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Contents

Table of Contents

Articles

Servicization in East Asia..... 4

Ting-Kuei Kuo (郭庭魁)

*Assistant Professor, Graduate Institute of Technology Management,
National Taiwan University of Science & Technology*

An Elusive Quest: The Future of an East Asian Community..... 12

Eric Chiou (邱奕宏)

Associate Research Fellow, TIER

Strengthening Regional Economic Integration the APEC Way.. 17

Chen-Sheng Ho (何振生)

Associate Research Fellow, TIER

The Green Growth Discourse in APEC..... 22

Wayne Chen (陳威仲)

Associate Research Fellow, TIER

State of World Economy 27

Darson Chiu (邱達生)

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Serviceization in East Asia

Ting-Kuei Kuo (郭庭魁)

In the late 1990s, leading firms in the advanced developing countries of East Asia particularly Korea and Taiwan began to confront a difficult strategic dilemma (Hobday, 2003). Should they attempt to compete with the leading Western firms as R&D, market or brand leaders, or should they continue with the tried and tested formula of low cost competitiveness under the contract manufacturing arrangement? Some companies chose contract manufacturing such as Quanta, Compal and Foxconn, whilst some chose to develop their own branding such as Acer. For each firm in the two categories, they all began to offer certain types of services to their customer as an added value or new business. Branding companies have to develop distribution and marketing services for their consumers. Contract manufacturing firms start to offer design service and logistic service to their customers. Innovation in manufacturing has continued ever since, including notable examples such as Total Quality Management, Business Process Reengineering, Mass Customization, Balanced Scorecard, Open Innovation and so forth. One of the latest trends, service business development in manufacturing firms has become an emerging phenomenon (Neely, 2007). This research aims to explore the fundamental research question how manufacturing firms reconfigure their innovation capability in developing service business (referred to as serviceization hereafter).


Valuable as services are to manufacturing firms, there are clear signs of difficulties in achieving benefits from them. Neely (2007) observed that hybrid manufacturing firms were 2.7 times more likely to go bankrupt than their peers who remained in pure manufacturing. A study of 477 manufacturing firms during 1990-2005 (Fang, Palmatier & Steenkamp, 2008) suggested that return on service strategies did not materialize until service sales accounted for over 20% of the total revenue. It highlights the considerable effort that may be required if any service initiative is to succeed.

Despite such warnings, concerns over the success of servicization have not received sufficient attention from the literature (Olivia & Kallenberg, 2003). Given the increasing prevalence of servicization, in-depth studies are urgently needed to offer a better understanding of the phenomenon and to provide guidance for practitioners who have responsibility to manage the process of service business development. Servicization is regarded as a key area for exploration in both the fields of manufacturing and service research (Bowen & Hallowell, 2002; Slack, 2005).

This following section provides an overview of the field and examines its historical development as to probe the research question. First, it identifies the driving force and evolution of servicization. Then, the unique characteristics of innovation in developing countries are portrayed to identify the theoretical gap in innovation.

Evolution of servicization

Service business development in manufacturing firms, or in short servicization, has drawn pervasive interest from industry and academia over the past few decades. It is not a transient phenomenon; it has been driven by at least four enduring forces: customer orientation, market evolution,



outsourcing, and development in technologies and methods. The first driver is the change of company orientation toward the marketplace (Kotler, 2003). Firms were suggested to operate as "a-customer-satisfying process, not a goods-producing process" (Levitt, 1960). In other words, what manufacturers make "is not something people buy, but a tool they use – a tool solve their problems or to achieve their intentions" (Levitt, 1972). Recognising the rising market power on the customer's side and the growing competition on products, manufacturers began to realize that service can play an important role in satisfying customers and winning the competition (Vandermerwe & Rada, 1988).

The second driving force that has led to the rise of service business in manufacturing firms is the evolution of the market. As products approach market saturation, further growth in the existing market becomes difficult and in response, firms are under pressure find new ways of value creation (Slywotzky, 1996). In addition to technology development, geographic expansion, and industry diversification, developing and selling services become an attractive option.

The trend of outsourcing is the third factor that motivates servicization. Since the late 1980s, business organizations have adopted a strategy to focus on core competence and outsource the rest to external suppliers (Prahalad & Hamel, 1990). Meanwhile, the concept of single sourcing became popular, which underscored long-term business relationships as opposed to the traditional approach of multiple sourcing. These trends have given manufacturers enormous opportunities to grow beyond products.

