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Economic Interdependence and Macroeconomic Coordination

by

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ABSTRACT

In a world rapidly becoming more economically integrated, the spill-over effects of policies and actions on other countries have become very substantial. The issue of how policies can be coordinated in order to minimize the negative externalities has arisen. This paper reviews the record of various forms of policy coordination. It explores various aspects of "constrained decentralized policy making" and various levels of policy coordination. The gains and costs are discussed and some suggestions for Philippine policy making are given.

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The New Environment

The world is rapidly becoming more economically integrated. This was announced with dramatic flourish by the dismantling of the Eastern European socialist economies at the turn of the decade and the signing of the World Trade Organization accord in Marakkesh in 1993. Rather than a drastic upheaval, the process has been one of continual opening of individual country markets or of groups of countries (inspite of the appearance given by periodic announcements of increasing protectionism and by calls for protection by certain sectors). Figures 1 to 3 show total trade, exports and imports in proportion to gross domestic product for four ASEAN countries from the 1980's to 1990-94.

Figure 1

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[1]Member, Monetary Board, Bangko Sentral ng Pilipinas. The author would like to thank Ponciano Intal, Takeshi Nohara, Robert Scollay, and Maria Lourdes Sereno for valuable comments, the Center for Integrative and Development Studies for financial support, and Jose Antonio Tan III for research assistance. All remaining errors are, of course, the author's. Any opinion expressed are those of the author and not those of the Bangko Sentral ng Pilipinas or the University of the Philippines School of Economics.

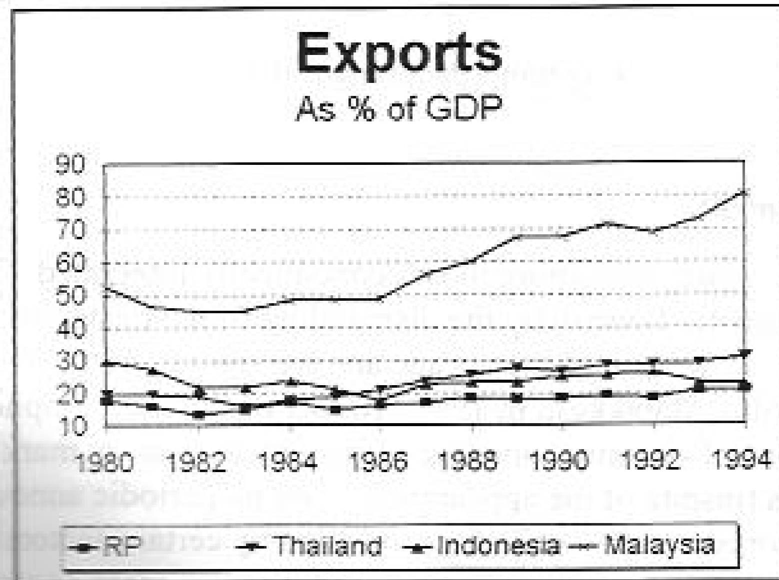

Figure 2

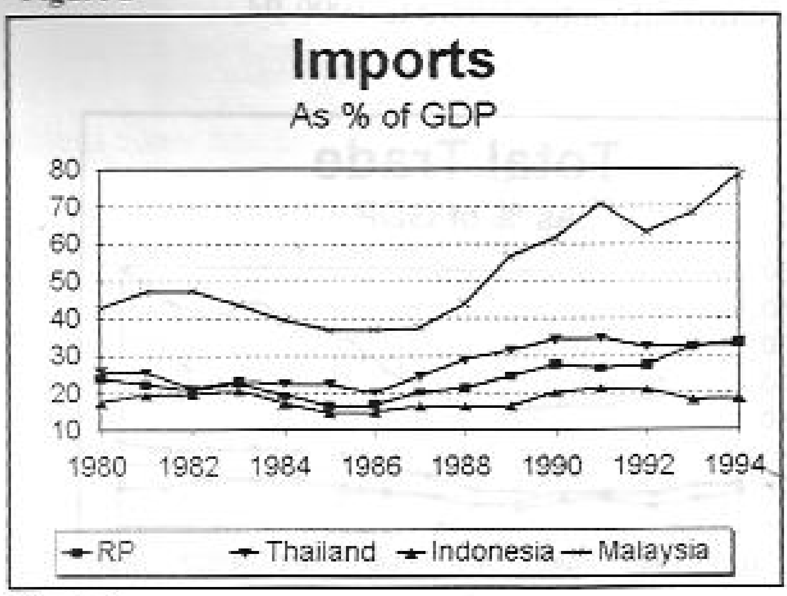

Figure 3

This increased integration in the goods market has been matched by a parallel integration in financial markets. Figure 4, for example, shows the increasing flow of capital to the developing countries. From 1960's to 1993, there has been almost a <u>hundredfold</u> increase in annual flows. Table 1, shows the average ratio of capital flows to gross domestic product for some developing countries during 1980-89. Figure 5 shows the more recent trends of the gross capital flows ratio.[2] With the increasing financial flows equity market capitalization has also increased. Figure 6 shows the increase for the four ASEAN countries. This has strengthened the integration of the countries' securities and equity markets to the international financial markets. Table 2 shows the inflows of foreign direct investment (as % of GDP) for selected Asian and Latin American economies and a similar inference can be drawn from it.

