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## **The ASEAN Political-Security Community and the Financial Crisis**

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### **Introduction**

This paper looks at how the global financial crisis impacts on the ASEAN aspiration to build an ASEAN Community. In particular, it looks at the crisis' effect on the establishment of an ASEAN Political-Security Community (APSC). It argues three points. First, the most important contribution of the APSC is in the normative foundations it outlines for ASEAN. These foundations are first and foremost directed at ensuring domestic stability and harmony, but it has its principal objective in strengthening ASEAN's position in East Asian regionalism and in maintaining security in Southeast Asia and the broader context of the Asia Pacific region. The normative commitments outlined in the APSC, however, also imply the need for a certain degree of institutionalization – an outcome that ASEAN does not seem to be as committed to. This brings out the second point – ASEAN, despite its rhetorical commitment to a particular set of normative structures, will continue to be bogged down in setting up the institutional mechanisms needed to realize these normative structures. Third, the intra-ASEAN dynamics at the center of this issue will be further complicated by the effects of the global financial crisis. ASEAN will continue to be burdened by the inherent contradiction between the normative aspirations expressed in the APSC Blueprint and its desire to maintain existing institutional structural arrangements.

### **The ASEAN Political-Security Community**

A paper conceptualizing an ASEAN security community authored by Rizal Sukma of the Centre for Strategic and International Studies in Jakarta was presented at a seminar on "ASEAN Cooperation: Challenges and Prospects in the Current International Situation" held at New York on 3 June 2003. Sukma pointed to the need for the establishment of an ASEAN security community that would pursue a comprehensive framework of security that gives equal importance to both traditional and non-military security issues and responses. (Sukma 2003, 3) The paper was conceived in reaction to the proposal of the Singaporean government to establish an ASEAN Economic Community (AEC) that went beyond the ASEAN Free Trade Area (AFTA). Sukma rationalized the need for an ASEAN Security Community (ASC) by pointing out that "ASEAN can no longer pretend that 'peace, stability, and prosperity' can only be achieved through economic cooperation." (Sukma 2003, 2) This paper was eventually used as a departure point for what became an Indonesian government initiative for the establishment of the ASC.

The establishment of the ASC as part of a projected ASEAN Community was formalized in the Declaration of ASEAN Concord II, or Bali Concord II. In this document, the reference to the ASC re-emphasized a number of fundamental norms that ASEAN defines as being essential to its identity as a long-standing regional association. These include: (Bali II 2003)

1. the continued subscription to comprehensive security with its recognition of the interconnectedness of political, economic and socio-cultural realities;
2. respect for national sovereignty and non-interference in the internal affairs of other countries;
3. consensus-based decision-making; and
4. the renunciation of the use or threat of the use of force, and peaceful settlement of disputes and differences.

It made the outright claim, however, that some issues, particularly maritime issues, are transboundary in nature and require a regional response. This, in fact, is the starting point for the rationale behind the ASC: the need to intensify ASEAN cooperation in areas of security where self-help is insufficient as an approach. To this end, Bali Concord II specifically mentions that the members of ASEAN are committed to strengthening *regional and national capacities* to address terrorism, trafficking in drugs, persons and other transnational crimes.

The more detailed provisions contained in the Vientiane Action Program (VAP) fundamentally followed from the Bali Concord II and from what the framers of the ASC had originally intended. The VAP stated that the concept of the ASC affirms ASEAN's adherence to comprehensive security. This is a perspective of security which holds to the idea of the interdependence between the political, economic and social life of the region. To this end, its foundational elements include political and social stability, economic prosperity, narrowed development gap, poverty alleviation and the reduction of social disparity. Thus, even as ASEAN continued to commit itself under the ASC Plan of Action to addressing issues that reflect typical security concerns (e.g. the implementation of the Declaration on the Conduct of Parties on the South China Sea, military exchanges and cooperation short of a formal defense agreement, counter-terrorism, counter-insurgency and concerns regarding the maintenance of territorial integrity and respect for national sovereignty), it also noted the need to adopt policies in relation to non-traditional security issues such as transnational crime and other transboundary problems, maritime security cooperation, law enforcement cooperation, and cooperation on environmental problems. Beyond this dichotomy between traditional and non-traditional security, however, the ASC Plan of Action in the VAP also specifically commits the ASEAN states to the establishment of a peaceful region in the context of "a just, *democratic*, and harmonious environment." (VAP 2004, 6) Key to this is the need to pursue such issues as democratization, human rights promotion (and even outright protection in the case of women, children and migrant workers), and post-conflict peace-building.

The APSC Blueprint which was accepted by the ASEAN leaders on 1 March 2009 fundamentally follows from the general outline of the ASEAN Security Community Plan of Action in the VAP. Turning it into the ASEAN Political Security Community, however, is a recognition of what has been clear in the VAP – the ASEAN Security Community Action Plan gives expression to the broader political aspirations of ASEAN rather than a strictly security one. Another way of arguing it is that the envisaged security community very clearly goes beyond the traditional understanding of security (as Sukma had originally noted it should). Fundamentally, the APSC promotes the establishment of:

1. a rules-based community of shared values and norms;
2. a cohesive, peaceful, stable and resilient region with shared responsibility for comprehensive security; and
3. a dynamic and outward-looking region in an increasingly integrated and interdependent world.

It again emphasizes the idea that ASEAN must strive towards a regional environment of justice, democracy and harmony among its members and its people. The APSC is intended to be the means by which greater cooperation between its member countries can be achieved in order to attain higher levels of political development. It is in this context, however, that the APSC significantly moves beyond the ASC Action Plan.

Even as the latter emphasized the need to promote democracy and human rights, it was limited by the injunction that ASEAN must act in concert only in those areas where there is already a consensus. Thus, the VAP limits the action plan on human rights to the protection of women and children's rights since all the members of ASEAN have already acceded or ratified the Convention on the Elimination of Discrimination against Women and the Convention on the Rights of the Child. In fact, prior to the inception of the ASEAN Charter, ASEAN had already formally sought the assistance of the informal Regional Working Group on the Establishment of an ASEAN Human Rights Mechanism. The ASEAN Foreign Ministers had tasked the working group to assist in the drafting of a blueprint for a regional mechanism for the protection of women's and children's rights, as well as looking into a mechanism for migrant workers rights in the region. The ratification of the ASEAN Charter, however, superseded all of these. The APSC Blueprint, with guidance from the Charter's provisions, now includes the promotion and *protection* of human rights in general – not just women's and children's rights. To implement this, the Charter commits ASEAN to the establishment of a regional human rights body the terms of reference for which is currently being drafted by a high level panel. In discussions during the drafting of the ASEAN Charter up to the present, the establishment of a regional human rights body has been the highlight of the Charter – a highlight that has overridden all other considerations. In fact, civil society groups were critical of the Charter because it fell short of expectations raised prior to and during the drafting process. (See Kraft 2007) They were willing, however, to overlook the

problems because of the perceived advantages that the provisions on human rights in the Charter provided.

While the human rights provisions in the Charter and, by extension, in the APSC are important, there are other aspects present in both documents that provide possible spaces for advancing advocacy on security sector reform. One is the commitment to the establishment of a rules-based community of shared values and norms. In particular, the opportunities emerge not just from the commitment to promote and protect human rights, but even more so from the commitment to establish a community subordinated to the principles of democracy and good governance. Another is the openings implicit in what is an emerging shift in the security framework in ASEAN. The APSC makes clear the continuing commitment of ASEAN to a comprehensive framework of security. As has been mentioned before, comprehensive security presupposes the interconnectedness of economic, political and social concerns, and that these may be sources of insecurity as much as the military threats from which states are supposed to protect their citizens. While comprehensive security, however, largely emphasized *national resilience* and attention to the development of national capacities, the security issues that the ASEAN states identify as being central to their concerns increasingly require a regional approach, and, more importantly, go beyond strictly state concerns. At the same time, however, the opportunities provided by these same spaces are not very clear as they face continuing challenges from long-standing ASEAN practices and attitudes.

### **Providing a Normative Platform for ASEAN**

As noted earlier, the ASEAN Charter makes very clear normative commitments to democracy, the rule of law and good governance, and the promotion and protection of human rights. In the APSC Blueprint, the member-states of ASEAN are charged with establishing a standard of common adherence to “norms of good conduct among member states of the ASEAN Community; consolidating and strengthening ASEAN’s solidarity, cohesiveness and harmony; and contributing to the building of a peaceful, democratic, tolerant, participatory and transparent community in Southeast Asia.” (APSC 2009, p. 3) To further the development of common norms and shared values, it incorporates a number of specific action measures. Among these, the following general categories are of particular importance:

*Increased consultation outside of formal ASEAN networks.* Section A.1 (especially the provisions in numbers 5 and 6) of the APSC contains items and proposed action measures that are directed towards increasing the involvement of entities outside ASEAN’s formal networks to its formal processes. These include specific references to increasing the engagement with civil society groups, the private sector and academic networks. ASEAN has been noted for its networking activities among the ASEAN states and with their dialogue partners. Since 1996, however, there has been a notable increase in direct involvement between ASEAN as a body and its different processes

with civil society groups within the region. Significantly, the most extensive engagement has perhaps revolved around the establishment of a regional human rights body. What the engagement has wrought, however, is an emerging habit of consultation with different groups outside the formal networks of ASEAN on different issues, including the issue of ASEAN itself. The drafting of the Charter was replete with numerous consultations, from the work of the Eminent Persons Group, to the High Level Task Force, to the continuing discussions on the different Blueprints. Admittedly, these engagements are uneven across countries. While civil society involvement in these processes are encouraged and supported in Indonesia, the Philippines, Thailand, and, to an increasing degree, Malaysia and Vietnam, there is still hesitation in involving these groups in Singapore and Laos. In Myanmar and Brunei, there is hardly any consultation taking place outside of the formal institutions of government.

*Greater exchange of and the free flow of information.* The provisions in the APSC Blueprint on this particular area fundamentally call for greater openness between and within the ASEAN member-states. (In particular, see Section A.1.2 of the APSC Blueprint) This covers an extensive range of activities which are largely projections at the moment but once implemented would have significant influence over developments in ASEAN. The initial effort has to do with exchanging information on national laws, political systems. Beyond this, however, the APSC Blueprint enjoins the different member countries to facilitate the free flow of information *within* each country. The implications of the provisions on this particular point are significant as far as debating democracy and good governance is concerned. Again, the limitation is that the injunction is held back by the proviso that this be done within the limits of the different laws and regulations of each country. On the other hand, these injunctions are clear opportunities that could be used to promote greater levels of democracy to be practiced in the different member-states of ASEAN. These are also wedges into a more liberal way of enforcing the long-standing ASEAN adherence to the principle of non-interference.

*Encouragement of activities that would promote good governance, the protection and promotion of human rights, and the principles of democracy.* The APSC Blueprint promotes the implementation of a number of general measures in direct relation to good governance, human rights and democracy. There is a specific item on combating and preventing corruption, but to a large extent this is all part of ensuring good governance. All of these recommended actions that could be undertaken could be the basis for initiatives that could be advanced by different groups. The existence of more liberal governments means that there are institutional spaces that could be utilized to promote these activities in order to really make these aspirations meaningful. A key issue here is the ASEAN Human Rights Body. The Terms of Reference document for this institution is still being drafted, but already there are dangerous indications that this body will again be more of a showcase than an actual prize.<sup>ii</sup>

The regional aspect to all these activities is concerned with how they could contribute to regional peace and stability. Even as these activities and the goals they are directed at are discrete, they are all part of an overall framework to strengthen cooperation that would enhance the security of the region – an important aspect of which is the further reduction of the prospects for conflict. This refers not only to inter-state conflict among the ASEAN states (which is already minimal even with the skirmishes that take place at the Thai-Cambodia, the Thai-Myanmar borders and the fishing lanes in the South China Sea and the tri-border area between Indonesia, Malaysia and the Philippines) but to inter-state conflict among the major powers and intra-state conflict which could overspill into inter- and extra-ASEAN state relations.

In comparison with the ASC Plan of Action, the APSC Blueprint provides specific action programs designed to facilitate widespread dissemination and sharing of these norms. As can be gleaned from the sections above, there is a particular emphasis on making sure that the ASEAN idea goes beyond bureaucratic elites. In fact, the ASEAN has begun to institutionalize processes of engagement with civil society groups through processes such as the ASEAN People's Assembly (an initiative of the ASEAN Institutes for Strategic and International Studies for bringing government representatives and civil society groups together in a Track Two forum) and the Civil Society Conference (an initiative of the Malaysian government which has largely been taken up by the different member states who have chaired the ASEAN Standing Committee since 2005). Platforms such as these have emerged and become mechanisms for direct and indirect state and non-state interaction on issues that concern the people of ASEAN.

More significantly, there is an emerging habit within ASEAN of direct consultations with interested publics on a number of issues. This has mostly been on the documents that constitute the Roadmap for an ASEAN Community. The drafting of the Charter, for instance, involved regular consultations with civil society groups and academics from the vision work done by the Eminent Persons Group, to the drafting work of the High Level Task Force, to the different fora which were responsible for inputs to the different blueprints. The Philippine government, for instance, started the ASEAN Social Forum as a consultation mechanism for the ASCC Blueprint. The practice, however, has been uneven in its application. While there have been extensive sets of consultations in Indonesia, the Philippines, and Thailand, and less so in Cambodia, Laos, Malaysia and Singapore, it is almost non-existent in Brunei and Myanmar. The practice, however, is increasingly becoming a regular part of ASEAN processes.

ASEAN has also moved relatively fast on the drafting of the terms of reference for the ASEAN Human Rights Body. The High Level Panel responsible for drafting the TOR has already submitted the first draft of the TOR. Although that draft has been much criticized, it indicates that ASEAN would like to showcase it as an example of ASEAN's commitment to human rights. The test, however, is on what will substantively be

contained in the TOR in terms of what the powers would be of such a body, and what its relationship will be with the ASEAN states.

The other side of the ledger on ASEAN's commitment to establishing a people-oriented ASEAN, however, shows how much ASEAN itself has to do on issues concerning its members. There has been very little done regarding continuing political repression in Myanmar, as emphasized by the experience of Daw Aung San Suu Kyi, and the case of the Rohingyas. Cutting across the region is embedded political elite cynicism and opportunism which has allowed corruption, criminality, and lesser forms of political repression to prosper. More generally, there is still a lack of clear-cut cooperative activities addressing the economic gaps within ASEAN.

It can be argued though that it has been less than two years since the Charter was signed by the leaders of the ASEAN states and a few months since its ratification. If we look at it in terms of the APSC Blueprint, the time element becomes even shorter. It is obviously premature (if not outright unfair) to make judgments. It is not, however, so much what has been and has not been accomplished through the Charter or the APSC Blueprint that is really telling. The problem is that the institutional mechanisms that would be responsible for making the normative aspirations presented in the Charter and the APSC Blueprint a reality continue to be weak. In particular, two interrelated issue areas regarding its institutions continue to make the skeptics on ASEAN skeptical.

*Binding decisions.* A rules-based environment emerges from both procedural and substantive aspects of decision-making. Rules or decisions made must be clear to all and agreements reached must be made on the basis of good faith, i.e. that there is the intention to comply. The implication is that decisions are made to apply to all.

By and large, the binding nature of decisions made at the level of ASEAN had in the past been less of an issue because of the consensual process of ASEAN decision-making. Because a consensus approach meant that decisions could only be made on issue areas where the member-states of ASEAN were largely in agreement, it had prevented sensitive concerns from becoming divisive issues and thereby contributed to ASEAN solidarity over the years. Due to its consensus approach to decision-making, however, the language in ASEAN declarations tend to be less than explicit about commitments.

The less-than-binding nature of decisions presents continuing problems for ASEAN in relation to the case of Myanmar. The commitment to democracy and human rights that is part of the progressive aspects of the Charter, and the action plans specified in the APSC Blueprint only becomes meaningful if there is a serious intent to put into place mechanisms that will allow for the enforcement of human rights protection across the region. There are serious questions regarding the intention to take obligations on human rights that the Charter imposes on the ASEAN member-states seriously.

*Compliance and sanctions.* The seriousness with which states take their obligations under the Charter seriously would have more credibility if there were very clear structures for ensuring compliance. Criticisms directed by ASEAN governments at the military junta for its actions against its own citizens (e.g. excessive violence against demonstrators and the political persecution of Suu Kyi have been the constant bone of contention between the junta and its partners in ASEAN) have been brushed aside, and calls for political reform have at best been met with polite insouciance and less than sincere promises.

Considerations of ASEAN solidarity, however, have taken precedence over substantive concerns that may affect the credibility of ASEAN norms and values, and what the ASEAN Community stands for. Early in the process of the work of the High Level Task Force drafting the Charter, it was decided that provisions on discipline would be left out of the Charter to make the language less divisive.<sup>111</sup> Instead, a provision was included that referred questions of discipline regarding cases of serious breach of the Charter or cases of non-compliance on provisions of agreements to the ASEAN Summit. This effectively gives the state involved a veto on what should be done to it. The Charter's insistence on referring such matters to the ASEAN Summit, with its decision-making via consensus approach, negates the effect of the inclusion of even a weak reference to addressing non-compliance.

### **The Global Financial Crisis and Southeast Asia**

The emergence of the global financial crisis creates a different wrinkle in the prospective development of the APSC. To be clear about it, the issues related to the APSC presented above are concerns that preceded the global financial crisis. The crisis, however, can at best provide a distraction and at worst an excuse from seriously undertaking the action programs of the APSC.

At the end of 2008, there was a general sigh of relief and a sense that the impact of the global financial crisis on Asian economies was going to be less virulent than the effects of the 1997 crisis. (*The Economist* 2008, 35-36) At that point, there were significant downturns in the economies of the countries in the region, but without the sense of panic that emerged in the case of more than ten years ago. By the middle of 2010, however, some countries in the region had been hit hard by the global economic slowdown. High levels of exposure to the global financial markets and consumer markets have made them vulnerable over time to the lingering effects of the crisis. Singapore is expecting a contraction in its economy by as much as five percent, and projections for Thailand indicate a -2 percent growth to be likely. Malaysia's dependence on exports has likewise made it vulnerable to the effects of the global economic downturn. The Philippines' dependence on the remittances of overseas workers (particularly those from the economically strapped North American states) and



its high debt to GDP ratio also puts it in a difficult situation. (*The Economist* 2009a, 70; *Far Eastern Economic Review* 2009, 13-16) Vietnam expects that its economic growth will slow down to 3.2 percent from the previous year's 6.1 percent. Among the large countries in the region, only Indonesia has been able to keep its head above water. (*The Economist* 2009b, 26-27)

ASEAN does not have a good record of responding collectively to crises situation affecting its members over the last fifteen years. Its impotence during the crisis of 1997-1998 was the subject of much introspection over the future of the grouping. Subsequent developments wherein ASEAN was not able to decisively play a leading role in resolving issues such as the violence that came with the independence of Timor Leste from Indonesia, the haze, and the case of the Rohingyas have only served to confirm this problem. Given its institutional issues, this is not likely to be resolved over the short term. It is thus unlikely that ASEAN will be a major factor in the strategies of countries in the region out of the current crisis. The question here, however, is what does this poor record on crisis management portend for the prospects of the ASEAN-Political Security Community? On this point, the effect of the global financial crisis can be seen in two ways.

The first is more direct, but less decisive in terms of its effects on ASEAN progress on the establishment of the APSC. This refers to the material effects of the crisis – the economic costs involved in trying to counter the effects of the crisis. As noted above, the Indonesian economy has shown resilience in being able to get through the current crisis – the opposite of what happened in 1997-1998. The stimulus package of USD6 billion that the Indonesian government had put together has been a contributing factor in this. This constitutes 1.4 percent of the country's GDP in 2008. The Singaporean government on the other hand announced that it would put into place a stimulus package that would be worth 8 percent of its GDP. Other governments have similar policies that would mean increased government spending. In a situation where domestic economic conditions require the full attention of those in positions of authority, international concerns (short of war or conflict with other states) tend to be given less priority if not set aside completely. In the case of ASEAN, its inter-governmental nature implies that participation in regional programs depends on the willingness and capacity of governments. A number of the action programs recommended in the APSC Blueprint point to increased intra-ASEAN involvement – exchanges, educational and training activities, and capacity-building. With the crisis, governments will be too distracted to seriously engage in community-building, especially one that involves normative commitments that go against the existing political conditions.

