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GLOBALIZATION AND DEVELOPMENT REVISITED IN THE LIGHT OF ASIAN EXPERIENCE

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ABSTRACT

This paper analyzes the benefits and risks of participation in the globalization process in light of the development experience of selected countries of East/South-East Asia (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand). It is argued that isolationism is not the appropriate response to the perils of globalization; instead, efforts should be made to prevent the occurrence of any future crises or at least to moderate their adverse impact. In that context, the paper focuses on areas of international cooperation.

INTRODUCTION

1. Globalization has become a hotly debated subject in recent years. Much of the debate is propelled by the ideological predilections of the proponents of globalization and its opponents. This paper seeks to provide an objective assessment of the benefits and risks of participation in the globalization process in light of the development experience in selected countries of East/South-East Asia (Indonesia, Malaysia, the Philippines, the Republic of Korea and Thailand).

2. In order to provide clarity on the scope of the paper, it is useful to begin with a brief discussion on some definitional issues. The term "globalization" is multi-dimensional. It has economic, social, cultural and political connotations. The emphasis in this paper is on the economic dimension. In this context, globalization essentially implies increasing integration of product and factor markets across national boundaries. In practice, policy changes adopted at both national and international levels have been more conducive for cross-border movement of goods, services and capital, and much less so for labour. There remain serious impediments to the integration of labour markets because of immigration policies as well as linguistic, cultural and other barriers. The extent of product and capital market integration will be used in this paper as the criteria for measuring the degree of participation by East/South-East Asian countries in the globalization process.

3. Development also is a multi-dimensional term. In the minimum, it encompasses economic growth, structural change, elimination of absolute poverty and reduction in inequality of income distribution. Environmental sustainability is a more recent addition to the dimensions of development; one can think of many others such as equitable access of all segments of populations to health, education, safe drinking water, etc. In assessing the impact of globalization on development, this paper will focus on economic growth, structural change, progress towards elimination of absolute poverty and income distribution.

4. At this point, it is pertinent to remind the readers that globalization, as narrowly defined above, markedly accelerated during the 1980s and 1990s. To illustrate, world trade growth increased to 8 per cent per annum during the period 1994-1996 compared to an annual growth rate of 4 per cent during 1980-1993 period. The growth of world trade thus far exceeded the growth of world output, implying that a greater proportion of output was being internationally traded. This is an indication of the integration of product markets. Capital market integration has been even more dramatic. From 1990 to 1995, borrowing on international capital markets rose by one-fourth to US$ 1.3 trillion (Fischer, Bernhard, 1998). The global stock of foreign direct investment (FDI) increased four-fold between 1982 and 1994; over the same period it doubled as a proportion of world gross domestic product (GDP) to 9 per cent. The rate of growth of global FDI stock during the period 1986 to 1995 was more than twice that of gross fixed capital formation, indicating an increasing internationalization of production systems (UNCTAD, 1997).

5. The rest of the paper is organized as follows: Section I illustrates the extent of East/South-East Asian countries' participation in globalization. Sections II and III respectively discuss the positive and negative impact of globalization on development as interpreted above, and examine their relevance to the experience of East/South-East Asia. Section IV analyses the policy implications, with a particular focus on international cooperation.

I. East/South-East Asian Countries' Integration

6. The East Asian countries made a tremendous stride in integrating their economies with the global product and capital markets (table 1). The integration in terms of trade deepened significantly in Malaysia, the Philippines and Thailand, as measured by the ratio of trade to GDP. In the case of Indonesia where trade as a proportion of GDP remained largely unchanged between 1980 and 1995, it should be borne in mind that data for 1980 is distorted by the oil price boom of 1979-1980, especially because oil was the principal export item of Indonesia at that time. It should also be noted that the rate of growth of that country's export of goods and services averaged 10.8 per cent during the period 1990-1995, well exceeding the growth rate of GDP during this period and in sharp contrast with only 2.9 per cent average growth rates recorded during the period 1980-1990. In the case of the Republic of Korea where the degree of trade integration was already high in 1980, there was a modest decline in 1995. But, here again, the rate of growth of exports of goods and services averaged as high as 13.4 per cent during 1990-1995 period, much higher than the average GDP growth of this period and slightly higher than the average growth rate of exports during 1980-1990 period. It is thus apparent that East/South-East Asian countries made notable progress in their efforts to integrate into the global market. The process was facilitated by significant liberalization of trade policy regimes. Trade liberalization often involved reduction in tariff rates, narrowing the range of dispersion among different tariff rates and virtual elimination of quantitative controls and licensing requirements. Export incentives were maintained or strengthened through a variety of measures such as preferential access to credit, fiscal concessions and establishment of export processing zones as well as labour policies aimed at keeping wages at competitive levels.

7. Table 1 utilizes three indicators of integration into the global capital market; stock of debt to foreign private creditors, net portfolio equity flows and inward FDI stock. By all these measures, East/South-East Asian countries rapidly integrated themselves into the global capital markets by the mid-1990s.

8. Here again, insertion into the global capital market was the result of liberalization of policy regimes, which started in the mid-1980s. The policy reforms initially focused on liberalization of rules and regulations concerning inward FDI. The requirement of prior approval of FDI was considerably done away with; very few sectors were closed to FDI; free repatriation of profits and capital was allowed; and services provided to foreign investors were greatly improved through institutional measures; and more bilateral investment treaties were signed with source countries. These were complemented by financial sector reforms, which intensified during the 1990s.

