UNIT 15 REGIONAL TRADING BLOCS

Structure

15.0 OBJECTIVES

After reading this Unit, you will be able to:

- understand the economic logic of regional trading blocs; and
- examine the experiences of various regional trade integration initiatives.

15.1 INTRODUCTION

There are various forms of economic integration and regional trading blocs are only one of them. The degree of economic integration can be categorised into five stages: (i) Preferential trading area (ii) Free trade area (iii) Customs union (iv) Common market and (v) Economic and monetary union. In a preferential trading area, members grant tariff preferences amongst them while in a free trade area, members move towards zero or near-zero tariff levels amongst them on substantially all trade. In a customs union, members, in addition have a common external tariff on products coming from outside the union. Freer movement of factors of production is allowed in the case of common market. In the case of economic and monetary union, harmonisation of various economic policies, including monetary policies are also effected.

These stages of regional integration, if adopted in sequence, depict deeper economic integration processes. In reality, however, countries have embarked upon regional integration without, at times, following the strict sequence of different stages of integration.

The main reason for regional trade integration is imbibed in the theories of trade creation and trade diversion.

15.2 REGIONAL TRADING BLOCS AND TRADE CREATION

Trade creation means that a free trade area (FTA), through preferential tariff concessions, creates trade that would not have existed otherwise. As a result, supply occurs from a more efficient producer of the product within a free trade area. In all cases trade creation will raise a country's national welfare, as imports replace high-cost domestic production.

Trade diversion means that a free trade area diverts trade, away from a more efficient supplier outside the FTA, towards a less efficient supplier within the FTA. In some cases, trade diversion will reduce a country's national welfare but in some cases national welfare could improve despite the trade diversion.

Jacob Viner introduced the key concepts of trade creation and trade diversion in his pioneering study of the theory of customs unions. Through a simple model, Viner showed that forming a customs union could have welfare-increasing effects whereas it could have welfare-reducing effects in other circumstances.

This is illustrated in the Table 15.1, which shows production cost of a homogeneous product in three countries.

Table 15.1: Production costs of Homogeneous Product in Country X, Y, Z

Country	X	Y	Z
Production cost	500	400	300

Assuming that the production cost determines the price of the good and tariffs remain as the only source of divergence between price and cost it is possible to understand the effects of preferential tariff liberalisation under a customs union.

Initially if *X* imposes a tariff of 100 per cent, demand in *X* would have a choice among domestic products at a price of 500, imports from *Y* at a price of 800, and imports from *Z* at a price of 600. In such a situation, *X* would not import the good.

If *X* and *Y* form a customs union and impose the same 100 per cent tariff on imports from *Z*, consumers in *X* will face a choice between indigenous products at a price of 500, imports from *Y* at a price of 400, and imports from *Z* at a price of 600. *X* would then import the good from *Y*. This is an example of trade creation, which replaces relatively inefficient (high-cost) indigenous production with efficient (low-cost) imports from the partner country, leading to welfare gains.

In case, before the formation of a customs union *X* levies a tariff of 50 per cent then consumers demand in *X* would have a choice between domestic goods at a price of 500, imports from *Y* at a price of 600, and imports from *Z* at a price of 450. *X* would import the good from the lowest-cost import source, i.e. country *Z*. At this stage if *X* and *Y* form a customs union consumers in *X* will be faced with the choice of paying 500 for the indigenous products and 400 for imports from *Y*, and 450 for imports from *Z*. *X* will now import *X* from *Y*. Imports will be switched from the lowest-cost supplier, *Z* to the higher-cost supplier, *Y*. This is an example of trade diversion. Trade diversion takes place when a country shifts its source of imports from a more efficient country to a less efficient country because of the tariff-preferences in a customs union. This will lead to a lowering of welfare, as it entails a less efficient allocation of resources.

The issue becomes further complicated when under a regional trade agreement (RTA) tariffs are not reduced to liberalised full to make it zero. In which case, the calculations to find out the most-efficient supplier may vary as the members of the RTA do not have necessarily zero tariffs among them.

It is quite evident from the above that in the simplest form the Vinerian model trade creation is always welfare increasing and trade diversion always leads to a reduction in welfare. This is an argument often used by those who wish to highlight the limitations of RTA or a customs union. However, quite importantly if we do away with the assumption that demand is perfectly price inelastic then such a conclusion becomes erroneous. Both trade creation and trade diversion arise because formation of the customs union leads to a fall in the price faced by consumers in *X*. Thus, if demand is not perfectly inelastic then this fall in price could lead to an increase in consumption, which is a source of welfare gain to consumers. Consumption gains in this context enhance the welfare-increasing effects of trade creation. They have the potential to outweigh the welfare-reducing effects of trade diversion and could present a scenario wherein trade diversion leads to welfare-increase.

A more detailed treatment of this subject is presented here as this concept is the backbone of regional economic integration and has remained quite confusing.

15.2.1 Trade Diversion

Fig 15.1 demonstrates as to how trade diversion could be welfare reducing to a country that enters into an FTA. It shows the supply and demand curves for country A. P^B and P^C represent the free trade supply prices of the good from countries B and C, respectively. We assume that A has a specific tariff $t^B = t^C = t^*$ set on imports from both countries B and C. The tariff raises the domestic supply prices to $P_T^{\,B}$ and $P_T^{\,C}$, respectively. The size of the tariff is equal to $P_T^{\,B} - P^B = P_T^{\,C} - P^C$. It is quite clear that country A will import the product from country C and will not trade initially with country B. Imports would be to the order of $D^1 - S^1$.

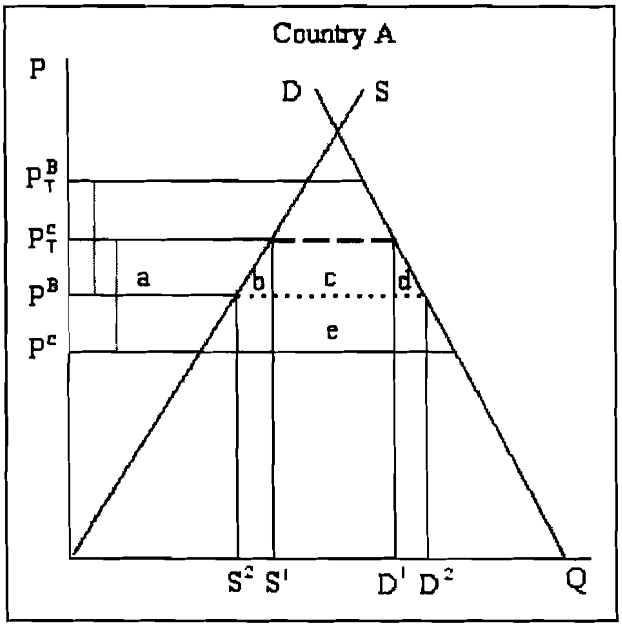

Figure 15.1: Trade Diversion

After countries A and B form an FTA, A would impose zero tariff on imports from country B. Consequently, the domestic prices on goods from countries B and C would be P^B and $P_T^{\,C}$, respectively. Since $P^B < P_T^{\,C}$, country A would import only from country B after the FTA. At the lower domestic price, P^B, imports would rise to $D^2 - S^2$. Since the initial price in country C is lesser than the price in country B, imports from B are considered as *diverted* from a more efficient supplier C to a less efficient supplier B.

Table 15.2: Welfare Effects of RTA: Trade Diversion

Effects on	*Country A*
Consumer Surplus	+ (a + b + c + d)
Producer Surplus	- a
Govt. Revenue	- (c + e)
National Welfare	+ (b + d) – e

It is evident from the Table 15.2 that the net national welfare effect can be either positive or negative. Usually, trade diversion is considered to be welfare reducing as highlighted earlier. However, in certain conditions the national welfare change could be positive under the trade diversion scenario as well. If the free trade supply price (P^B) offered by country B is lower and closer to country C's free trade supply price P^C , trade diversion still occurs after the FTA-formation. The welfare effects remain the same as far as the direction is concerned, however, they differ in magnitude. The consumer surplus gain is becomes larger due to the larger drop in the domestic price. Thus, in such cases, formation of an FTA that causes trade diversion could have a positive welfare effect. Thus, trade diversion need not necessarily be welfare reducing.

15.2.2 Trade Creation

Trade creation under an FTA implies that imports are sourced from a more efficient producer within the region, at times involving a shift of imports away from the rest of the world. Such a shift is welfare increasing in a member country of the FTA. In the above Figure 15.1 you should be able to see that if country A enters into a FTA with the more efficient supplier country C, there will be only trade creation and no diversion. Another example of trade creating effects, where country A forms an FTA with country B, is demonstrated in Figure 15.2.

