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for Asia-Pacific **Prosperity**

Structural Reform for Resilient and Inclusive Growth

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Key Messages

- **The world economy continues to confront risks and uncertainties while trade growth is slowing down.** From stock market and exchange rate volatilities to commodity price falls and slower GDP growth, the global economy has not looked so fragile since the Global Financial Crisis (GFC) of 2008. Moreover, for the first time in the past 25 years, trade growth has been lagging behind GDP growth in the APEC region for three years running. Based on the data, trade growth doesn't seem to be the driver of GDP growth that it used to be.
- **The slowdown in the responsiveness of GDP growth to trade is not cyclical but structural.** An analysis of GDP growth elasticity with respect to trade and internal sources of demand shows that the reduction in trade elasticity is a process that has been going on over 15 years. This lends credence to conjectures that the gains from liberalization and economic integration initiatives in the 1990s have run their course. On the other hand, the responsiveness of GDP growth to private consumption increased markedly after the 2008 GFC, implying that household demand—rather than trade or government spending—is the main driver of growth in the APEC region in recent years.
- **Based on this finding, it seems that future APEC growth lies in strengthening household consumption through structural reform.** Structural reforms pertain to policies that allow an economy to use its resources more efficiently and increase productivity. Moreover, structural reforms enable an economy to be more flexible in reallocating resources across sectors. These reforms should also aim to increase the disposable incomes of households in order to encourage domestic consumption as a resilient engine of growth..
- **Numerous studies show that structural reforms not only contribute to raising productivity, they also help make growth more inclusive.** Empirical findings show significant economic and employment gains from structural reforms such as fiscal rationalization, human capital investment, social protection, trade liberalization, financial market reform, labor flexibility, and institutional development. Structural reforms can also open up opportunities for women and vulnerable communities, increase competitiveness, and encourage innovation.
- **APEC has shown progress in its structural reform agenda, and is implementing several initiatives in the pursuit of resilient and inclusive growth.** For example, the 2011-2015 APEC New Strategy for Structural Reform (ANSSR) is a significant step towards the right direction in identifying strategic actions and points of cooperation to cohesively move forward with its structural reform agenda. In 2015, new initiatives for structural reform are being pursued, such as those prioritizing science and technology education; enhancing competitiveness in the services sector; fostering MSMEs' participation in regional and global markets; and strengthening connectivity across APEC economies. Going forward, APEC's structural reform agenda could focus on identifying new sources of growth (e.g., through innovation and MSME development), investing in human capital development, and improving infrastructure and connectivity.

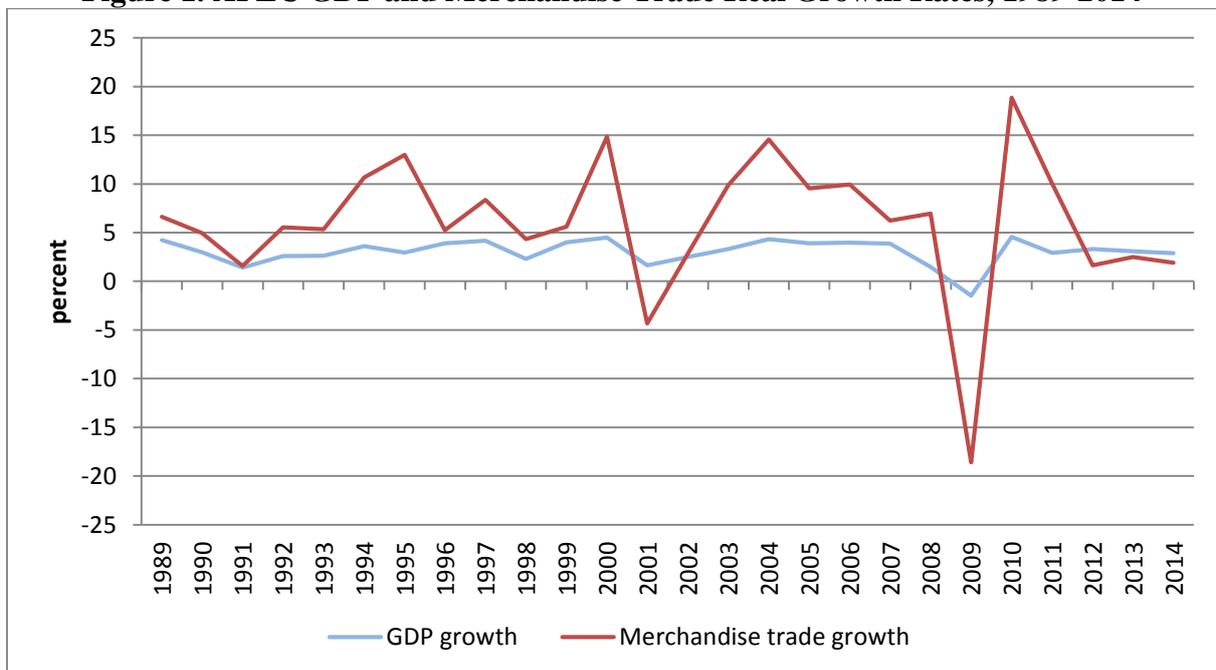
Structural Reform for Resilient and Inclusive Growth