The issue of normative commitments leads to the second point. The APSC Blueprint calls for activities that will promote democratization and human rights protection, the rule of law, and good governance. This is an area which arguably has more strategic

implications for ASEAN than the material aspect of the financial crisis. As noted previously, the most significant aspect of the APSC Blueprint is the normative foundation it lays out for ASEAN. More specifically, its emphasis on enhancing ASEAN cooperation to

“strengthen democracy, enhance good governance and the rule of law, and to promote and protect human rights and fundamental freedoms, with due regard to the rights and responsibilities of the Member States of ASEAN, so as to ultimately create a Rules-based Community of shared values and norms” presents a picture of the direction ASEAN would like to take in its future development. The APSC promotes increased engagement between governments, academics, and civil society.

These are, however, aspirational statements. The ASEAN states remain a diverse grouping of different peoples with different economic and political systems. The idea to pursue a course that promotes democratization and the commitment to promote and protect human rights is not a decision that would come easily to all its members. This is why the issues on decision-making and compliance are major institutional gaps that need to be reconciled with the inherent reticence of some ASEAN member-states in initiating a process that would lead to political change in their countries. The financial crisis provides a distraction in terms of the allocation of resources assuming that there is a sincere desire to pursue the aspirations laid out in the APSC Blueprint. The assumption of a “sincere desire,” however, is not an easy one to make considering past experience. If there is no “sincere desire” to initiate the process that would lead towards the APSC with all its normative structures intact, then the financial crisis would present an excellent opportunity to stall and delay. There are the continuing concerns over Myanmar (with the arrest and trial of Aung San Suu Kyi), and the forced relocation of families living in Phnom Penh as the cash-strapped government turns to real estate developers as part of its capital generation.

On the other hand, however, there can be no expectation of the ASEAN states delaying for too long. Having set the target for the establishment of the ASEAN Community by 2015, they have set a clear point of advocacy for civil society groups as well as government personalities who are intent in seeing the process through. With ASEAN governments and civil society engagement largely institutionalized, it can be expected that the ASEAN member-states will be constantly reminded of their commitments. The days of sweeping these issues under the rug have largely gone by. In the end, the current financial crisis will probably present opportunities to stall for those who are not intent on taking their commitments seriously, but it also provides opportunities for those who would like to ensure that the ASEAN states are kept honest about those same commitments.

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#### ENDNOTES

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**ASEAN ROUNDTABLE 2009**  
**The Global Economic Crisis: Implications for ASEAN**  
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**“What can ASEAN do to address rising poverty levels and social unrest”**

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**Introduction**

The topic “What can ASEAN do to address rising poverty levels and social unrest” is especially pertinent if the current global economic crisis is prolonged or worsens further. Even if the crisis abates during the next year, various forecasts point to a slower rate of growth in the ASEAN national economies. Continuing ripple effects on various economic sectors, socio-economic groups and local areas already badly hit as a result of the worsening economic conditions during the past 18 months can be expected for some time to come. To ensure that economic distress does not translate into sharply rising poverty levels and social unrest, policy makers in the region will need to be more proactive than they have been to date – both at the regional and national levels.

Unfortunately, at the regional level, the outcome of the most recent meeting of the Heads of State/Government of the ASEAN Member States in Cha-am Hua Hin on 1 March 2009 to discuss the global economic and financial crisis has provided little evidence or assurance that the governments at the regional level are focused on addressing the poverty and social impacts of the crisis. The press communiqué arising out of the meeting mainly affirmed “the necessity of proactive and decisive policy actions to restore market confidence and [to] ensure continued financial stability to promote sustainable regional economic growth”. Emphasis was placed on “expansionary macroeconomic policies, including fiscal stimulus, monetary easing, access to credit including trade

financing, and measures to support private sector, particularly small and medium enterprises (SMEs) undertaken by each ASEAN Member State to stimulate domestic demand". Although the importance of "coordinating policies and taking joint actions that would be mutually reinforcing at the regional level" was mentioned, this was more focused on the regional grouping's "determination to ensure the free flow of goods, services and investment, and facilitate movement of business persons, professionals, talents and labour, and freer flow of capital" rather than on alleviating the regional poverty and social impacts arising from the crisis.

In all, the meeting appears to have taken a hands-off approach in terms of a regional approach to the challenge of worsening poverty in the region arising from the global crisis, preferring – or at least it seems to the public - to opt for the national governments to deal with the impact in their own ways. Both at the national and regional levels, it is also noticeable that the immediate response packages to the crisis have been more directed towards stimulating growth and shoring up the banking, finance and manufacturing sectors with considerably less attention given to strengthening the social safety net and the introduction of special social protection programmes.<sup>1</sup> In the last few months, government in the region have stitched together a hodge-podge of modest social protection programmes in their fiscal stimulus response to the crisis but there is still little evidence of substantive efforts at formulating and implementing policies that systematically address the problem of rising poverty.<sup>2</sup>

### **Some Major Concerns When Addressing Poverty Impact**

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<sup>1</sup> In Malaysia, the government's first stimulus measure to cushion the shock was to increase the capitalization of a government investment company by \$5 billion, in part to stabilize the stock exchange. The move was heavily criticized by the major workers union in the country which argued that the government agency disbursing the funds "is the custodian of people's money and "not the ATM for the government" to bail out state-linked firms. "This is the hard-earned money of the workers, their retirement plan. How is this bailout plan going to benefit the workers?" See Lim Teck Ghee, "Global Economic Crisis and Impact on Malaysia", Presentation to Malaysian Parliamentarians, Kuala Lumpur, 29 October 2008

<sup>2</sup> Details of stimulus packages in various ASEAN member countries can be found in Annex 1.

What are the main concerns that should be uppermost on the minds of national and regional policy makers as they grapple with the economic crisis? There are at least three key sets of concerns which the region and impacted countries may want to prioritize in policy making and programming. The first relates to the impact on poverty numbers and poverty levels? How many in the countries and region are affected? Who are affected and where are they to be found? The second relates to the major ways in which the poor are affected by the crisis, and the types of remedial measures that can be of greatest benefit to the poor. This set also includes concerns on how to ensure that stabilization or social safety net assistance to regions, sectors and communities are well designed and robust and are not affected by political bias or other forms of distortion that will reduce their efficiency and impact. Especially important to address is how to ensure that social safety net measures do not suffer from leakage, bias or are undermined by high administrative costs. The last set of concerns relates to the relationship between poverty, inequality and the larger political economy in the longer run. This set is more complex than the first two and can cover a wide range of questions including

- how much priority should governments give to issues of redistribution during a period of prolonged economic recession or crisis and/or when government revenues are sharply reduced.
- how to ensure that spatial, occupational and group disparities are more efficiently addressed so that rising poverty does not lead to the destabilization of the economy or society.

### **The Numbers Issue: How Many More Poor?**

On the first set which relates to estimates or measurement of the impact of the crisis on income levels, livelihoods and welfare, no data is available yet of the increase in poverty numbers for the ASEAN region partly because the crisis is still in the process of unfolding. However, the major international development agencies working in the Asian

and ASEAN region are in general agreement that the impact of the crisis has plunged a very large number of people into poverty. According to a February report from the ILO as many as 23 million people could lose their jobs in Asia whilst more than 140 million could fall into poverty. These figures cover the entire Asian region but they have not been accompanied by disaggregated country breakdowns. During the same month, the World Bank also issued a policy note entitled "The Global Economic Crisis: Assessing Vulnerability with a Poverty Lens" on the impact of the crisis. According to the Bank's new estimates for 2009, lower economic growth rates will trap 46 million more people on less than \$1.25 a day than was expected prior to the crisis. An extra 53 million are expected to stay trapped on less than \$2 a day. This, according to the Bank, is on top of the 130-155 million people pushed into poverty in 2008 because of soaring food and fuel prices. In country terms, it was estimated that almost 40 percent of 107 developing countries were highly exposed to the poverty effects of the crisis and the remainder was moderately exposed, with less than 10 percent facing little risk.

### **Identifying Priority Poverty Groups**

Because the incidence of poverty and related socio-economic deprivation within the ASEAN region and at least 8 of the region's 10 countries are so large, it will be necessary for policy makers to prioritize which groups within the total population of the poor should require urgent attention. On this issue, it may be useful at least in planning terms to distinguish between the two major groups of poor that will need attention - the traditional poor and the new poor. The traditional poor are those that have long comprised the bottom strata of the income and occupational distribution in the ASEAN countries. These are primarily people who live in rural areas and are unemployed or under-employed or work in the lowest rung of the agricultural or urban sectors. The new poor consist of those who may have managed to climb above the poverty line but have now tumbled back below it as a result of the loss of jobs or income arising from the

crisis. In the region as a whole those most affected by recent job and income losses include the following<sup>3</sup>:

- 'Flexible' / migrant / undocumented foreign workforce
- Contract workers or over-time dependent workers
- Retrenched workers at the lower occupational rungs
- Agricultural sector workers and owners of small agricultural holdings
- Manufacturing sector workers
- Unemployed graduates, new entrants and under-skilled workers
- Self employed especially those severely affected by the ripple effects arising from the economic slowdown or recessionary conditions

Obviously not all who are identified as belonging to these groups fall into the category of the poor. Higher skilled manufacturing sector workers, unemployed graduates and more highly remunerated self-employed generally fall into the middle or higher income categories. They will have a greater capacity to withstand the challenges of the economic downturn on their own and could well do without the need for special state assistance.

National approaches in identifying poverty groups impacted by the economic crisis will vary considerably but all will need to take into account the key criterion of exclusion from productive resources, decent work and social security; as well as extreme vulnerability to higher food and fuel costs.<sup>4</sup> Careful targeting can separate out the most vulnerable in key socio-economic and occupational groupings that have been affected from those who are better able to fend for themselves in coping with the loss of employment or income. Such targeting is necessary to ensure that the stimulus packages or remedial measures do in fact reach the most deserving and most needy amongst the

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<sup>3</sup> The listing here is based on a Malaysian country presentation on the "Global Economic Crisis and Impact on Malaysia". See Lim Teck Ghee, Presentation to Malaysian Parliamentarians, Kuala Lumpur, 29 October 2008

<sup>4</sup> According to the latest UNESCAP annual report, "when people are affected by sudden shocks, the ones most at risk are the poor, women who are labourers in the manufacturing sector, the youngest and oldest populations and socially excluded groups". Not only have these groups fewer resources such as real assets and savings to cushion the shocks, "but they also have less influence on economic and political decision making" See "Economic and Social Survey of Asia and the Pacific 2009 – Addressing Triple Threats to Development", United Nations, New York, 2009, p. 13.

traditional and the new poor, and are not deployed on groups or sectors that have the capacity and ability to overcome the dislocation without the need for outside assistance.

### **Social Safety Net, Employment or Other Forms of Assistance**

The next set of questions relates to what needs to be done to alleviate the plight of the poverty groups affected by the crisis. Here again, various approaches are available to policy makers. In the recent policy recommendations advanced by the various international development agencies to address the poverty impact of the crisis, what is discernible is the (understandable) tendency for each agency to prioritize approaches that are related to the mandate and work programmes of the agency concerned. Thus the International Labour Organization has emphasized that the crisis is likely to lead to stagnant or falling real wages, with the potential for increased incidence of wage related disputes. It has also warned that the crisis was quickly evolving "into an employment and social crisis" with the region at the tipping point of seeing social unrest explode into the streets, as the jobless and marginalized demand greater government action.<sup>5</sup> To avert this social unrest, the ILO has recommended that "social partners should be included in policy discussions in order to make sure that the most vulnerable and affected people are given the central attention". Amongst some of the ILO's priority policy prescriptions are programmes to protect employment and support household purchasing power, public expenditure on schools, hospitals and healthcare, and the boosting of worker skills for longer-term productivity.<sup>6</sup>

For the World Bank, the crisis has highlighted the serious threat to the achievement of the U.N.'s Millennium Development Goals (MDGs), to which it is committed with specific

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<sup>5</sup> Migrant workers with short-term contracts as well as women working in small and medium sized factories and firms are particularly vulnerable. "From India to China to Vietnam, large numbers of internal migrants have lost their jobs, generating a reverse migration to the countryside in search of rural employment," Yamamoto said.

<sup>6</sup> The ILO's policy recommendations appear to be in line with or supported by the major regional developmental agency, the Asian Development Bank. According to the ADB's vice president for sustainable development, Ursula Schaefer-Preus, any stimulus packages would need to include job creation and infrastructure needs that will most benefit the poor. See <http://www.google.com/hostednews/afp/article/ALeqM5jYxfcKF30-iYHsHUv5GVXUS10F3Q>



targets to overcome poverty by 2015. According to the Bank's research, the sharply lower economic growth rates will significantly retard progress in reducing infant mortality, for example. According to preliminary estimates for 2009 to 2015, an average 200,000 to 400,000 more children a year, a total of 1.4 to 2.8 million, may die if the crisis persists. The Bank's recent policy note on the impact of the global crisis also emphasized that it was critical for exposed countries to finance job creation, the delivery of essential services and infrastructure, and safety net programs for the vulnerable. At the same time, the Bank has cautioned that up to three quarters of these countries cannot raise funds domestically or internationally to finance programs to curb the effects of the downturn.

One quarter of the exposed countries also lacked the institutional capacity to expand spending to protect vulnerable groups. To meet this shortfall, the Bank note has urged financial support in the form of grants and low or zero interest loans for these countries. It has also called for the establishment of a "Vulnerability Fund" in which each developed country devotes 0.7% of its stimulus package to the fund. Three priority areas for the Bank proposed Vulnerability Fund are: safety net programs, infrastructure investments, and support for small and medium-sized enterprises and microfinance institutions.

A different tack on the approach necessary to alleviate the impact of the crisis can be arrived at if the results of a recent study undertaken by the Institute of Development Studies (IDS) are given serious consideration. Drawing on empirical work undertaken in Bangladesh, Indonesia, Kenya, Jamaica and Zambia, the study established that people living in the world's poorest communities are eating less frequently and consuming worse food as a result of the global financial crisis. (The Guardian, Friday, 27 March 2009) "Eating less frequently and less diverse and nutrient-rich foods was commonly reported," the report states. Many poor people reported not being able to make ends meet. Managing food, health and educational needs has been a struggle, and not only for the very poorest. Secondly, many poor families hit by the economic downturn are also removing their children from school and pushing them into work much earlier. For some, particularly young children, the impacts may be permanent: children who drop out of

school to work or because their parents cannot afford fees, books or breakfast, are unlikely to re-enrol even if food prices begin to decline. Researchers stressed that it was difficult to untangle which aspects of hardship could be directly traced to either the current economic crisis, the fuel and food price rise of the previous year or the local political situation. At the same time - drawing from studies of the impact of previous recessions – the IDS concluded that “poverty, malnutrition and infant mortality increased during every national financial crisis in the past 11 years.”

Whatever the programmatic approach and strategy – whether it is a focus on food security or on employment generation; whether the target groups are women or the most vulnerable amongst the young and elderly – governments need to act quickly since prolonged deprivation and the associated impact on health and physical and economic well being could result in the inter-generational reproduction of poverty, making it more intractable to resolve if it is permitted to languish or grow. In fact this is probably the most serious outcome of deepening poverty – the silent and insidious erosion or reversal of past gains in key health and other well being indicators.

#### **Lessons from the 1997 Crisis and from Best Practices in Poverty Alleviation**

The last set of concerns relates to the effects of rising and entrenched poverty in a context of prolonged economic recession or crisis. Here, lessons from the region’s experience with the last economic crisis in 1997 are instructive.<sup>7</sup> Firstly, it should be noted that the negative effects on poverty generally extend beyond the period of the crisis itself. Although economic growth resumed fairly quickly after the 1997 crisis, in some countries it took as long as 10 years to recover lost ground in the national efforts to reduce poverty.<sup>8</sup> Secondly, the increase in poverty is likely to bring about increased

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<sup>7</sup> A recent ADB media note issued in connection with a forthcoming high level policy meeting to evaluate the impact of the global economic slowdown on poverty and sustainable development in Asia and the Pacific has stated that “the causes and impacts are different from the Asian Financial Crisis in 1998 in several respects. The current crisis concerns not only the very poor (i.e. those living under the \$1.25 poverty line) but more so the vulnerable poor, mostly educated youth in the export sectors (and backward industries and services). Impact channels are going through labor markets, migration and remittances, social budgets, social protection, gender, health, education and training, among others.” See <http://www.adb.org/Documents/Events/2009/Poverty-Social-Development/default.asp>

<sup>8</sup> ILO, Global Wage Report 2008/2009 (2008)

inequality. Income inequality levels in the ASEAN countries as measured by the gini measure of inequality are already amongst some of the highest amongst countries in the world and an increase in inequality is not only unacceptable socially and politically, but it could also very well generate severe socio-economic dislocation and pain with attendant costs to the larger economy and society. Thirdly, the potential for social unrest is especially pronounced in urban areas – not only in the mega cities but also in the smaller and equally crowded secondary cities. In these urban settings, the volatile combination of urban slums and squatters where the poor are concentrated, a growing unemployed population of low income wage workers and self employed (including foreign and local migrant workers), and widening disparities and inequalities of income and wealth could very well prove to be the spark to ignite a tinder box of dissatisfaction and unrest.

Other lessons in tackling entrenched poverty systematically and efficiently have long been available. Some of these lessons<sup>9</sup> include the following:

- they emphasize women's agency role in the development activity through a range of new freedoms such as the freedom women have to work outside the home, the freedom to earn an independent income, the freedom to have ownership rights, and the freedom to receive education. Beyond this, the focus on women has had an important (though underestimated but not yet well-studied) impact on reducing the inter-generational reproduction of poverty
- there is relatively open access to information and transparency in decision making. Once information and knowledge are accessed by poor communities, it places them on a more equal footing when negotiating with others as well as enables them to realize their full developmental potential
- they are often based on government-NGO-CBO (community-based organizations) partnerships or coalitions for change with project activities more geared towards control of resources and decisions by local communities than by outside parties
- they have moved from project, periodic, supply-led and output driven approaches to programmatic, continuous involvement, demand-driven and outcomes-oriented approaches. In some of the cases below, considerable upscaling and replication have taken place of initially modest or small projects
- they have ensured that sustainability is a key outcome through investments in networks of the poor and through the creation of organizational capabilities that have worked for the benefit of the many rather than the few

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<sup>9</sup> This is drawn from Lim Teck Ghee, "Best Practices in Poverty Reduction in the UNESCAP Region", unpublished note, 2005

- although initially focused on the creation of social capital, they have been able to bring about the rapid transformation of social capital into economic capital. This is particularly noticeable when comparing the East Asian with the South Asian experience where, in the case of the latter region, many initiatives have remained limited in their impacts as a result of the failure to move to the next stage of development after the achievement of social development gains
- exit strategies have been mainstreamed into project design through effective cost recovery approaches, review of grant/subsidy components, and monitoring systems to ensure optimisation of grant/subsidy impact
- Graft, leakage and corruption are major obstacles to progress
- Bureaucratic elites in collaboration with political elites - rather than the traditional bogeymen of middlemen and private sector intermediaries - are just as or even more likely to cream off poorly designed and monitored programmes

## **Conclusion**

The most important lesson perhaps to bear in mind is that the scourge of poverty can be successfully combated even in the most depressed of conditions. Often though it is precisely the great wealth of technical expertise and human resources brought to bear on anti-poverty work - especially in terms of the administrative apparatus used for planning, processing and targeting – that turns out to be a liability by diverting resources from the important work of empowering the poor and unblocking access for the needy. This problem is compounded by leakages through inefficient or corrupt practices. At the end of the day, it is the intangibles that result in desirable outcomes in anti-poverty work, namely the combination of strong political will, good governance, empowerment of the poor, commitment and stamina, and focused and targeted idealism, rather than technical inputs.

