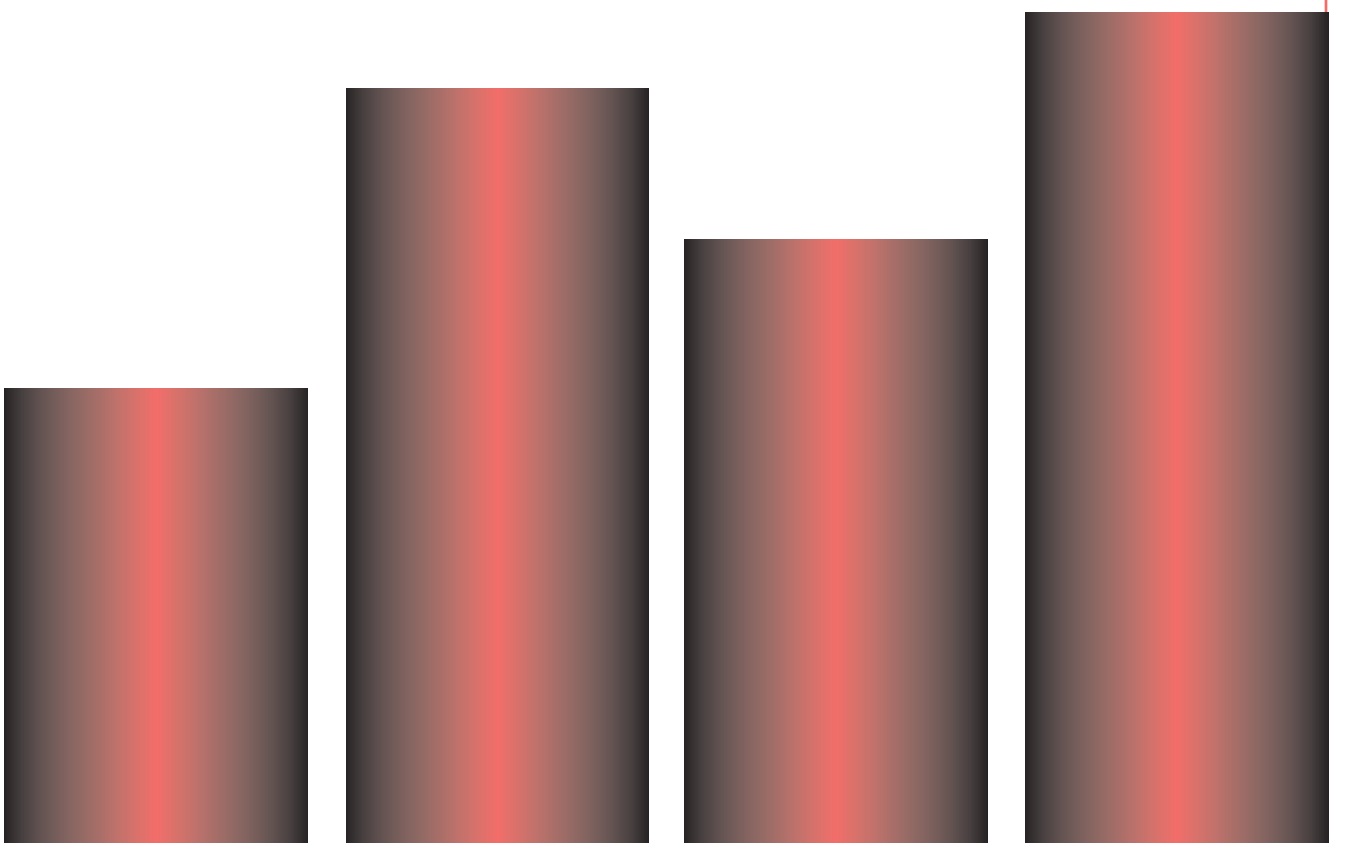
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Structural Aspects of the East Asian Crisis

OECD Centre for Co-operation with Non-Members



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Structural Aspects of the East Asian Crisis

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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The CCNM manages thematic and country programmes. The thematic programmes, which are multi-country in focus, are linked to the core generic work areas of the Organisation (such as trade and investment, taxation, labour market and social policies, environment). The Emerging Market Economy Forum (EMEF) and the Transition Economy Programme (TEP) provide the framework for activities under the thematic programmes. The EMEF is a flexible forum in which non-members are invited to participate depending on the theme under discussion. The TEP is focused exclusively on transition economies. Country programmes, providing more focused dialogue and assistance, are now in place for Bulgaria, China, Romania, Russia, the Slovak Republic (a candidate for accession to the OECD), and Slovenia.

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FOREWORD

A large number of East Asian economies achieved high economic growth, reduced poverty and raised living standards at a pace unprecedented in history. The financial crisis that hit these economies in the process of their integration into the global market does not mean that retreat from openness in trade and investment can provide a means to achieve high sustainable growth.

Rather, the main lessons of the crisis are that building an internationally competitive economy, as the basis for sustainable development over the long term, requires a broad national programme of reform and capacity-building. A major component of such a programme is the strengthening of governance, in particular an institutional and legal framework which supports the emergence of an enterprise-based economy, and rising levels of participation in economic and political life as a basis for broadly-based growth and social cohesion. Also important as components of the programme, are a consistent set of macroeconomic and structural policies conducive to higher domestic investment, and the domestic and international flow of economic and financial resources into competitive activities. In this context, it is important to strengthen regulatory and institutional capacities to ensure the well-functioning of domestic financial systems and to reinforce the international financial architecture.

The Symposium of 16-17 November, 1998, is part of a special programme of policy dialogue, adopted by the OECD, on issues arising from financial instability in non-member economies. As such, it provided valuable insights into key questions that will occupy policy makers in East Asia especially over the medium term. Economic recovery in East Asia is a high priority for the OECD. With its experience across a broad range of structural policies, the Organisation will continue to play a role in fostering an exchange of views with non-members on national experiences with policy reforms and possible improvements in the functioning of financial markets.

I would like to thank the authors and the discussants for their insightful contributions. The Symposium was organised by the OECD Centre for Co-operation with Non-Members. The staff of the Centre, in particular, Mr. Satish Mishra, Mr. Nils Björksten and Ms. Miranda Salt, played a key role in the organisation of the Symposium. Critical support was also received at various stages of the process from Ms. Anna-Maria Aicher, Ms. Alexandra de Miramon, Mr. Andrew Macintyre, Ms. Frances Rouard-Cramb and Ms. Sirkka Siikamäki. Ms. Salt was responsible for the compilation of this volume. The proceedings are published under the responsibility of the Secretary-General of the OECD.

Kumiharu Shigehara

Deputy Secretary-General

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OPENING ADDRESS BY DONALD J. JOHNSTON
SECRETARY-GENERAL

When the economic crisis in Asia erupted a year and a half ago, no one foresaw the disruption that we have witnessed since.

By early this year, it was apparent that the financial disruption had become a deep economic crisis with global implications. The equivalent of a spark which ignited a financial fire in Thailand quickly became a financial forest fire that could, if out of control, spread around the globe. What better example of global interdependence of financial markets, investment and trade than what we have witnessed during the past 18 months?

Economic recovery in Asia is a high priority for the OECD for several very obvious reasons. First of all, because of the drastic economic and social consequences in countries which have seen their economies savaged and their peoples thrown out of work without adequate social safety protection. In a matter of months, they have moved from buoyant optimism to pessimism and concern about their futures; and, second, because of the contagion effects, the spreading forest fire in financial markets and through trade linkages having a strong impact on economic activity in much of the rest of the world.

No one can ignore the enormous social impact of the crisis in Asia. The unprecedented decline in GDP in the countries directly affected, coupled with the collapse of currencies and dramatic shifts in relative prices have changed the economic balance across regions and sectors. The consequent explosion in poverty has reversed decades of achievements and has destroyed many enterprises built up by entrepreneurs and dedicated employees over many years.

With these concerns very much in mind, in March of this year, the OECD Council approved the "Special Programme for Asia", targeted primarily, though not exclusively, on Indonesia, Malaysia, the Philippines and Thailand. The programme focuses on four areas of what we might define as structural reform where the OECD has special competence:

- Corporate governance and financial market structure issues;
- Taxation policy;
- The policy environment for the private sector, including trade and investment policy, competition policy and regulatory reform;
- Labour market and social policy issues.

In April, OECD Ministers of Finance and Foreign Affairs reaffirmed the Organisation's commitment to contribute to the international effort to overcome the Asian financial crisis as rapidly as possible, through policy dialogue and co-operation in its areas of expertise. The G7 Finance

Ministers and Central Bank Governors recently called upon the OECD to complete quickly its work on a code of principles of sound corporate governance and to provide advice and assistance to countries to help them meet internationally agreed codes and standards.

OECD's discussions with our Asian partners have confirmed their interest in tapping into OECD's expertise. The Secretariat conducted an extensive mission to the region, and heard many expressions of interest in a dialogue with the OECD which could contribute to structural reform and labour market and social policy initiatives. For example, ten days ago we held a joint APEC-OECD Symposium in the Philippines at which 11 OECD countries and 17 APEC countries shared their experiences in adapting their tax systems to liberalised financial and capital markets. We agreed to continue that dialogue by organising with the Asian Development Bank, the InterAmerican Development Bank and the IMF in the Spring of 1999 a high-level seminar on "Open Markets and Taxation" which will draw from the experiences of OECD, Latin American and Asian countries.

The Symposium

Today's Symposium is part of the OECD's Special Programme for Asia. It provides an opportunity to reflect together on the following questions.

- What went wrong?
- What immediate corrective measures should be taken?
- What lessons should be drawn from the crisis?
- What policies, frameworks and/or institutions should be put in place to ensure that it does not happen again?

Returning to my forest fire metaphor, we must address these questions in concrete – not academic – terms. Remember that to be of value, your answers must speak to a political audience, not an academic one. Academicians will sift through the debris of this particular fire for many years and perhaps provide helpful insights for future policy makers. But that is not what is required now. People are suffering. Financial market instability must be arrested. What advice can we participants in this Symposium offer policy makers today that will ensure a rapid return to long-term stable economic growth while addressing the plight of those who are the immediate victims of this economic downturn in an area of the world that is expected to be the global economic locomotive of the 21st Century?

I know that is a difficult challenge. But that is precisely why you are here today.

Chapter 1

UNDERSTANDING EAST ASIAN GROWTH AND DEVELOPMENT

1.1 EAST ASIAN GROWTH: RETROSPECT AND PROSPECT

Anne O. Krueger, Stanford University[*]

Over the past several decades, the world economy has undergone profound changes. Among them, perhaps none is as dramatic as the greatly increased importance of the East and Southeast Asian economies, and especially those of the four "NICs". The four started out as desperately poor "underdeveloped countries". Then, "NIC" at first meant "newly industrialising country", as Hong Kong, Singapore, Korea, and Chinese Taipei experienced remarkable and sustained high rates of economic growth. As that high growth continued, however, "NIC" came to be taken to mean "newly industrialised". By l995, all four were among the world's twenty leading exporters and accounted for more than l0% of world exports.[1] Hong Kong, Singapore and Korea were all classified by the World Bank as high-income countries. Chinese Taipei's *per capita* income is estimated to be above Korea's, and its omission from the list reflects only the fact that it is not a member of the World Bank.

By the l980s, Southeast Asian countries appeared to be following closely behind the East Asian NICs, and achieved some of the highest rates of economic growth in the world. Southeast Asia's economic importance in the world had risen dramatically, and by the 1990s the old terminology no longer sufficed. For present purposes, I shall refer to the NICs when meaning the East Asian four plus the Southeast Asian followers (Indonesia, Thailand and Malaysia).

As of the mid l990s, most observers associated the Asian NICs with continuing high rates of growth at rates well above those in the rest of the world. The Asian NICs had continued to grow in the l980s when Latin America and other countries were seriously affected by the debt crisis. Korea had sustained growth during a transition to democracy. And, for the East Asian four, rapid growth had already persisted for almost four decades.

In l997-98, however, economic difficulties caught up with all Asian countries that had been rapidly growing over the past decade. Korea encountered a financial crisis, and approached the IMF for support. Thailand and Indonesia experienced financial crises and entered into IMF programmes, while Malaysia's difficulties were met with a reversion to earlier economic policies, including exchange control. By mid l998, Korea and the Southeast Asian countries were all experiencing recession, and the East Asian economies were, at a minimum, undergoing significant slowdowns in growth, and occasional runs on their currencies, their stock markets, and/or their banks.

It is the purpose of this paper to analyse the underlying factors at work in this rapid transformation with a view to assessing the degree to which the current slowdown may represent transitory phenomena (cyclical or otherwise) or a more fundamental shift in the underlying growth trajectories of the East Asian countries. Section l starts with a brief review of the status of the four NICs as of the 1950s, understanding of which is essential for appreciating their subsequent rapid

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growth, and then sketches the salient characteristics of the dramatic transformation of those economies. Section 2 then provides an analysis of the factors accounting for their phenomenal rapid growth. A third section then addresses the current slowdown, and reasons for it. A final section then evaluates the prospects for resumption of rapid economic growth.

1. The dramatic transformation of the NICs

In the l950s, almost all developing – or, as they were then called, underdeveloped – countries' policy makers were setting rapid economic growth as a priority objective, but were trying to achieve it through policies that, with hindsight, were highly counterproductive.[2] In the climate of opinion at that time, markets were viewed with deep suspicion, and governments were thought to be the agents that would direct economic growth. Government controls became pervasive over most types of economic activity, and state-owned enterprises were established in most developing countries to carry out the sorts of activities that had traditionally been undertaken in the private sector in the countries that industrialised in the l9th century.

Suspicion of the market was particularly strong when it came to the international economy. Because of that suspicion and for other reasons, most developing countries adopted policies of "import substitution" which were designed to induce domestic production of goods previously imported and to reduce "dependence" on foreign trade. The consequence was that most developing countries adopted exchange controls and resorted to various restrictions on imports to encourage domestic production (which, of course, discouraged the production of exportable goods).

In addition, fiscal policies in many developing countries were highly expansionary, in part because of the strong desires of the authorities to increase public expenditures and investments rapidly without any corresponding ability to increase tax revenues, and in part because it was believed in the l950s that inflation did not have significant economic costs in terms of economic growth.

At fixed nominal exchange rates, the result was generally increasingly restrictive trade regimes, accelerating inflation, and finally balance of payments crises which were seen as the cause of slow growth. Over the next several decades, countries that continued to adopt these policies, such as Pakistan, India, Ghana and Argentina, experienced relatively slow rates of economic growth.

For purposes of understanding Asia's rapid growth and the difficulties of the l990s, it suffices to note the salient features of the Korean economy in the early years. The other East Asian NICs' economies were similar, and those few significant differences there were will be noted after examining the Korean situation. Since the policies that were pursued to achieve rapid growth in Southeast Asia were modelled in large part on those of the NICs, such an understanding of policies, and of the ways they contributed to growth, is a necessary starting point for analysis of recent experience.

Among the countries whose economic policies were highly distorting, Korea was perhaps the most visible in the 1950s. It was viewed as having exceptionally poor development prospects. It had multiple exchange rates, the highest rate of inflation in the world, and severely restrictive import licensing with the inevitable black markets that follow. Expansion in domestic industry was in import substitution industries, almost all of it high cost. Korea's external accounts were in severe imbalance, with exports equalling about 3% of GDP while imports were equal to about l3%.

The result of these unpromising economic policies was an economy that performed very poorly. Despite the opportunities for rapid growth that a post-war environment creates, Korea from l953 (the end of the Korean war) to l960 grew at an average annual rate of less than 5%. It then had the highest density of population in agriculture of any developing country, the third lowest *per capita* income in Asia, and one of the lowest savings rates (very close to zero) of any developing country. More than 50% of GDP originated in agriculture and 70% of the population (which was growing at a rate well in excess of 2.5% annually) was rural. Concerning exports, 88% were primary commodities.[3]

Thus, by the late l950s, Korea was viewed as one of the countries with the poorest prospects for economic growth. The US Congress even voted in l956 to alter Korea's status so that the country would no longer be eligible for development assistance: it was concluded that all that was feasible was to support existing living standards on the part of the Korean people.

The situations in Chinese Taipei, Hong Kong and Singapore in the l950s were not quite as extreme, but equally unpromising. Chinese Taipei of course experienced a massive inflow of refugees from the mainland in the late l940s, inflation was rampant, public finances were in disarray, and there was a "shortage" of foreign exchange. It, too, followed policies of import substitution in the early l950s. Because of its relatively greater abundance of land, some of its initial exports, such as canned fruits, were based on its productivity in agriculture, although it, too, rapidly shifted its comparative advantage toward unskilled labour intensive manufactured goods. Two key differences between Chinese Taipei and Korea may be noted: Chinese Taipei's development was based largely on many small entrepreneurs successfully exporting, with policies to attract foreign direct investment to obtain technology and know-how. By contrast, until the l980s, Korea mostly discouraged foreign direct investment and relied on large firms – the *chaebol* – for much of its industrial development.

Singapore was part of Malaya, subject to British rule until independence, and the entire area was under arms as a result of the insurgency at that time.[4] Hong Kong was experiencing a massive inflow of refugees and *per capita* incomes were extremely low. In the cases of both Hong Kong and Singapore, observers then and now tended to dismiss those economies as "special" because of their city-state character, although the factors accounting for their growth are not significantly different from those affecting Korea and Chinese Taipei.

For present purposes, the key point is that growth prospects for all of the East and Southeast Asian countries seemed relatively poor in the late l950s. Economic policies were similar to those in other developing countries and, because of relatively poor natural resource endowments and high man-land ratios, *per capita* incomes were much lower than those of most African or Latin American countries. The growth prospects of Southeast Asia were viewed more favourably than those of East Asia, largely because of a perceived more favourable resource endowment.

But, starting in the late l950s and continuing until the mid l960s, the four NICs changed their underlying growth and development strategies. Instead of hoping to achieve growth through the expansion of manufacturing output to replace imports, policy makers changed to an emphasis on an "outward-oriented trade strategy" under which they recognised that their economies would have to integrate with the international economy if they were to achieve sustained growth. This set the East Asian NICs apart from most other developing countries whose policies were still largely oriented toward import substitution.

Again, Korea's example is illustrative. Starting around l960, the exchange rate was unified, and import privileges were restricted to those who were exporting. Exporters, in turn, had free access to

the international market[5] for their needed inputs, and were provided with strong incentives to develop new markets and to expand exporting.[6]

Once the export-oriented strategy was undertaken, complementary policy measures – including provision of adequate transport and communications, removal of quantitative restrictions on imports and lowering of tariffs, maintenance of a realistic exchange rate, fiscal reforms to reduce inflationary pressures – were also implemented. Over the next three decades, Korean policy makers were continuously analysing economic performance, identifying factors that were detrimental to continued growth, and then undertaking policy reform measures to correct the problem. The level of protection against imports gradually came down, tax and fiscal reforms were undertaken, and the economy was gradually liberalised. The interest rate paid on bank deposits was raised so that the real interest rate received by depositors and paid by lenders was positive, although the financial system was not entirely freed.

In the early years, however, the Korean economy – as others in Asia – was highly distorted, and policy makers either did not wish to or could not immediately address all distortions. Some, such as those in the credit market which led to credit rationing and the "credit subsidy" for exporters mentioned above, were used by policy makers to achieve their ends.

For a variety of reasons, the strategy worked. Table l (page 27) gives data on the average annual growth rates of *per capita* incomes for the Asian countries and the averages for all low and middle income developing countries for the periods l960-75, l965-85 and l985-95. The much higher rates of growth of the East Asian economies in the early period are evident. Chinese Taipei's data are not included, but the estimated growth rate is slightly higher than that for Korea over most of the period. By the decade starting in l985, Thailand's growth rate had surpassed that of the East Asian NICs, and growth in Malaysia and Indonesia had also accelerated.

In the early years of rapid growth of the East Asian NICs, export earnings grew at annual average rates in excess of 30% per year, at a time when world prices were fairly stable. Such a rate of export growth of course accounted for their increased share of world markets, but in addition was the "engine of growth" for domestic development.

Initially, the rapid growth of the East Asian NICs' exports was based largely on their comparative abundance (relative to the developed countries, which was virtually all that mattered since other developing countries were encouraging import substitution and therefore competing relatively little on world markets for labour-intensive goods) in goods that used relatively high inputs of unskilled labour. These exports included textiles and clothing, footwear, ladies' wigs, mechanical machine tools, and so on.

Over time, as exports and real incomes grew, the savings rate rose rapidly. Whereas foreign capital had earlier financed a significant fraction of investment in most East Asian countries, savings rates rose to levels well above 30% of GDP, and countries began investing abroad and incurring current account surpluses. Foreign capital came to be seen as more valuable for the technology and other attributes that came with it than as an essential source of finance in East Asia, and its relative importance diminished greatly.

As the capital stock expanded relative to the labour force, and as the educational attainments and experience of the industrial labour force rose, comparative advantage shifted away from these heavily unskilled-labour-intensive products[7], primarily toward mass production goods where more capital

relative to labour was needed. Later still, comparative advantage began moving toward activities using larger relative inputs of skilled workers.

Especially in the early years of development, the East Asian NICs relied on foreign capital. In the case of Korea, the current account deficit reached almost l0% per year in the late l960s, financed largely by borrowing from commercial banks. But since Korea's rate of growth was in excess of l0%, while exports were growing at a rate in excess of 30%, all measures of Korea's debt service burden declined during its period of rapid borrowing. More generally, for all the East Asian NICs, high real rates of return on capital permitted capital inflows, and current account deficits, without weakening the economic fundamentals.

Southeast Asian countries began their development efforts later and in a situation quite different from that of the East Asian countries. In particular, they had large and profitable primary commodity exports which meant that the initial "foreign exchange shortage" distortions of East Asian NICs in the l950s had been far larger than the distortions driven by import substitution policies in the Southeast Asian countries.[8] While Southeast Asian countries followed policies of import substitution in the l950s and l960s, these policies were by no means as extreme as those of many other developing countries, in part because they did not encounter the same degree of "foreign exchange shortage" because of their abundant primary commodities, and in part because their exchange rate policies – at least starting in the l960s – were by no means as unrealistic as those of other import substituting countries. Thus, even in the l950s and l960s, their rates of economic growth were above the average for developing countries, even if they were by no means as high as those in East Asia.

But as East Asian comparative advantages changed with rapid growth, the Southeast Asian countries became the relatively low-wage countries. Despite their greater abundance of natural resources (and considerably more land per rural worker), the positions had reversed in the l970s as the East Asian capital stock rose and as workers shifted to more productive urban occupations from the land. *Per capita* incomes and real wages in East Asia rose above those in Southeast Asia. In the mid-1970s, Southeast Asian efforts to move to a more export-oriented strategy had begun, in the belief that that would bring about higher rates of economic growth and of improvement in living standards.

But to achieve rapid export growth, most of them began encouraging direct foreign investment to enter their countries and to take advantage of their relatively abundant supplies of unskilled labour (as the East Asian countries' success resulted in their changing comparative advantage).[9] Indeed, as growth proceeded, Malaysia finally in the l990s began importing workers to meet the labour demands increased by large flows of foreign direct investment.[10]

For a variety of reasons, the initial Southeast Asian export boom and accompanying growth spurt was somewhat different from the East Asian boom of several decades earlier. It was different in that the encouragement to exports was, in an important sense, a policy superimposed on existing policies encouraging import substitution. There was no dramatic change in policies, as had happened in East Asia. And unlike East Asia, which began desperately poor and single-mindedly pursued an outward-oriented trade strategy, the Southeast Asian countries began richer, and could afford to encourage exports without removing many of their import substitution incentives. Moreover, the policy reforms that had underpinned continued success in East Asia were not so forthcoming in Southeast Asia. Educational attainment levels of the population rose, but much more slowly than they had increased in East Asia at a comparable stage of development; infrastructure was improved and capacity increased, but this happened after bottlenecks had arisen, and, indeed, bottlenecks – especially in

Thailand – worsened over time. Import substitution policies continued, as evidenced even in the l990s by Indonesia's car project and Malaysia's proposed information corridor.

Nonetheless, the economic growth rates of the Southeast Asian exporters were impressive. Thailand was the most rapidly growing country in the world in the decade ending in l995; Malaysia's growth rate was not far below it; and Indonesia had sustained rapid growth, averaging around 7%, over several decades. To external observers, these countries appeared to be much like the East Asian countries twenty years earlier, and with the potential those countries had then for continued growth. It should not be forgotten, however, that the highest rates of economic growth achieved in East Asia in the l960s averaged above l0% annually.[11] The high rates of growth in Southeast Asia were considerably below the record-setting pace of East Asia earlier, but were nonetheless dramatic – at 8 and 9% – by world standards (see again Table l).

2. What accounted for high growth rates?

The preceding discussion has already provided an implicit analysis of the causes of high growth rates. Initially, growth in East Asia was based largely on the very high real rates of return achievable by removing huge and costly economic distortions from their economies. As those distortions were removed and exports expanded rapidly (which was highly economic given the earlier situation in which incentives had been skewed against them), complementary investments in infrastructure, education, and business services were also highly productive.

There is no question but that the East Asian "model" was one based on rapid growth through reliance on an "outward-oriented" trade strategy. Simply because of the rapid growth of exports, they were an "engine of growth". That exports led growth is not questioned by any analyst. The important issue is the ways in which focus on exports affected the overall economy and its growth rate.

When the shift in development and trade strategies began, production of import-competing goods was incredibly high cost. At that juncture, policy makers had a clear vision that exports had to be encouraged. Because the distortions were so large, they were essentially right. And the incentive structure they put in place was one in which anyone who could export would be entitled to the same incentives.[12] Thus, new resources were being put into those export industries which were most economic, and pulled out of industries where their productivity was much lower.

That growth was rapid is not questioned, and that exports were the prime driver is also not subject to controversy. The real questions – and the ones that are important for understanding the evens of the late l990s – concern the channels through which rapid growth of exports resulted in such overall rapid growth. The first part of the answer concerns the mechanism already addressed – when resources were pulled from their low rate of return uses and placed in uses where returns were very high, the payoff in terms of growth was very large.[13] Clearly, a rate of expansion of exports in excess of 30% annually could not be sustained, although the larger share of exports in GDP meant that a lower rate of growth of exports could nonetheless contribute as large a stimulus to the growth of real GDP. When the East Asian NICs began their rapid growth, exports accounted for relatively small percentages of GDP; by the mid l980s, exports accounted for more than 35% of GDP in each of their economies.[14]

But the single-minded focus on exports contributed to growth in other ways. In the four NICs, virtually all economic policy was geared to facilitating exports. An important implication was that producers had to face competition on the external market, even if they were still protected at home. It

also meant that politicians avoided low-return economic activities to a much greater extent than in most countries.

Further infrastructure bottlenecks were quickly addressed and the activities of officials, as well as the private sector, were judged in terms of their impact on growth. Further, when officials intervened, as they did, there were tests of the efficacy of interventions; whether they in fact could result in more and profitable exports. Moreover, attention was given to encouraging domestic savings, so that the savings rates rose sharply, to rates in excess of 30% of GDP from their originally very low levels. This was done in part by raising domestic nominal interest rates to levels that yielded a positive real return to savers, and in part happened because real returns to investment were so high. But rapid growth was also important; the evidence is strong that savings rates were rising rapidly as income growth exceeded expectations.

There was thus something of a "virtuous circle". High returns to exporting led to rapid expansion of exports. That, in turn, resulted in increased savings. Success in exporting made the authorities more sensitive to the needs of exporters for efficient transport and communications. Investments which increased the efficiency of exporters' activities also increased the efficiency of the rest of the economy. Simultaneously, lowered export costs resulted in the ability of exporters to compete even more successfully in the international market and thus spurred further export growth. The fact that returns were high to exporting also meant that savings rates were rising, and that the incentives for individuals to strive for further educational attainments remained high.

Thus, rates of factor accumulation were high; opportunities to shift resources from low-productivity activities (especially in rural areas and in the informal sector) were great; and economic policies were geared almost solely to improving the functioning of the economy.

As they did so, that, too contributed to growth. With hindsight, it is often assumed that growth was seamless and smooth throughout the period. But, in fact, there were numerous challenges confronted by policy makers. To name just a few of the important ones: Korea faced an incipient debt crisis in l969; the oil price increases of l973 and l979 adversely affected all of the East Asian economies which were devoid of their own petroleum resources[15], the assassination of President Park in the case of Korea[16], and the debt crisis of the early l980s (when all the East Asian NICs were able to maintain voluntary debt servicing). The ability of policy makers to identify the key impediments to growth, and to take corrective measures in a timely fashion was clearly important for East Asian growth.

This naturally raises the question as to the role of total factor productivity in growth. It is well-known that some analysts, most notably Alwyn Young[17], have argued that total factor productivity growth was not a significant factor in East Asia. His argument was based on data covering the period 1970 to l985 – itself significant, because the most rapid growth, and the initial shift in trade strategies had taken place a good ten years earlier.[18] Moreover, even Young did not assert that there was no total factor productivity growth – he found Chinese Taipei to have experienced an economy-wide rate of TFP of l.5%, Korea l.4%, and Hong Kong 2.5%. Only for Singapore did he find low productivity growth.

Aside from questioning whether the measure of total factor productivity growth from year to year is appropriate in circumstances where the adjustment to changed policies occurs over a longer period of time, such as it did in East Asia, there are several other grounds (including the one indicated in Note 18, page 24) for questioning the accuracy, and the interpretation, of the finding. First, measures

of total factor productivity growth are highly sensitive to errors in data, since total factor productivity growth is itself a residual. Recently, estimates based on use of factor prices, rather than quantities, have cast doubt on the results, and most East Asian analysts have rejected Young's findings.[19] Second, Young's results assume that all factor accumulation is exogenous – whereas, as explained above, much of the rapid growth of savings and educational attainments of the labour force, can be attributed to a sustained high real rate of return induced by the shift in trade strategies.

On this interpretation, the rapid growth of East Asian NICs, and more recently Southeast Asian NICs, was based on an interaction of factor accumulation and increased productivity of factor utilisation brought about first by the shift to an outward-oriented trade strategy, secondly by the stimulus to domestic efficiency (resulting from policy reforms as well as the actions of individual entrepreneurs) resulting from the outward-oriented trade strategy, and thirdly by the responsiveness of policy makers to the emerging problems that arose in their economies.

3. What went wrong in l996?

There is no point in rehashing the events of the "Asian crisis". The salient facts are that once Thailand had confronted a foreign-exchange and financial crisis[20], Malaysia, Indonesia and Korea soon faced similar difficulties. Even the other East Asian NICs, which avoided the extremities of those four economies, were faced with sharp decreases in their stock market prices, runs on their currencies, and significant slowdowns in economic activity.

There is also no doubt that these were "crises". For analysing future growth prospects for the NICs, the crucial question is why they arose. There are three classes of explanation put forward: l) markets were irrational and the crisis was unwarranted; 2) the "fundamentals" of the NICs had altered significantly, and investor reaction was to attack; and 3) the long period of rapid growth is over, and the crisis of l997 simply signalled that fact. Any assessment of the longer-term growth prospects hinges crucially on which of these three interpretations is correct. And, to be sure, there are elements of each of them in play. But if interpretation (l) is correct, nothing was seriously wrong, and growth will resume as soon as confidence is restored. On interpretation (2), a prognosis depends crucially on the correction of the underlying weaknesses in fundamentals. On interpretation (3), an end to the recession will be followed only by significantly slower growth than happened earlier.

Before turning to assessing these arguments, two preliminaries should be dealt with. A first factor has to do with the role of Japan's slump, and the downturn in the semiconductor market that preceded the crisis.[21] Some observers have pointed the finger at these "external" elements as "causing" the problems. There are several difficulties, however, with that argument. First, while it is true that the Japanese economy (and therefore Japanese imports from other countries in the region) grew relatively slowly in the l990s, world trade in goods, and in goods and services, was growing rapidly. The volume of trade in goods rose by 9.3% in l994, 9.5% in l995, 9.5% in l996 and 6.6% in l997. For goods and services, the corresponding numbers were l0.2, l0.3 6.2, and 9.6%. Thus, while trade in some goods was not expanding rapidly, there were offsets elsewhere.[22] As a whole, the world trade environment was still conducive to expansion. Second, even for Japan, the early l990s were years of relatively slow growth, not complete stagnation. And the same slow growth in earlier years had not resulted in a crisis. It was not until l997 that the Japanese economy really stumbled.[23] Third, other economies (most notably Chinese Taipei and Singapore) were subject to the same international environment and did not experience the same crises.