9. The financial sector reforms encompassed many measures namely:

- reduction of barriers to entry for banks and non-bank financial institutions,
- deregulation of interest rates,
- relaxation of directed credit,
- promotion of new financial markets and instruments, and
- liberalization of the external dimension of the financial sector which is of particular relevance to integration with global capital market.

10. With some variation among countries, liberalization permitted local citizens and foreign residents to open accounts with commercial banks, either in national or foreign currencies; banks to extend credit in foreign currencies in the domestic markets; non-bank private sector corporations, as well as financial institutions to borrow abroad; foreigners to own shares listed by national companies on domestic stock exchanges; the sale of securities on international stock, and bond markets by national companies; the sale of domestic monetary instruments, such as, central bank bills and treasury bills to non-residents; greater freedom of entry into the domestic banking sector by foreigners; and establishment of off-shore banks, which were also allowed, in some cases, to borrow abroad and lend domestically.

II. Implications For Development: The Rosy Scenario

Growth

11. *Trade-orientation* has a significant impact on growth. The benefit of trade espoused in neo-classical international trade theory is that it promotes efficient allocation of resources in consonance with comparative advantage of nations. In addition to allocative efficiency, trade policies are likely to enhance the efficiency of resource use in particular activities. Export promoting policies, in combination with a liberal import regime, facilitate greater capacity utilization, reduce the need for excessive stock of inventories and discourage installation of excess capacity with a view to procuring premium-fetching import licences. All these determine the capital/output ratio and the volume of output that can be produced with a given amount of investment.

12. Apart from static efficiency gains, favourable trade policies can generate dynamic impulses for growth. There are empirical studies, which lend support to the view that exports have a positive influence on domestic savings. In addition, the nature of trade policies affects inflow of foreign savings. By generating confidence in a country’s capacity to service debt, exports can promote inflow of foreign capital, both from private and official sources. Moreover, export-promoting policies encourage foreign direct investment in export industries to take advantage of cheap raw materials or labour. Insofar as certainty and convenience of repatriation of profits affect foreign investors’ investment location decisions, export-promoting policies are likely to have a salutary impact.

13. Exports facilitate many other dynamic gains. Most export products of developing countries, particularly manufactures, comprise a small proportion of the world market. In consequence, it is possible to produce at a scale way above what would be feasible if output were constrained by domestic demand. This permits adoption of improved technologies, costs of, which might be prohibitive at lower production levels. Access to foreign technologies can also assist in expanding the production frontier and structural change through product diversification. And the knowledge of the existence of such technologies is largely gained through participation in international trade. Furthermore, producers in the export market are subjected to intense competition, which force entrepreneurs to reduce costs and improve product quality.

14. Most empirical studies investigate the relationship between exports and growth, but there also exists a close link between imports and growth. The gains from competition hold with respect to producers of import-competing products. Imports relieve bottlenecks created by the failure to produce raw materials, intermediate goods, capital equipment and technology. In order words, in developing countries, there may be a valid concept of the import multiplier. Moreover, where scarcity of wage goods causes high inflation with adverse impact on domestic savings, and volume and pattern of investment, the import of consumer goods also facilitates growth.

15. To sum up, the principal mechanisms through which trade promotes growth are the following:

- The growth of exports permits economies of scale, a degree of specialization and a level of production that cannot be sustained by domestic demand.
- The growth of imports alleviates growth-retarding supply shortages, especially of goods and services used in production, and contain increase in the costs of wage goods, raw materials, capital equipment, technology and services.
- Participation in international trade generates positive externalities, particularly through competition and opportunities for learning that can expand the production frontier.

16. ***Financial flows*** play two roles in improving a country's growth performance: they supplement domestic savings and investment and they assist in overcoming the foreign exchange constraint imposed by the imbalance between foreign exchange earnings and import needs. In other words, these flows play an integrating role between countries with surplus savings and countries with deficits. This transfer of savings makes available a higher volume of imports, including capital goods, to the countries with lower savings, thus enabling the two sets of countries to improve their structures of output and growth.

17. ***FDI*** plays a similar role as above. But its contribution extends well beyond relaxing savings and foreign exchange constraint. Transnational corporations (TNCs) who are the principal actors in FDI are often in possession of technological assets vitally required to upgrade the quality of products for sale in the domestic or external market. These assets relate not merely to "hard" dimensions embodied in machinery and equipment, but also to "soft" aspects such as product design, factory lay-out and organization of production as well as management. Another major asset that TNCs possess is their capacity to exploit established marketing links (both intra-firm and extra-firm) or to create new ones to promote exports. Transnational corporations play this role under a variety of arrangements that may encompass wholly-owned affiliates, majority

or minority joint ventures, subcontracts and other non-equity links. In consequence, domestic enterprises can benefit substantially from the assets possessed by TNCs and contribute to growth.

East/South-East Asian experience

18. Development experience of East/South-East Asian countries during their rapid globalization can be divided into two distinct phases. The first phase covers the period from the early 1980s to the first half of 1997. The second phase is covered by the period following the economic crisis, which began with floating of the Thai currency, the baht, on 2 July 1997. The following discussion examines the first phase; the experience of the second phase is analysed in the next section.