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ANNEX 1

Table 4.13. Selected fiscal stimulus packages in South-East Asian region

Country	Package Value	Package Details
Indonesia	US\$ 10.2 billion (Rp 102 trillion)	<p>US\$ 10.2 billion (Rp 102 trillion) - reduced import duties and taxes (Rp 3.3 trillion); infrastructure spending (Rp 10.2 billion); social security (Rp 2.6 trillion); rural development (Rp 0.6 trillion).</p> <p>Announced in January 2009, enhances a previous Rp 27.5 trillion stimulus package.</p>
Malaysia	RM 7 billion (US\$ 1.6 billion) 1% of 2009 GDP; fiscal deficit in 2009: 5.1% of GDP	<p>Investment funds to promote strategic industries and high-speed broadband (RM 1.5 billion); small-scale projects such as village roads, school repairs (RM 1.8 billion); affordable housing (RM 1.8 billion); education and skills training programmes (RM 1 billion); public transport and military facilities (RM 1 billion).</p> <p>Announced in November 2008, a second stimulus package was unveiled in February 2009.</p>
Philippines	P 330 billion (US\$ 6.5 billion) 1.2% of 2009 GDP; fiscal deficit in 2009: 3.1% of GDP	<p>Increase in expenditures (P 100 billion); infrastructure (P 100 billion); tax incentives and special provisions (P 40 billion); waiver of government-owned national banks' institutions (P 30 billion).</p> <p>Announced in November 2008, specific details not available at the time of writing.</p>
Singapore	S\$2.5 billion (US\$ 700 million) 11.5% of 2008 GDP; fiscal surplus in 2008: 0.9% of GDP	<p>Job Credit and Employer Cash Incentives for employees to cover part of their wage bills and social security levies (S\$1.5 billion); special risk sharing initiative; Government guarantees to working-capital loans (up to S\$5 million) to individual firms to stimulate bank lending; cut in corporate tax rate from 19% to 17%; and personal income tax rebates of 20% of taxes due (capped at S\$1,000).</p> <p>Announced January 2009, the Government plans to draw down S\$4.9 billion from Monetary Accumulated Reserves to finance the job credit and special risk sharing initiative programmes, and will also tap reserves held by the Monetary Authority of Singapore (the central bank) and the Government of Singapore Investment Corporation (a sovereign wealth fund).</p>
Thailand	B 115 billion (US\$ 3 billion) 1.2% of 2009 GDP; fiscal deficit in 2009: 1.4% of GDP	<p>One-time distribution of B 2,000 in cash to people who currently earn monthly salaries of less than B 15,000; support for social security; free education programmes; job creation; and low-interest loans to farmers.</p> <p>Approved by the cabinet in January 2009, the initiative extends by six months a package of economic stimulus measures implemented by the previous Government, including such measures as lower water and electricity charges, fee cuts on some of Bangkok's public buses and free first-class train ticket railroads.</p>
Viet Nam	D 17 billion (US\$ 4 billion) 1.2% of 2008 GDP (fiscal deficit in 2008: 4.1% of GDP)	<p>Details not announced at the time of writing. Components include: subsidised loans to farmers at an annual rate of 11.5%; a 4% subsidy on the interest rate contributions pay for their loans; and credit for small businesses.</p> <p>Announced December 2008.</p>

## **Introduction**

The global financial crisis that began with the loss of confidence in the subprime mortgages in the second half of 2007 has spiraled into a full blown crisis with severe impact on the real economies all around the world. Debates over the causes and consequences of this global crisis, which is no longer confined to the financial sector, continued even as “green shoots” of recovery are said to be appearing. What this paper will attempt to do is to focus on how this global economic crisis has changed the geo-economic and geo-political picture in Southeast Asia, and how these in turn will impact ASEAN’s own internal economic cooperation. Also to be discussed in the paper will be the impact the global economic crisis has on the ASEAN plus three process, and ASEAN’s relations with the European Union (EU). The paper will also draw from the lessons of the Asian financial crisis and ASEAN’s responses to this earlier crisis and speculate on some of the likely outcomes of the current crisis on ASEAN’s development of its regional processes and dialogue partnership.

## **Economic Impact of global crisis on Asia and ASEAN**

The global impact of the crisis has seen world trade contracted for the first time since World War II. WTO is forecasting that global trade will decline 9% or more in 2009. Till end of 2008 and early 2009, the picture was bleak. Growth has slowed considerably in all emerging economies and gone negative for several of the developed economies. Japan’s GDP contracted by 3.3%, the euro zone by 1.5% and the US by 1% in the last quarter of 2008. China which has enjoyed double digit growth for many years would see growth down to 5-6% in 2009. More broadly, what the crisis has done is to undermine the drivers of globalization – open markets, foreign direct investments and private ownership – and there is a risk of protectionist backlash and economic fragmentation.

In the early stages of the financial crisis in 2007, Asia was spared significant fallout leading to several economists hailing the “decoupling” of the Asian economies from the US locomotive. This was proven wrong as the crisis deepened and became a global economic crisis. As noted in the IMF Survey magazine, the impact of the global economic crisis on Asia “has been swifter and often deeper than for other regions, partly because of Asia’s export dependence and close integration into the global economy”. The collapse in demand for exports has dealt a heavy blow on the export-driven economies of Asia. The fact that Asia is far more integrated in its supply chain network meant a “contagion” effect that spread rapidly across the region when the demand from advanced economies dropped. A reflection of the severity of the impact of this global crisis on Asia is shown in figures provided by IMF – that between September 2008 and February 2009, merchandise exports fell at an annualized rate of about 70% in emerging Asia – almost three times more than during the Asian crisis in the later 1990s. Overall, the IMF expects growth for Asia to decelerate to 1.3% in 2009 from 5.1% in 2008 and growth will return to Asia when the global economy recovers.

Within ASEAN, as noted by Gregory Lopez, initially there was a feeling that the crisis was a problem for the rich countries and that they would weather the storm better because of the economic reforms and structural changes in the financial sector undertaken during the Asian financial crisis of the late 1990s.

Indeed, most ASEAN countries were enjoying current account surpluses and rapidly accumulating foreign exchange reserves. Budget deficits in many of these countries were modest and there were no cases of serious financial collapse or bank runs. Hence, in Southeast Asia, except for Singapore, the impact and extent of the crisis may not have been fully appreciated. The rapid decline in world trade and the flight to safety in capital markets are however beginning to sink in and growth in Southeast Asia as a whole will contract from 5.2% in 2008 to close to zero in 2009.

Southeast Asia was at the epicenter for the last major Asian financial crisis but is today an innocent bystander suffering the consequences of the financial meltdown in the West. According to Hal Hill, while its relative openness to trade means greater vulnerability to fall in global trade volumes, and the global economic crisis "will inflict some economic distress and social hardship, its effects on the region are likely to be contained". That said the greater geopolitical implications of the crisis and how ASEAN responds to these challenges would determine whether ASEAN would be taken seriously in its strategic relations with its North-east Asian partners, the US and EU.

### **Geo-political and geo-economic implications of the global economic crisis**

#### **The West in Decline**

The "decline" of the West and the "rise" of Asia had been very much in the literature since the 1990s. The Asian Financial crisis and the resurgence of the US economy in the first few years of the 21<sup>st</sup> Century dampen the euphoria about the impending arrival of the Asian century. However, the continued rise of China as an economic and political driver of the global economy, together with the rise of India and India's increasing integration in the global economy in the last decade have again fuelled the talk about an Asian global era. The current global financial crisis as Dominique Moisi put it "will accelerate the comparative decline of the West as a force today and as a model for the rest of the world tomorrow" (ST 8 October 2008). While US remained the only superpower in the military sense, the global financial crisis has further damaged America's reputation and (eroded already by the Iraq war and the abuses in Abu Ghraib and Guantanamo Bay) capacity for world leadership.

Roger Altman in an article in Foreign Affairs argued that the financial and economic crash of 2008 is a "major political geopolitical setback for the US and Europe" and it has stripped Washington and European governments of the resources and credibility they need to maintain their role in global affairs. While "these weaknesses may eventually be repaired, in the interim, they will accelerate trends that are shifting the world's center of gravity away from the United States." China will be a major beneficiary of this power shift because of its strong finances – a budget surplus, a current account surplus and nearly US\$2 trillion in foreign exchange reserves (Altman, 2009).

#### **China on the rise**

While there is no doubt that China will also be adversely affected by the crisis, it will still be able to maintain moderate economic growth through the global crisis. Most important of all as Altman rightly highlighted is that fortunately for China, its strong finances and large reserves has meant China has the means to maintain stability in its own financial system and to stimulate its domestic economy. The real economy remains relatively strong and hence, China is now seen as a major economic locomotive to fuel economic recovery.

The rise of China has been a phenomenon discussed for more than a decade now and with the current economic crisis 'impairing' the capacity of the West to act we are perhaps on the verge of a new

episode with China's return to its historically central role in the global political economy. However, the fact also remains that China's trade and investments have recorded sharp drops in the last two quarters and about 20 million workers have lost their jobs since the crisis hit. Hence, maintaining steady economic growth to ensure social and political stability remains China's central priority. The aggressive policy response with a US\$586 billion stimulus package to support domestic demand and maintain growth is seen as necessary to generate jobs consistent with social stability. China's main focus is still its domestic economy and as Premier Wen Jiabao put it "steady and fast growth of China's economy is in itself an important contribution to global financial stability" (quoted in Parello-Plesner, 2009).

China's rise may not necessarily mean that it is ready to shoulder the responsibility of providing global public goods. But at the regional level, China may be poised to exert greater influence in Southeast Asia. China's actions to further its leadership role in the region include a US\$10 billion investment cooperation fund and an offer of US\$15 billion in credit to Southeast Asian neighbours. These are aimed at helping countries weather the current crisis. The fund will finance infrastructure development linking China and its neighbours while the loans will be offered as rescue packages over the next three to five years. (Bezlova, 2009)

### G2 in the making?

With the way that the US economy and Chinese economy are intertwined like Siamese twins, and the fact that a large measure of the global imbalance is caused by the US because of its chronic deficits (fiscal and current account deficits) and by China because of its chronic surpluses (trade surpluses, and surplus in both capital and current accounts), there were calls for the establishment of a G2 partnership to help work out a global solution to these imbalances (Zheng 2009). The G2 concept was first proposed by US economist Fred Bergsten advocating a partnership between the US and China to exercise global economic leadership.

The idea has gained some traction, and champions of the G2 format in the US included Robert Zoellick (President of the World Bank) and former US National Security Advisor Zbigniew Brzezinski. The latter had called for an "informal G2 between the two powers that would advance cooperation beyond the frameworks of the G8 and G20 (Lelyveld, 2009). Some Chinese intellectuals also see this as a sign that time is ripe for China to assume global leadership.

However, Chinese leaders have remained realistic and pragmatic, taking pains to address misgivings expressed by some countries that the G2 would monopolize international affairs in the future. Premier Wen Jiabao told reporters at the end of the EU-China summit in Prague in May that it is baseless and wrong to think that world affairs will be managed by China and the US. He reiterated China's commitment to multilateralism and a multipolar world. (Xinhua, 25 May 2009).

Debates continued within both the US and China on the soundness and feasibility of such a framework and the idea of a G2 remains vague at best. However, it is acknowledged that global economic recovery will depend on close cooperation and coordination between US and China and Sino-US relations is the most important partnership for global stability.

### Need for rebalancing in Asia – move from export-driven growth to bolstering domestic demand

Current economic crisis exposed the risks of excessive dependence on external demand. Export-led growth cannot continue unabated. Countries need to strengthen domestic consumption and ADB in its latest report on the global economic crisis has urged Asia to increase domestic spending.



Rebalancing growth means altering the composition of aggregate demand in favour of internal demand, matched by changes in the production structure. Many Asian economies because of their favorable accounts surplus and foreign reserves have room for increasing consumer spending. Fiscal resources could be directed to strengthening the social sector protection (health, education, unemployment insurance, pensions).

#### Greater regional cooperation in Asia

A concerted global effort is required to effectively address global imbalances. Strengthened regional cooperation in Asia and provide countries with additional resilience. Asia must start to drive its own growth and cut down its dependence on Western markets. Structural decline in demand from advanced economies is to be expected making regional cooperation all the more important. As the ADB report noted, "regional cooperation proved its value during and after the Asian financial crisis and should be strengthened now to prepare for potentially larger shocks ahead" (ADB report 2009).

#### **From Asian Financial Crisis to Global Economic Crisis – ASEAN's response**

The Association of Southeast Asian Nations (ASEAN) was founded on 8<sup>th</sup> August 1967 at the height of Cold War tensions, and with regional disputes, particularly the Konfrontasi unleashed by Indonesia against its smaller neighbours, Singapore and Malaysia, still fresh in the memory. Against the backdrop, the original aim of ASEAN as envisaged by its founding members (Indonesia, Malaysia, Philippines, Singapore and Thailand) was very modest – to keep the peace in Southeast Asia through respect for each other's sovereignty and adherence to the principle of non-interference. Integration of any kind was never in the gameplan. Hence, in the first decade of ASEAN's existence, its priority was to establish an informal and flexible framework in order to accommodate a diversity of opinions and to build confidence.

Being an informal and flexible organization, ASEAN has shown itself generally nimble enough to respond to external challenges in the best possible way. It made its mark as a "diplomatic community" in the 1980s following the Vietnamese invasion of Cambodia in 1978. As new challenges arise in the 1990s, both in the economic and security arena, ASEAN responded with decisions to establish an ASEAN Free Trade Area (AFTA) in 1992 and to launch the first Asia-Pacific forum for security, the ASEAN Regional Forum (ARF) in 1994.

The Asian Financial Crisis of 1997 took the ASEAN countries by surprise. Coupled with the enlargement of ASEAN to all 10 Southeast Asian countries by 1999, ASEAN was faced with unprecedented challenges. ASEAN initial paralysis and disarray in the face of the financial crisis came as a shock leading later to much soul-searching within the region. The Asian financial crisis revealed the extent of the interdependence between the Southeast Asian region and Northeast Asian region. It was to catalyze new thinking on region-building in Asia. ASEAN also embarked on building new regional capacities inspired by the European experiences in response to the increasing economic challenges. There was increasing recognition of the need for ASEAN to become a much more integrated and coherent entity if it wants to remain relevant as a grouping and be the driving force behind the various ASEAN plus processes. This culminated into the ambitions of creating an ASEAN Community built on three pillars, the ASEAN Economic Community, the ASEAN Security and Political Community and the ASEAN

Sociocultural Community. Of the plans in building the three pillars of the Community, the most comprehensive has been the action plan towards an ASEAN Economic Community (AEC).

The AEC is a response to the increase in regionalism in Asia. But more importantly, it is a response to the global economic landscape that has changed dramatically after the 1997 financial crisis. ASEAN never fully regained its economic competitiveness after the Asian financial crisis. By 2000, when the ASEAN economies started on its road of recovery, China has moved way ahead in being the most attractive economy in the region, attracting the bulk of FDIs from the developed economies to developing economies. The decade of reforms in India which began in 1991 has also begun to bear fruit. The challenges posed by these two economic giants, China and India, was a wake-up call to ASEAN to accelerate its own integration process in order to realize the potential of a market of over 500 million consumers. That was the finding of a study done by McKinsey in 2003.

The McKinsey study finds that middle income ASEAN countries are no longer competitive and the region needs to look for new sources of growth. One key recommendation is for ASEAN to pursue deeper integration in order to take advantage of complementarities between ASEAN economies to achieve economies of scale, industrial efficiency and productivity. Regional production networks need to be revitalized and the nexus between trade and FDI need to be emphasized.

There was also increasingly recognition by the leaders of ASEAN that if it wanted to remain relevant as a grouping and to be the driving force behind the various ASEAN plus processes that have evolved since the 1990s, it needed to become a more integrated entity. All these culminated into the ambitions of creating an ASEAN Community built on three pillars – the ASEAN Security and Political Community, the ASEAN Economic Community and the ASEAN Sociocultural Community. The detailed plan to action to achieve the ASEAN Community in 2020 was spelt out in the Vientiane Action Programme (VAP) adopted in the 2004 Summit in Laos. Of the plans in building the three pillars of the Community, the most comprehensive and concrete proposals are in the blueprint for achieving AEC adopted by the leaders in 2007.

According to the AEC Blueprint, the “AEC is the realization of the end goal of economic integration as espoused in the Vision 2020 which is based on a convergence of interests of ASEAN member countries to deepen and broaden economic integration through existing and new initiatives with clear timeline ... The AEC will establish ASEAN as a single market and production base, making ASEAN more dynamic and competitive with new mechanisms and measures to strengthen the implementation of its existing economic initiatives ...”. (AEC Blueprint, 2007, p2)

One could say that the AEC is a logical extension of existing economic initiatives, building on AFTA, AIA and AFAS. The McKinsey study called for bolder and deeper integration within these existing initiatives, and the need to introduce new ones. It particularly focused on the need to create strong institutional mechanisms to see to the implementation of all these initiatives. Specifically, the McKinsey study proposed that given the difficulties of agreeing on cross sectoral broad and deep liberalization, ASEAN should priorities a number of sectors to undertake bold liberalization, and in each of these priority sectors, the focus should be on elimination of non-tariff barriers by increasing efficiency of the customs and harmonizing or mutual recognition of standards and regulation; enhance tariff reforms by closer alignment of each member's external tariffs; create a level playing field for capital by eliminating restrictions on cross-border investments within ASEAN and introducing an ASEAN-wide competition

policy; and improve regional collaboration in various other areas (Soesastro, 2005; McKinsey Competitiveness Study Report, 2003).

ASEAN leaders took on board several of these recommendations. Hence in the Action Plan to achieve ASEAN Economic Community, 11 priority sectors for integration were identified (Agro-based products; Electronics; Rubber-based products; Wood-based products; ICT / e-ASEAN; Tourism; Automotive; Fisheries; Textiles & Apparels; Air travel; and Healthcare). The AEC also called for a free and open investment regime and spelt out measures to intensify the implementation of AIA. Liberalization in trade in services and financial cooperation would also be accelerated. To address the problems of implementation associated with AFTA, AIA and AFAS, the AEC reiterated the need to establish an effective system to ensure proper implementation of all economic agreements and expeditious resolution of any disputes through appropriate advisory, consultative and adjudicatory mechanisms (Vientiane Action Programme, 2004).

At the 12<sup>th</sup> ASEAN Summit in January 2006, the ASEAN leaders reaffirmed their commitment to pursuing economic integration by bringing forward the deadline for the establishment of AEC from 2020 to 2015. The AEC Blueprint adopted in November 2007 spelt out in more detail specific action plans and strategic schedule for the achievement of each priority action. "Conceptually, the blueprint brings the constituent parts of the AEC... and also features a master implementation plan" providing for a review of the AIA and the ASEAN Comprehensive Investment Agreement, renewed focus on completely removing NTBs and initiates a regional discussion on competition policy (Lohman and Kim, 2008).

The Blueprint is an encouraging demonstration that recognizes the shortcomings of ASEAN thus far, the problems with implementation. ASEAN has never been short of grand declarations and initiatives. However, its implementation record of these various initiatives has thus far been abysmal. The Blueprint was organized to show that ASEAN takes the commitments towards economic integration seriously. But then again, the Blueprint alone will not lead to economic integration. As Hadi Soesastro pointed out, what ASEAN need is to find an ASEAN way that is rule-based and governed by stronger institutions. He noted "there is no point in pursuing an advanced and demanding notion as an AEC without deeper and testable commitment of the member states and stronger institutions or a detailed treaty from the outset. Without endowed ASEAN institutions, without a treaty, without transfer of powers, and without any budget, one should not expect a credible ASEAN Economic Community to emerge" (Soesastro, 2005). The decision to establish an ASEAN Charter after almost 40 years of ASEAN's existence was seen as a way to address this concern, and transformed ASEAN from a loose, informal organization to a more rules-based organization. The ASEAN Charter is supposed to set the framework and lay the legal foundations for ASEAN to restructure its mechanisms and improve its decision-making process to enhance efficiency and ensure prompt implementation of all ASEAN agreements and decisions.

