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# The Relationship between Openness and Economic Performance A Case Study of the Five Leading Emerging Markets in Southeast Asia: Vietnam Philippines Thailand Indonesia Malaysia

Trang Pham

*Union College - Schenectady, NY*

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**The Relationship between Openness and Economic Performance  
A Case Study of the Five Leading Emerging Markets in Southeast Asia:  
Vietnam, Philippines, Thailand, Indonesia, Malaysia**

by

Trang Pham

\* \* \* \* \*

Submitted in partial fulfillment  
of the requirements for  
Honors in the Department of Economics

UNION COLLEGE  
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## **ABSTRACT**

PHAM, TRANG M. The Relationship between Openness and Economic Performance. A Case Study of the Five Leading Emerging Markets in Southeast Asia: Vietnam, Philippines, Thailand, Indonesia, Malaysia  
Department of Economics, June 2012.

For the last two decades, the Southeast Asian countries have emerged as the fastest growing economies in the world, together with making significant progress in economic liberalization. The thesis studies the impact of economic openness on growth and volatility in the five leading Southeast Asia countries: Thailand, Vietnam, Malaysia, Indonesia, and Philippines. The results obtained include: 1) economic openness is a driving force for the rapid growth of the five countries during 1990-2010, 2) during transition into an open economy, volatility cannot be eliminated; however, if a country has sound macroeconomic policies, a reasonable ratio of foreign direct investment to total capital flows, and a diversified trading portfolio, the risk can be reduced, 3) evidence suggests that the “phoenix miracle” did happen in Indonesia after the East Asian crisis, which means the country was able to recover its output level long before it could recover its credit market, 4) in the case of Thailand and Malaysia, foreign capital flows, mostly in the form of foreign direct investment, were the driving force for their quick recovery subsequent to the East Asian crisis, 5) Vietnam is a late-comer for the process of economic liberalization, however, with progressive policy reforms during the last two decades, Vietnam has been able to bridge the gap between itself and the four other countries.

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# **CHAPTER I**

## **Introduction**

### **A. Motivation**

For the last two decades, Southeast Asia has emerged as the fastest growing economy in the world. Especially, the five leading countries: Thailand, Indonesia, Malaysia, Philippines, and Vietnam have grown at an average annual rate of 5.5% in terms of real GDP per capita. They are regarded as the Tiger Cub Economies, as they prove to have a great potential to compete with the four Asian Tigers (Singapore, Hong Kong, South Korea, and Taiwan). Despite the long-term high rate of growth, on a year to year basis, the five countries have experienced a number of ups and downs during 1990-2010. Also during this period of time, the five countries have taken major steps in opening their economies. Because of their growth potential, as well as their ongoing trend of economic globalization, I devote my thesis to studying the extent to which economic openness has an impact on the rapid growth and volatility of the five countries

### **B. Time Period**

In doing so, I have collected data from 1990 to 2010, due to the fact that Vietnam is a latecomer to the process of economic liberalization. Not until mid 1980s did Vietnam implement policy reforms to start integrating its economy into the world's economy. The effectiveness of these reforms became visible in early 1990s.

### **C. Structure of the Thesis**

I divide my thesis into five chapters. Chapters I and V are introduction and conclusion, respectively. Chapters II, III, and IV will study the following:

In chapter II, I review the current literature related to the impact of economic openness on growth and volatility, especially in emerging markets. To my knowledge, most of the studies that are able to prove the positive impact of trade liberalization and especially financial integration have to use the factors of a sound macroeconomic condition, good governance, high level of human capital, and a deep financial market. In addition, I also find literature on the composition of capital flows, the Phoenix Miracle, the threshold effects of product diversification and financial development helpful in explaining the differing effects of economic openness on each of the five countries.

In chapter III, I present cross-country analyses of real GDP growth and economic openness in the five countries. In studying the five countries' growth rates during 1990-2010, I notice that there were similar time periods during which these countries all had significant output volatility: 1997-1998 during the East Asian crisis, the early 2000s when a number of developed countries underwent crises, and the late 2000s during the subprime mortgage crisis. More importantly, I note that Thailand, Indonesia, and Malaysia were mostly affected during the crises, however, they were able to recover quickly. I then analyze factors that accounted for this phenomenon in chapter IV. To compare and contrast countries' levels of economic openness, I focus on three indicators: trade liberalization, financial integration, and institutional development. Trade liberalization is measured by the total exports and imports, financial integration is measured by net capital inflows, and institutional development is measured by a combination of factors such as economic openness, corruption, and state fragility.

In chapter IV, I study the causal factors to explain why countries are different from each other in their levels of output volatility during a crisis, and their speeds of recovery subsequent to a shock, both in real sectors as well as in the financial sector. I use country-specific data to study for such factors as threshold effect, composition of capital, absorptive capacity, policy toward economic liberalization, and the Phoenix Miracle. Taking the East Asian crisis as a case study, I also study what policy changes each country made during the post-crisis period and their impact.

I look to draw out meaningful conclusions on the impact of economic openness on the five developing countries' growth and volatility. With the knowledge of what factors can cause/reduce output volatility, countries might be able to smooth their transition to an open economy.

## Chapter II

### Literature Review

This thesis studies the impact of economic openness on economic performance through examining such factors as trade liberalization, financial integration, and institutional development. Each of the works reviewed contributes a new aspect to the general topic of globalization by focusing on different countries, and time periods, as well as on different international institutions. To my knowledge, none of these, however, adequately answers the question that I hope to approach in this thesis: the relationship between openness and economic performance of the five emerging Southeast Asian countries: Indonesia, Malaysia, Thailand, Philippines, and Vietnam during 1990-2010, especially during and after the East Asian crisis.

#### **A. Trade Liberalization:**

The literature on trade liberalization and emerging markets' output growth and volatility, especially during periods of financial crisis is very complex and diverse. Theoretically, steady gains from comparative advantage, knowledge and technology spillovers (especially when trading with more developed partners), and decrease in seasonal market fluctuation are among the channels that international trade can boost growth. Also as Haddad (2009) pointed out, the pro-competitive effects of openness can shrink marginal cost of



production, improve quality, and provide consumers with access to a wider range of goods at lower prices. In World Bank's 2002 Global Economic Prospects, we find: "A reduction in world barriers to trade could accelerate growth, provide stimulus to new forms of productivity-enhancing specialization, and lead to a more rapid pace of job creation and poverty reduction around the world" (World Bank 2002, p xi). Specialization by comparative advantage also enables a country to allocate scarce economic resources more efficiently. By studying data of the ASEAN<sup>1</sup> + 3 countries, namely China, South Korea, and Japan during 1995-2004, Gochoco-Bautista and Mapa (2009) found, in addition to financial variables such as the average FDI growth and a dummy variable of Asian financial crisis, the trade-related variables, such as average export growth of countries, and the import to export price index of commodities, together with the world price of oil are dominant factors driving the regional industrial production growth. To further study the impact of trade liberalization on emerging markets, especially during global crisis, using evidence from Laos, a least developed country, Kyophilavong (2009) indicated that global crisis has a negative impact on Laos' economy, while trade liberalization has a positive impact on Laos' economy through increasing household welfare and real GDP. As the result, Kyophilavong concluded that enhancing trade liberalization during the global financial crisis could minimize the negative impact of the crisis on Laos' economy. This conclusion also applies to other emerging markets in the Asian region. Kose (2004) found evidence for the positive impact of trade openness. He challenged the conventional belief on the negative relationship between growth and volatility that had been held till 1990s. By studying a sample of 85 countries (21 industrial countries and 64 developing countries) over the period 1960-2000, Kose found that trade and financial

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<sup>1</sup> As of today, ASEAN has ten members: Vietnam, Laos, Thailand, Brunei Darussalam, Cambodia, Indonesia, Malaysia, Myanmar, Philippines, Singapore

integration tend to alleviate the trade-off between growth and volatility. In other words, countries that are more open to trade appear to face less severe tradeoff between growth and volatility. A similar conclusion was drawn for financial integration, although not that robust. The results of his paper also imply a threshold in the relationship between growth and volatility. Beyond a certain level of trade/financial integration, this relationship turns positive. This helps explain why in developing countries, there is a negative relationship between growth and volatility while developed countries achieve a positive one. Developed countries certainly have higher level of economic openness than those in emerging markets. Not only the total export volume matters, but Haddad (2009) indicates that the level of export diversification also plays an important role in deciding whether the impact of trade openness on output growth volatility is negative or positive. Specifically, his model showed that the effect of trade openness on volatility is negative as long as the share of top ten export products of a country is less than 60% of the total export value. There are policies that a country can consider to promote export product diversification to move its economy from one side of threshold to the other. For example, improving market access abroad is quite crucial: it is difficult to export more products to a wider range of markets if foreign consumers are protected by high level of tariffs. In addition, reducing the fixed and variable costs of moving goods across borders such as developing trade-related infrastructure can also effectively promote export diversification (Haddad; (2009)). Furthermore, the evidence to support export product diversification acting as an effective stabilizer is noticeably more consistent than that for export market diversification. As a result, the author suggested that countries should consider pursuing an expanded base of production and export diversification strategies prior to broad tariff removal, especially for countries that are currently having a highly concentrated

production base. Our argument on the benefits of trade openness seems to pose a conflict between specialization and diversification. Evidence, indeed, suggests that specialization does not dominate until countries are well into high-income group. Trade openness also shows its benefit as effective stabilizer when there is demand shock in domestic market. Although this scenario does not attract much attention from scholars, it provides a more thorough cost-benefit analysis of trade openness. Haddad (2009) realized that once a country's export sector starts to operate more closely in tune with overseas market conditions, it becomes necessarily less strongly correlated with home market conditions. Because demand shocks at home and overseas are only imperfectly correlated, this force tends to reduce the overall volatility.

Despite these findings, the positive impact of trade liberalization on emerging markets has yet to be established since there are also many other research papers either not being able to draw out significant evidence on this matter or even indicating opposite impacts of trade liberalization. Scholars still question whether trade openness is a transmitter of shock during financial crisis and economic downturn. In contrast with what was found by Kyophilavong (2009) about the positive impact of trade openness on minimizing negative impacts of global financial crisis in Laos, Gruben (2002) further confirmed the hypothesis that had been tested by Frankel and Rose model (1998) that greater trade flows between any two countries cause greater synchronicity between their business cycles. If two countries have high level of trade flows, their policy makers might share similar views on rationalizing monetary policies, and/or a shared currency. Besides the two contrasting results on the shock -transmitting impact of trade openness, in their cross-country study of 158 countries during 1958-1988, Razin and Rose (1994) found no consistent link between trade openness and output volatility. The impact of trade liberalization on macro volatility depends significantly on the nature of

shocks and the degree of specialization rather than the total trading volume. Shocks can be transitory or persistent in duration; besides, they can be either common across countries, or country-specific.

As we can see, it is hard to draw out a definite conclusion since both sides of the argument have proved their own theories on the impact of trade liberalization. Countries are different in various aspects, thus a theory might work for most countries, but maybe not for every country. Therefore, in my thesis, using the updated data of the five countries, I study whether these theories from current literature are helpful in explaining the impacts of trade liberalization on these countries' economies. In addition, I expect to be able to draw out further peculiar characteristics of the trade openness that reflect the socioeconomic status and conditions in these countries.

## **B. Financial Integration:**

There has been a significant increase in the amount of international cash flow circulating among countries, mostly from developed countries to emerging ones within the last two decades. Many economists are concerned about the impact of such financial integration on the economic growth and stability of the emerging countries. Like the topic of trade liberalization, studies on financial integration and economic growth have not been able to establish a positive relationship between the two.

According to Gochoco-Bautista and Mapa (2009), there are direct and indirect channels through which financial integration can enhance growth. Direct channels include increasing domestic savings, lowering the cost of capital due to better risk allocation, transfer of technology, and stimulating the development of financial sector. Besides, financial integration can also indirectly enhance economic growth through promoting specialization,

inducing better macroeconomic policies, and enhancing capital inflows by signaling better policies. The question of whether financial integration also transmits shock, however, is an unsettled issue. In order for financial integration to be beneficial, countries might need to have several prerequisites such as a fairly high level of financial development. If a country has a shallow or less-developed financial market, then that country is less able to cope with “sudden stops” and exposes to more risk.

To further discuss these prerequisites of a country’s financial market, Prasad (2003) and Kose (2004) pointed out that there is a threshold effect. Once a developing country meets a certain level of financial integration, there will be a reduction in volatility. By using the ratio between total foreign investments and GDP as a measurement for a country’s financial development, the authors found out the threshold number to be 50%. Prasad also further indicated in his paper that a low to moderate level of financial integration may have had some countries subject to even greater volatility of consumption relative to that of output. Even when output growth performance is assumed to be positively related to financial integration, there is little evidence that financial integration has helped developing countries stabilize fluctuation in consumption growth. From the perspective of macroeconomic stability, consumption is regarded as a better measure of welfare than output growth; increased fluctuation in consumption, therefore, means negative impact of financial integration on welfare. Prasad concluded that while there is no robust evidence that financial integration has benefited growth in developing countries, there is evidence that some emerging countries might have experienced greater consumption volatility after opening up their financial market. Adding to this point of view, Agbola (2007), in using time-series framework during 1970-2006, indicated that the FDI is a vehicle for achieving economic growth in the Philippines

only in the presence of sufficient absorptive capacity. In doing so, the author suggests more investment in the private sector in Philippines.

On the other hand, Obstfeld (1994) devoted his paper to showing the benefits of international capital mobility. First, asset-price arbitrage ensures that people in different countries face identical prices for assets. Second, new saving, regardless of which countries, can be allocated toward the world's most productive investment opportunities. However, Obstfeld conducted this paper in early 1990s when financial integration had recently started to explode in most of the developing countries, thus there may not have been sufficient empirical evidence to corroborate his position. A more recent study that covered a longer period of time 1970-2007 also gave evidence to the beneficial impacts of financial integration on economic growth. By studying the case of ASEAN countries, Pradhan (2009) concluded that a high level of FDI can generate high level of economic growth and vice versa. This result implies a straightforward guidance for policy makers: to get more economic growth, we need to bring more FDI, and in order to attract more FDI, countries need to maintain a stable level of economic growth. Another factor that should be taken into consideration with regards to the impact of financial integration on developing countries' output and volatility is the nature of shocks. Medoza (1994) found that when shocks happen persistently on large scale, output volatility is positively related with the increase of financial integration. Also indicating that the relationship between openness and volatility depends on the nature of shocks, Razen (1994) categorized shocks into four categories: global or idiosyncratic, persistent or temporary. Buch (2002) pointed out that given financial integration, macroeconomic shocks increase the volatility of output, but decrease the volatility of consumption, while fiscal shocks give rise to both output and consumption volatility.

In response to the economic theory that capital mobility allows for savings to be channeled towards the countries with the more productive investment opportunities while reducing non-systematic risk between countries, Milesi- Ferreti (2011) argued that oversize capital flow can overwhelm recipient countries' abilities to absorb them, and lead to bubbles. This period of "exuberance" is often followed by a "sudden stop" where foreign investors abruptly stop funding and consequently cause recipient countries great loss in adapting to the new macroeconomic conditions.