Not since the Global Financial Crisis (GFC) of 2008 has the global economy faced so many uncertainties as it does now. In Europe, the Greek debt saga continues to cloud uncertainty over the Eurozone. In the United States, the good news of a slow but steady recovery is muted by apprehensions over monetary policy normalization and the resulting increase in interest rates. In Japan, monetary expansion and fiscal flexibility, which were successful in bringing the economy out of protracted disinflation, have not yielded the desired impacts on real economic growth. Meanwhile, low and falling commodity prices are threatening growth in major commodity exporters such as Indonesia; Malaysia; and Russia. Even China, whose rapid growth propped up the world economy during recent crises, is facing slower economic growth and experiencing volatility in its stock markets and exchange rates.

Adding to these uncertainties in international markets is the growing

observation that trade is no longer the driver of economic growth as it once was. A study by Constantinescu, Mattoo and Ruta (2015)ⁱ shows that trade growth is slowing down in recent years, and this may not be a cyclical event but a structural shift. That is, the slowdown in trade growth is not only due to temporary movements in global markets, but is indicative that the gains from trade liberalization and reforms of the 1990s have run their course. Indeed, a quick analysis of APEC production and trade data lends credence to this observation. Since APEC's establishment in 1989, there have only been two years when APEC trade growth was markedly lower than GDP growth: in 2001 during the dot-com bust and in 2009 in the aftermath of the GFC (Figure 1). However, since 2012, trade growth has been lower than GDP growth for three years running—for the first time in the APEC region, trade growth is consistently lagging behind GDP growth.

Figure 1. APEC GDP and Merchandise Trade Real Growth Rates, 1989-2014



Source: WDI data and APEC PSU estimates.