However, the Charter that was unveiled during the 13<sup>th</sup> Summit in November 2007 drew criticisms from several academics and civil society activists for not going far enough to transform ASEAN. Jusuf Wanandi in his op-ed in Jakarta Post expressed disappointment, calling the ASEAN Charter a "mediocre document" and a let-down to the expectations that have been raised. There were high expectations and hope that after "40 years of existence, ASEAN would now face the future with the vision, courage and unity needed to herald the new challenges of the strategic alignments of the 21<sup>st</sup> Century" (Wanandi, 2007). Critics of the charter took issue with the fact that the latter re-emphasized the principle of non-intervention, and continued with a decision-making process that is based on consensus and unanimity.

Overall, the ASEAN Charter did not provide clear evidence of a new ASEAN emerging. Many of the old institutional norms and mechanisms remained, and ASEAN is nowhere near to moving towards any supranational elements. The ASEAN Charter also did not address the implementation deficit that ASEAN suffered because of this lack of institutional mechanisms to ensure or enforce compliance on decisions taken. It reaffirmed a system of coordinating sovereignty rather than pooling sovereignty.

It is thus not surprising that ASEAN was silent in the face of the global economic crisis. In the most recent summit held in Thailand in February 2009, ASEAN could only manage a statement pledging to keep borders open to trade, services and investment and reaffirmed the commitment to achieving an ASEAN Economic Community by 2015.

Inaction by ASEAN due in part also to the domestic political problems of a few key member states and the lack of a coordinated response from ASEAN put to question the whole façade that ASEAN has tried to maintain for the last 10 years as being in the driver's seat behind the various regional architectures. The gaps between rhetoric and reality in ASEAN, between ambitions and ability have unfortunately been widening in the last decade. As long as each individual ASEAN state does not get its house in order, and as long as the ASEAN's non-intervention principles and lowest common denominator approach prevailed, ASEAN would come out short in undertaking clear and concrete commitments to deepen economic integration and to play a leading role in East Asian region-building.

Disappointment with the Charter and ASEAN's slow pace of progress has led to increasing voices within Indonesia (the only ASEAN member who is in the G20) to think beyond ASEAN and stopped treating ASEAN as the cornerstone of Indonesia's foreign policy (Sukma, 2008). Another leading intellectual, Jusuf Wanandi, has gone further to suggest a new architecture, a G8 of East Asia comprising Australia, China, India, Indonesia, Japan, South Korea, Russia and the US, leaving ASEAN represented by its Secretary-general as an Associate member (Wanandi, 2008).

The stresses brought about by the global economic crisis would probably accentuate some of the domestic problems faced by ASEAN member states. How would all these factors come interact

### **ASEAN plus Three process (China, Japan and South Korea)**

ASEAN's progress has been held back by the domestic political problems of some of its member states. Its ability to drive the ASEAN + 3 process is also increasingly in doubt. For 10 years since the launch of the APT process in 1997, ASEAN has been on the de facto driving seat in part because of the mutual suspicions that Japan and China have towards each other. ASEAN's role was crucial and the ASEAN + 3 process an important platform for the Northeast Asian economies to continue to meet each other even at one point when relations between China and Japan hit a new low in 2004-05.

The APT process has made significant progress particularly in the area of monetary cooperation. Having experienced the Asian financial crisis, the 13 East and Southeast Asian countries agreed in 2000 to establish a currency swap arrangement known as the Chiang Mai Initiative (CMI) to help each other in the eventuality of another currency crisis. Consisting of a series of bilateral swap agreements, an agreement to multilateralise the swap agreement was reached in 2005. A regional surveillance mechanism called the Economic Review and Policy Dialogue (ERPD) was also put in place. It was hoped that the ERPD would "evolve to the point of providing information and analysis that would permit the

identification of vulnerabilities among members and provide a foundation for regionally defined conditionality in the event that the BSAs were called upon (Henning 2009).

In the midst of the current economic crisis, senior officials of the ASEAN + 3 countries and their central banks have met three times between February 2009 to May 2009 and finally agreed to the establishment of a fund worth US\$120 billion. Members of the CMI can tap on this regional pool of foreign exchange reserves "to better fend off a financial crisis" (Rathus, 2009). China and Japan each contributed 32% to the fund, South Korea, 16% and the rest of the 20% from the ASEAN economies.

However, differences remained with regards to issues over economic surveillance and where to establish the CMI Secretariat.

What has been striking in the latest development in the APT process with regards to the CMI is the fact that China, Japan and Korea have been much more proactive in expediting the process of multilateralisation of the CMI. These three countries organized their first self-standing trilateral summit in Fukuoka on 13 December when the ASEAN summit and its attendant APT Summit and East Asia Summit has to be postponed because of the political crisis in Thailand, the Chair of ASEAN for 2008-2009. The lack of coherence in ASEAN and the fact that ASEAN has let domestic issues of one member state held the regional processes hostage came at the most awkward time when intense regional efforts are required to confront the challenges posed by the global economic crisis. It also called into question ASEAN's continued validity for occupying the driver's seat of the various regional processes.

### **ASEAN and the West**

Efforts in the past few years to bring up EU-ASEAN relations have borne some results. EU has since 2003 adopted a much more pragmatic approach in its relations with ASEAN after it revealed its new strategy paper toward the Southeast Asian region. Entitled "A New Partnership with Southeast Asia", this paper called for a multi-track approach to circumvent the thorny issue of Myanmar. Relations with some countries within ASEAN can move faster through bilateral cooperation agreements. The agreements can also be tailored to meet the different needs of the ASEAN countries, with focus on development cooperation to the less prosperous countries, and on trade, investments, research cooperation, political dialogue with the more developed countries.

In the document the European Commission noted that the desire to revitalize EU's relations with ASEAN is "built on the assumption that the countries of Europe and Southeast Asia share many common features and values... (including) a deep respect for cultural, religious and linguistic diversity, and a commitment to regional integration. There is also the increasing realization that many problems such as terrorism, environmental degradation, diseases, organized crimes are truly global in their nature, and can only be addressed effectively through international cooperation."

There are strong economic reasons for deepening ASEAN-EU engagement. In 2007, EU is ASEAN's 2nd largest trading partner while ASEAN is the EU's 5th largest trading partner. EU is also the biggest source of FDI in ASEAN. ASEAN's promise to build an AEC by 2015 and talk of transforming itself into a more rule-based organization on its 40th anniversary offered EU a good reason for stepping up engagement with ASEAN. Hence, in 2007, negotiations were launched for an EU-ASEAN FTA.

However, ASEAN now increasingly risked being sidelined. The lack of progress in achieving greater economic integration dilutes ASEAN's attractiveness as a potential market of 550 million consumers. As Razeen Sally put it, "there will be no true AEC – an integrated market for goods, services, investment and skilled labour – by 2015. Beyond supply-chain integration in a few sectors (mainly in the ICT), ASEAN has no single market" (Sally, 2009). EU's FTA negotiations with ASEAN has also been stuck. Efforts to bring up EU-ASEAN relations has borne some results but the crisis if prolonged is likely to take EU's attention away, and the temptation toward protectionism cannot be ruled out.

ASEAN has often "accused" the US of benign neglect of the region. Indeed there is widespread perception that America's commitment to the region is declining. The Bush administration's narrow focus on terrorism as the key agenda in US relations with Southeast Asia has also irked several of the ASEAN states. What ASEAN wanted was a comprehensive dialogue with the US, and for US not only to deal bilaterally with the various ASEAN countries but to also treat Southeast Asia as a community and take ASEAN seriously.

According to the Asian Foundation report, the US-ASEAN economic relationship is substantial, growing and mutually beneficial. The cumulative stock of American investments in Southeast Asia is about US\$100 billion which is higher than that in China or India. Despite this, and even with the change of the US government, there is the perception that a negative attitude towards ASEAN persists as a number of US officials regard ASEAN as a talk shop and an ineffectual regional organization. US continues to prefer dealing bilaterally with each ASEAN member state (Koh, 2008).

In the past few years, ASEAN's partnership with US is often contrasted with that of China. In order to raise US' interest in ASEAN, China's charm offensive and gains in the region is often highlighted to get the US attention on the strategic importance of the region to the US. In the face of the current global crisis, this "ploy" may no longer work as US and China need to work hand in hand to rebalance the global economy. ASEAN's silence and lack of response to the economic crisis may well confirm to the Americans the weakness of ASEAN.

### **Conclusion**

The real impact of the global economic crisis has not been fully played out within ASEAN and the extent of its "damage" to ASEAN is still not fully appreciated. Several key ASEAN players are caught in its own domestic political troubles and not sufficient attention has been paid to articulate a coordinated response and a vision of the way forward in coping with the global crisis. No one expects ASEAN to lead the economic recovery, but the relative inaction may mean that ASEAN would lose its driver's seat in East Asia. China will probably become increasing assertive in the region. The Northeast Asian partners of ASEAN were instrumental in multilateralisation of the CMI and launching the US\$120 billion fund as an insurance against further shocks.

The preliminary prognosis for ASEAN is that current global economic crisis will alter significantly the region's dynamics resulting in less room for ASEAN's manoeuvrability. Strategic dialogue with its Northeast Asian neighbours, particularly China will increase in importance while dialogue with its western partners will decline.

every day over security

supply side - demand side

Trade Finance: highly impact on the stability of the region

# ASEAN – The region’s financial sector amid the perfect storm

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- Impact on ASEAN from the global financial turmoil was severe, but manageable
- Yet further challenges lie ahead – higher NPLs, abrupt changes in capital flows, and a changing regulatory landscape
- Synchronisation in ASEAN financial markets reflects investor perception of interdependence within the region
- This calls for more financial-sector integration within ASEAN to pool resources and spur competitiveness

## A rough ride, but the ship is still intact

A decade after the Asian financial crisis, the reforms and progress achieved in ASEAN's economies<sup>1</sup> and financial sectors have been severely tested by the global economic and financial turmoil originating from the developed world. The collapse in investor risk appetite and economic activity globally threatened to wreak financial havoc on ASEAN once again. More than six months after the collapse of Lehman Brothers, the key turning point in the current global crisis, ASEAN financial and banking systems remain structurally solid, according to available data. Yet while the region's financial institutions have survived the first wave of the global financial storm, considerable challenges lie ahead in the months, quarters, and possibly years ahead. The aftermath of the storm is likely to put the region's financial system to new tests, both from cyclical and a structural perspective.

In this report, we share our observations of how ASEAN's financial and banking sectors have coped with the global financial and economic turmoil, and provide our thoughts on what can be expected in the medium term. In the first part, we examine the impact of the global financial and economic crisis on ASEAN's financial and banking sectors between September 2008 and May 2009 via a number of channels, including foreign-exchange movements and trends, equities, fixed income, and credit. We look at the effects of risk aversion and the USD liquidity squeeze on the region's banking sectors and lending behaviour.

In the second part, we discuss the outlook for ASEAN's financial and banking sectors as the crisis continues to unfold. There are some early signs of economic stabilisation in developed economies, and Asian exports appear to have bottomed. Global investor risk appetite also seems to have begun a steady recovery. The return of international capital should provide some relief to the region – but too much of a good thing can also create challenges in the future, such as overvaluation of financial assets. Meanwhile, the negative effects of the economic down-cycle on ASEAN's banking industry and financial markets, such as a rise in non-performing assets, may persist for some time. And the global regulatory landscape is also likely to change, which will impact the region's banking sectors both directly and indirectly.

<sup>1</sup> Association of South East Asian Nations (ASEAN) comprised of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. Due to data availability, most of the analysis in this paper will focus on Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

In summary, while ASEAN's financial markets and banks have suffered considerable negative impact from the global financial crisis, the damage has been manageable. This implies that the reforms undertaken by the region's governments, central banks, and regulators since the Asian financial crisis have put these economies and their financial industries on sounder footing. That said, this momentum will need to continue, as a fresh round of global financial regulatory reform is already underway.

### **How rough was the ride?**

The global financial turmoil led to considerable volatility in ASEAN's financial and banking sectors. We examine the extent of this volatility by drawing data from a number of markets, including foreign exchange, equities, interest rates, fixed income, and credit. Although the global financial and economic turbulence is likely to persist for some time and will continue to affect the region in bouts, we use data available through the end of May 2009, since it captures the initial shocks following the collapse of Lehman Brothers – which is generally seen as the 'game-changing' event that led to the USD liquidity crunch and global investor risk aversion.

The region's markets have been affected by common themes, which are in turn linked to troubles in the developed economies. Several factors reduced foreign investors' appetite for ASEAN financial assets:

1. Given uncertainty about financial-system stability and the economic outlook, investors in the developed world switched into 'safe-haven' financial assets. This led to capital outflows from emerging markets, including ASEAN.
2. For leveraged investors, the need for cash to meet margin calls as asset values declined exacerbated these capital outflows.
3. Concerns about ASEAN's economic outlook as a result of falling demand for the region's exports from the developed world prompted investors to exit their positions. There were also worries that the global financial crisis could undermine ASEAN's structural stability via the financial and banking sectors.

### **Equities – hefty losses, swift rebound**

Even before the collapse of Lehman Brothers, ASEAN equity markets were already consolidating throughout much of 2008. The MSCI Asia ex-Japan index reached its peak in early November 2007, and the region's individual indices also peaked around that time. As Table 1 shows, from these peaks until the Lehman Brothers collapse on 15 September 2008, individual stock indices had already lost between 28.5% (Thailand) and 59.3% (Vietnam). Following the Lehman collapse, the decline continued until the end of Q1-2009. Between 15 September 2008 and the trough in Q1-2009, regional stock markets declined between 20.6% (Malaysia) and 50.5% (Vietnam).

From peak to trough (January 2007 to April 2009), regional equity indices fell between 45.3% (Malaysia) and 79.9% (Vietnam). In Vietnam's case, one can argue that the particularly sharp drop was exacerbated by a stock-market bubble and the authorities' efforts to deflate it. In other markets, the magnitude of equity-market declines during this period was comparable to those during the Asian financial crisis for Singapore and Indonesia, but much milder for Thailand, Malaysia, and the Philippines. Since mid-March, renewed market confidence has been driving regional equity performance. By late May, Malaysia and Indonesia had seen their benchmark indices return to pre-Lehman levels.

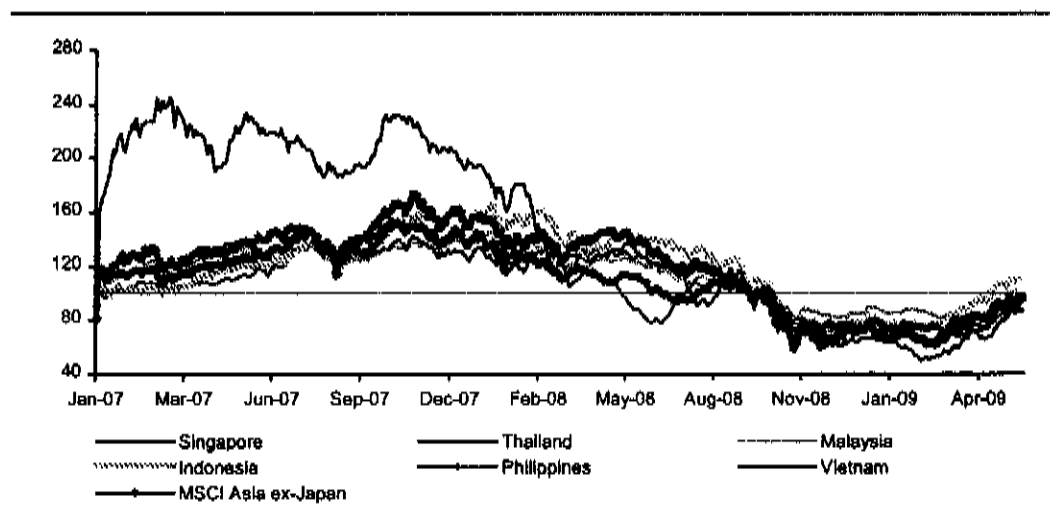


**Table 1: Regional equity benchmark performance (in local-currency terms)**

	Singapore	Thailand	Malaysia	Indonesia	Philippines	Vietnam	MSCI Asia ex-Japan
Cyclical peak to Lehman collapse	-32.9%	-28.5%	-31.1%	-36.3%	-31.7%	-59.3%	-41.3%
Lehman collapse to cyclical trough	-43.3%	-41.3%	-20.6%	-38.4%	-35.6%	-50.5%	-42.7%
Peak to trough	-62.0%	-58.0%	-45.3%	-60.7%	-56.0%	-79.9%	-66.4%
Asian financial crisis	-62.0%	-85.3%	-79.3%	-65.3%	-68.6%	N/A	-66.6%

Sources: Bloomberg, SCB Global Research

**Chart 1: Regional benchmark equity Index performance (15 September 2008 = 100)**



Sources: Bloomberg, SCB Global Research

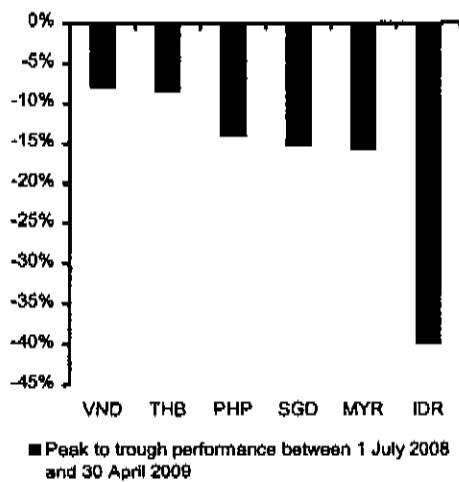
**Foreign exchange – strong fundamentals limit volatility**

ASEAN currencies have been less volatile than regional equity markets during the current crisis. In the first half of 2008, most ASEAN currencies were under pressure to appreciate due to trade surpluses and expectations that central banks would tolerate stronger exchange rates and tighten monetary policy to combat rising inflation. The prevailing market expectation at the time was for this ASEAN currency strength to persist into H2-2008. However, as inflationary pressures started to subside with the peaking of food and energy prices in August 2008, and as ASEAN exports showed early signs of weakness, the region's currencies began to lose support against the USD. Between July 2008 and April 2009 (Chart 2), the THB and VND lost just over 8% against the USD. The MYR, SGD, and PHP lost between 14% and 16%. The IDR was hit the hardest – investor concerns regarding the country's ability to meet its external liabilities caused the currency to drop almost 40% against the greenback. In October and November 2008, the IDR weakened from 9,500 to 12,100 against the USD.

Even taking into account the sizeable IDR drop, ASEAN currencies' reaction to the current economic turmoil has been limited compared with the declines seen during the Asian financial crisis. Sizeable foreign reserve positions built up after the Asian financial crisis give central banks a means to stabilise their currencies and

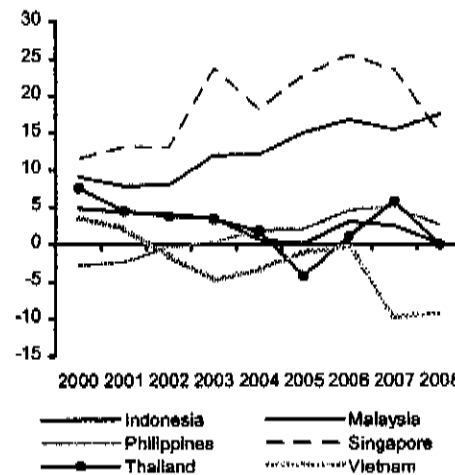
bolster investor confidence in their external debt positions. The healthy current account positions of most ASEAN economies (Chart 3) have also helped. Support from other governments (in the form of bilateral swap line agreements) and from international organisations such as the Asian Development Bank and the World Bank has further reinforced confidence. At the end of Q1-2009 and in early Q2-2009, ASEAN currencies found a footing and subsequently stabilised as global investor risk appetite appeared to find a floor.