A second factor that is sometimes mentioned as a precipitating factor in the Asian crisis is the opening of capital markets. Some observers have noted that Asian NICs were opening their capital accounts, and blame the volatility of capital flows for the ensuing crises.

It is certainly true that Asians were opening their capital accounts, and in some instances not recognising the constraints that placed on monetary policy and the creation of domestic credit.[24] However, it is equally true that Asian countries could not have grown as rapidly as they did had they not been removing their barriers to fuller integration with the world economy. In particular, the huge expansions of domestic credit prior to the l997 difficulties would have resulted in – at a minimum – significantly more inflationary pressure than was realised with an open capital account. Moreover, in order to maintain an outward-oriented trade policy, it was necessary to maintain a reasonably open capital account. While it is possible that a more gradual opening of capital accounts might have delayed the crisis, it is difficult to believe that rapid growth could have persisted until l996 in the absence of a fair degree of capital account liberalisation.

In that regard, it should also be noted that a part of the capital inflow was undoubtedly the result of the fixed-nominal-exchange rate policies of the Southeast Asian countries. To the extent that market participants believed in these commitments to fixed exchange rates, foreigners found domestic investments to be very attractive. Had exchange rate policy (discussed further below) been more realistic, capital inflows would have been at least somewhat smaller prior to the crises, thus reducing the required magnitude of adjustments.

Turning then to the "irrationality" argument, the case is put by analysts such as Radelet and Sachs: "[underlying problems]… at both a macroeconomic and microeconomic level…were not severe enough to warrant a financial crisis of the magnitude that took place in the latter half of l997".[25] While they recognise the existence of some weaknesses, especially in the financial sector, they believe that policy mistakes once the crisis started, plus irrational market reactions, were the chief culprits.

This view hinges crucially on an evaluation of the "fundamentals" prior to the crisis. For the "fundamentals" view suggests that there was a basis for markets to react. On that interpretation, the markets were not irrational.[26] Hence, the fundamentals view is inconsistent with the market irrationality view.

A first point, as already noted, is that Chinese Taipei, Singapore, and Hong Kong did not experience currency crises.[27] That is, indeed, an important clue as to causation. If markets were truly irrational, all countries (even if markets are so irrational as to lose confidence only in one region of the world) should experience attacks. Yet, the three economies with current account surpluses, large reserves, and (with the exception of Hong Kong – see Table 3, page 28) relatively small rates of growth of domestic credit managed to ward off speculative attacks. While they have experienced reduced growth rates due in part to reduced demand from their crisis-afflicted trading partners, expected growth remains positive in all three.

Most analyses of foreign-exchange and financial crises identify three key variables as predictors of crises: the degree of overvaluation of the (real) exchange rate; the over-expansion of domestic credit; and the size of the current account deficit.[28] Tables 2, 3 and 4 give data on each of these variables for the East Asian countries.

Table 2 (page 27) presents estimates of the orders of magnitude of current account deficits from l993 to l997 for the four "crisis" countries. Singapore is included to provide a contrast. As can be

seen, Singapore ran huge surpluses (and maintained reserves equal to more than six months of imports throughout the period) in all years. Hence, Singapore (and Chinese Taipei, in part because of its huge reserves) was not subject to attack.[29] But Thailand ran current account deficits in excess of 5% of GDP in every year from l993, and indeed, deficits exceeded 8% of GDP in l996 and l997. While these were readily financed by capital inflows, all reports indicated a marked reduction in the rates of return on investments, both in construction and in manufacturing. In Malaysia as well, current account deficits were considerable, reaching 8.6% of GDP in l995: a stabilisation programme was effected in l996, and the magnitude of the current account deficit declined to 5.3% of GDP, still a sizeable number in light of the relatively low real returns on capital. Indonesia's numbers also were fairly sizeable, reaching a peak of a current account deficit equal to 7.7% of GDP in l996. Only in Korea do the numbers appear to be somewhat smaller.

Table 3 gives data on the growth of domestic credit in the four crisis countries and provides data on Hong Kong and Singapore as well. As can be seen, Malaysia and Thailand had rates of expansion of domestic credit that are well above anything sustainable. By l996, even Korea was expanding domestic credit at an annual rate of l0% Indonesia had had rates of expansion of 9% or more since l994. Only Singapore shows moderate growth rates for domestic credit.

When domestic credit expands rapidly, several things happen. First of all, lenders cannot properly evaluate loan applications, due to the rapid rate of increase.[30] Second, the rapid expansion of domestic credit drives up asset prices, which then are used as collateral to seek more credit. While in the short run, borrowers are able to provide collateral, there is vulnerability when asset prices start falling. Third, in most circumstances, governments in countries with open capital accounts are in fact incurring contingent liabilities when domestic credit expands. That is, since all holders of domestic currency may seek foreign exchange from the authorities in exchange, borrowers (or those paid by borrowers) can at any time convert their bank deposits into foreign exchange. Fourth, if (as was the case in Thailand and Malaysia) the authorities are simultaneously attempting to defend a fixed or virtually fixed exchange rate, the vulnerability of the banking system increases markedly with any change in the exchange rate that does occur. Fifth, when domestic credit expands rapidly, the same factors that lead to a likelihood of lowered quality of banks' portfolios lead to lower real rates of return on investment.

One of the lines of argument used by Radelet and Sachs and others to support the view that it was market irrationality is that there were very small fiscal imbalances in the crisis countries. However, once there is convertibility on capital account, the entire increase in domestic credit is equivalent to an increase in the fiscal deficit – at least in the contingent liability sense.[31] Financing a low-rate-of-return investment in the private sector with domestic credit is then not significantly different from financing that same investment through public borrowing.

Finally, Table 4 (page 28) gives estimates of real currency appreciation over the period since l990. Thailand and Malaysia had in fact attempted to maintain a fixed nominal exchange rate for a long period before l990, and it can be argued that their currency had already appreciated in real terms to a degree unwarranted by the underlying economic realities.[32] But even if it is assumed that l990 was a year in which all the currencies were appropriately valued, it is evident that there was sizeable real appreciation: in the cases of Malaysia, Thailand and Indonesia, real appreciation over the seven years from l990 had reached 25%. Korea's was a much smaller 11%.

There are thus strong grounds for believing that there were significant economic policy problems in all four crisis countries. All but Korea had currencies that were arguably significantly overvalued.

All had very rapid rates of growth of domestic credit and because of that, the amount of non-performing loans in the banks' portfolios was increasing rapidly. And all were incurring sizeable current account deficits.

Since fundamentals were weak, issues such as the fall in semiconductor exports can be used to explain the timing of the first crisis; contagion may have been important in its spread; but the fact is that the countries which underwent financial crisis did have weak fundamentals in a number of important respects.

What, then, of the third hypothesis? That is, is it possible that markets recognised that there was a long-term slowdown in the potential growth rates of the East Asian NICs? There are several problems with the argument. First of all, given the length of time that East Asian NICs sustained their rapid growth, there is no reason why Thailand, Malaysia, and Indonesia, still at much lower *per capita* incomes and having experienced less than two decades of rapid growth, should experience a secular reduction in their rates of potential growth at this point in time.[33] Second, insofar as there was market expectation of a slowdown in growth, there is no reason why there should have been a sudden change in expectations. Third, there is no underlying reason why any growth slowdown should take place suddenly; much more likely would be a gradual reduction in the rate of economic growth.

4. What are future growth prospects for Asian NICs?

Given all these considerations, there is strong reason to accept the proposition that weak fundamentals were proximately responsible for the Asian crises. To be sure, their timing may have been influenced by a decline in semiconductor exports or the prolonged Japanese recession, but there is considerable basis for believing that policy weaknesses were the main factor.[34]

To the extent that interpretation is correct, it suggests that the chief determinant of the timing of a return to growth will be the rate at which the fundamental policy problems are addressed. Of the three problems pinpointed – currency overvaluation, large current account deficits, and rapid domestic credit expansion – the first two have been addressed. The third, domestic credit, appears to be the major issue that requires significant further policies if growth is to resume.

The reasons are straightforward. A significant fraction of non-performing loans in banks' portfolios requires one of two responses: either the borrowers who are unable to service their debts must be extended additional credit to cover their debt-service obligations (evergreen accounts) or the banks must recognise the non-performing loans on their books and become insolvent. When evergreen accounts are used to avoid recognition of non-performing loans, new domestic credit is diverted to those whose loans are non-performing. That, in turn, means that much of new domestic credit is not available to finance new, profitable, ventures (especially in small and medium firms and in tradable goods industries where changes in the real exchange rate have made new ventures more profitable). Since those activities are the ones which would generate economic growth, the inability to receive credit means that economic activity cannot expand. Meanwhile, domestic interest rates are high because of the unsatisfied demand for loans, which simultaneously chokes off new ventures (which would otherwise be the source of growth) and raises the fraction of domestic credit that must be addressed to evergreen accounts.

To be sure, restructuring of financial institutions cannot be undertaken without restructuring of the finances of the large debtors. In many instances, recapitalisation of firms is required, often focusing on debt for equity swaps. Moreover, there is little point in restructuring unless measures are

taken to insure more appropriate prudential lending in the future. That, in turn, requires recapitalisation of the banks, no easy task at a time of crisis.

To be sure, other policy changes will be facilitate more rapid growth. More attention to infrastructure, education, the functioning of labour markets, corporate governance, and similar issues is undoubtedly desirable if more rapid growth is to be attained. Over the longer term, addressing these structural economic issues which affect economic efficiency will determine whether Asian NICs can resume their phenomenal growth record or whether, like many other countries, structural weaknesses retard economic performance.

Similarly, the more rapidly the Japanese economy revives, the greater the stimulus to growth will be from those necessary reforms which are in fact undertaken in Asian countries. Over the short run, Japanese growth, the state of the world economy, and other external phenomena will affect economic performance. But those are largely cyclical issues. The longer-term prospects of the Asian NICs depend crucially on their ability to address those policy weaknesses that are resulting in major distortions in their domestic economies.

NOTES

1 World Trade Organization, *International Trade l995. Trends and Statistics*, p. 13. World Trade Organization, Geneva.

2 See my "Trade Policy and Economic Development: How We Learn", *American Economic Review*, March l997 for an analysis of the climate of opinion in the l950s and l960s and the changes that have occurred.

3 These data, and others, can be found in any standard treatment of the Korean economy during the l950s. Accounts may be found in David Cole and Princeton Lyman, *Korean Development, the Interplay of Politics and Economics*, Harvard University Press, Cambridge. 1971, and in Anne O. Krueger *The Developmental Role of the Foreign Sector and Aid, Studies in the Modernization of the Republic of Korea: l945-l975*. Harvard University Press 1979.

4 When Malaysia achieved independence after the insurgency, Singapore was a part of Malaysia. Singapore separated from Malaysia in l965 and adopted outward-oriented trade policies shortly thereafter. Its rapid economic growth dates from approximately l967.

5 Strictly speaking, there was a specified import content of most exportables, but it was sufficiently generously set with a "wastage allowance" that the above statement correctly describes the reality.

6 One source of misunderstanding of the success of the outward-oriented trade strategy has arisen because the authorities did not immediately move legally to a unified exchange rate. Instead, all exporters were entitled to a specified number of won per dollar as "tax rebate", "export subsidy" and "credit subsidy", in addition to the official exchange rate. But these entitlements applied to all exports, and did not discriminate among commodities. Moreover, all estimates show that the entitlements did no more than remove the discrimination against exporters that had earlier existed: the won received per dollar of exports remained at the same level as the won paid per dollar of imports (tariffs included). See Charles R. Frank, Kwang Suk Kim, and Larry E. Westphal, *Foreign Trade Regimes and Economic Development*, Columbia University Press, l975, for a careful analysis and quantification.

7 During the years of very rapid growth, real wages of relatively unskilled manufacturing workers were rising very rapidly.

8 It is sometimes forgotten that Thailand operated a multiple exchange rate system in the l950s which was regarded at that time as one of the more chaotic in the world.

9 It is of interest that neither Korea nor Japan had relied to any significant extent on direct foreign investment as a source of financing capacity expansion in the years of most rapid growth. Indeed, in South Korea, foreign direct investment was generally discouraged until the l980s, unless it was deemed to be desirable because of the technology that would come with it, or because of other attributes.

10 In a sense, it could be argued that even this was at least in a sense a form of "following the East Asians". Singapore had long since permitted a (controlled) inflow of foreign workers to avoid a labour

bottleneck to further growth; and Hong Kong of course continued to augment its population with refugees.

11 Korea actually achieved an annual average rate of economic growth in real terms of l3% annually over the decade starting in 1963.

12 There were, of course, deviations from the total commitment to exporting in NICs. But they were few and far between. For most of the NICs, economists have demonstrated that most of the deviations, when government officials attempted to encourage the development of new industries for the domestic market, resulted in a lower rate of growth than could otherwise have been achieved.

13 It is estimated that, during the l960s, the average real rate of return on investment in the NICs exceeded 30%. See, for example, Wontack Hong, "Trade and Employment in Korea" in Anne O. Krueger, editor, *Trade and Employment in Developing Countries*, Vol. 1, University of Chicago Press, Chicago, l983.

14 Singapore's exports are recorded at more than l00% of GDP because of the re-exporting of imported crude oil in its refined state. Korea's exports peaked at more than 35% of GDP, while Chinese Taipei's account for more than 40% of GDP.

15 After the l973-74 oil price increase, it was estimated that the most severe terms of trade shocks had been experienced by those economies which were not exporting other primary commodities (many of which had also experienced sharp price increases in the early l970s) and were importing oil. This categorisation fit all four East Asian NICs.

16 After Park's assassination, gross investment in Korea fell to zero over the next six months. In fact, Korean economic growth had almost stalled in l978-79. Export volume actually fell in l979, and major policy changes had to be made.

17 YOUNG, Alwyn (1993), "Lessons from the East Asian NICs: A Contrarian View", *NBER Working Paper* No. 4482, October l993.

18 Imagine an economy in which all (identical) workers are in agriculture, each working with a very small amount of capital and earning a very low marginal product. Suppose, then, that one factory were established in the urban areas in year l, with a marginal product of labour and capital each twice that in agriculture. Suppose further that 1% of resources move to that factory in year l. Total factor productivity growth would be l% (since 1% of resources moved and had 2% output growth). If, over the next few years, all other workers and capital shifted to the same type of factory employment, output would double (even without factor accumulation) and, from its initial level, so would total factor productivity. But, measured as a year-by-year process, zero factor productivity growth would be recorded after the first year: all growth would show up as consisting of intersectoral shifts of resources (in the absence of factor accumulation).

19 See for example the papers in Vittorio Corbo and Sang-Mok Suh, 1992, *Structural Adjustment in a Newly Industrialised Country*, Johns Hopkins Press, Baltimore. For very different total factor productivity growth estimates, especially for the earlier years in Korea, see Kwang Suk Kim and Michael Roemer, *Growth and Structural Transformation*, Harvard University Press, 1979.

20 It will be argued later that, in the context of an open capital account, a foreign exchange crisis is a financial crisis, and vice versa.

21 It is sometimes asserted that the earlier devaluation of the Chinese yuan was also a significant contributor. Yet the evidence suggests that the devaluation was more *de jure* than *de facto*, as about 90% of exports had been shipping at the new rate before it become official. However, it is certainly true that Chinese entry into international markets in the l990s provided additional competition for the Southeast Asian NICs. To that extent, Chinese competition, like the Japanese slump, was a contributor to the crisis, but all of these phenomena together cannot explain the data on fundamentals that are presented below.

22 Data are from International Monetary Fund, *World Economic Outlook*, May l998, Table A22. The dollar price of goods traded internationally is estimated to have decreased l.2% in l996, although prices in SDRs rose.

23 The real appreciation of the yen during the l990s intensified the overvaluation of the Asian crisis countries. This came about because they had linked their currencies to the dollar during the time of yen appreciation. See Table 3, and the discussion of exchange rate overvaluation.

24 When individuals are not free to convert their domestic currency into foreign exchange and vice versa, the "contingent liability" aspect of domestic credit creation, discussed below, is not as significant a consideration as it is when domestic currency is more fully convertible. Domestic credit creation in that case, however, results in accelerating inflation.

25 Steven Radelet and Jeffrey Sachs, "The Onset of the East Asian Financial Crisis", p. 3. *NBER Working Paper* No. 6680, August 1998.

26 The fundamentals view suggests that attacks will start occurring when current account deficits have resulted in reserve losses (or increases in short term liabilities) sufficient so that a government's ability to defend its currency is greatly diminished. Thus, a country could have "weak fundamentals" for a number of years if it started out with little debt and high-levels of reserves (or other foreign assets). As debt mounted and/or reserves diminished, the same weak fundamentals could lead to attack.

27 It is sometimes pointed out that China, too, escaped attack. But Chinese exchange controls, and the far smaller degree of integration with the world economy, make that argument inconclusive.

28 See Aaron Tornell, "Fundamentals and Contagion in Currency Crises", Center for Research in Economic Development and Policy Reform, Stanford University, *Working Paper No. 20*, September l998.

29 It is true that there were exchange rate adjustments in some of the economies that avoided crisis. However, once Indonesia, Thailand, Malaysia and South Korea had all experienced substantial real devalutions, the competitive positions of the other countries would have deteriorated markedly in the absence of exchange rate adjustment. Indeed, it can be argued that in the case of Chinese Taipei, the rapid adjustment of the exchange rate was a part of the reasons why crisis in the sense of Thailand and Malaysia was avoided.

30 Even if banks were to attempt to expand their lending departments rapidly, personnel would be highly inexperienced.

31 Note that it was increases in domestic credit that fuelled the large current account deficits, since government accounts were roughly in balance.

32 There is in the short-run a mechanism that enables real appreciation to persist. That is, as long as a currency is appreciating in real terms, the real rate of return to foreigners on investments exceeds the

real rate of return in domestic currency. Thus, foreigners may be induced to invest (primarily in home, or nontraded, goods) even when real rates of return are falling. The additional supply of foreign exchange provided by those foreign investors permits, at least for a time, the continued appreciation of the exchange rate.

33 It could, of course, be argued that failure to address fundamental policy problems, such as weaknesses in the financial system, will choke off further growth potential. But that line of argument supports the "fundamentals" hypothesis. It was always true in East Asia that had bottlenecks and distortions not been addressed, growth rates would have dropped.

34 Sachs and Radelet (l998) argue that there is little evidence that the markets anticipated the crisis. This argument has several weaknesses, of which the most important is that if the markets had earlier anticipated a crisis, the crisis would have come sooner! In addition, however, a continuing large capital inflow was necessary in order to maintain growth in the countries incurring large current account deficits. All that was required was for the capital inflow to slow down, and the policies that had been carried out before were no longer sustainable.

Table l**. Growth rates of Asian and other developing countries**

	l960-76	1965-85	1985-95
All low-income countries	0.9	2.9	3.8[1]
All middle-income countries	2.8	3.0	-0.7
Hong Kong	6.5	6.1	4.8
Indonesia	3.4	4.8	6.0
Korea	7.3	6.6	7.7
Malaysia	3.9	4.4	5.7
Singapore	7.5	7.6	6.2
Thailand	4.5	4.0	8.4

Notes:
1. The growth rate of *per capita* income for low-income countries excluding India and China was minus l.4% over the l985-95 time period.

Source: World Bank, *World Development Reports*, l976, l987 and l997.

Table 2**. Current account deficits**
(billions of US dollars and % of GDP)

	1993	1994	1995	1996	1997
Indonesia	2.1	2.8	6.4	7.7	4.8
	(l.3)	(1.6)	(3.2)	(3.4)	(3.6)
Korea	-1.0	3.9	8.5	23.0	8.2
	(-.3)	(1.0)	(1.9)	(5.0)	(3.3)
Malaysia	3.0	4.5	7.4	5.7	n.a.
	(4.9)	(6.1)	(8.6)	(5.3)	
Singapore	-4.3	-11.5	-14.4	-14.7	-14.8
	(-7.3)	(15.5)	(-16.8)	(-15.5)	(n.a.)
Thailand	6.4	8.1	13.6	14.7	2.9
	(5.2)	(5.6)	(8.2)	(8.2)	(2.8)

Notes:

1. A minus sign indicates a current account surplus.
2. Figures in parentheses are percentages of GDP.

Source: IMF, *International Financial Statistics,* September l998, lines 78ald, 99b, ae.

Table 3**. Growth of domestic credit**
(as % of GDP)

	1993	1994	1995	1996	1997
Hong Kong	22.6	28.9	11.7	24.0	26.2
Indonesia	8.3	9.4	9.2	10.0	11.9
Korea	6.7	9.4	7.8	10.6	14.1
Malaysia	9.3	10.9	21.7	22.8	28.0
Singapore	6.3	6.6	9.0	9.6	n.a.
Thailand	14.9	20.4	l8.2	l2.4	3l.0

Source: International Monetary Fund, *International Financial Statistics,* September 1998, lines 32, 99b.

Table 4**. Estimates of real currency appreciation**
(1990 = 100)

	Indonesia	Korea	Malaysia	Thailand
December 1991	99	99	99	97
December 1992	92	94	87	90
December 1993	88	93	88	88
December 1994	92	91	86	89
December 1995	89	88	84	87
December 1996	80	88	78	80
March 1997	75	89	72	75

Notes:

1. An increase means a depreciation
2. Wholesale price indices were used; trade weights were used for the OECD countries except for Mexico and Korea.

Source: Radelet and Sachs, op. cit. Table l0.

1.2 SOURCES OF ECONOMIC GROWTH IN EAST ASIAN ECONOMIES: WHY DID CAPITAL STOCK GROW SO RAPIDLY?*

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Introduction

Why did East Asian economies grow faster than most other developing economies during past decades? The question has stimulated a large number of empirical studies which attempted to identify factors contributing to the East Asian economic 'miracle'.[1] In previous literature, two types of empirical studies have been done. The first type of study was cross-country regressions based on data sets which cover a large number of countries (see, for example, World Bank (1993)). These studies frequently pointed out several factors contributing to the East Asian economic 'miracle': outward-looking development strategies, high domestic saving rates, strong inflows of foreign direct investment, technological 'catch up', relatively low income inequality, a stable macroeconomic environment, a market-friendly policy environment, and so on. However, even allowing these factors, the cross-country regressions failed to explain the 'miraculous' economic growth of East Asian economies, particularly high growth rates of the East Asian NIEs (see, for example, Pack and Page (1994), Page (1994), and Easterly (1995)).[2]

The second type of study was growth accounting approaches which calculated total factor productivity (TFP) growth by using country-specific time-series data. Although some of them found significant TFP improvement, most recent studies concluded that rapid expansion of the East Asian economies relied principally on the measurable mobilisation of additional resources, especially capital accumulation (Young (1992, 1994, and 1995), Kim and Lau (1993, 1994a, b), and Collins and Bosworth (1996)). In particular, based on their findings, Krugman (1994) suggested that the East Asian economies would not be able to maintain strong growth for long because the pattern of their growth is extensive, with little growth in total factor productivity.

These results are in marked contrast with those of cross-country regressions that failed to explain rapid expansion of the East Asian economies by measurable factors. One possible reason for having these conflicting findings is that cross-country variations of parameter values are allowed in growth

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accounting based on country-specific time-series data but not in cross-country regressions. In fact, some previous studies reported that the growth accounting might have estimated smaller East Asian TFP growth because they set larger capital shares in the East Asian economies (see, for example, Rodrik (1997), Dowling and Summers (1998)). Since cross-country regressions generally restrict cross-country variation of capital shares, it may cause bad performance of cross-country regressions in explaining rapid expansion of the East Asian economies.

However, in addition to this possibility, we need to note that a key explanatory variable is different between two types of analyses. That is, in capturing the effects of capital accumulation, growth accounting studies usually use growth rates of capital stock, while the standard cross-country regressions use shares of investment in total output. Although the use of investment shares in cross-country regressions can be theoretically justified by Mankiw, Romer, and Weil (1992), Benhabib and Spiegel (1994) have shown evidence that the use of capital stock data may change previous cross-country regression results drastically. The first purpose of this paper is to examine whether the use of capital stock data in cross-country regressions can improve explanatory power for East Asian high rates of economic growth. Replacing shares of investment in GDP by four alternative growth rates of capital stock, we find that cross-country regressions can explain East Asian high rates of economic growth remarkably well.

Proposing that rapid expansion of the East Asian economies relied principally on rapid expansion of capital stock, our result is observationally consistent with recent studies on growth accounting. However, it also indicates that the effect of growth rates of capital stock on the economic growth of East Asian economies, has been larger than that of shares of investment.[3] The second purpose of this paper is to examine what it was that made growth rates of capital stock so different from shares of investment in the East Asian economies. Compared with other developing countries, we show that high rates of investment were not unusual[4] but that low capital-output ratios, or equivalent labour-intensive industry structures, are quite unusual in the East Asian economies.

The last empirical finding is noteworthy because it indicates that the pattern of their growth was not necessarily extensive. That is, although rapid expansion of capital stock has been the primary source of economic growth in the East Asian economies, it did not need excessive investment rates in total output because of highly labour-intensive industry structures. This finding, however, raises another question as to why the East Asian economies have more labour-intensive industry structures. One plausible response is that the East Asian economies have had a comparative advantage in labour-intensive industries under an open trading system.[5] That is, most of the East Asian economies are small, open economies that have high population densities and low natural resources. Therefore, given an open trading system where prices are mainly determined in the world markets, they can specialise in exporting labour-intensive products through importing capital-intensive products and raw materials. Further, their outward-looking development strategies intensified this trading pattern and produced remarkable rates of economic growth with rapid expansion of capital stock but without excessive investment rates.

This view is consistent with our empirical findings because “openness” amplified the effects of capital accumulation on economic growth in our regressions. It is also partly consistent with a number of studies that stressed the special role of exports and outward orientation strategies for economic growth (for example, Balassa (1978), Krueger (1980), Feder (1982), Roubini and Sala-i-Martin (1991), and Edwards (1992)). However, while these previous studies highlighted various beneficial aspects of exports and international trade[6] our results indicate that in the case of the East Asian economies, “openness” was reflected mainly in remarkable growth rates of capital stock. In

particular, this implies that except for technological progress embodied in physical capital accumulation, exports and outward orientation did not lead to widespread technological spill-overs and cumulative productivity benefits in the East Asian economies.[7]

As previous studies on the Dutch disease pointed out, a rich endowment of arable land and natural resources can be a mixed blessing in an open trading system (see for example, Corden (1984) and Matsuyama (1992)). High productivity and output in the capital-intensive import substitution sector may squeeze out the labour-intensive manufacturing sector. On the other hand, economies which lack arable land and thus have the initial comparative (but necessarily absolute) advantage in labour-intensive manufacturing may successfully industrialise by relying heavily on foreign trade through importing capital-intensive products and raw materials and exporting labour-intensive manufacturing products. Noting that outward-looking development strategies intensified this labour-intensive exporting pattern, the rapid expansion of the East Asian economies can be considered a good example of this process of industrialisation.

The above version of East Asian industrialisation may imply that the East Asian economies have experienced significant technological progress embodied in physical capital accumulation. However, unless growth rates of output are as large as growth rates of capital stock, high growth rates of capital stock cannot support low capital-output ratios for long. In fact, when we plot the time-series data of capital-output ratios in the East Asian Economies, with the exception of Hong Kong we see a significant upward trend in their capital-output ratios. This indicates that rapid expansion of capital stock without excessive investment rates is becoming more difficult in the East Asian economies because their industry structures are changing from more labour-intensive ones to more capital-intensive ones.

The paper proceeds as follows: Section 1 presents standard cross-country evidence which fails to explain remarkable growth rates in East Asian economies. Section 2 shows that the use of growth rates of capital improves the explanatory power of cross-country regressions on economic growth in East Asian economies. Section 3 investigates the reasons why investment rates and growth rates of capital had different effects on economic growth in East Asian economies and Section 4 explores why the East Asian economies have such high labour-intensive industry structures. Section 5 discusses the sustainability of rapid capital accumulation in the East Asian economies, and Section 6 summarises our main results and discusses their implications.

1. Results from standard cross-country regressions

Recent empirical studies on economic growth have paid special attention to cross-country regressions using the data set of a large number of countries (e.g., Barro (1991)). In particular, Mankiw, Romer, and Weil (1992) have shown that once we allow the difference in human capital, the cross-country regressions strongly support Solow's (1956) neo-classical growth models. Although the results were somewhat sensitive in other empirical studies (e.g., Levine and Renelt (1992)), the data set which may have large measurement errors surprisingly explains overall world-wide economic growth quite well.

However, even allowing various factors, many earlier cross-country regressions could not explain the 'miraculous' economic growth of East Asian economies, especially the high growth rates of the Asian NIEs. The purpose of this section is to reconfirm these results.

A basic equation we estimate in this section is as follows[8]:

$$(1)\ \ \Delta y/y = constant + a * y_0 + b * (I/Y) + c *(\Delta L/L) + d*X + e*Dummies,$$

where $\Delta y/y$ is the growth rate of real *per capita* income, y_0 is the logarithm of *per capita* real income in 1960, *I/Y* stands for the average shares of investment in GDP between 1960 and 1990, $\Delta L/L$ for the rates of population growth from 1960 to 1990, and *X* denotes the other factors which may have affected the rate of economic growth.

In the regressions, we included two East Asian dummy variables, as well as a Latin American dummy (*LAAM*) and a Sub-Saharan African dummy (*SAF*). One East Asian dummy is the East Asian *NIEs* dummy which takes one when country (i) is a member of the NIEs (that is, Hong Kong, Korea, Chinese Taipei, and Singapore) and is zero otherwise. The other East Asian dummy is the *ASEAN* dummy which takes 1 when country (i) is either Indonesia, Malaysia, or Thailand but takes zero otherwise. Since economic growth in the Philippines was less rapid than other East Asian economies, we did not include the Philippines in our *ASEAN* dummy. If these East Asian dummy variables are significantly positive, we can see that the estimated equation cannot explain high growth rates of the East Asian economies.

Except for the use of the East Asian dummies, this type of linear regression is standard in recent literature of economic growth. Except for the other factors *X*, we estimated this basic equation by using the cross-sectional data sets which augmented the Real National Accounts constructed by Summers and Heston (1988, 1991). The data sets include almost all of the world other than centrally planned economies. We used the Internet version of Summers-Heston data set which is updated up to 1992 on the web site.

As for the other factors *X* in equation (1), we used measures of human capital in Barro and Lee's (1996) educational attainment data set and several measures in Sachs and Warner's data set.[9] Among various measures of human capital in Barro and Lee's data set, we used a log of average schooling years in the total population in 1960 (*Lh*) and its growth rate over the period 1960-1990 ($\Delta h/h$). From measures in Sachs and Warner's data set, we used the following six variables: openness (*OPEN*)[10], share of exports of primary products in GNP in 1970 (*SXP*), physical access to international waters (*ACCESS*), tropical climate (*TROP*), log of life expectancy at birth, circa 1965-1970 (*LIFE*), and the difference between the growth rate of the economically active population and growth of total population (*GPOP*).

Table 1 (page 44) summarises our regression results.[11] All estimates were consistent with previous studies and most of them were statistically significant. In particular, regardless of the choice of data sets and the East Asian dummies, the coefficient of initial real income level, y_0, was significantly negative, implying that there was evidence of strong convergence in the world economy. However, both the *NIEs* and *ASEAN* dummies were significantly positive for all cases, implying that the estimated regressions cannot explain high growth rates in the East Asian economies, particularly the East Asian NIEs, that is, Hong Kong, Korea, Chinese Taipei, and Singapore.

For example, when we estimated (1) based on three basic explanatory variables (y_0, *I/Y*, and $\Delta L/L$), the estimated coefficients of the *NIEs* and *ASEAN* dummies respectively took 0.036 and 0.017. This implies that the basic cross-country model underestimates growth rates of the NIEs by 3.6% and growth rates of ASEAN by 1.7%. Even when we include human capital variables (*Lh* and $\Delta h/h$) in the regression, the estimated coefficients of the *NIEs* and *ASEAN* dummies respectively took 0.031 and

0.014, implying that the model underestimated growth rates of the NIEs by 3.1% and growth rates of ASEAN by 1.4%.