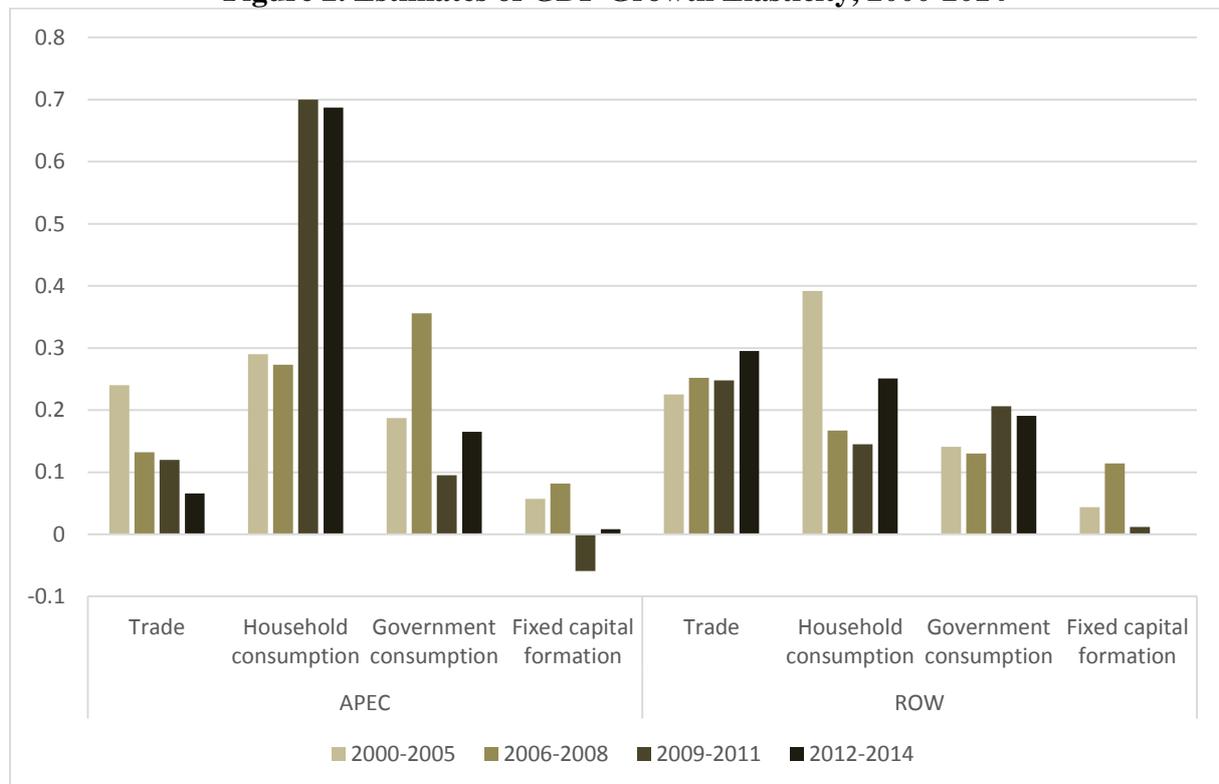
A slowdown in trade growth is a concern for policymakers as trade is a source of external demand, which can encourage domestic production and employment. Without a reliable source of external demand, economies may find it difficult to sustain economic growth. As a result, economies are looking for drivers of growth that are less vulnerable to the whims of international markets and less susceptible to spillovers from shocks in other economies. While manufacturing and commodity exports have been reliable sources of growth in the 1990s and 2000s, economies are now looking into new sources of sustained growth.

If not trade, what is the alternative?

If growth will not come from external demand, where then will it originate? The

immediate answer is internal demand, but internal demand can be many things. Based on the definition of GDP, internal demand could come from private household consumption, government consumption, or investment—which of these are more likely to drive growth in APEC economies? To answer this question, we estimate the elasticity of GDP growth with respect to trade and various sources of internal demandⁱⁱ for APEC and non-APEC economies over the period 2000-2014. The results, presented in Figure 2, show that the correlation between GDP growth and trade growth has been falling in APEC economies over the period. On the other hand, the household consumption elasticity of GDP growth remarkably increased in 2009-2014 in the aftermath of the GFC.

Figure 2. Estimates of GDP Growth Elasticity, 2000-2014



Note: ROW = rest of the world (i.e., non-APEC economies). Estimates show how a 1% increase in the x-axis correlates with GDP growth in percentage terms (e.g., a 1% increase in trade in APEC economies in 2000-2005 is correlated with 0.24% increase in GDP). Elasticities are derived through a fixed effects panel regression using robust standard errors. Estimates for fixed capital formation are not statistically significant.

Source: WDI data and APEC PSU estimates.