**Chart 2: Regional currencies' performance vs. USD (July 2008 to April 2009)**



Sources: Bloomberg, SCB Global Research

**Chart 3: Current account balance as % of GDP**

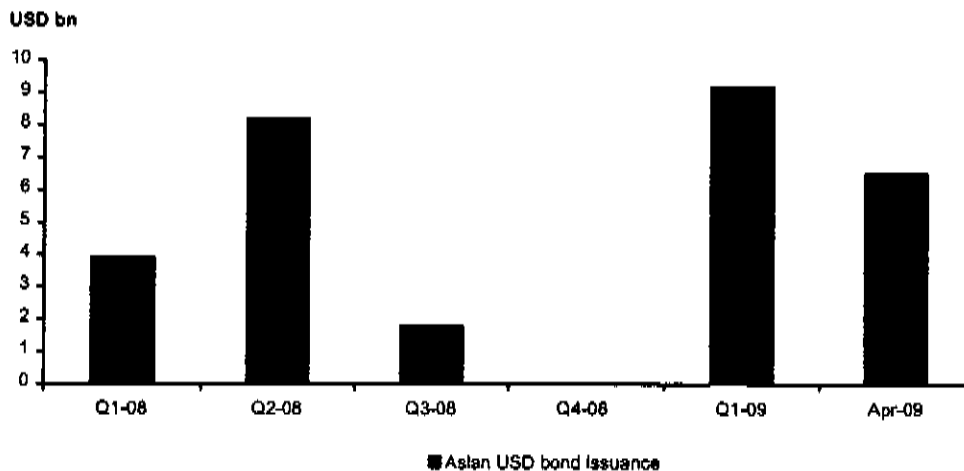


Sources: IMF, SCB Global Research

### Fixed income market – policy rates set the trend

In analysing the performance of sovereign local-currency bonds, the six ASEAN countries with better-established bond markets can be divided into two broad groups. The first group – Singapore, Malaysia, Vietnam, and Thailand – saw government bond yield curves shift lower in September and October, as inflation had peaked and their central banks were expected to ease monetary policy to support growth. The second group – Indonesia and the Philippines – initially saw their government bond yields rise in late September and October 2008 on investor risk aversion, in particular concerns about the countries' ability to meet their external liabilities amid weakening exchange rates. Yet this fear faded, and government bond yields in these two markets fell in line with the regional trend.

**Chart 4: USD bond issuance In Asia**



Sources: SCB Global Research

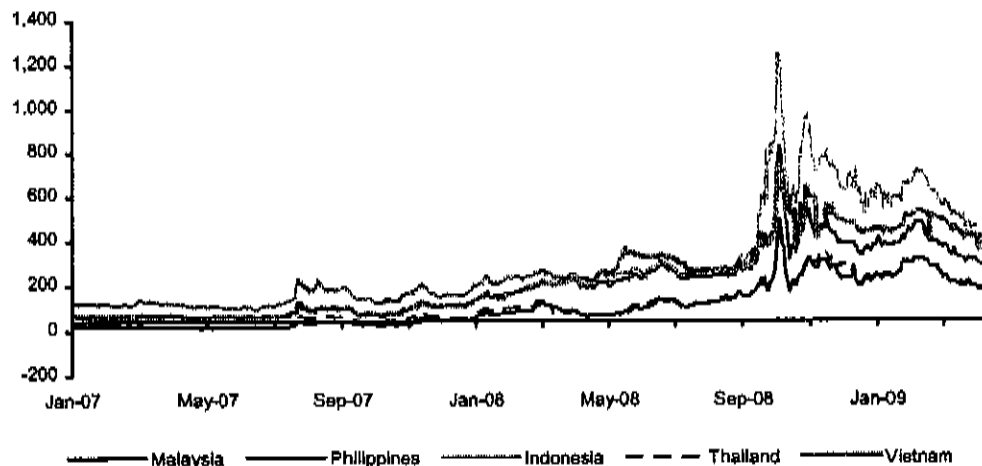
As the region's governments step up fiscal stimulus to support their economies, there have been concerns that government bond supply may surge, leading to possible downgrades in sovereign credit ratings. This caused some pickup in government bond yields, especially at the long end of the curve. In terms of issuance, risk aversion and the liquidity crunch negatively impacted the sovereign and corporate markets in Q4-2008, in both USD and local currency. The good news is that successful USD sovereign issues from the Philippines and Indonesia in Q1-2009 indicate a return of investor appetite. They also reflect a good understanding of market demand on the part of the issuers, as the tenors and issuance size were managed accordingly to ensure a warm reception.

#### **Sovereign credit default swaps (CDS) – dictated by risk appetite**

The collapse of Lehman Brothers triggered a wave of risk aversion, as reflected in the sharp surge in sovereign credit default swap (CDS) spreads, a gauge of market expectations of sovereign default risk. Following a spike in mid-September 2008, ASEAN CDS spreads have been highly volatile but have remained on a downtrend (Chart 5). By the end of May 2009, most, if not all, sovereign CDS spreads had returned to pre-Lehman levels, though they are still elevated relative to their levels between 2007 and H1-2008.

We believe the surge in CDS spreads is more a reflection of weak investor risk appetite than of a genuine deterioration in ASEAN sovereign credit quality. While the depreciation in some Asian currencies did put additional stress on those countries' ability to repay their foreign-currency debt, most ASEAN countries have sufficient foreign-exchange reserves or bilateral swap lines they can draw upon for foreign currency if necessary. Nonetheless, the widening of sovereign CDS spreads does reflect the previous difficulties ASEAN members faced in raising foreign-currency debt, and the narrowing of spreads indicates an easing of such tensions.

**Chart 5: Movements In sovereign CDS spreads (USD 5Y senior)**

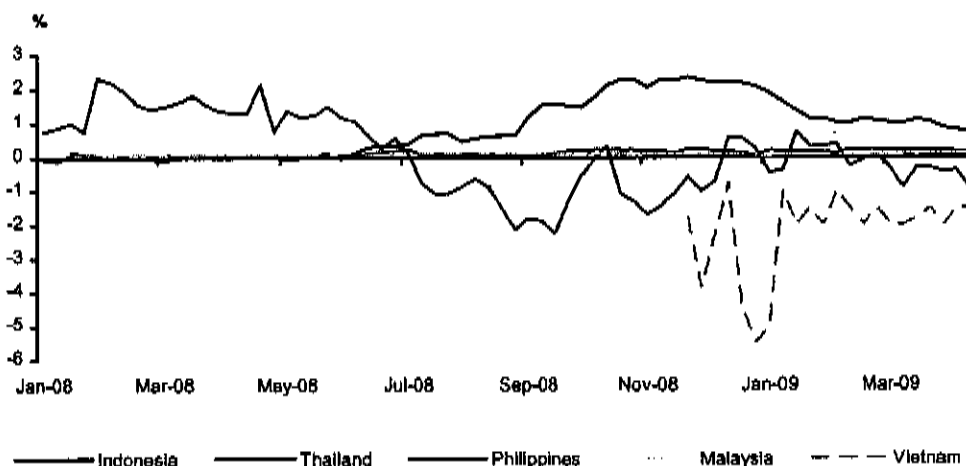


Sources: Bloomberg, SCB Global Research

**Interbank liquidity – Tight in USD, ample in local currencies**

A chronic shortage of USD liquidity has been a prominent feature of the current financial crisis. A lack of trust amongst financial institutions globally has led to considerable hoarding of USD liquidity, despite relief measures implemented by central banks in developed economies (i.e., enlarging their balance sheets). Quantifying the shortage of USD liquidity within ASEAN is challenging, as public information is not readily available.

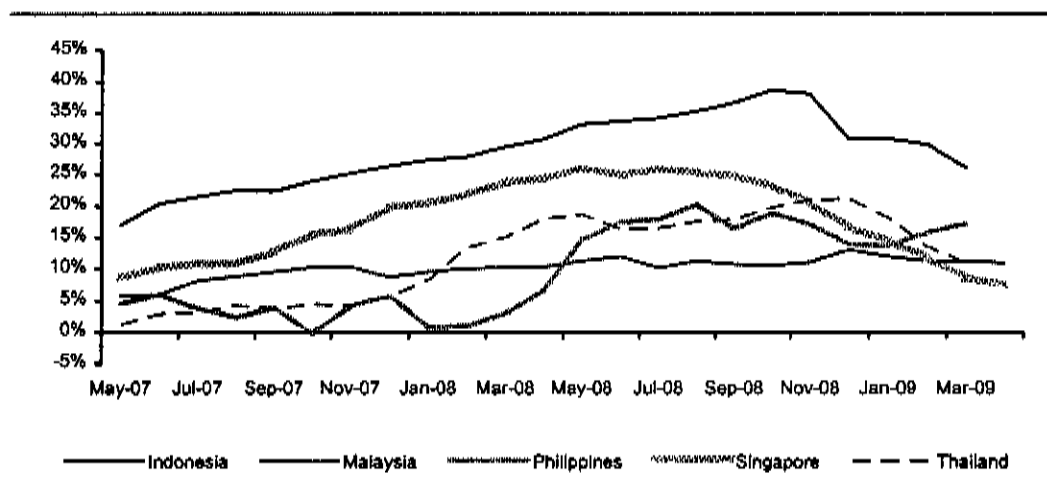
**Chart 6: Spread between central bank policy rates and 1M interbank market rates**



Sources: Bloomberg, SCB Global Research

We use the spread between central bank policy rates and local-currency interbank market rates as a proxy for the local liquidity environment (Chart 6).<sup>2</sup> The stable spreads for Thailand and Malaysia reflect that their central banks managed to maintain a stable local-currency liquidity environment. We believe the same is true for Singapore, despite the fact that it executes its monetary policy via the exchange rate rather than using a policy rate. In the Philippines and Vietnam, the central banks are also able to provide ample local currency to ensure liquidity. This is reflected in the fact that these countries' interbank market rates have been below their official policy rates for much of the post-Lehman period. Indonesia is the only country which saw the spread between its interbank market rate and its policy rate widen in Q4-2009, but this has eased since the turn of the year.

Chart 7: Total lending growth, y/y



Sources: CEIC, SCB Global Research

#### Bank lending – cut back in demand and supply

A clear deceleration in bank lending growth was seen in four ASEAN economies – Singapore, Indonesia, Thailand, and the Philippines (Chart 7) – until March/April 2009. These countries' total outstanding bank loans have actually contracted since the beginning of 2009. Malaysia is an exception – its year-on-year lending growth has been consistent into 2009, and its total loans outstanding have continued to expand. This can be explained by the lower degree of volatility in Malaysian lending over the past two years. Across most ASEAN countries, trade finance is another area where the business sector has found it difficult to obtain funding. In addition to a decline in the absolute quantity of lending, banks have also shifted to a preference for letters of credit over open accounts due to concerns about counterparty risk.

A slowdown in lending is natural in a cyclical slowdown and can be explained by both demand- and supply-side factors:

1. Financial institutions have faced a considerable liquidity crunch (especially in USD), during this crisis, and the need to preserve liquidity and protect capital has forced them to scale back lending

<sup>2</sup> One caveat is that the interbank lending markets in many ASEAN economies are not as mature as in developed economies, and hence interbank market rates may not accurately reflect the level of local-currency liquidity. Moreover, bigger banks, or those with government support, are likely to have better access to interbank liquidity in these markets due to concerns over counterparty risk.

and manage their balance sheets very conservatively. This applies to lending to corporates, individuals, and other financial institutions.

2. Given the prevailing economic conditions and the possible deterioration in credit quality, financial institutions have taken a more cautious lending stance enforced tighter risk management.
3. Foreseeing a decline in orders and a drop in revenue, corporate borrowers have postponed or cancelled investment plans to preserve cash flow.
4. Where possible, debts are being repaid to reduce interest charges. Leverage for financial investment has also been reduced as financial assets in the region fall in value.
5. The decline in commodity prices also implies that the value of trade financing required is reduced.

Points 1 and 2 represent supply-side constraints to lending, while points 3-5 are more demand-side factors leading to weaker lending growth, or outright contraction. To tackle the supply-side issues, authorities in the region have introduced initiatives aimed at sharing such credit risk, and hence encouraging banks to extend lending. These initiatives often target lending to SMEs, since this group of borrowers is often the most vulnerable in an economic downturn, with lenders reducing their credit lines substantially.

Foreign bank lending has also fallen substantially in the ASEAN region as US, UK, and European banks rein in lending to preserve capital. In H2-2008, according to BIS statistics, foreign banks reduced lending by a total of USD 86.3bn in ASEAN-6, accounting for 11.9% of total lending by foreign banks in the region. Singapore and Malaysia suffered the biggest declines in lending by foreign banks during the period, at USD 49.2bn and USD 22.2bn, respectively. This trend could continue as international banks, under pressure to shrink their balance sheets further, continue to consolidate their international activities.

### **The damage thus far is manageable**

Based on the financial-market and banking-sector data outlined above, we believe that the global financial and economic turmoil has had a significant, but manageable, impact on ASEAN's financial and banking sectors. Direct losses due to exposure to 'sub-prime' or other toxic financial assets appear limited. The damage to equity markets in the wake of the Lehman Brothers collapse was considerable, and in some cases comparable to the Asian financial crisis. The good news is that the return of investor risk appetite is facilitating an equally strong rebound in Q2-2009. With the exception of the IDR, the impact on exchange rates was small. Any negative reaction in local government bond markets was brief at the peak of the crisis, as aggressive rate cuts by the region's central banks helped to push government bond yields lower and overcome investor risk aversion. Commercial banks' more conservative lending approach has also prompted them to put more of their assets into government paper, supporting bond prices.

The slowdown in economic activity is likely to have a more prolonged impact than the financial turbulence on commercial banks. The USD liquidity crunch, higher default risk, and weaker borrowing appetite have all weakened lending growth, and in some cases caused an outright contraction in lending. This will have a direct impact on both global trade and capital expenditure plans.

Hence, the negative impact of the first wave of global financial-market turmoil on ASEAN was manageable, although some sectors, such as SMEs, have faced more difficulties obtaining credit. The volatility in financial asset values and exchange rates has not caused any structural damage to ASEAN's financial infrastructure. The second wave of tests is likely to start in H2-2009 and continue in the years ahead, even as global and regional economies recover.

## What next?

While the overall impact of the global crisis on ASEAN's financial and banking sectors has been manageable thus far, the region faces some major challenges in the foreseeable future. From a cyclical perspective, ASEAN banks are likely to face a decline in credit quality, which is likely to lead to lower returns as a result of higher write-offs and provisioning. However, we have already caught an early glimpse of international capital flows back into Asia as risk appetite returns, lifting the value of Asian assets. If left unmanaged, this could develop into an asset bubble, which could jeopardise the future stability of the ASEAN financial system.

Structurally, we can expect a major overhaul of the global financial regulatory landscape in the coming years, starting with the developed economies. Financial and banking regulators in the ASEAN region will need to decide whether to cooperate and join the developed world in such reforms or go in their own direction. Cooperation will ensure that the region remains connected and relevant to the global financial and banking system.

### Deterioration in asset quality

One challenge facing ASEAN banks is a potential decline in credit quality. Weak economic growth and the current liquidity shortage are likely to increase non-performing loans (NPLs). Across ASEAN, there has been a healthy decline in NPLs as a percentage of total loans in recent years (Table 2). Countries such as Malaysia, the Philippines, and Thailand saw their NPL ratios drop from the double digits in 2004-05 to the mid-single digits in 2008. Of course, this was partly the result of rapid lending growth in previous years, which expanded the denominator of the NPL ratio.

Table 2: Non-performing loan ratios (%)

	2003	2004	2005	2006	2007	2008	Latest data
Indonesia	6.8	4.5	7.6	6.1	4.1	3.5	Nov-08
Malaysia	13.9	11.7	9.6	8.5	6.5	5.1	Sep-08
Philippines	16.1	14.4	10.3	7.5	5.8	5.2	Jun-08
Singapore	6.7	5.0	3.8	2.8	1.5	1.4	Sep-08
Thailand	13.5	11.9	9.1	8.4	7.9	6.5	Dec-08

Sources: IMF, Global Financial Stability Report, April 2009

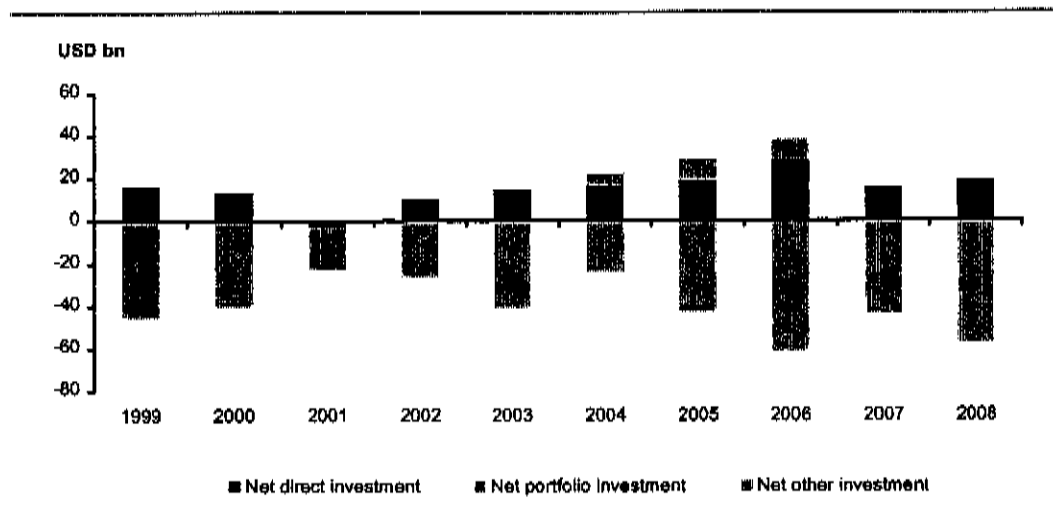
Going forward, NPL ratios are expected to rise given the slowdown in growth and the difficult business environment. The IMF, in its April 2009 Regional Economic Outlook, estimated that new writedowns for ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand) would be 2.5% of total loans, or 6% including provisions made in 2008. The silver lining is that the ASEAN corporate sector has enjoyed several years of strong growth, which allowed it to reduce leverage and improve profitability and liquidity.

### Capital flows set to return to Asia

Looking at private capital flows in and out of the region over the past 10 years, one notices that ASEAN has been a consistent net recipient of direct investment flows, averaging USD 15bn per year. 2001 was an exception due to the previous US recession. In terms of portfolio investment, ASEAN saw net annual inflows of between USD 5bn and USD 10bn from 2004-06, followed a marginal outflow in 2007 and a massive outflow of USD 57bn in 2008 as risk aversion surged and foreign investors needed to meet redemption demand from investors back home. In the 'other' investment category, which includes trade credit and bank

loans, ASEAN has seen outflows in recent years, mainly from Singapore and Malaysia due to their trade activities in the financial sector.

**Chart 8: ASEAN-5<sup>3</sup> private capital flows**



Sources: CEIC, SCB Global Research

Looking ahead, in 2009 and possibly 2010, direct investment inflows will likely remain subdued due to weak demand from the developed world. China could become a new source of direct investment in the years to come, but is unlikely to be a potent force in the near term. In terms of portfolio investment, there have been some early signs in Q2-2009 that foreign investors are re-entering selected ASEAN markets as risk appetite improves and bargain hunters regain confidence in the region's economic and currency outlook.

Provided that there are further signs of stabilisation in the region's economies, portfolio inflows could return to the region in H2-2009 and 2010, though the size and distribution of such flows among regional markets are difficult to predict. There are two areas of concern for authorities. Such capital inflows, alongside current account surpluses in most ASEAN economies, could put upward pressure on Asian currencies, which could prompt intervention by local authorities to limit volatility and curb excessive strength. Furthermore, as we anticipate the recovery in ASEAN economies in 2010 to be modest and subdued, such capital inflows could lift asset valuations above fundamentals. Prevention of asset bubbles should be a key objective of ASEAN central banks as they devise exit strategies from loose monetary policy in the medium term.