As many of the recent financial crises are liquidity ones, the impact of financial integration on the liquidity of a country is a concern of many economists; however, this issue is still a puzzle. By studying the stock markets of the six Asian emerging markets (Indonesia, India, Korea, Taiwan, Thailand, and Philippines) during 1999-2005, Agudelo (2010) pointed out several conclusions on the relationship between foreign investors and liquidity. On one hand, foreign investors have negative but transitory impacts on the overall liquidity due to the fact that they aggressively demand more liquidity than domestic investors. On the other hand, increased share of foreign ownership in a market improves liquidity provision, together with increased transparency and monitoring. One of the key factors in deciding the liquidity and stability of an economy and its currency in the international financial markets is the level of its international reserves. As emerging markets have been opening their economy to the developed countries, many economists argued that in protecting themselves from sudden stop in capital flows, emerging markets have been holding too much reserve as a way of self-insurance. The debate on the appropriate level of international reserves still goes on. Jeanne (2011) derived a formula to calculate the optimal amount of international reserve and the results they got can explain the extensive amount of reserves held recently by emerging

markets since 1980, but not for the recent accumulation in Asia. The formula takes into consideration two assumptions : sudden stops in capital flow can be significantly costly and emerging countries are highly risk averse. The recently excessive accumulation of reserve in Asia might be an unintended sequence of policies that maintain large current account surpluses.

Besides accumulating foreign currency reserve as provision for the liquidity issue, a country should also pay attention to the composition of capital flows, in particular, the amount of FDI flows compared to portfolio flows. Both Radelet (1998), and later on Bussière (2008) showed their concern over this issue as they believed that short-term foreign investments are more risky than long-term ones. By specifying such relevant indicators as FDI vs. portfolio flows, long-term vs. short-term portfolio capital, fixed-rate vs. floating-rate borrowing, and domestic currency vs. foreign –currency domination, Frankel (1996) went further in studying the impact of the composition of capital flows as well as the stock of debts. He was able to conclude that a low ratio of FDI to total foreign capital inflows is consistently associated with a high likelihood of a financial crash. Indeed, Calvo (2006) pointed out that sudden stop of capital inflows was the main actor in many recent financial crises in emerging markets such as the Tequila crisis episodes (Argentina 1995, Mexico 1995), the East Asian crisis episodes (Indonesia 1998, Thailand 1998, Malaysia 1998), and the Russian crisis episodes during late 1990s (Ecuador 1999, Turkey 1999, Argentina 1995). Despite the drawbacks of portfolio inflows, weak governance and poor financial supervision still allows large ratio of short-term debts because short-run debts are easier to build up in short-run. From the perspectives of foreign investors, portfolio investments are safer and quicker to make money, thus more attractive due to their relatively high liquidity. Considering the long-term growth of a



developing economy, however, Radelet (1998) suggested that liberalization of short-term capital movements should be undertaken only gradually and with extreme caution. On the other hand, opening financial sector to FDI should be much more rapid and straightforward.

Through the current literature that I have presented, capital inflows seem to be the driving force for economic growth in emerging markets, and also more often than not the causes of many recent financial crises. In further studying the impact of financial integration on the five Southeast Asian countries, I find the pioneer study on Phoenix Miracles by Calvo, Izquierdo, and Talvi (2006) quite relevant. By analyzing the collapse and recovery phase of output collapse during periods of large capital flow reversals, the authors realized a very similar pattern across different episodes: output recovers with virtually no recovery in either domestic or foreign credit. In explaining this phenomenon, the authors pointed out that liquidity can be restored by different means, one of which is discontinuation of investment projects. Since the affected emerging markets must have a period of excessive investment right before the crisis, this reduction in investment will not affect much on productivity. Instead, liquidity and output will increase. Also interested in learning more about this phenomenon, in 2011, Ayyagari, Kunt, and Maksimovic published their research paper: "Does Phoenix Miracles exist?" By studying this phenomenon at firm level during financial crises, the authors found their findings consistent with those of Calvo (2006) only at macro level. At micro-level, when Ayyagari and his co-authors examined if there was a recovery in aggregate sales without a recovery in aggregate short-term borrowing, they found that the recovery at firm level is not credit-less as modeled in Calvo (2006). Instead, they pointed out that on average firms substitute short-term credit with long-term external finance either through long-term borrowing or capital issuance. Thus, they indicated that at micro-level, the

potential miracles are miracles in a very restricted sense, if at all, in that firms are not relying on short-term financing but relying long-term financing. These findings on both macro and micro levels have significant policy implications for the role of credit market in stimulating the recovery of from a financial crisis. As the East Asian crisis episodes are identified with Phoenix Miracles, later in the thesis, I will study what specific policies were taken by each country in response to the crisis.

### **C. Institutional Development:**

While there is still much controversy over the impact of trade liberalization and financial integration, the discussions on role of institutions and governance reach much more consensus among economists and scholars. Most of the studies that were able to demonstrate the positive impact of trade liberalization and especially financial integration have to use the factors of a sound macroeconomic condition, good governance, high level of human capital, and a deep financial market. Prasad (2003) generalized these factors as a country's absorptive capacity, which he believed to be the preconditions for financial globalization. Foreign capital flows do not seem to generate productivity spillovers to domestic firms for countries with relatively low absorptive capacity, for example low levels of human capital. Another factor is good domestic governance which includes control of transparency, corruption, rule of law, and financial supervision. Prasad (2003) indicated that countries with a low degree of transparency tend to experience a greater volatility of capital inflows. For instance, in times of crisis, herding behaviors are more severe in such countries, which leads to the instability of their financial markets. To further analyze the role of transparency in attracting FDI and mitigating volatility, Gelos (2005) distinguished between corporate transparency and government transparency. Governance transparency includes data transparency and

macroeconomic policy transparency. Corporate transparency depends on the level of accuracy and sufficiency of financial disclosure. They were able to give out clear evidence that funds systematically invest less in less transparent countries, and tend to withdraw their investment quickly from those nontransparent countries during crisis.

Just as how much emphasis is put on the necessity of transparency, the same caution is directed to the control of corruption. Corruption has a strong negative effect on FDI inflows both quantitatively and qualitatively. Corruption might distort the diversification of capital inflows' structure, which makes a country more vulnerable to the risks of speculative attacks and contagion effects. Moreover, Dollar (2002) added that outright corruption in customs administration might distort the enforcement of tariffs. Prasad (2003) suggested that reducing corruption would be more effective in attracting FDI without having to practice tax concession and exemptions, which would reduce tax revenue.

Besides transparency and the control of corruption, good governance also is reflected in sufficient supervisory and regulatory capacity. Radelet (1998) indicated that inadequate regulation and supervision of financial institutions, together with growing short-term foreign debt, and rapidly expanding bank credit can increase the fragility of a country's financial market to a rapid reversal of capital flows as in the case of the East Asian Crisis in 1997. He then suggested that in order to prevent or manage future crises, developing countries should discourage short-term international financing either through administration and monitoring or taxation. Improved supervision characterized by quantitative control or taxation might not guarantee a certain amount of short-term debt, however, its influence is significant. Instead of building up short-term debt as an action during financial liberalization, countries should

consider further liberalization of long-term capital flows, which embrace little risk and also have long-term benefits.

As was mentioned at the beginning of this section, the positive effects of trade openness come in hand in hand with sound macroeconomic conditions. Dollar (2002) went further in supporting this point. There was no significant evidence on the relative importance of trade and quality of institutions on growth. Instead, these two factors often have high correlation, which implies their important joint role, especially in the very long-run. In the short-run, however, changes in trade policy seem to have more considerable impact on growth than changes in quality of institutions. One possible explanation for their correlation in the long-run is that trade and institutions do not only exert impacts onto growth but also have interactive impacts on each other (Kappel; (2004)). High trade barriers protect high production cost as well as high transaction costs caused by low-quality institutions. In other words, low-quality domestic institutions do not feel the urge to improve themselves as long as there is still high trade protection. Although Kappel (2004) emphasized the importance of trade policy, he indicated that openness is not only influenced by trade policy, but also by other policies, and the quality of institutions. His paper ended with a conclusion that liberal trade policies such as reducing trade barriers are recommendable, but must be complemented by sound macroeconomic management, micro- policy to strengthen domestic competition, and institutional improvements. Besides trade policy reforms, a country should also consider policy changes aiming at reducing large government deficits, controlling the inflation rate, maintaining market-oriented exchange rates, reducing government corruption, improving the education system, and strengthening the legal system (Baldwin 2003, p27). The accomplishment of these goals is not likely to be achieved in a short period of time, but they

can generate sustainable benefits for the economy of a country in the long-run. Without these actions, a developing country might experience the acceleration of growth immediately after liberalization due to an investment boom and a surge in portfolio and debt inflows, but may not grow faster or might even experience temporary growth reversals in the medium to long run. According to Bussière (2008), in the long-run, what matter are the quality of institutions, the composition of capital flows, and the sequencing of reforms. By sequencing of reforms, he did not mean any specific formula that can apply to every country and guarantee the effectiveness, but rather the sequencing of reforms differs from country to country, highly depending on the specific condition of each country.

To end this section, I would like to quote Mishkin (2011) who give an overall view of the impact of financial globalization on a country's economy.

“Financial globalization lowers the cost of capital, improves its allocation, and promotes the development of property rights and institutions, such as the financial system. Nations can develop only if funds flow to their most productive users. Financial institutions promote capital allocation by overcoming the problems of adverse selection and moral hazard, which means that prudential regulation and supervision are needed for a well-functioning financial system.”

## **Chapter III**

### **Cross-Country Analyses of Real GDP Growth and Economic Openness**

#### **A. Real GDP Growth and Output Volatility During 1990-2010**

Over the last two decades, the countries of Southeast Asia grew extremely rapidly. The five leading performers- Thailand, Indonesia, Malaysia, Philippines, and Vietnam grew at an average of 5.5% per year in per capita terms between 1990 and 2010. Growth rates of this magnitude and duration remind economists of the growth rates of the four Asian Tigers (Singapore, Hong Kong, South Korea, and Taiwan) during 1965-1990 (Radelet; (1998)). In fact, the five developing countries (Thailand, Indonesia, Malaysia, Philippines, and Vietnam) are regarded as the Tiger Cub Economies, as they prove to have the great potential to grow extensively in the future, competing with the long-time developed economies.

Despite the long-term high rates of growth, on the year to year basis, the five Southeast Asian countries have experienced a number of ups and downs during 1990-2010. I use the standard deviation of real GDP growth rate as a measure for the output volatility of the each country. Table 3.1 shows that the three countries that have the highest output volatility levels are

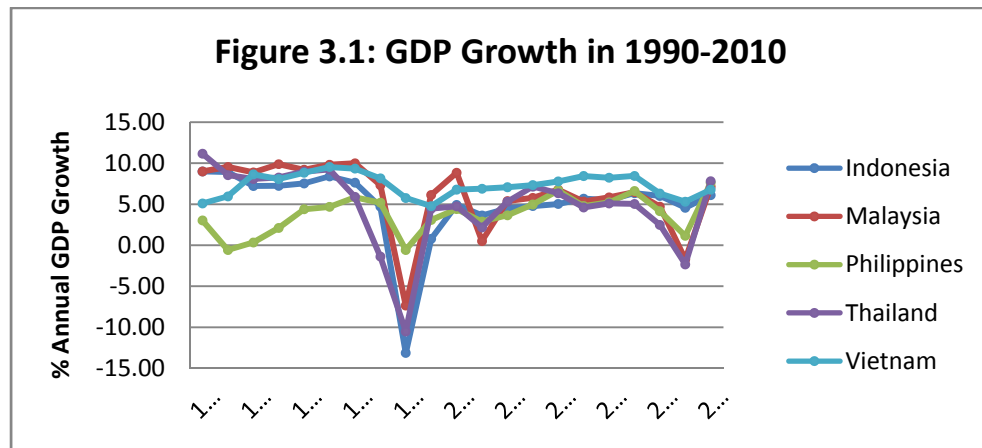
Thailand, Indonesia, and Malaysia respectively, while Philippines and Vietnam have noticeably lower levels of volatility.

<b>Table 3.1</b>	
Country	Standard Deviation of Real GDP Growth Rate During 1990-2010
Thailand	4.85
Indonesia	4.58
Malaysia	4.29
Philippines	2.29
Vietnam	1.40

Source: Data compiled from <http://databank.worldbank.org>

The fact that the five countries still share relatively similar average GDP growth rates in the long run might imply that those highly volatile markets were able to recover quickly to their previous levels of growth after an economic shock. In other words, economic openness might lead to more volatility, but it might also help economies recover faster. In the next chapter, I will study if this is the case for Thailand, Malaysia, and Indonesia.

By further studying the GDP growth patterns of these five countries, I notice some other interesting points. Figure 3.1 shows that there were similar time periods in which these countries all had significant output volatility: 1997-1998, the early 2000s, and the late 2000s. Putting these time periods in the context of the world economy, I realize that these time periods relate closely with the well-known economic episodes: the Asian financial crisis in 2007, the early financial crisis in 2001 that affected mostly developed countries, and the global financial crisis in 2008. Since volatility at other times is less noticeable and less consistent among the five countries, for the sake of comparison, I will focus on how these five countries were affected by these three specific economic shocks.



Source: Data compiled from <http://databank.worldbank.org>

The East Asian crisis is a regional crisis since it started in Thailand, and those countries that were affected the most were the East Asian countries. In his study of emerging markets' financial crises, Calvo, Izquierdo, and Talvi (2006) provided the level of output contraction that Thailand, Indonesia, Malaysia, and Philippines experienced during the East Asian financial crisis in 2007. With severe levels of output contraction, Thailand (-11.7%), Indonesia (-13%), Malaysia (-7.4%) were categorized as having a collapse in their output. Philippines was luckier when their output only dropped by 0.58%, a contraction that was believed to be mild compared to its peers. Vietnam was not included in Calvo, Izquierdo, and Talvi's study because despite the severe impacts that the Asian crisis had on the four other countries, Vietnam was still able to keep a positive output growth of 5.8%, decreasing from 8% the year before.

Unlike the East Asian crisis, which originated in Thailand, the recession in early 2000s was a decline in economic activity that occurred mainly in developed countries. The recession affected the European Union mostly during 2000 and 2001 and the United States mostly in 2002 and 2003. Japan's 1990s recession continued. Since the U.S., the European Union, and Japan are the major trading partners of our five Southeast Asian countries, it is important to keep in mind that these countries were deeply affected by the recession during this period of time. Their



decline in output growth as well as domestic demand might lead to a decline in trading activities, thus affecting the GDP growth of the Southeast Asian countries. Although Thailand, Indonesia, Malaysia, and Philippines did not suffer as much output contraction as during their regional crisis in 1997, the early 2000s recession still marked one of the three lowest points in the GDP growth patterns of these countries for the last two decades. This time, Thailand with a GDP growth of 2.89% was no longer the country that was affected the most, but instead, Malaysia's GDP growth rate dropped from 8.9% in 2000 to 0.52% in 2001. Thailand's decline in GDP growth was followed by those of Indonesia and Philippines, respectively. Once again, Vietnam is seen as an exception because the country's GDP growth (6.9%) even increased slightly from last year's rate (6.8%).

