PASCN Philippine APEC Study Center Network

PASCN Discussion Paper No. 99-07

The Asian Crisis and Economic Integration in APEC

Cayetano W. Paderanga, Jr.

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The Asian Crisis and Economic Integration in APEC

Cayetano W. Paderanga, Jr.

Executive Summary

The Asian crisis has put to question the evolving economic integration among APEC countries. This has taken several forms ranging from the increasingly open questioning of the arguments for economic integration and even up to actual policy reversals, such as the administrative controls on capital flows imposed by Malaysia.

There are two dimensions of this phenomenon. First, the crisis has sapped the resources and ability of APEC countries to carry out the activities needed for integration. This includes the fiscal and financial debilitation caused by the crisis. It has the effect of, at least, slowing down the speed of integration. The second aspect is the lessening in the countries' appetites for economic integration indicated by the calls for re-assessment of the assumptions underlying economic integration.

This paper surveys the main issues in the aftermath of the Asian crisis and examines the impact of the crisis on the policy options of APEC countries.

The Asian Crisis and Economic Integration

Cayetano Paderanga, Jr.*

1.0 Economic integration and its impact

Economic integration is rudely awakening most economies today. From the ASEAN free trade area agreement signed in 1992 to the most recent movement by European countries toward a single monetary system, countries have been raised almost inexorably to a level of connection with other economies unprecedented in for most of this century[1]. Furthermore, with recent technological innovations in transportation, communication, economic and financial theories, the character of integration may be qualitatively different from previous ones. These qualitative differences may account for some of the recent anxieties and reluctance of policy makers and the public at large to embrace "unqualified" globalization.

The Asian crisis has deepened this distrust of economic integration. The pain caused by deep exchange rate corrections, severe economic adjustments and social dislocations has made governments and societies risk-averse. Among the signs of a re-assessment of policy positions is the imposition of exchange controls by Malaysia and continuing discussions of the Tobin tax, reserve requirements on capital inflows, and cooperative arrangements to control large capital flows. The crisis has also weakened the ability of the governments to carry out the transition and adjustment programs needed to soften the impact of economic restructuring.

2.0 The meaning and implications of economic integration

Economic integration links the labor, product and capital markets of the world. Somewhat loosely, the increasing trend toward economic integration in recent decades has been termed globalization. Some observers use the latter term to refer to increasingly open commodity markets, providing producers the ability to penetrate more markets and giving consumers and downstream industries access to more choices. The latest round of the General Agreement on Tariffs and Trade (GATT) which ended with the setting up of the World Trade Organization (WTO) is just the most visible manifestation of this trend.

Others use the term to refer to increasing interlinked, interdependent financial markets with huge capital flows and connected changes resulting in correlated movements in exchange and interest rates. Still others refer to the increasing disposition of governments towards open economies and market orientation. At any rate, the term

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[1] Economic historians hasten to remind us that the situation at the turn of the century, when free trade was an accepted doctrine, is not manifestly different.

refers to a broad phenomenon moving towards seamless world commodity and financial markets.

Economic integration enables countries to achieve the best combination of resources and to temporarily bypass resource limitations by buying these resources or borrowing them. The ultimate result is to expand the production and consumption possibilities of countries in any time period by allowing them to trade not only across borders but also C by virtue of this possibility B across time. In fact, this opens the possibility of expanding the possibilities across all time, if the correct production consumption decisions are made.

1. *Product markets C*

The Uruguay-round agreements which included the creation of the World Trade Organization (WTO), is merely the latest in a series of steps to increase market access and lower barriers to the international flow of commodities and services. More than that, the round included an expanded set of issues whose importance had been heightened in recent years, as the intensity and level of interaction between economies increased. The new topics discussed in the Uruguay Round include intellectual property rights, trade-related investment measures, and services. The expansion in coverage recognizes the wider spectrum of economic interaction between economies in recent decades.

2. *Labor markets C*

The inclusion of services in the Uruguay Round merely recognizes the increased importance of services in individual economies and the increased trade in services. Finance, transport, communications and other services are now being traded internationally. This is probably best characterized by mutual recognition of professional standards in the European Economic Community. However, the flow of professional and lower-skilled services across borders is a growing phenomenon that is now explicitly recognized. Allowing easier flow of services, an objective of the General Agreement on Trade in Services (GATS) is expected to enhance the availability and efficiency of all services at lower costs.