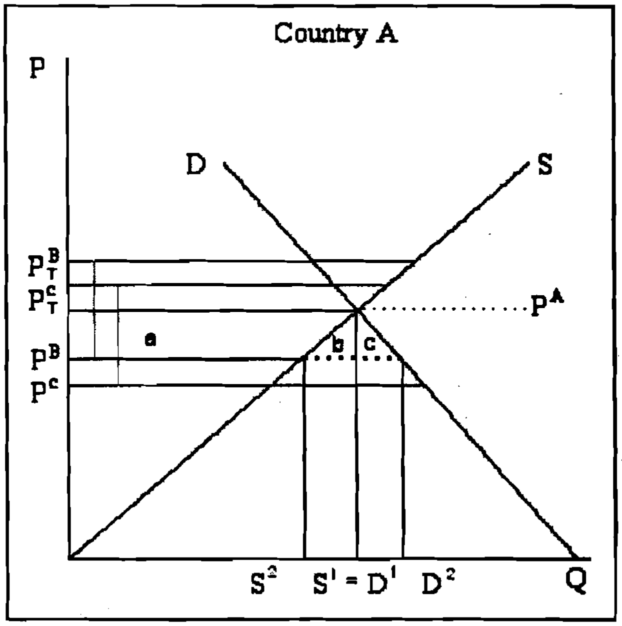

Figure 15.2: Trade Creation

The supply and demand curves for country A are displayed in the figure. The supply prices of the good from countries B and C, respectively, are represented by P^B and P^C. As assumed earlier, A has a specific tariff $t^B = t^C = t^*$ set on imports from both countries B and C. The tariff raises the domestic supply prices to P_T^B and P_T^C, respectively. The size of the tariff is denoted by $t^* = P_T^B - P^B = P_T^C - P^C$. Including the tariffs, the pre-FTA price in country A (P^A) is less than both P_T^B and P_T^C, hence the product will not be imported. Instead country A will meet its domestic demand with its own supply at $S^1 = D^1$.

If countries A and B form an FTA and A fully eliminates the tariff on imports from country B, the t^B, becomes zero but t^C remains at t^*. The domestic prices of goods from countries B and C become P^B and P_T^C, respectively. Since $P^B < P^A$, country A would now import the product from country B after the FTA. At the lower domestic price P^B, imports would rise to $D^2 - S^2$. It may be noted that trade now is generated in the post-FTA scenario from an efficient source within the region it is called trade creation.

Table: 15.3 Welfare Effects of RTA: Trade Creation

Effects on	*Country A*
Consumer Surplus	+ (a + b + c)
Producer Surplus	- a
Govt. Revenue	0
National Welfare	+ (b + c)

The net welfare effect for the country A can be assessed aggregating the gains and losses to consumers and producers. It has two positive dimensions: a positive production efficiency gain (b) and a positive consumption efficiency gain (c). Thus, an FTA that leads to trade creation implies net welfare gains. You should be able to show that the gain would be even larger if country A entered into the FTA with the more efficient supplier country C.

The analysis of trade creation and trade diversion can also be extended to many markets and multiple countries of an FTA. Therefore, the aggregate effects of an FTA can be obtained by summing up the effects across markets and across countries. Finally, the net welfare effects are measured by taking both trade creation and trade diversion into account. If the positive effects from trade creation outweigh the negative effects from trade diversion, the FTA under consideration is said to be welfare improving.

It is for this reason both trade creation and trade diversion effects need to be combined to assess the welfare-increasing effects of a customs union or RTA.

15.3 REGIONAL TRADING BLOCS AS PROMOTERS OF GLOBAL TRADE

It is clear from the preceding section that if the positive effects from trade creation are larger than the negative effects from trade diversion, the FTA will improve national welfare.

It is for this reason that even the multilateral regime of the erstwhile GATT and the present WTO allows for derogation from the principle of non-discrimination enshrined in Most-favoured Nation (MFN) as per Article XXIV an enabling clause this is also available under the General Agreement on Trade and Services (GATS).

Considering this, the vast majority of WTO members are party to one or more regional trade agreements. The surge in RTAs has continued unabated since the early 1990s. Some 250 RTAs have been notified to the GATT/WTO up to December 2002, of which 130 were notified after January 1995. Over 170 RTAs are currently in force; an additional 70 are estimated to be operational although not yet notified.

As a result, it is estimated that almost three-fourth of global trade is conducted under RTAs and not under the MFN principle. It is this sense that regional trading blocs have emerged as promoters of global trade. But if an RTA causes more negative effects of trade diversion than positive effects of trade creation then the RTA may be *welfare reducing* for a country. This is the argument often taken recourse to for arguing against the efficacy of regional trading blocs. Another problem with RTAs is that they involve complicated 'rules of origin' to ensure that imports are really coming from the RTA partners and not from outside countries. For all these reasons, it is argued that RTAs are stumbling blocks rather than building blocks of the multilateral free trade regime.

Check Your Progress 1

1) "Trade creation is always welfare increasing while trade diversion may be welfare reducing." Explain.

....

....

....

....

2) Briefly discuss the welfare effects of Regional Trade Agreements both in case of (i) trade diversion and (ii) trade creation.

....

....

....

....

3) Briefly explain the role of RTAs in Global trade.

....

....

....

....

15.4 CASE STUDIES OF REGIONAL TRADING BLOCS

In order to probe into the validity of some of the theories as also to highlight the differences in theories and practice it would be worthwhile to analyse some of the cases of regional trading arrangements in different parts of the world. In this regard, an overview of the experiences of APEC, EU, NAFTA, ASEAN, SAARC etc. are presented. In addition, some of the experiences relating to the India's engagements in this regard are also discussed. It would be noticed that the proliferation of RTAs have mostly been taking place due to their actual and potential trade and economic gains.

15.4.1 Asian Pacific Economic Cooperation (APEC)

APEC began as an informal Ministerial-level dialogue group with 12 members in1989 in Canberra, Australia. APEC Economic Leaders met for the first time to outline APEC's vision, "stability, security and prosperity for our peoples" in 1993 in the USA. In 1994 in Indonesia it set the Bogor Goals of, "free and open trade and investment in the Asia-Pacific by 2010 for developed economies and 2020 for developing economies." APEC adopted the Osaka Action Agenda (OAA) which provides a framework for meeting the Bogor Goals through trade and investment liberalisation, business facilitation and sectoral activities, underpinned by policy dialogues, economic and technical cooperation in 1995. Since then through the Manila Action Plan for APEC (MAPA) in 1996 and Early Voluntary Sectoral Liberalisation (EVSL) scheme of 1997 in 15 sectors efforts have been made to achieve the free trade goals.

In 2000 in Brunei, APEC established an electronic Individual Action Plan (e-IAP) system, providing IAPs online and commited to the Action Plan for the New Economy, which, amongst other objectives, aimed to triple Internet access throughout APEC region by 2005.

APEC's first Counter-Terrorism Statement is issued in China in 2001. It agreed to re-energise the WTO Doha Development Agenda negotiations and stressed the complementary aims of bilateral and regional trade agreements, the Bogor Goals and the multilateral trading system under the WTO in 2003 in

Thailand. APEC dedicated itself not only to promoting the prosperity of member economies, but also to improving the security of the peoples of the Asia-Pacific region. APEC pledged to take specific actions to dismantle terrorist groups, eliminate the danger of weapons of mass destruction and confront other security threats. Members sign up to the APEC Action Plăn on SARS and the Health Security Initiative to further protect personal security. APEC also strengthened its efforts to build knowledge-based economies, promote sound and efficient financial systems and accelerate regional structural reform.

In 2005 in Korea APEC adopted the Busan Roadmap, completed the Mid-Term Stocktake, which had found that APEC is well on its way to meeting the Bogor Goals, and the APEC Privacy Framework. Leaders issued a stand-alone statement in support of a successful conclusion to the WTO's 6th Ministerial Meeting in Hong Kong, China and agree to confront pandemic health threats and continue to fight against terrorism, which could cause deep economic insecurity for the region.

The above sequence of events and decisions only point to the fact that APEC has been high on its agenda but the actual progress in terms of trade and investment integration has been rather invisible. There are hardly any studies that offer any signs of progress in real terms. The main reasons for the less than desired success of APEC can be considered as disparate membership and very wide agenda, which has lacked focus.

15.4.2 European Union

The European Union grew out of the European Coal and Steel Community (ECSC), which was founded in 1951, by the six founding members: Belgium, the Netherlands and Luxembourg (the Benelux countries) and West Germany, France and Italy. Its purpose was to pool the steel and coal resources of the member states, thus preventing another European war. It was in fulfilment of a plan developed by a French civil servant Jean Monnet, publicised by the French foreign minister Robert Schuman. On May 9, 1950 Schuman presented his proposal on the creation of an organised Europe stating that it was indispensable to the maintenance of peaceful relations. This proposal, known as the "Schuman declaration", is considered to be the beginning of the creation of what is now the European Union, which later chose to celebrate May 9 as Europe Day.