So far, I have followed the GDP growth patterns of the five countries during their regional crisis as well as an out-of region recession. Now I will look at the global financial crisis in 2008- the most recent crisis. The crisis is considered by many economists to be the worst crisis since the Great Depression in 1930s. The bursting of the housing bubble, followed by the collapse of the banking system in the U.S. damaged financial institutions globally. This financial crisis led to a severe global economic recession in 2008. As the crisis 2008 and its consequences still remain as one of the hottest topic in today's economic discussions, more often than not the attention is directed toward the giant economies such as the U.S., the European Union, and Japan. During this period of time, however, countries in Southeast Asia also suffered a plunge in GDP growth. Similar to the two crises that are mentioned earlier in this thesis, during this 2008 crisis, Thailand (-2.3%) and Malaysia (-1.7%) were the two countries that were affected the most, Philippines's growth (1.2%) did decline but to a much smaller extent, and Vietnam's growth (5.3%) decreased even less than Philippines. The noticeable difference is that Indonesia's GDP

growth (4.58%) was only slightly affected by this outer shock. In the next chapter, I look to explain this phenomenon of Indonesia: what the country has done between the early 2000s crisis and the late 2000s crisis to make the country's output growth less volatile to outer shocks.

To compare and contrast the impacts that the three crises had on the five countries, I summarize how each of the five Southeast Asian countries reacted and recovered during crises. Economic shocks affected Thailand and Malaysia more than the other countries. Indonesia used to be vulnerable to economic shocks; however, toward the end of 2000s, this observation was no longer accurate. Although Philippines still resembles the ups and downs periods of Thailand, Malaysia and Indonesia, Philippines's output growth fluctuated within a much smaller magnitude. Throughout the course of twenty years, Vietnam has been an exception because the country's growth rate has been relatively stable at a high average level of 7.2%. These observations pose some questions that I want to address in the next chapter. First, why were Thailand's economy and Malaysia's economy much more volatile than those of the other three countries, especially during times of crises? More importantly, what helped them recover quickly to the pre-crisis level? Second, why has Vietnam been able to maintain relatively high level of growth while it seems to be immune to outer shocks?

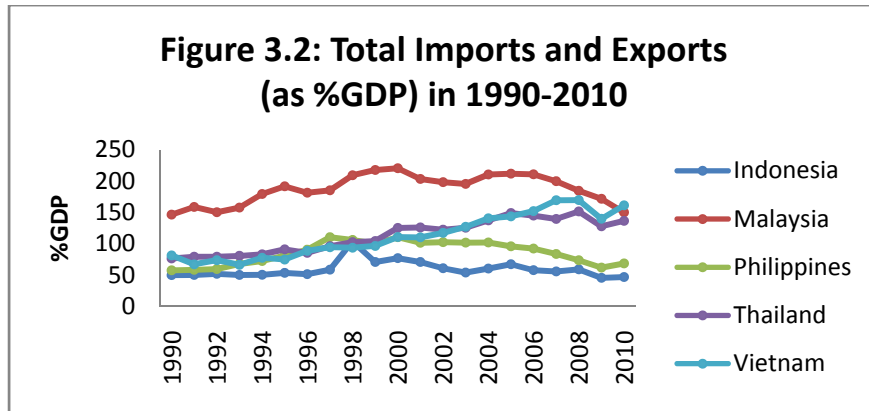
#### **B. Level of Economic Openness:**

Over the last two decades, parallel with the rapid growth rates, the five Southeast Asian countries have also taken major moves in opening their economies. In the next chapter, I want to address the question of whether it is this outward orientation that makes them rise as the highly potential markets competing with other emerging countries in Eastern Europe, Latin America, and even two largest developing countries in Asia: China and India. In doing so, I will first compare the level of economic openness in these countries. There are two major indicators of

economic openness, which are trade liberalization and financial integration. Besides, institutional development also plays a major role in deciding the level of economic openness of a country although it takes more effort to quantify this indicator. This section therefore, analyzes those indicators to compare the level of economic openness among the five countries as well as point out any peculiar characteristics in each country's liberalization process.

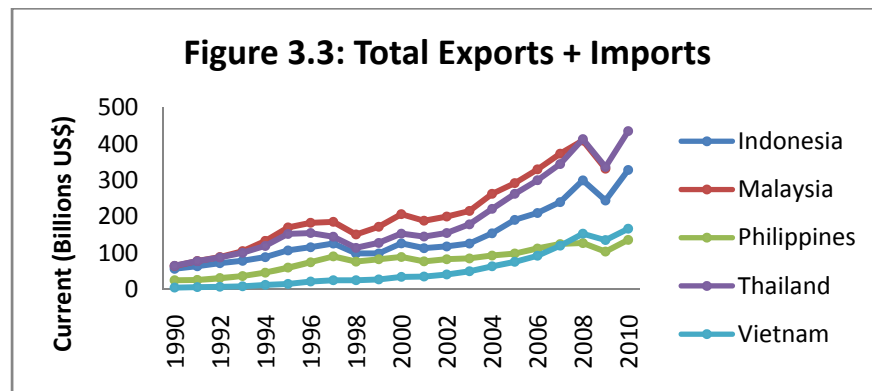
### **1. Trade Liberalization:**

In this thesis, trade liberalization is measured based on the value of total imports and exports of a country as a percentage of its real GDP. According to figure 3.2, since the early 1990s, Malaysia's exports and imports were already equal to 150% of the country's real GDP. Malaysia was able to maintain or even increase slightly this rate till 2006 despite some noticeable fluctuations in 1996-1997, and 2002- 2003. Since 2006, however, Malaysia's total imports and exports have dropped from 210% of real GDP to 150% of real GDP in 2010. Meanwhile, Thailand, Indonesia, Malaysia, and Vietnam started with a much lower level of imports and exports compared to their real GDP, only equal to around 50%-80% of each country's real GDP. Over the last two decades, the gap in trading volume as percentage of real GDP among countries have been narrowed down. Toward the end of 2010, Thailand's, Vietnam's, and Malaysia's values of exports and imports as percentage of real GDP almost converged. These figures indicate that Malaysia is the country with the highest level of trade liberalization among the five countries. Since Malaysia also has a relatively high level of output volatility, especially during the last three crises, this indication supports the argument that a country with higher level of trade liberalization incurs more output volatility.



Source: Data compiled from <http://databank.worldbank.org>

It is important to note that figure 3.2 only illustrates the level of trading activity as percentage of each country's real GDP. In order to further compare the trading volumes among the five countries, I shall use figure 3.3, which graphs the trading volumes of the five countries in current U.S. dollar.



Source: Data compiled from <http://databank.worldbank.org>

According to figure 3.3, Thailand, Indonesia, and Malaysia shared almost the same starting point of trading volumes in early 1990s. Thailand and Indonesia, however, have much larger economies in terms of real GDP than Malaysian economy, thus, when using each country's real GDP as benchmark, Malaysia seems to have a higher level of trading activity than the other two. In fact, in terms of current U.S. dollar, Thailand and Malaysia have quite similar trading patterns. As a much smaller economy, while Vietnam's imports and exports seem to catch up in terms of

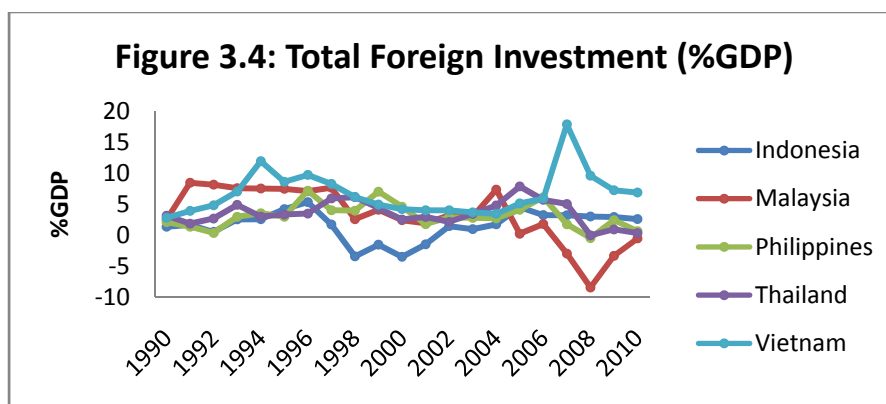
percentage of GDP, the current U.S. dollar value is still much lower. Although the current U.S. dollar value of Indonesia's imports and exports did increase, this rate must be lower than the rate of GDP growth, since Indonesia's trading activity did not show any remarkable increase in terms of percentage of real GDP. The case of Philippines even better illustrates that the growth rate of GDP is much faster than the growth rate of trading volume. Although trade liberalization is not the only factor that drives trade volume, changes in trade volume can still give us some sense on their trade liberalization. Therefore, I would like to conclude that Malaysia with a long-time high level of trading activity has slowed down slightly in trading liberalization, Thailand and Vietnam are accelerating their trading liberalization, Indonesia and Philippines do not seem to focus much on increasing trading volume in the process of economic openness.

In addition, during 2008 global crisis, all five countries experienced a drop in their total imports and exports. It seems that in countries with larger trading volumes such as Thailand, Malaysia, and Indonesia, the losses were even more severe. One possible explanation is that during crisis, the trading amounts cut by developed countries with each of their trading partners are different. In other words, to keep the diversification of trading products, developed countries might maintain the already low level of trading with countries such as Philippines, and Vietnam, while cutting much more from trading with Thailand, Malaysia, and Indonesia. This reduction in trading volume, therefore, might depend on what types of goods are traded in each country.

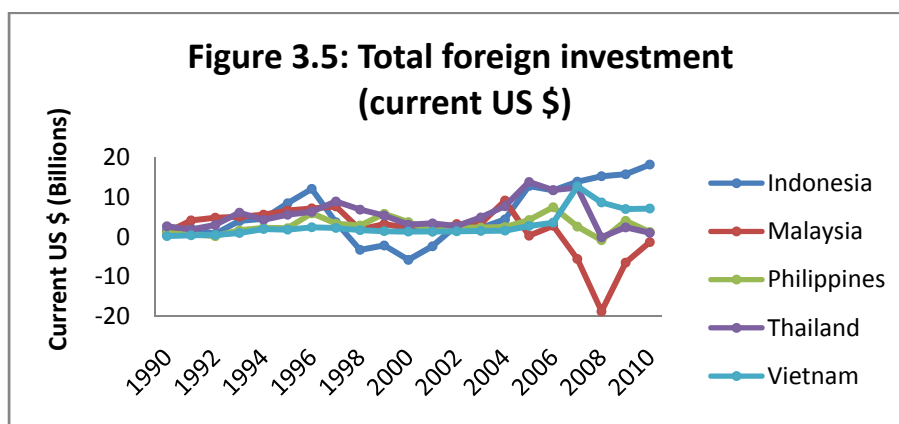
## **2. Financial Integration:**

In this thesis, I use the net inward investment as the measure for a country's financial integration. Net inward foreign investments include two major channels of capital inflows: foreign direct investment and foreign portfolio investment. In the next chapter, I will elaborate more on the difference between these two categories of capital inflows, and also their roles in

making a country's real GDP either more volatile or less. For this section, I want to compare the net inward foreign capital invested in each country to study whether increase in financial integration positively correlates with real GDP's volatility. According to figure 3.4, foreign investments as percentage of real GDP in each country seem to have high frequency fluctuations and quite differ from each other. Figure 3.5, however, helps us better understand where this difference comes from. By looking at the amounts of foreign investments in current U.S. dollars, I see Thailand, Malaysia, and Philippines' foreign investment were quite close to each other until around 2005. Not until 2005 did significant divergence start taking place. Therefore, the differences shown in figure 3.4 can be explained by the differences in GDP magnitudes of the five countries.



Source: Data compiled from <http://databank.worldbank.org>



Source: Data compiled from <http://databank.worldbank.org>

Note some steep drops that are shown in both figures. During the East Asian crisis, while all countries experienced a decrease in foreign investments, Indonesia's foreign investment dropped severely from 5.3% in 1996 to (-3%) in 1998. During the 2008 global crisis, however, while all four countries' foreign investments plunged, Indonesia was still able to keep a relatively stable foreign investment amount as percentage of real GDP. In the next chapter, I want to go further in studying how Indonesia has improved its financial system to make it less volatile. Another country that should be studied is Malaysia. Malaysia's foreign investment has been decreasing continuously for the last two decades. Malaysia ranked fourth in the world for foreign investment in 1990, but it was ranked 62nd in 2005 (Mun; (2009)). Most noticeably, during the 2008 crisis, Malaysia experienced a substantial decline in foreign investment from 7.3% in 2006 to (-8%) in 2008. This decrease in foreign investment might be one of the reasons that Malaysia has such a high level of output volatility over the last two decades. An explanation for this constant decrease in foreign investment in Malaysia has to do with not only the global crisis but also other factors such as governance, policies, and economic environment, which will be addressed in the next chapter. In contrast with Malaysia, Vietnam had a major increase in foreign investment in 2007. Capital inflow reached 17%- the highest level in terms of real GDP among the five countries. The fact that foreign investment did not significantly pick up till 2006-2007 might partially explain why Vietnam was able to maintain a relative stable real GDP growth over the 1997 crisis and the early 2000s crisis. Although this historically high investment rate was partly due to the small size of Vietnam's economy compared with Thailand's and Indonesia's economy, Vietnam actually showed strong intentions of liberalizing its financial market and its ability to attract foreign investment. This high rate did not last for long, however, as the global crisis arrived in 2008, foreign investment in Vietnam dropped to 7.21% in 2009.

Although Thailand's fluctuations in foreign investment were not as large in magnitude as those of Indonesia in 1996, and Malaysia in 2008, crises did affect much of Thailand's high level of foreign investment. This supports my finding earlier in this chapter that Thailand has such a high level of output volatility. The country that has the least fluctuation in foreign investment might be Philippines. Over the last twenty years, the country experienced a relatively stable amount of foreign investment, without any sharp drop or increase. It is likely that because of this stable and low level of foreign investment that Philippines's economy is not as volatile as countries such as Thailand and Malaysia.

In short, it is premature to either support or oppose the argument that a country with sufficient foreign investment is more likely to incur output volatility rather than real GDP growth in the case of the five Southeast Asian countries. In the next chapter, I will integrate other factors such as composition of foreign investments, investment policies, as well as threshold effects into consideration to draw a more definitive conclusion.

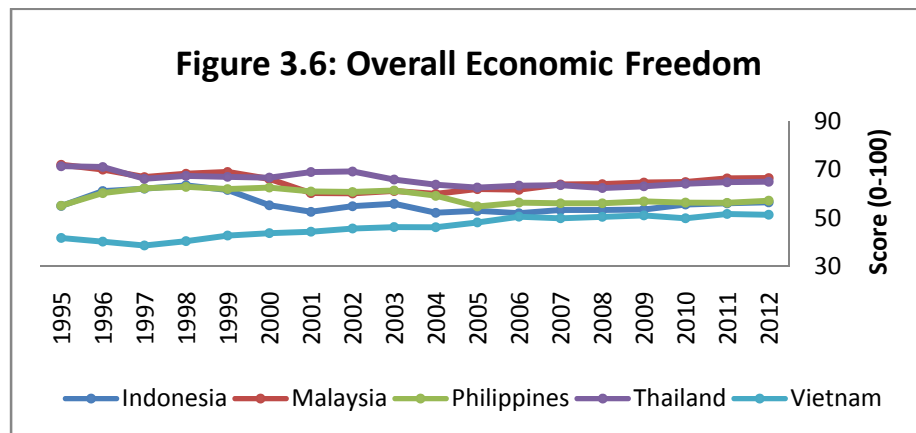
### **3. Institutional Development:**

In this section, I analyze the level of institutional development in these five Southeast Asian countries. Institutional development is just as important (if not more) as trade liberalization and financial integration because as I mentioned earlier in the literature review, most of the studies that were able to prove the positive impact of trade liberalization and especially financial integration have to use the factor of sound institutional development. Unlike trade liberalization and financial integration, however, there is no single indicator that can sufficiently measure a country's institutional development. Therefore, in order to compare this indicator among the five countries, I use three resources: the Index of Economic Freedom by



Heritage Foundation, the Corruption Perception Index by Transparency International, and the State Fragility Index by Polity IV.