Last, the vast development of technologies and management techniques has enable manufacturing firms to provide services that are markedly improved than before. The improvement in product design makes products more reliable and easier to maintain and repair (Goffin & New, 2001). The

application of information and communication technologies leads to remote services and make service work cost-effective (Allmendinger & Lombreglia, 2005). Management techniques have also played an important part in service business development.

The servicization phenomenon has been driven by the manufacturer's orientation shift, the market evolution, the trend of outsourcing and the advances in technologies and techniques. As servicization became increasingly common in manufacturing industries, it gradually drew attention from academic research.


Although a diverse range of concepts have been developed over time to understand the servicization phenomenon, the literature is largely fragmented. The lack of cross reference has led to difficulties in tracing the evolution of the literature. Prior research (Ren, 2009) followed an iterative process of database search and domain analysis, managing to identify three stages of development in the servicization literature. These three stages are illustrated in Table 1.

Table 1: Three stages of servicization literature

• Pre-1980	Servicization as an element in the marketing mix
• 1980- late 1990s	Servicization as a change of management logic and as a potential route to growth
• Late 1990s- present	Servicization as a business line in its own right and has implications for capabilities and organizations

Innovation in NIEs

Innovation has different characteristics in newly industrialised economies (NIEs) than it has in developed economies. The unique trajectories of innovation in East Asia present a reversed pattern of product and process



innovation. Previous studies provide perspectives on how NIEs can catch up technologically with developed economies, but they offer little advice about how to develop the market and service business. The need to explore issues of innovation management in newly industrialised countries, such as Korea and Taiwan, is recognised by scholars such as Hobday and Kim (Hobday, 1995b; Hobday, 2005; Kim, 1997).

There is a substantial body of research on the progress and performance of firms in East and South East Asia (Amsden & Chu, 2003; Ernst, 2004; Hobday, 1995a; Kim, 1997; Lazonick, 2003; Wong & Mathews, 2005). Kim and Utterback (1983) discovered that the patterns of evolution in firms' organizational characteristics such as technology and structure, differ in developing countries from the typical findings in developed countries, such as the U.S. and the U.K. They argue that a new industry in developing countries is often initially established in response to a market opportunity, and is created and protected by a government import substitution policy. Due to a lack of technological capability and market incentives, few indigenous efforts are undertaken in terms of product and process innovation. The sequence of innovation events (engineering, development and research) is reversed from that typically observed in developed countries (Hobday, 2005; Kim, 1980a)

This research question will make several important contributions to the literature of service science and innovation management, particularly in the context of developing economies. The industrial evolution toward servicization is a relatively recent phenomenon, and academic literature on the subject is in the very early stage of development. Scholars have only just begun to highlight the need for scholarly research of the phenomenon of this evolution (Hobday, 2003; Hobday, 2005; Kim, 1980b, 1997, 1998; Kim & Utterback, 1983; Kim & Mauborgne, 1999; Lin, 2004). This study will

present several studies attempting to develop a comprehensive understanding of the innovation capability reconfiguration of firms for servicization. The research specifically provides perspectives of (a) how manufacturing firms in developing economies evolve over time, and (b) how they reconfigure their innovative capability. The increasing awareness of Asian firms in the global marketplace warrants a systematic understanding of their business evolution (Dedrick & Kraemer, 2008; Foster, Cheng, Kraemer & Dedrick, 2006; Shin, Dedrick & Kraemer, 2008). Thus, this research makes a new and important contribution by providing a descriptive and explanatory theory which illuminates how firms reconfigure their innovative capability.

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An Elusive Quest: The Future of an East Asian Community

Eric Chiou (邱奕宏)

The evolution of regional integration in East Asia has been characterized by its messy process and manifold courses since the end of the Cold War. Although various approaches have been either proposed or undertaken to accelerate the pace of regional integration in East Asia, the long-term objectives behind these actions seem to gradually converge on one common goal: to establish an East Asian Community (EAC). The concept of the EAC is hardly a new idea. In 2000 the East Asian Vision Group (EAVG) had made a recommendation to the leaders of the Association of Southeast Asian Nations (ASEAN) and of China, Japan, and South Korea the idea of establishing an EAC. However, the realization of the EAC largely remained on the paper and no significant progress had been made.