When we included some measures in Sachs and Warner's data set, the coefficients of the East Asian dummies became smaller. In particular, the inclusion of "Openness" (*OPEN*) and share of exports of primary products (*SXP*) made the *ASEAN* dummy less significant and reduced the significance level of the *NIEs* dummy to some extent. This indicates that outward-looking development strategies without exporting primary products was one important factor contributing to the East Asian economic 'miracle'.[12]

However, even if we used these explanatory variables, the East Asian *NIEs* dummy remained significantly positive in all regressions. Therefore, in identifying factors contributing to the East Asian economic 'miracle', in particular high growth rates of the East Asian NIEs, the standard cross-country regressions were not successful enough.

2. Cross-country regression based on the capital stock data

In the last section, we reconfirmed that standard cross-country regressions could not explain 'miraculous' economic growth of East Asian economies, especially high growth rates of the East Asian NIEs. These results are in marked contrast with those of growth accounting studies which show that rapid expansion of the East Asian economies relied principally on the measurable mobilisation of additional resources, especially capital accumulation.

One possible reason for the conflicting findings is that cross-country variations of parameter values are allowed in time-series analyses but not in cross-country regressions. However, in addition to this possibility, we need to note that a key explanatory variable is not common between two types of regressions. That is, in capturing the effects of capital accumulation, growth accounting studies usually use growth rates of capital stock, while standard cross-country regressions usually use shares of investment in total output.

The purpose of this section is to examine whether the use of capital stock data in cross-country regressions can improve explanatory power for East Asian high rates of economic growth. Specifically, using growth rates of capital stock, we estimated the following cross-country version of the growth accounting equation:

$$(2)\quad \Delta y/y = constant + a^* y_0 + b^*(\Delta k/k) + c^*(\Delta h/h) + d^*Lh + e^*Z + f^*Dummies,$$

where $\Delta k/k$ stands for growth rates of *per capita* physical capital stock and $\Delta h/h$ for the growth rates of *per capita* human capital stock.

The standard growth accounting methodology with human capital specifies an aggregate production function in which *per capita* income, Y_t, is dependent upon three input factors – physical capital, K_t, labour, L_t, and human capital, H_t. Assuming a Cobb-Douglass production function, $Y_t = A_t K_t^{\alpha} L_t^{\beta} H_t^{1-\alpha-\beta}$, the relationship for long-term growth can be expressed as $\Delta Y/Y = constant + \alpha^*(\Delta k/k) + \beta^*(\Delta L/L) + (1-\alpha-\beta)^*(\Delta H/H)$. Defining that $y \equiv Y/L$, $k \equiv K/L$, and $h \equiv H/L$, equation (2) specifies this relationship with other explanatory variables: log of the initial level of *per capita* real income y_0, log of the initial level of human capital stock *Lh*, a number of 'ancillary variables' *Z*, and dummy variables. Except for ancillary variables and dummy variables, the equation is similar to the equations

estimated by Benhabib and Spiegel (1994) and Pritchett (1995). Except for growth rates of capital stock, it is also similar to equation (1).

On world-wide estimates of physical capital stocks, limited studies provide alternative data sets. In the following analyses, we use the following four data sets of physical capital stocks: Nehru and Dhareshwar (1993), Benhabib and Spiegel (1994), King and Levine (1994), and the data from the World Development Report 1991.[13] These data sets estimated a variety of measures of physical capital stocks of nations by using the perpetual inventory method based on alternative assumptions to generate initial capital stock estimates.[14] Needless to say, world-wide estimates of capital stock are susceptible to measurement errors because of differences in measures of capital, depreciation rates applied, and a number of other factors. However, substantial measurement errors only tend to degrade the strength of estimated statistical relationships. In addition, checking the sensitivity of the results by alternative data sets, we may mitigate the possible estimation biases caused by measurement errors in capital stock.

Table 2 (pages 45-46) summarises our estimation results of equation (2) with and without three ancillary variables: $OPEN*(\Delta k/k)$, *TROP*, and *GPOP*.[15] Except for the East Asian dummies, the estimated coefficients were quite similar to those in previous studies. However, regardless of the choice of capital stock data, the table shows that growth rates of capital stock had a more significantly positive effect on economic growth than did shares of investment. In addition, even without three ancillary variables, the inclusion of growth rates of capital stock in the regression greatly reduced the significance level of the East Asian dummies.

For example, when we estimated equation (2) based on four basic explanatory variables (y_0, $\Delta k/k$, Lh, and $\Delta h/h$), the estimated coefficients of the *NIEs* and *ASEAN* dummies lay between 0.015 and 0.021 and between 0.002 and 0.009 respectively. Recalling that the corresponding estimates in Table 1 were 0.031 and 0.014, this indicates that when we simply replace I/Y by $\Delta k/k$ in the regression, the coefficient of the *NIEs* dummy declined from 1% to 1.9% and that of *ASEAN* declined from 0.5% to 1.2%. In particular, when we included three ancillary variables, especially a variable of $OPEN*(\Delta k/k)$, the East Asian dummies turned out to be statistically insignificant in most cases. This indicates that high rates of economic growth in the East Asian economies are no more unusual given their high growth rates of capital stock and high degrees of openness.

One noteworthy result in the above findings is that growth rates of capital stock and shares of investment had different effects on rapid expansion of the East Asian economies. In fact, when we plot both shares of investment and growth rates of capital stock, we find that the East Asian economies are remarkable outliers in the figure. For example, using four alternative data sets, Figure 1 (pages 48-51) shows cross-country evidence on how average shares of physical investment in GDP are correlated with growth rates of physical capital stock.[16] At the world-wide level, we can easily see that there exists strong positive correlation between investment rates and growth rates of capital stock in all cases. However, except for the Philippines (PHL), East Asian economies and Japan (JPN) are outliers for this world-wide positive correlation.

Among seven East Asian economies, Korea (KOR) and Chinese Taipei (TWN) are remarkable outliers in all figures, and so is Singapore (SGP) in three of four figures. For Hong Kong (HKG), Indonesia (IDN), Malaysia (MYS), and Thailand (THA), the deviations from world-wide positive correlation are relatively moderate. But, even in these economies, actual growth rates of capital stock were more than 2% higher than what was predicted by the world-wide positive correlation. Therefore, we can conclude that compared with other countries, these East Asian economies have had

enormously high growth rates of physical capital stock for their relatively moderate investment rates.[17]

3. Investment rates and growth rates of capital stock

In the last section, we presented cross-country evidence that growth rates of physical capital stock and shares of physical investment had different effects on rapid expansion of the East Asian economies. The purpose of this section is to investigate what made growth rates of physical capital stock so different from shares of physical investment in the East Asian economies.

Let us define physical capital stock at time t by K_t, output at time t by Y_t, and physical investment at time t by I_t. Then, we can derive the following identity:

$$(3)\quad I_t / K_t = (I_t / Y_t) / (K_t / Y_t)$$

Because I_t / K_t is approximately equal to $(K_t - K_{t-1}) / K_{t-1}$, this identity indicates that growth rates of capital stock can be high either when shares of investment in GDP (I_t / Y_t) are high, or when capital-output ratios (K_t / Y_t) are low.

When we look at world-wide data, the cross-country evidence shows that growth rates of physical capital stock have no significant negative correlation with capital-output ratios. For example, using King-Levine and Nehru-Dhareshwar data sets, Figure 2 (pages 52-55) presents cross-country evidence on how growth rates of *per capita* capital stock are correlated with average and initial capital-output ratios.[18] In the figure, we see no world-wide evidence that growth rates of capital stock have a significantly negative correlation with capital-output ratios. Recalling that growth rates of capital have had strongly positive correlation with shares of investment in GDP in Figure 1, this indicates that physical investment rates have been the dominant source of physical capital stock growth in most of the world economies.

However, except for the Philippines (PHL), the East Asian economies and Japan (JPN) are remarkable outliers for this world-wide evidence; as we have already seen, Figure 1 shows that the East Asian economies have had enormously high growth rates of capital stock for relatively moderate investment rates. On the other hand, Figure 2 demonstrates that the East Asian economies are unique in experiencing at the same time both low capital-output ratios and high growth rates of capital stock. In particular, focusing on the case of capital-output ratios in 1960 (Figure 2-(2a) and Figure 2-(2b)), we find that the East Asian economies, especially Korea (KOR), Chinese Taipei (TWN), and Singapore (SGP)), were located at the northwest of the figure, implying that they had exceptionally low capital-output.

The above result indicates a unique feature of the East Asian development process where low capital-output ratios at the early stage of industrialisation were responsible for remarkably high growth rates of capital stock in the following periods. Needless to say, this unique feature does not deny the importance of high investment rates and other factors in explaining high growth rates of capital stock in the East Asian economies. However, we should note the evidence that high investment rates were not enough to explain remarkable high growth rates of capital stock in the East Asian economies.

As far as we know, almost all of the previous studies interpreted rapid expansion of capital stock in the East Asian economies as attribuable to their high investment rates. In particular, several studies

such as Young (1995) and Krugman (1994) concluded that rapid expansion of the East Asian economies relied principally on extensive use of output for investment because rapid expansion of capital stock has been the primary source of their rapid economic growth. However, our result implies that this conclusion is not necessarily correct in explaining the remarkably rapid expansion of the East Asian economies during past decades, as it neglects the fact that capital-output ratios were exceptionally low in these economies.

In general, equation (3) suggests that when capital-output ratios are low, relatively moderate rates of investment can achieve highly unusual capital accumulation. Therefore, even if rapid expansion of capital stock is the primary source of economic growth, the economy can achieve it without excessive investment rates. Our result indicates that rapid expansion of the East Asian economies should be interpreted as such a development process. In particular, because economies with low capital-output ratios are labour-intensive, a source of remarkable capital accumulation in the East Asian economies should be attributed to highly labour-intensive industry structures at the early stages of their industrialisation.

4. Why were the East Asian economies so labour-intensive?

In the previous section, we pointed out that the East Asian Economies could achieve rapid expansion of capital stock without excessive investment rates because their industry structures were highly labour-intensive at the early stage of industrialisation. This finding, however, raises another question as to why the East Asian economies have more labour-intensive industry structures.

One plausible answer to this question is that the East Asian economies have had a comparative advantage in labour-intensive industries under an open trading system. In fact, most of the East Asian economies are small, open economies with high population densities and low natural resources. Therefore, in an open trading system where prices are mainly determined in the world markets, they have been able to specialise in exporting labour-intensive products through importing capital-intensive products and raw materials.

This view is consistent with our empirical findings because “openness” amplified the effects of capital accumulation on economic growth in our regressions. It is also consistent with the view that the East Asian economies lacking natural resources, and thus an initial comparative advantage in labour-intensive manufacturing, can successfully industrialise by relying heavily on foreign trade through importing capital-intensive products and raw materials, and exporting labour-intensive manufacturing products.

However, we should recall that unless remarkably high growth rates of capital stock were taken into account, the East Asian dummies remained significantly positive even if we included “openness” variables (that is, *OPEN* and *SXP*) in standard cross-country regressions.[19] This indicates that “openness” was not enough to explain the East Asian economic ‘miracle’ when we ignore the role of capital accumulation without extensive investment, or equivalently the role of labour-intensive industry structures at the early stage of industrialisation. It also implies that exports and outward orientation did not lead to widespread technological spill-overs and cumulative productivity benefits in the East Asian economies, with the exception of technological progress embodied in physical capital accumulation.

Moreover, we should note that outward-looking development strategies contribute to remarkable rates of economic growth only under labour-intensive industry structures. Recalling that labour-

intensive industry structures were guided by targeted industrial policies in many East Asian economies, this implies that outward-looking development strategies in the East Asian economies were successful not only because they established an open trading system but also because they targeted appropriate industries following the pattern of industrial sequencing.

In fact, under typical outward-looking development strategies, many of the East Asian economies started exporting highly labour-intensive industrial products such as textiles, apparel, and toys at the early stage of industrialisation. Only after the success of these labour-intensive light industries, did they move to the next stage of importing more sophisticated and less labour-intensive goods such as machinery, steel, chemicals, and shipbuilding.[20] During this industrialisation process, capital accumulation might have been observationally a primary source of economic growth in terms of growth accounting, and technological progresses could exist only when they were embodied in physical capital accumulation. However, for these economies, it was vital that less labour-intensive industry was promoted only after the success of more labour-intensive industry. If this pattern of industrial sequencing was not followed, the East Asian economies could not have achieved rapid capital growth of capital stock without extensive investment.

5. Sustainability of capital accumulation without extensive investment

In general, output level can grow as large as capital stock when there exist increasing-returns to scale in capital, when growth rates of human capital are large, or when rates of technological progress are large. Thus, if the East Asian economies satisfied these conditions, they could have supported low capital-output ratios for long. However, when we plot time-series movement of capital-output ratios during past decades, we can see significant upward trends in the capital-output ratios in the East Asian Economies, with the exception of Hong Kong.

For example, using King-Levine data set, Figure 3 (page 56) presents time-series evidence on how capital-output ratios in the East Asian NIEs and Japan have changed during past decades. The evidence shows that in all of the East Asian NIEs, capital-output ratios were relatively stable until the mid-1960s. Even after the late 1960s, capital-output ratios in Hong Kong (HKG) were stable around 1.5. However, since the early 1970s, capital-output ratios have had drastic upward trends in the other Asian NIEs. In particular, capital-output ratios in Singapore (SGP) rose from 1.5 to nearly 3, and those in Korea (KOR) and Chinese Taipei (TWN) rose from 1 to 2.

These upward trends in capital-output ratios probably reflect the fact that East Asian industry structures changed from more labour-intensive to less labour-intensive ones. Therefore, to the extent that technological progress was embodied in physical capital accumulation, the East Asian economies did enjoy a kind of technological spill-over with cumulative productivity benefits. However, the upward trends in capital-output ratios imply that rapid expansion of capital stock without excessive investment rates is becoming more difficult in the East Asian economies.

In fact, most of the East Asian economies experienced a significant decline in growth rates of capital stock in the 1980s, although their investment rates didn't decline in the 1980s. For example, Table 3 (page 47) shows how growth rates of *per capita* capital stock and investment rates changed from the mid-1960s to the 1980s in the East Asian economies. It shows that growth rates of capital stock in Korea and Chinese Taipei declined drastically in the first half of the 1980s and so did those in Indonesia and Malaysia in the latter half of the 1980s. However, it also shows that investment rates in these economies had upward trends from the mid-1960s to the 1980s.

In general, promoting particular industries at the early stages of industrialisation tends to be successful because it is relatively easy for the government to find targeted industries. However, it becomes more and more difficult as the economy develops and becomes more mature. The above empirical findings suggest that the East Asian economies are experiencing this type of difficulty, one which is commonly observed in most mature economies.

6. Concluding remarks

This paper tried to find an answer to the question of what contributed to faster growth in East Asian economies. In previous literature, cross-country regressions failed to explain the 'miraculous' economic growth of East Asian economies by measurable factors, while growth accounting studies based on country-specific time-series data found that rapid expansion of the East Asian economies relied principally on the measurable mobilisation of additional resources, especially capital accumulation. This paper first reconciled these two conflicting findings by showing that in replacing investment shares by growth rates of capital stock, cross-country regressions can explain East Asian high rates of economic growth remarkably well.

The result is observationally consistent with recent studies on growth accounting in concluding that the rapid expansion of the East Asian economies has relied principally on the rapid expansion of capital stock. However, it also indicates that growth rates of capital stock and shares of investment had different effects on economic growth in the East Asian economies. In fact, we found that high rates of investment were not unusual but that low capital-output ratios, or highly labour-intensive industry structures, were quite unusual in the East Asian economies. The above empirical findings are noteworthy because they indicate that the pattern of economic growth with high growth rates of capital stock was not necessarily extensive and that technological progress existed, embodied in capital accumulation of the East Asian economies.

We conjectured that the East Asian economies had a more labour-intensive industry structure because of their comparative advantage in labour-intensive industries under an open trading system. We also stressed the role of targeted industrial policies in establishing labour-intensive industry structures at the early stage of industrialisation. However, unless growth rates of output are as large as growth rates of capital stock, high growth rates of capital stock cannot support low capital-output ratios for long. By showing significant upward trends in their capital-output ratios, we were able to illustrate how rapid expansion of capital stock without excessive investment rates is becoming more difficult in recent East Asian economies.

Given these empirical facts, one possible structural reform in the East Asian economies is to find a new growth strategy without relying on rapid capital accumulation. For this new growth strategy, it is indispensable to promote investment in human capital accumulation and R&D activities in the long run. However, this strategy is not necessarily a realistic reform for the East Asian economies in the short run. For the short term, a more realistic structural reform would be to stop too rapid increases in capital-output ratios in the East Asian economies. Since remarkable growth performance in the East Asian economies has relied heavily and for a long time on highly labour-intensive industry structures, drastic increases in capital-output ratios could have a variety of negative impacts on East Asian economic growth. Such negative impacts would be costly, and gradualism is called for, in order to slow down the too-rapid increase in capital-output ratios.

NOTES

1 Throughout this paper, we define the East Asian economies by the Asian NIEs (Hong Kong, Korea, Chinese Taipei, and Singapore) plus three ASEAN countries (Indonesia, Malaysia, and Thailand).

2 In previous literature, Grier and Tullock (1989), Helliwell (1992), and Fukuda and Toya (1994, 1995) have shown that there was little evidence to support the convergence hypothesis in Asian countries.

3 In their growth accounting study, Drysdale and Huang (1997) found that replacing growth rates of capital stock by shares of investment led to larger TFP growth in East Asia.

4 This observation was stated in Page (1994).

5 Sachs and Warner (1995) emphasized this view in their empirical studies.

6 Highlighted various beneficial aspects of exports and international trade are greater capacity utilization, resource allocation according to comparative advantage, exploitation of economies of scale, technological improvements and efficient management in response to competitive pressures abroad, and so on (see Edwards (1993) for the survey).

7 This observation is consistent with Rodrik's (1994a,b) critics on the export-led growth, although he did not make distinction between capital stock growth and investment.

8 These estimations are based on the White's heteroskedastic-consistent estimates of the standard errors.

9 See Sachs and Warner (1997a) and (1997b) for a description of the data. The data set of Sachs and Warner provides other variables such as central government savings, a general institutional quality index, a measure of ethno-linguistic fractionalization, average national saving 1970-89, and average inflation 1965-90. However, because these variables are available only for limited number of countries, we did not include them in our explanatory variables.

10 The OPEN variable is a slightly revised version of the variable used in Sachs and Warner (1995). It is defined as the fraction of years during the period 1965-1990 in which the country is rated as an open economy according to the criteria in Sachs and Warner (1995). An economy is deemed to be open to trade if it satisfies four tests: (1) average tariff rates below 40%; (2) average quota and licensing coverage of imports of less than 40%; (3) a black market exchange rate premium that averaged less than 20% during the decade of the 1970s and 1980s; and (4) no extreme controls (taxes, quotas, state monopolies) on exports.

11 Because the Barro and Lee's human capital measures are available for 83 countries, most of our cross-country regressions are based on the sample size of 83 countries.

12 This view has been emphasized in a large number of previous studies (e.g, World Bank (1993), Pack and Page (1994), Page (1994), Fukuda and Toya (1995), and Sachs and Warner (1995)).

13 Except for the data of Benhabib and Spiegel (1994), we downloaded the capital stock data from the World Bank's homepage. As for the data on the East Asian economies, the data of Hong Kong is missing in Nehru and Dhareshwar (1993) and the data of Indonesia is missing in the data for World Development Report 1991.

14 The estimates by Benhabib and Spiegel (1994) and King and Levine (1994) are based on investment data in the Summers and Heston data set, while Nehru and Dhareshwar (1993) and World Development Report are based on investment data in the World Bank set.

15 OPEN*($\Delta k/k$) ≡ an OPEN variable multiplied by growth rates of *per capita* capital stock. After estimating equation (2) with several ancillary variables in Sachs-Warner data set, we found that these three ancillary variables were statistically significant and stable.

16 Average shares of investment in GDP are based on the Summers-Heston data set from 1960 to 1990.

17 In Figure 1, some African countries are also outliers in terms of this world-wide positive correlation. However, capital stock data of these countries might have serious measurement errors.

18 In the figures, we excluded the data of countries whose capital-output ratios exceeds four because measurement errors may be serious for them.

19 Picking up examples of Turkey and Chile in the early 1980s, Rodrik (1994b) showed that export orientation policy did not necessarily lead to an investment boom.

20 See Teranishi (1992) and Ito (1994, 1996) for Japanese experience.

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Table 1. **Estimation results from standard cross-country regressions**

y0	-0,005	-0,008	-0,012	-0,012	-0,011
	(-1.82)	(-2.97)	(-4.11)	(-4.52)	(-4.74)
I/Y	0,071	0,004	0,024	0,015	0,023
	(2.37)	(1.24)	(0.90)	(0.62)	(1.19)
ΔL/L	-0,267	-0,267	-0,171	0,168	0,224
	(-1.16)	(-1.27)	(-0.68)	(0.64)	(1.11)
Lh		0,012	-0,005	0,003	0,004
		(3.41)	(1.12)	(0.64)	(1.08)
Δh/h		0,012	0,005	0,004	0,005
		(2.70)	(0.99)	(0.82)	(1.06)
TROP			-0,012	-0,014	-0,009
			(-3.26)	(-3.73)	(-2.64)
LIFE			0,027	0,017	0,019
			(1.51)	(1.09)	(1.32)
ACCESS			-0,001	-0,005	-0,006
			(-0.47)	(-1.71)	(-2.42)
GPOP			0,011	0,010	0,011
			(1.55)	(1.79)	(2.89)
OPEN				0,018	0,017
				(3.57)	(4.65)
SXP					-0,050
					(-2.96)
SAF	-0,011	-0,009	-0,002	-0,000	0,004
Dummy	(-2.49)	(-1.80)	(-0.39)	(-0.23)	(0.96)
LAAM	-0,008	-0,009	-0,005	-0,001	-0,000
Dummy	(-1.90)	(-2.19)	(-1.35)	(-0.43)	(-0.21)
NIES	0,036	0,031	0,024	0,018	0,013
Dummy	(10.36)	(9.40)	(3.86)	(3.36)	(3.11)
ASEAN	0,017	0,014	0,018	0,008	0,010
Dummy	(4.37)	(3.34)	(3.92)	(2.16)	(1.58)
Adj. R-sq.	0,611	0,644	0,713	0,771	0,831
# of coun.	83	83	83	83	79

Notes:

1. T-values are in parentheses.
2. Estimated constant terms are not shown in the table.

Table 2-(1). **Cross-country regression results using capital stock data**

	King-Levine Data Set	King-Levine Data Set	Nehru Data Set	Nehru Data Set
y0	-0,004	-0,006	-0,003	-0,006
	(-1.99)	(-3.13)	(-1.33)	(-2.79)
Δk/k	0,341	0,190	0,364	0,195
	(5.00)	(2.73)	(4.77)	(2.30)
Lh	0,010	0,007	0,008	0,006
	(4.03)	(2.58)	(2.09)	(1.49)
Δh/h	0,009	0,005	0,007	0,006
	(2.46)	(1.66)	(1.22)	(1.13)
TROP		-0,010		-0,008
		(-3.68)		(-3.04)
GPOP		0,013		0,011
		(2.57)		(2.02)
OPEN		0,204		0,289
**(Δk/k)*		(2.05)		(3.43)
SAF	-0,004	-0,000	-0,006	-0,002
	(-0.92)	(-0.00)	(-1.07)	(-0.06)
LAAM	-0,008	-0,004	-0,008	-0,002
	(-2.90)	(-1.37)	(-2.90)	(-0.81)
NIES	0,020	0,008	0,012	0,005
Dummy	(4.35)	(1.17)	(2.37)	(0.82)
ASEAN	0,002	-0,001	0,005	-0,002
Dummy	(0.21)	(-0.13)	(1.44)	(-0.43)
Adj. R-sq.	0,755	0,806	0,755	0,815
# of coun.	83	83	73	73

Notes:

1. T-values are in parentheses.
2. Estimated constant terms are not shown in the table.

Table 2-(2). **Cross-country regression results using capital stock data**

	Benhabib Data Set	Benhabib Data Set	WDR Data Set	WDR Data Set
y0	-0,004	-0,007	-0,004	-0,006
	(-1.90)	(-3.54)	(-1.68)	(-2.80)
Δk/k	0,277	0,128	0,206	0,112
	(3.86)	(1.88)	(3.19)	(1.41)
Lh	0,007	0,005	0,009	0,007
	(1.84)	(1.43)	(2.71)	(2.04)
Δh/h	0,007	0,005	0,008	0,005
	(1.53)	(1.18)	(2.01)	(1.16)
TROP		-0,011		-0,010
		(-4.32)		(-3.00)
GPOP		0,011		0,013
		(2.27)		(2.25)
OPEN		0,295		0,113
**(Δk/k)*		(3.06)		(1.09)
SAF	-0,005	-0,000	-0,007	-0,003
	(-1.15)	(-0.11)	(-167)	(-0.76)
LAAM	-0,010	-0,002	-0,008	-0,005
	(-3.37)	(-0.97)	(-2.93)	(-1.91)
NIES	0,021	0,005	0,015	0,005
Dummy	(4.05)	(0.59)	(1.72)	(0.47)
ASEAN	0,008	0,005	0,009	0,007
Dummy	(2.07)	(1.17)	(2.00)	(1.24)
Adj. R-sq.	0,732	0,809	0,755	0,745
# of coun.	83	83	82	82

Notes:

1. T-values are in parentheses.
2. Estimated constant terms are not shown in the table.

Table 3. **Growth rates of capital stock growth, and investment rates in East Asia**

(i) Growth rates of capital stock

	KOR.	CH. TAI.	SING.	H.K.	INDON.	MAL.	THAI.	PHIL.	JAP.
1965-69	12%	10%	7%	4%	9%	4%	9%	4%	11%
1970-74	12%	13%	15%	5%	14%	7%	6%	3%	10%
1975-79	11%	10%	8%	6%	12%	7%	5%	6%	5%
1980-84	5%	6%	10%	7%	12%	9%	4%	3%	3%
1985-88	6%	4%	n.a.	5%	5%	2%	3%	-3%	3%

(ii) Shares of investment in GDP

	KOR.	CH. TAI.	SING.	H.K.	INDON.	MAL.	THAI.	PHIL.	JAP.
1965-69	18%	19%	24%	19%	7%	17%	19%	14%	34%
1970-74	22%	25%	39%	18%	14%	23%	18%	14%	39%
1975-79	28%	27%	33%	21%	18%	24%	18%	20%	35%
1980-84	28%	26%	40%	21%	24%	31%	17%	19%	32%
1985-89	31%	22%	33%	18%	26%	25%	18%	13%	34%
1990-92	n.a.	n.a.	35%	18%	27%	32%	29%	16%	38%

Legend: KOR. - Korea; CH. TAI. - Chinese Taipei; SING. - Singapore; H.K. - Hong Kong; INDON. - Indonesia; MAL. - Malaysia; THAI. - Thailand; PHIL. - Philippines; JAP.- Japan

Notes:

1. All figures are averaged values during the specified periods.
2. Growth rates of capital stock are based on the King-Levine data set.
3. Shares of investment in GDP are based on the Summers-Heston Data Set.

Figure 1-(1). **Physical investment and capital stock growth: King-Levine data set**

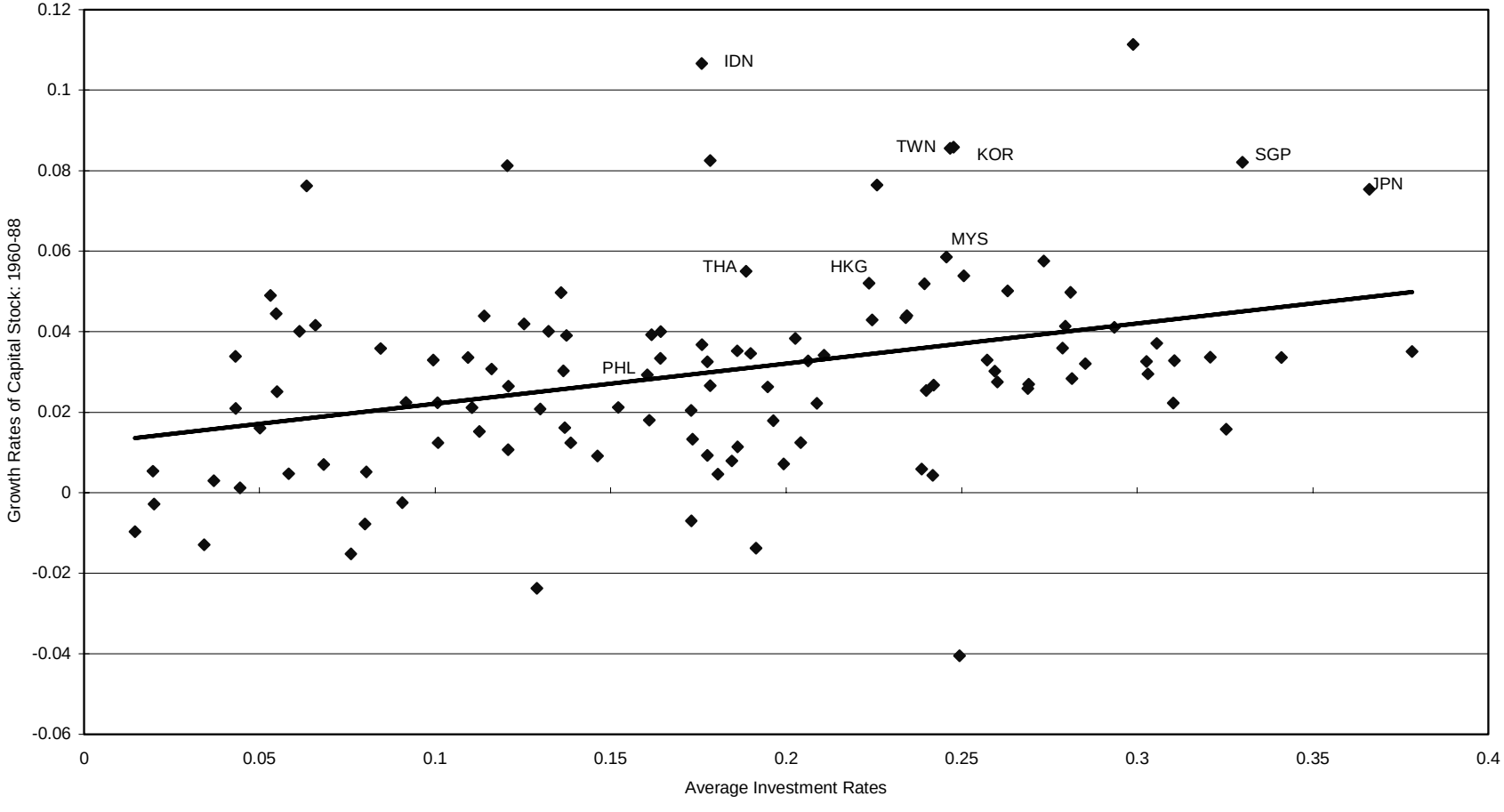


Figure 1-(2). **Physical investment and capital stock growth: Nehru-Dhareshwar data set**