First, the Index of Economic Freedom assesses the liberty of individuals to use their labor or finances without undue restraint and government interference. To do so, the Index measures ten separate areas of economic freedom: property rights, freedom from corruption, fiscal freedom, government spending, business freedom, monetary freedom, and the development level of financial market. Each of the freedoms is individually scored on a scale from 0 to 100<sup>2</sup>. A country’s overall economic freedom score is the simple average of its scores on the 10 individual freedoms. According to the index, Malaysia and Thailand are categorized as the moderately free group which includes countries ranging from 60 to 69.9/100. Indonesia, Philippines, and Vietnam fall into the mostly unfree group which includes countries ranging from 50 to 59.9/100. In addition, as shown in figure 3.6, there has been a trend of convergence among the five countries’ economic openness.



Source: The 2012 Index of Economic Freedom at <http://www.heritage.org/index/default>

Since 1995, Vietnam seems to have a continuous increase in economic liberalization, while the four other countries remained at the same level, or even reduced slightly. Since 2006, Vietnam’s

<sup>2</sup> Please refer to Figure 3.8 in the Appendix to see individual scores on the 10 freedoms in 2011

economic openness has been very close to that of Indonesia and Philippines. It is likely that in the near future, Vietnam will be able to catch up with Thailand, and Malaysia.

While the ten factors are all important in making up the overall economic openness of a country, I find freedom from corruption should be the priority. By distorting the policy-making process and also the efficiency of any government regulations on customs practice, financial supervision, and business opening, corruption can exert the negative impact on the whole economy. Even more directly, a country with high level of corruption will drive foreign investment away or lead to inefficient allocation of those capital flows. Because of its significance, I decide to use the Corruption Perceptions Index by Transparency International to specifically study the corruption status in each country. On a scale of 0 (highly corrupted) to 10(very clean), the index measures the perceived levels of public sector corruption in 185 countries. Based on their scores, countries' corruption levels are also ranked among those of others. Since we already have the big picture of each country's overall economic freedom during the last two decade (figure 3.6), for this corruption index, I only pick data from year 1996 and year 2008, which are the periods right before the East Asian crisis, and the global crisis respectively.

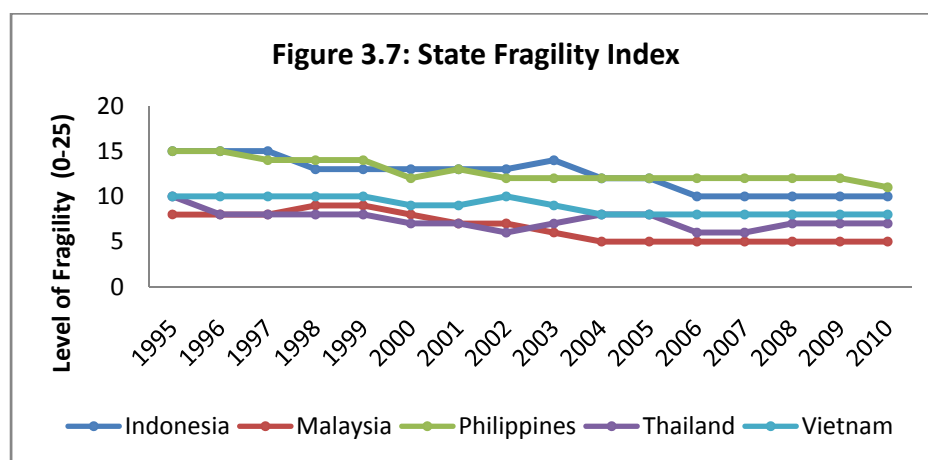
<b>Table 3.2: Corruption Perceptions Index</b>					
Year	Indonesia	Malaysia	Philippines	Thailand	Vietnam
1996	2.4 (130)	5.0 (44)	2.5 (121)	3.6 (63)	2.6 (111)
2008	2.6 (126)	5.1 (47)	2.3 (141)	3.5 (80)	2.7 (121)

Source: Transparency International

As shown in the table 3.2, in 1996, Indonesia, the largest economy in Southeast Asia, is also the most corrupted country among the five, followed by Philippines and Vietnam. There is a significant gap between Thailand and these three countries, and another significant gap between Malaysia and Thailand. Note Malaysia scores 5.0, while the majority of all 185 countries and

territories assessed score below 5.0. Looking into 2008, no significant improvement on corruption has been detected in the five countries. Instead, Thailand and Philippines' levels of corruption even got worse compared with that in 1996. Thailand ranked 63/185 in 1996, but only ranked 80/185 in 2008. Philippines ranked 121/185 in 1996, but only ranked 141/185 in 2008.

Besides economic freedom, a country's long-term growth also depends on other performance dimensions such as security, political, and social. To capture these factors, I will use the State Fragility Index by Polity IV. The index assesses a country's capacity to manage conflict, make and implement policy, and deliver essential services and its systemic resilience in maintaining system coherence, cohesion, quality of life; responding effectively to challenges and crises, and continuing progressive development. Each of these factors is measured separately before being combined to give out the state fragility index. The index ranges from 0 "no fragility" to 25 "extreme fragility". On that scale, Indonesia and Philippines are considered to have serious state fragility (ranging from 12 to 15); Vietnam's government is moderately fragile (ranging from 8 to 11); while Thailand and Malaysia seem have low fragility (ranging from 4 to 7).



Source: State Fragility Index and Matrix 1995-2010 at Polity IV

Furthermore, as shown in figure 3.7, there are some major improvements in countries' levels of fragility. During 1990s, Indonesia and Philippines were at the upper bound of serious

fragility category. Since the late 2000s, Philippines has moved to the lower bound of the serious fragility category, and Indonesia has even joined the moderately fragile countries. The considerable improvement in stability in Indonesia might be explained by the fact that president Suharto's era ended in 1998 after 34 years. Although Suharto's presidency brought about economic growth and industrialism, there were riots to fight against his authoritarianism and the administration's widespread corruption. After Suharto's era, Indonesia has made a transition into democracy. Malaysia also made a significant progress from a moderately fragile level to a low fragile level. Meanwhile, Thailand's fragility status has fluctuated significantly with the peak in political instability in 2006. In 2006, the Royal Army staged a coup against the elected government of Prime Minister Thaksin Shinawatra. The coup was the first non-constitutional change of government in fifteen years, and followed a year-long political crisis involving Thaksin, his allies, and political opponents.

In short, the three indexes have shown a relatively consistent picture of each country's economic openness, political stability, and governance. Among the five countries, Indonesia's government is the most corrupt. Although there have been very few riots under the new democratic administration for the last ten 10years, the country's ratings on freedom from corruption and economic freedom are still much behind those of Thailand and Malaysia. This factor might partly explain why it took Indonesia much longer to recover foreign investors' confidence after the East Asian crisis compared to Thailand and Malaysia. Much like Indonesia, Philippines also has a relatively high level of corruption, high state fragility, and low economic freedom. This might shed light on the fact that Philippines' total foreign investments have not increased much both in terms in US dollars as well as percentage of its GDP over the last two decades. These findings have some implications on the importance of institutional development

in regards to the process of liberalization as well as the speed of recovery after crisis. Countries with higher institutional development look more attractive to foreign investors. Moreover, during and after the crisis, those countries are also able to better maintain and/or recover investors' confidence;, thus they can recover faster after a crisis. In the case of Vietnam, it is still premature to draw out the similar conclusion since the country is a latecomer to the process of liberalization. Until the East Asian crisis, Vietnam's economic openness was still much lower than the four other countries, which might explained why the country did get affected much by the regional contagion.

## CHAPTER IV

### **Explaining the Differing Effects of Economic Openness on Each Country**

In chapter III, we gained a sufficient understanding of how the five Southeast Asian emerging markets are different from one another in their output volatility and their levels of economic openness. The major question that I want to address in chapter IV is what caused those differences. Many economists have studied a similar question, however, their focus, more often than not, is on the major emerging markets such as China, Brazil, India, and Russia. As I mentioned earlier in the literature review chapter, factors such as threshold effects, composition of capital flows, and a country's absorptive capacity have proved to play an important role in the effects of economic openness on emerging markets. In addition to those pre-existing factors, how domestic as well as international policy makers choose to react to the on-going crisis in each country also causes different speeds of recovery. In this chapter, I want to apply those factors to the specific situation of each of the five countries to see if those factors help explain what happened in those countries.

#### **A. The Threshold Effects**

##### **1. Trade Liberalization**

When countries want to increase their trading volumes, they have to consider two factors: the products and the trading partners. Specifically, for exports, they need to find their competitive advantage in producing certain kinds of products, and then figure out what markets would have demand for those products. For imports, countries would want trading partners who

can offer products at lower prices than they could produce by themselves. If that were always the case, then there should not have been any doubt about the positive impacts of trade openness. There is a risk, however, that either the supply or the demand from trading partners can fall, especially during crisis times. To reduce risk, in economics and finance, diversification has been the rule of thumb. Indeed, Haddad (2009) pointed out that there is a threshold effect: as long as the top 10 exports products account for less than 60 per cent of a country's total export value, then that country will experience the benefits of trade openness rather than volatility. According to Haddad's model, during 2001-2005, Malaysia (49.9%), Indonesia (39.3%), and Thailand (30.9%) were all below the threshold; the Philippines (69.1%) were not. Although Vietnam was not included in his study, the country's official statistics show that as of 2005, Vietnam was also above the threshold: 69.2% of the revenues came from seven biggest currency earners, namely crude oil, garment and textile, footwear, seafood, woodwork, electronics appliances, and rice<sup>3</sup>. Furthermore, if we compare the level of product diversification among the three countries, trade openness must have worked even better in Thailand than in Indonesia and Malaysia. This implication is, indeed, consistent with what Chansomphou and Ichihashi (2011) concluded in their paper. The authors indicated that although trade also had a positive impact on Indonesia and Malaysia, its impact was relatively smaller than that of Thailand before and after the 1997 financial crisis. This finding can help explain why it did not take Thailand long to recover from the Asian crisis. Indonesia's and Malaysia's recovery followed that of Thailand. For Philippines, Chansomphou and Ichihashi indicated that trade openness seems to perform well before the crisis, but after the crisis, trade openness lowers income per capita. Although product diversification seems to help countries recover more quickly from economic shocks, countries

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<sup>3</sup> Vietnam: Overview of Seven Biggest Currency Earners in 2005. Available at [http://www.business-in-asia.com/vn\\_seven\\_top\\_revenue.htm](http://www.business-in-asia.com/vn_seven_top_revenue.htm)

such as Thailand, Malaysia, and Indonesia's real GDP growth still plummeted significantly during crisis. I, therefore, assume there must be other factors in economic openness that account for such volatility in emerging markets.

## **2. Financial Integration**

Another threshold effect that economists have found to be useful in forecasting the impact of economic openness on country's growth performance is the level of financial development and financial integration. According to Khadraoui (2010), financial development is measured by ratio of credits for private sector divided by GDP, and financial integration is measured by ratio of net private capital flows divided by GDP. Based on his model, Khadraoui concluded that the level of threshold of financial development is estimated to be around 50%. Financial integration is associated with the highest volatilities of growth rates if the level of domestic financial development is below such threshold. In his paper, Khadraoui studied two major groups of countries: the developed countries, and the developing countries over the period from 1970 till 2009. Among the developing countries, he further divided them into the more financially integrated (MFI), and the less financially integrated (LFI). Although Thailand, Malaysia, Indonesia, and Philippines were categorized as MFI countries, they were still well below the threshold. As presented in Khadraoui's model, all the countries that have a degree of financial integration above this threshold are industrial countries. The study did not include Vietnam. Further research, however, shows that despite the substantial escalation in capital flows into Vietnam in late 2000s, the country's level of private capital flows was 8.9% GDP as of 2010. Even when Vietnam reached its highest value of capital flows in 2007, the level was only 17.97% GDP<sup>4</sup>. Since all the five countries are well below the threshold number for financial integration,

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<sup>4</sup> Vietnam- Private Capital Flows. Available at <http://www.indexmundi.com/facts/vietnam/private-capital-flows>



a high level of volatility that is reflected in the real GDP growth graph, especially during crisis times, is expected.

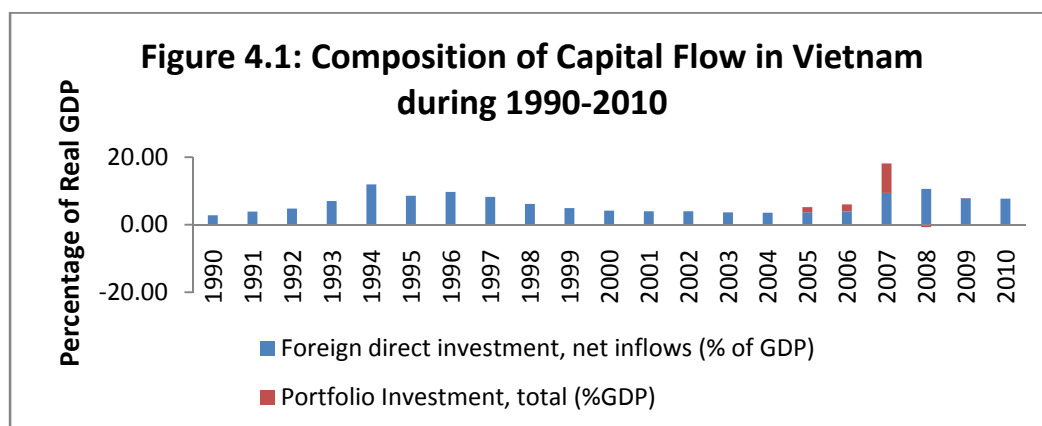
This threshold effect also has another implication on the sequence of the opening process: whether a sufficient financial development should be in place first or financial development will come as a result of financial integration. The fact that the five Southeast Asian financial markets are below the threshold effect and have experienced great GDP volatility supports the first hypothesis: domestic financial system has to be a prerequisite for the effect of successful financial integration. In fact, Khadraoui (2010) concluded that although financial integration can catalyze financial development, improve governance, and impose discipline on macro policies, without a basic pre-existing level of these supporting conditions, financial integration can aggravate instability. Given the knowledge of that threshold effect, the five countries should put efforts toward developing a broader range their financial market, as well as greater financial depth. By paying attention to these factors during their transition to the threshold, countries might be able to reduce the risk, but cannot eliminate it.