Until 2009 the idea of the EAC was revitalized, mainly due to two former prime ministers' new initiatives to add some momentum to the process of regional integration. The former Australian Prime Minister Kevin Rudd was vigorously engaged in restoring Australia's leading role in Asia. In September 2009 he proposed the idea of building an "Asia-Pacific community" (APC) to strengthen the existing dialogue and cooperation mechanism between leaders. Before long, the former Japanese Prime Minister Yukio Hatoyama initiated his version of an "East Asian Community" in November 2009, aiming to establish a regional cooperative framework, based on European experiences,


to cover issues such as trade, climate change, disaster relief, energy, and environment.

Although at that moment both initiatives seemed to shed a silver lining and invigorate the long-delaying progress of regional integration in East Asia, two years after, few significant achievements have been accomplished. It seems that both initiatives were brought into the grave with the step-down of their advocates in both nations. Nevertheless, a lack of improvement in the EAC does not slow down the rapid pace of deepening economic interdependence in the region by any means, nor does it undermine individual state's efforts to enhance economic linkages with neighboring countries by signing free trade agreement (FTA) in East Asia.¹

In fact, many existing or new initiatives toward enhancing regional integration have been undertaken. There are largely five different groupings of economic integration arrangements in the region. The first bloc of regional economic integration is the ASEAN Free Trade Area (AFTA), covering ten ASEAN states. The second grouping is based on the members of ASEAN-plus-Three (APT), forming an East Asia Free Trade Area (EAFTA), which was one of nine long-term measures by the East Asian Study Group (EASG) and adopted by APT in 2002. In 2006 Japan proposed the Comprehensive Economic Partnership in East Asia (CEPEA), including thirteen APT members, India, Australia, and New Zealand.

In comparison with the aforementioned ASEAN-centered groupings of economic integration, the U.S.-led Trans-Pacific Partnership (TPP) has also made remarkable progress in recent years and continues adding new members, such as Malaysia and Vietnam. Furthermore, other countries, like

¹ For example, China-ASEAN Free Trade Area (CAFTA) started to implement in 2010. U.S.-Korea Free Trade Agreement was signed in early 2011.



Canada, Japan, and the Philippines, have expressed their interests to join the negotiation. Finally, the broadest arrangement of economic integration is APEC's Free Trade Area Asia-Pacific (FTAAP). In 2011 APEC has declared that ASEAN+3, ASEAN+6, and TPP are possible pathways to FTAAP. Hence, the composition of FTAAP not only includes APEC's 21 economies, but also covers some countries, like India, Laos, Myanmar, and Cambodia, which are not part of APEC.


Despite so many integration initiatives in the region as mentioned above, it seems clear that the regionalism based on ASEAN (i.e., ASEAN-centered East Asian regionalism) has been a driving force for three groupings of regional economic integration, in which the rivalry between China and Japan generates competing initiatives of EAFTA and CEPEA. On the other hand, APEC's FTAAP as a long-term goal of economic integration in Asia-Pacific region has been added some momentum by the U.S.-led TPP. By making TPP as a new "high quality and standard" free trade agreement, the United States not only attempts to restore its leadership in East Asia, but also intends to undermine any formation of East Asian regionalism that excludes the role of the U.S. Essentially, APEC recognizing the arrangements of ASEAN+3, ASEAN+6 and TPP to be possible pathways to FTAAP reveals the U.S. strategy of utilizing TPP to balance and compete with existing ASEAN-centered free trade arrangements.

From the above analysis, it is not difficult to capture the shadow of power politics behind each initiative of economic integration. Due to great powers' competition for leadership in this region, this dynamics generates various regionalisms and develops at least five existing arrangements to promote economic integration. Nevertheless, the challenge to the formation of the EAC is not because of a lack of regionalism initiatives or existing interstate cooperation mechanisms, but due to a lack of consensus on what an

EAC should be and how to achieve this goal. Furthermore, a hidden reality underneath a variety of competing regionalisms in East Asia is a power struggle between leading states in the region.