19. It appears that much of the potential benefit of globalization was, in fact, realized in East and South East Asian countries. One objective indicator is the rate of growth of GDP, data on, which are presented in table 2. With the exception of the Philippines which was characterized by comparatively little integration into the global market as well as generally unfavourable policy environment during the 1980s, all the countries achieved growth rates much higher than the average of all developing countries in each of the two periods. During 1990-1997, even the Philippines exceeded the average growth rate of all developing countries which was only 2.8 per cent.

20. It should be emphasized that economic growth involves a complex interaction among domestic resources, policies, institutions and integration into the global economy. Nevertheless, in light of the discussion in this paper on the potential gains, it can be asserted that their stellar growth performance could not be achieved under autarky. In particular, it would be impossible to support the high levels of investment underlying their growth in the absence of rapid expansion of exports to the world market and access to external private capital. The high rates of growth were also accompanied by notable structural changes. This is evident in the steep decline in the share of agriculture in GDP (with corresponding increase in the share of industry and services); even more striking is the increase in the share of manufacturing in merchandise exports (table 3).

Equity

21. Perhaps the most important mechanism through which a *trade regime* can promote equity is through its effect on employment. In the first instance, employment effects can be linked to the growth effects. In so far export oriented policies promote faster economic growth, there would be a direct increase in employment through the production of final output as well as of intermediate goods and services.

22. Secondly, employment can be affected by trade through its impact on the composition of output. If trade policies are of an export-promoting character and exports are more labour-intensive than output for the domestic market, the reallocation of resources in favour of export production would increase employment.

23. Another mechanism through, which trade regime affects equity is through its impact on functional distribution of income. The essence of the argument is that a country engaging in international trade specializes in the production of goods using more of its abundant and cheaper resources. Consequently, the demand for these abundant factors rises and the demand for scarce factors falls. Prices of the relatively abundant factors thus increase and those of the relatively scarce factors decline. There is thus a tendency towards the equalization of factor prices.

24. The implications of this analysis for the functional distribution of income within developing countries are that the income of the more abundant factor of production, labour, would rise and the income of capital, the scarcer factor, would fall. If the inequities in the distribution of income are largely between wage-earners and owners of capital, as typically is the case, policies oriented towards more free trade and the promotion of exports would result in a more egalitarian distribution. Similarly, it can be argued that import-substituting strategies based on overvalued exchange rates and high rates of protection of domestic manufactures would tend to discourage the export of agricultural crops and reduce their domestic prices. If inequities in income distribution are largely attributable to inter sectoral differences between agriculture and manufactures, export promotion policies would tend to produce more equitable distribution.

25. The positive implications of *financial flows* and *FDI* for equity largely emanate from their impact on growth, employment and structural changes all of which also affect wage-rental or wage-profit ratios.

26. There is a substantial measure of consensus that growth is an important antidote against poverty. A number of arguments underlie this consensus. Economic growth expands employment opportunities. The only asset that most of the people below the poverty line possess is their labour. The most effective route for them to get out of poverty trap is through income-generating employment. As they earn more income, they are in a position to invest in enhancement of skills and productivity, leading to further improvements in living standards. Economic growth also helps poverty alleviation by enabling governments to mobilize resources for expanding social services such as health and education, for increasing investments in rural infrastructure and for undertaking transfer payments to benefit the poor.

27. As noted before, participation in the globalization process helped East/South-East Asian countries achieve high rates of economic growth. This also had a virtuous impact on poverty alleviation, as evidenced unmistakably by data in table 4. It is worth pointing out that the relatively slow progress in the Philippines here again is attributable to its poorer growth performance.

28. The picture with respect to income distribution, as measured by Gini co-efficient, is more mixed. There has been a notable improvement in the Republic of Korea, while in Thailand there was a significant deterioration. In the other three countries, either there was no change or some small improvement. On balance, therefore, one can say that East/South-East Asian countries succeeded in globalizing their economies without necessarily entailing any major deterioration in income distribution

III. The prognosis for gloom

Growth

29. The reliance on *trade* as an engine of growth is not free from risks. The classic argument against free trade relates to the infant industry protection. Given the unrealistic nature of many of the assumptions underlying the espoused benefits of free trade, (particularly those relating to identical production function across countries and absence of externalities), it is quite possible that potentially viable domestic industries may be wiped out as a result of premature exposure to competition from imports.

30. A higher proportion of exports in GDP may also expose an economy to the vulnerabilities arising from external events beyond its control. These may take many different forms, such as a sudden drop in the demand for major export items, devaluation of the currency of a competitor country, recession in trading partners, change in the marketing strategy of TNCs in situations where they spearhead a country's exports, or imposition of restrictions against imports by trading partners through tariff and (increasingly) non-tariff barriers, such as anti-dumping measures, and regulations relating to health, labour and environmental standards.