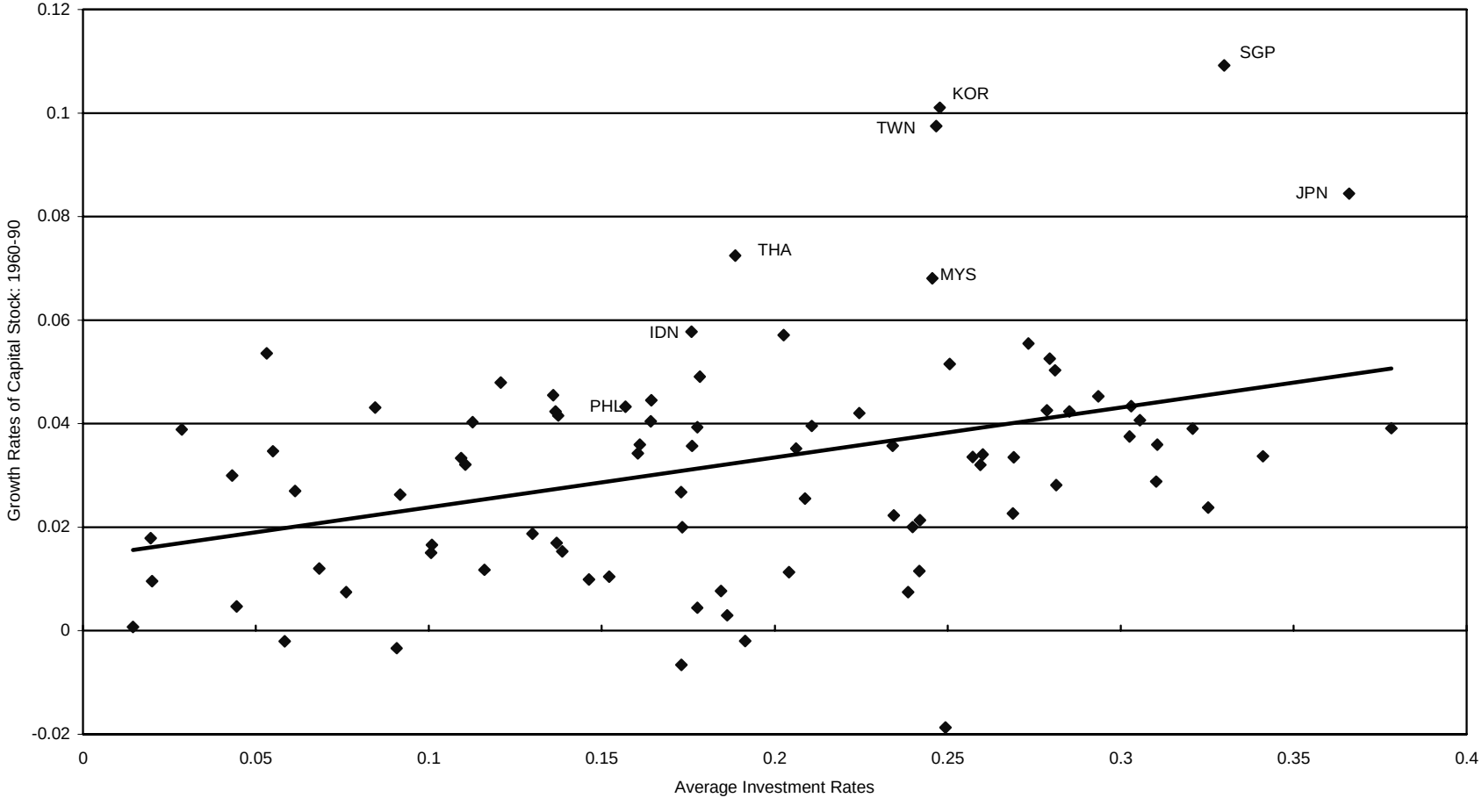


Figure 1-(3). **Physical investment and capital stock growth: Benhabib-Spiegel data set**

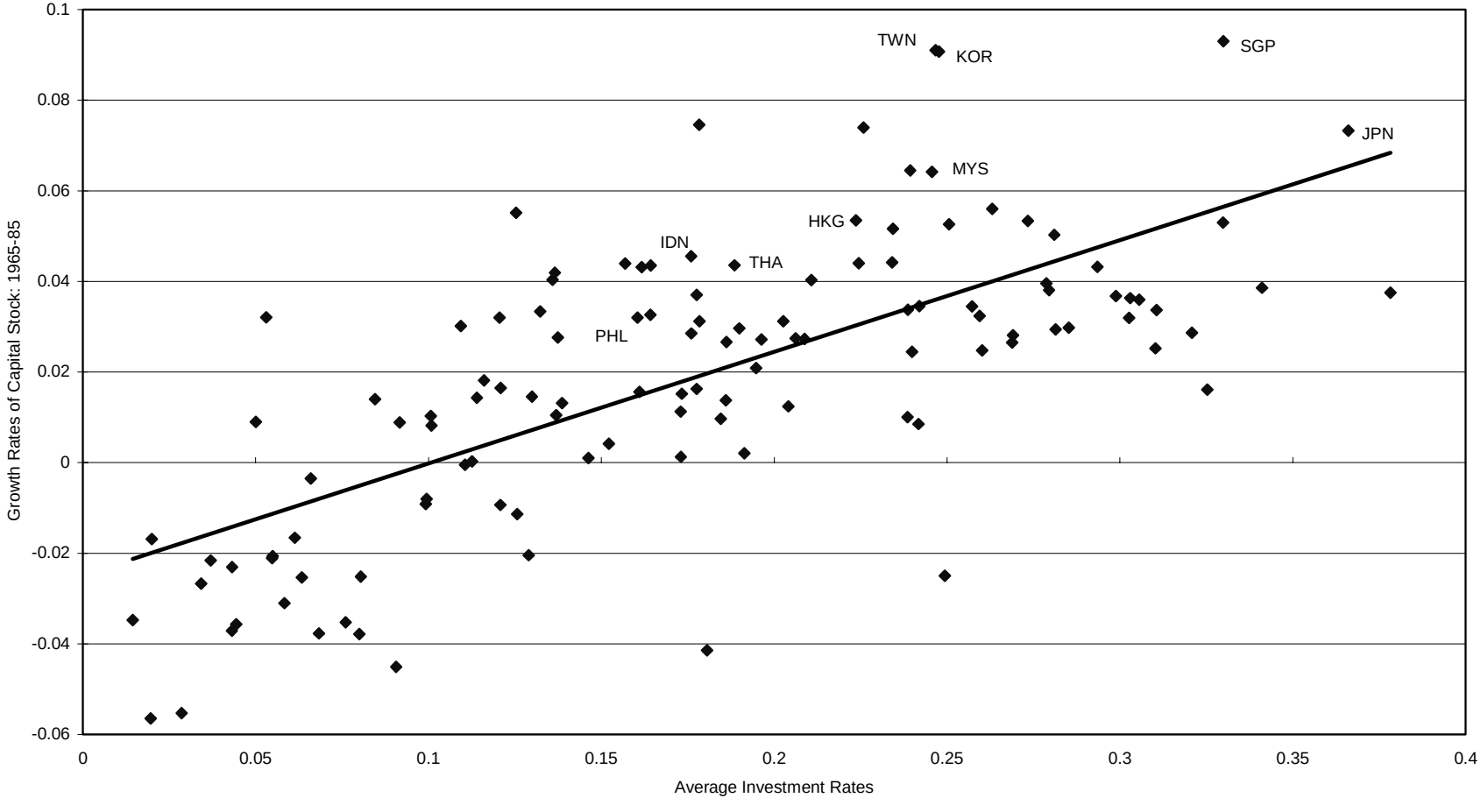


Figure 1-(4). **Physical investment and capital growth: World Development Reprot data set**

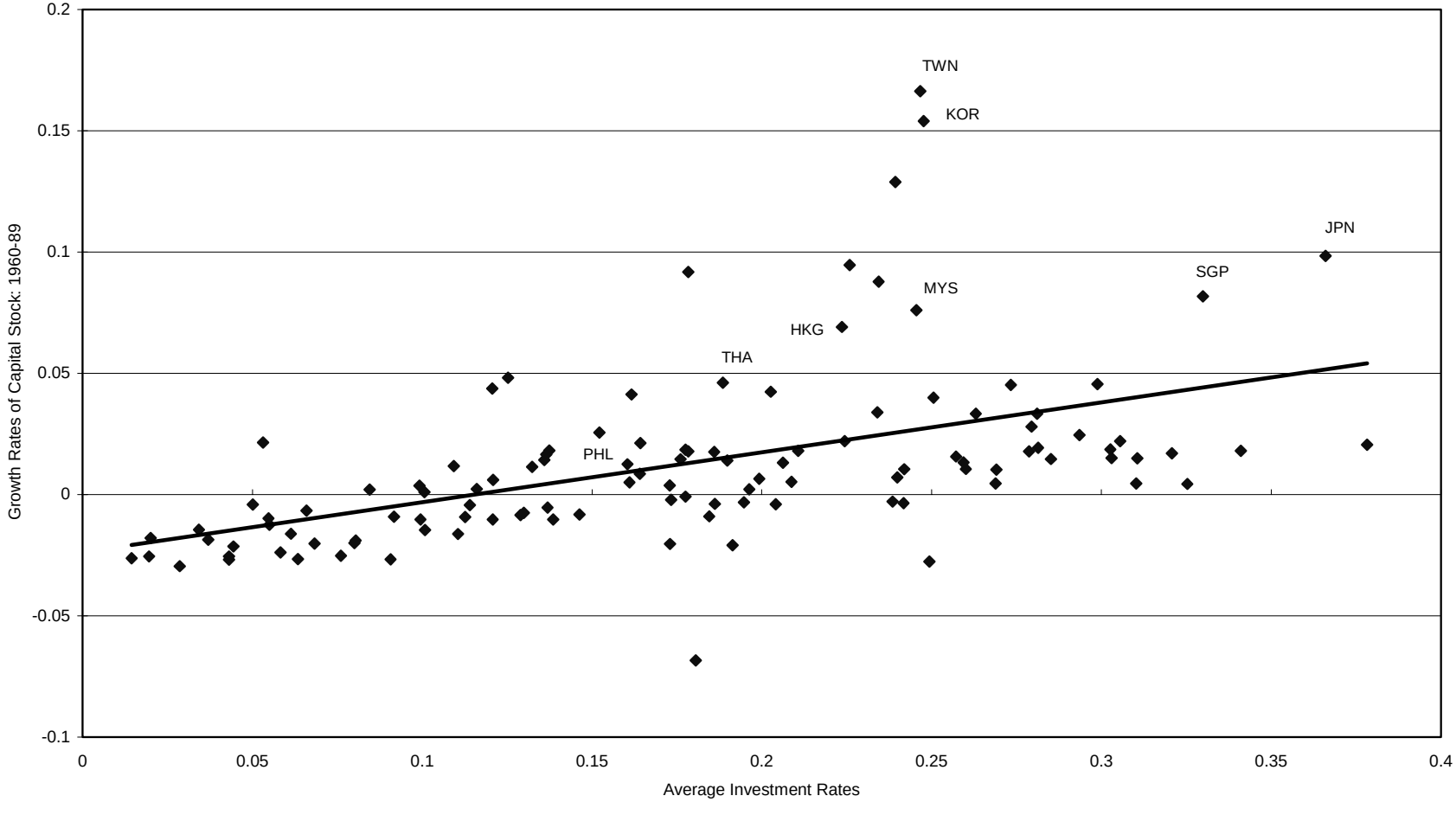


Figure 2-(1a). **Average capital-output ratios and capital stock growth: King-Levine data set**

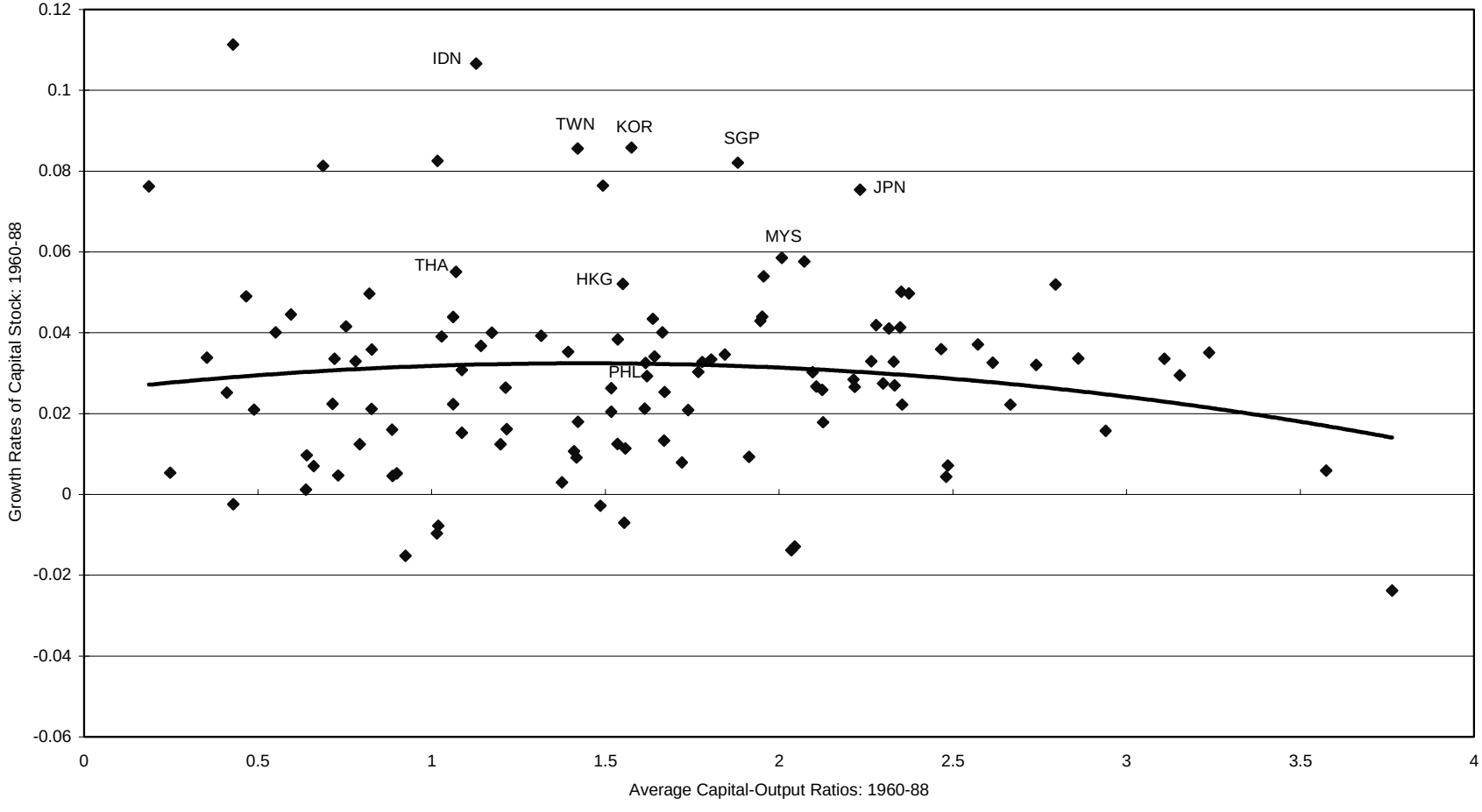


Figure 2-(1b). **Average capital-output ratios and capital stock growth: Nehru-Dhareshwar data set**

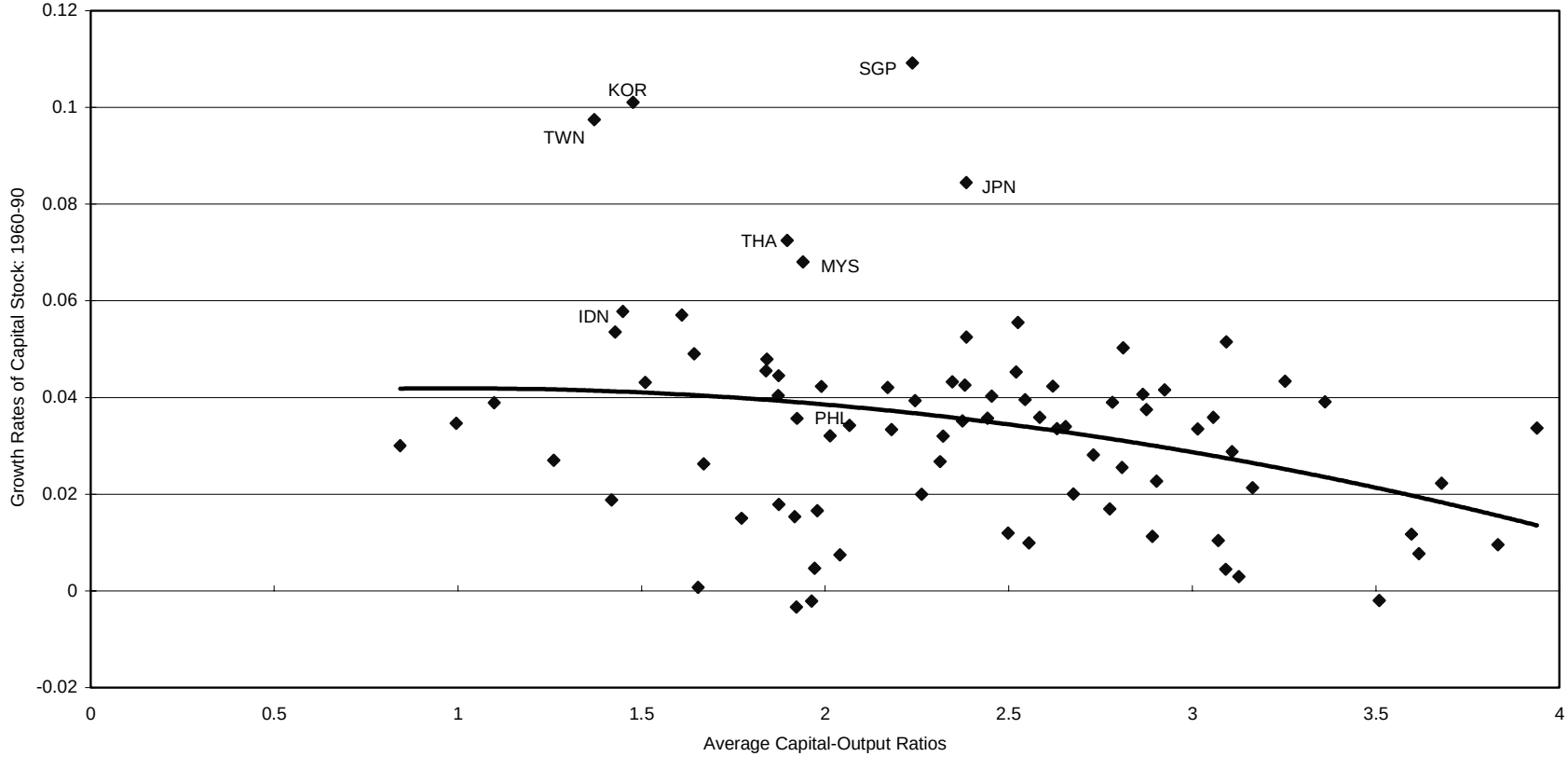


Figure 2-(2a). **Initial capital-output ratios and capital stock growth: King-Levine data set**

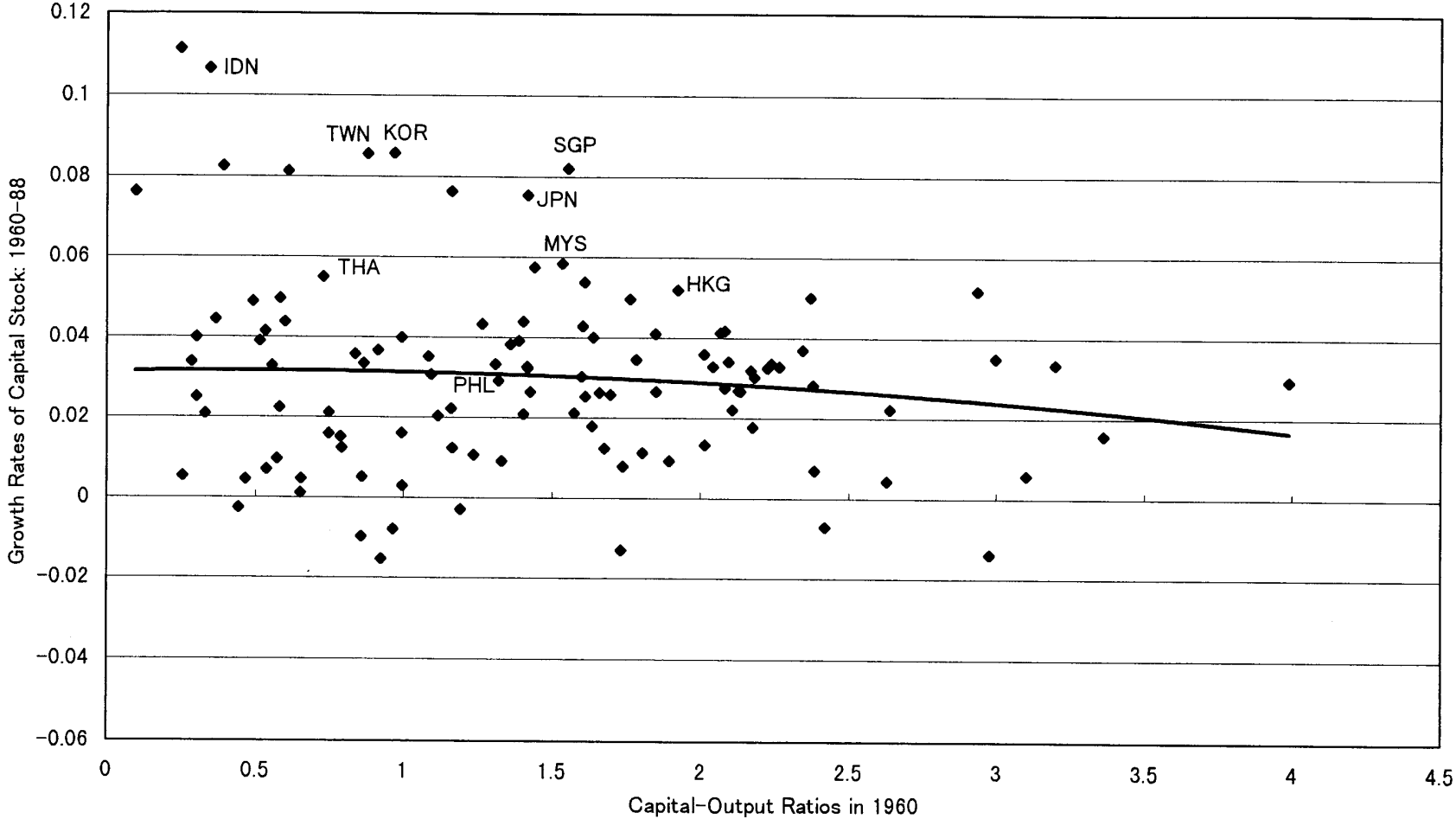


Figure 2-(2b). **Initial capital-output ratio and capital stock growth: Nehru-Dhareshwar data set**

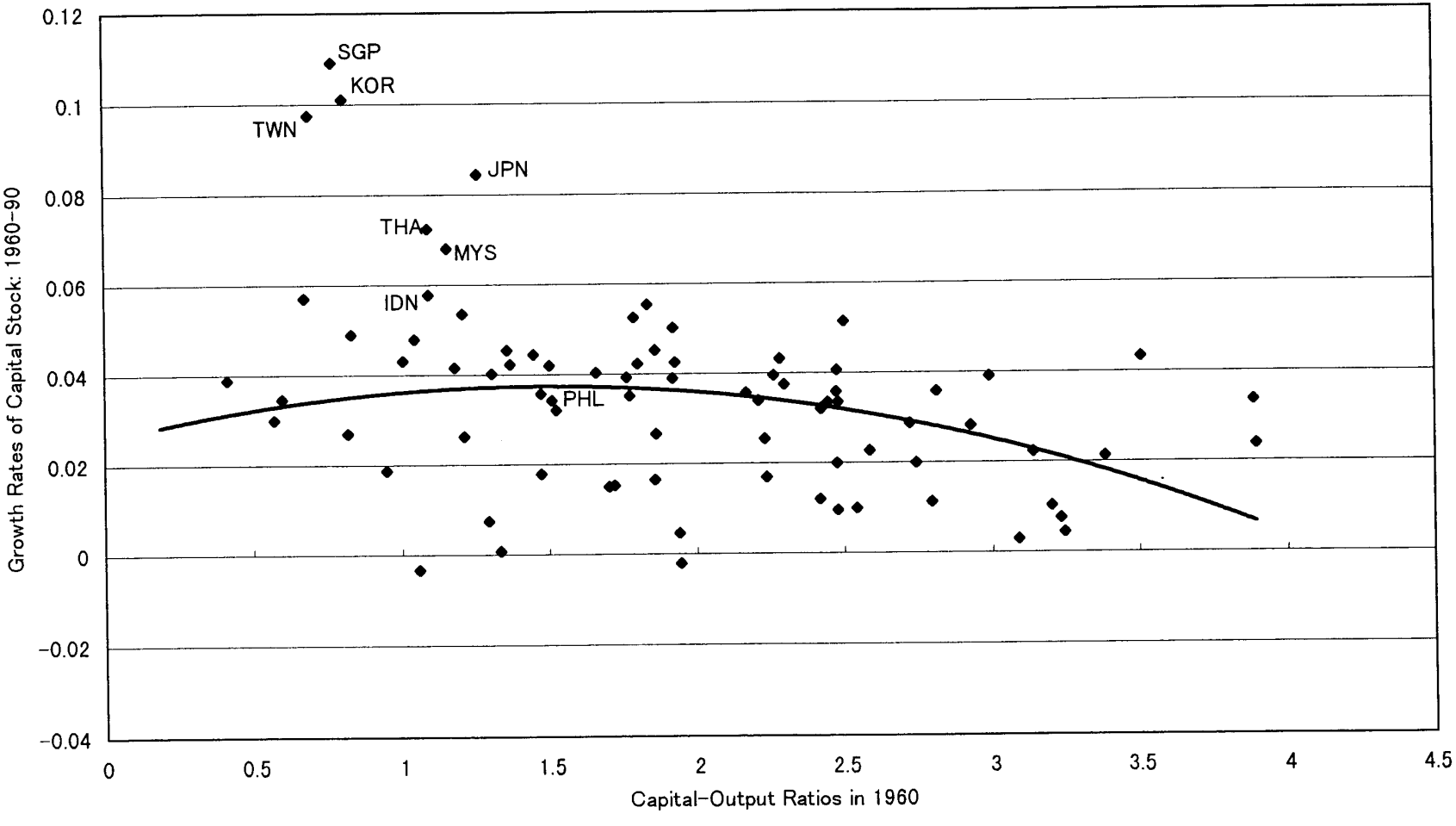
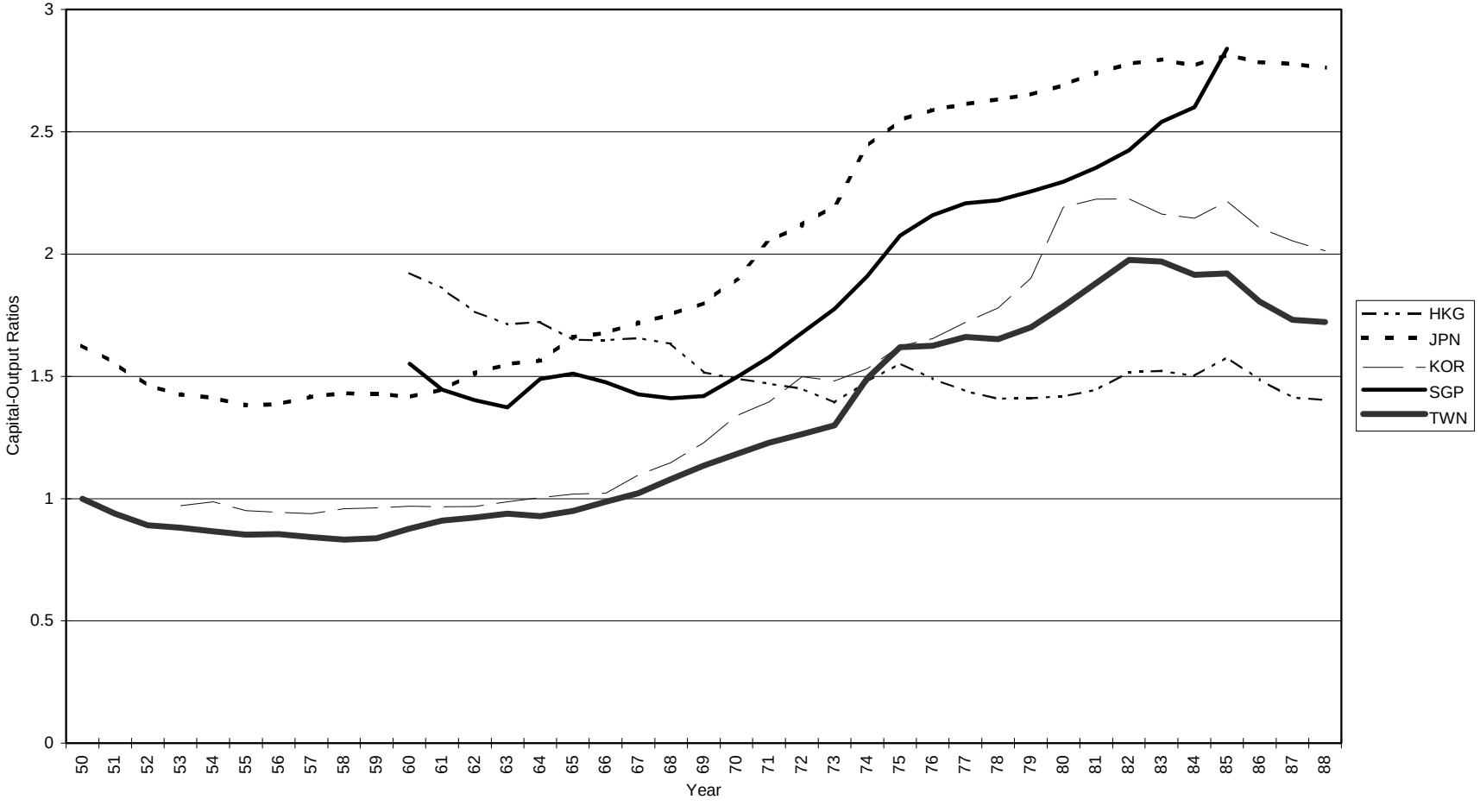


Figure 3. **Time-series evidence on capital-output ratios in the East Asian economies**



1.3 DISCUSSION OF PAPERS BY ANNE KRUEGER AND SHIN-ICHI FUKUDA

W. Max Corden, Johns Hopkins University

I have been asked to focus on policy issues and to provide some framework for later discussion at the conference. Hence I shall give an overview of the main policy issues raised by the Asian crisis. In particular, I shall classify the various structural reforms that have been proposed or that have been conditions for IMF assistance.

One may distinguish desirable from necessary reforms. By desirable reforms I mean those reforms that, if implemented, may well improve the long-term economic performance of the affected countries, but are not really necessary to deal with or to avoid a recurrence of the crisis. Reforms of the labour market or further trade liberalisation, for example, may well be desirable, at least in the long run, but are hardly necessary from a financial crisis point of view. Hence I shall now discuss necessary or directly relevant reforms.

The most important reforms concern the financial, and especially the banking sectors. Such reforms have played a prominent role in IMF programmes and have been widely discussed. Clearly, major reforms are required here both to deal with the immediate problems and the future. Such reforms would not avoid booms and busts – of which there have been many examples in history – but they would moderate them and allow the system to cope with them more quickly. Among other things, these involve more information and transparency, adequate supervision of banks, and implementation of capital adequacy requirements.

Second, institutional arrangements need to be set in place to allow for quick rescheduling or rollover of short-term debts in a crisis of this kind, and possibly also for writing down of the nominal value of debts and the conversion of short-term into long-term debts. Bankruptcy laws and procedures similar to those operating in developed countries, notably the United States, need to be introduced.

Third, the crises in a direct sense have been caused by excessive short-term private borrowing. This meant that, when a market panic developed, foreign debt needed to be, but could not be refinanced. Foreign exchange reserves, though quite high in some cases, were not sufficient to cover short-term private debt. This raises the very important policy issue of whether short-term borrowing (other than trade credit) should be limited, controlled, or taxed in some way, at least when the capital inflow booms reach “euphoria” levels.

Some of the proposed reforms are concerned with avoiding a future euphoria boom, and making it possible to deal with a crisis more efficiently in the future. But the immediate problem is that there are deep recessions in the affected countries. We have had the crises, and these reforms have not been in place. The big question is then: are these severe recessions really inevitable?

This raises the issue of appropriate fiscal and monetary policies in a crisis. To some extent, the severe falls in outputs and incomes have been caused by drastic declines in demand owing to

cessation of investment spending, leading to a typical Keynesian multiplier which reduces output and incomes. The question then is whether Keynesian remedies, especially fiscal expansion, should have been pursued earlier, and to what extent they should now be pursued further. Here, it has to be remembered that the crucial limitation to a Keynesian expansion is the availability of adequate temporary foreign financing. The need for financing would only be temporary since, in due course, an export boom, made possible by the big real depreciations, should come to the rescue. Of course this requires the developed countries, primarily the United States and Europe, to accept the increased imports from Asia that such an equilibrating adjustment requires.