### The changing financial regulatory landscape

The financial crisis in the developed world has brought strong demand for regulatory reform of the financial and banking sector. Although the crisis originated in the US and Europe, such reforms will have global implications. Several areas of reform have been suggested by regulators in the US, the UK, and Europe.<sup>4</sup>

1. **Ensuring adequate capital, both in terms of quantity and quality.** Banks are expected to build up a strong capital base. It has also been suggested that the level of capital should vary over an economic cycle, being counter-cyclical rather than pro-cyclical. This implies that banks are expected to set aside more capital and prevent excessive lending or balance-sheet expansion

<sup>3</sup> ASEAN-5: Indonesia, Malaysia, Philippines, Singapore, Thailand

<sup>4</sup> For more details on the latest thinking, we recommend the Turner Review, published by the Financial Services Authority in the UK



during times of strong economic growth, and lend more aggressively during economic downturns, to prevent abrupt cutbacks in liquidity.

2. **Further ingraining risk management culture into governance.** There have been calls for banks to adjust their governance structure to increase the independence of risk management functions. Furthermore, the remuneration of bankers should take into account the sustainability of profit and prevent excessive risk-taking behaviour. There are also reviews of whether commercial banks should conduct proprietary trading, which may or may not have direct relevance to their core business.
3. **Extending the reach of regulation across products, financial institutions, and geographies.** There is demand for more oversight of hedge funds and their investment activities in financial markets, including naked short-selling (selling without owning the underlying securities). In the CDS market, it has been suggested that transactions should be centralised and conducted on exchanges rather than being done over the counter. In terms of geography, regulatory bodies are trying extend global financial regulatory agreements to cover offshore financial centres.
4. **Increasing international coordination.** Greater cooperation amongst financial regulators around the world is seen as a must. Exchanging standardised information and data, as well as holding regular discussions on specific issues, should help regulators to better identify potential stress points and learn from the past.

Regulators in the ASEAN region will need to consider the best way to respond to these changes in the regulatory landscape. Given the crucial role of globalisation in ASEAN's economic and financial development in the past decade, it would be natural for the region's policy makers to embrace these changes and be part of the reform process. While there has been strong criticism that inadequate financial supervision and regulation in developed economies led to the current financial crisis, this should not be a reason for ASEAN governments and regulators to ignore global developments. In order to play a more prominent role in the global economy, the region will need to take on board the regulatory changes being made in the developed world and be ready for them.

In our view, a sensible strategy for the ASEAN region is to adopt a regional framework for banking and financial regulation based on the redesigned global regulatory structure, rather than for each member country to have its own set of rules. This could help to foster the development of banks and financial institutions in the region, as synchronised regulation across the region will reduce regulatory costs for both local and foreign banks. Greater consistency and transparency will also help to attract foreign investors and financial institutions to invest or operate in the region. Meanwhile, by avoiding simply carbon-copying the global standard, the ASEAN financial regulatory framework will provide the flexibility needed to facilitate the development of specific segments or products, especially Islamic banking and financing.

## **Implications for ASEAN**

The global financial crisis has led to considerable volatility in ASEAN financial markets, as well as the region's real economies. While stock-market losses were significant and activity in credit and debt markets froze temporarily, the negative impact on foreign exchange, government bonds, and the structural fundamentals of the banking sector has been more manageable. While there are signs of stabilisation in the global financial markets and the rate of economic deterioration has slowed, the repercussions for ASEAN's financial and banking sectors are not yet over. Deteriorating credit quality, abrupt capital flows in and out of the region, and an overhaul of the global financial regulatory landscape are some of the challenges these sectors are likely to face in the coming months and years, in the aftermath of the turmoil.

It is also worth noting that the regional markets have been moving in sync. Further to being a reflection of the global liquidity environment, it can also be interpreted that the co-movements of equities and CDS within the region indicate investor perception that the region is becoming more interlinked and interdependent.

This implies that the need for close cooperation and integration within ASEAN is stronger than ever. The protection offered by foreign-exchange reserves helps to support investor confidence in times of stress. The bilateral swap lines available to the region under the Chiang Mai Initiative serve this purpose. The proposal to expand this to a multilateral reserve pool of USD 120bn, with contributions from ASEAN, China, Japan, and South Korea, will further strengthen the region's resilience. Even though USD 120bn is a relatively modest amount (less than 5% of Asia's total FX reserves) at a time when recapitalising a single financial institution may require tens of billions of dollars, putting the framework in place and agreeing on monitoring and surveillance are key steps forward. Further reserves can be injected into the pool as member countries deem appropriate.

Given the changing global regulatory environment, ASEAN countries may find that prescriptions from the developed world do not perfectly suit local circumstances and conditions. The next-best solution in this case would be to have a set of regional standards that build upon the principles of the new financial regulations, which can be seen as adopting global financial regulation, but with ASEAN characteristics. There should be no debate over the principles of adequate capital, independent risk management, more comprehensive regulatory coverage, and international coordination, though how these principles are applied to the region as a whole may be subject to debate. Such a regulatory framework would coincide with ASEAN's strategic goals for the financial services sector, including the promotion of free investment and capital flows, outlined in the ASEAN Economic Community Blueprint.

The global financial crisis has undoubtedly created considerable turbulence in ASEAN's financial and banking sectors, and its impact could linger in the years ahead. Yet the fact that the region has broadly avoided collateral damage to its financial sector should be seen as a positive sign that years of reform and lessons learnt have improved the region's resilience to financial crises. That said, as the global financial landscape continues to evolve and the balance of economic power shifts from the developed economies to emerging markets, the need for improvement continues, and there are opportunities to be captured. We believe further integration within ASEAN is necessary to give the region critical mass amid the rise of China and India, and to ensure that these two powers are partners rather than threats.

## **A Bumpy Road toward ASEAN Economic Community 2015**

Raymond Atje and Pratiwi Kartika

### I. Introduction

At the ASEAN Summit Meeting in Singapore in November 2007, the ASEAN Leaders adopted the ASEAN Economic Community (AEC) Blueprint. AEC is one of the three pillars of the ASEAN Community to be established by 2020. The other two pillars are ASEAN Political and Security Community, and ASEAN Social and Cultural Community. In a declaration which marked the launching of the AEC Blueprint, the ASEAN Leaders stated that the AEC 'will transform ASEAN into a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the global economy.' AEC is the ultimate goal of ASEAN's deliberate push toward a greater regional economic integration which was started in 1992 when the ASEAN Free Trade Area (AFTA) was launched.<sup>1</sup> There were two other initiatives introduced during the subsequent period, namely, the ASEAN Framework Agreement on Services (AFAS) in 1995, and the ASEAN Investment Area (AIA) in 1998. The three initiatives form the basis for the AEC.

Initially, the full implementation of AEC was scheduled for 2020 but was subsequently moved forward to 2015. The same factors that led to the institutionalization of AEC seem to be behind the decision to expedite its implementation. Firstly, the rapid rise of China not only as a regional but increasingly as a global manufacturing powerhouse. This development raises a concern among ASEAN leaders that, unless the member states agree to deepen and widen the region's economic integration, it will be difficult for ASEAN to compete with China in the global market. It is one reason as why AEC Blueprint envisions the region as a single production base. Secondly, more recently, India also began to emerge as a regional economic power. Unlike China, India's main strength is in the services sector, most notably in IT sector. In particular, the country's IT sector received a boost from the emergence of global outsourcing mode of production. Finally, there is a concern that ASEAN economies or, more precisely, some member economies seem to get stuck in the so called middle-income trap. On the one hand, their technology is not sophisticated enough to compete with rich countries. On the other hand, their costs of production are not cheap enough to compete with low income countries such as China.<sup>2</sup>

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<sup>1</sup> There had been a number of other regional economic cooperation initiatives introduced prior to 1992 such as, the ASEAN Industrial Project (AIP), the ASEAN Preferential Trading Arrangement (PTA), ASEAN Industrial Joint Venture (AIJV), and ASEAN Industrial Cooperation (AICO). All these initiatives ended up in failure, however.

<sup>2</sup> According to Eeckhout and Jovanovic (2007), the middle income trap phenomenon is a consequence of international mobility of labor service made possible by global outsourcing. In their model, rich countries specialize in design and managerial work, while poor countries specialize in wage work.

ASEAN as whole has a population of about 575 million, and a combined nominal GDP of US\$1282 billion (2007 figures). The idea is, by integrating the region into a single economic entity, it can provide firms operating in the region with economies of scale that will enable them to compete in the global arena. As noted by Pelkmans (2009), the crux of AFTA, and for that matter AEC, is about competitiveness of ASEAN countries in world trade. The idea of a single market and production base is an ambitious one considering that ASEAN is one of the most diverse regions in terms of economic development, culture, and social and political systems. Some of these countries may be regarded as still in the post colonial stage; they have strong senses of national identity and jealously guard their sovereignties. It may be argued that, because of such a background, ASEAN has opted for a consensus decision making mechanism, a mechanism that is preserved in the recently adopted ASEAN Charter. Needless to say, such a decision making process tends to be very slow and the countries involved tend to adhere to the lowest common denominator in every decision to be made.

This paper attempts to assess possible implications of the ongoing global financial crisis on the implementation of AEC, i.e., whether the crisis will cause some serious delays in the execution of the roadmap and, hence, in the realization of the AEC by 2015. Almost immediately after the launching of AEC Blueprint, a couple of major external economic shocks began to hit the region one after another and have caused considerable problems to ASEAN member economies. During the first half of 2008, a sharp increase in prices of oil and some other commodities has generated inflationary pressure especially in Vietnam where, at one point, inflation rate reached 25 percent and banished more people to poverty. This was followed by the current global financial crisis which started in earnest in the second half of the year and already sent Singapore into recession while other member countries saw their economic growth significantly reduced. There is a concern that the current crisis may persuade some ASEAN members to postpone the implementation of the blueprint. Friedman (2005) argues that during a time of economic crisis, people tend to look inward and less tolerant toward competition from others. It is conceivable therefore that, because of the crisis, some governments in the region decide to impose protectionist measures so as to placate pressures from certain domestic interest groups.

Unfortunately, under the current circumstances, it is quite difficult for an outsider to monitor and verify such implementation. On one hand, the ASEAN Secretariat which is given the task to monitor and review the implementation of the blueprint may not be able publish the results of its monitoring activities on a timely basis. It simply lacks the capacity to do the job properly. Moreover, rather than collecting all the necessary data and information itself, it relies primarily on relevant government agencies to provide them. On the other hand, ASEAN Secretariat will disseminate the monitoring results only after being reviewed by senior officials from member states. This limits the effectiveness of the peer pressure mechanism adopted by ASEAN for this purpose. Openness and transparency are essential for a peer pressure mechanism to work. Peer pressure will work effectively if and only if all the reports concerning the implementation of the Blueprint are made public on a timely manner.

## II. A Brief Review of AEC

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The ASEAN Economic Community Blueprint provides, in the main, important features of the economic community to be established in 2015. Like many other ASEAN documents, the Blueprint only outlines the main characteristics of the AEC, leaving the details to further negotiation among the member governments. The first main objective of the Blueprint is to establish ASEAN single market and production base. The main characteristics of ASEAN single market and production base are: (i) free flow of goods; (ii) free flow of services; (iii) free flow of investment; (iv) freer flow of capital; and (v) free flow of skilled labor. An ASEAN single market, at least in theory, will generate both tangible and intangible benefits to people of the region. On the one hand, free flow of goods and services within the region, as a manifestation of a single market, will generate welfare gain to people of the region. The deeper and wider the degree of market integration the greater the gain will be.

On the other hand, a larger, single, ASEAN 'domestic' market can provide an impetus for industrial agglomeration within the region. There are two channels through which a large market may generate an industrial agglomeration. The first channel is through internal economies scale. Internal economies of scale imply the size of an individual firm matters; larger firms have a costs advantage over smaller ones. In this regards, agglomeration is driven by pecuniary externalities mediated through market prices. A large market allows greater product variety and lower costs (Krugman, 1991).<sup>3</sup> The second channel is through external economies of scale, where the size of the industry matters. A firm trying to expand its production will face increasing costs; however, as the industry as a whole expands, the cost of individual firms are lowered.

In view of the foregoing, a large ASEAN market, implied by ASEAN single market, may, in a way, be viewed as a prerequisite for the creation of a single production base in the region. As it is, the idea of a single market as envisioned by the Blueprint is quite different from that of European Union (EU). Free flow of goods simply implies removals of tariff and non-tariff barriers. However, unlike in the EU, shipments of goods from one member country to another will still have to go through border inspection since ASEAN is not a customs union. It should be noted that the removal of tariff and non-tariff barriers are necessary but not sufficient to ensure that a single market will prevail. ASEAN should, in addition, minimize adverse effects of other border and behind border measures through trade facilitation, customs integration, ASEAN single window, harmonization of standards, etc. Finally, for a single market to prevail ASEAN should bring trade costs which include transportation and telecommunication costs down to levels comparable to those in other regions.<sup>4</sup>

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<sup>3</sup> ASEAN firms will be able to take advantage of a larger ASEAN market only if each member country treats firms of other members as equal, in every respect, to its own firms. In other words, ASEAN members should apply national treatment to each other firms, not just with regard to investment, but in every other aspect that matters to firms' expansion.

<sup>4</sup> Even if all of these have been achieved, the ASEAN market that is emerging may remain fragmented. Moreover, there is no guarantee that a single production base will emerge either. A number empirical studies on US-Canada cross border trades show that borders matter a lot even after the existing trade barriers have been substantially removed. A study by McCallum (1995) for instance show that, other things equal, Canadian firms trade far more with each other than with US companies. Similar findings for the EU have been reported as well

With regard to trade in services, the intention is to liberalize all four modes of supply. Yet, the degree of trade liberalization will depend on how officials from the member countries view the notion that 'there will be *substantially no restriction* to ASEAN services suppliers in providing services and in establishing companies across national borders within the region, subject to domestic regulations' (author's italics). One should expect tough negotiations ahead since member countries are not allowed to back-load their commitments. Another important issue is the primacy given to domestic regulations in this case. It means a member's commitment to liberalize its trade in services may not contradict the country's domestic regulations pertaining such trade. Finally, while the Minus X formula may help some members to precede with their liberalization programs, yet it may also provide other members with a pretext to procrastinate.

Similarly, the notion 'free flow of skilled labors' should not be interpreted literally. The movement of skilled labors within the region may not be as free as one would like to think. It is actually managed movements and in addition, mutual recognition arrangement (MR) and certification will still be needed. Conspicuously missing from the Blueprint is any attempt to deal with the movement of unskilled labors. While, arguably, it is better if this issue is dealt with at the regional level, since it often involves a number of member countries at the same time. ASEAN should, therefore, have a mechanism to regulate the movement of unskilled labors within the region and the regulation should be as liberal as possible. It seems, however, that the member states are unwilling to do so. They, instead, decide to let this issue to be settled bilaterally between countries involved.

The second important objective of the Blueprint is to make ASEAN a competitive economic region. This concept is closely linked to the concept of single market and production base. Here competitive economic region implies that ASEAN-based firms are highly competitive in the global market. In a way, market integration may be viewed as a way to force competitive discipline and efficiency on indigenous companies in ASEAN. But this will happen only if ASEAN domestic markets are highly competitive in the first place.

The third important objective is to eliminate the existing development divide between ASEAN-6, i.e., Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand on the hand, and Cambodia, Laos, Myanmar and Vietnam (CLMV) on the other. And the last one is to fully integrate ASEAN into the global economy. To achieve this objective ASEAN will need substantial amount of resources. Unfortunately, ASEAN does not have any mechanism to pool its resources, at least not yet. At the moment ASEAN relies mainly on external sources to fund such programs as the Greater Mekong Subregion Economic Cooperation Program clearly illustrates. But it will be difficult for ASEAN to continue relying solely on external sources to finance its Initiative for ASEAN Integration (IAI) or for that matter its SME development program. Arguably, it is better for ASEAN if it somehow could mobilize resources of its own to finance, at least partially, its various development projects. In addition to giving ASEAN a sense of ownership of those projects, it will also boost ASEAN's sense of solidarity and unity.

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(e.g., Head and Mayer, 2000). In addition, a single production base is more likely to emerge if ASEAN intraregional trade costs fall below a certain threshold level.

Finally, it should also be added that development gaps also exist within some of the ASEAN-6 countries, most notably Indonesia and the Philippines. Arguably, the gaps are comparable in both the degree and magnitude (the number of people involved) to that between ASEAN-6 and CLMV. They too, therefore, require serious attention if ASEAN is to achieve a more equitable community.

### III. ASEAN Economies amid global financial crisis

#### III.1 Performance of ASEAN Economies

Despite differences in their severity, all countries in Southeast Asia are adversely affected by the global crisis. The most affected economies are Singapore, followed by Thailand and Malaysia, while Indonesia, Vietnam, and the Philippines are less affected. The effects are captured in the region's worsening performance of GDP, investment, trade, and exchange rates since the second semester of 2008. The decline has been more pronounced in Singapore, Malaysia, and Thailand, than others in the region. It seems that the depth of the decline hinges on the sources of their economic growths, with the more-affected economies having higher export contribution to growth relative to less-affected ones. Singapore has the highest ratio of export to GDP i.e. 234%. Since 2006, net export has overtaken investment and consumption to be the key driver of Thailand's economic growth. The increased involvement of the region's countries in the International Production Network has expanded the value of export and, thus, the role of export in boosting the GDP growth. Therefore, the current world crisis which hampers export inhibited mostly economies with a large dependency on exports.

Table 1 illustrates the downward trend of GDP growth. The countries, except the Philippines, started at around the same level of growth in the first quarter 2008. Since then, however, Singapore suffered the most as it rapidly and steadily plunges every quarter and recorded -4% and -10% GDP growths in the last quarter 2008 and first quarter 2009. Thailand has also been hard hit by the crisis since the third quarter 2008 and the economy contracted by 4% and 7% in the last quarter 2008 and first quarter 2009. Malaysia also documented similar growth figures with Thailand except a slightly positive growth of 0.1% in the last quarter 2008. Meanwhile, Indonesia and Vietnam still witnessed robust economic growths of more than 6% during the year 2008. These countries upheld their growth in the first quarter 2009 by growing at 4% and 3% for Indonesia and Vietnam respectively. The Philippines, which historically had lower GDP growth than its neighbors, grew at even slower pace since the last quarter 2008.



**Table 1 Year-on-year GDP and Investment Growth of Selected ASEAN Member Countries, 2008-Q1 2009**

	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
Q1-2008 GDP	6.25	7.41	3.92	6.66	5.97	7.52
Q2-2008 GDP	6.42	6.56	4.16	2.51	5.28	6.54
Q3-2008 GDP	6.40	4.77	4.56	0.04	3.90	6.52
Q4-2008 GDP	5.18	0.13	2.85	-4.23	-4.20	6.23
Q1-2009 GDP	4.37	-6.17	0.45	-10.14	-7.11	3.12

Source: CEIC Database

Note: Investment refers to Gross Fixed Capital Formation

Investment in the form of gross fixed capital formation fluctuated in line with the GDP growth. Investment growth of Singapore drastically fell from 30% in the first quarter 2008 to -15% in the same quarter 2009 while that of Indonesia was the most stable among others, declining from 14% in the first quarter 2008 to 3.5% in the last quarter 2009. The size of investment in Malaysia, Thailand, and the Philippines declined significantly in the end of 2008, creating high negative growths in the first quarter 2009.