Essentially, the confrontation between two structural powers (land power vs. sea power) has been shaping the direction of East Asian development. In the aftermath of the Cold War, these two structural powers, backed by different major powers have resulted in different regionalisms, which further evolve into five ongoing projects of economic arrangements. However, among these feasible options toward the EAC, EAFTA and TPP can be two promising alternatives to achieving the goal of the EAC after the demise of Hatoyama's EAC proposal and Rudd's APc initiative. This is because the composition of major players and their internal interaction mechanism increase their prospects of success. EAFTA contains major players, such as China, Japan, and ASEAN. Hence, the key of its success hinges on whether China and Japan can overcome their mutual distrust and move together toward the same goal of achieving the EAC. On the other hand, due to close security and political ties between the U.S. and Japan, TPP may eventually include Japan and cover two main regional players. Nevertheless, the critical precondition for TPP to become the solid foundation of a future EAC depends on China's participation. As a consequence, these two alternatives, though having potential to become the cornerstone of a future EAC, are still facing some critical challenges that should be resolved.

In the end, the pursuit of an EAC remains an elusive quest. It is not because of a lack of economic incentives to promote it, but because of overwhelmingly geo-political consideration over the rationale of economic interests. As the gravity of the world economy gradually shifts to East Asia, power struggle over the issue of regional integration between major players is likely to be acute and intense. This development is not beneficial to facilitate




the formation of the EAC. Hence, in the near future, we may witness a disturbing reality that deepening regional economic interdependence in East Asia coexists with incomplete, separate, and competing proposals of economic regionalisms. Consequently, the full-blown realization of the EAC may still have a long way to go and may be difficult to be fulfilled in the foreseeable future.

Strengthening Regional Economic Integration the APEC Way

Chen-Sheng Ho (何振生)

In the beginning of APEC's existence, APEC's aim was to enhance economic cooperation in the Asia-Pacific region. This initial stage began in 1989 with the creation of APEC and lasted until 1994. The second stage started with the development of the Bogor Goals in 1994. Since the creation of the Bogor Goals, APEC has worked to achieve them through the implementation of individual and collective actions in the areas of trade and investment liberalization and facilitation (TILF) and economic and technical cooperation (ECOTECH).

In recent years, APEC has entered the third stage of its existence when it begins to discuss the possibility of creating a Free Trade Area of the Asia-Pacific (FTAAP). Additionally, APEC has sought to strengthen regional economic integration (REI). With the initiation of new goals in addition to the Bogor Goals, there is the need to analyze these APEC goals and their relationship to each other. The purpose of this article is to examine the goals relating to the APEC REI agenda, so as to provide a clear understanding of APEC's work. An analysis of APEC goals must also take into account the APEC decision-making process and the APEC structure. The interactions of the triangular relationship among goals of APEC REI agenda, decision-making process and structure result in the strengthening of APEC REI.



The third of stage of APEC's existence will be the focus of this article because it includes all the major elements for advancing APEC REI. The main work will be to refine the three elements, so that they are able to smoothly interact with each other. The first element to be examined is the goals of the APEC REI agenda. The most significant goal of the APEC REI agenda is the Bogor Goals. The Bogor Goals call for APEC developed economies to achieve free and open trade and investment by 2010 and developing economies to do so by 2020. The rationale is that free trade in the APEC region will enable APEC economies to increase their trade among themselves, so that APEC REI is enhanced. APEC has also called for the creation of an FTAAP in the future. Thus an FTAAP is another goal of the APEC REI agenda. It has stated that ASEAN+3, ASEAN+6 and TPP could serve as pathways to FTAAP. Furthermore, the third main goal of APEC REI agenda is the advancement of next generation trade and investment issues focusing on SMEs, supply chain and innovation policy.

The relationship among the aforementioned three goals needs to be analyzed, in order to determine their position in the APEC REI agenda. The first goal of APEC in the immediate future should continue to be the Bogor Goals. APEC's assessment of the Bogor Goals in 2010 indicated that more work to be done even though progress had been made. Therefore, APEC must continue to seek the achievement of the Bogor Goals, so as to show the world that APEC is serious about accomplishing its goals.

The second goal of APEC should be the advancement of next generation trade and investment issues. The purpose of the second goal is to serve as a bridge for the realization of the third goal, the FTAAP goal. This means that APEC can develop FTA model measures for next generation trade and investment issues in the areas of SMEs, supply chain and innovation policies.