## **B. Composition of Capital Flows**

In the previous section, I discussed the financial integration threshold based on the ratio of the net private capital flows divided by the GDP. In this section I want to point out that not only the quantity factor matters, but the quality factor is also equally important. In other words, different kinds of capital flows are associated with different levels of risk. There are two major categories of capital flows: foreign direct investment (FDI) and portfolio investment. An inflow of investment to acquire 10 percent or more of voting stock is considered FDI, while any investment that accounts for less 10 percent of the domestic company's shares is categorized as portfolio investment. This fundamental difference between FDI and portfolio flows leads to a

number of other differences between the two categories. First, because more often than not FDI investors directly get involved in the management of the domestic corporation, they face less asymmetric information issues between investors and company managers compared with portfolio investors. Consequently, portfolio investors may require a more sophisticated domestic credit market to mitigate these problems before they consider making their investment (Sakuragawa; (2006)). From the perspective of the country receiving the investment, since FDI is long-term capital flow, and portfolio investment is short-term capital flow, capital flows from FDI are believed to be more stable than from portfolio investment. Indeed, Frankel (1996) concluded that a low ratio of FDI to total capital flows is consistently associated with a high likelihood of financial crash. Since the five Southeast Asian financial markets are relatively young and shallow as compared to industrial countries, and even to other major emerging countries, these countries should take extreme caution in liberalizing short-term capital flows. On the other hand, the five countries should improve the investment environment to attract more FDI. A study of the actual composition of capital flows in the five countries during 1990-2010 shows that this recommended strategy reflects most visibly in Vietnam. As shown in figure 3.17, throughout the last two decades, FDI has consistently been the major investment channel into Vietnam. In her paper, Ngo (2009) indicated that until 2004, the foreign portfolio capital inflows into Vietnam were still insignificant due to the infant stock market and poorly developed money market. Around 2006-2007, besides the high level of FDI, Vietnam witnessed an amazing surge of foreign portfolio investment. This phenomenon is explained by two factors: the boom of Vietnam's stock market and the perceived attractiveness of Vietnamese economy after its WTO entry in 2007. Later in this chapter, I will go deeper in studying which changes in policy were used to stimulate this boom of Vietnamese financial market. This substantial level of portfolio

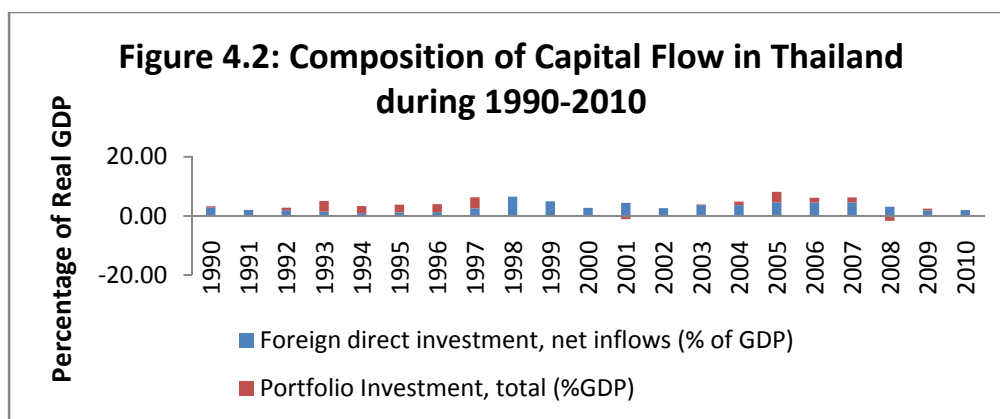
investment, however, did not last for long. Since 2008, foreign portfolio inflows in Vietnam have plummeted due to the capital flight effect of the global crisis. Meanwhile, FDI only incurred a mild reduction. Within the last decade, Vietnam has emerged as a leading recipient of FDI inflows (compared to the size of the economy).



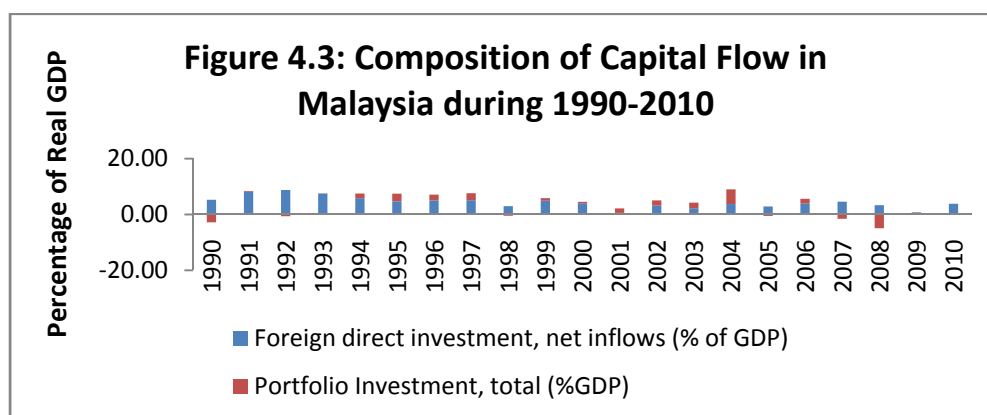
Source: Data compiled from <http://databank.worldbank.org>

As shown in figures 4.2 and 4.3, Thailand and Malaysia also maintained a relatively high level of FDI compared to portfolio investment, although this ratio is not as consistent as that of Vietnam. The higher proportion of portfolio investment in these two countries might be explained by the fact that they opened up their economies much earlier than Vietnam. Malaysia and Thailand were recognized by IMF as completing their member obligations to fully liberalize their current account in compliance with the Fund's Article VIII in 1968, and 1990 respectively, compared with 2005 for Vietnam (Ngo; (2009)). By further studying the fluctuations in portfolio investment versus FDI in Thailand, and Malaysia, I can point out that during crisis times, portfolio investment was the major contributor to the fall in the total capital flows. During 1993-1997, the two countries received significant amounts of portfolio investment inflows. These capital flows contributed to the rapid growth of the two countries, reinforcing their positions as the tiger economies in Asia. The financial crisis in 1997 brought about drastic changes in the Thai economy and Malaysian economy. Due to the deterioration in the investment environment,

perceived as riskier, the amount of portfolio investments in the two countries decreased significantly. During the early 2000s financial crisis and the 2008 global crisis, the same declining trends in portfolio investment can be seen. The reason behind this reduction might be because of the economic slowdown in foreign investors' country, rather than changes in domestic investment environment. Either in response to a regional shock or an out-of-region shock, FDI shows to be consistently less volatile than portfolio investment. The high level of portfolio investment followed by a significant drop during the crisis times might partly account for the great volatility in GDP growth that Thailand and Malaysia experienced. After the crisis, it does not seem that portfolio investment inflows returned quickly to their pre-crisis level, instead, FDI seems to have contributed to the quick recovery of the two markets.



Source: Data compiled from <http://databank.worldbank.org>



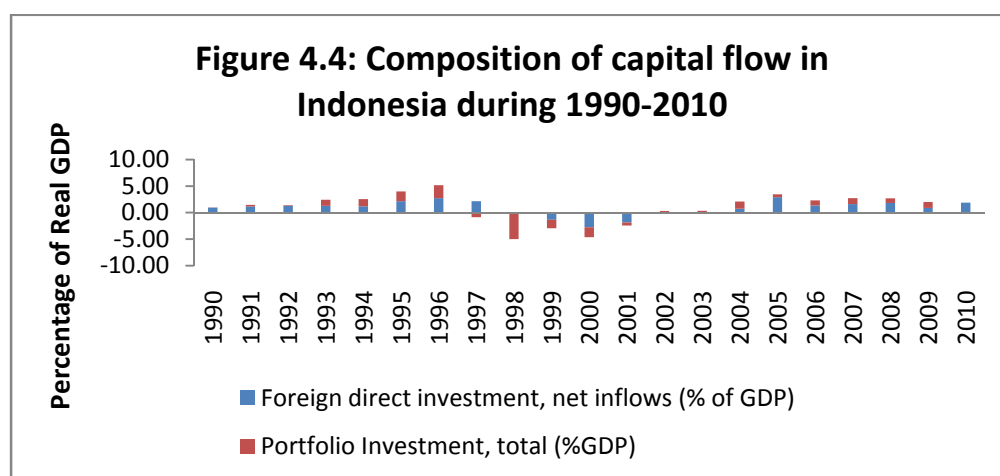
Source: Data compiled from <http://databank.worldbank.org>

Different from the four other countries, Indonesia's capital flows have not always generated a surplus. For years after the crisis, the capital inflows into Indonesia were smaller than the actual capital outflows from the country for loan servicing. From 1990 to 1997, the country's financial account ran a surplus; however, from 1998 until 2003, there was a deficit in financial account. As Goeltom (2008) explained in her paper, there are many casual factors for this. One is the reduction in government inflows, primarily due to less foreign grants for projects. For example, in 2000, grants from the Asian Development Bank, the International Bank for Reconstruction and Development, and Japan fell by 59%. In addition, food assistance also decreased by 73%. Another causal factor is the drop in private capital inflow, mainly due servicing private foreign debt. Capital outflow reached its highest level during the economic crisis period 1997-1998. Goeltom (2008, p.271) analyzed:

In July 1997, contagion from the balance of payments crisis in Korea and Thailand placed mounting pressure on the rupiah. With the domestic economy already fragile, the exchange rate turmoil quickly unfolded into a fully fledged financial and economic crisis in Indonesia. Externally, the exchange rate crisis triggered massive private capital flight with Indonesia's balance of payments recording a deficit for the first time since 1989/90. The rupiah value of foreign debt and debt servicing obligations soared, causing many companies to default.

During the Asian crisis, all affected countries also experienced capital flight, mostly in short-term investment. However, what made the crisis's impact on Indonesian economy more severe and unique was that the country suffered from substantial and sustained negative FDI inflow. Gray (2002) indicated that in Thailand, capital inflows actually increased in 1998, before falling back, but were still higher than pre-crisis level. In Malaysia, capital inflows fell sharply during the crisis but substantially recovered to the level close to pre-crisis peak. Meanwhile, in Indonesia, not until 2004 did foreign investment start flowing back into the country thanks to the improved macroeconomic stability. Capital inflows, however, were still lower than the pre-crisis

level, and mainly came from portfolio investment flows. The Indonesian government has been making efforts to attract more long-term investment in order to benefit from technology spillovers as well as reduce the short-term liability. Significant improvement in the country's investment environment has recently helped the country gain the investment grade rating by Moody's in 2011 after a 14-year interruption since the Asian crisis. Later in this chapter, I will go further in analyzing what macroeconomic fiscal policies as well as other measures have been implemented to help Indonesia regain its reputation as an attractive destination for foreign investments.

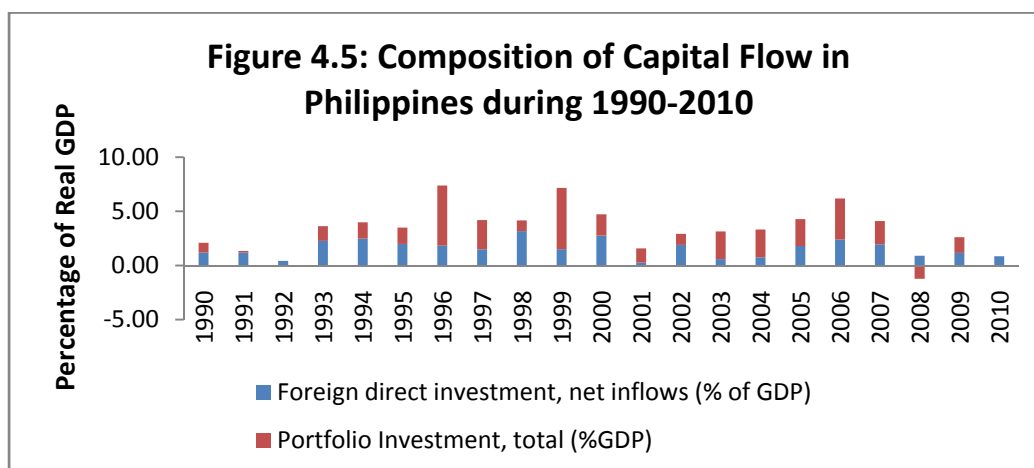


Source: Data compiled from <http://databank.worldbank.org>

As shown in figure 4.5, Philippines has a relatively high ratio of portfolio investment in relation to the total capital flow. The graph, however, also shows that during the Asian financial crisis, the Philippines' contraction was considerably less severe than those experienced by its neighbors. Indeed, Noland (2000) mentioned that on the eve of the crisis in mid-1997, the Philippines was still forecasted to grow at more than 6% in 1998- a rate faster than both that of most other low-income countries worldwide and the Philippines's pre-crisis performance. Since I have provided evidence that a country with a high level of portfolio investment is more vulnerable to internal and external shocks, this unique behavior of Philippines might be able to

point out some exception to that hypothesis. Many economists believe that the Asian financial crisis hit the regional countries through two main factors: weak domestic fundamentals and international contagion. Through studying these two factors, Noland (2000) concluded that Philippines endured the crisis more successfully than its neighbors because the country's financial system was in better shape and also the country had a uniquely low vulnerability to contagion. I will go further in studying the country's fundamental economic condition later in this chapter. For now I want to focus on the second factor and study how Philippines were able to insulate their economy from the financial market contagion in the region. As Noland (2000) pointed out, the country's strong stand during the crisis lay in the fact that Philippines had already had its financial crises, and as a consequence had implemented measures to strengthen its domestic financial system. After the debt crisis in 1980s, the country's policy makers had learnt the lesson and become more risk-averse, especially with short-term, fixed interest-rate bank debt. Most of capital inflows in Philippines in early 1990s were medium to long-term loans. Notably, Philippines was successful in issuing some medium-term bonds from government as well as private corporations in 1994. In addition, Philippines had relatively less exposure to Japanese banking lending due to low levels of Japanese foreign direct investment in the Philippines compared to other Southeast Asian countries, and policies that had encouraged non-Japanese banks in Philippines markets. In contrast, Thailand had half of the country's debt owed to Japanese banks. For the crisis in 1997, Japan was one of the most-affected countries. As the result, when Japanese banks refused to roll-over loans and even called existing ones during the crisis, countries such as Thailand, Indonesia, Malaysia's capital outflows were more severe. Beside Japanese banks, many of the Southeast Asian countries received "hot money" flows from mutual funds for the period before the crisis, and were seriously damaged by its sudden stop.

Luckily, around that time, foreign mutual fund managers had not perceived Philippines as an attractive investment destination. For all these major reasons, Noland (2000) then concluded that the crisis that hit Philippines in July 1997 was largely home-grown rather than regional contagion.



Source: Data compiled from <http://databank.worldbank.org>

In short, after studying the composition of capital inflows, together with the fluctuation of capital inflows in each of the five countries, I see that FDI tends to experience less volatility than portfolio investment, especially during crisis times. The risk of short-term capital inflows has shown to be much more severe compared with that of long-term investments. Therefore, it would be recommended for the countries' stable growth, FDI should be the focus and priority during countries' transition into a developed financial system. Once a country has reached a certain level of financial development, as in the case of Philippines compared to Thailand, Malaysia, and Indonesia around the 1997 crisis, the country might be able to protect itself from external shocks such as regional contagion and capital flight.

### C. Absorptive Capacity

Although in the previous sections, I was able to provide the threshold and other quantitative guidance for countries in transition to economic openness, much of the impact of



economic liberalization on growth and volatility still depends on such qualitative factors as sound macroeconomic conditions, human capital, rule of law, political and social stability. All these factors contribute to a country's absorptive capacity.