These results show that the reduction in the responsiveness of GDP growth to trade growth in APEC economies has been ongoing over the past 14 years; however, the major shift towards internal sources of growth—particularly household consumption—only occurred after the GFC.

Figure 2 also shows elasticity estimates for the rest of the world (ROW): results show that, unlike in APEC economies, the trade elasticity of growth in non-APEC economies has been going up over the period. The elasticity results for APEC and ROW seem to point to the idea that global value chain (GVC) consolidation is more advanced in APEC economies than in non-APEC economiesⁱⁱⁱ. Hence, gains from globalization, as measured by the responsiveness of GDP growth to trade, is falling among APEC economies while that for non-APEC economies still has room to increase.

Another notable finding from Figure 2 relates to the elasticity of GDP growth with respect to government consumption: while there is no clear pattern for APEC economies, the ROW yields a more distinct result in that GDP growth has been more responsive to public spending in the aftermath of the GFC. This is interesting because most regions implemented monetary and fiscal expansion measures in response to the GFC, notably quantitative easing in the United States and Europe, monetary base expansion in Japan, and public infrastructure investment in China. It seems, however, that the GDP impact of monetary and fiscal expansion in APEC economies is channeled through household consumption, while it is more direct in non-APEC economies.

Why structural reform?

It is clear in the analysis that in APEC economies, future growth lies in strengthening household consumption. This is where structural reforms come in. In the

context of APEC, structural reforms are often referred to as behind-the-border improvements, as opposed to policy changes that directly affect cross-border trade and investment. More broadly, structural reforms pertain to policies that allow an economy to use its resources more efficiently and increase productivity. Moreover, structural reforms enable an economy to be more flexible in reallocating resources across sectors in response to shocks or structural changes (e.g., technological advancement or demographic shifts). In the case of APEC economies, these reforms should also aim to increase the disposable incomes of households in order to encourage domestic consumption as a resilient engine of growth.

Empirical studies have shown that structural reforms result in productivity and income gains. A study by Bouis et al. (2012)^{iv} on the impact of structural reforms spanning 30 years suggests that while structural reforms are associated with long-term benefits, they also yield short-term positive effects, particularly on employment levels. For example, tax reforms that effectively lower income tax burdens resulted in reduced unemployment levels, triggering stronger female and youth participation. Increased spending on active labor market policies in terms of employment incentives also raised aggregate employment, especially among women and the elderly. Moreover, streamlining product market regulations led to an increase in women's employment rate.

Likewise, a study by Dabla-Norris et al. (2013)^v shows that productivity-enhancing structural reforms lead to sustainable growth and increased income. They also find that the type of reforms needed for economies to grow varies across different income levels. Low-income economies need to strengthen economic institutions, reduce trade barriers, improve basic education and infrastructure, and introduce reforms in the banking and agriculture sectors. Meanwhile, lower middle-income economies require reforms

in the banking and agricultural sectors, but they also need to reduce barriers to foreign direct investments (FDI), increase competition in product markets to enhance the services sector, improve the quality of secondary and tertiary education, and mitigate infrastructure bottlenecks. On the other hand, the key areas of reform for the upper-middle income economies include deeper capital markets, more competitive and flexible product and labor markets, more skilled labor force, and higher investments in research and development to encourage innovation. They further argue that economies which have been successful in implementing the high volume, low-value added assembly operations model largely through the adoption of existing technologies will need to upgrade skills, attain tertiary education and build reliable knowledge infrastructure in order to increase the potential to innovate and to move up the value chain. Thus, the pursuit of sustainable and inclusive growth via structural reforms requires advancing education and knowledge parallel to instituting capacity-building initiatives.