With the building of APEC FTA model measures, APEC will systematically

pave the way for the eventual realization of an FTAAP. It is also suggested that APEC can enlarge the list of next generation trade and investment issues and then to generate FTA model measures for those issues.

The third goal of the APEC REI agenda should be the creation of an FTAAP. APEC has stated that this is a long-term goal. However, the challenges facing the WTO Doha Round negotiations could encourage APEC members to show greater support for an FTAAP. Presently, APEC considers ASEAN+3, ASEAN+6 and TPP to be pathways to an FTAAP. There is the strong likelihood that TPP would become the primary pathway to an FTAAP, because the TPP already includes members from both sides of the Pacific Ocean and they are all APEC economies. On the other hand, ASEAN+3 and ASEAN+6 consist of members from Asia. Thus it would be easier and more logical to make the TPP becomes the model for an FTAAP.

The second element affecting the enhancement of APEC REI is the APEC decision-making process. Since the creation of APEC in 1989, APEC has ensured that decisions are made on the basis of consensus. All APEC members must support the implementation of collective actions, in order to proceed. In the case where a few members do not support an action initially, other APEC members will need to apply peer pressure. Most of time, it may also be necessary to revise the plan for an action, so that it will be accepted. In the end, an action may be different from the initial plan but it becomes acceptable to all APEC members because their views are taken into consideration. The inclusion of both developed and developing economies in APEC means that all actions must be carefully cultivated and beneficial to all APEC members.

Furthermore, the APEC decision-making process also incorporates the non-binding principle. A decision that has been endorsed by APEC members may not need to be implemented. There is no penalty for not physically



implementing an action. Thus an action must be developed in such a way that it will be easy for all APEC members to implement. The result is less failure and more active participation from APEC members in the actions' implementation process.

The third element that influences the strengthening of APEC REI is the APEC structure. APEC has created various fora to discuss TILF and ECOTECH issues. In the case of REI, all APEC fora are involved. The strengthening of APEC REI is one of the main themes of APEC in 2011. The REI agenda will continue to remain important for APEC because APEC is about enhancing REI in the Asia-Pacific region. At the present moment, there is no need to create a new APEC group to discuss the REI issue. However, once the achievement of the FTAAP goal becomes the center of attention in APEC, then it may be necessary to develop a new group focusing on advancing FTAAP.

After separately analyzing the three elements that affect the advancement of the APEC REI agenda, it will be useful to examine their interactions holistically, so as to derive suggestions for APEC. The APEC decision-making process and the APEC structure has reached maturity, so that there is high degree of certainty that they cannot be changed. APEC members will certainly proceed with great care. This means that the attainment of the three REI goals consisting of Bogor Goals, next generation trade and investment issues, and FTAAP must proceed in a systematic manner.

It is suggested that APEC continues to seek the achievement of the Bogor Goals in 2020. In 2012, APEC could begin to generate FTA model measures for next generation trade and investment issues. APEC would follow closely the development of ASEAN+3, ASEAN+6 and TPP, as these FTAs could provide the basis for APEC's FTA model measures. This action would serve to prepare APEC for the eventual creation of the FTAAP.

Furthermore, it is suggested that by 2015, APEC would decide which one of the three regional undertakings (ASEAN+3, ASEAN+6, TPP) would serve as the model for APEC's FTAAP. Finally, from 2015, APEC members will be able to join the FTAAP, as long as they are capable of meeting the FTAAP requirements. By the year 2020, the deadline for the attainment of the Bogor Goals, APEC members will decide whether or not to completely transform APEC into an FTAAP or to continue with enlarging the FTAAP and also maintaining APEC at the same time.



The Green Growth Discourse in APEC

Wayne Chen (陳威仲)

APEC, given the deliberation on environmental issues from 2007, and declaration of 'Promoting Green Growth' to be one of three priority tasks for 2011, showed that its green agenda was conducted to cope with Climate Change, map out low carbon development pathway for the Asia-Pacific region and explore for future green order by following market-based approaches and meanwhile attempt to continue proceeding regional economic integration. Noticeably, the green growth 'discourse' in APEC is much related to economic security under which individuals economies express in accordance with existing domestic economic activities and interests.