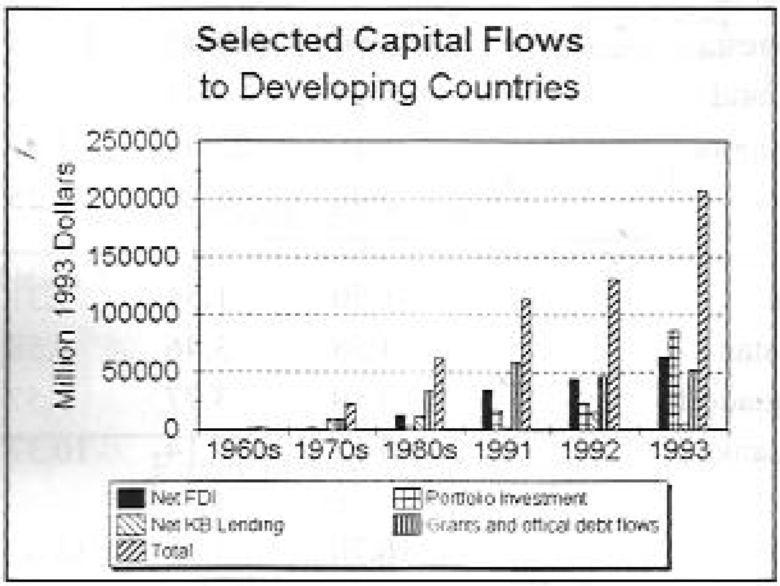

Figure 4

[2]This figure uses the financial account of the new BOP format of the International Financial Statistics.

Table 1
Ratio of Gross Capital Flows to GDP
(Annual average, in percent)

	1980-89	1984-86	1987-89
Philippines	8.94	9.77	6.09
Malaysia	9.10	10.10	8.88
Indonesia	4.96	4.45	7.15
Thailand	6.20	6.45	6.04
Singapore	21.15	22.99	23.07
Korea	5.42	5.27	4.25
India	1.50	1.51	2.31
Pakistan	3.58	3.46	4.58
Bangladesh	3.79	3.77	3.57
Sri Lanka	9.15	9.14	10.37
Chile	16.70	24.18	13.63
Uruguay	8.04	4.57	9.65
Venezuela	6.48	3.36	9.04
Mexico	9.01	9.05	6.98

Source: Montiel (1994)

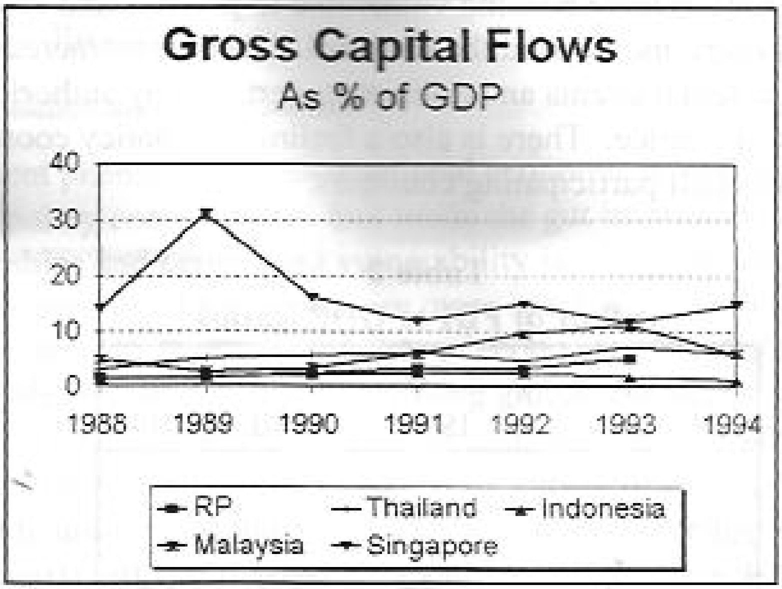

Figure 5

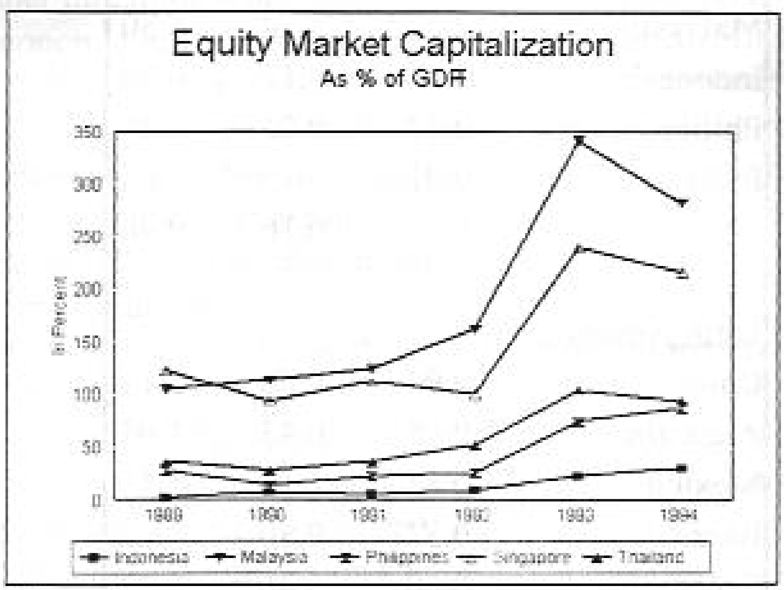

Figure 6

These data showing increasing integration of world financial markets have raised fears that countries have become vulnerable to policies and events happening outside their borders and beyond their control. There is an increasing feeling of vulnerability to external events and policies undertaken by authorities not subject to domestic influence. There is also a feeling that policy coordination can increase the welfare of all participating countries.

Table 2
Inflow of FDI to GDP Ratios

	1970	1980	1990
Asia			
Korea	0.82	0.01	0.30
Taiwan	0.01	0.10	3.35
Singapore	4.91	9.36	13.90
Thailand	0.61	0.58	2.96
Malaysia	2.24	3.74	5.50
Indonesia	1.44	0.17	0.90
Philippines	-0.37	-0.32	1.21
India	0.01	n.a.	n.a.
China	-	0.16	0.96
Latin America			
Chile	-0.97	0.76	2.14
Argentina	0.05	0.43	1.93
Mexico	0.84	1.10	1.11
Brazil	0.34	0.80	n.a.
Colombia	0.60	0.46	1.22
Peru	-0.97	0.13	0.09
Venezuela	-0.17	0.08	0.93

Source: Urata (1994)

Economic Coordination

A. Interdependence among countries

The recent phenomena in international economic relations have led to calls for economic policy coordination. But while the gut impression of deeper international relationships and heightened vulnerability is easily grasped, the bases and details of economic coordination require more specification. One proposal proceeds from the increased vulnerability of economies to events happening outside their pale of control. With increasing global interaction in finance and communication, the adjustments and anticipation of events around the world are quite rapid and, because of this, stronger. The impact of external events is both more difficult to anticipate (and absorb) and larger. Economic policy coordination (and cooperation) could help in avoiding or moderating the adverse impact of external events through preemptive and preventive macroeconomic cooperation or, at least, consultation.