This important fiscal policy issue goes beyond the scope of this conference. I have discussed this at length elsewhere.[1]

Let me now turn to the exchange rate issue, touched upon by Professor Krueger. She has referred to policy mistakes in the Asian affected countries, reflected in real exchange rate appreciation, in excessive credit creation, and in high current account deficits. This relates to the widely discussed issue of whether a contributory cause of the crisis was the maintenance of (more or less) fixed nominal exchange rate regimes.

Here I would like to suggest that real appreciation, current account deficits and high credit expansion were all part of a single story which did not depend on the exchange rate regime. There was excessive foreign borrowing and lending owing to a typical "euphoria" boom, and its sudden ending led to the crisis. Inevitably, high capital inflow led to real appreciation.

In a fixed exchange rate regime, high spending leads to rising prices and wages, and thus real appreciation, and therefore some loss of competitiveness. If the exchange rate had floated, capital inflow would have led, instead, to nominal appreciation, and thus also to real appreciation. Inevitably the current account goes into deficit. This was the result of the combination of higher spending and real appreciation. To some extent private capital inflow led to accumulation of foreign exchange reserves, but inevitably it also financed current account deficits. Increased domestic credit resulting both from increased foreign exchange reserves (and thus a higher money base) and from euphoria about profitability prospects, was also part of the story.

The fixed exchange rate regime did have an adverse effect in leading to foreign-currency denominated borrowing – which created severe problems once the exchange rates depreciated. But, in my view, the fixed exchange rate regime was not really the cause of the high capital inflow. Irrespective of the exchange rate regime, there would have been real appreciations during the boom. After all, the US current account deficit of the early and mid-eighties, also associated with real appreciation and capital inflow, happened in a floating-rate regime.

But it is true that any attempt to maintain a fixed exchange rate once the boom ended will at first lead to an unnecessary loss in reserves (as in the case of Thailand and Korea) and then to the inevitable abandonment of the peg, or even of the regime, in a crisis situation.

Finally, it may be useful if I summarise the main – and very interesting – conclusion of Professor Fukuda's paper. There are several steps in the argument.

The four East Asian economies have a comparative advantage in labour-intensive products. Hence, the more open such economies, the greater the weight of labour-intensive production on their economies. And they have been outstandingly open economies. The next step in the argument is that the more labour-intensive their output patterns, the more capital is economised – and thus the higher

the average product of capital (or the lower the capital/output ratio). This means that for any given ratio of investment to output, the higher is the rate of growth of capital (in algebraic terms, if Y is output, K is capital and dK is investment or the increase in capital, $dK/K = dK/Y \cdot Y/K$, where dK/Y is the investment ratio and Y/K is the average product of capital.)

Professor Fukuda's point is that openness increases Y/K, and the countries have been exceptionally open. It is well-known, and supported by much empirical work, that these countries have had high investment ratios (dK/Y), but the additional point is that high growth rates of capital and of output are also explained by a high productivity of capital, caused by openness. I find this an interesting and original argument.

NOTES

1 CORDEN, W. Max, “The Asian Crisis: Is There a Way Out?”, Singapore: Institute of Southeast Asian Studies, 1998.

Chapter 2

THE ROLE OF STRUCTURAL REFORMS IN LIGHT OF THE RECENT CRISIS

2.1 RESTORING ECONOMIC GROWTH IN ASIA: PRIORITY AREAS OF REFORM AND PROSPECTS*

Jungsoo Lee, Asian Development Bank, Manila

Introduction

The sudden and sharp reversal in economic performance of the "Asian tiger" economies since the second half of 1997 has taken many by surprise. These economies have been star performers in the developing world for the past two decades or so and were known to have pursued the "right" macroeconomic policies. With hindsight, it is clear that strong macroeconomic indicators effectively masked weaknesses in the financial, corporate, and government sectors.

The effects of the Asian financial crisis have been spreading and deepening across Asia and have begun to bite into the economies of other regions. Concerns are being raised about the severity of the downfall in domestic demand in the crisis-affected countries and contagion to the global economy.

The affected Asian countries are in the process of undertaking reforms recommended in relation to the rescue package led by the International Monetary Fund (IMF). The countries need both stabilisation and structural measures to restore their economies to a normal growth path. The stabilisation measures include a tightening of monetary policy (with the raising of interest rates) and the maintenance of a sound fiscal policy. Structural reform measures aim to achieve relative price realignments and institutional reforms in various sectors intended to make the economy more efficient and more flexible and thereby to engineer sustainable long-term growth. The scope, speed, and sequence of the reforms, as well as priority areas for reform, deserve serious discussion.

The urgent issue facing the countries in crisis is how to arrest their economic decline and facilitate economic recovery. This paper suggests the priority areas of structural reform required for sustained economic recovery, examines potential bottlenecks, and recommends some measures to overcome these bottlenecks. Section 1 briefly analyses the extent of economic recession in the affected countries. It examines how domestic and external demand have been affected by the crisis. Section 2 reviews the relationship between structural reforms and economic recovery. It discusses the reforms being taken under the IMF-led structural reform package, and identifies priority areas for structural reforms in the countries in crisis. Section 3 focuses on the issues related to financial sector restructuring, which is key to economic recovery and Section 4 reviews the progress of financial sector restructuring in the crisis-affected countries. Section 5 analyses events typical of economic recovery and discusses prospects for the region. The last section summarises the main findings of the paper.

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1. Financial crisis and deepening of recession in Asian economies

The combination of massive short-term capital movements[1] and the weaknesses in the financial and corporate sector against the backdrop of liberalised capital accounts and pegged exchange rates was a recipe for financial crisis. The affected economies contracted severely due to the unprecedented reversal in private foreign capital flows and drying up of domestic credit, coupled with large currency depreciation and declines in asset prices.[2] A vicious circle of asset price fall, rise in bankruptcy, financial distress, and falling domestic demand emerged. Tight monetary and fiscal policies strengthened the vicious circle, at least in the short term.

The impact of the financial crisis has been very traumatic. Economies have contracted precipitously, surpassing the most pessimistic projections made in the initial phase of the crisis. Social costs in terms of rising unemployment, reduction in income, higher inflation, and reduced access to social services are particularly acute. Repatriation of overseas workers is exacerbating the downfall in domestic demand and employment situations in the affected countries.

Analyses of quarterly data for the crisis-affected countries reveal that the gross domestic product (GDP) growth rate started falling soon after the crisis and, since the first quarter of 1998, GDP growth has been significantly negative (see Figure 1, pages 88-89). In Indonesia, the GDP growth rate declined from 3.3% in the third quarter of 1997 to –17.4% in the same quarter of 1998. Korea's GDP fell from 6.1% to –6.8% during the same period. Malaysia and Thailand also experienced a drastic decline in their GDP. In the Philippines, the decline in the GDP growth rate was relatively moderate.

The sharp fall in economic growth in the crisis-affected countries was caused mainly by the downturn in domestic demand, which was in turn affected by a combination of various factors such as reduced purchasing power, inadequate financing, and corporate difficulties. Purchasing power was reduced due to (i) the loss of consumers' wealth as a result of the sharp fall of stock and real estate prices, (ii) rising unemployment and the decline in real wages of the working population, and (iii) natural disasters that eroded incomes. Inadequate financing was caused by (i) the curtailment of access to international capital, (ii) capital flight, (iii) reduced credit supply and raised interest rates under the stabilisation policies, and (iv) problems in the corporate and financial sector. At the same time, company bankruptcy and corporate restructuring were deterring investment.

Investments were hit very severely. In Indonesia, gross domestic investment in real terms declined by 32% in the first quarter of 1998 and by 53% in two subsequent quarters. In Korea, investment fell 66% and it fell 54% and 45% in the subsequent two quarters. The Philippines also experienced a steep decline in investment. While private consumption remained relatively firm in the Philippines, maintaining positive growth, it showed small negative growth in Indonesia, and fell sharply in Korea.

Merchandise exports in US dollar terms have virtually remained unchanged in the first half of 1998 relative to the level a year ago. Both demand-side and supply-side constraints are responsible for the stagnation. From the demand side, weaker economic activity in Japan and elsewhere in Asia caused imports to fall sharply. The Asian economies rely heavily on trading with one another: more than 50% of Asian exports are to other countries in Asia. Due to this close trade linkage among Asian economies, the economic recession in the region is posing serious demand-side constraints on exports. Weak demand and currency devaluation have also depressed export prices, although export volumes from the crisis-affected countries have shown credible growth. From the supply side, exports are limited by the liquidity crunch and slow progress in corporate debt-restructuring. Exporters have

faced financing constraints as a result of the disruption of the financial system, and this has adversely affected exporters' capability to expand production in response to drastic devaluation of the domestic currency. Although exports have not grown, the merchandise trade balance has improved substantially as a result of the drastic drop in merchandise imports. This reflects the sharp fall in domestic demand in the crisis-affected countries.

As a result of the sharp decline in domestic demand and stagnant export growth, the crisis-affected countries are undergoing an economic recession of a depth that they have not experienced in recent years. Despite some differences in implementing structural reforms in individual countries, the crisis-affected countries have generally been undertaking the recommended reforms and their currencies showed a stabilising trend by the first quarter of 1998. However, the crisis-affected countries are not yet showing a strong sign of economic recovery.[3]

2. Structural reforms and their priority areas

To revive investors' confidence in the crisis-affected countries, it is essential to restore fiscal discipline and monetary stability in the economy. Without prudent measures for macroeconomic stability, investors' confidence will not be restored and capital flows will not be reversed. Short-term stabilisation measures therefore feature strongly in the rescue packages organised by the IMF.

While it is essential in the short term to address macroeconomic imbalances through a stabilisation programme, the longer term recovery of an economy will require a supporting set of structural reform measures to strengthen the supply response. The main thrust of structural reforms is to improve allocative efficiency so that resources are allocated to the most productive uses.[4] This includes wide areas of activities that directly or indirectly have implications for the allocation and use of resources. For example, getting the prices right through greater reliance on market forces means reducing and redefining the role of the government, and increasing competition. The other important area is strengthening of the regulatory framework and institutional capability to foster competition and good governance and to protect the interest of both consumers and producers, through which allocative efficiency is maximised at sector and economy levels as well as at the level of firms.[5]

Structural reforms included in the policy matrix of the IMF-led rescue package cover wide areas of reform (see Box overleaf). They entail (i) bank restructuring, strengthening of the regulatory framework, and capital market development; (ii) corporate governance and enterprise reform; (iii) corporate debt restructuring; (iv) market opening policies; (v) labour market reform and social safety nets; (vi) transparency, monitoring, and information disclosure; (vii) privatisation and public enterprise; and (viii) environment.

While these reforms are all needed, the question is whether the crisis-affected countries will be able to implement all of them together, or whether they should first focus on reforms that are most urgently needed to regain investor confidence, and prioritise the reforms properly. While the IMF makes it clear that the comprehensive reform of financial systems constitutes the centrepiece of the IMF package (see IMF, 1998a), many observers believe that it is not practicable for the IMF to attempt to simultaneously remove all weaknesses in the economic system of an afflicted country, and that it should focus instead on the root causes within each country, whether these caused the crisis or not (see Kissinger, 1998 and Feldstein, 1998).[6.]

Box: **Scope of policy commitments in the IMF package**

Korea	**Indonesia**	**Thailand**
• Macroeconomic policies	• Fiscal issues	• Comprehensive financial restructuring
• Financial sector restructuring	• Monetary and banking issues	• Additional financial sector reforms
- Undercapitalised commercial banks	• Bank restructuring	• Banking system
- Remaining commercial banks	• Corporate debt and bankruptcy reform	• Specialised state financial institutions
- Korea First Bank and Seoul Bank	• Foreign trade	• Finance companies
- Specialised and development banks	• Investment and deregulation	• Regulatory and supervisory framework
- Merchant banks	• Privatisation and public enterprises	• Tax code
• Prudential regulations and supervision	• Social safety nets	• Comprehensive deposit guarantee
- Foreign exchange liquidity and exposures	• Environment	• Corporate debt restructuring
		• Tax measures
		• Corporate debt workouts

Sources:
Indonesia: *Letter of Intent*, 11 September, 1998
Korea: *Memorandum on Economic Program*, 24 July, 1998
Thailand: *Letter of Intent*, 25 August, 1998

A review of the crisis indicates that its root causes include weaknesses in the financial and corporate sector, and poor corporate and public governance. Without the proper regulatory and supervisory framework, intricate relations between government, banks, and enterprises allowed the banking sector to accumulate a high level of non-performing assets. Banks borrowed and lent aggressively during the upswing of the business cycle, resulting in a heavy reliance on short-term debt denominated in foreign currencies, which caused serious mismatches in currency and maturity. Due to the lack of accounting, disclosure, and legal frameworks, the potential for market discipline to monitor and penalise excessive risk-taking was impeded. Bank owners, managers, and depositors were not forced to bear the consequences of excessive risk taking. Supervisors were not pressured into implementing corrective action. Sudden withdrawal of short-term capital from the crisis-affected countries exposed these structural weaknesses in their financial sector.

With the onset of the crisis, many financial institutions are struggling to remain solvent and are unwilling to provide new loans or renew old loans. Without adequate liquidity, debt-strapped enterprises will have difficulty resuming their economic activity. While the crisis must be attacked on a number of fronts, one cannot overemphasise the importance of restructuring and recapitalising the financial sector on the road to economic recovery. Until financial institutions are restored to health, corporations and small business enterprises will be starved of the vital credit that they need for working capital. And without credit, fundamentally viable but illiquid enterprises will perish, and with them the jobs and incomes that support workers and their families. Asia can ill afford the economic and social costs of the unnecessary destruction of capital – organisational, physical, and human – that a disorderly and inefficient restructuring of the banking sector would entail. Financial sector reform is, therefore, essential to revive the supply of domestic credit to enterprises.

The priority for structural reforms should, therefore, be on strengthening the foundations of the financial sector to support the sustainable financing of private investment, which is one of the most important determinants of economic recovery. The process of competition should be enhanced, while the role of governments should be strengthened for establishing and enforcing prudential regulation of financial institutions and securities activities.

As the priority areas for structural reforms for economic recovery are focused on the financial sector, it may be useful to examine the relationship between financial development and economic growth. This issue has been discussed widely in academia, but conflicting evidence has been reported. A recent survey by Levine (1997) found that the nature of the link between finance and development is ambiguous at both theoretical and empirical levels. A World Bank study (1998a), on the other hand, evaluated the correlation of real sector performance to financial sector performance and indicated that development of the financial sector may lead to stronger real sector performance, in particular, higher GDP growth rates. Many other findings support or reject the hypothesis of a positive relationship between financial development and economic growth.

However, the above discussion may not be directly relevant to the banking crisis, which has hindered economic recovery as credit has become scarce. Financial sector restructuring is necessary to resume the supply of liquidity, the lack of which constitutes a serious bottleneck to production for domestic consumption and for exports. In normal times, finance may not matter much in the sense that increased credit does not necessarily lead to increased production. But during a banking crisis, finance matters a great deal.

In prioritising structural reforms, it should also be realised that the social costs of the crisis are increasing rapidly. As economic difficulties in the crisis-affected countries have deepened and as an increasing number of people suffer from the sharp economic downturn, tight monetary and fiscal policies have been relaxed somewhat and emphasis given to the alleviation of social difficulties. The situation is difficult because the crisis-ridden countries are not well-equipped with social safety nets. Thus, a huge number of people may not be able to meet their basic human needs. If this situation continues, public support for reform will weaken and the sustainability of reforms will be threatened. Sufficient attention should, therefore, be paid to alleviating the social impact of the crisis through the provision of social safety nets for vulnerable groups.[7]

As structural problems in the banking and financial sector lie at the heart of the crisis, it is natural to give priority in the structural reform efforts to financial sector restructuring. However, without addressing the problems in the corporate sector, the structural problems in the financial sector will not go away. If corporate sector reforms are not undertaken simultaneously, financial sector restructuring will not have a lasting impact as the two reforms are closely related and the performance in one sector will certainly affect that in the other sector. This is why financial sector restructuring and corporate sector reform should go hand in hand. The next section focuses on major issues in the financial sector restructuring.

3. Financial sector restructuring: major issues

A sound and efficient financial system is an integral component of a market-based economy and one of the most important components of successful economic development. With robust financial systems, a country can mobilise large quantities of domestic savings and international finance and channel these resources to productive, growth-enhancing investments (Stiglitz, 1997). When the

financial system does not perform these roles properly, the consequences can be enormous. Furthermore, in the globalised environment, as the East Asian crisis has shown, the adverse consequences of financial sector weaknesses can be magnified. The efficiency of banks affects the entire economy, and banking system failure erodes public wealth and confidence in the economy. This section reviews features of the financial sector crisis in the Asian region and examines major issues related to financial sector restructuring with a view to proposing some recommendations.

Banking sector problems are now at the centre of the financial crisis in Asia. Currency devaluations, asset price deflations, and a dramatic slowdown of economic growth have exposed weaknesses in banks' balance sheets. As troubled banks have struggled to shore up their capital, loanable funds have begun to dry up. In some places, liquidity has contracted so much that even creditworthy borrowers are not complying with their loan obligations. As an increasing number of banks run into difficulties, trade and investment have been severely disrupted. Banking reform is, therefore, an essential element of structural reforms in crisis-affected countries. Full economic recovery requires regaining investor confidence by properly addressing these structural problems in the financial sector.

The main features of the banking sector crisis in the affected countries are summarised as follows.

1. The crisis was preceded by an extraordinary expansion in bank credit in all these economies. According to Bank for International Settlements data, during 1990-1997 the annual rate of expansion of bank credit to the private sector was as high as 18% in Indonesia, the Philippines, and Thailand; 16% in Malaysia; and 12% in Korea. As a result, the ratio of bank credit to GDP increased several fold during the 1980s and 1990s in most Asian economies (see Table 1, page 87).

2. The mismatch between maturity of assets and liabilities of commercial banks increased dramatically during the 1990s as banks, making use of the greater access to global financial markets, borrowed short in foreign markets and lent to long-term infrastructure projects and the real estate sector in the domestic economy. This proved disastrous when confidence in the banking sector weakened and creditors sought to shift to higher quality. The crisis-affected countries were highly vulnerable when judged by the vulnerability indicators such as short-term debt as a percent of foreign reserves (see Table 2, page 88).

3. In many cases the banks also suffered from a currency mismatch in their assets and liabilities. The assets were domestic currency denominated while the liabilities were accumulated in foreign currency to take advantage of the lower interest rates in foreign markets with the assumption that the exchange rate would remain stable. The worst case was Indonesia, where about one third of domestic banks' balance sheets was denominated in foreign currency. In Thailand, greater access to foreign borrowing resulted from the government's desire to establish Thailand as an offshore banking centre.

4. In other cases, the banks tried to hedge against the exchange rate risk by lending to borrowers in foreign currency and passing on the exchange risk to the borrower. However, when the currency depreciated sharply, these borrowers' incomes were in domestic currency, and the exchange risk became a credit risk.

5. In a number of cases the banks were part of a larger conglomerate with diversified interests in manufacturing, domestic and international trading, and real estate. The conglomerates used the banks to finance aggressive market grabbing and expand capacity on thin margins. This variant of connected lending resulted in increasing magnitudes of non-performing loans: when major companies within a conglomerate failed, liquidity for the entire group, including the bank, was adversely affected.

6. Commercial banks also suffered from the consequences of government-directed lending for financing large infrastructure projects on which the government had staked its prestige. In some cases this was used for financing government industrial policy objectives.

7. The unduly high level of commercial banks' exposure to the real estate sector is now acknowledged and is normal in a boom situation. Banks use property values as collateral for their loans. These values rise rapidly during boom periods and encourage banks to underestimate credit risks inherent in lending to this sector. This is equally true of lending for equity investment as these values also rise rapidly during cyclical upswings. Banks actively contribute to building an asset bubble and then suffer the consequences when the bubble bursts and asset prices crash.

8. The deregulation of the financial sector resulted in excessive entry and fragmentation of the banking sector in crisis-affected countries. Competitive pressure drove financial institutions to offer higher returns, reduce their working margins and spreads, and undertake increasingly risky asset formation. The making of a banking sector crisis is inherent in such behaviour.

Scope of financial sector restructuring

As mentioned earlier, comprehensive financial sector restructuring is the centrepiece of IMF-led reform packages. The objective is to resolve the financial difficulties of the weak banks and establish a sound, functioning banking system quickly. Key elements of restructuring require action to close insolvent institutions; recapitalise or merge viable banks; introduce internationally accepted practices for capital adequacy requirements, disclosure rules, etc.; and increase foreign participation in domestic financial systems. These must be combined with longer-term structural reforms to strengthen prudential standards and supervision.

Financial sector restructuring is a complex, long-term process. It requires accurate diagnosis, effective damage control, and efficient loss allocation (Sheng, 1996). It aims at restoring solvency and returning to profitability. Financial restructuring is done to restore solvency by improving a bank's balance sheets, which can be accomplished by raising additional capital, by reducing liabilities, or by boosting the value of assets. Operational restructuring is necessary for banks to return to profitability and sustained solvency by improving their income statements. Measures for operational restructuring include renewed attention to business strategy, improved management and accounting systems, reduction in the number of branches and staff, and better credit assessment and approval techniques. Most countries were much more successful in addressing solvency problems than profitability problems (see Dziobek and Pazarbasioglu, 1997 and 1998). However, without proper operational restructuring, the impact of financial restructuring will be short-lived.

The actual scope of the financial sector restructuring exercise in each country can vary widely depending on the country's specific circumstances. The design of financial sector restructuring should, therefore, be country specific and it should be based on an in-depth diagnosis of the root causes of the crisis and specific circumstances of the country concerned.

Political support

Success in implementing structural reform may depend on a government's skill in mobilising political support and holding off the opposition (Haggard and Webb, 1993). The path of economic recovery can be long and arduous and involves harmonising the conflicting interests of different stakeholders. Mobilising broad-based support for painful reforms is a challenge facing policy makers.

Restructuring entails short-term costs and, therefore, has distributional implications. To obtain continued support, policy makers should avoid sharp distributional changes among the people. A loss-sharing arrangement between the state, shareholders, bank managers and employees, and depositors is an integral part of successful bank restructuring. Some sort of compensation for losing groups may be necessary to secure political support for programme. Direct compensation schemes should, however, be avoided as much as possible as they generally do not achieve the intended purpose. The three arguments against direct compensation are (i) a country simply may not have the funds to compensate losers; (ii) some types of compensatory measures may undermine the reform: compensating workers for a nominal devaluation by increasing wages directly undermines the objective of increasing competitiveness; and (iii) the likely recipients of politically motivated compensation may not be the poor (see Haggard and Webb, 1993).

Proper handling of non-performing loans is important in loss allocation since it helps reduce bank restructuring costs and sends the appropriate signals to delinquent borrowers. Failing to manage non-performing loans creates an inequitable distribution of losses by rewarding defaulters and impairing incentives for debt repayment in the future (Dziobek and Pazarbasioglu, 1998). Restructuring also requires transparent exit criteria. Some governments prefer to rescue the potentially well-connected from insolvency. Without transparent criteria, public support for the reforms will not be forthcoming.

Role of government

While competition should be an underlying principle of financial restructuring, the importance of the role of government in financial restructuring cannot be disregarded. In crisis-affected countries, problems in their banking sectors threaten their entire financial infrastructure, risking a breakdown of the payments system and of the real economy. As recent events attest, financial and economic distress in one economy can also easily spill over into others. When the risk of systemic bank failure looms, only government can co-ordinate an effective response.

Where restructuring is part of a long-run process, the comparative advantage of government lies in moulding the policy and institutional environment within which an efficient and market-oriented banking sector can flourish. An important lesson to be drawn from Asia's historic experiences of banking sector development is that government should not be in the business of running banks or allocating credit. Despite information difficulties, and the resultant problems of adverse selection and moral hazard, these responsibilities should be left to the private sector. The ultimate objective of banking sector restructuring and reform should be to let markets discipline an open and competitive banking system that is subject to appropriate prudential, supervisory, and disclosure standards. The

government's monitoring and supervisory role is important and should be the focus of government intervention in the banking sector.

Institutional capacity

Even if reform measures are strongly supported by the people, restructuring efforts will not bear fruit if governments and concerned institutions have inadequate resources to implement those reforms. Inadequate institutional capacity has been an important handicap to reform efforts in many countries. For successful financial sector restructuring, capacity must be enhanced in the government, central bank, supervisory body, and financial institutions.

Institutional capacity building is, however, a time-consuming exercise. There are three different approaches to incorporating institutional considerations in the design of structural reforms (Levy, 1993). The first approach is to ignore institutional considerations entirely and design programmes on the assumption that public organisational capabilities and the political commitment to reform will be forthcoming. The second approach is to acknowledge the institutional constraints, but to earmark technical assistance for weak institutions only after the reform package has been designed on the basis of other considerations. The third approach is to bring institutional considerations to centre stage, designing and sequencing programmes in ways that are consistent with the capabilities of the reforming country. The third approach is most ideal. Unfortunately, however, the most common practice today is the second approach. This approach is preferable to the first approach, but its potential is limited because it does not address political obstacles to reform and presumes that technical assistance will be sufficient to enhance organisational capability even in the short term.

Use of public money

The use of taxpayers' money to protect depositors and recapitalise banks is unavoidable, particularly when private investors – whether they are local or foreign – are not putting up new capital for troubled banks. As policy makers cannot pass large bank losses on to depositors, bank losses ultimately become a fiscal burden. This is, to a certain extent, inevitable to avoid widespread bank failures.

The use of public money for financial restructuring threatens macroeconomic stability. This adds enormous pressure to the fiscal balances and may generate inflationary pressures, unless fiscal stabilisation measures are undertaken. The need for recapitalisation is huge: amounting to 20-30% of GDP for some crisis-affected countries. These are much larger magnitudes than was the case in the Latin American banking sector crisis of early 1990s, where recapitalisation needs ranged between 5 and 7% of GDP. Given the huge recapitalisation needs in the crisis-affected countries, it is practically impossible for governments to bail out all the troubled banks exclusively on the basis of budgetary support. Conditions for bailing out should, therefore, be very strict and it is more practical to tackle the problem through closures and mergers as well as recapitalisation, rather than through recapitalisation alone.

Foreign participation

As mentioned above, the costs of revitalising banks in Asian crisis-affected countries are so huge that not all of them can be met by domestic resources. Foreign participation should be sought as much

as possible. Foreign ownership restrictions and other legal obstacles to foreign ownership of banks need to be relaxed to harness both the funds and the expertise of overseas banks in rehabilitating domestic ones. Fears of foreign take-over are generally misplaced. Foreign capital and expertise can play an important role in financial sector restructuring. Foreign involvement can also help improve the management and standards of financial institutions. There is also a view that if more foreign banks had been involved, the Asian financial crisis would not have been so severe because (i) branches of major international banks would have been much less subject to depositor panics; (ii) foreign banks would have been less likely to withdraw their own loans to local customers than to withdraw their cross-border credits to Asian banks; and (iii) these banks would have raised the general level of competition in the banking system, and would probably have helped to limit the politicisation of bank ownership and bank lending (Radelet and Sachs, 1998). It is important to note that financial sector restructuring and foreign participation could reinforce each other. While it is difficult to mobilise foreign capital now, it will become easier as financial restructuring progresses.

Speed of reform

How fast should the reforms be undertaken? The majority view is that prompt action is an important ingredient of success.

The rationale for prompt action is as follows.

- When a programme is implemented slowly, confidence in it deteriorates; markets have remained sceptical where reform efforts have been perceived to be incomplete;

- Political momentum in favour of reform packages will not last if the package does not generate investment and growth within a reasonable time span (Haggard and Webb, 1993);

- In the world of open capital accounts and “high-tech” financial markets, there is little time for protracted decision-making; markets move very quickly to punish a policy error;

- Problems do not go away; if they are not tackled, they fester. The sooner structural problems are recognised and dealt with, the lower the costs to the economy and the banking system. The recent experience of Japan has shown that, if structural problems are not addressed in time, sustained economic recovery is difficult to achieve.

Although most political considerations support the argument for moving quickly, some people argue that rapid adjustment could have higher short-term costs. Rapid adjustments tend to provoke resistance because they are more unsettling and have higher short-run costs. Riots in response to rapid price reforms are typically cited as a cost of moving too quickly. Because firms and households can shift into new activities only with a lag after a programme is put in place, shock programmes face the hurdle of getting through an extended period of extremely limited support. Going slow limits the initial costs and allows some of the front-end measures to work. A go-easy strategy seems more applicable to certain types of structural realignment than to macroeconomic policy, though, and has worked best in countries where macroeconomic imbalances are not severe (see Haggard and Webb, 1993). In difficult circumstances such as the current crisis, one must take into account potential tensions between the short-run and the long-run consequences of policies (see Stiglitz, 1997). Some

policies that have been suggested might eventually improve the efficiency of the financial sector, but would have the immediate consequence of undermining the expected profitability of banks and their franchise value, and thus encourage them to take imprudent risks. Such consequences are clearly undesirable. Thus, the speed of reforms should be situation- and country-specific and should be based on an in-depth diagnostic study.

Sequencing

Part of the blame for the Asian crisis can be laid on improper sequencing of capital account liberalisation. It is now widely recognised that the crisis-affected countries opened up their capital accounts prematurely. The capital accounts should have been opened only when the macroeconomic situation was stable, a sound regulatory framework and effective supervision for banks were in place, information systems were adequate, and banks had positive net worth and capable management and staff.

A legitimate question to ask is whether the crisis-affected countries should backtrack and close their capital accounts or maintain the open status. It would be ideal if these countries could fulfil preconditions as soon as possible. However, this will take many years. While recommendations could vary across countries, depending on the time required for them to fulfil the preconditions, the countries should at least be ready to control volatile short-term capital flows – either directly or indirectly – particularly when the flows are influenced by excessive optimism or pessimism, threatening the soundness of the financial system.

The sequencing issue is also important in pursuing recapitalisation. For recapitalisation to be successful, it must be preceded or accompanied by operational restructuring, as discussed earlier in relation to the scope of financial sector restructuring.

4. Progress of financial sector restructuring in the crisis-affected countries

The progress of financial sector restructuring varies across the crisis-affected countries. This section briefly reviews the progress of restructuring in each country and points to major issues that require special attention.

Indonesia

In Indonesia, the banking sector has been rendered dysfunctional by the crisis. The non-performing loans (NPLs) of banks skyrocketed due to the large rupiah depreciation. High interest rates have resulted in negative margins for banks, eroding their capital base and increasing insolvency of the banking system.

The government has taken several initiatives to restructure the banking sector and resolve the NPLs. The government closed sixteen insolvent commercial banks in November 1997 and announced a state bank merger plan in December 1997. The Indonesian Bank Restructuring Agency (IBRA) was established in January 1998, under closer supervision of Bank Indonesia, and has been tasked with restructuring distressed banks. In April, IBRA suspended operations of seven commercial banks and took over the management of another seven. The recent passage of amendments to the Banking

Restructuring Law has strengthened IBRA's legal powers to deal with the restructuring process. IBRA now controls fifty-five banks, including the seven state banks.

The government also announced a major recapitalisation scheme for private banks, excluding joint venture banks.[8] The recapitalisation costs will be financed through bond issues and sale of assets transferred to IBRA. The interest costs on bonds will be charged to the budget.[9] According to the trajectory agreed with the IMF, banks must reach capital adequacy ratios (CARs) of 4% by the end of 1998, 8% by 1999 and 10% by 2000. The restructuring process will force consolidation of banks over a short period. It will also result in effective nationalisation of a large segment of the banking system.

Korea

The Korean government has closed a number of nonviable financial institutions, including sixteen merchant banks, two securities companies, and one investment trust company, while the operations of other troubled financial institutions, including five commercial banks and four insurance companies, have been suspended.

In the case of commercial banks, the Financial Supervisory Commission (FSC) reviewed the rehabilitation plans submitted by the twelve unsound banks.[10] Based upon the prospects for viability, the FSC classified the twelve unsound banks into two categories: five were "disapproved" and seven were "conditionally approved". The five disapproved banks whose rehabilitation plans were rejected outright were liquidated in July 1998. In addition, two nationalised banks (Korea First Bank and Seoul Bank) will be sold in an open auction at the earliest possible date. Viable banks, including thirteen healthy banks and the seven conditionally approved by the FSC, are following through on the strong corrective actions the FSC imposed to improve their soundness through mergers, rehabilitation, and/or management reform.

To support the financial sector's restructuring effort, the National Assembly approved the government's plan to inject 64 trillion won ($53 billion) for the resolution of NPLs, recapitalisation, and deposit protection. At the same time, the Korean government undertook institutional reforms, including improvement of the deposit insurance scheme, strengthening of standards for prudential regulation and supervision, and introduction of prompt corrective action.