The ECSC was followed by attempts, by the same member-states and with much encouragement from NATO, to found a European Defence Community (EDC) and a European Political Community (EPC). Following the failure of the EDC and EPC, the six founding members tried again at furthering their integration, and founded the European Economic Community (EEC). The purpose of the EEC was to establish a customs union among the six founding members, based on the "four freedoms": freedom of movement of goods, services, capital and people. Euratom was to pool the non-military nuclear resources of the states. The EEC was by far the most important of the three communities, so much so that it was later renamed simply the European Community. It was established by the Treaty of Rome of 1957 and implemented January 1, 1958.

The growth of these European Communities into what is currently the European Union can be said to consist of two parallel processes – first their structural evolution and institutional change into a tighter bloc with more competences given to the supranational level, which can be called the process of European integration or the *deepening* of the Union. The other is the enlargement of the European Communities (and later European Union) from 6 to 25 member states, which is also called the *widening* of the Union.

In January 1960, Britain and other OEEC members who didn't belong to the EEC formed an alternative association, the European Free Trade Association. But Britain soon realised that the EEC was more successful than the EFTA and decided to apply for membership. From an original EC membership of 6 in 1958, the EU has gradually expanded and as of 1 May 2004, there are total 25 Member States. There have been four enlargements since 1958:

- 1973 - to include Denmark, Ireland, and the UK.
- 1981 - to include Greece.
- 1986 - to include Spain and Portugal.
- 1995 - to include Austria, Finland and Sweden.

A historic achievement was marked on 1 May 2004, when ten countries joined the existing fifteen Member States of the European Union, uniting the continent after decades of division. On that day, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia joined the EU as new Member States

In 1992, the Maastricht treaty was signed, which at the same time modified the Treaty of Rome. It established the European Union, turning the European Communities into the EU's so-called "first-pillar", and adding two further pillars of cooperation, on Common Foreign and Security Policy and on Justice and Home Affairs. At the same time it established Economic and Monetary Union as a formal objective. The Maastricht treaty came into force in 1993.

The European Economic Area was founded in 1994 in order to allow EFTA countries to participate in the Single Market without having to join the EU.

In 1997, the Treaty of Amsterdam was signed, which updated the Maastricht treaty and aimed to make the EU more democratic.

In January 1999, eleven countries (Austria, the Benelux countries, Finland, France, Germany, Ireland, Italy, Portugal and Spain) agreed to join the euro and abandon their existing currencies. Greece joined two years later, in January 2001, bringing the members of the eurozone to twelve. On January 1, 2002, Euro notes and coins entered circulation.

The EU is considered to be the most telling example of a customs union and a monetary and economic union. However, due to differences among its members problems lie ahead such as in the case of the Euro, which does not have full membership.

15.4.3 North American Free Trade Agreement

In January 1994, Canada, the United States and Mexico launched the North American Free Trade Agreement (NAFTA) and formed the world's largest free trade area. NAFTA is considered to have brought economic growth and rising standards of living for the people of all three member countries since 1994. This has been achieved by strengthening the rules and procedures governing trade and investment throughout the continent.

This has been brought about by formulating and implementing the free trade agreement, which covers dimensions such as the Trade in Goods, Rules of

Origin, Technical Barriers to Trade; Government Procurement, Investment, Services and Related Matters, Intellectual Property, and Administrative and Institutional Provisions.

Following a final tariff reduction between Canada and Mexico, which took effect on January 1, 2003, virtually all trade in the NAFTA region has flowed tariff-free.

NAFTA has enabled both Canada and Mexico to increase their exports to the United States: Canadian manufacturers now send more than half their production to the U.S., while Mexico's share of the U.S. import market has almost doubled from 6.9% in pre-NAFTA 1993 to 11.6% in 2002. Manufacturers in all three countries are better able to realise their full potential by operating in a larger, more integrated and efficient North American economy. In 2002, Canada was the most important destination for merchandise exports from 39 of the 50 U.S. states.

Under NAFTA, countries have been able also to introduce the highly successful approach of parallel environmental and labour cooperation agreements. The economic integration promoted by NAFTA has spurred better environmental performance across the region. Through the North American Agreement on Environmental Cooperation, the three partners are promoting the effective enforcement of environmental laws. Through the North American Agreement on Labour Cooperation, Mexico and the United States are working together to protect, enhance and enforce basic workers' rights.

Given these, NAFTA is often cited as a successful example of a regional trading bloc, which has through the effects of trade creation brought welfare gains to the participating countries.

Check Your Progress 2

1) Briefly discuss the role of APEC in the promotion of trade and investment.

....

....

....

....

2) Explain the formation and growth of European Union.

....

....

....

....

....

3) "NAFTA is cited as a successful example of RTA". Discuss.

....

....

....

....

15.4.4 ASEAN

The Association of Southeast Asian Nations (ASEAN) was established in 1967 in Bangkok by the five original Member Countries, namely, Indonesia, Malaysia, Philippines, Singapore, and Thailand. Brunei Darussalam joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997 and Cambodia in 1999, making it ASEAN-10.

ASEAN began with emphasis on political issues but in recent times economic integration has become priority, especially since the Asian crisis of the 1997. In 1992, the ASEAN Heads of State and Government declared that ASEAN should intensify its external dialogues in political and security matters as a means of building cooperative ties with states in the Asia-Pacific region. Two years later, the ASEAN Regional Forum or ARF was established. The ARF aims to promote confidence-building, preventive diplomacy and conflict resolution in the region.

When ASEAN was established, trade among the Member Countries was insignificant. Estimates between 1967 and the early 1970s showed that the share of intra-ASEAN trade from the total trade of the Member Countries was between 12 and 15 percent. Thus, some of the earliest economic cooperation schemes of ASEAN were aimed at addressing this situation. One of these was the Preferential Trading Arrangement of 1977, which accorded tariff preferences for trade among ASEAN economies. Ten years later, an Enhanced PTA Programme was adopted at the Third ASEAN Summit in Manila further increasing intra-ASEAN trade.

The Framework Agreement on Enhancing Economic Cooperation was adopted at the Fourth ASEAN Summit in Singapore in 1992, which included the launching of a scheme toward an ASEAN Free Trade Area or AFTA. The strategic objective of AFTA is to increase the ASEAN region's competitive advantage as a single production unit. The elimination of tariff and non-tariff barriers among the member countries is expected to promote greater economic efficiency, productivity and competitiveness. The Fifth ASEAN Summit held in Bangkok in 1995 adopted the Agenda for Greater Economic Integration, which included the acceleration of the timetable for the realisation of AFTA from the original 15-year timeframe to 10 years.

In 1997, the ASEAN leaders adopted the ASEAN Vision 2020, which called for ASEAN Partnership in Dynamic Development aimed at forging closer economic integration within the region. The vision statement also resolved to create a stable, prosperous and highly competitive ASEAN Economic Region, in which there is a free flow of goods, services, investments, capital, and equitable economic development and reduced poverty and socio-economic disparities. The Hanoi Plan of Action, adopted in 1998, serves as the first in a series of plans of action leading up to the realisation of the ASEAN vision.

ASEAN cooperation has resulted in greater regional integration. Within three years from the launching of AFTA, exports among ASEAN countries grew at an average yearly growth rate of 28.3 percent. In the process, the share of intra-regional trade from ASEAN's total trade rose from 20 percent to almost 25 percent. Tourists from ASEAN countries themselves have been representing an increasingly important share of tourism in the region.

ASEAN economic cooperation is comprehensive, which covers the following areas: trade, investment, industry, services, finance, agriculture, forestry, energy, transportation and communication, intellectual property, small and medium enterprises, and tourism.

The above suggests that the ASEAN is a successful regional trading bloc developing world taking advantages of the economics of trade creation.

15.4.5 MERCOSUR

A short while after the creation of the European Coal and Steel Community (1954) and the European Economic Community (1957), Latin America was already beginning to take its first steps towards regional integration. The treaty that created the Latin American Free Trade Association (ALALC), signed in 1960, provided for the creation of a free-trade zone, by means of periodical and selective negotiations between its member states. The ALALC trade opening program developed reasonably well in its first years but lost impetus in 1965 and almost came to a complete standstill in the 1970s.

The Latin American Integration Association, created in 1980 to replace ALALC, used other means to attempt member state integration. In place of the free-trade zone established by ALALC, an economic preference zone was established creating conditions favorable to the growth of bilateral initiatives, as a prelude to the institution of plurilateral relationships in Latin America. Under the ALADI system Brazil and Argentina signed in 1986 twelve commercial protocols, which brought the two countries closer.