This article illustrates how green growth was discussed at the first Senior Officials' Meeting (SOM1) hosted by US in Washington D.C in March, where interests of member economies was reflected by their propositions, and how the 'security discourse' influenced economies' standpoints in discussion of APEC green growth agenda, particularly in identifying future actions.

The 4 primary tasks of green growth were concluded in the SOM Chair Letter Post-SOM1 are:

- 1.Promoting Trade and Investment in Environmental Goods and Services.
- 2.Streamlining Import Procedures for Advanced, Low-carbon Demonstration Vehicles.
- 3.Combating Trade in Illegal Logging.

4. Phasing Out Inefficient Fossil Fuel Subsidies.


Promoting Trade and Investment in Environmental Goods and Services

This work is very much connected to WTO's efforts in promoting environmental goods and services (EGS) focused on aligning international trade and climate mitigation actions. The US argued that reducing Non-Tariff Barriers (NTBs) and Non-Tariff Measures (NTMs) is essential to boost market access of EGS. Trade in relation to the automotive industry should be more emphasized.

Although promoting EGS as an objective was greatly agreed by most participants, which methods should be taken vary among member economies. China, for instance, suggested that APEC should view the EGS issue from a development perspective, and, beside market access, knowledge dissemination, capacity building and technological cooperation are no less important than promoting market access for APEC economies. On the other hand, Peru suggested that natural resource should also be considered as environmental goods and to be encouraged under the green growth agenda.

Streamlining Import Procedures for Advanced, Low-carbon Demonstration Vehicles

Streamlining Import Procedures of Low-carbon Demonstration Vehicles was not discussed intensively at SOM1, but in the 14th Automotive Dialogue (AD). There were 3 main stands reflected by discussion of the Low-carbon Demonstration Vehicles in the 14th AD. Improving energy security and efficiency was the main reason the APEC Energy Working Group (EWG) promotes low-carbon demonstration vehicles, and therefore, while EWG



was also focused on biofuel and infrastructure. Some economies, e.g. Thailand and Chinese Taipei, emphasized green technology, innovation and government policy for transforming transport sector; and US is more focused on accelerating import procedures for low carbon demonstration vehicles.

Combating Trade in Illegal Logging

Forest management and land use were more marginal issues in APEC which was focused more on conventional economic activities, e.g. regional economic integration, trade and investment, before the Sydney Declaration in 2007. Afterwards forest work gradually obtained its significance in APEC economic agenda as reflected by the 2007 and 2010 APEC Leaders' Declaration which state that "(APEC) will enhance work on meeting the aspirational goal of increasing forest cover in the region by at least 20 million hectares of all type of forests by 2020."

The Establishing an APEC Strategy on Illegal Logging and Associated Trade initiative was proposed by Indonesia and the US aiming at enhancing forest management by enforcing regulations on related market activities. Another important event for APEC forest actions in 2011 is the First APEC Forestry Ministerial Meeting to be hosted by China in September which would analysis and assessment of forest resources in Asia and the Pacific, exchange experiences and lessons learned from forest policies and actions among APEC economies, and establish further practical cooperation mechanism to achieve the regional forest goal.

Dissimilar to other green growth actions, the Combating Illegal Logging initiative as well as the First APEC Forestry Ministerial Meeting was greatly supported by developing economies. Chile, Indonesia, Mexico, PNG and Peru emphasized that forest management should be of APEC priority works.

Furthermore, eco-tourism and the Reducing Emissions from Deforestation and Forest Degradation (REDD+), which is a compensation mechanism for forest conservation in mitigating climate change, and is promoted mainly under UNFCCC were touched upon in discussion.


Phasing Out Inefficient Fossil Fuel Subsidies

The reform of subsidies, proposed by New Zealand, was more a controversial issue in deliberating green growth despite it was already recognized as a crucial action in enhancing energy security and green growth by other multinational negotiations, e.g. OECD. Michael Froman, the SOM Chair accented that reducing inefficient fossil fuel subsidies is crucial to improve energy security and efficiency for APEC region, however, some economies were skeptical due to this policy may impose pressure on livelihood of vulnerable people.

