

Learning to Live in an Integrated World Economy

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The global financial crisis, which originated in the US, has spread to every corner of the world. Such rapid and widespread contagion was due to the increased global economic "integration" through trade and financial linkages. Thus understanding rising trade and financial linkages is key to understanding and diagnosing the present global economic situation.

At the onset of the crisis, severely affected economies were those with extensive financial linkages with the US, particularly its European counterparts. The financial systems in the US and European economies were closely linked via international banking businesses and capital-market transactions. Western European banks borrowed US dollars from US banks to finance their short-term funding needs, while also holding a sizable amount of US assets that later became toxic. Consequently those banks faced huge losses after the US financial market plummeted. The domino effect was then felt in several Eastern European economies as their domestic banks had also borrowed heavily from banks in Western Europe.

With the lessons well learnt from the previous crisis, Asian economies were safe during the first round of the crisis owing to their minimal exposures to toxic assets and relatively low levels of borrowing abroad. However, the significant drop in regional exports since the fourth quarter of 2008 meant that small open economies in Asia could not escape from this global crisis. Despite fast rising intraregional trade among Asian economies over the past two decades, the final demand for Asian exports is still concentrated in the G3 economies. As a result, Asian exports have been severely hit by the second-round effect of the crisis through global trade linkages. The substantial decline in exports has eventually led to a sharp slowdown in domestic demand, especially private investment.

It is clear from the ongoing crisis experience that global economic integration has brought about not only considerable benefits but also possibly grave costs. With increasing integration, no open economy can be shielded from cross-border contagion. Therefore, each economy has to enhance resilience and preserve room for policy management to withstand external shocks.

In Asia, foreign-reserve accumulation has thus far proven to be one important aspect of resilience among others that has helped cushion shocks reasonably well. Therefore, regional financial cooperation should also be further enhanced as part of the integration process. The enlargement of bilateral swap arrangements under the Chiang Mai Initiative (CMI) by the Asean-plus-Three group from US\$80 billion (Bt2.8 trillion) to \$120 billion has been the recent positive move in this direction. More recently, six countries in Asia and Latin America have also established swap agreements with China between their own currencies and the yuan to facilitate trade and provide an additional cushion in times of difficulties.

Having said this, the world must learn the lesson that in taking further steps towards integration each and every member of the global community must have a good understanding of the linkages integration creates and also about safeguards that they need to strengthen in order to cope with potential recurring storms down the road.

(Views expressed are the author's own.)

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