After the adhesion of Paraguay and Uruguay a new treaty was signed by all four countries on March 26, 1991 to be known as the Southern Common Market (MERCOSUR).

The trade opening program targeted the end of duty and other nontariff restrictions on trading between Argentina and Brazil by December 31, 1994, and by December 31, 1995 for trade with Uruguay and Paraguay.

Trade between the four member countries has grown sharply. In the period 1990-1994, the value of intraregional trade nearly tripled, from US$4.1 billion to US$10.7 billion. This growth partly reflects the progress made under the Trade Liberalisation Program, as well as the gradual elimination of non-tariff restraints to reciprocal trade and an increase in trade and production initiatives among entrepreneurs in the region.

In 1994, intraregional exports increased for the fifth consecutive year, to nearly one-fifth of the combined value of exports of the four countries, well up from a level of under 9 per cent in 1990. This and the recent performance confirms the trend in which MERCOSUR has consolidated its position as the principal trading partner of Paraguay and Uruguay and the principal market for Argentine exports.

The impact of the creation of MERCOSUR has also been reflected in the increasing flow of intraregional investments. Macroeconomic stability in Argentina, together with the strong economic growth seen in the last four years in this country, has created incentives for both investors in the sub-region and multinational corporations. In response to the opportunities afforded by a larger economic market, multinational corporations have formed partnerships with entrepreneurs in the sub-region or have set up subsidiaries in a broad range of production and commercial sectors.

This is yet another successful example of regional integration in the developing world. Since Mercosur is a customs union and a common market, it is more deeply integrated than ASEAN.

15.4.6 SAARC

The South Asian Association for Regional Cooperation (SAARC) was established when its Charter was formally adopted on 8 December 1985 by the Heads of State or Government of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

The Association provides a platform for the peoples of South Asia to work together in a spirit of friendship, trust and understanding. It aims to promote the welfare of the peoples of South Asia and to improve their quality of life through accelerated economic growth, social progress and cultural development in the region.

The areas of cooperation under the reconstituted Regional Integrated Programme of Action which is pursued through the Technical Committees now cover: Agriculture and Rural Development; Health and Population Activities; Women, Youth and Children; Environment and Forestry, Science and Technology and Meteorology; Transport; and Human Resource Development. Working Groups have also been established in the areas of: Information and Communications Technology (ICT); Biotechnology; Intellectual Property Rights (IPR); Tourism; and Energy.

Summits are the highest authority in SAARC and are to be held annually. The Council of Ministers comprising Foreign Ministers, meets at least twice a year. Its functions include formulating policy, reviewing progress of regional cooperation, identifying new areas of cooperation and establishing additional mechanisms that may be necessary.

The Standing Committee comprising Foreign Secretaries, monitors and coordinates SAARC programmes of cooperation, approves projects including their financing and mobilises regional and external resources. It meets as often as necessary and reports to the Council of Ministers. The Committee on Economic Cooperation consisting of Secretaries of Commerce oversees regional cooperation in the economic field.

The Agreement on SAARC Preferential Trading Arrangement (SAPTA) was signed in 1993 and four rounds of trade negotiations have been concluded. With the objective of moving towards a South Asian Economic Union (SAEU), the Agreement on South Asian Free Trade Area (SAFTA) was signed during the Twelfth Summit in Islamabad in January 2004. SAFTA entered into force since July 2006.

During the Twelfth Summit in Islamabad, the SAARC Social Charter was signed in order to address social issues such as population stabilisation, empowerment of women, youth mobilisation, human resource development, promotion of health and nutrition, and protection of children, which are keys to the welfare and well-being of all South Asians. The Governors of the Central Banks of Member States under the auspices of SAARCFINANCE meet regularly to consider cooperation in financial matters.

The intra-SAARC trade has hovered around 4-5 percent of the total trade of SAARC countries despite the rich potential that the region has, as evident from various studies on prospects for trade creation and scope of trade complementarities.

15.4.7 India's Engagements

In recent times, India has got engaged actively in regional economic integration processes at various levels of bilateral, sub-regional and regional cooperation. India has a treaty of trade with Nepal and a free trade agreement with Bhutan. Both the experiences have been successful in generating bilateral trade flows on a preferential basis. India also signed an implemented and FTA with Sri Lanka, which has also emerged as a success story in as much as trade deficit for Sri Lanka has declined vis-à-vis India. Moreover, Sri Lanka has also gained in receiving outward FDI from India in various sectors. India is also actively participating in the South Asian Free Trade Area (SAFTA) Agreement.

More recently, India has implemented an Early Harvest Scheme (EHS) with Thailand under the Framework Agreement. Presently, negotiations for the India-Thailand FTA are underway. A Comprehensive Economic Cooperation Agreement (CECA) has also been implemented between India and Singapore which includes agreements for promoting trade in goods and services as well as investment.

India-ASEAN FTA and BIMSTEC FTA are also under negotiation and efforts are on to build upon various initiatives leading towards an Asian Economic Community. Studies are underway for examining the feasibility of bilateral economic cooperation of India-China, India-Japan, India-South Korea, India-Malaysia etc. India is also focusing on cooperation to augment trade and investment with GCC, Central Asian Republics, Africa, MERCOSUR etc. Economic partnership agreements with developed regions like the EU and the US are also being contemplated upon.

These are indicative of the fact that India is making attempts to tap trade complementarities with various countries and regions in the world by taking advantage of the trade creating effects of regional trading blocs. You will learn more about this in Unit 17 in Block 6 of this course.

Check Your Progress 3

1) "ASEAN is a successful trading bloc". Discuss.

....

....

....

....

2) How MERCOSUR was formed? Discuss its origin and growth.

....

....

....

....

3) Discuss the formation of SAFTA. What is the Role of India in SAFTA?

....

....

....

....

15.5 LET US SUM UP

You have learnt about economic logic behind formation of regional trading blocs. The Unit explain to you that formation of such blocs leads either to trade creation or trade diversion. Depending upon the welfare effects of both trade creation and diversion, the welfare effects of RTA are assessed.

The Unit also exposes you to the various regional trading agreements all over the world. It discusses the origin and growth of APEC, EU, NAFTA, ASEAN, MEARCOSUR and SAARC.

15.6 KEY WORDS

Busan Roadmap: In the seventeenth ministerial conference held at Busan, republic of Korea, a joint statement was issued on Nov. 15, 2005 for charting out a action plan for APEC to Strengthen the Multilateral Trading System, Trade and Investment Liberalisation and Facilitation (TILF) and emerging security issues.

Customs Union: A group of countries that adopt free trade (zero tariffs and no other restrictions on trade) on trade among themselves, and also, agree to levy the same tariff on imports from outside the group on each product.

Harmonisation of Economic Policies: The changing and making the government regulations and practices, as a result of an international agreement compatible. For example, in the case of tariffs, this means making tariff rates more similar across industries and/or across countries.

Homogeneous Product: The product of an industry in which the outputs of different firms are indistinguishable.

Maastricht Treaty: The Maastricht Treaty (formally, the Treaty on European Union) was signed on 7 February 1992 in Maastricht between the members of the European Community and entered into force on 1 November 1993, under the Delors Commission. The Commission is considered to be the "Founding Fathers of the Euro" as they laid down the foundation for the Economic and Monetary Union (EMU) under the Treaty of Maastricht.

Preferential Trading Arrangement: It is a group of countries that levies lower (or zero) tariffs against imports from members than outsiders. It includes FTAs, customs unions, and common markets. PTA may be used for an arrangement where internal tariffs are reduced but are not zero, reserving FTA for a trading bloc with zero internal tariffs

Regional Integration: The formation of closer economic linkages among countries that are geographically near each other, especially by forming preferential trade agreements.

Regional Trading Bloc: A group of countries those are geographically closely associated in international trade, usually some sort of Preferential Trading Arrangement (PTA).

Schuman Declaration: The Schuman Declaration is the name of the May 9, 1950 public appeal by Robert Schuman, French Foreign Minister, to place

France's and West Germany's coal and steel industries under joint management. Inspired by Jean Monnet, the declaration's goal was for France, West Germany, and the Benelux countries to share strategic resources in order to build a lasting peace in Europe. This led to the creation of the European Coal and Steel Community (ECSC) in 1951, first of the European Communities and predecessor of the European Union.

Trade Creation: Viner gave the concept of trade creation in 1950. It is that trade, which occurs between members of a preferential trading arrangement and that replaces what would have been produced in the importing country in the absence of PTA. Trade creation is associated with welfare improvement for the importing country since it reduces the cost of the imported good.