Human capital development, in the form of education and skills training, is also an important contributor to productivity and efficiency, apart from education being a basic human right. Evidence from Aghion and Howitt (2006)^{vi} points to the importance of primary and secondary education to boost an economy's capacity to imitate frontier technology, while tertiary education has a bigger impact on the economy's potential to innovate. Meanwhile, Hanushek and Woessmann (2009)^{vii} find that an increase in an economy's average cognitive test scores is associated with a 1.2 to 2.0 percentage points increase in per capita GDP growth rates; in low-income economies, increasing average math and science scores expands growth rates by 2.0 and 2.3 percentage points.

Significant improvements in productivity, however, will remain inadequate if gains are

not felt across all income levels. While inclusive growth is an end in itself, it also enhances efficiency and promotes resilient growth. Apart from their ability to reduce inequality, social protection programs such as health insurance and unemployment assistance are important for inclusive growth as they allow households to better manage risks (and thereby smooth consumption patterns) and enable them to invest in skills development (UNDP 2013)^{viii}. These, in turn, provide more flexibility to an economy in terms of reallocating labor across sectors by aiding job search and skills matching.

A dynamic and productive micro, small, and medium enterprises (MSMEs) sector also contributes to inclusive growth by being more labor intensive and providing employment opportunities for skilled and unskilled workers. What is important for the economy, then, is to increase productivity in this sector in order to raise worker wages as well as contribute to economic growth. To achieve this, a study by Beck and Demircug-Kunt (2004)^{ix} shows that it is important to develop institutions that protect property rights and enforce contracts, as well as promote a business environment that facilitates firm entry and exit. Ease of market entry and exit for MSMEs will then allow the sector to contribute to efficient reallocation of productive resources due to structural changes.

APEC's Structural Reform Agenda

Since its establishment in 1989, APEC has endeavored to reduce barriers to trade and investment by addressing regulatory issues and streamlining rules and procedures. But in 2004, the region started paying more attention to behind-the border issues with the adoption of the Leaders' Agenda to Implement Structural Reform (LAISR) towards 2010. The LAISR identified five priority areas for structural transformation including regulatory reform, competition policy, economic and legal infrastructure,

public sector governance, and corporate governance.

In 2011, APEC widened the scope of its structural reform agenda with the APEC New Strategy for Structural Reform (ANSSR) with a target year of 2015, adding a social dimension that is aimed at enhancing opportunities for women as well as promoting education and SME development. Specifically, ANSSR focuses on promoting (1) more open, well-functioning, transparent, and competitive markets; (2) better functioning and effectively regulated financial markets; (3) labor market opportunities, training and education; (4) sustained SME development and enhanced opportunities for women and vulnerable populations; and (5) effective and fiscally sustainable social safety net programs. It is worthwhile to note that the ANSSR is not a prescriptive reform agenda that imposes on all APEC economies. Instead, the ANSSR is a reform process that allows individual economies to identify specific priorities given their respective resources vis-à-vis constraints, towards the attainment of the overarching goals of economic and social development.

In 2013, a mid-term review of the implementation of the five priority areas under ANSSR was conducted. The objective of the assessment was to highlight commonalities in the implementation efforts of member economies, and thereby, facilitate intra-APEC knowledge sharing. The mid-term review pointed to the promotion of more open, well-functioning, transparent, and competitive markets as the most common structural reform activity shared by 18 economies. Under this reform area, competition policy—in various stages, from formulation to implementation and broadening to strengthening of existing rules—is the flagship of reform efforts by both developed and developing economies. The second most common reforms were those that promote labor market opportunities, training and education, with

16 economies indicating related actions. Notably, a number of economies worked towards ensuring increased labor force participation rate and better matching of potential employees to available positions. The thrust towards sustained SME development and enhanced opportunities for women and vulnerable communities followed closely with 15 economies listing measures under this reform priority. Indeed, a wide range of economies recognized the need for a vibrant SME sector to provide strong support to broader economic objectives. Reforms that promote effective and fiscally sustainable social safety net programs as well as those that enhance financial markets were the fourth and fifth most common priority areas, respectively. In the case of social safety net programs, constraints in technical and financial capacities form part of the challenges. In addition, the sense of urgency differs between economies as developing economies prioritize the expansion of social programs while developed economies are more concerned about the fiscal sustainability of existing and future programs. Finally, introducing medium- to long-term financial market reforms grapples with continually changing dynamics, especially after the 2008 GFC.