The other thrust for economic policy coordination stems from the simple increase in economic interaction because of increased trade, finance, communication and other channels mentioned earlier. Increased commerce among countries brought about by world-wide liberalization and the deepening of multilateral trade agreements, especially the World Trade Organization, provide opportunities for interdependent countries. Cooperative or jointly determined macroeconomic actions can be coordinated for maximum effectiveness. Strictly speaking, it is only if the openness and the size of the economy are such that it is itself affected by the impact of its own actions on the rest of the world that the openness becomes interdependent (Cooper, 1985). There are two ways this may operate for small countries like the Philippines: first, if, as in the present world environment, countries warily watch each other and immediately institute countervailing actions against those which they perceive to have adverse impact on themselves; and second, if the macroeconomic action's impact is confined to a smaller area then neighboring countries, even if small, start to have strong interdependent relationships[3].

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[3]The importance of this phenomenon may be inferred from the gravity models being applied to international trade. See for example, Frankel, et al (1995).

Cooper (1985) distinguishes four types of interdependence. *Structural interdependence* refers to the situation where two or more economies are highly open with respect to each other that economic events in one strongly influence economic events in the other. This interdependence implies that each country will have a strong interest in information about the structure of the other economies. The ASEAN Free Trade Area (AFTA), for example, is expected to lead to such close interdependence among the members. That is why there is intensifying interest in what the other member countries are doing.

Everybody expects increased structural interdependence from the coming implementation of AFTA. What is not so obvious is how each member, even as of now, could be watchfully conscious of the real effective exchange rates (REER) of every other member because they are in many cases competing for the same markets and also thinking of selling to each other. This is *interdependence among the objectives* of macroeconomic policy. That is, one country is significantly affected by the attainment of targets in another country.

There may also be high *interdependence among the exogenous disturbances* to a group of countries. If disturbances exogenous to a group of countries are highly correlated, these (disturbances) may intensify the externalities due to high structural interdependence. Unfortunately, the same tendencies which increase structural interdependence (such as openness, global financial integration, etc.) may also increase the correlations among exogenous shocks to these economies.

Finally, all of the interdependencies mentioned above give rise to *policy interdependence*. As countries become aware of the externalities among them, they may start manifesting strategic game behavior when deciding on macroeconomic policy. An international version of the prisoners' dilemma would be counter productive for all countries. The "beggar-thy-neighbor" attempts by countries during the great depression immediately come to mind. On the other hand, the externalities can also be exploited in order to magnify the benefits (or lessen the cost) of policies taken in coordination with other countries.

All of the foregoing dimensions of interdependence has led to increasing calls for economic coordination or cooperation.

B. The need for policy coordination

Interdependence among countries imposes significant externalities or spillover effects on other countries. Policy actions by some countries have increasing effects on other economies. Coordination of some form or another is then seen as a facilitating mechanism for internalizing these externalities (Frenkel, et al, 1988). In a departure from the largely self-contained economies in previous times, countries base their policy decisions on factors that include those which are beyond their control. Larger countries which exercise some degree of influence over prices, including crucial interest and exchange rates, may manipulate such prices to their own advantage and at the expense of others. Coordination is best seen as a facilitating mechanism for internalizing these externalities.

The other argument given for coordination is the presence of international public goods. Frenkel, et al. (1988)

The argument for economic policy coordination under the conditions mentioned above is not conclusive. There are costs to coordination as will be discussed below just as there are benefits. And just as in the classical case of markets for commodities, the optimal choice for an individual country depends on the costs and benefits leaving things in the uncoordinated situation (the analogue of leaving things to the market) or committing to the disciplines of economic policy coordination. This raises a third alternative (i.e. besides coordination and *laissez faire)*, the acceptance of a common set of rules designed to reduce or make visible the externalities that countries impose on each other.

Once we accept the conclusion that the uncoordinated environment is untenable, it is the third alternative which can be the benchmark against which coordination is compared. Grant, for example, the case where uncoordinated national policy making imposes costs which overwhelm the benefits of independent policy decision making. One may choose to lessen the cost of externalities by accepting mutually agreed-upon rules for everybody to follow. Within these rules, countries can implement policies based on the (residually) national conditions alone. The rules may lessen the externalities enough such that the net benefits of this "constrained decentralized policy making" may be superior to closer coordination among countries.

In a way, the combination of the Bretton Woods agreement on the International Monetary Fund (and the World Bank) and the General Agreement on Trade and Tariffs is an application of the "constrained decentralized system." Countries accepted some restraints on their ability to structure trade and tariff policies and adhered to a system of generally fixed exchange rates in the belief that these would expand world trade and this would benefit everybody. The unprecedented growth in the world economy during the succeeding forty years is taken by most observers as an indirect validation of that belief. It is also a model of how some other version of constrained decentralized policy system can operate. Table 3 shows the results of Harrison, Rutherford and Tarr (1995) indicating the short-term and long-term welfare effects of increasing openness and global integration. Table 4 focuses on the welfare effects of the agricultural reform component of the recent Uruguay Round.

The general observation is that the deepening openness in trade through the WTO and the increasing globalization of the financial system requires more coordination. The question for a country like the Philippines is whether a deepening of the constrained decentralized system (i.e. additional rules but with essentially the same mechanism) is superior to one with more formal (and periodic) coordination.

C. Methods of policy coordination

The exact manner of coordination has many levels and dimensions. Several aspects of economic policy can be the objects of coordination. Cooper (1984) identifies three. First, goals can be coordinated. There is a presumption that if goals can be coordinated, the relevant macroeconomic policies will automatically coordinated. Goals can be competitive, common or related to one another only through general economic interdependence. Sometimes goals are directly competitive as in exchange rate targets where bilateral and multilateral current account balances are directly affected. Here countries may already get engaged in strategic game behavior by, for example, pushing for agreements on goals which favor themselves.