The impact on the labor sector comes from two directions. The greater openness to trade in commodities and services means an expansion in employment and income from both ease in direct cross-border employment and indirectly from the growth of production to serve an enlarged market. On the other hand, the increased competition and the relative ease with which capital can shift locations in search of the highest returns greatly imperil jobs, wages and social security in those countries that fail or are slow to adapt to the changing economic environment (Esguerra, 1996).

3. *Capital markets C*

The integration in the commodity markets has been matched by a parallel integration in financial markets. From the 1960's to 1993, there has been almost a hundredfold increase in annual capital flows (Paderanga, 1996b: p. 345). This integration in capital markets allow countries to temporarily escape capital constraints and embark on comprehensive developmental investment programs as well as provide market discipline and efficiency.

All in all the integration of product, service and capital markets enable the global economy to achieve faster growth.

I. Requirements

Economic integration requires economies to undertake policy and structural changes so they can benefit fully from the changes. These include policy, structural and program changes.

1. *Policy changes*

To ease the implementation of economic integration, policies have to be changed towards a general reduction in barriers. A clear and explicit break from the regime of protectionism and closed economy is best in order to minimize the confusion that may come from changing the rules. To minimize the pain of economic integration, it is also best if conscious effort is devoted to designing and implementing transition and adjustment mechanism. Transition mechanisms refer to the phasing and sequencing of the policy changes in order to bring about the orderly movement towards integration. Adjustment mechanisms, on the other hand, refer to the institutions and programs designed to facilitate the movement towards integration. Among others, this includes programs to help move economic resources (especially labor) from declining to expanding sectors. An example would be re-training programs for workers.

2. *Structural changes*

Economic integration also implies fundamental changes in the economic landscape. Unless these changes take place the economy is not getting the benefits of integration.

The first structural change is the change in the composition and volume of industrial output. Industries in which the economy enjoys comparative advantage expand while those where the economy is relatively uncompetitive contract. As a general rule, if the economy is going from a relatively closed to a more open one, more goods become traded goods. That is, more commodities are imported and exported than used to be the case. The reduced barriers allow consumers and producers access to more choices for consumption and for inputs into their own production. This process of industrial restructuring almost certainly accompanies increased economic integration. If this does not happen, then the economy is caught in bottlenecks or may be paying the price in terms

of higher costs and less income.

The transformation in industrial structure will also be almost certainly reflected in a substantial reshaping in geographic and sectoral patterns. Depending on the location of the "sunset" and "sunrise" industries, regions and more specific localities will expand or contract relative to other places.

The relative positions of the different sectors will also be rearranged. Starting with the functional classification of sectors, functional factors, which used to be scarce will become more abundant as the economy's access to world resources increase. On the other hand, the more abundant resources may acquire access to markets abroad. This is the case of Philippine labor that has enjoyed increased employment abroad in recent decades.

II Characteristics

Economic integration is a complex process that implies the outlay of resources. First it requires real costs. Investments become obsolete as industries suddenly become uncompetitive with the opening of the economy and as industrial restructuring takes place. Of course, second hand equipment can still be sold to countries where the optimal location of a particular industry moves. However, this still involves moving costs and if not properly carried out will even mean incomplete recovery of the present value of the equipment as owners try to avoid the financial costs of idle capital.

What is true of capital stock directly used in production also holds for support and institutional infrastructure. For example, training facilities overly specialized in the skills and knowledge of the departing industry will also lose their capital value in the country of origin. A host of support infrastructure could mean many ancillary industries that now must shift to other activities.

This is, of course, also true in the normal course of a country's development. However, the pace is faster and the shifts can be sudden as many more countries are included in the search for optimal locations. As production costs change in more countries due to changing internal conditions the optimal site for each industry can also move rapidly. This leads to shorter recovery cycles for investments. On the other hand, the increasing market size also provides for greater opportunity for firms to maintain or lower their costs or search for new customers. Nevertheless, the increasing possibility for change requires that producers and suppliers become more nimble.

All the changes implied by economic integration require adjustment mechanisms and programs. The change also causes transition costs to producers, suppliers and workers themselves, separate from the capital and institutional costs. These transition costs have to be balanced against the perceived benefits from globalization.