### **1. Human Capital and R&D**

The quality of human capital and the expenditure on research and expenditure (R&D) are considered the two major determinants of a country's productivity. In the process of economic liberalization, these two factors also play an important role in both maximizing the benefits of technology spillovers as well as attracting more foreign investments. More often than not, FDI investors not only invest money into a country, but they also provide frontier technology. Countries receiving investments, however, are different from each other in how they efficiently apply the new technology. Human capital, therefore, is a decisive factor in explaining these differences in efficiency. The capacity to quickly take on frontier technology also makes a country more attractive as an investment destination. Foreign investors tend to look for emerging markets where they can minimize training cost while still receiving the standard-quality products. In this thesis, the human capital is measured by the percentage of labor force with tertiary education, and the expenditure on R&D is measured as percentage of GDP.

Based on the most recent data in 2011 available from World Bank, among the five Southeast Asian countries, Philippines has the highest level of labor force with tertiary education (27%), followed by Thailand, and Malaysia with relatively similar level of 20%. Noticeably, Vietnam (9%) and Indonesia (6.5%) are much lower than the other countries.

On R&D expenditure, Malaysia has spent much more than the other countries with 0.63% GDP. Thailand and Vietnam follow with 0.24% GDP and 0.19% GDP respectively. Indonesia turns out to be country with the least spending on R&D with only 0.04% of their GDP.

Since Indonesia falls far behind the four other countries on both human capital and R&D expenditure, it might be helpful go further in learning about the country's policies on these subjects. Statistically, Indonesia's expenditure on R&D has always been very small, never exceeding 0.2% GDP, and mostly came from the public sector. The insufficient spending on R&D comes from several casual factors. First is the lack of investment in R&D from private sector. Multinational Corporations (MNEs) do not regard the country as a suitable base for R&D activity, owing to the weak skill base, the limited protection of intellectual property rights, and the absence of any significant public support for R&D. Most R&D activities have come from Indonesian Institute of Sciences, a major government agency, and from public universities. However, none of these institutions has received sufficient funding (Hill; (2010)). Another factor is insufficient allocation of resources due to corruption. As Basri (2001) clearly shows, most industries that received assistance were dominated by politically influential individuals, and the industries have tended to under-perform by the usual performance benchmarks. Indonesia's policy makers should improve these weaknesses so that the country can benefit from technology spillovers from foreign investment.

## **2. Policy Framework Toward Economic Liberalization**

For the last two decades, the five emerging markets have taken major changes in policy to liberalize their economy both in terms of international trade and financial system. Most of the new policies aim at attracting more trade partners and foreign investors through loosening domestic restrictions.

### **a) International Trade**

All five countries have pursued a triple-track strategy of international trade negotiations. This comprises the multilateral track under the support of the WTO; the regional track, which

focuses on ASEAN and ASEAN+1 regional agreements; as well as negotiation of bilateral trade agreements with developed countries. This strategy aims at an export-oriented, business-driven environment in order to expand international markets and support global efforts. While liberalizing trade, the five countries still protect national economic interests and maximize the potential benefits for national welfare. Among the five, Thailand seems to be the most ambitious in increasing its world export market (Tulyanond; (2005)).

The year 1995 saw the major forward movement of Thailand, Indonesia, Malaysia, and Philippines in trade liberalization as the four countries became members of World Trade Organization (WTO). Vietnam is a latecomer: not until 2007 did the country join the WTO. WTO allows the five countries to access developed markets at lower tariffs, while taking time to remove reciprocal tariffs in their own markets. This gives these countries an opportunity to adjust to sophisticated multinational corporations and their mature industries before opening the developing countries' markets to overwhelming competitive pressure. Since their commencement as WTO's member, the five countries have implemented a number of WTO's obligation to lower/eliminate tariffs and non-tariff barriers. In particular, the five countries accord "Most Favored Nation" (MFN) status to other WTO members, which means the countries give trade advantages either through low tariff or high import quotas to other WTO members. Besides, these emerging markets also set priority on agriculture trade reform to open markets, eliminate export subsidies, and make deep cuts in trade-distorting domestic support. Countries also lower/eliminate tariffs in sectors such as non-agricultural, manufactured goods, and information technology. The speed and level of liberalization in each sector varies to help domestic suppliers get prepared for the new level of competition with foreign suppliers. Besides reforms on tariffs, the five countries also reinforce property rights as another WTO obligation to

give more protection and incentive to foreign investors: patent applicants are required to disclose the origins of genetic material and any associated traditional knowledge used in inventions, and to show evidence of prior informed consent and benefit sharing.

Besides reinforcing the multilateral negotiations as members of WTO, the five Southeast Asian countries also tighten their regional cooperation with each other through the Association of Southeast Asian Nations (ASEAN) and the Asia-Pacific Economic Cooperation (APEC). Thailand, Malaysia, Indonesia, and Philippines are all founding members of ASEAN (1967) and APEC (1989). Vietnam did not join ASEAN until 1995, and APEC until 1998. As members of ASEAN, all countries have actively implemented the Common Effective Preferential Tariff (CEPT) which aims to enhance the ASEAN Free Trade Area (AFTA). Under the CEPT, it was agreed that tariffs on goods subject to tariff reductions would be reduced to 0-5% by 2002 for the founding members, and by 2006 for Vietnam. ASEAN members also promote cooperation among service suppliers in ASEAN over and above WTO commitments. Several packages of service sector liberalization cover construction, telecommunications, business services, financial services, air and maritime transparency and tourism. This involves preferential access for other ASEAN member states in the establishment of service entities and employment of professionals. By 2020, ASEAN also aims to establish the ASEAN Economic Community (AEC)- a single market providing for the free flow of goods and services, skilled labor and capital<sup>5</sup> The strong integration among the five countries does not only help foster the trading activities within the region, but also strengthens their bargaining power in negotiating with developed countries.

Besides the multilateral and regional tracks, each of the five countries has also improved their bilateral arrangements. Thailand has four free-trade or economic partnership agreements

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<sup>5</sup> WTO Trade Policy Reviews: Indonesia (2010), Thailand (2010), Malaysia (2010), Philippines (2005)

with Australia (2005), New Zealand (2005), India (for 82 goods tariffs lines, 2004), and Japan (2007). Malaysia has completed three bilateral free-trade agreements with Japan, New Zealand, Pakistan, and is negotiating with Australia, Chile, India, and the U.S. Indonesia has completed several rounds of Economic Partnership Agreement talks with Japan in 2005 and 2006. The country is now considering free-trade agreements with other potential trading partners such as the U.S., Pakistan, and India. Philippines completed its free-trade agreement with Japan in 2004. Philippines is in the process of negotiating with the U.S., and likely with Chinese Taipei. Although Vietnam is a latecomer in the international trade market, the country has achieved some significant results in trade liberalization. Among the five countries, only Vietnam has completed its bilateral trade agreement with the U.S. in 2001. The country is still in the process of negotiating with the European Union over a free trade agreement.<sup>6</sup>

#### **b) Foreign Investment:**

Over the last two decades, the five Southeast Asian countries have become the hub for foreign investment. It is indisputable that foreign investment, mostly in the form of direct investment (FDI), provides the five emerging markets plentiful resources to grow fast. However, in order to efficiently turn these resources into productivity and competitiveness, countries also need to have a sound policy framework. Therefore, in this section, I want to study what policies have been taken to attract more foreign investment in these countries, as well as what has been done to make sure the resources are best allocated. All the five countries more or less have to deal with similar weaknesses such as low education levels, a shortage of suitably qualified workers, intellectual-property rights violations, and red tape.

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<sup>6</sup> WTO Trade Policy Reviews: Indonesia (2010), Thailand (2010), Malaysia (2010), Philippines (2005)

Since 1990, Thailand has maintained a relatively open foreign investment regime. The country views foreign direct investment (FDI) as vital to the economy's growth, and encourages investors from all sources. There are more and more sectors fully open to foreign capital participation such as light manufacturing, pharmaceutical products, and food products. Despite the open policy framework, Thailand has been losing its leading position as an investment destination in Southeast Asia because of several causal factors. Political instability has eroded Thailand's competitiveness compared to that of Indonesia, and Vietnam. Investors are also concerned about policy unpredictability. For example, in 2009, Thailand decided to halt temporarily dozens of large-scale projects in Map Ta Phut, the country's biggest industrial zone.<sup>7</sup> The country also kept postponing the auction for third-generation mobile-telephony licenses. In addition, in 2011, Thailand had the worst flooding in 70 years. This made foreign investors, especially the Japanese companies--Thailand's biggest foreign investor-- consider diversifying their investment in neighboring countries such as Indonesia, and Vietnam.<sup>8</sup> Besides, Thailand is still working on infrastructure bottlenecks, particularly in and around Bangkok and the eastern seaboard. For all these reasons, during the late 2000s, FDI inflows into Thailand were less than those into Indonesia, and Vietnam.

Much like Thailand, Malaysia is also aware that FDI has been the driving force for its economic growth, bringing in capital investment, technology, and management knowledge. Thus, the government has been trying to encourage FDI by streamlining its regulatory framework, and removing/ reducing equity and other restrictions on foreign investment. In 2009, Malaysia raised foreign equity limits from 49% to 70% for stock-broking firms and unit trust management

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<sup>7</sup> WTO Trade Review Thailand 2010

<sup>8</sup> Teso, Y., D.T.Kate, *Thai Floods May Shift Japan Investments to Indonesia and Vietnam*. Available at <http://www.bloomberg.com/news/2011-11-14/thai-floods-may-spur-japanese-manufacturers-to-shift-output-to-indonesia.html>

companies, and from 70% to 100% for fund management companies providing wholesale services. In addition, there were some relaxations on the acquisition of property, as some property transactions involving foreign investment no longer require approval from the Foreign Investment Committee (FIC). Also in 2009, major reforms have been made in the service sector, which is identified as a leading growth engine. 100% foreign equity is allowed in 27 services subsectors, covering health and social services, tourism, transport, business services, and computer and related services. For new business openings, Malaysia has also developed a one-stop center (the Malaysian Industrial Development Authority) for evaluating applications for tax incentives, and promoting other investment facilitation measures. Malaysian incorporated companies, whether locally or foreign-owned, are encouraged to invest in targeted industries and activities through tax incentives. With all these considerate relaxation, the government looks to the future growth and development of the Malaysian economy.<sup>9</sup> Although the government considers FDI beneficial to the economic growth, they still maintain local participation in some areas to promote domestic capabilities and capacities. In particular, sectors that have an impact on national security and overall socio-economic wellbeing are not to be liberalized.

Sharing the same attitude toward FDI as Thailand and Malaysia, since the 1990s, Philippines has adopted more open and flexible policies toward FDI. The country accelerated the FDI liberalization process through the Foreign Investment Act (FIA) in 1991. The FIA allows foreign equity participation up to 100% in all areas not specified in the Foreign Investment Negative List. Overtime, this negative list has been reduced significantly. The Philippines has established a one-stop centre to facilitate the investment process, getting rid of the opaque and time-consuming regulations and procedures required by various government bodies. In addition,

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<sup>9</sup> WTO Trade Policy Review Malaysia 2010

Philippines offers incentives to multinational corporations that establish regional headquarters (RHQ) in the country. These corporations are exempted from all taxes, fees or charges imposed by a local government unit except real property tax. While Philippines has made substantial progress in liberalizing its FDI policy, the country still maintained barriers on certain sectors that have impact on national security such as mass media, land ownership, natural resources, and public utilities where foreign ownership is limited to 40% (Albada; (2006)).

As I mentioned in the previous chapter, foreign investment into Indonesia dropped sharply during and after the Asian crisis 1997/1998. Not until 2005 did capital inflows into the country start to pick up again. It is widely accepted that for the last decade, the Indonesian government has made significant progress in both restoring political stability and improving the investment class. The country's current president has been running Indonesia for two terms without destabilizing riots, or major cabinet crises, and no serious challenges to the presidency as used to occur under the dictator Suharto's regime. In terms of economic policy, the new investment policy package in 2006 addresses drastic reduction of the time needed to start a business, acceleration of the review process of non-business-friendly local regulations, and also streamlining of customs procedures and improvement of customs regulations. These political and economic reforms have removed some investor risks and improved market sentiment. In 2011, Indonesia gained back its investment grade for the first time after 14 years by Moody's and Fitch. Although Indonesia has been able to draw so much foreign money, the country still has to deal with many lingering weaknesses. Some of the major shortcomings include high costs associated with corruption and poor contract enforcement, excessive and uncertain regulations, and unreliable infrastructure. Overall, Indonesia's investment climate is still rated poorly compared to other countries in the region. Foreign investors came to Indonesia because they want to get



access to the country's vast natural resources and large consumer market of more than 200 million people.<sup>10</sup> In 2010, foreign investment into Indonesia was even higher than that of Thailand. In the future, Indonesia needs to implement further policy reforms, focusing on reducing the extent of regulation to enable Indonesia to better compete in the global market place.<sup>11</sup>

As a latecomer to the process of economic globalization, compared with the four other countries, Vietnam's first Foreign Investment Law came out in 1987. Since then, Vietnam has continually amended and issued new laws and legal provisions to create a transparent legal framework to encourage foreign investment. Since 2001, the State Bank of Vietnam (SBV), the central bank, has allowed FDI enterprises to buy foreign currencies from commercial banks for their legal needs. The government even guaranteed to sell foreign currencies to some important FDI projects. The withholding tax on profit remittance of FDI projects was lowered and subsequently abolished. The limitation of 30% for foreign ownership in FDI enterprises was abolished, with some exceptions. Most recently, in 2005, Vietnam passed its second Investment Law, which unifies principles related to investment in Vietnam by foreign and domestic investors. Under this reform, both domestic and foreign investors are entitled to the same investment incentives such as tax incentives, incentives of land use, and depreciation of fixed assets. The Investment Law also aims at integrating both domestic and foreign companies under the same simple registration and licensing system, which can save foreign investors much time and effort. Because of these consistent improvements, Vietnam has competed with other bigger economies such as Thailand and Indonesia in attracting FDI.

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<sup>10</sup> Bellman, E., *Indonesia Sees Surge in Foreign Investment*. Available at <http://online.wsj.com/article/SB10001424052970204616504577170160678124608.html>

<sup>11</sup> WTO Trade Review Policy 2010

Besides FDI, Vietnam also focuses on encouraging foreign indirect investment or the portfolio investment as the country is trying to develop its quite young stock market. Vietnam's stock market was first opened in 2001 while the four other countries have had their stock markets for more or less 50 years. Over time, the regulation on capital contribution and share holding by foreign investors in Vietnam enterprises has continuously loosened. The permitted room for foreign participation was increased from 30% in 2003 for both listed and unlisted companies to 49% in 2005 for listed companies, except banks. Individual investors are tax-exempted for their income from capital contribution or share purchase in Vietnamese enterprises. In 2004, the SBV even removed the requirement that portfolio investment has to remain at least one year in the country before it can be repatriated. However, for SBV to have certain control over capital flows, foreign capital on arrival is required to be converted into the local currency and held in a specialized account with a commercial bank to realize the investment in Vietnam.