Second, information might be "coordinated" or exchanged on goals, forecasts, economic structure, and intended actions. Individual countries can then act on the basis of more accurate information on other countries' future economic

Table 3
Welfare effects of the Uruguay Round
(billion dollars) 1/

	Agricultural reform		MFA reform		Manufacturing sector reform		Uruguay Round		Complete Reform as a % of GDP	
	Short-term effect	Long-term effect	Short-term effect	Long-term effect	Short-term effect	Long-term effect	Short-term effect	Long-term effect	Short-term effect	Long-term effect
Australia	0.7	0.9	0.0	0.1	0.5	2.3	1.2	3.3	0.4	1.1
New Zealand	0.3	0.5	0.0	0.0	0.1	0.9	0.4	1.4	1.0	3.6
Canada	0.3	0.2	0.9	1.0	0.1	1.3	1.3	2.6	0.2	0.5
United States	1.8	3.2	10.0	9.2	1.2	13.7	13.3	26.7	0.2	0.5
Japan	15.1	16.8	-0.6	-0.5	2.2	6.2	16.9	22.7	0.5	0.6
Korea	4.6	5.2	-0.5	-0.4	0.7	2.7	4.8	0.5	1.5	2.5
European Union 2/	28.3	26.4	7.6	7.8	3.0	14.9	39.3	0.9	0.6	0.7
Indonesia	0.2	0.3	0.6	0.9	0.6	1.4	1.3	2.6	1.1	2.1
Malaysia	1.2	2.2	0.1	0.3	0.7	2.6	1.8	5.0	3.3	8.8
Philippines	0.7	1.1	0.0	0.2	0.4	1.1	0.9	2.4	1.6	4.4
Singapore	0.6	0.5	-0.2	-0.2	0.5	0.4	0.9	0.7	2.1	1.7
Thailand	0.8	1.4	0.1	0.8	1.8	10.3	2.5	12.6	2.1	10.9
China	-0.5	-0.8	1.0	1.7	0.9	1.2	1.3	2.0	0.3	0.5
Hong King	0.6	0.6	-1.7	-1.5	-0.1	-0.2	-1.2	-1.1	-1.4	-1.1
Taiwan Province of China	0.0	0.0	-0.4	-0.3	0.8	1.3	0.4	1.1	0.2	0.5
Argentina	0.4	0.7	0.0	0.1	0.3	1.6	0.7	2.3	0.3	1.0
Brazil	0.3	0.1	-0.0	0.1	1.2	4.0	1.4	4.3	0.3	1.1
Mexico	-0.0	0.7	-0.1	0.2	0.3	1.4	0.2	2.3	0.0	0.7
Latin America	1.5	2.0	-0.5	0.3	0.3	3.2	1.3	4.7	0.4	1.7
Sub-Saharan Africa	-0.2	-0.5	-0.0	-0.1	0.1	0.2	-0.3	-0.7	-0.2	-0.4
Middle East and North Africa	-0.3	0.1	-0.4	0.2	0.8	1.9	-0.3	1.5	-0.1	0.3
Eastern Europe 3/	-0.1	-0.0	-0.5	-0.3	0.8	2.3	-0.2	1.2	-0.1	0.1
South Asia	0.3	0.2	0.9	1.9	3.1	5.3	3.7	6.7	1.0	2.0
Other European countries	2.2	1.6	-0.2	-0.8	1.7	7.0	4.2	8.8	0.3	0.7
Developing countries	9.9	13.9	-1.5	3.4	12.9	40.5	19.4	55.2	0.4	1.2
Industrial countries	48.7	49.8	17.9	16.9	8.7	46.3	76.7	115.4	0.4	0.6
World	58.6	63.7	16.4	20.3	21.7	86.8	96.0	170.6	0.4	0.7

Source: Harrison, Rutherford and Tarr (1995)
Note: The first three headings represent the effect of each reform by itself. The fourth heading (Complete Uruguay Round) reports the welfare effects of all reforms combined.
1/ 1992 dollars.
2/ Membership in 1994.
3/ Also includes the Baltic countries, Russia, and the other countries of the former Soviet Union.

Table 4

Decomposing the welfare effects of agricultural reform
(billion dollars)

	All distortions 1/	Export Subsidies	Production subsidies	Import distortions
Australia	0.7	0.1	0.1	0.4
New Zealand	0.3	0.1	0.1	0.1
Canada	0.2	0.0	0.3	-0.1
United States	1.7	-0.0	1.5	-0.1
Japan	15.2	-2.2	-0.5	17.7
Korea	4.6	-0.2	-0.0	4.7
European Union	28.5	11.5	17.8	-1.2
Indonesia	0.2	0.0	0.1	0.1
Malaysia	1.2	0.0	0.1	1.2
Philippines	0.6	-0.1	-0.0	0.9
Singapore	0.6	-0.0	0.0	0.6
Thailand	0.7	-0.0	0.2	0.6
China	-0.6	-0.2	-0.1	-0.3
Hong King	0.6	0.1	0.0	0.2
Taiwan Province of China	0.0	-0.0	0.0	0.1
Argentina	0.4	0.1	0.2	0.1
Brazil	0.3	-0.0	0.2	0.1
Mexico	-0.0	-0.0	-0.0	0.1
Latin America	1.4	-0.0	1.4	0.1
Sub-Saharan Africa	-0.3	-0.4	-0.1	0.3
Middle East and North Africa	-0.4	-0.8	0.2	0.1
Eastern Europe	-0.2	-0.6	0.3	0.0
South Asia	0.1	-0.0	0.1	0.0
Other European countries	2.4	-0.6	2.1	0.5
Developing countries	9.2	-2.3	2.4	8.8
Industrial countries	49.1	9.0	21.5	17.3
World	53.8	6.7	24.0	26.1

Source: Harrison, Rutherford and Tarr (1995)

1/ Import distortions and export and production subsidies on agricultural goods.

2/ Membership in 1994.