**Table 2 Year-on-year Export and Import Growth of Selected ASEAN Member Countries, 2008- April 2009**

		Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
Apr, 2008	Export	22.5	20.9	4.9	16.4	16.6	29.1
May, 2008	Export	31.6	22.9	2.4	12.5	12.5	32.1
Jun, 2008	Export	34.1	18.6	9.2	10.9	20.6	34.1
Jul, 2008	Export	24.8	25.3	4.4	15.2	39.7	47.1
Aug, 2008	Export	29.9	10.7	6.6	7.7	15.2	36.8
Sep, 2008	Export	29.0	15.0	1.3	11.4	18.2	28.6
Oct, 2008	Export	4.7	-2.6	-14.4	-4.3	2.4	20.1
Nov, 2008	Export	-1.8	-4.9	-11.4	-11.9	-20.1	-6.3
Dec, 2008	Export	-18.7	-14.9	-40.3	-20.4	-11.5	4.3
Jan, 2009	Export	-35.0	-27.8	-40.6	-37.8	-24.6	-25.5
Feb, 2009	Export	-32.3	-16.0	-39.0	-23.7	-6.6	32.3
Mar, 2009	Export	-27.9	-15.6	-30.8	-20.7	-16.6	13.0
Apr, 2009	Export	-22.6	-26.3	n.a.	-26.0	-16.1	-16.1

Source: CEIC Database

Exports of all countries in the region have contracted since October 2008. The exception is Vietnam's export which experienced monthly positive growths for a few times since the end of 2008. Indonesia, the Philippines, and Singapore endured the largest proportion of export reduction. Indonesia's export grew by 34% (y-o-y) in January 2008, but fell by about the same percentage in January 2009. The decrease might due to the end of high commodity-price period. The Philippines' export has also significantly dropped by around 40% per month since December 2008. The reason might be its lack of diversification of export products and destinations since export is highly concentrated in the electronics sector with the US as its major destination. Falling demand of electronics and declining demand from the US may have been responsible for the deterioration of the Philippines' export performance. Meanwhile, Singapore's export growth also tumbled to -26% in April 2009.

Import of the Southeast Asian countries fell around 30% in the first quarter 2009. This reflects the weakening domestic purchasing power and less activity of manufacturing industry since the industry usually has high import content.

The global financial crisis has contagious effects on the countries' local currencies as market confidence to these countries also dropped following the news of recession in developed economies. Since mid 2008, Malaysian Ringgit, Singaporean Dollar, and Thailand Baht depreciated after strengthening for quite long period since 2007. Vietnamese Dong was constantly at about VND16000/USD before continuously weakening from May 2008. Indonesian Rupiah and Filipinos Peso were considered to be the more persistent despite an unavoidable depreciation in the last quarter of 2008.

**Table 3 Year-on-year Inflation of Selected ASEAN Member Countries, 2008- April 2009**

	BRUNAI	INDONESIA	PHILIPPINES	SINGAPORE	THAILAND	VIETNAM
Jan 2008	6.1	2.3	4.9	6.6	4.3	14.1
Feb 2008	6.4	2.7	5.4	6.5	5.4	15.7
Mar 2008	7.1	2.8	6.4	6.7	5.4	19.4
Apr 2008	7.4	3.0	8.3	7.5	6.1	21.4
May 2008	8.6	3.8	9.5	7.5	7.6	25.2
Jun 2008	11.0	7.7	11.4	7.5	8.8	26.8
Jul 2008	11.9	8.5	12.3	6.5	9.2	27.0
Aug 2008	11.9	8.5	12.4	6.4	6.5	28.3
Sep 2008	12.1	8.2	11.8	6.7	6.1	27.9
Oct 2008	11.8	7.6	11.2	6.4	3.9	26.7
Nov 2008	11.7	5.7	9.9	5.5	2.2	24.2
Dec 2008	11.1	4.4	8.0	4.3	0.4	19.9
Jan 2009	9.2	3.9	7.1	2.9	-0.4	17.5
Feb 2009	8.6	3.7	7.3	1.9	-0.1	14.8
Mar 2009	7.9	3.5	6.4	1.6	-0.2	11.3
Apr 2009	7.3	3.0	4.8	-0.7	-0.9	9.2

Source: CEIC Database

Different from other indicators, inflation shows improvement since mid 2008. Prices have been more stable with Thailand and Singapore recorded year-on-year deflation in April 2009. Vietnam has the most volatile prices, touching an inflation of 28% in August 2008 before lowering down to 9% in April 2009. The contributing factor of this price control may be the turning down of oil and commodity prices.

### III.2 Policy Responses to the Crisis

Governments take policy actions as their response to the crisis in order to minimize its adverse impact and boost economic growth. Governments in the region generally ease monetary policy and inject fiscal stimulus. Liquidity problem arose and, therefore, certain policy actions were taken to overcome this. Singapore ensured the liquidity of its Singaporean Dollar by monetary operations and standing facility. To enhance the flow of credit to real sector, Singapore also initiated Special Risk-sharing Initiative (SRI) i.e. government program to cover 75% of risk borne by banks providing working capital and trade-financing loan to business. Other countries in the region loosened their monetary

stance later than others in East Asia. Indonesia and the Philippines were struggling with high inflationary pressure in 2008 due to oil and commodity price hikes. Interest rates remained high until December 2008, when they started to gradually trim the benchmark interest rates. This interest rate downward rigidity was probably the reason behind the liquidity problem in the banking sector. To increase liquidity, Central Banks cut the bank's statutory reserve requirement. Thailand has also lessened its key interest rate from 3.75% to 2% although the Central Bank acknowledges the rather ineffectiveness of Thailand's monetary transmission to real sector via interest rate.

Fiscal stimulus packages are introduced to domestic economies, mostly taking the forms of infrastructure projects and tax cut. Indonesia disburses Rp 78 trillion (USD 7.8 billion); around 60% of which are to cover income-tax reduction. The rest is for subsidy and government expenditure such as infrastructure project and rural sector development. Thailand implements stimulus package of THB 117 billion (USD 3.4 billion); THB 19 billion of which has been distributed as cash-handout to low-income people. The rest will be spent for education, public works in rural areas, transportation and utility providence, and financial assistance to enterprises. The Philippines plans to stimulate PHP 330 billion (USD 6.8 billion) in 2009; mostly are allocated for infrastructure projects. Malaysia also has realized its first stimulus package of RM 7 billion (USD 2 billion) in November 2008 although there are doubts on the effectiveness of the package. Another package of RM 15 billion will also be disbursed in 2009. Singapore stimulates its economy by conducting Job Credit Scheme i.e. cash granted to enterprises for them to keep hiring the employees.

#### IV. Possible Implications of the Current Crisis on Achieving AEC Goals

There are a number of reasons as to why some countries may want to delay the implementation of the AEC Blueprint. First, governments are under intense domestic pressure to stop or even reverse economic reforms, especially trade liberalization. As suggested by Friedman (2005) such pressure tends to intensify during a time of crisis. And as the foregoing discussion clearly shows, ASEAN countries are experiencing adverse effects of the current global financial crisis, albeit with different degrees of severity. Second, quite often economic reforms lead to reallocation of resources from one group of people to another and therefore, tend to generate winners and losers, at least in the short run. It is one reason as to why economic reforms often encounter oppositions from those who are likely to be losers. Finally, member governments do not consider the implementation of the Blueprint not as their top priority or even under an impression that the Blueprint is not binding.

Some governments may therefore be tempted to use the current crisis as pretext to defer the implementation of the Blueprint. However, it is worth noting that, despite the crisis, no ASEAN country has openly declared its intention to defer the implementation of the Blueprint. Moreover, it may be argued that a deferment is likely to have only a marginal impact, if at all, on economic performance of

the country that does it. The reason is ASEAN countries trade primarily with non ASEAN countries and, hence, removing of all barriers to intra-ASEAN trade is unlikely to worsen their trade performances. In addition, the implementation of the Blueprint is done in an incremental way. Yet, the damage of a deferment to the regional cooperation is likely to be long lasting. It will certainly damage the reputation not only of the country involved but also of ASEAN as whole.

Nevertheless, it should also be added, that the fact that no member has stated its intention to defer the implementation of the Blueprint does not necessarily mean that they will actually implement the Blueprint as scheduled. Alas, as noted earlier, it is not always easy for outsiders to find out the status of implementation of the Blueprint for two reasons. First, the ASEAN Secretariat which is given the task to monitor the implementation of the Blueprint does not have the capacity to do the job properly. They have many other duties beside this one. In addition, ASEAN Secretariat depends primarily on inputs of government agencies of the member states. It may serve these agencies own interests not to reveal the actual status of the Blueprint implementation.

Second, even if ASEAN Secretariat is able to detect any infringement of the Blueprint objectives on time, it may not be able release the findings to the general public. On one hand, as with many other ASEAN documents, a report concerning the implementation of the Blueprint has to be reviewed by senior government officials from the member states before the ASEAN Secretariat can disclose it to the public. They (the officials) can stop the disclosure if they deem the report will hurt their countries' interests. It is possible, therefore, that the ASEAN Secretariat will not publish the report or publish a watered-down version of it.

On the other hand, to make sure that the members will implement the Blueprint, ASEAN is relying on a pure peer pressure mechanism devoid of any notion of adversarial approach to dispute resolution among members. In addition, ASEAN also shuns the use of penalties against those who evade their obligations under the Blueprint. All of these coupled with the existing monitoring mechanism will certainly limit the effectiveness of the ASEAN Secretariat's monitoring mechanism and the peer pressure that comes with it. The peer pressure mechanism will work effectively only if the monitoring report is published as it is and on a timely basis. In addition members should be able to convey their dissatisfaction with, and put pressure on, other members that fail implement the Blueprint.

One way to temporarily mitigate this problem is to encourage all stakeholders, particularly business community and news media, to participate in monitoring of the implementation of Blueprint and publish their findings. In the long run ASEAN should establish an independent monitoring body to monitor development toward AEC in particular, and to ASEAN Community in general.

The foregoing discussion clearly indicates that the success or failure of ASEAN to establish ASEAN Economic Community by 2015 depends primarily on the commitments of the member states to implement the Blueprint. Understandably, ASEAN countries' attention may have been distracted by the current global financial crisis but they should not be paralyzed by it. Open economies like those of ASEAN are bound to experience economic shocks, external or otherwise, from time to time. But, as argued above, they should not use the crisis as a pretext to delay the implementation of the Blueprint.

## V. Conclusion

This paper argues that the road toward AEC 2015 is bumpy. It is bumpy because some of ASEAN members are among the most open economies in the world. As it is, the region is likely to experience economic shocks from time to time which may divert the members' attention from implementing the Blueprint as scheduled. A crisis may push the implementation of the Blueprint further down in members' priority lists. To mitigate this problem ASEAN should improve its monitoring mechanism to enable it to detect non compliance as early as possible and to publish its finding on a regular basis as transparent as possible. Arguably, it is better if such a task is done by an independent body. In addition, ASEAN should remind its members that the implementation of Blueprint is a binding commitment.

Another issue that needs further attention is how to treat the losers. As noted earlier, economic reforms, especially those that involve reallocation of resources tend to generate winners and losers, at least in the short run. ASEAN should find a way to dampen oppositions from the likely losers. ASEAN should at least ensure its members that this problem is not their problem alone but also of ASEAN as an institution.

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## ASEAN'S RESPONSE MECHANISMS FOR LABOUR AND SOCIAL PROTECTION: CHALLENGES IN CREATING CRISIS-RESILIENT ECONOMIES

### 1. The economic and social impacts of the global crisis in ASEAN

#### 1.1. Economic impact and transmission mechanisms

While many ASEAN member countries only saw moderate deceleration in economic growth in 2008, as the crisis intensified and demand began to sharply slow in the United States, the European Union and Japan, a substantial decline in economic activity took place in many of these countries from late 2008 and 2009. Current IMF forecasts indicate that economic growth in the Asia region as a whole will drop to 1.4 per cent this year while the ASEAN-5 countries combined may see no growth in 2009.<sup>1</sup>

There are a number of ways in which the current crisis is being transmitted to Asian economies. Understanding the specific mechanisms through which industries and economies are being affected is essential for assessing the likely labour market impact and for designing appropriate policies to mitigate the adverse effects.

Exports have played a major role in ASEAN's phenomenal growth performance, with many Asian economies highly reliant on exports to earn foreign currency and fuel domestic development. Heading into the crisis, manufacturing exports comprised more than 140 per cent of GDP in Singapore, nearly 70 per cent in Malaysia, more than 40 per cent in Cambodia and Thailand and more than 30 per cent in the Philippines and Viet Nam. On the other hand, manufacturing exports make up only around 11 per cent in Indonesia.<sup>2</sup> As consumers in developed economies abruptly cut back on spending in 2008 and the beginning of 2009, demand for ASEAN's exports have fallen sharply. The January 2009 export data for Malaysia and the Philippines indicated an astounding year-on-year drop of more than 34 per cent and 41 per cent, respectively.<sup>3</sup> Accordingly, many firms in the ASEAN region are sharply cutting production, with an unmistakable rise in factory closures.

Foreign direct investment (FDI) has also been an important contributor to growth in many ASEAN economies – allowing them to move up the value chain through increased access to both capital and more advanced technologies. As a share of gross fixed capital formation, FDI comprises some 60 per cent in Singapore, 52 per cent in Cambodia and 25 per cent in Viet Nam. FDI also accounts for a large share of capital formation in Malaysia, Pakistan, Thailand and the Philippines. In 2008, growth in FDI turned negative in several Asian countries, including Singapore, Thailand and Indonesia.<sup>4</sup> Overall, current estimates are that total FDI to developing countries will shrink by more than 30 per cent in 2009, and while Asia may continue to outperform other developing regions with regard to attracting FDI, the chance is slim that the region can avoid a decline in foreign

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<sup>1</sup>IMF: *World Economic Outlook: Crisis and Recovery* (April 2009). ASEAN-5 includes Indonesia, Malaysia, the Philippines, Thailand and Viet Nam.

<sup>2</sup>World Trade Organization: Statistics Database, October 2008.

<sup>3</sup>World Bank: *East Asia and Pacific Update: Battling the Forces of Global Recession* (April 2009).

World Trade Organization: Statistics Database, October 2008.

<sup>4</sup>United Nations Conference on Trade and Development (UNCTAD): "Global Foreign Direct Investment now in decline – and estimated to have fallen during 2008", UNCTAD/PRESS/PR/2009/001.rev1, 19 January 2009.

investment.<sup>5</sup> In Cambodia, for example, FDI in 2009 is forecast to contract to US\$390 million, about half the amount in 2008.<sup>6</sup>

As migrant workers' incomes are at risk in the current economic downturn, so too are remittances, which represent a vital source of income and foreign exchange for many ASEAN economies, and in particular for poor households. Remittances comprise between 7-12 per cent of GDP in the Philippines and Viet Nam. Remittance flows to developing economies began to slow in the third quarter of 2008 and the World Bank now forecasts an overall fall in remittances to these economies in 2009 of approximately 5 per cent.<sup>7</sup> In addition to remittances, official aid flows are likely to be affected by tighter budgets in advanced economies. This is likely to add pressure in the region's least developed countries to government budget items directed toward economic development and poverty reduction.

## 1.2. Labour market impact

While the impact of the crisis on ASEAN's labour market will differ by country, a few common patterns and particularly vulnerable groups are emerging from available information to date. The first of these patterns is growing job losses. Thousands of workers in key export industries in the region have been retrenched. In Malaysia, the number of retrenched workers totaled 12,600 in the first quarter of 2009.<sup>8</sup> While the absolute number of retrenched workers may be small, the number is nearly a fourfold increase from the average quarterly number of retrenched workers in 2008 of 3,460. More than three-fourths of the retrenched workers in the first quarter of 2009 were in manufacturing.

In Indonesia, the Ministry of Manpower and Transmigration reported that job reductions exceeded 51,000 workers while the Indonesian Employers' Association (APINDO) reported that 237,000 layoffs between October 2008 and March 2009, with the textile and garments sector accounting for the bulk of those retrenchments, followed by palm oil plantations, automotive and spare parts, construction and footwear.<sup>9</sup> In Cambodia, employment in the garment sector contracted by 15 per cent between September 2008 and February 2009.<sup>10</sup> In Thailand, the number of persons on unemployment insurance rose by 17.2 per cent in January 2009 alone, after rising by 38.3 per cent in 2008 compared to the previous year.<sup>11</sup>

While the direct impact in terms of cutting existing jobs can be approximated, we cannot measure how many jobs would have been created more in the absence of the financial crisis. This would of course depend on growth scenarios. Employment growth of 7.9 million jobs from 2006 to 2007<sup>12</sup> in ASEAN offers a perspective in this regard. In other words, the impact of the global crisis may imply substantial 'opportunity' costs. These are

<sup>5</sup> Patricia Lui: "Emerging Markets Face \$180 Billion Investment Decline", *Bloomberg*, 21 January 2009.

<sup>6</sup> World Bank: *East Asia and Pacific Update: Battling the Forces of Global Recession* (April 2009).

<sup>7</sup> Dilip Ratha and Sanket Mohapatra: *Revised Outlook for Remittance Flows 2009-2011: Remittances expected to fall by 5 to 8 per cent in 2009*, Migration and Development Brief No. 9 (Washington, DC, World Bank, March 2009).

<sup>8</sup> Malaysia Ministry of Human Resources. From the number of total layoffs reported between October 1, 2008 and May 14, 2009, it appears that around 75% of retrenchments are permanent, while 25% of retrenchments took place under voluntary separation schemes.

<sup>9</sup> "This year's unemployment target is 8 per cent", *Tempo Interactive*, 13 May 2009; "Total workers laid off reach over 200,000: Apindo", *Jakarta Post*, 12 March 2009.

<sup>10</sup> H. Jalilian et al.: "Global Financial Crisis Discussion Series Paper 4: Cambodia" (London, ODI, 2009).

<sup>11</sup> Thailand Office of National Economic and Social Development Board: "Economic outlook: Thai economic performance in Q4 and outlook for 2009 (February 23, 2009).

<sup>12</sup> ILO: *Labour and Social Trends in ASEAN 2008* (2008)



even more relevant for countries with a high population growth. Some of these countries already faced serious youth employment challenges that are further aggravated by the global crisis.

In situations of high levels of poverty and inadequate social safety nets, workers who have lost their jobs are left with few alternatives except to turn to lower productivity and informal economic activities. One useful indicator in this regard is the number and share of workers in vulnerable employment, which is defined as the sum of own-account workers and unpaid family workers. Many workers in these types of employment status in developing economies do not enjoy social protection in case of job loss, personal or family illnesses or other difficulties; they are less likely than formal wage employees to receive an adequate income and to have their fundamental labour rights respected. Women comprise a disproportionately large share in vulnerable employment throughout the region.

A larger impact than job losses in ASEAN and Asia more generally is the shift to informal and vulnerable employment, including the rural economy. Recent official data in Indonesia and Thailand corroborate this trend. In Indonesia, the number of employees expanded by 1.4 per cent between February 2008 and February 2009 but occupations considered more vulnerable outpaced the growth in wage employment during the same period. In particular, the number of casual workers outside agriculture increased by around 7.3 per cent during the period. In Thailand, the fourth quarter 2008 figures indicate that the number of wage employees contracted by more than 100,000 or by 0.6 per cent, while the number of own-account and contributing family workers combined increased by an astounding 800,000 compared to the previous year.

As many workers in vulnerable employment are more likely to be in the lower end of the income spectrum, trends in vulnerable employment are linked with trends in working poverty. A great deal of uncertainty remains as to how the current crisis will affect overall levels of poverty and working poverty in the Asia region. However, a substantial impact will likely be felt by the workers and households who have risen just barely above the poverty line in recent years due to new formal employment opportunities and are now vulnerable to falling back into poverty as a result of the crisis. More than 52 million workers are currently living just 10 per cent above the extreme US\$1.25 poverty line, while more than 140 million are living just 20 per cent above the extreme poverty line.<sup>13</sup>

## **2. Recommended labour market responses to the global crisis**

In the short-term, focusing on employment and social protection macroeconomic policies would enhance the resilience of the economy to the adverse impact of the crisis as well as accelerating the recovery process. Since the current global financial and economic crisis is characterized by the global economic downturn, it is not an option in the short run for any country to export its way out of the crisis. Stimulating domestic economic activities and supporting aggregate demand through employment and social protection is a viable policy direction, which induces gradual recovery of trade. Coherent employment and enterprise policies at the global, regional and the national level, renewed commitment of each nation to a basic floor of social protection, upholding fundamental principles and rights at work and international labour standards are the preconditions for sustained and accelerated economic, employment and social recovery. In the medium-term, appropriate employment and social protection policies must be kept in place, if not strengthened, since labour market recovery lags economic recovery by four to five years. The

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<sup>13</sup> ILO: Trends Econometric Models (December 2008).

continuous policymakers' attention is required to support vulnerable groups in the labour market as well as monitoring the trends in quantity and the quality of employment.