Malaysia

After the onset of the financial crisis, Korea and Thailand closed distressed financial institutions, while Bank Negara Malaysia (BNM) has maintained its traditional strategy of encouraging mergers and consolidation in the banking sector. In January 1998, BNM announced its plan for mergers of thirty-nine finance companies, which were merged into eight by the end of March. In the case of commercial banks, in June 1997, two banks merged with Rashid Hussain Bank, which took over another bank in April 1998.

For further restructuring of the financial sector, the government created two institutions: the national asset management company and the special-purpose vehicle. In July 1998, the national asset management company, Danaharta, was established to deal with NPLs and assets in the banking system. Danaharta is likely to raise an estimated RM25 billion through government-guaranteed bonds on the domestic and international markets. Danaharta plans to complete its work by the end of 1999. In the first stage, its acquisition process addresses the secured NPLs, and NPLs in sectors considered

strategic to the nation such as manufacturing and infrastructure. Danaharta targets completion of this stage by the end of March 1999. The second stage involves acquisition of unsecured loans, while the third covers more complicated facilities such as foreign currency loans and guaranteed facilities. Danaharta will soon buy from eleven financial institutions NPLs valued at RM11.2 billion, which represents 22% of the NPLs in the system in September 1998.[11]

A special-purpose vehicle to recapitalise and consolidate the banking sector began operations in September 1998 under the name of Danamodal Nasional Berhad (Danamodal). BNM, a shareholder, contributed RM1.5 billion ($400 million) in seed capital. The main objectives of Danamodal are to recapitalise and strengthen the banking industry and help facilitate consolidation and rationalisation of the banking system to support economic development. Danamodal will issue RM11 billion nominal value zero-coupon unsecured redeemable bonds to fund the Bank recapitalisation programme. Danamodal and Danaharta will complement each other to strengthen the banking system.

Philippines

The impact of the financial crisis on the Philippine financial sector was relatively mild in comparison with that on other crisis-affected countries. However, the government is accelerating efforts to improve prudential and supervisory systems with a view to maintaining the fundamental health of the financial system. The four main elements of the banking reform strategy are to:

1. Enhance the banks' capacity to withstand shocks by raising their capital and encouraging some consolidation in the industry;

2. Reduce bank risks by tightening provisioning requirements and strengthening regulatory oversight;

3. Provide a level playing field among different types of instruments with a view to reducing disincentives to peso intermediation;

4. Deal expeditiously with any problem banks while safeguarding the soundness of the banking system.

To support implementation of this plan, the government requested a financial sector adjustment loan from the World Bank. To develop larger and stronger financial institutions, the Central Bank provided additional incentives to promote and encourage mergers and consolidations among banks and other financial intermediaries. The incentives have been made available for a period of three years from 31 August 1998.

Thailand

The Thai authorities dealt with the problems of finance companies by closing fifty-six finance companies and placing seven more under the control of Bank of Thailand (BOT). However, weak and small commercial banks continued to pose insolvency problems. To restore financial system stability, BOT decided to place four commercial banks under its control after writing off bank loans by reducing bank capital. BOT then converted Financial Institutions Development Fund loans to these banks into equity and injected additional capital.

The government then decided to take over two banks, dissolve one bank, and merge three banks and twelve finance companies with rescuing banks that were considered strong enough to take charge of these insolvent financial institutions. The government has allowed eleven banks and twenty-four finance companies to continue their own operations.

For the recapitalisation of financial institutions, the government will issue B300 billion of bonds to help financial institutions raise their capital and to provide the private sector with assistance for corporate debt restructuring and new loans. The package introduces two capital support schemes: the Tier 1 Scheme and the Tier 2 Scheme. The Tier 1 Scheme is intended to restore and maintain the solvency and credibility of the financial system. Capital injection will take the form of exchange preferred shares for 10-year government bonds. B200 billion will be allocated to this scheme. The Tier 2 Scheme involves a form of exchanging subordinate bonds issued by financial institutions for non-tradable government bonds with a maturity of ten years.

Issues

While some countries have made significant progress in restructuring their financial sector, concerns are being raised regarding several aspects of the implementation of reforms in the crisis-affected countries.

- Important decisions on financial sector restructuring have been announced in the crisis-affected countries, but detailed procedures and time frames need to be determined in some countries;

- Potential political interference is a matter of concern in relation to the selection of financial institutions for closure and recapitalisation, and also in the area of asset evaluation/selection of Asset Management Units (AMUs);

- The AMUs accumulate a large portfolio of assets which they expect to convert into cash. Sales of such a large amount of assets in an already depressed market could depress asset values further. These sales will therefore need to be phased over time to recover their real worth. But this requires that AMUs build a capacity to manage these assets till they are sold;

- Restructuring will result in nationalisation of many financial institutions. The nationalised banks should be privatised as soon as possible to reduce the fiscal burden and to ensure that competition and market principles apply in their management;

- Financial sector restructuring is an arduous and long-term process. Perhaps the most critical concerns are (i) how to sustain the reform, and (ii) how to mobilise political support for the reform.

5. Economic recovery: experience and prospects

Although it is generally agreed that financial sector reform is essential for economic recovery, a question arises of how long it will take for the economy to recover from the shock of financial crisis. Experience indicates that it may take more than three years. Timing and strength of economic recovery will depend very much on the progress of structural reforms addressing the problems in the

financial sector. This section reviews stylised facts about economic recovery after financial crisis and provides prospects for economic recovery in the crisis-affected countries.

Experience of economic recovery

A number of countries have experienced financial crisis and have undertaken structural reforms to surmount the crisis. While the pattern of economic recovery related to structural reform is different from country to country, a typical pattern is a sharp decline in economic growth before and during the reform period followed by gradual recovery. However, this is not the only pattern of economic recovery. The IMF has identified three different types of economic recovery pattern[12]: Mexico experienced a sharp but short-lived "V-shaped" cycle; Chile and the US experienced much larger "U-shaped" recessions; and Japan has witnessed a shallow but prolonged "L-shaped" downturn that, as yet, shows no sign of ending.[13]

It is also interesting to see what actions initiated economic recovery in these countries. Experience shows that "turnarounds did not occur until decisive actions were taken to deal with the bad loans of the banking system and to wind up insolvent institutions. In the United States, this occurred at the time of the bank holiday of 1933. In Chile, decisive actions were taken in 1984, when the central bank purchased the bad loans of the commercial banks. In Mexico, the turning point came in 1995, with the establishment of programmes to recapitalise banks and restructure non-performing loans. Sustained recoveries began in all three cycles in the year following these actions".[14] Although each crisis has its unique elements, these experiences suggest that decisive reforms to restore confidence in the financial sector are essential to initiating sustained recoveries. The key to recovery is regaining the confidence of investors. This can be achieved only when there is strong evidence of comprehensive and thorough restructuring of the banking system, addressing the root causes of the crisis.

Salient features of economic recovery in the aftermath of a banking crisis are summarised as follows[15]:

- *Recovery of output growth.* For the currency crises, on average, output growth returned to trend in a little over one and one-half years. If the currency crises were accompanied by banking crises, recovery took longer—on average, a little over three years.

- *Cumulative loss in output growth.* The cumulative loss in output growth per crisis was 4.25 percentage points for the currency crises. However, when banking crises occurred within a year of currency crises, the losses were larger, amounting to 14.5 percentage points, on average.

- *Trade*. Following real depreciation of the domestic currency, exports rose significantly during and after the crisis, while imports contracted sharply during the same period.

- *Equity price*. The recovery in equity prices typically began a year or so after a crisis had peaked.

- *Inflation.* With the onset of a crisis, the rate of inflation surged over the next 12 to 18 months, as the exchange rate depreciation began to be reflected in domestic prices.

Following the initial spurt, however, inflation began to slow around 18 months after the crisis date.

These features do not apply exactly to the Asian crisis. In particular, exports are not showing a sharp rise, and the decline in output growth is more precipitous than the typical events indicate. The Asian crisis may be more severe than other crises of recent years.

Prospects

Global and regional developments have created concern about the economic recovery of crisis-affected countries. Initially, the vicious circle was feeding a virtuous one in the United States' and European markets. However, it is not clear how long this favourable situation will continue. Also, prolonged difficulties in Japan's financial sector and the resulting recession have adversely affected exports to Japan from the crisis-affected countries. What will happen in the US, Europe, and Japan will have significant impact on economic recovery in Asia.

The severity of the crises and the associated downturns in activity vary widely across economies. The issues of when recoveries will begin and how strong they will be remain uncertain. Countries that have implemented bold, up-front reforms are reaping benefits from enhanced market confidence. For example, exchange rates have strengthened substantially in Korea and Thailand. Korea and, to a certain extent, Thailand, has regained access to the international capital markets although at a high premium. The external current accounts have shifted from deficits to surpluses in the crisis-affected countries.

The events typical of economic recovery from the banking crises in other countries indicate that full recovery to normal growth rates will take a few more years in East Asia. The significant fall in investment activity could prolong the period of stagnation, as was witnessed in Latin America in the 1980s (Shirazi, 1998). Conversely, the sharp fall in economic activity could allow for relatively fast rebounds as confidence recovers.[16] The severity and importance of the crisis, and other structural weaknesses in the countries concerned, mean that corrective measures are likely to take longer to implement than in other crises, which were resolved mainly by macroeconomic adjustment. The implementation of comprehensive financial reforms in the face of serious economic recession will involve further difficult policy decisions. However, if governments show strong commitment to reform and investors believe in the capacity of governments to implement the reforms, economic recovery could come earlier than expected.

To revive the economy in the crisis-affected countries, exports must be supported, domestic demand boosted, supply-side response improved, and international capital flows restored.

Exports

As expected, trade balances have improved substantially in all crisis-affected countries. However, this has not been sufficient to offset the drastic decline in domestic demand. The improvement in the trade account was brought about by a drastic decline in imports, which, in turn, was caused by the sharp fall in domestic demand. Exports have not shown a rapid rise. Both demand-side and supply-side constraints are to be blamed as mentioned earlier. Prospects for exports will depend on easing these constraints. Demand-side constraints will be eased gradually as Asian countries recover from their worst crisis, initially by more expansionary monetary and fiscal policies and later by improved

efficiency through structural reforms. However, a lot will depend on the recovery of Japan's economy, a crucial engine of Asian economic growth. From the supply side, even if export competitiveness has been improved in these countries as a result of drastic currency devaluation, the financing constraints faced by exporters as a result of disruption of the financial system could limit their ability to expand production in response to enhanced competitiveness. The supply-side constraints may, however, be eased slowly as financial restructuring takes effect in the crisis-affected countries. Some export items – such as resource based products and labour-intensive goods – may rise strongly as their competitiveness improves.

Domestic demand

While trade adjustments should play an important role in containing declines in economic activity in the near term, full-scale recoveries may have to wait for rebounds in domestic demand. The latter, in turn, is unlikely to stage a meaningful resurgence until confidence is restored in the financial sectors of these countries. Structural weaknesses in the financial sectors and the sharp outflow of private capital disrupted domestic financial intermediation, imparting an adverse impact on domestic demand and exports.

Investment is likely to remain depressed because there is still large excess capacity in the crisis-affected countries. Consumer confidence is declining due to rising unemployment and declining purchasing power. What is the best way for governments to reactivate domestic demand, stimulate investment, and retrieve their economies from recession? A recent World Bank report (1998b) states that short-run fiscal and monetary policies are potent instruments to influence aggregate demand. The report finds that if countries in the region, including Japan, were to increase their deficit spending by 1 percentage point of GDP, they could generate new demand that would lift the crisis-affected countries' economic growth rate by 2 percentage points.

The crisis-affected countries, have, in recent months, already shifted from a very tight fiscal policy – which was instituted at the onset of the financial crisis – to a more expansionary one.[17] While the desired level of easy monetary and fiscal policies is still debated, some relaxation thereof seems to be appropriate, given the stabilisation of exchange rates and severity of social impact of the crisis. However, the easing of stabilisation policies should be managed cautiously so that the foundation of macroeconomic stability is maintained.

Supply response

As the crisis-affected countries suffer from excess capacity, supply response could be fast when demand recovers. After the outbreak of the crisis, however, the corporate sector is facing difficulties in responding to demand because of serious financial bottlenecks. The corporate sector has a high need for funds to meet the heavy burden of short-term foreign debt service. Both domestic credit and foreign capital are in short supply. How to improve financial intermediation is an issue that requires careful attention to eliminate supply-side constraints.

The decisive steps taken by crisis-affected countries in various areas (including banking and capital markets) to restore their health and efficiency, contribute to a platform for stronger growth in future years. With the help of strong fundamentals for economic growth, such as a well-educated labour force and high domestic savings, supply response will not be a major bottleneck for recovery. There remains concern about the liquidity constraint, but this will gradually ease as financial

restructuring and corporate debt problems are addressed. However, if the crisis drags on and removes opportunities for the education of young people, this may have a serious impact on human resource development and supply-side fundamentals could become weaker.

Capital flows

The timing and prospects for economic recovery in the affected countries depend very much on, among other things, restoring international private capital inflows. Recovery in private capital inflows would pave the way for renewed growth in private spending. However, such inflows will return only when investors regain confidence in the governments' determination and capability to undertake structural reforms. Recovery in financial flows, therefore, will depend very much on the progress of financial sector restructuring.

What are the medium term and longer term prospects for the resumption of private capital inflows to the affected countries? In the medium term, the prospects are not very encouraging. The affected countries are doing their part to restore investor confidence. They are undertaking difficult structural reforms including restructuring banks and companies and improving the governance system. However, foreign investors who left East Asia are waiting for stronger signs of economic revival. Improved investor confidence requires good economic performance of which foreign capital, at least in the long term, is an important determinant.

Some encouraging signs of investor confidence emerged in the region during the first four or five months of 1998 following the agreements to roll over and restructure Korea's and Indonesia's short-term bank debt. The stock markets and currencies of the affected countries had stabilised and strengthened somewhat, with a reversal in later months. In recent months, another round of optimism swept the stock and currency markets in East Asia. How long it can be sustained remains to be seen. The stock markets and currencies of the affected countries strengthened and foreign direct investment showed strong increases in some countries.[18]

With uncertainty in Japan and the People's Republic of China, foreign investors appear to have become a bit a more apprehensive. Resurgence of anti-market sentiment in several Asian countries may have an adverse impact, intimidating foreign investors.[19]

Prospects for private capital are much brighter in the longer term. As globalisation of financial markets progresses, private capital flows, not only to the affected countries but also to the other Asian countries, are expected to rise significantly. Capital will flow not only from the industrial countries to the Asian developing countries but, increasingly among the Asian developing countries themselves, for a number of reasons. First, longer term fundamentals for the East Asian countries are still strong, and the ongoing reforms will provide significant opportunities for overseas investors. Second, technological innovations will continue to reduce transaction costs and make distant markets more accessible to small as well as large investors. Third, as the Second World War "baby boomers" are preparing for retirement, an increase in savings will be available for investments in Asian emerging markets. Fourth, the demographic features in Asia – except for the newly-industrialising economies – make for an expanding market and lower dependency ratio for the coming decades.

6. Conclusions

The root causes of the Asian crisis are structural, that is to say, due to weaknesses in the financial and corporate sector. Structural reforms in the financial and corporate sector are the key to economic recovery. Without resolving these structural problems, fully-fledged economic recovery is unlikely.

While the potential benefits of structural reforms are generally great, losses could also be substantial if the reforms are poorly designed and executed. Some structural reforms can have adverse consequences in the short run, although they might be good in the long run. Many structural reforms entail short-term costs while their benefits take longer to unfold. They also have significant distributional implications. Structural reforms are necessary, but should be carefully sequenced and wisely implemented to take into account the political and social conditions in each country.

The previous sections emphasise the need to address weaknesses in the financial sector and note that the design of financial sector reforms should not be stereotyped and should be country-specific, based on an in-depth diagnosis. Systemic problems have multiple causes, and probabilities that structural reforms will succeed are greatest when the underlying causes are diagnosed accurately. Utmost care should be exercised to avoid a nation-wide bank run. Appropriate timing, speed, and sequencing of reforms are thus essential. Recapitalisation will not be meaningful unless the underlying incentive system is revamped. Financial restructuring and operational restructuring should go hand in hand.

In implementing financial sector restructuring the crisis-affected countries will face various obstacles, including lack of political support, inadequate institutional capability, difficulty in securing financial resources for recapitalisation, opposition to foreign participation, and slow implementation. These issues have been discussed and recommendations made in the paper. In particular, this paper emphasises the importance of mobilising political support for the reforms to ensure their success. To mobilise people's support, it is important to enhance transparency in major decisions on financial restructuring, allocate the cost of adjustment in an equitable fashion, avoid political interference, and provide social safety nets for the people affected by restructuring. The paper also argues that for the recapitalisation of weak banks, reliance on public money is inevitable, but that it is practically impossible for the governments to bail out all the troubled banks exclusively on the basis of budgetary support. Conditions for bailing out should, therefore, be strict. It is more practical to tackle the problem through closures and mergers as well as recapitalisation, rather than through recapitalisation alone.

The crisis-affected countries are unlikely to experience initial recovery through rapid export expansion. Because these countries rely heavily on each other's markets and most of them are in recession simultaneously, the initial impetus of recovery may have to come from domestic demand. The use of more expansionary macroeconomic policies to arrest the sharp decline in economic activity is, therefore, justified. However, recovery from the banking crisis is a complex and time-consuming process. The crisis-affected countries should aim at achieving sustainable economic growth rather than merely a rapid recovery. Well-designed structural reforms in the financial and corporate sector will be essential in restoring and sustaining economic growth in the crisis-affected countries.

NOTES

1 Reflecting the sudden shift in market sentiment, private capital flows to the affected countries fell precipitously in the crisis-affected countries, from US$73 billion in 1996 to an estimated outflow of US$11 billion in 1997. This swing of approximately US$84 billion amounts to about 8% of the combined GDP of the affected countries. The sharpest outflows were recorded from Thailand and Korea, of some US$18 billion each. Portfolio flows to the affected countries fell but remained positive, while foreign direct investment flows remained relatively resilient. Capital flight from the countries also increased as suggested by the large errors and omissions in the balance of payments.

2 A self-reinforcing vicious circle occurred between currency and asset market declines and banking and corporate failures. The falling currency drastically increased the local currency equivalent of foreign debt owed by local enterprises, which in turn exacerbated the currency decline. The fall of asset market prices decreased the capital of the banks which held the assets, and increased the level of nonperforming loans to the corporate sector that used assets as collateral. The vicious circle has contributed to the drastic depreciation of currencies and a large number of banking and corporate bankruptcies that are still plaguing some countries (see Sato, 1998).

3 As the economic situation worsened, despite the implementation of IMF-led reform programmes, the effectiveness of those programmes is being questioned. *The Economist* magazine (11 July 1998) noted "Asian crisis-affected countries are disillusioned with the IMF's prescriptions, which are criticized as crippling countries through fiscal austerity. In fact, as the crisis has deepened, the IMF has tolerated looser government budget. It envisages a budget deficit of 8.5 per cent of GDP in Indonesia, 4 per cent in Korea, and 2 per cent (raised to 3 per cent later) in Thailand. The other criticism is of monetary policy. Interest rates are kept high to prevent currencies entering free fall again. Yet this makes it hard even for companies with healthy financial status to service their debts or to finance their trade. So the volume of bad debts keeps mounting".

4 The effect of structural adjustment measures on improving the efficiency of resource use – and the rate of economic growth – needs in-depth analysis. The analysis should cover micro and macro policy and institutional concerns in each country. A difficulty to be faced in the analysis lies in measuring efficiency and isolating the effect of structural reform from other factors affecting a country's economic performance.

5 A question that is often raised is whether the reallocation of resources will have a one-shot increase in economic growth or a permanent impact. There is a view that the rise in economic growth could be registered only while the one-time reallocation of productive factors lasts, without necessarily raising the rate of growth over the medium to long run. This issue, however, requires further examination.

6 Similar argument can be found in Radelet and Sachs (1998). "In two other regards, the IMF programs were far from optimal in restoring market confidence in the short term. First, these programs have covered a very wide range of policies beyond the immediate financial crisis, including trade liberalization de-monopolization, privatization, and so forth. Reform in such areas may well be desirable, and some may be germane to strengthening the weak banking sector. Most of the structural reforms in the programs, however, are simply a distraction from the financial crisis. These reforms

have taken government expertise, negotiating time, and political capital away from the core issue of financial markets, exchange rate policy, and the like".

7 IMF-led reform programmes are more receptive to social issues now than in the initial period of the crisis. When national budgets were cut, the IMF tried to preserve essential social spending. IMF is also working closely with the World Bank to help maintain food supplies and distribution, and to improve the targeting of subsidies. In Indonesia, fuel price increases were concentrated on products most used by the better-off, while the prices of goods (such as cooking oil and kerosene) bought by the poor were not raised as much, and the price of rice was kept unchanged. In the IMF's most recent Indonesian programme, large subsidies are maintained to protect the poor (see Fisher, 1998). The Asian Development Bank also provided programme loans to mitigate the social impact of the crisis in Indonesia and Thailand.

8 To be eligible, banks must have a capital adequacy ratio (CAR) of not less than –25% of assets, after full provisioning of impaired loans. The banks and the government will inject new capital to achieve a minimum CAR of 4%. For every rupiah contributed by the owners, government will contribute 4 rupiahs. The government will hold an equity position proportional to its capital injection, in the form of ordinary preference shares.

9 The 1998/99 revised budget includes 15 trillion rupiah as interest costs on bond issues. The total fiscal cost over three years is estimated at about 100 trillion rupiah ($13billion).

10 As of the end of 1997, 13 banks satisfied the BIS ratio requirement of 8%, while 12 banks had reported BIS ratios of less than 8%.

11 Together with the other NPLs that Danaharta has acquired, RM18.8 billion or 38% of the NPLs will be removed from the banking system.

12 IMF, *World Economic Outlook*, 1998b, p. 46.

13 Dziobeck and Pazarbasioglu (1997) identified three slightly different patterns of economic recovery. In the U-shaped pattern, macroeconomic conditions deteriorated slowly preceding bank restructuring, worsened significantly at the onset of bank restructuring and recovered in the following years. A good example is Sweden in early 1990s. The second pattern showed a steady improvement of macroeconomic conditions during and after the reform period. Countries that fit this pattern had experienced significant economic deterioration before bank restructuring, which did not appear to have been incompatible with economic recovery. This pattern is most accentuated in Peru. The third pattern showed a slow but steady deterioration of certain macroeconomic indicators. An example is Ghana, where real GDP growth fell from an average of 5 to an average of 4% during a nine-year period.

14 See IMF, *ibid*, 1998b

15 See IMF, *ibid*, 1998b.

16 See IMF, *ibid*, 1998b.

17 Larger fiscal deficit is partly a result of shrinking income. Therefore, it does not necessarily imply expansionary policy in cyclically-adjusted terms.

18 Foreign direct investments in the Philippines rose 30% to US$506 million in the seven months to July from US$389 million in the period a year ago (*Asian Wall Street Journal,* 6 October 1998). Korea also experienced substantial increase in the inflow of foreign direct investment.

19 Reflecting these adverse trends, the Institute for International Finance has recently revised its forecasts downwards. While in April 1998, it had expected net capital flows to the affected countries to stabilize this year (that is, be close to zero as compared to the sharp fall in 1997), it is now expecting a net outflow of US$25 billion from the affected countries (considerably more than the outflow of US$6 billion in 1997). The situation is expected to improve next year, but the projection for affected countries is an outflow of US$15 billion. According to this scenario, stability and a recovery of international private capital flows to the affected countries is still in the distant future.

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Table 1. **Bank credit to the private sector**[a]

	Annual rate of expansion[b]		As a percentage of GDP		
	1981-89	1990-97[c]	1980	1995	1997[c]
India	8	4	20.2	23.9	24
China, People's Republic of [d]	12	12	47.5	83.9	97
Hong Kong, China	13	8	71.7	321.4	157
Taipei, China	15	13	49.2	143.1	138
Indonesia	22	18	8.1	49.1	57
Korea, Republic of	13	12	36.2	55.7	64
Malaysia	11	16	33.1	76.9	95
Philippines	-5	18	37.9	39.3	52
Singapore	10	12	62.9	84.9	97
Thailand	15	18	27.5	88.7	105
Argentina	-2	4	16.5	17.9	18
Brazil	7	4	17.5	27.4	24
Chile	8	11	26.5	43.6	53
Colombia	7	9	10.8	16.4	20
Mexico	-2	7	12.8	33.6	14
Peru	-13	27	9.2	12.7	19
Venezuela	-3	-9	24.9	7.0	9
Memorandum items:					
United States	5	0.5	62.1	63.3	65
Japan	8	1.5	81.0	115.1	111

Notes:
[a] annual average.
[b] deflated by consumer prices
[c] 1997 data are preliminary.
[d] Credit other than to central government

Sources: BIS Annual Report 1996 and 1997

Table 2. **Short-term external debt in selected countries**
(Percent of total external debt outstanding and total international reserves, end 1996)

Asian Crisis-Affected Countries	*Percent of*		**Other Countries**	*Percent of*	
Country	Total external debt outstanding	Total international reserves	**Country**	Total external debt outstanding	Total international reserves
Indonesia	25.0	166.2	China	19.7	22.7
Korea	48.2	257.3	India	7.5	27.0
Malaysia	27.8	39.7	Argentina	13.0	61.9
Philippines	19.3	68.0	Brazil	19.8	59.4
Thailand	41.4	97.4	Mexico	19.1	154.2
			Russia	9.5	72.6

Sources: World Bank, *Global Development Finance*, 1998; for Korea, ADB, *Key Indicators*, 1998.

Figure 1**. Progress of recession in the crisis countries**

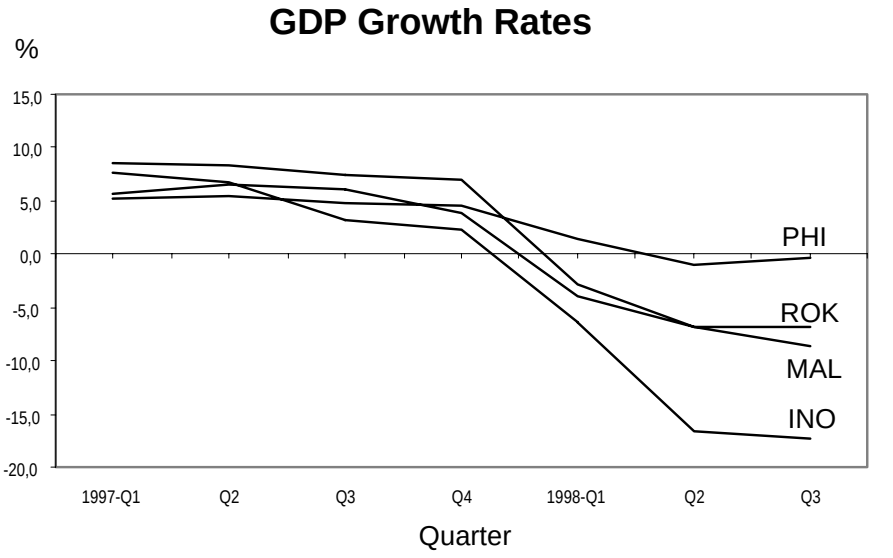
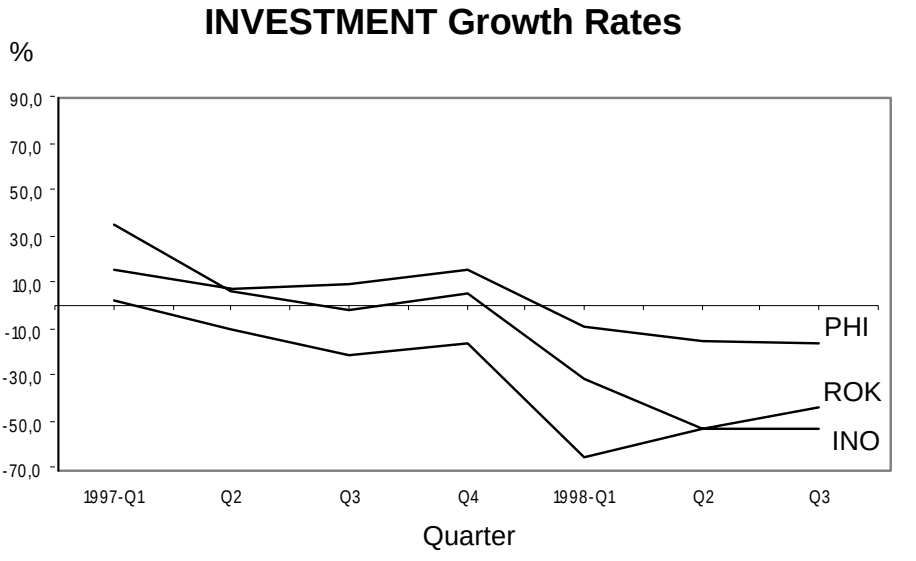
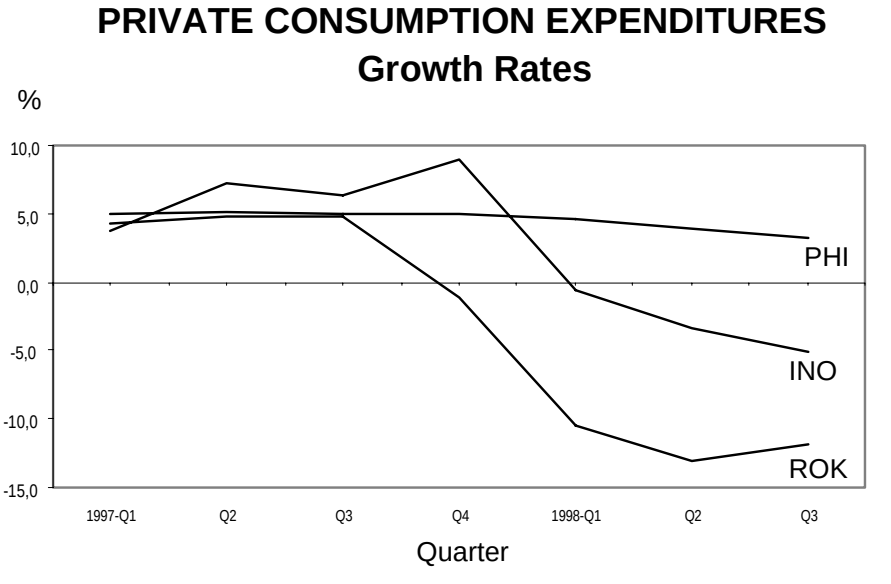


Figure 1**. Progress of recession in the crisis countries *cont'd***





Legend: INO: Indonesia; ROK: Republic of Korea; MAL: Malaysia; PHI: Philippines

Note: Growth rates are on an annual basis with respect to the same quarter of previous year.

2.2 POLICY SHOCKS, MARKET INTERMEDIARIES, AND CORPORATE STRATEGY: THE EVOLUTION OF BUSINESS GROUPS IN CHILE AND INDIA*

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Introduction

Numerous countries have undergone fairly rapid transitions in their economic environments.[1] The objective of this paper is to examine changes in corporate strategy accompanying such significant national economic policy changes in emerging markets. It is unlikely that the effects of liberalisation programmes will be fully understood unless the microeconomic responses by firms to these policy changes are better analysed. In this paper, we take a step in this direction. In particular, we concentrate on an organisational form that is ubiquitous in virtually all emerging markets, that of the business group[2], and use detailed field-collected data to ask how major business groups have responded to significant policy changes in two emerging markets, Chile and India.

These countries offer interesting experimental settings for several reasons. First, as summarised in Section 1, both countries have made major changes in their economic policies. These changes resulted in significant deregulation of product and capital markets leading to increased domestic and international competition. Second, prior to these economic changes, both countries' private sectors were dominated by large diversified business groups. Conventional wisdom suggests that these groups ought to make significant changes in their scope and structure in response to the policy changes. Third, both Chile and India are also ideal for our empirical analysis in that group membership is clearly defined.[3] Finally, the policy changes in Chile and India differ in two respects: (1) while government still plays an critical role in the Indian economy, its role has been dramatically reduced in Chile; (2) the economic reforms in Chile have played themselves out over a period of two decades, whereas they are relatively recent in India. These differences provide us with an opportunity to conduct research in two different contexts of policy changes.