31. The dependence on external *financial flows*, particularly private flows, to finance investment and accelerate growth is fraught with many risks. First, the sustainability of these flows does not entirely depend on the recipient countries' policies. For example, a rise in interest rates in the source countries for their own domestic macroeconomic reasons may dry up new inflows and even cause an outflow. Second, these flows inevitably generate return flow in the form of repatriation of principal, interest and dividend and thereby create pressure on the balance-of-payments. Third, the pressures on the balance-of-payments may severely undermine the prevailing exchange rate regime with grave implications for the real sector of the economy. Unless effectively supervised by regulatory authorities, pressures on balance-of-payments can be aggravated through a maturity mismatch as well as a currency mismatch. For example, funds borrowed with short-term maturity may be used to make investments which yield returns only after a long period and borrowed funds may be invested in non-tradables which generate returns in local currency while servicing costs are denominated in foreign currency. Fourth, excessive dependence on external financial flows exposes an economy to the double jeopardy of an exchange rate crisis and a financial sector crisis which reinforce each other and cause a vicious spiral (Kaminsky and Reinhart, 1999). An expectation of devaluation, for reasons not

necessarily having to do with the wrong fundamentals in the host economy, changes the future profile of returns, as viewed by the creditors and short-term investors. The perceived benefits of early withdrawal encourage repatriation of funds abroad. This leads to depletion of reserves and forces a devaluation of the currency. The withdrawal of funds by foreign creditors and short-term investors also causes a drain on the host country's financial intermediaries, affecting their liquidity and even solvency. Fifth, financial markets generally and especially international financial markets are inherently prone to "asymmetric information", "moral hazard", "adverse selection" and "contagion" (Wiplosz, 1999) and "herd reaction". Asymmetric information refers to the discrepancy of information between lenders and borrowers, causing inefficient intermediation. Moral hazard often leads to excessive borrowing/lending in the expectation that borrowers/creditors will be bailed out by public authorities in order to avoid a systemic break-down. Adverse selection occurs when good borrowers refrain from borrowing while desperate borrowers are willing to borrow on expensive terms. This may lead to an excessive contraction of credit market. Contagion is the phenomenon of sharp changes in flows into or out of a country being triggered by events elsewhere. Herd reaction is the case when as one leading actor moves, the others follow suit. Sixth, financial flows tend to be procyclical, these pour in when an economy is booming and tend to rush for the exit door with the first signs of trouble. Finally, dealing with a financial crisis may entail significant fiscal or quasi-fiscal costs.

32. The afore-mentioned risks are less relevant for FDI. Nevertheless, there are some commonalities. The infant industry argument may apply with respect to FDI as well. The question of sustainability of FDI inflows remains a matter of concern, despite its generally stable pattern. This assumes particular relevance because technological changes driving the process of global expansion of FDI flows tend to make more and more industries increasingly foot-loose. While this may widen the opportunities for some countries to attract FDI, others may be deprived. FDI also generates reverse flow of resources in the form of repatriation of profits and capital and exerts pressure on balance-of-payments, especially when foreign investments are concentrated in domestic market-oriented or non-tradable sectors. With increasing competition, among countries to attract FDI, undue incentives may be offered without causing any net increase in FDI. Besides, much of the potential benefits of FDI can be realized only if a host country satisfies certain preconditions.

Equity

33. The actual realization of the positive impact of openness to trade on equity is partly contingent on unrestricted access of labour-intensive exports to the global markets. In practice, many of the labour-intensive export items from developing countries face barriers, particularly in the form of non-tariff barriers. An important illustration of these barriers is in the quota arrangements for textiles. In addition, many agricultural and agro-based products are subjected to arbitrary health, sanitation and other standards which, in effect, amount to non-tariff barriers to trade. More importantly, participation in the globalization process and the associated policies may exert unfavourable influence on equity through a number of channels.

34. The neo-classical trade theory does not take into account the changing pattern of global demand. The most dynamic segment of global trade consists of technology and skill-intensive products. As developing countries seek to re-orient their production structure to conform to this pattern of demand, there occurs a relative decline in the demand for unskilled labour and the differential between wages of unskilled labour and those of skilled labour may widen.

35. In so far as earlier policies pursued during the import-substitution phase of development provided disincentives to agricultural exports, food prices might have been kept low (Khan, 1997). With greater openness to trade, food prices may go up. There is ample evidence to show that increase in food prices hurts the poor most, as they are typically net purchasers of food.

36. The liberalization of import regimes can switch demand from goods that were previously non-traded in favour of imported substitutes. This may cause a loss of employment, uncompensated by the increased employment in export-oriented production.

37. Industries, which attract FDI may be more capital and/or skill-intensive. Given that the supply of skilled labour in developing countries is usually quite inelastic, FDI can increase the wage differential between skilled and unskilled labour.

38. Efforts to attract private portfolio inflows are often underpinned by high interest rate policies. To some extent, high interest rates also result from the increased sale of monetary instruments in the domestic market as a means to sterilize the impact of capital inflows on the exchange rate. Interest payments on such instruments generally accrue to the relatively richer sections of the populations.

39. Privatization and public enterprise reforms undertaken as a part of policy package to accelerate integration into the global economy often lead to reduced labour absorption and accentuate poverty as well as inequality. In addition, privatization tends to aggravate inequality in the distribution of assets, with a bearing on the distribution of income in the future (Cornia, 1999).

40. The above consequences may be reinforced by changes in tax and public expenditure. There may be an inclination to reduce taxes on income, corporate profits and on imports as countries seek to integrate with global markets. In consequence, there may be a greater reliance on indirect taxes on domestic production and consumption, leading to a greater regressivity in tax regimes. At the same time, measures aimed at reduction of budgetary deficit through recovery of costs of publicly provided social services may undermine the redistributive role of the government.

41. Policies intended to bring about greater flexibility in labour markets may imply the reduced bargaining power of the workers, aggravated by the consequence of a particular feature of the process of globalization presently at work. This has to do with the fact that capital has become much more mobile internationally, while cross-border movement of labour, particularly unskilled labour, remains severely restricted.