#### *Support small and medium-sized enterprises (SME)*

A large number of workers work in small and medium-sized enterprises (SME) and their employment is at stake since many SMEs are threatened by declining global demand for their products and services, directly or indirectly through intertwined supply chains. Besides falling sales, the ailing financial market severely engenders the survival of otherwise sound business. In fact, the IMF observed shrinking trade credit and increases in the pricing of trade-financing instruments. In addition, financial institutions perceive higher risks of non-performing loans and are very reluctant in granting new or additional loans. Central banks in the region have cut interest rates to support the industry; however, SMEs are often not in a position to benefit from these moves towards quantitative easing unlike large enterprises. Restoring credit and the normal function of financial markets are of high priority in safeguarding SMEs, the backbone of employment. In the meanwhile, the governments in the region must give due policy attention to alleviate cash-flow problems that confront SMEs. Measures to this end *inter alia* include providing credit guarantees by the government or public banks, relaxing collateral requirements, speeding up loan appraisal, and creating venture capital funds or new types of financial instruments for SMEs. Allowing access to competitive credit lines would effectively prevent unnecessary lay-offs and wage cuts and helps the economy prepare for eventual recovery.

#### Box 1: A new consensus – sustainable enterprises

The 2007 International Labour Conference discussed sustainable enterprises and concluded: "A well-functioning financial system provides the lubricant for a growing and dynamic private sector. Making it easier for small and medium-sized enterprises, including cooperatives and start-ups, to access financing, for example credit, leasing, venture capital funds or similar or new types of instruments, creates appropriate conditions for a more inclusive process of enterprise development. Financial institutions, particularly multilateral and international ones, should be encouraged to include decent work in their lending practices". The very essence of the conclusion, which was endorsed by the ILO tripartite constituents, has to be upheld and used as a guideline during the crisis.

#### *Social dialogue and collective bargaining as a tool to cushion the impact of the crisis on workers*

Social dialogue can play a vital role in mitigating the labour market and social impact of the crisis on workers and their family members as well as facilitating adjustment at the company level. Social partners can join forces and flexibly arrange acceptable alternative solutions to layoffs. Safeguarding existing jobs, for example, prevents a loss of firm-specific skills while reducing firing costs as well as (re)hiring and (re)training costs when the economy starts picking up. Layoffs should be the last resort when all other possible means of avoiding retrenchment are exhausted. Alternative solutions to layoff *inter alia* include: working hour reduction, work sharing, (re)training and wage moderation. Some companies do see the period of slack production as an opportunity of upgrading workers' skills and productivity. The government may wish to assist with alternative arrangements to layoffs by offering targeted reductions in social security contributions and/or providing training to upgrade the skills of at-risk workers.

In order for social dialogue to play these roles of providing alternative solutions to layoffs, greater efforts are required to facilitate social dialogue at the international, national and sectoral levels and in public and private workplaces. The ILO strongly supports social dialogue and the practice of tripartism between governments and social partners within

and across national borders in jointly coming up with optimal solutions to the challenges posed by the crisis. The ILO Declaration on Social Justice for a Fair Globalization (2008) states that “promoting social dialogue and tripartism are most appropriate methods for:

- Applying Decent Work strategic objectives in national circumstances
- Translating economic development into social progress
- Building consensus on employment and labour policies
- Making labour law and institutions effective”.

Through social dialogue the government and social partners can safeguard with enhanced vigilance fundamental principles and rights at work during the economic downturn. The effective and maximum use of social dialogue to formulate and implement policies is a key to weather through the crisis with the minimum social impacts.

#### *Policies targeted to vulnerable groups*

Adverse impact of the crisis is not evenly shared by all types of workers. Some categories of workers are more vulnerable to the economic slowdown, calling for policymakers’ attention. For example, the youth employment situation may deteriorate since large numbers of school leavers will join the labour force despite the crisis. The scarcity of employment opportunities due to the crisis will make their job search efforts more strenuous.

Women form another vulnerable group in the labour market. Owing to the high concentration of workingwomen in export sectors, women are disproportionately affected by the crisis. In addition, women are likely to shoulder the intensified double burden of family care and income generating activities in part because of reduced men’s take-home wages and the lack of formal care systems. For these reasons, national policy responses must take the gender dimensions into account. Enhancing equal access to public works by men and women can be achieved by including social services and environment protection components in such schemes.

Migrant workers and their families become more vulnerable in times of crisis. Migrant workers, especially undocumented ones, may be the subject of discrimination and exploitation. Governments are urged to ensure the full application of the principle of equal treatment and non-discrimination in the areas including working conditions, entitlement to social security and training programmes. Countries experiencing large-scale return migration may need to devise targeted employment policies and other mechanisms that lend help to repatriated overseas migrant workers.

#### *Expand and enhance social protection*

In developing countries where social security system only covers workers in the formal sector, additional poverty alleviation programmes are justified to provide income support and social protection to those who are at risk of poverty but not covered by social security. Economic crises shed formal employment and increase the number of informal workers. An increased labour supply in the informal economy tends to deteriorate the working conditions of informal workers, increasing and deepening poverty as a consequence. Expansion and implementation of social protection programmes are indeed necessary to alleviate the adverse impact of economic crises on the deprived. Employment guarantee programmes as well as conditional cash transfer schemes are known to be effective interventions especially in developing countries.

In the framework of its Campaign for the Extension of Social Security to All and as part of its constitutional mandate to promote the Extension of Social Security to All, the ILO is promoting a basic and modest set of essential social transfers that could ensure:

- universal access to essential health services for all residents;
- income security for all children through child benefits;
- modest income support for the poor in active age combined with employment guarantees through public works programmes; and
- income security through basic tax-financed pensions for the old, the disabled and those who have lost the main breadwinner in a family.

Such a set of minimum guarantees is affordable for most countries. An ILO costing study<sup>14</sup> of 12 developing countries shows that the initial gross annual cost of the overall basic social protection package (excluding access to basic health care that to some extent is financed already) is projected to be in the range of 2.3 to 5.5 per cent of GDP in 2010. Individual elements appear even more affordable. The annual cost of providing universal basic old-age and disability pensions, for example, is estimated in 2010 at between 0.6 and 1.5 per cent of GDP in the countries considered. In some countries it may still require a joint effort between low-income countries and the international donor community for a transition period. However, even low-income countries may be able to increase domestic resources or reallocate some of their existing resources over the next decade.

#### *1) Employment guarantee as a safety net*

Well-designed and targeted employment guarantees can be a cost-effective policy to counter economic crises. It was proven to be successful in Argentina and Indonesia. The case of India is of particular interest because it addresses employment creation, rural development, social protection and poverty alleviation simultaneously. India's National Rural Employment Guarantee Act (NREGA) targets poor informal workers in rural areas. The Act guarantees 100 days of work and 33 per cent of employment is reserved for women. NREGA created about 1.4 billion person days of work in 2007–2008, of which about 42 per cent by women. The cost was about 0.5 per cent of the GDP of India. This type of employment policy is particularly effective in times of crisis since it provides the deprived with a minimum income security, mitigating the impoverishing effect of the global economic slowdown. Employment-rich public work schemes have already been in place in the region and member states of ASEAN expand such schemes so as to absorb redundant labour. The success of employment guarantees is, amidst others, contingent on the administrative capacity of implementing agencies.

#### *2) Employment intensive or local resource based approaches to infrastructure investment*

Relating to employment guarantee schemes, employment-intensive approaches to infrastructure investment are key tools for employment creation, local economic development and poverty alleviation. These approaches are also known as local resource-based (LRB) approaches given the optimum and flexible use of locally available workforce, materials, skills and capacities. Employment-intensive (or LRB) approaches are effective in mitigating the adverse impact of the crisis on a labour market because of their high capacity in absorbing labour. Many countries in the region including Indonesia, the Philippines and Cambodia benefited from these approaches to infrastructure development.

#### *3) Social protection programmes*

Economic stimulus packages must incorporate substantial components expanding existing social protection schemes to cover more people, as well as initiating investments in

<sup>14</sup> ILO. 2008. *Can low-income countries afford basic social security?* (Geneva).

supplementary poverty relief schemes. Among various social protection schemes, conditional cash transfer schemes are proven to be effective in addressing abject poverty, human capital development and inter-generational poverty traps simultaneously. School subsidies and scholarships are other examples of effective social policy interventions, since they help keep children in school and reduce the incidence of child labour.

**Box: Global Jobs Pact**

**-Decent work response to the crisis-**

The Global Jobs Pact is a policy package, proposed by the ILO and agreed to by the ILO's tripartite constituency, which aims to alleviate the adverse impact of the global financial crisis on workers and companies in all sectors including the rural and informal economy. It acts as a catalyst for productive and sustainable recovery since it leverages stimulus packages and other relevant national policies to address employment and labour market issues and to promote social protection and respect for workers' rights. Social dialogue is a key consensus-building tool indispensable to the Pact.

### 3. Current social protection in ASEAN countries

Social protection schemes in ASEAN countries<sup>15</sup> are in general at an early stage of development. While public sector employees in all ASEAN member states but for Cambodia enjoy social insurance, the general public is not necessarily covered by similar social insurance. Besides, the vast majority of informal workers are excluded from existing social protection. Brunei Darussalam is the only country among ASEAN member states that has a universal pension. In many cases, social protection programmes are managed by various organizations and remain fragmented. At the regional level, the ASEAN member states regularly exchange information on social protection; however, formulating regional coherent policies or strategies to strengthen social protection is a future task. Table 1 summarizes various schemes of social protection in place in ASEAN member states.

Table 1. Social protection schemes in ASEAN member states

	Brunei	Cambodia	Indonesia	Laos	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam
Old age	P/U		P	S	P		S	P	S	S
Invalidity	P/U		P	S	S/P		S	P	S	S
Survivors	P		P	S	S/P		S	P	S	S
Medical care	U		S	S	U	S	S	P/A	U/S	S
Sickness	E	E	E	S	E		S	E	S	S
Maternity	E	E	E	S	E		S	E	S	S
Work injury	E	S	S	S	S/E	S	S	E	S	S

Note:

S: social insurance, P: provident fund, U: universal, E: employer liability, A: social assistance

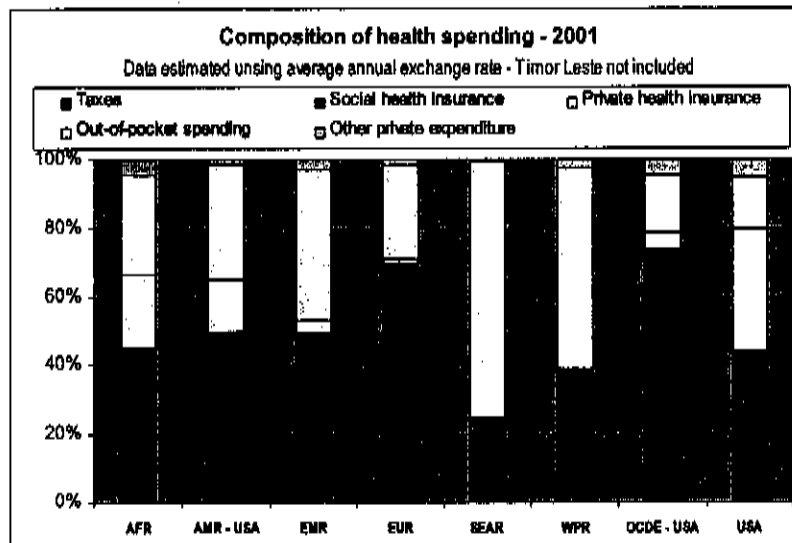
Source: Yamabana, Hiroshi "Overview of social protection scheme in Asia Pacific countries" a presentation delivered at Kuala Lumpur on 19 August 2008

Poverty and healthcare costs constitute notorious vicious circles of poverty: many people are forced into poverty by healthcare costs in the absence of social insurance or universal

<sup>15</sup> This section draw information from Arif, Fifi Anggraini "Social protection and social pension in ASEAN region: Strengthening regional cooperation" a presentation delivered at the South East Asia Social Pension Meeting on 22 January 2009, Chiang Mai, Thailand and Yamabana, Hiroshi "Overview of social protection scheme in Asia Pacific countries" a presentation delivered at Kuala Lumpur on 19 August 2008.

healthcare. Among the ASEAN member states, Brunei, Malaysia, Thailand and the Philippines are successful in achieving (quasi) universal health insurance coverage or a universal healthcare system, while social health protection fails to cover the poor and informal economy workers in some member states of ASEAN. Healthcare costs in Southeast Asia are largely financed by out-of-pocket spending and social health insurance plays a limited role. The share of tax-based healthcare funding is low relative to other regions (figure 1). Health financing in the region must gradually shift from out-of-pocket spending to social insurance and universal coverage based on taxation in order to expand healthcare coverage.

Figure 1.



Note: AFR: Africa, AMR: Americas, EMR: East Mediterranean, EUR: Europe, SEAR: South East Asia, WPR: Western Pacific  
Source: NHA Unit, EIP/FER/RER, World Health Organization

Unemployment insurance schemes are still limited for most countries in ASEAN member countries. Thailand implemented unemployment insurance in 2004 and Vietnam followed in 2009. Other countries still rely on severance payments for providing income security in case of job loss. Severance payments, however, may fail to provide sufficient income security especially when companies become insolvent. Severance payments are seldom linked with active labour market policies such as vocational training and employment placement services.

Since formal social protection schemes are not always successful in covering the deprived, many governments in the region supplement existing schemes with pro-poor programmes. Indonesia for example implemented a scholarship and school subsidy programme in 1998 as a response to the Asian financial crisis. Conditional cash transfer schemes are effective in alleviating abject poverty as well as cutting inter-generational poverty traps by assuring education of the next generation. Indonesia has expanded conditional cash transfers - Hopeful Family Programme - to cope with the current crisis. Economic stimulus packages must incorporate social objectives of poverty alleviation. Implementing or expanding existing schemes of social protection targeting low-income groups and informal workers is an appropriate crisis response. Thailand for example allocated 35 per cent of its economic stimulus package on cost of living alleviation and sustenance allowance.

Social protection is not a cost but a key investment in human capital, which should be part of development plans. The right to work is a universally recognized right and a form of minimum employment guarantee could be promoted as a response to the economic slowdown. Simultaneously, the current crisis is an opportunity to realize the long-pending

agenda of extending basic social protection to cover all women and men. The cost of extending social protection is estimated not too large as a percentage of gross domestic product (GDP). Governments and social partners can collaborate in designing and implementing labour and social protection systems.

#### 4. Moving Forward

At the summit meeting in January 2007, the ASEAN leaders committed themselves to accelerating integration between member countries, with the ultimate aim of establishing an ASEAN Community by 2015. They envisaged that greater integration within the region will help to narrow the gaps in development between member countries and allow each to maximize their productivity, competitiveness and individual development potential. At the same time, all stand to benefit from the many advantages that a large, single market would offer. Greater integration would create a protective environment, offering security, stability, shared prosperity and social progress. Nonetheless, as highlighted in earlier sections, a crucial challenge to achieving greater integration entails strengthening the social dimension of integration. The 1997-98 Asian financial crisis served to highlight that without social dimension policies, including effective labour market and social protection policies, irreversible losses in human capital occur, undermining sustainable development and social progress.

In recognition, the ASEAN Socio-Cultural Community Blueprint contains elements on strengthening social protection. In that Blueprint, "ASEAN is committed to enhancing the well-being and the livelihood of the peoples of ASEAN through alleviating poverty, ensuring social welfare and protection, building a safe, secure and drug free environment, enhancing disaster resilience and addressing health development concerns". Furthermore, the Blueprint seeks to "ensure that all ASEAN peoples are provided with social welfare and protection from the possible negative impacts of globalization and integration by improving the quality, coverage and sustainability of social protection and increasing the capacity of social risk management."

In light of the above commitments, the time has come to strengthen the social dimension of regional integration through improved access to basic health care, protection for children, the elderly and people with disabilities, social assistance for people who are poor or unemployed and other features that vary according to country needs and stages of development. Building such a "social floor" is crucial in times of crisis but also in coping with adjustment that accompany dynamic societies and economies. Such a floor is vital in ensuring security, and guaranteeing equal opportunities for everyone to participate and benefit from the process of integration. Success in this regard is crucial to the longer-term viability of economic integration and the underlying social fabric.

In the context of the crisis, social assistance programmes such as targeted cash transfers and employment programmes are generally regarded as the most effective way for governments to support the purchasing power of vulnerable households. Employment programmes can create much-needed employment opportunities in local public works projects and if cash transfers are linked to a certain conditions, such as low income, occupation or location, or to a mandated behaviour, such as sending children to school and not to work or attending health clinics, they can lead to double dividends for policy-makers. While providing effective social safety nets in the short term, such transfer programmes can help reduce inter-generational poverty traps in the longer term.

Investing in human capital is a critical driver of competitiveness. Until now, many low-

and medium-income ASEAN countries have pursued a growth strategy based on high savings rates, fixed investment, abundant labour supplies and export promotion. However, this formula is becoming less and less appropriate as competition from China, India and other emerging economies is mounting and labour force growth in some countries is slowing down. Moreover, this approach to growth is unsustainable in the long term because it tends to neglect the intangible assets of economic competitiveness, such as innovation and creativity.<sup>16</sup> As these countries begin to focus on developing more efficient production processes and improving product quality, competitiveness becomes increasingly driven by the quality of the workforce and by the ways in which human resources are managed at the workplace. For ASEAN countries moving into, or already at, a higher stage of development, the only way to sustain economic growth and social development is to compete through innovation in products, processes and technologies, using well-educated workers and progressive workplace practices. A social floor provides the reassurance for innovation, human capital deepening and the foundation for productivity growth.

In close cooperation with employers' and workers' organizations, governments can review how the basic components of their social security system meet the needs of their economic and social development objectives in the context of the crisis but also the rapidly changing economic, demographic and social circumstances. Besides from immediate crisis measures, the broader social protection system in ASEAN member countries can be strengthened incrementally according to each country's realities and priorities. This could empower millions to move out of poverty and further ahead in life. Furthermore, ASEAN member countries should collectively seek to establish mechanisms for learning and sharing of information on strengthening social protection and, in particular, extending it to the informal economy.

The involvement of the tripartite partners - governments, employers and workers - is particularly important in undertaking the needed social protection reforms. Importantly, all three share the common fundamental goal of achieving sustainable growth and social progress. To realise this goal, businesses will require productivity growth and upward mobility in the value chain to ensure long-term competitiveness; and workers will require access to decent work, meaning opportunities through productive employment creation, empowerment through the recognition of their fundamental rights, security through social protection, and an effective voice through democratic institutions and social dialogue. In addition to mobilizing support for needed reforms and ensuring their effective implementation and monitoring, good mechanisms for social dialogue, combined with mutual understanding between government, businesses and workers, can foster cooperation and innovation, allowing them to find negotiated solutions in dynamic labour markets. This could, in turn, support not only an environment conducive to investment and growth; it could also become a unique source of the region's competitiveness in the years to come.

In addition to collaboration among ASEAN member countries, greater coordination and collaboration at other levels are required for a coherent response to the crisis and in building effective social protection systems. In this regard, building on the *ILO/ASEAN Cooperation Agreement* and past collaboration with ASEAN member countries in the area of social protection as well as other inter-connected areas, the ILO will continue to support ASEAN in extending the effectiveness and coverage of social protection and in addressing the current economic crisis, with the Decent Work Agenda and the Asian Decent Work Decade providing the framework.

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<sup>16</sup> PricewaterhouseCoopers: World Economic Forum on East Asia, briefing material, Singapore, 24-25 June, 2007, p. 11.