Preliminary findings of the 2015 end-review of the ANSSR reveal that, out of the 17 APEC members so far, around 90 percent implemented reforms that impact on their respective competitive policies and labor markets, followed in ranking by SME development, while social safety nets and financial markets remain as the less widely covered reform areas.

The APEC has also pursued its structural reform agenda alongside initiatives that are geared towards attaining inclusive growth. Although the Bogor Goals of 1994 already mention the pursuit of equitable growth, more explicit attention to inclusive, sustainable, and secure growth was given in the 2010 APEC Growth Strategy endorsed

by Leaders in Yokohama. This strategy of promoting not only rapid economic growth but also inclusive and sustainable growth through structural reform is reinforced in the APEC Accord on Innovative Development, Economic Reform and Growth^x, which was endorsed by APEC Leaders in 2014. The Accord recognizes that deep structural reforms, innovative development, and the identification of new sources of growth are key factors towards unleashing the full potential of productivity and creating an environment that is conducive to sustainable, strong, balanced and inclusive growth.

In 2015, the Philippines as APEC host economy highlighted inclusive growth in its theme “Building Inclusive Economies, Building a Better World”. In particular, the spotlight is on initiatives and drivers that encourage the participation of all members in the region towards inclusive growth. These initiatives include investing in human capital development to help vulnerable communities acquire the skills required to be competitive in an increasingly globalized and digital world and extending assistance to women, vulnerable groups, and indigenous and rural communities to facilitate their participation in global markets via the development of MSMEs.

The inclusion of women and vulnerable groups in the economy forms part of the major reform areas under APEC’s structural transformation agenda. In 2011, the Policy Partnership on Women and the Economy (PPWE) was established to expand and advance the economic integration of women in the APEC region. The PPWE addresses five key pillars that impact on women’s economic empowerment: access to capital, access to market, skills and capacity building, women’s leadership and agency, innovation and technology. Regional efforts towards this end focused on skills development and connecting indigenous women to global markets, improving livelihoods and facilitating entrepreneurship

through vocational training programs, and broadening job opportunities by providing computer skills to vulnerable rural and urban communities.

The Way Forward

In a dynamic global environment where growth drivers are starting to deviate from traditional contributors such as exports, it is essential to implement structural reforms that lead economies away from the low growth trap, and instead towards a sustainable, inclusive and higher growth path.

One important tool that could provide impetus for long-term growth is fiscal policy. A 2015 IMF study^{xi} estimates that fiscal policy can expand growth by 0.75 percentage point for advanced economies, and up to 2.5 percentage points for developing economies. The study identifies four key channels where fiscal consolidation impacts on growth: (1) labor supply, since the tax-benefit system affects decisions on whether to participate in the labor market and how much work to put in; (2) physical capital, wherein investment-friendly taxes bolster public capital spending and encourage innovation with higher savings; (3) human capital, because both tax and fiscal expenditure policies can upgrade human capital stock, directly increasing important inputs to production; and (4) total factor productivity, either by spending or giving incentives for innovative activities.

Fiscal structural reforms, therefore, if implemented with the appropriate pace, scope and policy mix could mean ample policy space to spend on programs that could translate into accelerated growth in the medium- to long-term.

For APEC economies, fiscal rationalization could mean the ability to spend on programs that upgrade the levels of education and skills, increase investments in infrastructure, implement labor market policies that

enhance employment opportunities for women and vulnerable groups, and strengthen institutions. The pursuit of a rebalanced and higher growth trajectory necessitates that APEC's efforts to transform the structural landscape should continue post-ANSSR, that is, from 2016 onwards. These efforts should focus on the following: (1) identifying new sources of growth by promoting innovation and MSME development; (2) investing in human capital development; and (3) improving infrastructure and connectivity.