From analyzing the different absorptive capacities of each country, I can come to the conclusion that export expansion as well as increases in FDI have certainly been the driving forces toward the economic growth of all five countries. In other words, without the extensive economic liberalization, in particular the leverage power from foreign capital inflows and technology, countries would have stayed at a much lower economic level than is the case today. And countries that have been successful in attracting FDI are the ones that also show great efforts in improving their country's absorptive capacity. When choosing their investment destinations, foreign investors consider both the country's economic fundamentals as well as the investment incentives. Focusing on only one factor without improving the other would not be enough to win over foreign investors' decisions. Absorptive capacity is not only necessary in

attracting FDI to come in, but also helpful in stabilizing investors' confidence, thus minimizing capital flights during financial crises.

#### **D. Phoenix Miracle**

As mentioned in the literature review, phoenix miracle is a phenomenon that can also help explain why countries recover from regional shock at different speeds. There are two kinds of recovery that I want to discuss: the output recovery, and the recovery of capital flows, i.e. the credit market. According to Calvo (2006), phoenix miracle is identified with the episodes in which the output level is able to recover to the pre-crisis level before the recovery in the credit market. As shown in table 4.1 and also figure 3.1, phoenix miracle is likely to have happened in Thailand, Malaysia, and Indonesia after the East Asian crisis as it did not take the three countries long to return back to their pre-crisis output level.

	Pre-crisis Peak	Trough	Recovery Point
Thailand	1996	1998	2002
Malaysia	1997	1998	2000
Indonesia	1997	1998	2003

Source: Calvo (2006)

As I turn back to figure 4.2, 4.3, and 4.5<sup>12</sup>, however, I realize that it only took Indonesia many years to recover their credit market. In Thailand and Malaysia, capital still flew in right after the crisis. But after the crisis, the dominant channel was foreign investment, instead of portfolio investment as before. With that finding, among the three countries, only Indonesia would be the best fit for the theory of phoenix miracle.

Since Thailand, and Malaysia still seem to receive foreign capital flow after crisis, their output recovery is expected. In the case of Indonesia where there seems to have been “creditless”

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<sup>12</sup> Please refer to the Appendix for these figures

recovery, the proposed mechanism in Calvo (2006) might be useful. Calvo (2006) pointed out that economic episodes like the East Asian crisis were not insolvency crises, but rather liquidity ones. What it means is that there was not any correspondingly sharp collapse in either physical capital or the labor force. Therefore, although the credit crunch appears to be central for explaining output collapse, recovery can take place without credit. Liquidity can be restored by discontinuation of investment projects. One might question if such reduction in investment would cause negative impact on long-term growth. The answer for that lays in the fact Indonesia might have experienced a five-year period of excessive investment right before the crisis, thus a break from investment would have a mild effect. Meanwhile, money can be spent on output and restoring liquidity.

Although I have shown there are other sources of financing that lie outside the formal credit market as supposedly in the case of Indonesia, methods such as postponing investment project to create liquidity can be very costly (Calvo 2006). Thus, it is important to study how Thailand and Malaysia were able to attract capital inflows right after crisis. On the eve of the East Asian crisis, portfolio investment had dominated their capital accounts. When a major property developer, Somprasong Land, was unable to meet a foreign debt payment in early 1997, investors started to panic about the solvency of financing companies and banks (Radelet 1998). As panic mounted, portfolio investments flew out of Thailand swiftly. Not too long after that, the panic spread out to the whole region, Indonesia and Malaysia also experienced sudden stops of capital inflows. However, as portfolio investors rushed out of the countries, in Thailand and Malaysia, foreign direct investors started pumping their money in. Figure 4.2, and 4.3 clearly show foreign investment quickly replaced portfolio investment, which helped heal the financial market much faster than in Indonesia. The inflow of foreign investment in Thailand and

Malaysia might sound paradox amidst the crisis; however, there is a reasonable way to explain for it. The crisis was a liquidity crisis due to the panic among investors, especially those short-term investors. Long-term investors might have seen the crisis as an opportunity to start buying assets in Thailand and Malaysia as prices went down. Their rationale is that since there was no collapse in physical capital, or labor, as long as the liquidity problem was solved, the two countries would grow fast again. Another factor, and probably the major reason why foreign direct investors chose Thailand, Malaysia, but not Indonesia was the quality of governance. As I point out in the previous chapter, Indonesia had the worst investment environment among the three, with a low economic freedom, high level of corruption, and political instability.

#### **E. Post-crisis Policy Changes and Their Impacts**

Before the crisis, Thailand had maintained a fixed exchange rate; Indonesia, Philippines, and Malaysia had had a “managed floating” regime. Following the East Asian crisis, the four countries made a transformation in their official-declared the exchange rate regimes in two opposite directions. While Thailand, Indonesia, and Philippines announced a new “free-floating” regime, Malaysia decided to move to a “pegged arrangement” regime. As Hernandez (2001) pointed out, although Thailand, Indonesia, and Philippines moved substantially to greater flexibility in foreign exchange in the post-crisis period than in the pre-crisis period, they have appeared to have attempted to influence their bilateral exchanges rate against the U.S. dollar to a significantly greater extent than have industrial countries that are “pure floaters”. In particular, the three countries have still intervened in foreign exchange markets, and also used the domestic monetary policies to defend the value of the exchange rate. According to Hernandez, there are three major rationales for countries to implement such policy: to stabilize high-frequency exchange rate movements, to slow the pace of real appreciation after the overshooting associated

with the crisis, and to accumulate liquid foreign exchange reserves. In fact, these policies have been successful in both avoiding extreme episodes of exchange rate pressure as well as in boosting macroeconomic performance. In particular, during the post-crisis period, growth picked up rapidly, inflation remained low, and current accounts adjusted rapidly (Hernandez ; (2001).

Above all these changes in foreign exchange regimes, all five countries have improved their regulatory and supervisory framework for the financial sectors, capitalizing, and addressing problem of corporate governance. These reforms aim at reducing the incidence of moral hazard problems, preventing speculations. In particular, in July 1997, Thailand unified the two-tier currency market that created to separate exchange rates for investors who bought Baht in domestic and overseas markets. In addition, in order to prevent the currency crisis or bankruptcy of commercial banks, the commercial banks were required to maintain at least 6% of their nonresident foreign exchange deposits in the form of: 1) at least 2% as non-remunerated balance at the Bank of Thailand; 2) at most 2.5% vault cash; and 3) the rest in eligible securities.<sup>13</sup> In August 1998, the Central Bank of Malaysia imposed controls requiring banks to limit outstanding noncommercial-related Ringgit offered side swap transactions to \$2 million a foreign customer.<sup>14</sup> In March 1998, Philippines allowed the Peso to float more freely against the dollar. The band included a 6% limit around the exchange rate of the previous day, with trading being suspended for the remainder of the day if the limit was reached.<sup>15</sup>

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<sup>13</sup>International Economics. Historical Exchange Rate Regime of Asian Countries: Thailand. Available at [http://intl.econ.cuhk.edu.hk/exchange\\_rate\\_regime/index.php?cid=2](http://intl.econ.cuhk.edu.hk/exchange_rate_regime/index.php?cid=2)

<sup>14</sup> International Economics. Historical Exchange Rate Regime of Asian Countries: Malaysia. Available at [http://intl.econ.cuhk.edu.hk/exchange\\_rate\\_regime/index.php?cid=4](http://intl.econ.cuhk.edu.hk/exchange_rate_regime/index.php?cid=4)

<sup>15</sup> International Economics. Historical Exchange Rate Regime of Asian Countries: Philippines. Available at [http://intl.econ.cuhk.edu.hk/exchange\\_rate\\_regime/index.php?cid=1](http://intl.econ.cuhk.edu.hk/exchange_rate_regime/index.php?cid=1)

## **CHAPTER V**

### **Conclusions**

#### **A. Summary of Findings**

In my thesis, I have examined the impact of economic openness on the following aspects of the five Southeast Asian countries: the rapid growth rate during 1990-2010, the output volatility during crisis periods, and the speed of recovery subsequent to a shock. From a wider perspective, my thesis also sheds light on the simple idea that it is always better to have trade liberalization and financial integration. Following are some findings after my study of the five countries: Thailand, Indonesia, Philippines, Malaysia, and Vietnam.

Overall, my thesis indicates that the role of economic openness in the rapid growth of the five countries during the last two decades is indisputable. More importantly, the benefits of economic growth are widely spread among the population. Gains have not only been detected in income per capita, but also in education, health, and general welfare. Even when we take into account the crisis episodes, the benefits that the five countries have gained from their outward orientation cannot be wiped out. Overall, countries have gained a higher level of living standard that without economic liberalization, it would have taken them much longer to reach. Economic openness, therefore, is beneficial to the five countries, and even to any of the developing countries from a long-term perspective.

From a short-term perspective, however, increase in trade and financial integration would make countries more susceptible to shocks, if their levels of trade liberalization as well as financial integration fall below the threshold numbers. Since all five countries have not reached the threshold level, their output levels tend to fluctuate significantly during crises. During the East Asian crisis, Thailand, Indonesia, and Malaysia were the most-affected countries, while Philippines was luckier as its output fell relatively mildly compared to the other three. My thesis finds that on the eve of the crisis, Thailand, Indonesia, and Malaysia had a large ratio of portfolio investment as percentage of their total debts, while Philippines was more cautious with short-term debts. This led to another conclusion that composition of capital flows can also determine countries' risk of volatility due to disruption of capital flows. Since the five countries have not developed a sophisticated financial system, they are advised to attract more foreign direct investment, while take extra caution in absorbing portfolio investment. In the case of Vietnam, my thesis shows that up till 1997-1998, Vietnam's economic openness was much behind the other four. That might explain why the country did not get much of the regional contagion and was still able to manage a positive growth rate during the East Asian crisis. Since Vietnam first announced an open-economy policy in early 1990s, foreign investment has been the major investment channel into the country. Not until 2005-2006, did Vietnam have a substantial surge in portfolio investment.

Since foreign direct investment is much less risky than portfolio investment, my thesis also points out what factors help countries better attract foreign direct investment. Foreign investors consider two factors when choosing their investment destinations: the country's economic fundamentals, and its investment incentive policy. Therefore, excessive practice of tax exemptions and other trade-promotion policy would not be enough to attract foreign investment.



This is, indeed, the case of Thailand during the late 2000s. Although Thailand has maintained a relatively open foreign investment regime, the country no longer keeps the leading position as an investment destination in East Asia. Political instability in late 2000s and the disastrous flooding in 2011 have eroded foreign investors' confidence in Thailand. Investors have diversified their investment portfolio to new destinations such as Vietnam, and Indonesia. Over the last two decades, Vietnam has extensively accelerated its process of economic liberalization to catch up with other countries in the region. For Indonesia, foreign investors have one more reason to invest in this country: Indonesia is known for its vast natural resources and a large consumer market of more than 200 million people. In order to sustain investors' interests, all five countries need to keep improving their absorptive capacity (human capital and research & development).

Besides, my thesis also focuses on studying the factors that account for different speeds of recovery subsequent to a shock. Following the East Asia crisis, Thailand, Malaysia, and Indonesia were able to quickly recover to their pre-crisis's output levels. In Indonesia, the fast output recovery seems to have happened in a phoenix miracle fashion since there was no recovery in credit market until 2004. In order to restore liquidity and output level, Indonesia might have postponed investment projects, at least during the period right after the crisis. Meanwhile, in Malaysia and Thailand, portfolio investment outflows were quickly replaced by foreign direct investment inflows. Since the East Asia crisis was a liquidity crisis, not an insolvency crisis, long-term investors considered the crisis an opportunity to start buying cheap assets, rather than felt panic as short-term investors. Long-term investors believed that Thailand and Malaysia still had full potential to grow fast once liquidity was restored. What made investors put confidence in Thailand and Malaysia, but not Indonesia was the investment environment. At that time, among the three countries, Indonesia was considered the worst

investment environment with low economic openness, high level of corruption, and political instability. It took Indonesia over 14 years to fully recover from the shock. In 2011, Indonesia gained back the investment grade from two rating firms Moody's and Fitch.

The East Asia crisis has taught the five countries how important it is to improve the regulatory as well as supervisory framework for the financial sectors, capitalizing, and addressing problem of corporate governance. They also underwent major changes in exchange-rate regimes: Thailand, Indonesia, and Philippines turned into free-floating exchange regimes, although they still used macroeconomic policy to interfere to a certain extent. On the other hand, Malaysia started implementing a "pegged arrangement" regime. All countries looked to reduce the incidence of moral hazard as well as speculation, which had played key role in causing the financial crisis.

In short, I would like to further confirm the benefits of economic openness in the long run. In the short run, however, the impact of economic openness on developing countries depends on a combination of both economic and non-economic factors such as absorptive capacity, financial development, macroeconomic conditions, political stability and demographics. The better those factors are, the less output volatility developing countries will incur during crisis, and also the faster they will recover from a shock.

## **B. Suggestions for Future Research**

In this thesis, the East Asian crisis has been an informative case study to show the behaviors of the four countries: Thailand, Malaysia, Indonesia, and Philippines. Vietnam's economy, however, was not as much integrated regionally and globally yet during 1997-1998. Thus the thesis's conclusions on Vietnam's process of economic openness and output volatility are relatively limited. This matter can be the topic for future research. Instead of focusing on the

East Asian crisis, future research can study the impacts of subprime crisis on Vietnam's economy since during the late 2000s, since Vietnam's economic openness had already made significant progress compared to that during 1997-1998.