3/ Also includes the Baltic countries, Russia, and the other countries of the former Soviet Union.

magnitudes. This would already be a step towards incorporating, though incompletely, externalities.

Third, the choice, magnitude and timing of policy actions might be coordinated. Under this alternative alone, several levels and combinations of commitments are possible.

Discussions on the various aspects above can be under a strong intercountry government much like that envisioned under the European Monetary System, under formal rules and procedures but with each country reserving policy implementation to itself, or under a looser system of periodic talks among the major policy makers where forecasts and intended policy actions are discussed.

The width and depth of the discussions also have to be agreed upon and countries will probably consider the exact combination in deciding whether macroeconomic coordination is advantageous to themselves. Width or range pertains to what policies will be included in the discussion. A good example of this issue is the present World Trade Organization (WTO) which includes in its areas of coverage such things as TRIMs (trade-related investment measures), TRIPs (intellectual property rights), and agriculture in addition to trade in commodities which was the only area covered by the General Agreement on Tariffs and Trade (GATT). A similar distinction in range of coverage of macroeconomic coordination exists. Wider coverage will afford more areas for trade-offs which may make compromises and agreements easier to achieve. On the other hand, more areas of coverage also brings in more domestic sectors to consult, lessening policy makers' flexibility in international negotiations.

The depth of negotiations refers to the specificity and disaggregation of policy agreements which can range from broad commitments on macroeconomic balances to commitments on such specific items as tax policy changes. The issue is important because broad agreements on, say, the government deficit will have varying impact on bilateral current account balances depending on how the deficit or surplus is financed. A similar distinction can be made in structural policies. On the other hand, more specific agreements are harder to achieve and may put any agreement out of reach.

Barriers to macroeconomic coordination exists, however. First; international policy bargains that involve shared objectives can be frustrated if some policy instruments are treated as objectives in themselves (e.g. exchange rates). Second, there can at times be sharp disagreements among countries about the effects that policy changes can have on policy targets. Part of the game behavior can be expressed in trying to get the others to agree to elasticity estimates which favor one country. Third, countries may disagree about the impact of policy instruments on targets. While the differences here can be narrowed by analytical studies, national agenda may preclude truthful exchange of information. Fourth, there remain huge cross-country differences in the degree of interdependence, leading to differences in willingness to submit to disciplines. Finally, international bargaining comes after domestic bargaining, i.e. compromises between growth and stability at the national level may leave little room for further compromise at the international level.

D. Experience with global economic policy coordination

In some sense the Bretton Woods Agreement in 1944 provided for decentralized national policy making under certain restrictions --- in this case fixed exchange rates needed for expanding world trade. While there have been various criticisms, that arrangement allowed an enormous increase in trade and an unprecedented rate and length of economic growth throughout the world. This arrangement unravelled when growth in other countries tipped the economic balance toward more equality between the U.S. on one hand and Japan and Europe on the other and when the U.S. could no longer bear the nth country obligations under the Bretton Woods agreement (i.e. low inflation and disciplined fiscal balance).

The formal rupture in the old arrangement occurred August 15, 1971 when the United States broke the link between the gold and dollar and the other countries consequently had to adjust the values of their currencies. The ten percent tax on imports that the United States imposed was meant to signal how much they felt the other currencies should adjust their exchange rates with respect to the U.S. dollar. On December 17-18, 1991, the Smithsonian Agreement attempted to save the Bretton Woods system by raising the price of gold to $38 per ounce and expanded the exchange rate bands of the major currencies to 2.25 percent around their new par values (up from one percent under Bretton Woods). However, the system could no longer be salvaged and on February 12, 1973 the United States devalued the dollar by ten percent and all the other major countries allowed their currencies to float against it. This floating rate system has persisted to the present with all the major currencies (the U.S. dollar, the Deutschmark, the British pound, the Japanese yen and the Swiss Franc) without any fixed official exchange rate with each other.

The breakdown of the Bretton Woods exchange rate system turned out to be an important stimulus for international economic policy coordination. With floating exchange rates, governments found out they had more control over their macroeconomic policies and proceeded to operate in a manner that was relatively free of the Bretton Woods constraints. However, the enlarged space for discretionary national action led to uncoordinated directions for major economies and markets, resulting in increased external uncertainty. The consequential difficulties provided the impetus for the summit conference in 1975 where inflation and balance of payments issues occupied the ministers' time. Subsequent discussions were carried out under the Group of Five or Seven framework.

Ad hoc coordination of macroeconomic policies was significantly exercised for the first time in 1978 at the Bonn conference where Japan and West Germany agreed to accelerate their growth and the United States committed to control its inflation and oil problems. In 1982, the major industrial countries agreed to strengthen multilateral surveillance at the Versailles conference. This was intensified with increasing elements of policy consultation and coordination with the Plaza accord in 1985 where an orderly appreciation of major non-dollar currencies against the U.S. dollar was deemed desirable. Governments and central banks of the five major nations declared their willingness to cooperate in order to achieve this objective. The Louvre Accord and December statement of 1987 confirmed this. A recent example of this cooperation was the episode last year when the central banks of major countries (especially the U.S., Japan and Germany) jointly acted to successfully reverse the appreciation of the yen and the deutschmark against the U.S. dollar.

Grober (1988) concludes that these summit meetings fell short of policy coordination in favor of a limited cooperative approach designed to reduce risk and uncertainty for national policies. Discussion was directed at harmonization of policies and priorities, judgment on the functioning of economies and of national strategies rather than on policies themselves. "True policy coordination," according to him would require participating countries to agree on national measures that are different from those implemented without coordination." In reality, and especially where the process is periodic and continuing, this is difficult to distinguish because the discussions will already influence national decisions long before the inconsistencies become glaring.