New sources of growth relate to innovation and entrepreneurship—i.e., knowledge-based capital that could bring about significant turnarounds in productivity and growth. This would mean increasing investments in research and development, patent processing, software, data, skills and capacities, as well as new management techniques and business models, among others. Easy access to financing by innovative firms and new businesses is an important corollary to increased investments. In contrast to physical capital, investments in knowledge-based capital could foster continued growth because aside from raising productivity, economies of scale are realized as costs are not incurred with the reuse of available knowledge and innovations. Hence, in August 2015, APEC conducted the first High-Level Policy Dialogue on Science and Technology in Higher Education^{xii}, which identified strategic actions to support and promote science, technology, and innovation by mobilizing talents and advancing cross-border education and inter-university collaboration.

Innovations have the potential to affect all sectors of the economy by introducing methods and solutions that ease the cost of doing business. In this way, innovations can also enhance the services sector. Since services have a strong presence in global production chains, building the services sector by introducing innovations will not

only enhance APEC's regional productivity, but will also strengthen the region's capacity to move up the value chain. Recognizing the increasing contribution of the service sector to employment and economic growth, the APEC Ministers Responsible for Trade in 2015 welcomed plans to provide a common direction and more coherence in APEC's work on services through the APEC Services Cooperation Framework (ACSF) and APEC Virtual Knowledge Center on Services^{xiii}.

Meanwhile, entrepreneurship, particularly participation of MSMEs, is one avenue where women and vulnerable groups can be more engaged in the economy. Thus, MSME development is an important building block towards inclusive growth. Since MSMEs contribute to employment and income growth, they need to be strengthened in order to adapt to a dynamic business landscape that is characterized by new technologies and inter-connected markets. Actions towards harnessing SMEs as critical partners in development and economic progress include improving the legal and regulatory frameworks to make business transactions simple and easy; upgrading management and entrepreneurial skills towards gainful employment; promoting liberalization and best practices along with enhancing networking skills to widen market access; adopting new and innovative technologies and systems to make MSMEs more competitive; expanding credit access and availability by developing government programs that give incentives for financial institutions to allocate resources for SMEs; and implementing sound and sustainable business practices that will both reduce poverty and improve living standards. APEC endeavors to increase efforts to address barriers to trade and investment that disproportionately impact on MSMEs compared to large firms. As embodied in the Boracay Action Agenda to Globalize MSMEs^{xiv}, APEC economies agree to implement actions that are focused on ensuring MSME's entry in international

markets and integrating them in global value chains.

Crucial to the promotion of innovation and entrepreneurship is investment in human capital development through improving education, upgrading capacities, and preserving their health and well-being. Higher-skilled and better-educated individuals possess the technical know-how needed to conceive innovative designs and systems, utilize existing technologies, and apply business models. Another important component of sustainable and inclusive growth is infrastructure development that results in stronger connectivity. Infrastructure encompasses physical facilities (roads, buildings and power and internet supplies), regulatory frameworks, organizational networks, financial markets, risk management processes, and trade and investment arrangements that are necessary to facilitate the free flow of goods, services, capital and skilled people in the region. The APEC Connectivity Blueprint 2015-2025, endorsed by APEC Leaders in 2014, aims to guide cross-cutting efforts that are expected to translate to significant improvements in business climates, infrastructure development, structural landscape, cross-border education and skilled labor mobility. Addressing issues that will accelerate “at the border” trade liberalization and facilitation, improve the business environment “behind the border” and enhance regional connectivity “across the border” is expected to enhance trade connectivity and economic integration that will benefit all APEC economies.

Concluding Remarks

As trade growth slows down and GDP becomes less responsive to trade growth, economies need to find alternative sources of demand to sustain economic growth. In APEC economies, household consumption is the prominent alternative. This means

policies that can give households more disposable income will be a boost to the economy. However, household income can only increase if real wages or entrepreneurial profits increase through increased productivity.