A hindsight on the recent crisis

42. The economic crisis that hit the East/South-East Asian countries with unprecedented ferocity in the second half of 1997 clearly exemplifies the perils associated with globalization. As is well known by now, the crisis, which had begun with the floating of Thai baht on 2 July 1997 rapidly engulfed the other four countries considered in this paper. A vast literature has already emerged on the causes, consequences and policy implications of the crisis. No effort is made here to summarize this literature or to draw out the commonalities and differences. What follows seeks to relate the process leading to the crisis directly to some of the risks of globalization noted above.

43. This author has argued elsewhere (Islam, 1999) that one of the fundamental causes of the 1997 crisis lay in the sharp deceleration of exports in 1996 that persisted through 1997. In fact, Thailand experienced a decline in the absolute dollar value of exports. A slackening in export demand for some major exports from the region, such as electronic goods, was partly responsible for the sharp export slowdown in 1996. To some extent, it reflected the deceleration in global trade. An important reason, however, was the gradual erosion of the competitiveness of the region's export industries as a result of rising domestic costs, especially wage costs, against the backdrop of the industrialization process which was not very effective in shifting from labour-intensive industries to higher levels. There was also a tendency for the real exchange rates to appreciate, as the nominal exchange rates with the United States dollar were held stable while domestic inflation rates tended to exceed those of major trading partners, including the United States. The realignments of currencies of the other countries also had an effect on the appreciation of real effective exchange rates. At the same time, new competitors emerged both within and outside the region to encroach upon the markets for the labour-intensive products of some of the countries.

44. The sharp decline in export growth caused a very large increase in short-term debt as a proportion of exports as well as of reserves. As a result, there arose concerns about debt-servicing capacity, sustainability of what were essentially pegged exchange rate regimes and the viability of the financial institutions. These concerns led to precipitous capital flight and, in turn, caused dramatic depreciation of exchange rates, crash of the stock markets and major problems in financial intermediation.

45. The second villain of the piece was the rapid liberalization of capital account without fulfilling the supervisory, regulatory and institutional prerequisites for minimizing the traumatic consequences associated with volatile capital flows.

46. The rapid growth of the stock of debt owed to private lenders as well as of portfolio equity flows has already been noted. In part, this was caused by rather large and continuing differential between domestic and international interest rates. Most of the external liabilities were not hedged against currency risks.

47. Much of the external borrowing was of short-term maturity. The proportion of short-term debt in total stock of debt to private creditors ranged from 56 per cent in Malaysia to 68 per cent in the Republic of Korea immediately prior to the crisis. There was thus clearly a maturity mismatch as the borrowed funds were invested in projects, which would yield returns in the longer run. There was also a currency mismatch in that a substantial proportion of funds was invested in non-tradables, which would generate returns only in local currency. In Thailand, for example, total credit to the manufacturing sector expanded 10-fold between 1985 and 1996; but credit to the real estate sector expanded 22-fold during the same period.

48. All these countries experienced considerable increase in domestic credit as a proportion of GDP, reaching over 90 per cent in Malaysia and Thailand in 1996. Such credit growth could, to a great extent, be attributed to asymmetric information, moral hazard and herd reaction characteristics of the financial markets. To a great extent, these problems in the financial sectors of the crisis-affected countries were the result of easy access to external capital, facilitated by the liberalization of capital accounts.

49. Mention should also be made of the contagion effect. In a world of integrated financial markets, commercial bank lenders and portfolio investors such as mutual funds or hedge funds tend to look upon a region or a sub region as a single market. The problems confronted in one country may prompt them to pull out of the whole region or sub region in a herd reaction. This is evidenced by the fact that many short-term investors pulled out of the markets of East/South-East Asian countries more or less at the same time, following the problems in Thailand. Net portfolio equity inflows to the five affected countries amounted to $12 billion in 1996 and turned into net outflows of $4 billion in 1997. This exposes the fragility of the argument that portfolio investment should not be a matter of concern. One rationale underlying the argument is that portfolio investors share the burden of adjustment as they suffer losses in the course of withdrawal. The second rationale is that initial losses may be a disincentive for further withdrawal and so a self-correcting mechanism may come into play. The Asian experience clearly shows the ineffectiveness of such a mechanism. One reason is that if some fund managers start withdrawing, others feel compelled to follow suit to avoid blame in the event equity markets go down further. Moreover, any sizeable withdrawal by some investors may give rise to an expectation of devaluation and thus provide an incentive to all to withdraw early before devaluation actually takes place. Similar comments also apply with respect to behaviour of bank lenders. By the end of 1997, there was a net outflow of commercial bank credit from the five affected countries amounting to $27 billion as a against a net inflow of $56 billion in 1996.

50. The investors overreacted in a panic-stricken manner, even though all these countries had some strong economic fundamentals immediately prior to the crisis. In 1996, all the countries had high rates of savings exceeding 30 per cent with the exception of the Philippines; budgets were in surplus; foreign exchange reserves were rising; and inflation was moderate at less than 7 per cent except in the Philippines where it was 8.4 per cent. Besides, market operators withdrew simultaneously from all countries without taking into account the differences among them in terms of indicators of external balance. To illustrate, the current account deficit as a proportion

of GDP in Indonesia in 1996 was less than half of that of Thailand, its exchange rate was more flexible, and it had a smaller volume of foreign private debt. Similar observations apply to the Philippines. As for Malaysia, the current account deficit as a proportion of GDP was a little higher than that of Indonesia and the Philippines, but considerably lower than that of Thailand, and its stock of foreign private debt was higher than that of the Philippines, but less than half of that of Indonesia and a third of that of Thailand.