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Chile has an additional attractive feature as the site of one of the most radical experiments by an emerging economy in the development of markets. As such, the time-series variation in the economic context is substantial. Our approach is to obtain data about the intermediation roles played by groups at two points in time, 1987 and 1997, the former date corresponding to the period of Chile's second wave of privatisation (and wholesale retreat of the public sector in economic activity). India offers an appropriate foil in that it is one of several countries to have undergone a sharply defined policy shock, prompted by a foreign exchange crisis in 1991. We focus on the intermediation roles played by Indian groups in 1990, immediately prior to the shock, and in 1997.

Khanna and Palepu (1997, 1998) hypothesise that the scale and scope of emerging market business groups allow them to internally replicate the functions provided by stand-alone market institutions in advanced economies. Consistent with this hypothesis, they report evidence that the largest and most diversified Indian business groups out-perform their focused counterparts. This paper extends Khanna and Palepu's research on emerging market business groups by examining groups' strategic choices and their performance in the context of major policy changes. The research seeks to answer the following questions: (1) How do groups change their scope and their intermediation roles following policy shocks? (2) What are the performance consequences of these observed changes? In Section 1, we present two hypotheses with very different predictions regarding the actions taken by business groups in response to policy changes of the sort seen in Chile and India. To address these questions, we conduct field research (described in Section 2) in a small sample of very large and very diversified business groups (nine in each of Chile and India) that our prior research suggests are most likely to perform value-creating intermediation functions. [4]

Our analysis, discussed in detail in Section 3, leads to the following conclusions. First, large business groups in both Chile and India show no evidence of a significant reduction in their scope of activities. While they some peripheral businesses, they continue to be highly diversified. Further, they have made (or have plans to make) significant investments in new lines of business as economic liberalisation opens up new opportunities. Second, groups seem to strengthen their internal structures and processes in ways that will enable them to increase their role as intermediaries in domestic product, labour, and capital markets, and in international markets for capital and technology. Third, there is evidence that their actions are associated with performance improvements.

The above findings contradict the traditional view that liberalisation is likely to reduce the role of the largest and the most diversified business groups in the economy. As discussed in Section 3, there are two potential explanations for our findings. The first explanation is that the absence of an active corporate control market allows managers of business groups to pursue sub-optimal strategies. This explanation implies that business groups will underperform focused firms in the post-deregulation era. We examine the profitability of business groups to test this explanation, and do not find evidence consistent with it. The second explanation for the observed behaviour of the business groups is that deregulation of primary markets, without a simultaneous development of intermediaries to facilitate transactions in these markets, increases the value creation potential for business groups. This explanation is consistent with the observed increase in scope, strengthening of internal intermediating mechanisms, and the fact that the diversified business groups undertaking these actions show a performance improvement.

In Section 4, we point out some limitations of our research, and discuss what we can learn from a comparison of firm behaviour in Chile and India.

1. Hypotheses

A. Institutional context and strategy

Recent work by institutional economists recognises the dependence of economic outcomes on the institutional context. North's (1990) work, in particular, recognises institutions as "humanly devised constraints" that shape, and are shaped by, economic outcomes.[5] There is an extensive literature in economics and finance on the critical role intermediaries play in reducing transaction costs in product, labour and capital markets.[6] The transaction cost theories proposed by Coase (1937) and Williamson (1975, 1985) suggest that the optimal scope of a firm depends on its institutional context. Khanna and Palepu (1997) draw upon this literature to arrive at the proposition that the institutional context is important in determining the extent to which diversified business groups create or destroy value.

In the US, the institutional context is characterised by well-functioning capital, labour, and product markets. These markets, and the evolution of intermediaries in these markets to address potential information and contracting problems, permit individual entrepreneurs to raise capital, access management talent, earn customer acceptance and play by the rules of the game. They can be sure of the protection of the property rights that the legal environment confers upon the fruits of their entrepreneurial activity. In this context, it is less likely that the entrepreneur will benefit significantly by being associated with a large corporate entity (relative to the benefits that an entrepreneur would receive from such an association in an economy with more severe imperfections). Hence, the costs of business diversification are likely to exceed any potential benefits, as supported by the extant empirical evidence.

In an emerging market like India or Chile, in contrast, there are a variety of market failures, caused by information and contracting problems. For example, the financial markets are characterised by a lack of adequate disclosure and weak corporate governance and control. Intermediaries such as financial analysts, mutual funds, investment bankers, venture capitalists, and the financial press are either absent or not fully evolved. Finally, securities regulations are generally weak, and their enforcement is erratic. Inadequate contractual enforcement may lead to information problems, as for example, in the case of companies failing to be prosecuted for not revealing information accurately to their shareholders. A similar absence of intermediaries in product and labour markets ensures that these are also characterised by institutional voids.

The absence of intermediaries in emerging markets makes it costly for firms to acquire necessary inputs like finance, technology, and management talent. Market imperfections also make it costly to establish quality brand images in product markets, and to establish contractual relationships with joint venture partners. As a result, an enterprise may be more profitably pursued as part of a large diversified business group which can act as an intermediary between individual entrepreneurs and imperfect markets. For example, groups may act as capital market intermediaries by using their broad scope to smooth out income flows and by thus ensuring access to internal finance in an environment where external finance is even more costly than it is in advanced economies. By guaranteeing the actions of member firms, groups may facilitate the access of member firms to technology or capital from overseas (Amsden and Hikino (1994), Guillén (1997)) in the face of severe cross-border market imperfections. In this sense, they can act as cross-border intermediaries when stand-alone

intermediaries are missing or poorly functioning. Khanna and Palepu (1998) demonstrate that the largest and most diversified Indian business groups out-perform their focused counterparts.[7]

B. Changes in institutional context in Chile and India

In this paper, we examine the relation between corporate strategy and institutional context in a dynamic setting. Firms operating in both Chile and India faced significant policy changes in recent years. These policy changes opened both economies to global competition, freed up domestic markets from excessive regulation, and increased the role of the private sector in the economy.

The first stage of Chile's policy changes began with General Pinochet's takeover from Allende's socialist regime in 1973, and was characterised by rapid and drastic reform. Massive privatisation of state-owned firms (including firms appropriated by the state during the Allende years) was coupled with removal of entry barriers in product markets for domestic and foreign firms, and by the imposition of severe restrictions on labour unions. However, the retreat of the state in the absence of an appropriate regulatory framework, coupled with unfavourable macroeconomic circumstances, resulted in a crisis from 1981-1983, followed by renationalization and re-regulation. A second wave of reform commenced in 1985, characterised especially by extensive privatisation (not only of the recently taken-over firms, but also of so-called "core" sector state-owned enterprises). The third phase of Chilean economic reforms was triggered by the introduction of democracy in 1990. The new policies restored the role of unions in labour markets, and further strengthened prior policies of globalisation of product and capital markets. Appendix 1 (page 115) provides further details of policy changes during our sample period 1987-1997.

In India, the policy changes we focus on were initiated in 1991 following a severe balance of payments crisis. The reforms eliminated many stringent restrictions on entry and capacity expansion in product markets (popularly referred to as the "licence-permit-raj"). The new policies also significantly reduced entry barriers for foreign firms to operate in India. Infrastructure sectors, such as airlines, telecommunications, and power were opened for the first time to private sector operators. Restrictions on private sector banking were significantly reduced. Foreign investors were allowed to invest in the Indian stock markets, and restrictions on foreign exchange flows on the capital account were eliminated. Labour markets, however, were untouched by reforms. Further, significant restrictions remained in some sections of capital markets (the insurance sector was still heavily regulated). While several institutions existed on paper in India, inadequate monitoring of these institutions appeared to lead them to perform inefficiently.[8] As an example, capital market intermediaries such as India's national development banks continued to perform quite inefficiently (Khanna and Palepu, 1998c). Appendix 1 provides further details of policy changes.

While both Chile and India experienced major policy shocks, there are some important differences between the two contexts. First, the process of reform has lasted much longer in Chile (from 1973 through 1997, with a reversal in the period 1981-1983) than in India (1991-1997). Second, the Chilean context is characterised by a far less intrusive role of the state than is the Indian context. Third, Chilean economic policies on the whole are more market friendly than the Indian policies (this is especially true in the labour markets where Indian policies continue to severely restrict firms' ability to lay-off workers). Fourth, till the introduction of democracy in the early 1990s, Chile was characterised by a lack of free flow of information, and the lack of an independent judiciary; in contrast, India has a vibrant press and a relatively independent judiciary. Finally, the number of firms operating in Chile is significantly smaller than that in India, leading to differences in

the depth of asset markets and markets for intermediaries. All these differences between Chile and India make them a complementary set of contexts for our research.

C. Hypotheses on corporate strategy responses

Prior to the economic changes in both Chile and India, private sector activity was dominated by large diversified business groups. What do changes in institutional context imply for the corporate strategy of these groups? At first glance, it appears that the freer flow of information (especially in product and capital markets), the removal of barriers to capital and product mobility, and the removal of restrictions on the operation of the price mechanism should allow markets to function more efficiently. This, in turn, should diminish the value creation potential of diversified business groups as intermediaries in imperfect markets. Business groups in Chile and India should increase their business focus, and reduce their intermediation role. Groups that fail to follow this optimal response will experience poor performance.

The above predictions assume that deregulation of markets, and the attendant increase in competition, will lead to an immediate reduction in transaction costs. However, as Palepu and Khanna (1998) argue, liberalisation of primary markets, without an adequate development of market intermediaries, will not reduce transaction costs significantly. There are two reasons why the development of market intermediaries in the capital, labour, and product markets may lag primary market deregulation. First, in both Chile and India, to a varying degree, the policy changes focused on deregulation of the primary markets, but restrictions on the operation of markets for intermediaries continue to exist. For example, in India, entry in banking, accounting, insurance, and venture capital remain highly restricted. Similarly, India restricts the entry of international magazines such as *Consumer Reports* which act as valuable information intermediaries in product markets. In Chile, until the introduction of democracy in the early 1990s, it was difficult for independent information sources to function freely.

A second reason for the intermediation market to lag the primary market development has to do with the fact that institutional development is slow and complex because of the inter-relationships among institutions.[9] For example, well-functioning financial markets need a reliable financial reporting system, independent auditors, financial analysts, a vibrant financial press, mutual funds, and a sound corporate governance system. All these institutions require highly skilled professionals, and a political climate that is conducive to the free flow of information. These, in turn, presuppose the existence of well-developed educational institutions, impartial legal institutions, and mature political institutions. The development of economic intermediaries in both Chile and India has been hampered to a varying degree by such complex inter-relationships.

When primary markets are deregulated but market intermediaries are not well-developed, the internal intermediation capabilities of diversified business groups are likely to become more, not less, valuable for exploiting new business opportunities in the economy. This suggests that, at least in the short to medium term, these groups are likely to increase the scope of their business activities, and invest in strengthening their internal intermediation capabilities. Groups following such a strategy will be able to capitalise on new opportunities offered by the deregulated markets, and realise superior economic performance.

Of course, very little is known about what it *means* for groups to strengthen their intermediation capabilities. Our fieldwork suggests that a combination of economic and social linkages between the

various firms in a group make it feasible for agglomerations of quasi-independent firms to act in concert.[10] We attempt to characterise the extent of economic and social linkages by developing a measure of group identity. It is worth singling out the importance that this measure assigns to the involvement of a common family across a group's firms (Dutta (1997)); indeed, most groups in both countries are strongly affiliated with a single family. An interpretation of the oft-asserted role of the family is that it creates a system of social norms that reduce intra-group transaction costs by encouraging information dissemination among group firms, reducing the possibility of contractual disputes, and providing a low-cost mechanism for dispute resolution. An auxiliary prediction of the above hypotheses, therefore, is that the need for intermediation goes hand-in-glove with the development of group identity.

To summarise, traditional arguments suggest that the transition from deregulation to the removal of market imperfections is short. Therefore, the optimal response of business groups to market deregulation is to reduce their scope, reduce their group identity, and thereby limit their intermediation role in product, labour, and capital markets. Institutional economics, in contrast, emphasises the lags between deregulation and the removal of market imperfections, and leads to a set of opposing predictions for optimal behaviour by groups. Groups should increase in scope, invest in group identity, and increase their intermediation functions. The empirical research presented in the rest of the paper provides evidence on these two opposing sets of predictions.

2. Data

Our data is primarily field-collected, based on extensive interviews with eighteen business groups in Chile and India. The field approach is guided by our belief that publicly available data are inadequate to get at the roles actually played by groups. The small sample approach is guided by our desire to obtain very detailed data on the internal operations of groups, and by the transaction costs inherent in obtaining such data, especially in emerging markets.

Interviews with the group head (CEO), the group chief financial officer (CFO), and the group human resources manager (HRM) constitute our primary data source. In all cases, there was no ambiguity as to who was the group head, typically a member of the family associated with the group.[11] In most cases, there is no individual with the formal designation of group CFO or group HRM, but in all cases, there was no ambiguity about who filled the role. In rare cases, the same individual filled two roles (two of the roles of CEO, CFO and HRM). Our data collection process is described in some detail in Appendix 2 (page 116).

An important outcome of preparatory case-writing and preliminary interviews was the identification of the time period during which it made sense to study the evolution of groups. Since India's economic transition begins quite cleanly with the crisis of 1991, studying a time-period immediately prior to this (1990), and up to the current time (1997), seemed appropriate. Given Chile's long history of reform, it is unclear what a good starting point is for an investigation of the structure of groups. With assistance from observers in Chile, we chose a point in the mid-1980s (1987) because a point further in the past would have risked greater unreliability and imprecision in data collected, because it did correspond to a period after the economic crisis in the early 1980s when substantial changes were put in place in Chile, and because it encompasses the post-1990 period during which practitioners suggest that financial markets developed most rapidly (Khanna and Wu (1998)).

The sampled groups are all in the first or second size quartile and first or second diversification quartile of the entire population of groups in their country. [12] [13] While we identify the groups in the sample, in the remainder of the analysis, we do not further reveal which aspects of internal group structure apply to which particular group; this is done to respect confidentiality. Hereafter, groups are assigned a numeric identifier, which bears no systematic relationship to the order in which the groups are listed in Table 1 (page 117).

In both countries, our sample of groups span a range of industries. Our Chilean group sample collectively accounts for 37.0% of the assets of all publicly traded Chilean group firms, and 15% of the market capitalisation of the Santiago stock exchange. Our Indian group sample collectively accounts for 10.3% of the assets of all publicly traded Indian group firms, and 8.8% of the market capitalisation of the firms traded on the Bombay Stock Exchange.[14] The groups in the samples do not appear to be concentrated in any particular set of industries. Some of the groups in each country sample have been around for several decades, while others are under a decade old; in this sense also, they are representative of the overall population of large diversified groups.

For our analyses, interview data is supplemented with data from several other sources. For Chile, we rely on proprietary data regarding group affiliation provided by the *Superintendencia de Valores y Seguros (SVS)* in Santiago, and on publicly available accounting data from SVS and stock market data from Datastream. For India, publicly available data is from the *Centre for Monitoring the Indian Economy (CMIE)*, Bombay.[15]

3. Results

Responses to the CEO, CFO and HRM questionnaires are used to identify changes in the scope of groups in Chile and India, changes in the extent of intermediation performed by the groups, and changes in the extent of 'group identity' between 1987 and 1997 in Chile, and 1990 and 1997 in India. The last sub-section, for which we use non-interview data, examines the performance of our samples of groups over this time period, and relates the changes in performance to changes in the earlier-identified extent of group intermediation and of group identity.

We also collected data (not reported here) regarding the CEOs' perceptions of what most influenced their restructuring decisions. In Chile, CEOs cited better access to foreign capital and product markets, and changes in domestic financial markets as the most important changes in their economic environment. A few CEOs also mentioned reduction in regulatory intervention in their businesses, changes in the domestic labour market, and better access to foreign technology. In India, the most often mentioned policy changes included the elimination of "licensing" requirements in product markets, greater prevalence of multinationals, improvements in domestic financial markets, and better access to foreign capital and technology. These perceptions confirm that the sample CEOs were well aware of the major policy changes that took place in their respective countries, and their importance for their own businesses strategies.

A. Changes in scope

The CEO questionnaire is used to determine the extent to which the group had entered or exited industries (expanded or contracted product scope), and the change in the importance of international activity to the group. We are able to verify the veracity of the asserted major changes in group scope

from public sources; however, many of the smaller scope changes (or the planned changes) are unverifiable from public sources.

Chile

Seven of the nine groups entered new industries (defined as those in which they had no presence prior to 1987) between 1987 and 1997 (Table 2, page 118). No major exits were reported by these groups. There were some small exits, and these often occurred in conjunction with entry into new industries. Finally, several groups indicated plans to diversify their product range further, while no further exits were planned. The net result is a broadening of product scope in seven of the nine groups, with no change in product scope in the remaining two groups. There is virtually no change in the reported extent of vertical integration. Finally, there is a striking increase in the importance of international activity at the group level. All nine groups had expanded into neighbouring Latin American countries in industries in which they had developed expertise in Chile.

India

The data on scope changes in India is less clear (Table 2). As regards product scope, three groups reported a clear increase in group scope, while there was no change in group scope in three groups. For the remaining three groups, major entry and exit decisions occurred in tandem, so that the net change in product scope of the group is ambiguous. We do not have data to be more precise on the changes in group scope in these cases of ambiguity. Six of the nine groups reported an increase in the importance of international markets, while the remaining three reported no change.

Qualitative data from our interviews with the CEOs of the Indian Groups suggests that almost all the groups exited or planned to exit peripheral businesses that they entered under the earlier economic regime for purely regulatory reasons. For example, prior to economic liberalisation, one of the business groups entered into leather exports as a way to meet export obligations; after economic liberalisation, the group no longer needed to meet these obligations, and hence decided to exit the leather export business.

In each country, though much more so in India, our conversations revealed that reducing the scope of operations was not devoid of costs. The sources of these costs are in line with several mentioned in Ghemawat and Khanna (1998). Most frequently mentioned were related to the absence or poor functioning of institutions that would facilitate restructuring. These include lack of a liquid market for assets, regulatory restrictions on cost cutting through reduction of employees, lack of professionals with experience in take-overs, buyouts, and restructurings, and prohibitive taxes (for example, “stamp duty” in India) on gains on asset sales.

B. Changes in extent and nature of intermediation

We define and construct “intermediation indices” for product market intermediation (PMI), managerial labour market intermediation (LMI), and capital market intermediation (CMI). Each of these indices is based on responses to several questions about activities undertaken by the group at each of two points in time (1987 and 1997 for Chile, and 1990 and 1997 for India). Each response is scored from 1 to 5, where ‘1’ refers to the activity in question being performed purely at the individual firm level, and ‘5’ refers to the activity in question being performed purely at the level of

the group. These responses are aggregated as described below for each of the indices. We are thus able to construct, for each group and for each time period, three intermediation indices.

The PMI index is based on responses to eight questions. These are sub-divided into three categories with which group managers identified on the basis of pre-interview conversations. These categories pertain to the extent to which the group brand (or an alternate brand with which the group is associated but which may not conform to the group name) benefits the member firms, the extent to which the group structure helps initiate and manage alliances, and the extent of intra-group sales. The questions are detailed in Table 3 (page 119). The mean value of the responses to the questions regarding the group brand are reported in Table 4 (page 120) for each group, for each time period. Similarly, Table 4 also reports the mean value of the responses for the other PMI sub-categories (Alliances, and Intra-Group Sales). Finally, the PMI index for each group, for each time period, is defined as the mean of these three means.

The LMI index is defined as a similar aggregation of the mean responses to four sub-categories of questions regarding managerial labour market intermediation: recruiting, labour mobility, training and compensation. Means for these sub-categories are formed from responses to nine questions in total on labour market intermediation.

Finally, the CMI index is aggregated from the mean responses to three sub-categories of questions regarding capital market intermediation: interfacing with financial intermediaries, managing internal financial resources, and orchestrating changes in the scope of the group. Means for these sub-categories are formed from responses to 22 questions in total on capital market intermediation.

A handful of questions were refined as a result of the interviews in India (chronologically prior to the interviews in Chile). As a result, some of the questions used in the construction of the Chilean intermediation indices were not posed (or were posed differently) in India. These minor differences are indicated in Table 3.

By their very nature, the data used to calculate intermediation indices are highly confidential, and not verifiable from external sources. We attempted to pose selected samples of questions to other senior managers within the group to cross-check the responses offered by the group CEO, CFO and HRM. Inconsistencies were few and far between, and where they existed, they prompted us to re-pose the question to the original respondent and clarify the response.

Chile

Table 4 reveals that the PMI index has risen for six of the nine groups, and stayed constant for the other three. This increase is driven both by increases in the importance of group branding, and increases in the manner in which group membership facilitates alliances. Interestingly, there is no evidence that intra-group product market transactions play any role in either of the two time periods.

The LMI index has risen for five of seven groups (for which labour market intermediation data is available) and fallen for the other two. The rise in the LMI index is driven primarily by the role that the group plays in fostering labour mobility and ensuring the dissemination of information regarding the availability of opportunities and that of talent across various group firms. It is also driven by a somewhat greater role played by the group in training in some instances. The rise is not driven by the

group role in recruiting, nor is it driven by group metrics being used in the determination of managers' compensation packages.

The CMI index has risen for three of the five groups (for which capital market intermediation data is available) and fallen for the other two. The sub-categories of capital market intermediation show similar equivocal results. In each of the three sub-categories, there were groups that reported an increase in capital market intermediation and others that reported the reverse.

Finally, a mean intermediation index (defined as the simple average of the PMI, LMI and CMI indices) shows an increase for six groups, and a decrease for two of the nine Chilean groups. The extent of intermediation by our sample of Chilean groups appears to have broadly increased over this ten year period. Product market intermediation shows the most robust increase over the time period, while capital market intermediation shows the most decline over the time period.[16]

Pearson correlation coefficients between the PMI, LMI and CMI indices are also interesting. In 1987, these are 0.42 (PMI, LMI), 0.29 (PMI, CMI), and 0.53 (LMI, CMI). In 1997, each of these pairwise correlation coefficients rises to 0.77 (PMI, LMI), 0.75 (PMI, CMI), and 0.84 (LMI, CMI). The (PMI, LMI) and the (LMI, CMI) correlation coefficients are significant at conventional levels. Further the p-values of all the correlation coefficients decline between 1987 and 1997. Results using Spearman's rank order correlation coefficients are qualitatively identical. The data suggest that the extent to which forms of intermediation go hand-in-glove appears to have increased between 1987 and 1997.[17]

As part of our CEO questionnaire, we also asked which of several intermediation possibilities were especially valuable to their particular group members (not reported here). Chilean CEOs indicated that the group role as an intermediary in accessing international capital was the one that had increased the most between 1987 and 1997. The most important intermediation function in both 1987 and 1997 (with no change in the number of CEOs citing it as especially valuable), however, was that of attracting skilled managers.

India

The results based on intermediation indices are qualitatively similar in the case of India (Table 5, page 121). Of the nine groups, the PMI index rises between 1990 and 1997 for five groups and falls for only one. The increase in PMI is generally driven by an increase in the importance of group branding and an increase in the importance of alliances, with internal product markets playing very little role in both time periods.

The LMI index rises for four groups and falls for only one. The rises are driven more by increases in the group role in recruiting than by increases in the group role in fostering intra-group labour mobility or by increases in groups' compensating managers on the basis of group level metrics.

The CMI index rises for seven groups and falls for two groups. Here the rise is driven primarily by the increase in the group role in managing internal capital markets, and to a lesser extent by orchestrating the financial aspects of changes in the scope of the firm. The group generally appears to be playing less of a role in interfacing with financial intermediaries.

The average intermediation index rises for seven of nine groups, and falls for only two. As in Chile, the extent of intermediation has generally increased across our sample of groups.

The Pearson correlation coefficients between PMI, LMI and CMI all show robust increases in the time period from 1990-1997, as in the case of Chile. The (PMI, LMI) correlation coefficient rises from 0.10 to 0.37, the (LMI, CMI) correlation coefficient rises from -0.32 to 0.22, and the (PMI, CMI) correlation coefficient stays steady at 0.20. None of these pairwise correlations are significant at conventional levels, though, as in Chile, the p-values all decline between 1990 and 1997. Again, the results are qualitatively similar when Spearman's rank order correlation coefficients are computed. There is thus weaker evidence of the increased co-incidence of the three intermediation categories.

The results regarding Indian CEOs' perceptions of most important intermediation roles (not reported here) were different from those of Chilean CEOs. The forms of intermediation that increased in importance the most between 1990 and 1997 were access to a group brand name, access to skilled managers, and access to (international) alliance partners. It is also noteworthy that a form of intermediation that ranks very high in both 1990 and 1997 (with a slight decline during this time period) is the advantaged access to domestic capital sources that group membership brings.

Constructing a slightly different intermediation index as the simple average of the sub-categories that aggregate into PMI, LMI, and CMI yielded equivalent results. We also investigated the correlation coefficients across the different sub-categories that aggregate into PMI, LMI and CMI. There are ten such categories for which we have data for Chile and nine categories for India. Of the 45 possible Pearson correlation coefficients this yields for Chile, only four were significant at conventional levels in 1987 but nine were significant at conventional levels in 1997. Of the 36 possible correlation coefficients this yields for India, five were significant at conventional levels in 1990 but nine were significant at conventional levels in 1997. In both countries, the significant correlation coefficients were generally positive. This suggests that the increase in the extent to which different forms of intermediation co-occur is not driven by the aggregation into PMI, LMI and CMI indices.

Thus, in both Chile and India, group intermediation appears to have increased more often than it has decreased. Despite the literature's disproportionate focus on groups' financial market intermediation (Leff (1976)), our evidence shows that the groups accord enormous and undiminishing importance to non-financial forms of intermediation.[18] The increase in correlation among the various forms of intermediation may be driven by changes in some common underlying unobservable, or may reflect genuine complementarities among forms of intermediation.

C. Changes in group identity

In addition to intermediation indices, we also construct a measure of "group identity" designed to get at the extent to which firms in the group are tied together. Table 6 (pages 122-123) describes the three questions posed to the Group CEO to get responses relevant to this issue. The questions have to do with: (a) the extent of board level interlock among the firms in the group, (a) the extent to which it is possible to share along each of twelve different activities in which the group firms are engaged, and (c) the extent to which the family identified with the group is actively involved in these twelve activities. As with the intermediation indices, the responses to these questions are coded on a scale from '1' to '5' as described in the notes to Table 6. The simple average of the responses for each group yields the requisite measure of group identity. We also posed a direct question to the CEO asking for a summary assessment of the way in which the ties between group firms had changed over the time period in question, with '1' indicating a severe reduction in ties, and '5' indicating a great strengthening in ties.

Chile

We find the group identity measure to be increasing for three of the nine groups, staying constant for three, and declining for three. The CEO's assessment of the changes in the strength of group ties was that it had risen for five of the nine groups, stayed constant for two, and declined for two. The constructed group identity measure, and the response to the direct question about group identity are inconsistent in only one case, that of Group 9.[19] It is actually not difficult to reconcile this inconsistency, as this is a group in which the press and annual reports of firms in the group report large increases in the extent of family involvement (as measured by the number and activity of family members involved in the group's firms), though it is a group to which we were unable to get a direct response to questions about family membership (which affects our construction of the group identity measure for this group).

The Pearson correlation coefficient between the average level of group intermediation and the group identity measure is 0.58 (p-value 0.10) in 1987 and 0.55 (p-value 0.12) in 1997. Further, we also find that changes in group identity and changes in the intermediation index are positively correlated (Pearson correlation coefficient 0.36, p-value 0.30).

India

The results for India are qualitatively similar and even more striking (Table 6). The group identity measure increases for seven of the nine groups. Further, the CEO's assessment of the change in the strength of group ties suggests that group ties have increased for all nine groups.

As with Chilean data, the average level of intermediation is positively correlated with the group identity measure (Pearson correlation coefficient is 0.42, p-value 0.26, in 1990 and 0.45, p-value 0.23, in 1997), and changes in intermediation level are strongly positively correlated with changes in group identity (Pearson correlation coefficient 0.72, p-value 0.02).

Group identity appears to have increased in more groups than it has decreased in both countries. Our interpretation, based on the comments of the executives we interviewed, is that group identity makes it feasible for intermediation to occur. This can account for the positive correlation between group identity and group intermediation, and for the positive correlation between changes in each of these constructs. Our fieldwork also suggested a number of other interesting observations common to both Chile and India related to the notion of group identity. Since these are more difficult to capture in a numeric measure, we discuss these observations separately:

1. There was an almost uniform emphasis on facilitating the flow of intra-group information in those groups which indicated that group ties had strengthened over the period in question. An oft-heard refrain was for the need to "think like a group" to combat increased competition, especially foreign competition. This is consistent with the general increase in intermediation indices reported above, since it is difficult to imagine running internal labour or capital markets, say, without having information flow freely across group firms. A common action taken by many groups (four each in Chile and India) was to move toward a reporting structure that emphasised clusters of firms within groups (the former structures were combinations of ad hoc reporting structures, or of structures where every firm reported directly to the group CEO).

2. The role of the family was important as a means of disseminating information among group firms in virtually all groups in both countries. Generally, it appeared that the role had become more important in two Chilean groups and less in one, with no change in the others. The Indian groups did not report much change in the importance of the family during this period. In both countries, we observed that family members often had responsibility for running individual firms within each group (with an alternative pattern where a family member ran one function, say, marketing, for all group firms, being much rarer). In any event, whatever the manner in which family members were involved, there did not appear to be much change in their patterns of involvement.

3. A common co-ordination mechanism among group firms in both Chile and India was along functional lines. For example, executives across group companies in a single functional area organise periodic meetings to discuss "best practices", and to participate in common executive development programmes.

4. A burgeoning field of "corporate identity design" has taken hold in India. These specialised intermediaries are focused on helping their clients develop corporate identities. The anecdotal observation that their clients are mostly business groups is consistent with these groups' strong attempts to increase group identity.

D. Interface with the government

Prior studies have hypothesised that business groups earn economic rents through their ability to effectively interface with the government.[20] In our interviews, we asked the CEOs to describe the nature of their interface with the government in the pre- and post-liberalisation periods.[21] [22] In India, the most significant interface in the pre-liberalisation era involved industrial policy (eight groups), labour policy (seven groups), accessing foreign capital markets (two groups), entry of foreign firms (two groups), and accessing foreign product markets (one firm). In the post-liberalisation period, there has been a marked shift in the emphasis of group-government interface from domestic policy issues to accessing foreign capital and technology: six groups mentioned entry of foreign firms as an important issue of discussions with the government officials, four mentioned accessing foreign capital markets, two mentioned accessing foreign product markets. In contrast, only four groups mentioned industrial policy issues, and five mentioned that labour policy issues continue to be important. In Chile, CEOs seem to view interactions with the government as far less important, both in the pre- and post-liberalisation periods. The two most important areas in which Chilean CEOs mentioned significant interactions with the government were access to foreign capital markets and environmental pollution (two groups each).

These results suggest that interfacing with government is far more important in India than in Chile, an unsurprising observation given the difference in the extent of government involvement in the two countries. The results also suggest that business groups in India still view interfacing with the government to be an important issue, even though the nature of the interface appears to have changed from dealing with domestic competition to foreign competition.

E. Changes in group performance

In this section, we examine the correlation between the changes in performance of firms in our sample groups and the changes in group identity and the intermediation index. Our first performance

measure is the firm's return on assets, ROA, defined as {net income + interest*(1-tax rate)}/{total assets}, where an average tax rate is estimated for each firm. We also construct a proxy for Tobin's Q, which we define as {market value of equity+book value of preferred stock + book value of debt}/{book value of assets}, where the market value of equity is calculated using closing stock prices on the last trading day of the year. Data limitations preclude us from computing as close an approximation to Tobin's Q as some prior studies have done.[23] However, we compute this second measure because there is some ambiguity about whether ROA or Tobin's Q is a better measure in our case.[24] Change in performance is measured between 1990 and 1995 for India, and between 1988 and 1996 for Chile.[25]

Indian data are obtained from databases provided by the *Centre for Monitoring the Indian Economy*, Bombay. These databases have been extensively investigated and used by us in earlier work (Khanna and Palepu (1998), Fisman and Khanna (1998)), and issues regarding their use are discussed therein. Data availability constraints suggest that the ROA measure can be computed only for publicly traded firms, whereas Tobin's Q can only be constructed for those firms traded on the Bombay Stock Exchange. In our interviews, we verified that the publicly traded firms account for the vast majority of group operations.[26] The Chilean accounting data are obtained from the *Superintendencia de Valores y Seguros*, Santiago, and stock market data from Datastream.[27] Again, these are available only for publicly traded firms in the group. In order to control for industry effects, we assign a 2-digit SIC equivalent categorisation to each firm in the Chile and India data, based on descriptions of the product range of each firm.