Trade Diversion: Viner gave the concept of trade diversion in 1950. It is that trade, which occurs between members of a preferential trading arrangement that replaces what would have been imports from a country outside in the PTA. It is associated with welfare reduction for the importing country since it increases the cost of the imported good.

Treaty of Rome, 1957: The Treaty of Rome refers to the treaty, which established the European Economic Community (EEC) and was signed by France, West Germany, Italy, Belgium, the Netherlands and Luxembourg (the latter three as part of the Benelux) on March 25, 1957. The French leader de Gaulle denied access to the Great Britain on account of British ownership of U.S. missiles. The treaty is now generally called the Treaty establishing the European Community or the EC Treaty.

15.7 SOME USEFUL REFERENCES

Viner, Jacob. 1950. *The Customs Union Issue*, New York: Carnegie Endowment for International Peace.

Sodersten, B. and Reed, G. 1994. *International Economics*, 3rd ed., London: Macmillan.

RIS. 2005. "Regional Trading Arrangements (RTAs) in the World and Asia: Options for India", *Policy Brief* No. 17.

WTO. 2000. "Mapping of Regional Trade Agreements", WT/REG/W/41

http://www.europa.eu.int

http://www.nafta-sec-alena.org/DefaultSite/index_e.aspx

http://www.aseansec.org

http://www.saarc-sec.org/

http://www.wto.org/english/tratop_e/region_e/region_e.htm

http://www.ris.org.in

15.8 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Read Section 15.2

2) Read Section 15.2

3) Read Section 15.3

Check Your Progress 2

1) Read Sub-section 15.4.1

2) Read Sub-section 15.4.2

3) Read Sub-section 15.4.3

Check Your Progress 3

1) Read Sub-section 15.4.4

2) Read Sub-section 15.4.5

3) Read Sub-section 15.4.6 and 15.4.7

UNIT 16 INTERNATIONAL CAPITAL MOBILITY AND THE EMERGING MONETARY SYSTEM

Structure

16.0 OBJECTIVES

After reading this Unit, you will be able to:

- understand globalisation and macroeconomic management;
- describe the evolution of the global financial and capital regime;
- appreciate the nature, causes, impact and lessons from Asian crisis;
- analyse the evolution of the international monetary system; and
- derive the implications for the developing countries, especially after the Maastricht Treaty.

16.1 INTRODUCTION

International capital mobility has depended to a large extent on the nature of international financial system since the beginning of the Bretton Woods system. In Unit 5, you learned about the GATT and the WTO; in Unit 8, about the evolution of the international monetary system; in Unit 9, about the Bretton Woods financial institutions, the IMF and the World Bank; and in Unit 10, about the debt crises in various developing countries in the 1970s and 1980s. Given the fact that in present times, trade in goods and services are often linked to capital flows like the FDI and portfolio as well as the global technology regime it is important to understand the functioning of the erstwhile GATT and the present WTO, governing global trade through multilateral rules. This is an aspect often missed out in a discussion on international capital flows.

It would be noticed that the international monetary issues are difficult to discuss in isolation from the exchange rate management issues. In other words, the international monetary system has to be studied with the evolution of some of the related international financial and macroeconomic issues. This Unit therefore begins with a brief exposition of the standard IS-LM model for an open economy with the possibility of capital flows. This is followed by a review of the evolution of the international monetary system. It is discernible from the analysis that at present there is hardly any effective global monetary system under any one single multilateral institution. Recent developments of financial market integration and globalisation of capital flows have rendered the monetary system quite fragmented in nature and it often lacks coherence. On the other hand, they have increased the risk of contagion of crises. The Asian currency crisis is dealt with at some length. This only calls for setting in place a more strengthened international monetary and financial architecture. In the last part of this Unit a brief account of the theory of optimal currency areas is given, and post-Maastricht developments in the EU have been presented along with some of their possible implications for the developing countries.

16.2 GLOBALISATION AND MACROECONOMIC MANAGEMENT

Closer integration makes both a qualitative and quantitative change in economic decision-making. On the quantitative front, multipliers are smaller (because of the larger 'leakage' into imports) so that government needs to undertake larger policy actions either stimulate the economy or to slow it down. But it also means that a country is more readily affected by developments abroad. So a government has not only to respond to domestic events, but also foreign events including policy actions by governments of major countries and partners.

Qualitatively, capital market liberalisation has significant effects on economic management. Capital flows can have substantial destabilising effects. Most governments need to supplement domestic savings to maintain a high rate of investments and achieve higher growth. Policy makers have to become cautious about the danger that outflow of foreign capital can generate.

Consequently, most governments are striving to maintain adequate level of reserves. It is an open question whether it is good for poor country to hold such large reserves on which they earn a very low return. Building up of reserves means that either developing countries run a current account surplus, which means they are actually lending to the developed countries or build up reserves by borrowing for which they pay a higher interest rate. Therefore, in recent years, developing countries have been borrowing but most of this borrowing does not seem to have been used to boost the investment rate. Investment rates in Africa and Latin America are lower than they were in late 60s and 70s and this lowering of investment rates has contributed to reduced growth rates in these regions.

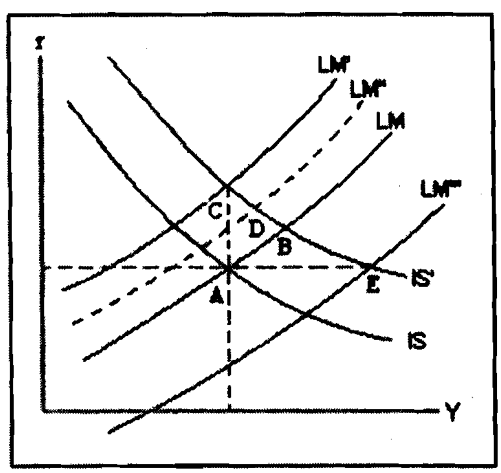

Figure 16.1: Effect of expansionary fiscal policy under Fixed Exchange Rate

Capital flows require a fundamental change in policy-making. We discuss how globalisation affects the ability of monetary and fiscal policy to affect the level of income. To examine this, we use the conventional IS-LM framework. You should revise your basic macroeconomics and the BOP concepts from Units 7 and 8. Suppose the government adopts an expansionary fiscal policy, then the IS curve shifts rightward from IS to IS'. This leads to an increase in the income and the interest rate, as the equilibrium shifts from A to B (Figure 16.1). The increase in income leads to higher imports and so to a worsening of the current account. If there are no capital flows, the worsening of the current account is also worsening of the BOP. This, under a fixed exchange rate (ER) system, will lead to a fall in foreign assets, a decline in the money base and in the money supply. So the LM curve will shift leftward to LM' and the new equilibrium will be at C. Here the original level of income and the current account is restored. The higher interest rate implies that interest sensitive expenditures, most importantly investments, are lower, namely have been crowded out by the expansionary fiscal policy.

If capital flows are permitted then because of the higher interest rate, capital will flow in so that there is a capital account improvement and the worsening of the BOP will be less and equilibrium could be at a point such as D where the current account deficit is matched by a capital account surplus. The position of D depends on the extent of capital mobility. If capital mobility is relatively small, as at D, there will only be a small improvement in income. The greater is the capital mobility, the greater is the increase in income and the smaller is the rise in the interest rate. If there is perfect capital mobility, the country can borrow any amount from the rest of the world at the going interest rate, which will also determine the domestic interest rate, which must therefore be the same as before the expansionary fiscal policy was implemented. The large inflow of capital would imply a BOP surplus and an outward shift of the LM curve to LM''' so that equilibrium is at E.

Suppose instead of a fixed ER, the country has a flexible exchange rate. If there are no capital flows, the BOP deficit after the expansionary policy will lead to a depreciation of the ER. This will increase net exports if the Marshall-Lerner-Robinson condition is satisfied (as explained to you in Unit 8), so that the IS curve will shift further to the right, to IS", leading to an equilibrium at F where income and the rate of interest are even higher (see Figure 16.2).

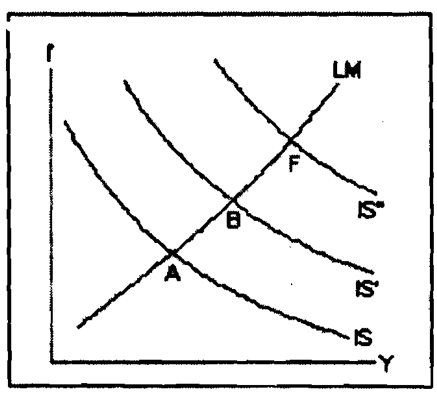

Figure 16.2: Effect of an Expansionary Fiscal Policy with a Flexible exchange Rate

If, however, there are capital flows, the inflow of capital will limit the depreciation, and so the rightward movement of the IS curve. With perfect capital mobility, there will be a BOP surplus and the ER will appreciate leading to a fall in net exports and hence a leftward shift of the IS curve. Ultimately, equilibrium will be restored at the initial level of income and the interest rate. In this case, the higher ER is crowding out exports to nullify the expansionary fiscal policy.