All these changes can be more easily borne and managed with careful (and fortunate!) planning. To fully exploit the benefits of economic integration, a country

needs to plan, design, and implement the adjustment and transition mechanisms.

III. The Asian Crisis and Economic Integration

Growth Impact

The most immediate impact of the Asian crisis was on the immediate growth prospects of the affected countries. Because of the crisis, growth trends have reversed and a few of them have even experienced negative growth in the past year or two. As the crisis deepened, the prospects for countries became worse and worse. Table 1 shows the growth rates for each of the countries in 1997 and 1998. Table 2 shows how the prospects for the Philippines became worse as the crisis evolved.

Table 1: Growth rates of selected Asian countries, 1997 and 1998

Country	1997	1998e
Korea	5.5	- 7.0
Indonesia	5.7	-15.3
Malaysia	7.7	- 7.5
Philippines	5.2	0.0
Thailand	- 1.3	- 8.0

Source National Statistical Coordination Board; International Financial Statistics; International Monetary Fund.

Table 2: Some Macroeconomic Targets, Philippines (various dates)

Particulars (Percentage rates)	1 9 9 7		1 9 9 8			
	Target	Actual	As of July	As of Aug	Per Dec 5	As of Jan
GDP Real Growth	5.5 - 6.5	5.1	7.6 - 8.3	6.5	4.0 - 5.0	2.4 - 3.5
Inflation Rate	6.0 - 7.0	5.1	5.0 - 5.5	7.0	6.5 - 7.5	7.5 - 8.5
91-day Treasury Bill Rate	12.5	13.1	10.5	11.5-12.5	14.0-15.0	17.0-18.0

Source: Various documents, Development Budget Coordination Committee, NEDA.

The resulting macroeconomic slump and the industrial restructuring has also had adverse impact on employment in the affected countries. Aside from the severe immediate

unemployment coming from the output slum, lower growth also impairs employment generation for the next few periods. Affected countries, therefore, face possibility of increasing unemployment. Besides, the depth of the exchange rate correction implies substantial industrial restructuring for these countries. Given some friction in the shift of resources from "sunset" to "sunrise" industries, this development will add to the unemployment problem in the region.

Fiscal and financial impact

Very serious fiscal and financial difficulties resulted from the exchange rate correction and the resulting growth impact. Government foreign obligations increased in terms of domestic currency. Government revenues contracted due to the slowdown in economic activity arising from the uncertainty spawned by the currency crisis. For example, import duties, which account for 20% of government revenue in the Philippines, contracted by 9.3% from 1996 to 1997. Finally, interest expense on government domestic obligations inflated as central banks increased interest rates in an effort to stabilize gyrating currency exchange rates. The net result has been fiscal for governments in the affected countries, lessening their abilities to soften the impact of the crisis, not to mention their willingness and capabilities to push forward continuing economic integration.

The financial sectors in the affected countries suffered even more difficulties as they bore the first round impact of the exchange rate corrections. Banks that had contracted substantial foreign exchange obligations saw their liabilities balloon in domestic currency terms. In frequent cases, this changed their balance sheet ratios away from those required by bank prudence and central bank regulations (e.g. the capital to risk assets ratio). The effort to return to the required ratios often implied curtailment of credit.

Those banks with large loans to firms similarly exposed suffer potential deterioration in their non-performing loan ratios. These banks either try to collect their questionable loans or reduce their loans outstanding in order to meet the required ratios on valuation reserves. Either way, the result is contractionary behavior by the banks.

The international turmoil also resulted in uncertainty by foreign investors about the country or region as a whole. Because of that, foreign capital, especially short-term funds, departed. The continuation of capital inflows into the affected countries during the immediate and medium-term future is in doubt. This outflow and discontinuance of inflows has not only resulted in the exchange rate correction. It has also led to upward pressure on the domestic interest rates as the foreign source of cheaper capital has dried up. The ultimate result is a slowdown in investments and production as long-term and working capital has become scarce. This has contributed substantially to the overall slowdown in the affected economies.

Impaired ability to maintain economic integration

The fiscal, financial, monetary and overall economic difficulties have crimped the abilities of governments in the Asian region to maintain the move towards economic

integration. The combination of production slowdown and financial stress has diminished the ability of firms to carry out the restructuring needed for more intense competition. This has led to agitation to slow down the pace of integration in order to give firms more time to adjust.

