rather than seek funding through traditional channels, municipalities had helped recovering small enterprises go directly to local residents to borrow based on individual projects. For example, small energy projects like windmills or agricultural initiatives received funding based on the promise of a set return. In Mr. Yoshino's view, such creative measures were necessary to extend finance to places where traditional outlets of financial intermediaries would not reach.

Keynote Speech 2: Masatsugu Asakawa (Director General, International Bureau, Ministry of Finance, Japan)

Masatsugu Asakawa gave his view of several major issues in the economies of Asia. He began by reviewing Abenomics, going through some of the indicators on the effect it has had on deflation. Although much more remains to be done, he insisted that the early signs were promising that there would be a sustainable shift in the deflationary mindset. While recent periods of contraction and a decline in inflation had caused some consternation, staying the course would eventually bear fruit, according to Mr. Asakawa. However, even if Japan reversed the disinflationary mood, the problem of public debt had to be addressed with fiscal consolidation and prudent structural reforms. In addition, Mr. Asakawa ruminated on the state of Asian financial integration and cooperation. The Chiang Mai Initiative (CMI) was a regional fund meant to relieve Asian nations facing financial crisis. While this was a good step, he emphasized that more needed to be done.

As was pointed out in subsequent discussions, there were uncertainties with respect to the operability of the CMI as it had never been activated. Moreover, the opportunity to conduct tests was not clear because the majority of the fund was tied up with IMF action and the remainder was bound on the condition that the beneficiary nation was not engaged in poor macroeconomic policy. As a result of these limitations, more cooperation and dialogue between the region's stakeholders needed to take place, Mr. Asakawa stated.

Session IV: Globalization and Income Distribution

Jianwei Xu (Associate Professor, School of Management, Beijing Normal University) opened the session on a talk concerning the impact of globalization on inequality in the PRC. His study set out to answer two questions concerning income: The first goal was to determine whether there was a difference in wages between exporting and non-exporting firms and the second objective was to determine whether or not exporting firms give a skilled wage premium over non-exporting firms. The study presented by Mr. Xu confirmed that exporting firms paid more than non-exporting firms across the sample set. Moreover, he found a clear skill premium in the data; the higher one's education level, the higher the comparative increased. This relationship was further elucidated when filtering for the type of firm; those in research and development (R&D) intensive industries and in more productive businesses tended to exhibit a greater wage premium.

Andreas Esche (Director, Bertelsmann Foundation) discussed the impact of globalization from a macroeconomic standpoint in Germany. He started by mentioning that the literature theorized that globalization exerted downward pressure on costs by increasing competitive pressures. He then described that since the 1970s the change in Germany's labor productivity

had consistently been higher than the rise of real GDP due to an increase in the capital intensity of production. As a consequence, labor input was reduced and real wages had been stagnant, in contrast to increasing capital income. He explained that this trend led to a widening income disparity between capital income households and those with only labor income, hurting purchasing power on the whole. This, in turn, depressed consumption and investment, holding back economic growth potential. In his conclusion, Mr. Esche asked whether there was a way to reduce income inequality without hurting a country's competitiveness.

Guanghua Wan (Principal Economist and Head, Poverty-Inequality Research Group, Asian Development Bank) approached the question of globalization's impact on income distribution by attempting to determine the impact of trade and foreign direct investment (FDI). Using statistical analysis, Mr. Wan determined that there was proof of trade and FDI contributing to inequality over the past two decades in the PRC. Moreover, the data suggested this was a rising trend. He also investigated the trade-off between efficiency and equity with the aim of determining whether or not globalization and FDI were good overall for the general welfare. Mr. Wan found that while both factors were correlated with rising inequality, they both had a significant contribution to social welfare as they promoted growth. He concluded that for the time being, globalization had a net benefit for the PRC and Asia.

Session V: Strengthening the World Trading System: Multilateralizing Regional Trade Agreements

Gabriel Felbermayr (Professor, Ludwig Maximilian University of Munich and Director, Ifo Center for International Economics, University of Munich) discussed the future direction of multilateral trade agreements by examining the example of the Transatlantic Trade and Investment Partnership (TTIP). He explained that the rationale of TTIP was to reap the benefits of close integration with the world's two largest economic blocs, the EU and the US. In addition to the near elimination of all tariffs, TTIP's ratification would liberalize trade in services and investment, open the long contested issue of public procurement, and lead to regulatory cooperation. Mr. Felbermayr's projections indicated that TTIP would have a prodigious impact on the income levels of both the US and the EU. Mr. Felbermayr proposed five ideas to ensure TTIP was development-friendly. His suggestions included the simplification of rules of origin, the harmonization of technical standards, open regulatory councils, avoidance of trade diversion, and that TTIP should be open to additional partners or a merger with other free trade agreements.

Innwon Park (Professor, Division of International Studies, Korea University) evaluated the state of regional trade agreements (RTAs) in Asia and the Pacific. He explained that, contrary to expectations, RTAs had not led to unhindered growth because negotiating partners had been creating various agreements haphazardly. The result was a situation that he described as the "spaghetti bowl phenomenon" where many interlocking and overlapping agreements encroached

upon each other with complicated rules, preventing the full efficient utilization of the various agreements. According to Mr. Park, this phenomenon is exacerbated by deepening value chains, prompting governments to look at other ways to negotiate trade agreements, through the so-called mega-RTAs such as the Trans-Pacific Partnership (TPP). Mr. Park doubted, however, whether this was an especially promising pathway to a new global trade regime as fitting together the existing RTAs seemed very difficult. To alleviate these problems, he said that it was necessary to increase the utilization rates of RTAs and to this end prescribed several solutions all with the aim of simplifying the trade rules. His hope was that with less stringent rules or more harmonized rules, there would be fewer obstacles in the way of utilizing the market access that was nominally guaranteed by the trade agreement.

Sebastien Jean (Director, Centre d'Etudes Prospectives et d'Informations Internationales) started his presentation by discussing how trade volumes within RTAs had increased strongly, albeit unevenly across continents. He further showed that unilateral trade liberalization had played a prominent role in opening up international trade. Due to the successful trade opening through regional and unilateral efforts, the stakes in multilateralism were declining, according to Mr. Jean. To ensure that regionalism was not conflicting with multilateralism, he argued that the currently envisaged mega trade agreements should avoid excessively complex and tough standards and should strive to establish rules that are friendly to third parties. This would open the pathway to fitting these regional agreements within a larger global context down the line and avoid turning them into isolated trade blocs. In order to advance the multilateral trade talks, Mr. Jean recommended limiting the ambitions and abandoning the principle of single undertaking.