Hence, the fiscal policy is more effective in the presence of capital flows when the ER is fixed, but is ineffective when the ER is flexible.

Let us now examine the operation of monetary policy. An expansionary monetary policy will shift the LM curve rightward leading to equilibrium at J in the first instance (see Figure 16.3). Here income is higher so that there is current account deficit, and if there are no capital flows, a BOP deficit. Therefore, the country loses foreign exchange reserves to finance the deficit and money supply shrinks until the original equilibrium is restored, so monetary policy has no lasting effect on income. If, however, capital is mobile, there will be a deficit on the capital account also as capital flows out due to downward pressure on the domestic interest rate, so the LM curve will shift leftward faster. With perfect capital mobility, the LM curve will not shift at all, because any monetary expansion will lead to an equal outflow of foreign exchange. In this case, monetary policy is completely ineffective in changing the income level. This is often referred to as the impossible trinity – a country cannot simultaneously have a fixed ER, free capital mobility and an independent monetary policy.

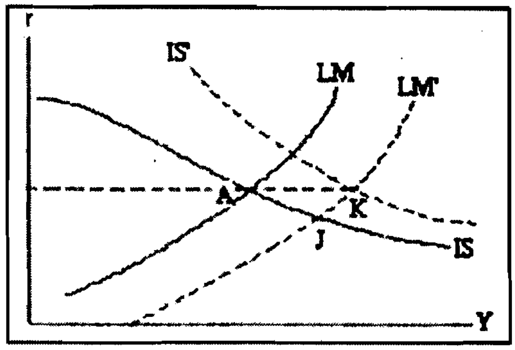

Figure 16.3: Effect of an Expansionary Monetary Policy under Fixed and Flexible Exchange Rates

If the ER is flexible, then with no capital mobility, the initial deficit will lead to a depreciation and a rightward shift in the IS curve so that there is still higher income. The depreciation will be still larger if capital is mobile as the capital account is in deficit. So the IS curve will shift until equilibrium is restored at the original interest rate, but at a higher level of income, say at point K.

Therefore, in a world with perfect capital mobility monetary policy is ineffective in a fixed ER system and very effective in a flexible ER system.

Hence, whether to use fiscal policy or monetary policy to manage short-term fluctuations depends on the extent of capital mobility.

Check Your Progress 1

1) What is the impact of capital mobility on fiscal policy?

....

....

....

....

....

2) Examine the impact of capital mobility on expansionary monetary policy.

....

....

....

....

....

16.3 EVOLUTION OF INTERNATIONAL MONETRAY SYSTEM AND ITS PRESENT STATUS

When a subject like the international monetary system is approached the first question which arises is in terms of a definition of it as opposed to the international financial system. The international financial system often includes the monetary and exchange rate arrangements in its coverage. The international financial system is defined as a set of global financial markets, global financial institutions, official lenders such as the IMF, and global regulatory arrangements.This set of institutions exists and has developed to facilitate cross border transactions in financial instruments. In the present Unit, developments in both monetary and financial matters would be taken up to elucidate any important dimension of the global financial and monetary systems'dynamics.

In economic theory, the interdependence of the international monetary system stems from the fact that balances of payment are connected together. If one country has a balance of payments surplus, the rest of the world has a balance of payments deficit and vice versa. If one country has a balance of trade surplus, the rest of the world has a balance of trade deficit. This has an influence on the exchange rate system. In a world of n countries with n currencies, there are n-1 independent exchange rates. No country can fix exchange rates. There would be too many fixed exchange rates. There is one degree of freedom, giving rise to what theorists called the redundancy problem. The role of that extra degree of freedom was to maintain a stable price level, or in the case of the gold standard, to maintain the price of gold.

With the rapid expansion of cross-border capital flows, the problem of what is widely known as the "impossible trinity" came to the fore. As you learnt above, it is impossible to achieve simultaneously the goals of a fixed exchange rate, an open capital account, and a monetary policy dedicated to domestic economic goals.

At this stage, the fixed exchange rate regime in various countries was dropped as a goal worth pursuing. Before 1971, in the fixed rates regime, the IMF could defend and manage the anchored dollar system of fixed exchange rates. The IMF lost its role as a guardian of the international monetary system since 1971 and especially after1973, the year the international monetary system moved towards flexible exchange rates. The Fund was then shifted from its role at the centre of the international monetary system to a new role of ad hoc macroeconomic consultant and debt monitor. With the breaking down of the gold exchange standard, which acted as a price-stabilisation mechanism through the interdependence of the currency system, there was inflationary pressure witnessed worldwide. Consequently, the Articles of Agreement of the IMF were amended in 1978 with a focus now on price stabilisation as imbibed in the amended Article IV.

The factors that led to the breakdown of the Bretton Woods system were discussed in Unit 8.3. To reiterate, in 1971, the United States decided to de-link the dollar from gold. Regarding role of the Fund, it is amply clear that the international monetary system was being run by industrialised countries and not by the IMF, as envisaged. When the challenge of the transition countries arose, the Fund had no coherent system for monetary stabilisation to offer. An international monetary system in the strict sense of the world does not presently exist. Every country has its own system.

There have been severe criticisms of the role and functioning of the IMF as a global institution playing a developmental role. The credentials of the IMF have been questioned by raising several issues including if IMF-supported programs impose austerity on countries in financial crisis. Alternatively, we may ask whether IMF-supported programs will facilitate bankers and elites. Similarly, one may ask whether programs supported by IMF constrain spending on priority sectors like education and health by "imposing" fiscal deficit limits. On the other hand, is the IMF unaccountable?

These have given rise to various unique trends in the international monetary system. These trends are fragmented and there is no one-umbrella institution, which can be said to be providing an international monetary and financial architecture, presently. These trends are summarised below:

- domestic financial market deregulation and opening by countries since the early 1980s
- internationalisation of domestic financial markets and institutions
- companies and financial institutions approach international capital markets to raise needed funds
- investors seeking investment opportunities abroad
- countries allow foreign corporations and financial institutions to issue bonds and stocks denominated in different currencies (including their own) in their domestic financial markets and also allow foreign investors to buy their domestic securities
- emergence of other international financial centers located in Europe and Asia along with the US bond and stock markets (the traditional international capital markets)
- growth of offshore money and capital markets such as the markets for Eurobond etc.
- integrated stock markets
- rapid globalisation of banking, insurance, and other intermediation businesses
- large banks from the U.S, Europe, Japan etc. have global network of branches and subsidiaries

Thus, the international capital market is not a single market. Instead, it refers to a group of offshore and onshore capital markets that are closely interconnected to one another and in which domestic and foreign residents buy and sell many different types of financial instruments. It is true of banking, insurance, and other intermediation businesses as well.

Resultantly, the growth of international capital flows has continued steadily in recent decades. However, as their volume grew, the potential effects of reversals became larger, and countries dependent on such flows, primarily short-term flows, became increasingly vulnerable to crises of confidence. In addition, contagion, the spreading of crises from one country to another, due to financial integration, has become a part of reality. That was evident not only in the Asian crisis of 1997, but also in Latin America and Russia in 1998. What is important such effects were felt even when economic fundamentals of the crisis-ridden countries were strong. Nevertheless, at this stage, the role played by the IMF cannot be discounted and the crisis only pronounced the need for having a strong global monetary and financial institution, which functions on developmental imperatives more than bailing out countries from crisis. We shall now explore the causes and consequences of the Asian crisis.

Check Your Progress 2

1) Point out the important dimensions of global financial and monetary system.

....

....

....

....

....

2) What are the trends in the international monetary and financial system?

....

....

....

....

....

16.4 SHORT-TERM CAPITAL MOVEMENTS AND EAST-ASIAN CRISIS - LESSONS FOR DEVELOPING COUNTRIES

The global financial system evolved over the years in a manner in which private capital flows took precedence over institutionalised flows from the Bretton Woods system. One of the main recipients of such attraction from the global capital market was the Asian region.

One of the reasons of such an attention was the economic dynamism displayed by the Asian countires whose achievement was broadly acclaimed by economic institutions including the IMF and World Bank, and was known as part of the Asian economic miracle. This economic dynamism was reflected in countries such as Thailand, Malaysia, Indonesia, the Philippines, Singapore, and South Korea that experienced high GDP growth rates of 8-12% in the late 1980s and early 1990s. However, a debate on the success of the Asian countries got initiated with Paul Krugman's article attacking the idea of an Asian economic miracle in 1994 by arguing that it lacked long term sustainability. He argued that East Asia's economic growth had historically been the result of capital investment, leading to growth in productivity. However, total factor productivity had increased only marginally or not at all. Krugman argued that only growth in total factor productivity, and not capital investment, could lead to long-term prosperity.