Fortunately, increasing productivity is, in part, influenced by policy through structural reforms that allow an economy to more efficiently and flexibly utilize resources. The magnitude, pace and coverage of the reform agenda may vary across economies given different resources and constraints, but it is imperative to implement deeper structural reforms in the near-term in order to boost growth in the medium- and long-term. Structural reforms that promote education and skills development, innovation and entrepreneurship, open up opportunities in the labor market, improve the quality of products and services, liberalize frameworks, expand infrastructure investments and strengthen regional and global connectivity will help pave the way towards sustainable and inclusive growth.

With uncertainties in international markets and structural changes slowing global trade prospects, regional economic integration is needed to arrive at a balanced and coordinated approach to address vulnerabilities. Rather than give in to protectionist impulses and hostile economic measures, APEC economies have shown that the impetus for meaningful structural reforms can be achieved through cooperation.

Notes

ⁱ Constantinescu, C., A. Mattoo and M. Ruta. 2015. “The Global Trade Slowdown: Cyclical or Structural?”. IMF Working Paper WP/15/6.

ⁱⁱ Growth accounting is the common way of analyzing sources of growth; however, the methodology for growth accounting is, as the name suggests, an accounting identity: if trade isn’t contributing to growth, then by definition the other factors should be contributing to it. Estimating elasticities is more nuanced by allowing the data to freely calculate correlates to growth: if trade elasticity is low, the other sources of demand are not expected to compensate for it.

ⁱⁱⁱ Note, however, that ROW is the average of various regions including Africa, Europe, and South Asia. It is possible that some regions within ROW also exhibit a high degree of integration.

^{iv} Bouis, R., O. Causa, L. Demmou, R. Duval and A. Zdzienicka. 2012. “The Short-term Effects of Structural Reforms: An Empirical Analysis”. OECD Economics Department Working Papers No.949.

^v Dabla-Norris, E., G. Ho, K. Kochhar, A. Kyobe and R. Tchaidze. 2013. “Anchoring Growth: The Importance of Productivity-Enhancing Reforms in Emerging Market and Developing Economies”. International Monetary Fund Discussion Note.

^{vi} Aghion, P. and P. Howitt. 2006. “Appropriate Growth Policy: A Unifying Framework”. *Journal of the European Economic Association* 4(2-3): 269-314.

^{vii} Hanushek, E. and L. Woessmann. 2009. “Do better schools lead to more growth? Cognitive skills, economic outcomes, and causation”. NBER Working Paper No. 14633.

^{viii} United Nations Development Programme. 2013. “Social Protection, Growth, and Employment”. UNDP: New York, USA.

^{ix} Beck, T. and A. Demirguc-Kunt. 2004. “SMEs, Growth and Poverty”. World Bank Note Number 268.

^x Annex C of 2014 Leaders’ Declaration, available at https://www.apec.org/Meeting-Papers/Leaders-Declarations/2014/2014_aelm/2014_aelm_annexc.aspx

^{xi} Staff Report on Fiscal Policy and Long-term Growth. 2015. International Monetary Fund.

^{xii} APEC Joint Statement of the 1st High-Level Policy Dialogue on Science and Technology in Higher Education. 13-14 August 2015. Manila, Philippines. Available at <http://apec2015.ph/2015/08/14/joint-statement-of-the-1st-hlpd-sthe/>

^{xiii} Statement of APEC Ministers Responsible for Trade. 23-24 May 2015. Boracay, Philippines. Available at http://www.apec.org/Meeting-Papers/Ministerial-Statements/Trade/2015_trade.aspx

^{xiv} Boracay Action Agenda to Globalize MSMEs. 24 May 2015. Boracay, Philippines. Available at http://www.apec.org/Meeting-Papers/Ministerial-Statements/Trade/2015_trade/2015_mrt_standalone.aspx