51. Finally, it should be noted that certain aspects of public policy changes implemented during the first phase as well as in the immediate aftermath of the crisis aggravated the social impact of the economic crisis. Specifically, the liberalization measures on the revenue side of fiscal policy equation led to the emergence of the following characteristics:

- Decrease in taxes on international trade as a proportion of tax revenue;
- Reduction in the share of income and corporate taxes in total tax revenue, accompanied by reduced progressivity;
- Rise in the share of domestic indirect taxes on goods and services in tax revenue;
- Slow growth or stagnation in total tax revenue as a proportion of GDP.

52. The equity implications of the above profile of tax regimes were most likely adverse. Domestic and foreign investors as well as others in the upper income brackets appear to have been favoured. The tax systems thus tended to become regressive. The changes were, of course, driven by the desire to promote exports, reduce the cost of imports, attract FDI and encourage other private capital inflows.

53. At the same time governments sought to maintain balanced budget or run fiscal surplus in the interest of maintaining price stability which was considered to be a prerequisite for facilitating trade, FDI and financial flows. Therefore, they had no choice other than to reduce public expenditure in the face of falling tax revenue. And, despite occasional increase in share of expenditure on social services as a proportion of government expenditure, total public expenditure on social services either declined or grew very modestly as a percentage of GDP.

54. Based on a large sample of countries, including many developed countries, Rodrik (1998) has rigorously established the following four propositions:

- Greater openness increases volatility in domestic income and consumption;
- A larger share of government expenditure in GDP reduces volatility;
- The risk-mitigating role of government spending is displayed most prominently through expenditure on social security and welfare;
- The line of causation runs from external exposure to government expenditure.

55. The normative conclusion that emerges from this analysis is that as countries become more integrated into the international division of labour, the share of public expenditure in GDP as well as the share of public expenditure on social services in GDP should increase. The picture in East and South East Asia seems to have differed from this norm. They apparently did not prepare themselves adequately to meet the social consequences of a crash, while they were increasing their exposure to external shocks through greater openness.

56. In the event, the crisis had a devastating impact on economic growth. In consequence, unemployment soared and there was a notable increase in poverty (table 5). Not much information is available on the impact on income distribution. Most likely, there has been a significant deterioration. In the Republic of Korea, for example, Gini co-efficient rose to 0.3238 in the third quarter of 1998 compared with 0.2873 in the third quarter of 1997. The gains achieved during the benign phase of integration into the global economy were thus seriously undermined.

IV. Implications for International Cooperation

57. The development experience of East/South-East Asian countries clearly demonstrates the gains that can be realized from active participation in the globalization process as well as the perils associated with it. The fact that strongly positive gains were realized over many years suggests that isolationism would be a retrograde move. What is called for is a better understanding of the steps needed to prevent the occurrence of any future crises or at least to moderate their adverse impact, while maintaining the basic stance in favour of integration with the global economy.

58. The on-going debate in the academic communities as well as national and international policy circles has generated a large degree of consensus on the pre-emptive steps that can be taken by national authorities. These include: a greater flexibility in exchange rate regimes; conscious efforts to maintain international competitiveness, particularly through technological upgrading and human resources development; ensuring a sound banking system; a cautious approach to liberalization of capital account; development of early warning systems; strengthening prudential supervision of financial institutions; improved corporate governance; and adequate provisions for social protection.

59. It is also generally recognized that national measures can not be adequate by themselves to prevent any future crisis and that important changes need to be made in the international monetary system as a whole (Bezanson and Griffith - Jones, 1999). Nevertheless, there is very little agreement on the nature of actions that should be implemented at the international or regional levels. The following paragraphs offer some thoughts in this regard.

The need for an international lender of last resort

60. The rapidity with which the International Monetary Fund (IMF), in collaboration with other financial institutions and bilateral donors, was able to mobilize fairly large sums of money to provide support to the countries which sought assistance in the wake of the crisis was undoubtedly remarkable. Nevertheless, the crisis revealed a serious inadequacy of the present international financial architecture in that there exists no organization with a specific mandate, backed up by adequate resources, to perform the role of an international lender of last resort. Yet there is considerable opposition, particularly in developed countries, either to give such a mandate to IMF or to create a new institution.

61. The argument against an international lender of last resort centres around moral hazard implications. There are two strands of this argument. The first is that countries may pursue irresponsible macroeconomic policies with the expectation that they would be bailed out by the lender of last resort in the event of any trouble. The second is that similar considerations may prompt foreign investors and lenders to take excessively risky positions. Based on IMF experience, it has been stated that there is no validity of moral hazard argument with respect to policy makers since most countries do their utmost to avoid seeking assistance from IMF (Fischer Stanley, 1998). The second strand can be easily addressed through an appropriate design of conditionalities for granting assistance to specific countries in distress or through credible, pre-announced eligibility criteria as well as policy statements that the resources of the lender of last resort would not be available for redeeming obligations to foreign private investors or lenders.