By 1997, Asia attracted almost half of total capital inflow to developing countries. The economies of Southeast Asia in particular maintained high interest rates attractive to foreign investors looking for a high rate of return. As a result the region's economies received a large inflow of hot money (short-term capital) and experienced a dramatic run-up in asset prices.

The Southeast Asian countires had large private current account deficits and the maintenance of pegged exchange rates encouraged external borrowing and led to excessive exposure to foreign exchange risk in both the financial and corporate sectors. In the mid-1990s, two factors began to change their economic environment. As the U.S. economy recovered from a recession in the early 1990s, the U.S. Federal Reserve Bank began to raise U.S. interest rates to combat inflation. This made the U.S. a more attractive investment destination relative to Southeast Asia, which had attracted hot money flows through high short-term interest rates. This step also raised the value of the U.S. dollar, to which many Southeast Asian nations' currencies were pegged, thus making Southeast Asian exports less competitive. At the same time, Southeast Asia's export growth slowed dramatically in the spring of 1996, due to a glut in the international market (more countries exporting similar products), deteriorating their current account position. Triggered by events in Latin America, particularly after the Mexican peso crisis of 1994, Western investors lost confidence in securities in East Asia and began to pull money out, creating a snowball effect. The Asian crisis started in mid-1997 and affected currencies, stock markets, and other asset prices of several Southeast Asian economies. Further, the financial crisis led to an economy-wide crisis and in some coutries even led to social and political problems.

16.4.1 Impact of Crisis

As mentioned, the impact of the financial crisis ranged from the financial and banking spheres to general economic and social conditions. Some of the major dimensions of the impact are summarised below.

- Economic growth turned negative.
- The currency devaluations exerted immediate upward pressure on the prices of imported goods and services or goods with high import content.
- Inflation generally increased (see Table 16.1).
- Since food prices generally increased more rapidly than non-food prices, the impact of inflation was harsher on the poor.
- Inflation not only reduced purchasing power but along with the collapse of stock markets and banks also drastically reduced the real value of household savings.

- Bankruptcies resulted in loss of savings and contributed to unemployment.
- In terms of the social impact, overall the unemployment rates increased in all the countries affected by the crisis (see Table 16.2).
- The informal labour force expanded with the entry of the unemployed from the formal sector, resulting in lower earnings per worker.
- The share of wage and salary incomes in total income declined, thereby altering functional income distribution.
- All these together led to increasing poverty levels. A common feature of the crisis was that increases in poverty were greater in the urban areas than in the rural areas.

Table 16.1: Impact of Crisis on Growth and Inflation

Variable	Year	Indonesia	South Korea	Malaysia	Philippines	Thailand
GDP growth rate (%)	1997	4.9	5.5	7.7	5.2	-0.4
	1998	-13.7	-5.5	-6.2	-0.5	-8.0
CPI (% Change Per Annum)	1997	6.6	4.5	2.7	5.9	5.6
	1998	57.9	7.5	5.3	9.7	8.1

Source: ADB (1999)

Table 16.2: Unemployment Rate (%)

	1993	1996	1998
China, People's Rep. of	2.6	3.0	3.1
Hong Kong, China	2.0	2.8	4.7
Indonesia	2.8	4.9	5.5
Korea, Rep. of	2.8	2.0	6.8
Malaysia	3.0	2.5	4.9
Philippines	8.9	7.4	9.6
Singapore	1.9	2.0	3.2
Thailand	1.5	1.1	5.3

16.4.2 Causes of Crisis

The causes of the crisis are often disputed. Overemphasis on excessive financial and capital market liberalisation as opposed to generating real sector activities have been considered as the root cause of the crisis. This led to speculative capital of short term nature to flow into these countries and when its outflow began it left the countries in a state of financial crisis. Due to capital market integration while on one hand such rapid outflows were facilitated, on the other hand, it also created the 'contagion effect' – crisis spreading from one country to another.

Some economists have maintained that the main cause of the crises was excessive real estate speculation and the mismatch between foreign currency-denominated borrowings and local currency denominated returns. While some consider 'moral hazard' in the banking and financial system, others give more emphasis to excessive speculation by short-term investors.

Arguments of others have downplayed the role of the real economy in the crisis compared to the financial markets due to the speed of the crisis. The rapidity with which the crisis happened has prompted Sachs and others to compare it to a classic bank run prompted by a sudden risk shock. Sachs points to strict monetary and contractory fiscal policies implemented by the governments at the advice of the IMF in the wake of the crisis, while Frederic Mishkin points to the role of asymmetric information in the financial markets that led to a "herd mentality" among investors that magnified a relatively small risk in the real economy. The crisis has thus attracted interest from behavioural economists interested in market psychology.

However, some believed that the Asian crisis was created not by market psychology but by macroeconomic policies of the crisis-hit countries that distorted information, which in turn created the volatility that attracted speculators. According to this argument, what some have called "herd mentality" was merely the result of speculators behaving rationally, noting the fraudulent currency policies of the countries (fixed exchange rates defended by the governments), which speculators assumed could not be sustained.

16.4.3 Role of the IMF

The role of the IMF has been considered quite controversial during the crisis. To begin with, many commentators in retrospect criticised the IMF for encouraging the developing economies of Asia down the path of "fast track capitalism", meaning liberalisation of the financial sector (i.e. elimination of restrictions on capital flows); maintenance of high domestic interest rates in order to suck in portfolio investment and bank capital; and pegging of the national currency to the dollar to reassure foreign investors against currency risk.

However, the greatest criticism of the IMF's role in the crisis was targeted towards its response. As country after country fell into crisis, many local businesses and governments that had taken loans in US dollars, which suddenly became much more expensive relative to the local currency, which formed their earned income, found themselves unable to pay their creditors. The dynamics in this scenario were similar to that of the Latin American debt crisis. In response, the IMF offered to step-in in the case of each nation and offer it a multi-billion dollar "rescue package" to enable these nations to avoid default.

However, the IMF's support was conditional on a series of drastic economic reforms influenced by neoliberal economic principles called a structural adjustment package (SAP). The SAP's called on crisis nations to cut government spending to reduce deficits, allow insolvent banks and financial institutions to fail, and aggressively raise interest rates. The reasoning was that these steps would restore confidence in the nations' fiscal solvency, penalise insolvent companies, and protect currency values.

But the effects of the SAP's were rather mixed and their impact controversial. Critics noted the contractionary nature of these policies, arguing that in a recession, the traditional response is to increase government spending, support major companies, and lower interest rates. The reasoning was that by stimulating the economy and eliminating recession, governments could restore confidence while preventing economic pain.

16.4.4 Lessons from the Crisis

Some of the major lessons from the crisis are:

i) Sound Macroeconomic and Exchange Rate Management
ii) Development of Financial Market Structure and Regulation
iii) Strengthening of Financial Supervision and Oversight Mechanism
iv) Development of Non-Bank Financial Sector
v) Developing Frameworks for Bank and Corporate Crisis Resolution
vi) Crisis Prevention and Management

(a) **Tax to Check Volatile Capital Flows**

One of the major lessons for developing countries in the context of the crisis is to exercise caution in opening capital accounts and short-term capital inflows. One of the remedial measures for checking volatile capital flows is suggested to be in the form of a tax on international capital transactions, widely known as the 'Tobin Tax' (Box 16.1).

Box 16.1: Tobin Tax Proposal

Tobin Taxes are excise taxes on cross-border currency transactions. They can be enacted by national legislatures, followed by multilateral cooperation for effective enforcement. The revenue should go to global priorities: basic environmental and human needs. Such taxes will help tame currency market volatility and restore national economic sovereignty. (The name Tobin Tax and the original concept derives from James Tobin, a Ph.D. Nobel-laureate economist at Yale University.)

Source: http://www.ceedweb.org/iirp/

Interest in the potential for taxing international capital flow stems from concern that exchange rates under floating regimes are too volatile, and that exchange rate target zones are too vulnerable to real shocks or inconsistent macroeconomic policies. A contributing factor in both cases is the rapid development of capital mobility in the last decade, deriving from capital markets liberalisation and technological innovation. The crisis-situations in several parts of the world including the Asian region have given further impetus to this idea.