A more formal version of policy coordination, of course, follows the structure proposed for the European Monetary Union under the December 1991 Maastricht treaty became effective in November 1993. In the final stage, envisioned to be implemented by January 1997 (or January 1999 at the latest), fulfillment of the four convergent criteria governing inflation rates, fiscal deficits, interest rates and the exchange rate. Under this framework, members will be part of an economic and monetary union with the commencement of a European System of Central Banks, the irrevocable fixing of currencies against the ECU, and the rapid introduction of a single currency. Under this system, member countries give up almost all of their independence for macroeconomic policy making in return for the attainment of a single commodity and financial market. The implication is that the expected benefits of a larger market outweigh the loss of benefits from independent macroeconomic policy action.

E. Economics of Policy Coordination

The gain from economic policy coordination comes from several sources. First, is the basic increase in welfare coming from increased commerce --- goods and services included --- among countries. This is the objective of multilateral trade agreements such as the World Trade Organization. Economic policy coordination, by further diminishing the uncertainty in the trade and foreign exchange areas, adds to the intensity and breadth of commerce among the members. Although it contains other ingredients, the European Common Market is a good example of how a smaller grouping can enhance trade even beyond global multilateral systems (in this case GATT).

The second source of gain from policy coordination is the reduced uncertainty as countries exchange more information about their economic situation, structure and policies. The third source also comes from reduced uncertainty when countries unmistakably convey their intentions in economic discussions. A third, very important source is reduced adjustment costs and increased policy benefits as countries simultaneously incorporate the policy actions and responses of other members at their first cut in policy design rather than ratchety adjustments are other countries adjust and readjust to each other's policies (assuming that there is policy convergence).

The final source of gains come from the increased ability of countries to undertake difficult policy changes that they would otherwise have been unable to implement. This makes a presumption, supported by the experience of multi-country groupings such as the European Community, that these policy coordination exercises typically require policies which are in some fundamental sense good for the countries. As economic policy coordination exercises become deeper and more frequent, the constant reminder provide many occasions achieving the discipline needed.

At the same time, there are costs to economic policy coordination. The most obvious is the loss of strategic behavior in relation to other countries, e.g. exchange rate targeting. As more information is available and policy reviews are more frequent, the ability to undertake this behavior is drastically reduced. The second source of costs, both political and economic, comes from the reduced ability to a country to design and time policy responses to external (and internal) events. The combination of both developments leads to a reduced ability to design policies finely honed to a country's circumstances. The trade-off is of course improved circumstances afforded by the positive externalities of economic policy coordination.

II. Macroeconomic Coordination for the Philippines

A. The Philippine situation

The Philippines also shows the general trend of increasing openness. Figure 1 shows how total trade has increased as a proportion of gross domestic product for the Philippines and the other ASEAN countries. For the Philippines, the pattern shows an increasing percentage since 1986, a recovery since the lowest point in 1984-85. This can been seen from Figure 7. Figures 4 and 6 also show how capital flows to developing countries have increased and how the equity market capitalization has increased tremendously in the Philippines in the last few years[4]. The gross capital flows ratios and foreign investment inflows for the Philippines suggest the increasing openness of the capital accounts over past one and a half decades, particularly in the nineties.

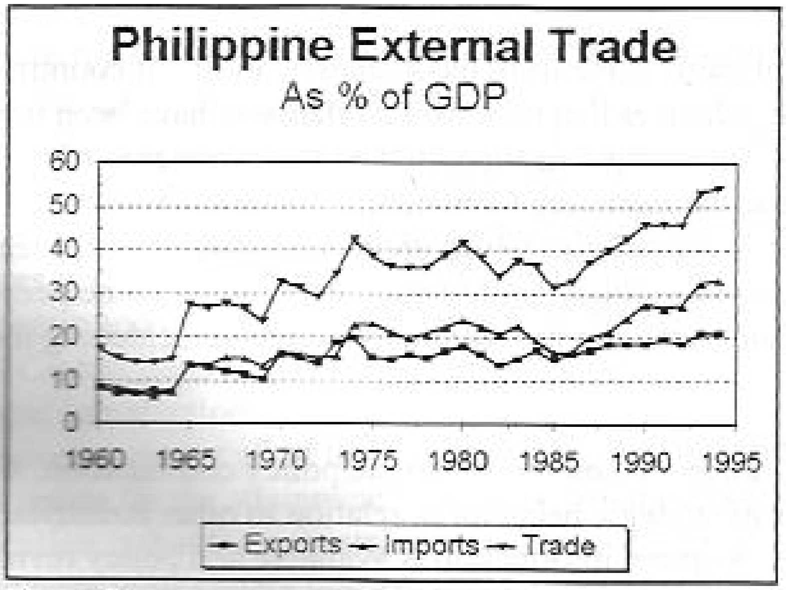

Figure 7

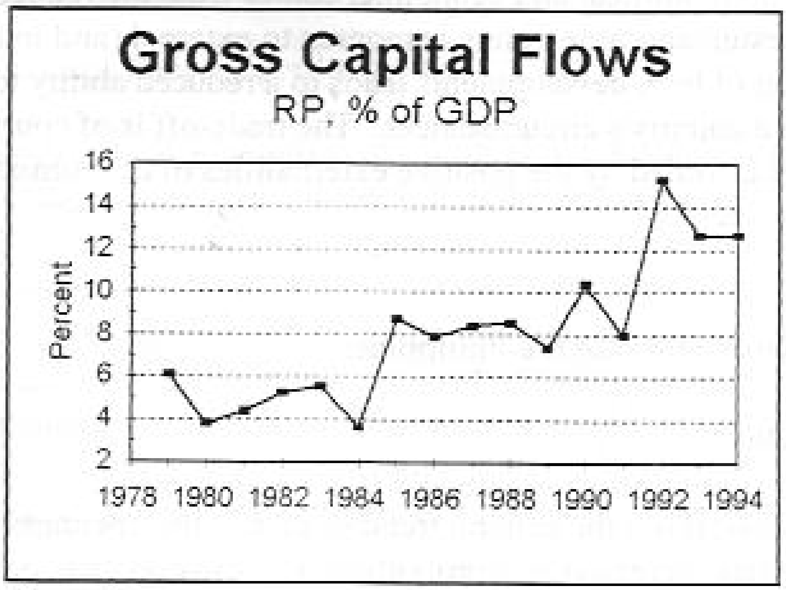

Figure 8

[4]The absolute values for Thailand and Indonesia are larger but because their economies are bigger, the percentages are clustered closer.