China, Malaysia and Korea expressed deep concern for that phasing out fossil fuel subsidies may undermine welfare and livelihood of the poor in societies. Capacity building and knowledge dissemination, China says, should be centered in subsidies reform. On the other hand, Canada, Brunei and Thailand are supportive regarding this initiative. Singapore offered a more balanced touch on this issue by highlighting that APEC should assist to reduce 'inefficiency' rather than 'fossil fuel subsidies'.

Green growth: a discourse divided by economies of differentiated economic activities

Deliberation of green growth at SOM1 demonstrated that APEC member economies recognized green growth as a new engine for local



economic development and promoting international trade. Their stands, therefore, in related discussion were very much subject to their own economic development and existing local economic activities. Developing economies would like to see APEC enhancing capacity building, knowledge dissemination, and technology cooperation. On the other hand, developed economies are more focused on promoting market access and international trade.


Despite different methods in implementing green growth agenda resulted from these two standpoints, APEC economies still follow conventional economic approach in pursuing green future. Radical transformation of the established economic order, which is the free market economy and often blamed for environmental degradation, would rarely be initiated from such 'econocentric' soil.

State of World Economy

Darson Chiu (邱達生)

As said by recent international economic statistics and data, we may see that high unemployment rates in advanced countries in Europe and America remain. European and American economies are striving to improve their fiscal conditions; nevertheless, their economic growth gradually slowed down. In the mean time, they also need to deal with other negative effects. Europe has not yet completely eliminated the threat of sovereign debt. The Obama administration is trying to fix the budget and reduce the risk of increasing public debt, but the administration has to negotiate with and convince the opposition party first. Raw material and crop prices go up due to the climate factors. The geopolitical factor originated from the Middle East and North Africa making the global inflation even more serious as the oil prices also surge. As inflation has been the major problem for most advanced and emerging economies, a severe earthquake and tsunami hit Japan on the 11th of March 2011. The catastrophic incident induced more uncertainties to the global economy.

By comparison, the current US economic recovery is more robust than the Euro area and Japan. The US Bureau of Economic Analysis (BEA) has recently issued an upward revision on the real GDP growth rate of the 4th quarter of 2010. The revised rate compared with the same period in 2009 was 2.8%. That means an additional 0.1 percentage points. The GDP growth



looks fine, but the unemployment is still a problem. The unemployment rate of March 2011 was 8.8% according to the US Department of Labor. The rate was 8.9% in February. It means that the US job market is gradually improving, but in an extremely slow pace. Inflation is also a problem for the US, but Fed decided to continue its 2nd quantitative easing measure as planned due to high unemployment.

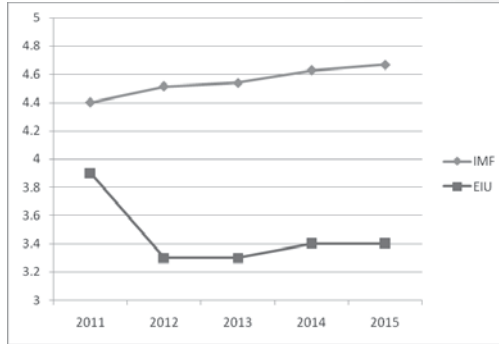
The European Central Bank (ECB) adopted a different approach. In response to the inflation pressure, ECB started to tighten its monetary policy by raising benchmark interest rate one quarter point from 1.0% to 1.25%. The reason was because the Euro zone consumer price index (CPI) annual growth rate reached 2.7% in March 2011; therefore, ECB decided to adopt tightening operation despite of a 9.9% unemployment rate.

The March 11 earthquake and tsunami impacted on the Japanese economy to a certain degree. Because of unstable power supply, decline of tourism, shutdown of plants in impacted area, Japan's economy in the short term is indeed not quite optimistic. However, the reconstruction is likely to bring new business opportunities in growth momentum to Japan and her neighboring economies. For Japanese, the natural disaster shattered their consumers' confidence for sure, but the damage on the long term economy is unsure.

As for China and other emerging markets, inflation is the number one problem. Most advanced economies that are dealing with cost-push inflation; however, the inflation facing emerging economies is originated from both cost-push and demand pull factors. According to the Chinese Bureau of Statistics data, China's economic growth rate was 9.7% for the 1st quarter of 2011. China's growth momentum was mainly from domestic consumption and investment. Although the growth in China is currently very strong, but there is also a 5.0% consumer prices rise to be handled. The People's Bank of China has been trying to tighten its monetary policy and shall continue to do so.