62. It is also argued that unlike a national central bank which exercises supervisory control over the banking system and is armed with a number of instruments to enable it to perform its functions effectively as a lender of last resort, an international lender of last resort cannot intervene in the affairs of individual member countries. This is not a convincing argument because even at present IMF does play a significant role in the determination of macroeconomic policies of developing countries through its advice which no country treats lightly. This is so not merely because access to IMF funding could be denied, but also because access to resources from other international financial institutions and private investors and lenders is often contingent on agreement with IMF. A more plausible argument is that the effectiveness of an international lender of last resort is open to question because of inadequacy and uncertainty of resources available at its disposal. This is a problem of political will, not of inherent impracticability.

63. Now that cross-border flows of funds have assumed much significance, the need for early warning systems for countries that may develop debt servicing or repayment problems is paramount. However, early warning systems encompassing the disclosures of governments and of financial institutions should not be expected to obliterate the exaggerated responses on the part of market participants. Asian experience suggests that excesses were built upon sound fundamentals, such as low fiscal deficits, low inflation and stable exchange rates, which generated moods of over-optimism. Knowing when the line between stability and instability is crossed is not simple, except with hindsight. Uncertainties of this kind make predictions very unreliable, and preemptive action particularly difficult.

64. In this context, it is worth remembering that in most countries affected by the crisis in Asia, external capital, in the form primarily of short-term banking credits, continued to flow in even though widely available statistics in the public domain indicated that short-term debt had risen dramatically over the previous 12 months. However, even credit rating agencies failed to provide adequate warning of any impending debt-servicing difficulties in these economies. It is thus one thing to have early warning signals, quite another for market participants to take them into account. Moreover, foreign investors can genuinely underestimate the risks involved and overestimate the rewards that they expect to earn. Such biases, combined with informational asymmetries, can render even the most elaborate early warning systems ineffective.

65. This is not to say that effort should not be put in the development of more credible early warning systems. The problem is that investors are creatures of psychology and of peer pressure as much as they are of rational calculation. Consequently, investors will choose to ignore early warning signals as the distinction between rational investor behaviour and that undertaken through simple peer pressure as part of a herd instinct can be very thin. This reinforces the case for an effective international lender of last resort.

66. The problem of the prevention of contagion also rests on the presumption of rational behaviour by market participants. However, in an atmosphere of heightened uncertainty when a crisis has just broken in one country, it is all too easy for market participants to lose confidence in neighbouring countries, or even in countries further afield. Given such behaviour based on sentiment rather than a cool appreciation of the facts, there can be very little protection against contagion in the short term with open capital accounts. Hence, the need for quick and perhaps unconditional access to foreign exchange resources from outside on an adequate scale. This provides an additional rationale for an international lender of last resort, be it IMF or a newly created institution.

Comprehensive global financial supervision and regulation

67. Bail outs for the financial system or any form of depositor guarantee are said to create moral hazard problems. Nevertheless, the mistake is to imagine that the need for such actions can be wished away as no country could allow its financial system to be closed down even if its aggregate capital and reserves had been wiped out by the accumulation of bad debts. There is no argument that a healthy financial system is a critical pre-requisite for a healthy economy. The need is to prevent excessive risk-taking, often with the support of foreign investors and lenders. An obvious issue therefore is the need for clear, internationally comparable and transparent operating standards for the financial sector. Without such comparability it would be impossible to assess the relative health of financial systems in any country. Hence, the importance of a global organization that can formulate standards of conduct by all actors in the financial systems, monitor compliance and enforce implementation with assistance from national authorities.

68. The rapid pace of international financial integration has to a large extent overtaken the ability of national supervisory bodies to oversee the activities of financial sector entities with significant cross-border activities or exposure. Effective supervision has been further complicated by the proliferation of instruments and services on offer from the financial sector, euphemistically referred to as "off-balance sheet" activities, and the availability of tax havens and off shore centres with lax or nominal supervision. The activities of hedge funds, with their off shore domiciles and methods of incorporation, appear to fall outside the ambit of any reporting or regulatory system.

69. It is obvious that mere reliance on self-regulation or on market discipline is neither adequate nor satisfactory. In view of the severity of events that have engulfed not merely countries in Asia but in other parts of the world as well, improving international supervision and regulation through a new body requires urgent consideration. Such a body should determine the appropriate distribution of regulatory responsibilities, both within and across countries. It is a function that cannot be entrusted or grafted on to the IMF.

70. In certain less than formal ways the Bank of International Settlements (BIS)is providing a venue for the discussion of the problems that have come to the fore since the Asian crisis. The BIS, however, provides little formal access or participation to developing countries which is a major weakness. A new overseeing body for international capital should be given a specific mandate dealing with the monitoring, and eventual regulation, of short-term cross-border flows to develop, as in the case of the World Trade Organization (WTO), a rule-based system, rather than one dependent upon ex post facto disclosures. Private sector representative might also be associated with it in some manner. It is well to admit that the proposal for a new international organization to oversee international capital movements is not going to be easy to implement. It, however, deserves serious consideration in light of the devastating impact that unregulated movements had in recent years on so many emerging economies.

Design of orderly debt workouts

71. A number of models of debt restructuring are available from the debt crisis of the 1980s. However, implementation of any of them is constrained by two considerations. First, there is a tendency on the part of both lenders and borrowers to play for time through a series of *ad hoc* measures and, even more important, to count on recovery as a means of resolving the debt problem. Second, creditors, especially foreign creditors, tend to maintain the assumption of "full value maintenance", i.e. the amounts owed to them would be repaid in full.