An interesting issue is the increase in interaction among ASEAN members with the implementation of the ASEAN Free Trade Agreement (AFTA) and the possibility of deepening of the Asia-Pacific Economic Conference (APEC). The increased trade among the ASEAN members are expected to deepen the inter

Figure 9

dependence among these countries. Simulation results by Tuh and Low (1990), for example, show there will a decrease in domestic income multipliers and an increase in cross-country multipliers with increasing intra-ASEAN trade. Table 5 show the change in multipliers with a 50 percent increase in ASEAN Trade. That is, interdependence increases with increasing trade openness. They conclude further that "better coordination of trade policies and national policies ... become even more important" under these circumstances. Yap and dela Paz (1990) also showed that "while the effects of external shocks on domestic economies could be reasonably estimated in isolation, there is some worth in testing the effects using a linked model.."[5] An integrated outlook may, therefore, be useful for national policy making.

[5]Although their results show decreases (compared to the base runs) in some macroeconomic variables with increases in intra-ASEAN trade.

Table 5
Simulation Results of an Increase ASEAN Trade by 50%
Income Multipliers with respect to change in final demand

		G1	G2	G3	G4	G5
(a) Period 2						
Indonesia	Y1	2.4150	0.0963	0.0508	0.3554	0.0319
Malaysia	Y2	0.0295	1.5485	0.0374	0.2904	0.0571
Philippines	Y3	0.0105	0.0408	3.0867	0.0450	0.0109
Singapore	Y4	0.1078	0.2967	0.0341	1.2480	0.0786
Thailand	Y5	0.0200	0.0835	0.0117	0.1117	2.5057
(b) 50% increase in ASEAN Trade						
Indonesia	Y1	2.3331	0.1573	0.0766	0.4509	0.0555
Malaysia	Y2	0.0479	1.4100	0.0525	0.3399	0.0809
Philippines	Y3	0.0169	0.0579	2.9978	0.0610	0.0173
Singapore	Y4	0.1368	0.3472	0.0474	1.1014	0.1031
Thailand	Y5	0.0325	0.1184	0.0190	0.1471	2.4077
(b)-(a) Differential						
Indonesia	Y1	-0.0819	0.0610	0.0259	0.0955	0.0236
Malaysia	Y2	0.0184	-0.1385	0.0151	0.0495	0.0239
Philippines	Y3	0.0064	0.0171	-0.0889	0.0160	0.0064
Singapore	Y4	0.0291	0.0504	0.0133	-0.1466	0.0245
Thailand	Y5	0.0125	0.0350	0.0073	0.0354	-0.0980

Source: Yap and dela Paz (1990)

This increasing interaction raises the possibility that the Philippine economy is now substantially integrated with global financial markets. In the last few years, policy reforms have made it increasingly so (Paderanga, 1996). Sakai (1994), for example, asserts that Philippine interest rates are more correlated with New York and Hongkong interest rates than to domestic supply and demand con ditions. Figures 10 and 11 illustrate Sakai's hypothesis. A rough and preliminary test using the uncovered interest rate parity condition (Paderanga and Tan, 1996) indicates that the Philippines is financially integrated to the rest of the world[6]. At any rate, the current trends in the economy points toward increasing openness and integration within the next few years to a degree that economic vulnerability and the need for economic policy coordination have become serious issues.

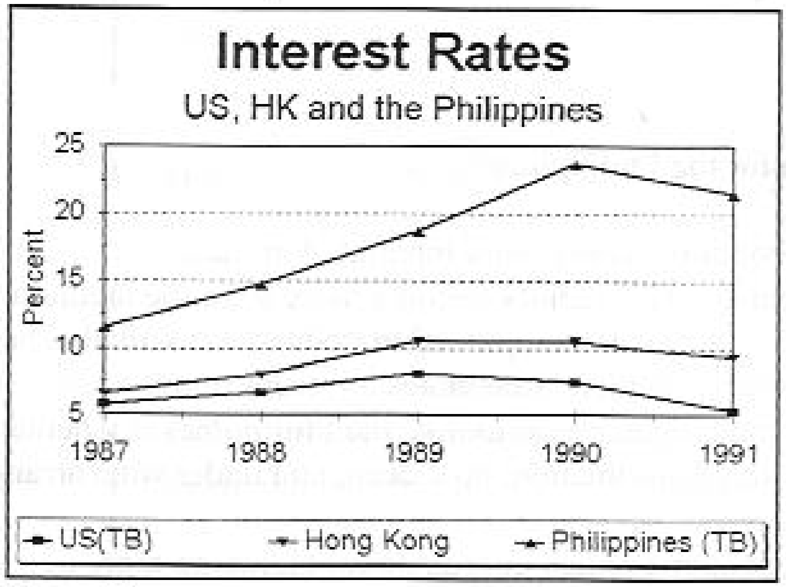

Figure 10

[6] Montiel's (1994) results using the uncovered interest parity test indicates otherwise. However, his test covered an earlier period than ours.