(b) **Regional Financial Cooperation**

The ASEAN countries believed that the well co-ordinated manipulation of currencies by speculators was a deliberate attempt to destabilise the ASEAN economies. At the 30th ASEAN Ministerial Meeting held in Malaysia they issued a joint declaration on 25 July 1997 expressing serious concern and called for further intensification of ASEAN's cooperation to safeguard and promote ASEAN's interest in this regard.

As a response to the crisis, Asian countries began to consider establishing regional financial facilities. This was a reflection of their views that the provisions of international financial assistance through existing multilateral arrangements had been neither timely nor sufficient to deal with the crisis. Finally, the finance ministers of ASEAN+3 (China, Japan and South Korea) countries reached an agreement on the Chiang Mai Initiative (CMI), which was the first significant regional financing arrangement to enable countries to cope with disruptive capital flows and maintain exchange rate stability in Thailand in May 2000.

(c) Reforming International Financial Architecture

The crisis has also prompted for a comprehensive review of the present architecture of the international monetary system. With a view to developing, a framework to prevent, manage and resolve future crisis, within the context of a global environment of liberalised capital flows it is necessary to institute an international financial architecture responsive to developing countries' needs. In this regard, some reforms of the IMF may be necessary to reduce contagion effects of similar crises in the future. There is a need to develop a mechanism to provide for an orderly resolution of any financial crisis in the future, as what is lacking is an effective rule-based and adequately funded international lender of last resort. The IMF needs to seriously consider assuming this role, and make changes in the terms and conditions of its financial support facilities, to better assist countries affected by the crisis and effectively stabilise the economy and financial markets.

(d) Devising Adequate Social Safety Nets

One of the most important lessons of the Asian crisis is that adequate social safety nets need to be set in place. In the era of global interdependence including in the area of capital markets, risk of crisis would always remain with economic openness. While it is imperative to calibrate capital market integration and regulate short term volatile capital flows, it is equally important to build institutional mechanisms to deal with occasions of crisis. To this end, one of the very significant responses at the national level would be to develop adequate social safety nets for the people. This would help minimising the adverse impact of crisis on those who are already poor those whose social conditions deteriorate due to crisis as experienced in all the countries of the Asian region.

16.5 POST-MAASTRICHT DEVELOPMENTS AND DEVELOPING COUNTRIES

The aim of the European Community, as per the recommendations of the Werner Report of 1972, was the establishment of a *European Monetary Union* (EMU). The original target date for EMU was set in that Report at 1980, but the accession of Denmark, Eire and the United Kingdom in 1973 delayed implementation of this goal. As you saw in the preceding Unit 15, in 1991 the members of the EC signed the *Maastricht Treaty*. which declared their intention to harmonise their domestic laws and policies as the European Union. They also laid down a plan to move towards a monetary union with a single currency and a single central bank. Most of the countries gave up their national currencies and adopted a common currency, the Euro. This means that out of the "impossible trinity", they gave up independent monetary policies.

Some guidance on the desirability of forming a monetary union is given by the *theory of optimum currency areas*. This branch of economics is concerned with the criteria that determine the optimal coverage of a single currency. In Unit 8.8, you learned about the various merits and demerits of fixed and flexible exchange rates. A currency union is an extreme case of a fixed exchange rate in which the members adopt a common currency, and the costs and benefits are similar. On the one hand, abolition of national currencies means that there is no exchange rate risk between members, no transactions costs in converting from one currency to another, and greater price transparency because all prices in the union are expressed in a common currency. This facilitates trade and capital investments between the countries. There is also greater monetary discipline on the central bank. On the other hand, countries will have to give up their independent monetary and exchange rate policies, which they could use to offset domestic macroeconomic cycles.

If the countries already trade extensively amongst themselves, with large flows of capital between them, then all the benefits listed above will be greater. Also, if they undergo correlated macroeconomic cycles, then there is less conflict in policy. Otherwise, one member country could be suffering from inflation (requiring deflationary monetary policy and currency appreciation) while another suffers from recession (calling for expansionary monetary policy and depreciation). If labour is allowed to move freely between countries, then uncorrelated cycles are less of a problem, because workers can move from the country with recession to those with expansion. It is also easier if taxes can be imposed in the expanding region to support the workers in the stagnating region. The EU comes closest to these conditions for a successful monetary union. However, the Maastricht treaty had to impose on its members certain macroeconomic performance targets to minimise the problems discussed above.

Not much work is available in terms of the intricate implications of European monetary integration and adoption of euro for developing countries. They need to be understood given the trade and investment relations that different countries or regions in the developing world have. It would also depend upon the use of euro as a currency of exchange between the EU and partner developing countries. It is in this sense that countries of Latin America and Africa would experience different impact than Asian countries. However, for the Central and Eastern European Countries vis-à-vis their membership of the EU has been analysed and studies have highlighted the dilemma that exists in terms of choosing their exchange rate policies to achieve a combination of low inflation and exchange rate stability while at the same time contemplating a transition towards a peg to euro.

Especially, countries having more trade-intensity with EU, having euro-denominated debt and those whose currencies are pegged to euro would experience different effects through different channels. For instance, changing values between the euro on one hand and dollar or yen on the other could affect such countries' external competitiveness. An increase in the value of the Euro would benefit those countries that peg their currencies to the Euro, as it would decrease the domestic currency cost of servicing such debt. Conversely, any depreciation of the Euro would increase the cost of such debt service.

Price transparency in a single currency is likely to narrow the differences between the prices paid for the same product in different European countries. Therefore, the likely improvements in price transparency coupled with the reduction in transaction costs due to elimination of risk would lower the trading costs to the business sector in developing world.

Check Your Progress 3

1) What was role of IMF during Asian Crisis?

....

....

....

....

....

2) What are the major reasons of Asian Crisis?

....

....

....

....

....

3) Briefly discuss the theory of optimum currency areas.

....

....

....

....

....

16.6 LET US SUM UP

The Unit discusses different aspects of international capital mobility and the emerging International Monetary System. It starts with Globalisation and Macroeconomic Management. It gives a brief exposition of the standard IS-LM model for an open economy with the possibility of capital flows. The Unit discusses Evolution of International Monetary System and its Present Status. It also explains to the learners Short-Term Capital Movements and East-Asian Crisis – Lessons for Developing Countries. While discussing Short-Term Capital Movements and East-Asian Crisis, the Unit explains Impact of Crisis, Causes of Crisis, Role of the IMF and Lessons from the Crisis. The Unit ends with Post-Maastricht Developments and Developing Countries.

16.7 KEY WORDS

Asian Crisis: A major financial crisis, which began in Thailand in July 1997 and quickly spread to other East Asian countries of the region.

Fiscal Policy: Any macroeconomic policy, which involves government purchases, transfers, or taxes, usually implicitly focused on domestic goods, residents, or firms. A fiscal stimulus is an increase in purchases or transfers or a cut in taxes. Fiscal policy can be expansionary/contractionary if it tends to cause aggregate output (GDP) and/or the price level to increase/fall.

Impossible Trinity: The impossibility of combining all three of the following: monetary independence, exchange rate stability, and full financial market integration.

Maastricht Treaty: It is the 1991 treaty among members of the EU to work toward a monetary union, or common currency. This ultimately resulted in adoption of the euro in 1999.

Monetary Policy: The use of the money supply and/or the interest rate to influence the level of economic activity and other policy objectives including the balance of payments or the exchange rate. Monetary policy can be expansionary/ contractionary if it tends to cause aggregate output (GDP) and/ or the price level to increase/fall.

16.8 SOME USEFUL REFERENCES

Krugman, Paul. 1994. *The Myth of East Asia's miracle,* Foreign Affairs, vol. 73 (November/December 1994), pp. 62-78.

Krugman, Paul. 1998. *What Happened to Asia?* http://web.mit.edu/krugman.

Mundell, Robert A. 1961. A Theory of Optimum Currency Areas, *American Economic Review* 51, (September), pp. 657-665.

Paul A. Samuelson and William D. Nordhaus. 1998. *Economics: An Introduction*, 17th ed., McGraw-Hill

Sachs, Jeffrey, Aaron Tornell and Andres Velasco. 1996. Financial Crises in Emerging Markets: The Lessons from 1995, *Brookings Papers on Economic Activity*, vol. 1: 147-215.

Sen, S. 2003. *Global Finance at Risk*, New York: Palgrave Macmillan.

Sodersten, B. and Reed, G. 1994. *International Economics*, 3rd ed., London: Macmillan.

http://www.imf.org

http://www.worldbank.org

http://www.wto.org

http://www.adb.org

http://www.unescap.org

http://www.rbi.org.in

16.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Read Section 16.2

2) Read Section 16.2

Check Your Progress 2

1) Read Section 16.3

2) Read Section 16.3

Check Your Progress 3

1) Read Sub-section 16.4.3

2) Read Sub-section 16.4.4

3) Read Section 16.5