Global Economic Outlook and Potential Challenges

Graph 1: World Real GDP Growth Forecasts (%)



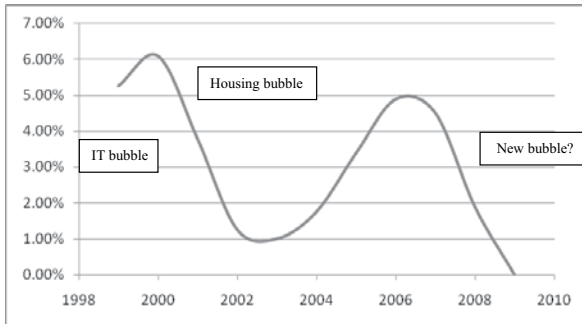
Source: IMF, World Economic Outlook Database and EIU Data Services.

According to the recent forecasts issued by IMF and EIU, the global economy will be growing steadily. IMF is however more optimistic. IMF forecasted that the aggregate GDP of the world this year will be 4.4% more than the total GDP of last year, and the growth will continue for the next 4 years. EIU is not as optimistic, and the agency forecasted that a drop of growth will happen in 2012. However, EIU predicted that the world economic growth can remain stable for the next 3 years from 2012 on.

The real GDP growth is not a problem in the near future. The problem will have two folds, unemployment and inflation. When both indicators go up meaning that the misery index also goes up. Misery index initiated by Robert J. Barro, a famous Harvard economist, is an index widely referred by theorists and decision makers to measure economic and social performance of a country, in other words, the living quality of citizens. The index that combines the unemployment rate and inflation rate is supposed to be an

objective reference, a reference that we can rely on and trust. The only exception is when the aggregate demand shrinks and the economy is dealing with deflation, then the implication of misery index will be twisted. The higher the misery index, the more painful the people should be. When more people are in pain, it is more difficult for people to trust the government. When the trust is gone, geopolitical matters emerge. Middle East and North Africa countries that involved in the recent geopolitical turmoil all have double-digit misery index.

Graph 2: the US Fed Monetary Policy (3-month moving average)



Source: US Federal Funds Rate, Board of Governors of the Federal Reserve System.


For most people, jobless recovery is not even a "bona fide recovery". As mentioned earlier in this article, the recovery of job markets would be slower than the revival of economic production and outputs. Global recessions in periods of 2000-2001 as well as 2007-2009 were in fact followed by jobless recoveries of most economies in the world. The key problem would be structural unemployment. The business cycles would cause structural change making higher structural unemployment, and the job opportunities before the change are now simply not there to any further extent. As a result, in order

to meet the new needs, job training is more important than real GDP growth. The unemployment is more of a structural but cyclical type. Basically, structural unemployment is a problem facing not only advanced countries but also emerging economies.

The business sectors of advanced countries are not quite certain about future demands after the crisis. They are especially not sure about whether or not the demands were created by stimulus policies. Therefore, they tend to be extra cautious about investing further and hiring more employees, since future profits are uncertain. Emerging economies are also coping with structural unemployment, due to the fact that structural change has been continuously set off by their high growths (see graph 1). For example, their agricultural outputs over GDP ratio is very like to decrease and their services sectors are more prone to develop further.

The other major challenge is the notorious inflation. As we all know that inflation can be made from cost-push or demand-pull. If it's cost-push, it would be mainly from the surging of energy and food prices, and we call it imported inflation. If it's demand-pull, then it can be the beginning of a potential bubble. A sloppy tightening policy may make the bubble burst and trigger another crisis. A careless loose operation could invite a hyperinflation, which is almost impossible as the central bank will never let it happen. For the time being, advanced countries such as the US and Euro area are combating cost-push inflation, whereas emerging economies like China, India, and Indonesia are dealing with cost-push and demand-pull inflation.

China's 12th 5-year-plan is seeking an economic structural change changing her economy from export-oriented to more internal demand based. China's monetary operations have been on a continuous tightening process by adjusting key interest rates and required reserve ratios upward. The monetary policy will be more effective when the People's Bank of China



further appreciates RMB. It also makes sense to do so, since the appreciation of RMB can help with the planned structural change.