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## TABLES

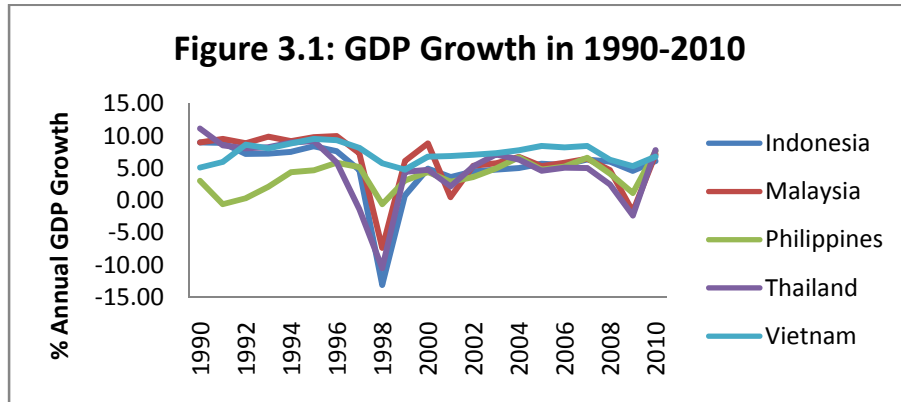
<b>Table 3.1: Standard Deviation of Real GDP Growth during 1990-2010</b>	
Country	Standard Deviation of Real GDP Growth Rate
Thailand	4.85
Indonesia	4.58
Malaysia	4.29
Philippines	2.29
Vietnam	1.40

<b>Table 3.2: Corruption Perceptions Index</b>					
Year	Indonesia	Malaysia	Philippines	Thailand	Vietnam
1996	2.4 (130)	5.0 (44)	2.5 (121)	3.6 (63)	2.6(111)
2008	2.6 (126)	5.1 (47)	2.3 (141)	3.5 (80)	2.7(121)

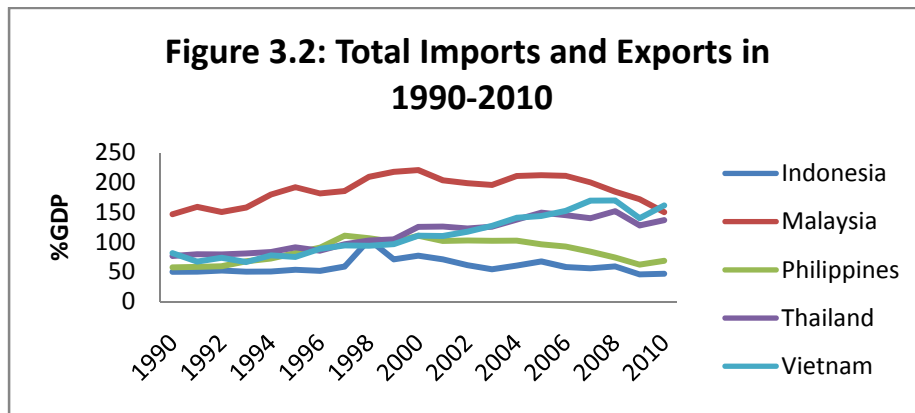
<b>Table 4.1: Output Volatility during East Asian Crisis</b>			
	Pre-crisis Peak	Trough	Recovery Point
Thailand	1996	1998	2002
Malaysia	1997	1998	2000
Indonesia	1997	1998	2003



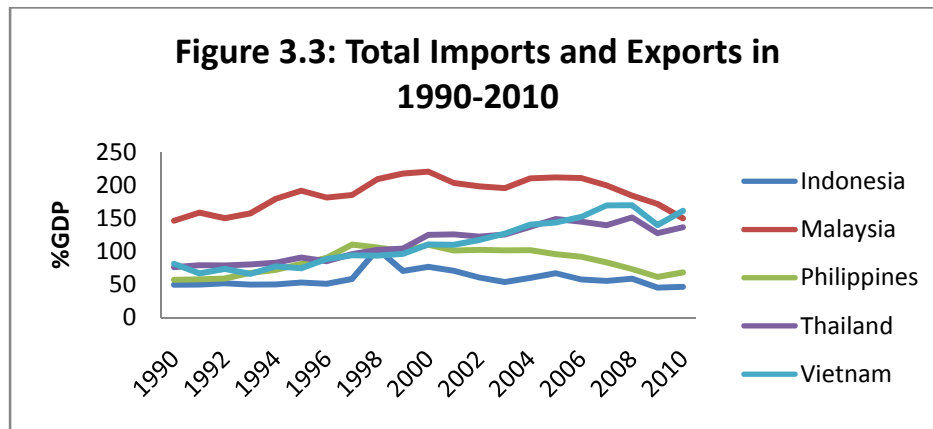
## APPENDIX



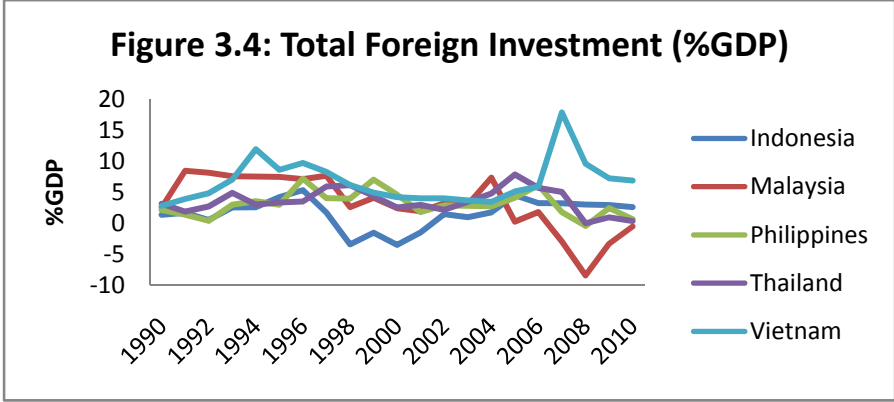
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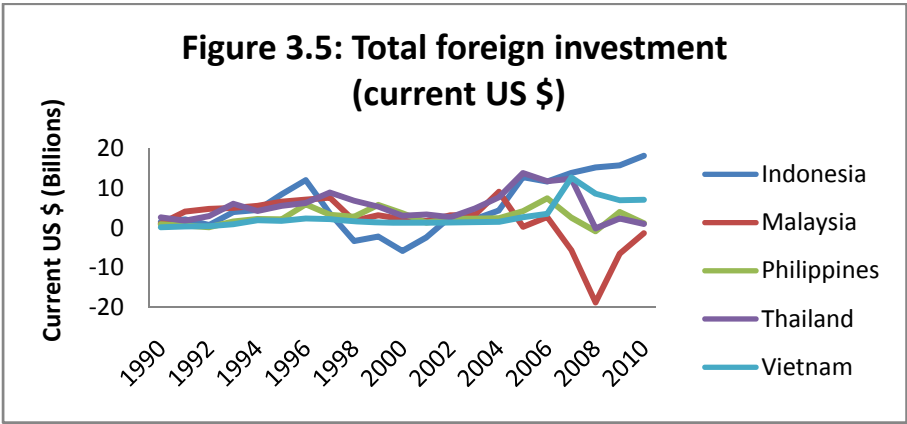
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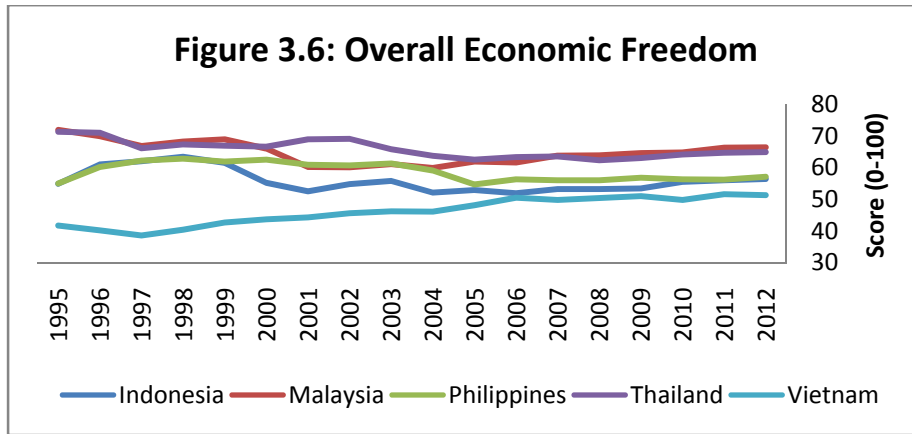
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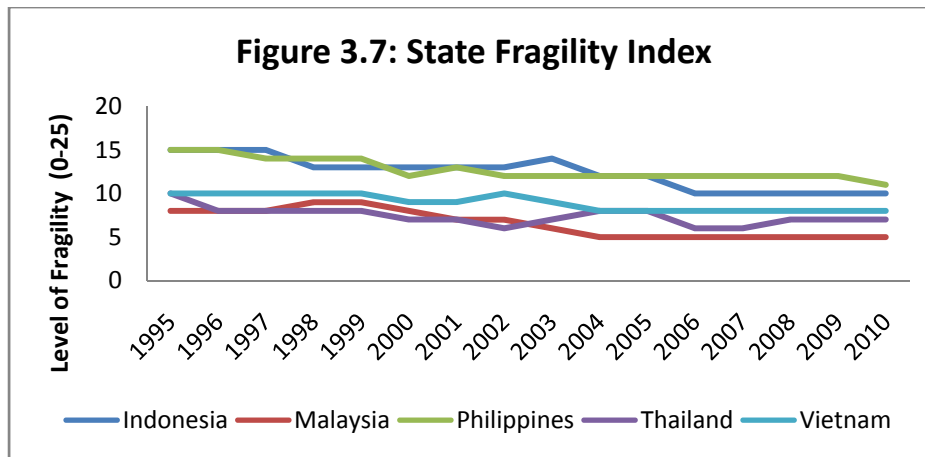
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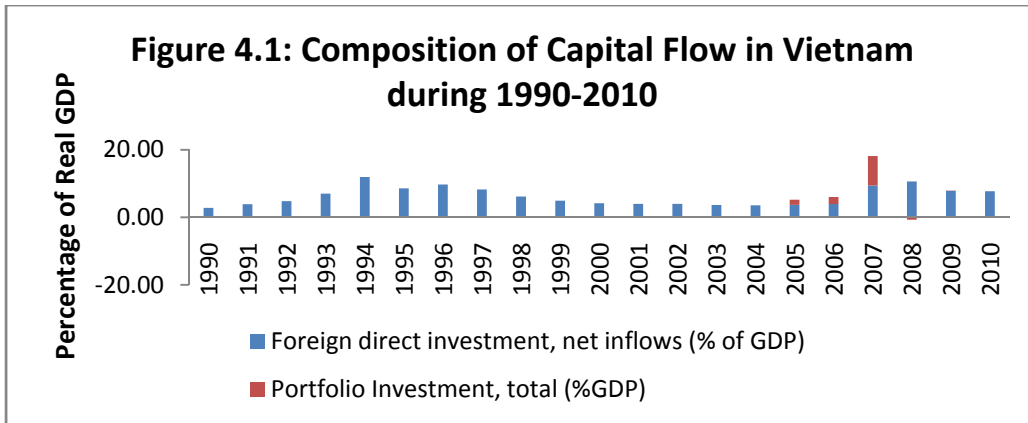
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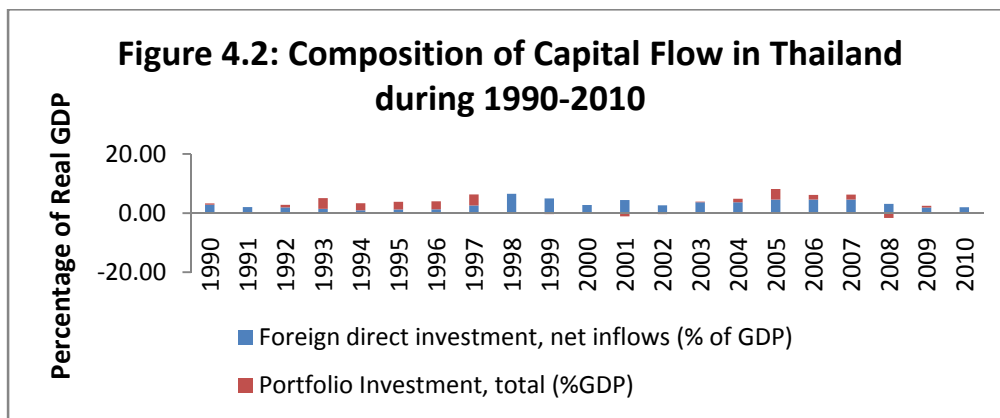
Source: The 2012 Index of Economic Freedom at <http://www.heritage.org/index/default>



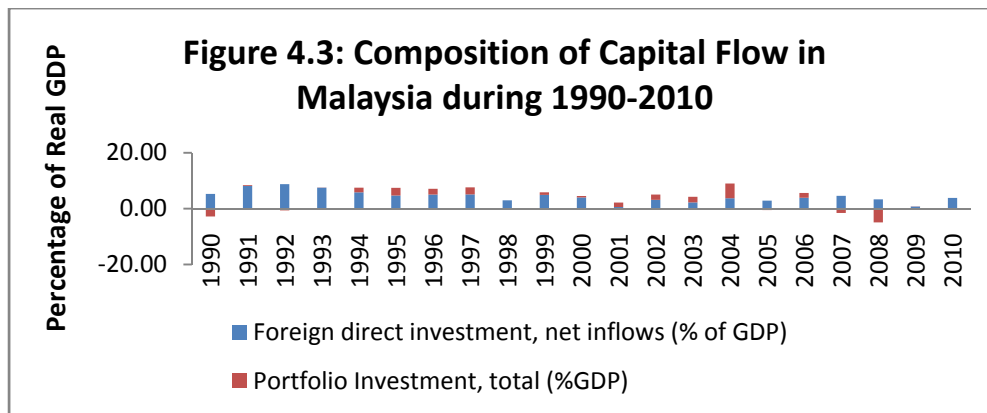
Source: State Fragility Index and Matrix 1995-2010 at Polity IV



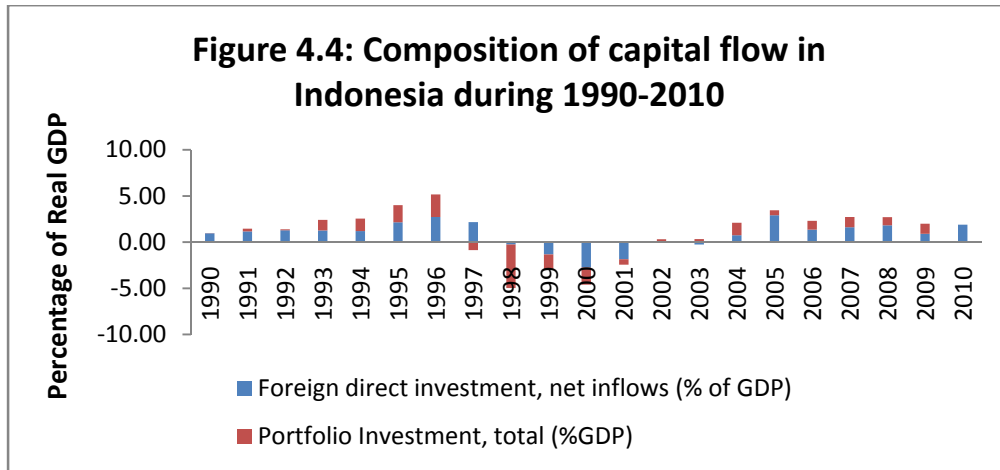
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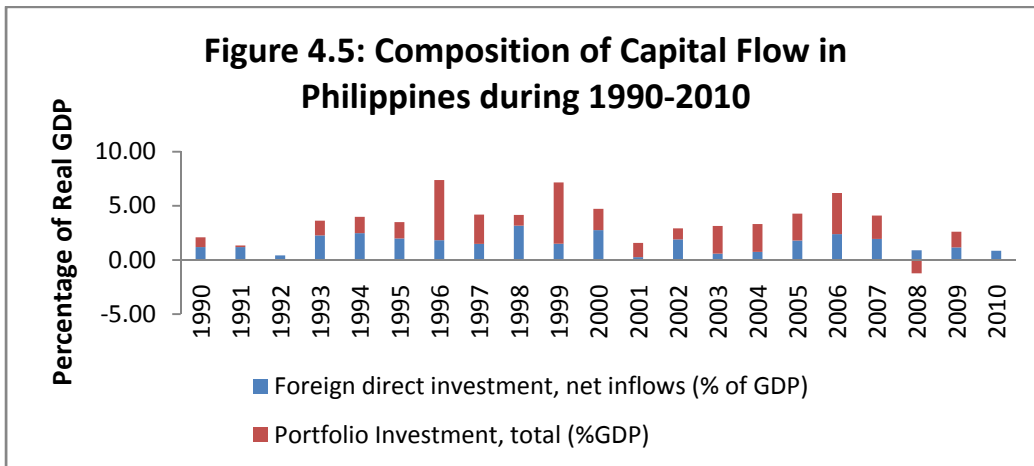
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