72. For any orderly, durable, and equitable debt workout both considerations are equally harmful and need to be countered. It is important that any debt workouts be based upon a set of principles, otherwise, countries get bogged down in time-consuming discussions and negotiations. In these principles, debt, in the form of loans from banks, should not enjoy any seniority in claims, compared to, say, bonds or debentures. This is admittedly normal practice in corporate liquidations. However, in a corporate liquidation full value is not, and cannot be, guaranteed to any creditors. It has to be remembered that in the event of a crisis many, if not most, borrowers become *de facto* bankrupt. If they were to go into liquidation, banks would recover only a small fraction of their original loan amounts and that, too, after a substantial delay. Equally, however, it is not in the interest of the borrowers to go into bankruptcy as this would impair, perhaps fatally, their access to future credits. In an orderly debt workout there would thus need to be a mutually satisfactory adjustment of claims. A set of principles should be internationally agreed upon. Those should include elements such as conversion into longer term securities, reduction in face value, lower interest rates and standstill on debt servicing. The objective is to impart a certain degree of automaticity to the negotiating process, rather than to rely on open-ended negotiations in which debtors and creditors may adopt extreme positions and it takes a long time to find a middle ground or alternatively, developing country debtors easily succumb to foreign creditors' pressures.

An Asian Fund

73. In the Asian context, there is one area where regional cooperation is both desirable and eminently feasible. This relates to the establishment of an Asian Fund. One argument against such a Fund is that it would duplicate IMF. This argument can be turned over its head and a point can be made that Asian Fund would augment IMF resources. It may be noted that the possibility of duplication did not prevent the establishment of regional development banks in parallel with the World Bank. The second argument is that Asian Fund could undermine the conditionalities of IMF. This should hardly be a matter of concern as IMF should welcome competition in the realm of ideas concerning macroeconomic management. The sole wisdom of IMF has been questioned by many in view of the impact of policy packages prescribed for the Asian countries in crisis. And if the moral hazard argument with respect to policy makers is not valid in the case of IMF, it should be equally inapplicable to Asian Fund. On the positive side, the existence of a quick-disbursing Asian Fund, with conditionalities limited to immediate stabilization measures rather than a complete overhaul of economic structures during a crisis, is likely to reduce exaggerated reactions on the part of market participants and mitigate incentives for rapid exit.

Table 1. Indicators of integration into the global economy

	Trade (Percentage of GDP)		Stock of debt to foreign private creditors (billions US dollars)		Net portfolio equity flows (annual average, million US dollars)		Inward FDI stock (Percentge of GDP)	
	1980	1995	1992	1996	1985-1989	1993-1997	1980	1995
Indonesia	53	53	28	55	40	2'879	14	25
Malaysia	113	194	8	22	56	2'237	25	52
Philippines	52	80	7	13	51	1'244	4	9
Republic of Korea	74	67	39	100	42	3'414	1.8	2.3
Thailand	54	90	23	70	421	1'195	3	10

Sources : ESCAP, 1997 and 1998; UNCTAD, 1997; and World Bank, 1999a.

Table 2. GDP growth rates

	1980-1990	1990-1997
Indonesia	6.1	7.5
Malaysia	5.2	8.7
Philippines	1.0	3.3
Republic of Korea	9.5	7.2
Thailand	7.6	7.5

Source : World Bank, 1999b.

Table 3. Selected indicators of structural change

	Agriculture (Percentage of GDP)		Manufacturing exports (Percentage of merchandise exports)	
	1980	1997	1980	1996
Indonesia	24	16	2	51
Malaysia	22	13	19	76
Philippines	25	20	21	84
Republic of Korea	15	6	90	92
Thailand	23	11	25	73

Source : World Bank, 1999b.

Table 4. Incidence of poverty and inequality

	Percentage of poor population		Gini coefficient	
	1980	1996	1980	1996
Indonesia	28.6	11.3	0.340	0.340 a/
Malaysia	20.7 b/	6.8 c/	0.480 b/	0.464 d/
Philippines	54.0 e/	40.0	0.461 e/	0.450 f/
Republic of Korea	24.5	7.0	0.389	0.295
Thailand	23.0	11.4	0.453	0.477

Source: ESCAP Secretariat, based on various national sources and ESCAP, 1998.

a/ Data pertains to 1993.
b/ Data pertains to 1984.
c/ Data pertains to 1997.
d/ Data pertains to 1995.
e/ Data pertains to 1985.
f/ Data pertains to 1991.

Table 5. Incidence of unemployment and poverty and GDP growth rates

	Unemployment			Percentage of poor population		GDP growth (Percentage)	
	1996	1998					
	(Percentage)	(Percentage)	Number (millions)	1996	1998	1998	1999
Indonesia	2.3	17.1	16.2	11.3	40.0	-13.5	-2.3
Malaysia	2.6	3.9	0.3	6.8 a/	7.6	-6.9	1.3
Philippines	8.6	10.1	3.1	40.0	43.0	-0.5	2.1
Republic of Korea	2.0	6.8	1.5	3.0 b/	7.5 c/	-5.8	5.2
Thailand	1.5	4.0	1.3	11.4	12.9	-8.9	2.7

Sources : ESCAP Secretariat, based on various national sources.

a/ Estimate refers to 1997.
b/ Refers to 1997 fourth quarter data for urban workers' households.
c/ Refers to third quarter data for urban workers' households.

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