At the same time, fiscal difficulties have also diminished the ability of governments to underwrite transition programs and safety nets. These nets, designed to alleviate the plight of those most adversely affected, would have speeded up integration by allowing full commitment without having to wait for the last to adjust. Further, governments are now preoccupied with stabilization programs which use scarce resources and slowdown adjustments to restructuring.

All of the difficulties abet the threatened slow down in economic integration. They magnify the objections to economic integration and occasion a re-assessment. Among these ominous changes are the imposition of administrative controls on foreign exchange in Malaysia and increasing calls for the imposition of a "Tobin tax" on foreign exchange transactions. Other countries also increasingly study the use of reserve requirements on capital inflows to try to discourage short-term capital. The more orthodox approaches to managing capital flows and their consequences include strengthening prudential regulations on banks and other financial intermediaries, a call for more transparency in the foreign exchange and other financial markets, more information about economies and the larger firms, and closer coordination among central banks and other economic policy makers.

These difficulties also provide an opportunity for protectionism to regain respectability in the economic debate. Heard all over again are allegations of unfair trade and dumping by producers in the affected countries who have "the advantage of competing with devalued currencies" or "have to sell at whatever price to keep their idle factories working." All at once "import surges" are perceived and imminent ballooning in the unemployment rate are seen.

IV Leading issues

Size and meaning of the changes

There are a few characteristics of the Asian crisis that seems new and unanticipated by most observers and researchers. These are the speed and depth of the exchange rate corrections involved. First is the speed with which the crisis spread from one economy to another. This rapid "contagion" caught both researchers and policy makers by surprise and may have contributed to the extent of uncertainty and doubt about the possibility of controlling the extent of the damage. This phenomenon fed back and further escalated the extent of the crisis.
Related to the speed of the exchange rate correction experienced by the affected economies is its depth. There is a feeling that because of the way the crisis spread, the ultimate level of corrections reached by the affected currencies were too far, that is there was an over-correction which was not warranted by the underlying fundamentals before

the crisis[2].

Finally, a distinction has to be made between the depth of the crisis and the restructuring due to economic integration. During the last decade, starting with the signing of the ASEAN Free Trade Agreement in 1992, the region has moved towards more integrated commodity and capital markets. AFTA includes a reduction of tariff barriers towards a very low 0 to 5% in 2008 (since accelerated to 2003) and more liberal investment policies. Progress in this effort, therefore, implies continuing restructuring in the ASEAN countries.

The correction in exchange rates identified with the Asian crisis also implies and extends the restructuring. Industries and activities viable under the old exchange rates are no longer feasible, while new activities are now possible. This restructuring can be confounded with the economic slowdown caused by the Asian crisis. Nevertheless, the resulting adjustments all add to the pain of the crisis.

The new international financial architecture

The manner and extent of the Asian currency crisis as well as the dislocation it caused has led to a call for caution in economic integration, especially that of international financial markets. More to the point, there has been a search for ways to manage international capital flows. The suggestions have ranged from outright administrative controls to an international system for collaboration among national monetary and fiscal policy makers and even to a more powerful global financial watchdog.

There are now initiatives among the multilateral financial bodies such as the International Monetary Fund, World Bank, and Asian Development Bank and academic circles to formulate systems to manage the international financial framework. Among these initiatives are changes in the rules in international finance and banking. For example, for the last meeting of the IMF and World Bank, three committees were set up to explore the various rules for banks, financial transactions and market behavior.

Reassessing the speed and extent of economic integration

On a broader front, the Asian crisis and its effects has engendered a re-examination of economic integration. Doubts about unobstructed commitment to economic integration are taken more and more seriously. Even where the conclusion is to continue with integration, qualifications to the extent and speed of integration are being considered.

What next?

The task now is to determine the direction of policy related to economic integration. If the consensus is to continue with it, the manner and speed of achieving this should be discussed deliberately. This would gain the benefits of integration ---- greater

2 There is now increasing recognition that economies may have “multiple equilibria” and the final point may depend on which of the equilibria is finally “chosen.” This justifies the use of policy interventions designed to bring about some equilibrium positions rather than others.

productivity, more choices, faster growth, and even more equity (if properly managed) and more security. At the same time, the issues of transition and safety nets need to be considered openly. Well-designed transition programs and safety nets could help us avoid the more obvious negative side effects of economic integration.

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