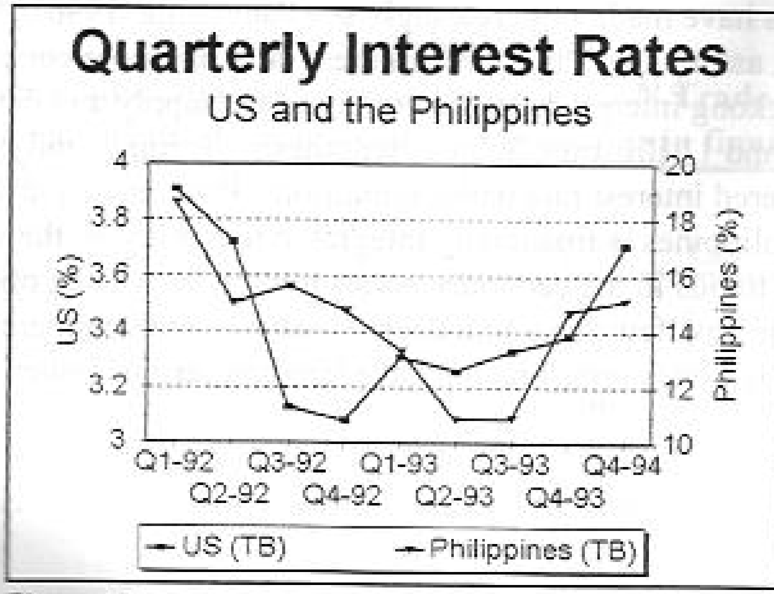

Figure 11

B. Policy coordination for the Philippines?

The Philippine economy is now more integrated in trade and financial terms with the rest of the world and will rapidly become more so in the medium term. This is especially true for our relationships within ASEAN. It will also be true within APEC when cooperation there accelerates as recent trends seem to indicate. The question before a small, open economy like the Philippines is whether to commit to economic policy coordination, how deep, and under what arrangements.

The gains from economic policy coordination, including more agreements in trade and investments, will come from increased access to a larger market. Under AFTA, the ASEAN market is no longer in doubt. There, our task is how to adjust to the new conditions. APEC offers increased access just by the mere exchange of information and easier connections even under its most modest agenda. In both cases, the strategy of the Philippines to develop under open markets will be tremendously facilitated. Table 6 shows the surge in intra-Pacific trade during the 1980's. This has continued unabated up to the present.

Table 6
Intra-Pacific Trade
1980 and 1990

	1980	1990
1. Intra-Pacific trade (billion of US $)	378.0	939.3
2. Intra-North American trade		
Dollar value (billions)	102.0	230.0
Share of (1), percent	27.0	24.5
3. Intra-East Asian trade		
Dollar value (billions)	100.7	286.3
Share of (1), percent	27.0	30.5
4. Trade between North America and East Asia		
Dollar value (billions)	118.6	326.0
Share of (1), percent	31.4	34.7

Source: Dobson (1993)

Increased confidence in our ability to weather crises is also enhanced by (a)increased and early exchange of information on economic and political developments, (b) complementary agreements regarding assistance during crises (for example, temporary liquidity arrangements to respond to adverse capital flows), and (c) specific cooperative agreements which may be expected to follow. These have the immediate effect of decreasing country risk and, therefore, lowering the cost of capital and of doing business. Increased access to resources resulting from this can accelerate development.

Costs of policy coordination

The costs of policy coordination consists primarily of the loss of independence and ability to maneuver. First, the policy instruments available are less. For example, in that environment the ability to target the exchange rate or use the exchange rate to target levels of current account balance is severely curtailed. The room for strategic behavior is rendered extremely limited. No longer available are the predatory export programs and competitive exchange rates used by Japan and the NICs in the past[7]. Second, there may also be restrictions on the depth and timing of policy instruments which are still available. For one, policy changes with significant impact on other members will need to be consulted before being used. A bureaucratic and complicated process may be required before use of some policy instruments. This may make decision making unwieldy and inflexible, resulting in opportunity losses. Finally, because of the limitations on policy instruments, some development strategies which rely on programs that exploit strategic behavior may no longer be available. At any rate, this commitment constrains policy independence to some extent.

D. Recommendation

The Philippines needs to recognize that there are costs and benefits to economic policy coordination and act on that basis. In the end, it will have to decide whether it is a net gain or loss to commit to economic policy coordination. The following recommendations fall into two parts: First, are suggestions for a research program to i) add up the costs and benefits of joining an economic policy coordination agreement, and ii) identify the areas where policy coordination will have adverse impact and how to insulate these areas; second, are suggestions for the government to formulate a strategy agenda for the discussions on policy coordination.

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[7]Former Taiwanese Minister for Economic Affairs K.T. Li once asserted in a private conversation that they did not have an exchange rate policy *per se*. But after they realigned the New Taiwan Dollar in the late 1950's, they had a policy of low inflation (which effectively achieved real exchange rate depreciation under fixed nominal exchange rates).

The research program needs to identify the areas of the economy which would have benefited from an environment without policy coordination (e.g. one where strategic behavior would have been advantageous for us) and analyze how the new environment will affect these areas. The costs of inflexibility in decision making and loss of some instruments may not be easily computed but these still have to be recognized. These costs will be weighed against the against the benefits of committing to policy coordination (some of which can be estimated, as in the benefits from increased trade).

The government can then formulate a strategic agenda for approaching the economic policy coordination discussions. Several components can be identified this early. First, we can negotiate to exclude certain areas where we expect some losses. Second, we can negotiate for temporary differential treatment for countries under certain conditions. Third, we can also propose a system where inter-country assistance is available in case of adverse externalities due to policy coordination. Finally, we can formulate the rules which we feel are optimal for the Philippines and push for their acceptance.

In the case of economic policy coordination, the correct answer may not be categorical *yes* or *no*. Rather, it may be how we shape the rules and the mechanisms to address the opportunities and problems presented by the changing environment. The challenge for the Philippines is how to alter its policies and decision-making and negotiating mechanisms to take full advantage of the opportunities provided by increased economic cooperation (and whatever coordination may be collectively agreed upon).

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Appendix:

Some International Coordination Agreements

1971 Smithsonian Conference on exchange rates.

1975 "First" economic conference, when inflation and BOP disequilibria had upset the world economy. (Subsequent annual meetings of heads of seven major industrial countries followed using the Group of Five or Seven format).

1978 Bonn Economic Summit: Japan and Federal Republic of Germany agree to accelerate growth while U.S. agreed to control its inflation and oil problems. (Ad hoc coordination of macroeconomic policies begin).

1982 Versailles Economic Summit: Called for the strengthening of multilateral surveillance.

1985 Plaza Accord: Elements of policy coordination appeared.

1986 Tokyo Economic Summit: closer and more frequent consultations in-between annual meetings.

1987 Louvre Accord: Elements of policy coordination reinforced, February. Statement of the Group of Seven in December also restated this.

Note: Excluded from this list would be the near continuous discussion and decision making at the executive boards of the International Monetary Fund and the World Bank.