We estimate the following regression: $\Delta\Pi_i = \alpha + \beta*\log(\text{Assets}_i) + \gamma*(\text{Change in group}_j\text{'s intermediation index}) + \phi*(\text{Change in group}_j\text{'s identity index}) + \Sigma_k\, \delta_k(\text{Industry dummy})_k + \varepsilon_i$, where Π_i is firm i's performance measured by ROA or Tobin's Q, and firm i belongs to group j and industry k.

Using OLS for these estimations implicitly assumes that the error term, ε, is uncorrelated across the firms in a group. However, this assumption may be unwarranted. Following Moulton (1990), we note that observations sharing an observable characteristic like group membership may also share unobservable characteristics that may cause the error terms to be correlated. This would cause the standard errors obtained using OLS to be understated, leading to potentially spurious claims of statistical significance, with the problem being more acute the greater the extent of within group unobservable correlations (Moulton (1986)). Accordingly, we use an estimation approach which assumes that observations are independent across groups, but relaxes the independence assumption within groups. Additionally, the standard errors reported are also heteroscedastic-consistent White standard errors.[28] The estimation is done at the firm level as this allows us to capitalise on firm level variation in profitability (which would be lost if we aggregated data into a group level performance measure), and appropriately recognises the fact that each firm publishes its own financials and is a separate legal entity, responsible to its own shareholders. Each firm tends to be in only one line of business, so that there is no ambiguity about the nature of the industry fixed effects for which the we need to control.

Specifications (i) and (ii) in Table 7 (page 124) report results using ROA. The results for both Chile and India show that the change in group intermediation index is significantly positively related to the change in ROA; the estimated coefficient for change in group identity is insignificant in both countries. Specifications (iii) and (iv) are estimated on the significantly smaller sample sizes for which Tobin's Q measures could be constructed.[29] In Chile, change in Tobin's Q is statistically significantly and positively correlated with changes in the group intermediation index, while change

in group identity is insignificant. In India, there is no statistically significant correlation between change in Tobin's Q on the one hand, and change in either index on the other. These results suggest that increases in group intermediation and group identity did not negatively affect the performance of member firms. If anything, these strategic responses appear to be positively associated with performance in both countries.

A couple of econometric issues deserve comment. First, it is theoretically possible that, rather than increased intermediation leading to improved performance, successful firms plough resources (unproductively) back into internal intermediation attempts. Limited data preclude us from dismissing this econometrically, but we note that, if this were the case, the market ought to penalise these firms for doing so. The fact that our Tobin's Q measure yields similar results to ROA in the country in which Tobin's Q is more likely to accurately reflect performance (Chile) suggests that reverse causality is unlikely to be the underlying mechanism for our results. Second, while group identity does not emerge as a significant performance-driver in our regressions, it is worth recalling that it is strongly correlated with group intermediation. The group intermediation index might well be picking up the effects of both constructs. Larger sample data with greater variation in these indices is needed to shed further light on this issue.

F. Summary of results

The data support the following conclusions:

1. Groups have generally become more diversified in both Chile and India, and have expanded their geographic scope, while there has been little change in the extent of their vertical integration.

2. In both Chile and India, there are more groups for which the intermediation index increases than there are groups for which it decreases.

3. Group identity has strengthened in all groups in India, and in most groups in Chile. Further, there is a strong, positive correlation between the group identity measure and the average group intermediation index, as well as a strong, positive correlation between the changes in both these measures (for both Chile and India).

4. There is evidence that increased intermediation is associated with improved accounting and stock market performance in Chile, and with improved accounting performance in India.

4. Discussion and conclusion

Both Chile and India have seen an opening up of their economies and an improvement in the state of their primary markets. Yet, contrary to conventional wisdom, we find no evidence that the intermediation roles played by groups have declined over reasonably long periods of time: 1987-1997 for Chile, and 1990-1997 for India. In fact, our field research at nine groups in each country suggests that groups have strengthened the ties that bind their firms together, that their self-reported intermediation attempts have increased more often than they have decreased, and that their product and geographic scope has generally increased. We also find evidence consistent with the proposition that the strengthening of the role of these groups is associated with an improvement in profitability.

A plausible explanation is offered by institutional economics. To varying degrees, the policy changes in both countries focused on deregulation of the primary markets, but restrictions on the operation of markets for intermediaries continue to exist. Deregulation of the primary markets, without a simultaneous development of intermediaries to facilitate transactions in these markets, increases the value creation potential for business groups. As a simple example, business groups may be the only domestic entities capable of pulling together the capital and management talent to address the new opportunities thrown open by the deregulation of primary markets.

Some limitations to our research are worth noting. First, care should be exercised in drawing conclusions from this exercise for the entire population of groups. We designed our sample to focus on a subset of groups that our prior research suggested were most likely to be carrying out intermediation attempts. Our prior work suggests that, in contrast to the samples here, smaller and less diversified groups are not likely to be carrying out value-creating intermediation roles (Khanna and Palepu (1998, 1998b)). Thus, the response of such groups to changes in the institutional context, given their initial lack of intermediation, might very well have been the opposite of the pattern seen for our sample of groups, i.e. they might very well have focused, and reduced their intermediation attempts and group identity measures.[30] Their response patterns await further analysis.

Second, as discussed earlier, our research does not examine the responses of focused firms in Chile and India. It is possible that some of the responses by groups, for example, building reputation in product, labour and capital markets, are also being undertaken by focused firms. Our prior work suggests that it is more economical for groups to invest in creating internal institutions that substitute for the absence of external institutions. This does not, however, preclude the possibility that certain focused firms may be able to attain the scale needed to justify such investments. Indeed, in the absence of a comparable sample of non-group firms, we have to be cautious not to imply that group-affiliates are better-positioned than unaffiliated firms to exploit new opportunities that deregulation has made available. As such, we also cannot make any statements about the aggregate importance of groups versus non-groups (as measured, say, by market share) in these economies.

Despite these limitations, the combination of results from two countries allows us to contribute to a theoretical debate about the reasons for the existence of groups. In particular, Ghemawat and Khanna (1998) have argued that groups may either be an efficiency-enhancing response to market imperfections, or an organisational device that facilitates rent-seeking by a privileged few. They argue that the responses of groups to changes in institutional context can be used to infer their underlying *raison d'être*. Sorting through these, especially with an approach that relies on self-assessment by the groups, is fraught with obvious problems. It is indeed possible that some of our documented expansion in scope of Chilean and Indian groups may result from privileged access to new opportunities. However, the constellation of attempts to create internal markets does not appear to us to be consistent with a pure rent-seeking interpretation of group existence. Facilitating an internal managerial labour market across group companies or developing a group brand that connotes quality in a context where external institutions that perform these functions are lacking are actions that are not easily interpreted as rent-seeking. Further, if groups everywhere were primarily rent-seeking devices, Chile would be an unlikely place to find them. The country is among the least regulated and least corrupt of emerging markets.

It is also useful to note that the move toward free-markets in Chile has been underway since the mid-1970s. Even with the passage of so much time, and even in the case of what is considered a fairly rapid reform process (Bosworth, Dornbusch, and Laban (1994), especially Chapter 1), intermediaries that facilitate the functioning of markets do not appear to have emerged to the extent necessary for a

general reduction in the value creation potential of large groups.[31] The increases in intermediation attempts by groups in both countries (and the lack of value destruction associated with these attempts), however, casts doubt on the notion that the largest and most diversified groups are likely to vanish quickly in response to liberalisation.

NOTES

1 See Sachs and Warner (1995) for a documentation of the fact that a large number of countries have gone from being "closed" to "open" economic regimes. Additionally, several other countries that have undergone significant liberalisation of their internal markets (without external liberalisation). See Ghemawat and Khanna (1998), and Ghemawat, Kennedy and Khanna (1998) for attempts to specify a research agenda related to rapid changes in policy regimes and their associated industrial organisation effects.

2 For broad discussions of the phenomenon of business groups in different countries, see Leff (1976, 1978), Amsden and Hikino (1991), Granovetter (1994), Khanna and Palepu (1997), and Ghemawat and Khanna (1998). Multiple references to country-specific studies of business groups can be found in these references.

3 Indeed, Chile is one of the few countries in which groups are legally defined entities. In both these countries, unlike in numerous others, firms are members of only one group. Further, marital alliances between families that run different groups are relatively rarer here than in some other countries, again contributing to the clarity of group definition. Finally, unlike in numerous other countries (Indonesia, Malaysia, and several Central American countries are examples), a larger proportion of groups are publicly traded in Chile and India, thus enabling field researchers to ratify some aspects of collected data.

4 In our research design, we made a choice to analyse changes in business group strategies in two different countries. An alternative design is to contrast the responses of business groups and focused companies in the same country. There are pros and cons to both approaches. Our choice is motivated by a desire to obtain an in-depth understanding of business groups, and ensure that the observed responses are not unique to one setting. Since the type of data we gather is very time consuming to obtain, we do not extend our research to focused companies in the current study.

5 Aoki's (1984) celebrated study of the Japanese firm (and the work that it has spawned by Japan-scholars) is an example of a study that centres on understanding the institution-specific nature of the resolution of such problems. Greif (1994, pp. 944), in his historical study of 16th century Maghribi traders and Genoese traders in the Mediterranean region, also highlights that "it is misleading to expect that a beneficial organisation in one society will yield the same results in another". In our study, we view the value creation potential of business groups to be a function of the institutional context.

6 See, for example, Akerlof (1970) for the role of intermediaries in product markets, Spence (1973) for their role in labour markets, Diamond (1984) for their role in financial markets, and Spulber (1996) for a general treatment of intermediation in a range of markets.

7 However, their results also show that groups of intermediate size and intermediate diversification levels underperform focused firms. Performance is measured by accounting measures (pre-tax ROA) and by stock market measures (an approximation to Tobin's Q).

8 We thank an anonymous referee for suggesting this point to us.

9 Aoki (1994) discusses the co-emergence of two features of the Japanese context, the main bank system and imperfect labour markets, and their effect on the organisation of production within Japanese firms.

10 A dramatic attempt at strengthening group identity is provided by the Tata Group in India, where we spent a substantial amount of time prior to undertaking the research for this paper (Khanna, Palepu and Wu (1998)). Ratan Tata, group head since 1991, embarked on a series of actions designed to weld the fairly independent entities of the Tata Group into a more coherent group, opining that "We have somehow to consider ourselves as one group. That's what we're trying to do in terms of corporate communications". Actions undertaken include increasing the financial interlocks among group companies, increasing the overlap in number of directors across companies, and becoming CEO of several of the major group companies. From 1991-1996, several major Tata companies outperform comparable industry benchmarks.

11 Only one of the eighteen groups in our two-country sample has no family affiliation.

12 The population of groups was constructed from data obtained from the *Superintendencia Valores y Seguros*, Chile, and from *Centre for Monitoring the Indian Economy*, India. While the Indian data on group affiliation is publicly available, the Chilean data is not, and was obtained with considerable effort; nonetheless, the Chilean data has been verified by cross-checking with knowledgeable observers in Chile. For each country, we constructed group diversification indices by first assigning two-digit SIC equivalent codes to each member firm in the group in question. The assignment of two-digit SIC code was made on the basis of the description of the product line of each firm.

13 For two of the Chilean groups, we obtained data only on subsets of the group, with each subset being a collection of companies and a sub-group in its own right.

14 Chilean groups account for 77% of the assets of all publicly traded companies in Chile, while Indian groups account for 29% of the assets of all publicly traded companies in India, and 72% of the market capitalisation of the companies traded on the Bombay Stock Exchange (Companies in India trade on several stock exchanges, of which the Bombay Stock Exchange is the oldest, largest and has by far the most listings.) The percentages reported in this paragraph are based on 1996 data for all Chilean firms, and on 1993 data for India (the year for which we have the most comprehensive data).

15 The Indian data was also cross-checked by data we obtained from the Confederation of Indian Industry (CII), New Delhi, and by the Institute of Chartered Financial Analysts of India (ICFAI), Hyderabad.

16 However, it is worth noting that the mean level of the CMI index is considerably higher than that of the mean levels of PMI or LMI in either of the two time periods.

17 In contrast, there is no discernible pattern in the correlation coefficients within the PMI sub-categories, or the within the LMI or CMI sub-categories, i.e. there is no evidence that one form of product market intermediation necessarily goes hand in hand with another (with the same comment applying for labour and capital market intermediation). There is also no discernible pattern in the trends of these correlation coefficients. Similar comments apply to the analogous Indian correlation coefficients discussed below.

18 In four of the ten Chilean group-year combinations for which we have complete sets of intermediation indices, max(PMI, CMI, LMI)≠CMI. Similarly, in ten of eighteen Indian group-year combinations, max(PMI, CMI, LMI)≠CMI.

19 Here inconsistencies are defined to occur when one option says "increase" and the other says "decrease".

20 Indeed, much of the literature has emphasised rent-seeking and directly unproductive profit-seeking activity (Krueger (1974), Bhagwati (1982)). Ghemawat and Khanna (1998) consider a method for choosing between these reasons for the existence of groups, and those where groups are efficient intermediaries in response to some informational imperfection.

21 We recognise that the questions of this type are potentially sensitive in nature, and the responses therefore are subject to bias. Our reported results in this area, therefore, should be viewed with caution.

22 The possible categories of influence in Chile, determined from several pre-interview conversations, were Industrial Policy, Labour Policy, Privatisation, Development of Domestic Financial Markets, Accessing Foreign Product Markets, Accessing Foreign Capital Markets, Entry of Foreign Companies, and Other. In India, the categories were the same (though Privatisation and Development of Domestic Financial Markets were not included).

23 Other studies that have computed Q in some detail include Lindenberg and Ross (1981), Montgomery and Wernerfelt (1988), Wernerfelt and Montgomery (1988), Lang and Stulz (1994)). Lang and Stulz (1994) use several years of data to compute the replacement value of assets under some assumptions. We cannot replicate this step with only one year of good data. None of our results are sensitive to the use of prices at different times, or an average market price over the year, for the construction of our Tobin's Q measure.

24 ROA suffers from business cycle effects, does not consider differences in systematic risk, and is not forward looking (Benston (1985)). Tobin's Q mitigates these problems but makes the problematic assumption, given the illiquidity and untimely disclosure problems of the capital markets in question (especially India), that stock prices appropriately reflect the benefits and costs of diversification.

25 Data on ROA is available for a majority of the firms for the whole time periods; however, for some firms, ROA data is available for only a subset of the years. Data on Tobin's Q is available for an even smaller subset of firms. We measure the change in each of the performance measures for the longest time period available for each of the sample observations (Table 7). Results remain unaltered when we restrict the ROA analysis to the subset of the firms for which data is available for the entire time period, though restricting the Tobin's Q analysis to a comparable subset results in an untenably small sample. Reliable data was unavailable for 1987 and 1997 for Chile, and 1996 and 1997 for India.

26 For example, 95% of group assets of the RPG Group are within its public companies (Khanna (1996)).

27 By Chilean accounting conventions, a firm that owns more than 50% of another firm consolidates the accounts of the latter into its own statements. We have to make substantial adjustments to avoid double-counting in the construction of group level aggregates.

28 The results reported below are not sensitive to changes in functional form regarding firm size, or to the addition of firm covariates like firm age.

29 In Chile, change in ROA and change in Tobin's Q are positively correlated (Pearson correlation coefficient 0.46, p-value 0.04; Spearman rank correlation coefficient 0.42, p-value 0.08). Change in ROA for the sample of firms for which Tobin's Q could be computed has mean of –6.7%, median of -4.3% and standard deviation of 8.0%. This compares to change in ROA for the full sample of Chilean firms which has a mean of –4.6%, median of 0, and standard deviation of 21.6%. In India, the changes in performance are also positively correlated (Pearson correlation coefficient and Spearman correlation coefficient are each 0.41, with p-values each of 0.001). Change in ROA for the sample of firms for which Tobin's Q could be computed has mean of 1.3%, median of 0.3% and standard deviation of

8.4%. This compares to change in ROA for the full sample of Indian firms which has a mean of 1.9%, median of 1.0%, and std. dev. of 9.1%.

30 Indeed, in Khanna and Palepu (1998b), we conduct a multivariate analysis of 120 publicly traded Chilean firms over a time period similar to that in this paper. Our sample includes affiliates from groups across the size and diversification spectrums. We find that the benefits of group affiliation remain positive and statistically significant throughout most of the sample period, but decline gradually. This suggests that the average value of intermediation by groups has declined over time in Chile. We conjecture that this is driven by differences in changes in intermediation between large groups and small groups.

31 As an example, Jaime Charles, Chief Financial Officer of the CAP group of companies in Chile, where we spent much time prior to conducting the research reported in this paper, had the following to say regarding the slow development of pension funds (AFP) in Chile, and their development of a capability at investing and at monitoring firms in which they had investments: "AFPs have gone through a gradual learning process regarding monitoring the management of the companies in which they own shares, though there is still room for significant improvement in several instances" (Khanna and Wu (1998).

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APPENDIX 1

Brief description of major policy changes in Chile and India

CHILE, 1988-1997	**INDIA, 1990-1997**
Product Market Changes	
-*Tariff barriers* lowered to 11% in 1991. Non-tariff barriers banned. -Chile pursues *regional integration* by linking with neighbouring Mercosur countries.	-*Customs duties* lowered from over 100% to 65% (raw materials) and 25% (finished goods). -*Industrial licensing* abolished for most industries. -*Controls* over capacity expansions abolished. -*Prices* over most controlled items liberalised.
Capital Market Changes	
-Nascent *pension fund* industry develops. Funds gradually allowed to invest in domestic equities, international equities, and riskier ventures. Laws passed to enforce percentage of monthly earnings be channelled into pension funds. -Lending to related parties monitored to protect *minority shareholders.* -*Foreign exchange restrictions* largely removed -*American Depository Receipt* market becomes accessible -Domestic and international *analysts* emerge. -*International bond rating* improves access to global capital markets	-*Foreign Exchange Regulation Act's* restrictions on foreign firms' equity holdings in Indian firms abolished -Access to *short-term foreign currency loans* easier for firms that are net foreign exchange earners. -*Pricing* of capital issues deregulated -150 approved *foreign institutional investors* enter -*Mutual funds* no longer restricted to public sector -*Global capital issues* restrictions lifted. -*Over-the-counter m*arket develops for smaller capital stocks -*Interest rate deregulation* develops debt markets
Labour Market Changes	
-Enhanced right to unionise amidst tripartite agreement between government, business & labour. *New social contract* calls for growth with equity. -*Retrenchment* of workers made more difficult.	-*Wages* remain highly regulated for large firms. -No progress on *"exit"* policy. Very difficult for firms to retrench or redeploy workers.
Other Policy Changes	
-1982 crisis resulted in government take-over of recently *privatised* entities, creating 'odd sector.' These are reprivatised, followed by privatisation of 'core' state-owned enterprises. Privatisation of social services also occurs extensively. -Independent *Central Bank* established. -*Democracy* restored with 1990 hand-over of power from General Pinochet to centre-left government of Aylwin. Reaffirmed with Frei election in 1994.	-Slow *privatisation* of some state-owned enterprises. Harder to privatise loss-making units. -Beginning of attention to developing *physical infrastructure* in the country. -Peak *corporate income tax* rates reduced from 65% to 46%. -*Free convertibility* of the Rupee on the current account. Goods no longer required to be purchased at government determined exchange rates.

APPENDIX 2

Data collection process

1995-1997: Research and teaching cases written on Indian groups (Tata, RPG) and a Chilean group (CAP) as a means of familiarising ourselves with the relevant institutional context and the issues faced by groups in the particular country, over the two years prior to the actual interviews with companies. (See Khanna (1997); Khanna and Wu (1998); Khanna, Palepu and Wu (1998) for the case studies, and Eckstein (1975), Eisenhardt (1989) and Ghemawat (1997) on the use of case studies and field research).

1996-1997: Cases taught in MBA programme at Harvard with participation of the groups' executives, and revised and refined based on input from these discussions.

1996-1997: Extensive open-ended interviews with academics, business-people and regulators conducted in Chile and India to further identify relevant aspects of the institutional context.

Early 1997: Local institutions recruited to assist with process of interviewing groups, and to help identify knowledgeable observers: Universidad Adolfo Ibanez, Santiago, and Confederation of Indian Industry (CII), New Delhi.

June-July 1997: Sample Identification. Prior statistical work using Chilean and India data suggested that value creating intermediation was most likely to be found in the largest, most diversified groups (Khanna and Palepu (1998, 1998b)). Accordingly, we approached a collection of groups which fit this profile and were headquartered in large, metropolitan cities. The major criterion for inclusion was that the Group CEO participate in the interviews in the weeks available to us for travel. None of the groups refused to participate, though several were excluded because of the CEO's absence from the city during the weeks of the interviews. Nine groups in each of Chile and India emerged as a result of the application of these criteria.

June-September 1997: Pre-interview communication with the selected groups to describe the content of the interview. At the request of some groups, we pre-sent the questionnaire that we were going to use for the interviews.

August 1997: Interviews in India (Bombay, Madras and New Delhi) conducted over two-week period. Two hour, face-to-face structured interviews with each of group CEO, group CFO and group Human Resources Manager (HRM). Additional open-ended interviews with senior personnel recommended by one or more of the group CEO, CFO, or HRM. Approximately, one business day spent per group.

October 1997: Similar interviews conducted over ten day period in Santiago, Chile. Two hour, face-to-face structured interviews with each of nine Group CEOs, with seven of nine group HRMs and with five of nine group CFOs, plus open-ended interviews with other group personnel as in India. Some minor refinements of the questions in the structured interviews were implemented in Chile to build on the India experience.

September-November 1997: Post-interview follow-up. Accumulation of pending data items from groups.

Table 1. **Group samples for Chile and India**

The table shows the sample of nine groups in each of Chile and India who participated in the study. The size measures of the group are based on total group assets, and group diversification is measured as the total number of 2-digit SIC equivalent industries in which the various group firms are active. For a group to be in size quartile 1, it has to be among the largest 25% of all groups in the respective country. Similarly for a group to be in diversification quartile 1, it has to be among the 25% most diversified groups in the respective country. The overall population of groups is obtained from public sources data provided by *Centre for Monitoring the Indian Economy*, Bombay, India, and from privately collected data from the *Superintendencia de Valores y Seguros*, Santiago, Chile.

Chile

Group	Size Quartile	Diversification Quartile	Industries
Luksic Group	1	1	Forestry, Fishing, Pulp and Paper, Electricity, Financial Services
Angellini Group	1	1	Agricultural Products, Mining, Food and Beverages, Textiles, Wood and Metal Products, Retail Trade, Communications, Financial Services
Grupo Larrain	1	1	Food and Beverages, Wood Products, Chemicals, Transport, Trade, Financial Services
Grupo Claro	1	1	Food and Beverages, Glass, Transport, Financial Services
Corp Group (Saieh Group)	1	2	Chemicals, Transport, Financial Services
Banco Santander Group	1	2	Financial Services, Business Services
Grupo Bhif	2	2	Food and Beverages, Chemicals, Financial Services, Business Services
Grupo Penta	2	2	Financial Services, Medical Services
Empresas Carozzi	2	2	Food and Beverages

India

Group	Size Quartile	Diversification Quartile	Industries
RPG Enterprises Group	1	1	Agricultural Products, Electricity, Chemicals, Plastics and Rubbers, Services
T.V.S. Iyengar Group	1	1	Base Metals, Chemicals, Electronics, Plastics and Rubbers, Services, Textiles, Transport
Murugappa Chettiar Group	1	1	Agricultural Products, Base Metals, Electronics, Food and Beverages, Non-Electrical Machinery, Services, Transport
Mahindra and Mahindra Group	1	1	Base Metals, Electronics, Plastics and Rubbers, Services, Transport
Birla C.K. Group	1	1	Chemicals, Electrical Machinery, Electronics, Non-metallic Minerals, Transport
Larsen and Toubro Group	1	1	Electric Machinery, Electronics, Non-electrical Machinery, Services, Transport
Hero (Munjals) Group	1	2	Transport
Godrej Group	1	1	Chemicals, Electrical Machinery, Electronics, Fats and Oils
Sanmar Group (Chemplast)	2	2	Chemicals, Plastics and Rubbers, Services

Table 2. **Scope changes in Chile and India**

The table reports changes in horizontal and vertical scope as reported by the group CEO. The change in importance of international markets is coded on a scale from 1-5, with '1' indicating that international markets are significantly less important at the end of the period than at the beginning, and '5' indicating that they are significantly more important. Vertical integration refers to both individual group companies being vertically integrated or the collection of group companies being vertically integrated, with '1' and '5' respectively indicating the lowest and highest levels of vertical integration.

Chile, 1987-1997

Group Number	Entry into new businesses	Exits	Further entry planned?	Further exit	Change in importance of int'l markets	Vertical Integration in 1987	Vertical Integration in 1997
1	entry into businesses that now form mainstay	small exits	yes	no	5	3	3
2	no	no	no	no	5	1	1
3	entry only within very similar businesses	no	no	no	4	1	1
4	entry but new business is small	no	no	no	5	3	1
5	entry only within very similar businesses	no	yes, similar business	no	4	3	3
6	entry into businesses that now form mainstay	small exits	yes	no	4	1	1
7	entry into businesses that now form mainstay	small exit	no	no	5	2	3
8	no	no	no	no	5	1	1
9	entry into businesses that now form mainstay	no	unsure	no	5	1	1

India, 1990-1997

Group Number	Entry into new businesses	Exits	Further entry planned?	Further exit planned?	Change in importance of int'l markets
1	entry but new business is small	small exits	yes	unsure	3
2	yes	no	yes	no	4
3	yes	small exits	no	unsure	5
4	entry but new business is small	no	yes	yes	5
5	entry into businesses that will form mainstay	small exits	yes	small exits	4
6	yes	yes	yes	no	3
7	small entry	small exits	major entry planned	no	4
8	yes	yes	yes	yes	5
9	yes	yes	no	yes	3

Table 3. **Questions used to determine intermediation indices**

These questions were posed to senior officers of each group. Questions regarding product market intermediation, labour market intermediation, and capital market intermediation, were posed respectively to the group CEO, the group head of human resources and the group CFO in structured interviews that lasted 1.5-2 hours each. The respondents chose from a scale of 1-5, where a response of '1' typically indicated the lowest possible extent of group intermediation in the issue in question, while '5' indicated the maximum possible role for group intermediation. The sub-categories of questions within PMI, LMI and CMI are chosen on the basis of extensive pre-interview discussions with group members and independent observers in Chile and India as being sensible aggregations of various intermediation roles.

PRODUCT MARKET INTERMEDIATION (PMI)

Group Brand

Degree of sharing in the development of group brand

Fraction of companies that use the group brand in company name or product name***

Extent of spillover benefits from group brand, or from any other brand with which the group is associated

Alliances

Extent to which group initiates alliances

Extent to which group is engaged in ongoing management of alliances*

Extent to which there are spillover benefits from alliances to other group firms not engaged in these alliances

Extent to which there is sharing in alliance management expertise

Intra-Group Sales

Extent to which sales of group firms are to other firms within the group

LABOUR MARKET INTERMEDIATION (LMI)

Recruiting

Extent of group involvement in entry-level recruiting**

Extent of group involvement in non-entry-level recruiting**

Mobility

Percentage of managerial workforce that has worked in more than one group company during their career at group***

Degree of importance of those managerial moves that did occur around the time period in question*

Extent to which promotions at a group company were made from personnel at other group companies

Extent to which non-managerial labour was obtained from other group firms as opposed to from the market*

Training

Extent to which training programmes were carried out at the group level as opposed to at the individual firm level*

Extent to which consulting affiliations were arranged at the group level, or were at the group level, as opposed to the individual company level*

Compensation

Extent to which group level metrics were used in determining performance-related pay

CAPITAL MARKET INTERMEDIATION (CMI)

Relationships with Financial Intermediaries

Extent to which relationships with domestic banks are maintained at group level, as opposed to by individual group firms

Extent to which relationships with other domestic debt-holders are maintained at group level, as opposed to by individual group firms

Extent to which relationships with domestic stockholders are maintained at group level, as opposed to by individual group firms

Extent to which relationships with foreign banks are maintained at group level, as opposed to by individual group firms

Extent to which relationships with other foreign debt-holders are maintained at group level, as opposed to by individual group firms

Extent to which relationships with foreign shareholders are maintained at group level, as opposed to by individual group firms

Extent to which relationships with international lending agencies are maintained at group level, as opposed to by individual group firms

Extent to which relationships with foreign analysts are maintained at group level, as opposed to by individual group firms

Extent to which relationships with domestic analysts are maintained at group level, as opposed to by individual group firms

Managing Internal Finances

Extent to which internal cash surpluses are managed at group level

Extent to which funding needs of group firms are met by group issued securities as opposed to company issued securities

Extent to which external providers of finance to particular group companies care about state of other group companies

Extent to which group plays a role in financial distress

Extent of lending to or investment by group firms in other group firms

Orchestrating Changes in Group Scope

Extent to which financing for acquisitions was provided by more than one group firm

Extent to which acquisitions were orchestrated by multiple group companies or by central group entity

Extent to which group expertise in orchestrating acquisitions was sufficient, so as not to require recourse to expertise provided by specialised intermediaries

Extent to which financing for greenfield investments was provided by more than one group firm

Extent to which greenfield investments were orchestrated by multiple group companies or by central group entity

Extent to which group expertise in orchestrating greenfield investments was sufficient, so as not to require recourse to expertise provided by specialised intermediaries

Extent to which group expertise in orchestrating divestitures was sufficient, so as not to require recourse to expertise provided by specialised intermediaries

Extent to which group expertise in orchestrating group restructuring was sufficient, so as not to require recourse to expertise provided by specialised intermediaries

Notes:

* Indicates questions which were not posed to the Indian groups

** Indicates that these questions were combined into one in the interviews with the Indian groups

*** These questions received a numeric answer which, for coding purposes, was converted in linear fashion to a 1-5 response scale.

Table 4. **Intermediation indices for Chilean groups**

Each cell reports the average response of the group respondent to the questions in the category (as specified in Table 3). The average PMI is the simple average of the values in the sub-categories within product market intermediation. Average LMI and Average CMI are constructed similarly. In all cells, values of '1' indicate a minimal intermediation role for the group, and values of '5' indicate a maximal role for the group.

Group Number	*1*		*2*		*3*		*4*		*5*		*6*		*7*		*8*		*9*	
	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997
PMI*																		
Group Brand	1.67	1.67	2.00	2.00	4.33	4.33	1.00	1.00	2.33	3.33	1.00	1.00	1.33	1.67	3.67	4.00	1.00	1.00
Alliances	3.00	3.00	1.60	2.00	1.00	1.00	1.00	1.20	2.80	3.20	1.00	2.20	2.60	2.60	4.00	4.20	4.00	4.00
Intra-Group Sales	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Average PMI	1.90	1.90	1.53	1.67	2.11	2.11	1.00	1.07	2.04	2.51	1.00	1.40	1.64	1.76	2.89	3.07	2.00	2.00
LMI**																		
Recruiting	4.50	2.50	1.00	1.00	5.00	5.00	4.00	2.00	1.00	2.00	1.00	1.00	1.00	1.00				
Mobility	2.50	2.75	1.00	1.00	3.00	3.25	3.75	2.00	2.25	3.25	1.33	2.67	1.75	2.25				
Training	2.00	2.00	1.00	2.00	1.00	3.00	1.00	2.00	4.50	5.00	1.00	1.00	1.50	2.00				
Compensation	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	2.00	1.00	1.00	1.00	1.00				
Average LMI	2.50	2.06	1.00	1.25	2.50	3.06	2.44	1.75	2.19	3.06	1.08	1.42	1.31	1.56				
CMI***																		
Interfacing with Intermediaries	4.17	2.63	1.00	1.00	1.00	2.43	1.75	4.00	5.00	5.00								
Managing Internal Finances	2.60	2.20	1.60	1.60	2.00	3.50	3.40	1.60	3.60	4.40								
Scope Changes	4.00	2.50	3.00	3.80	4.30	4.00	4.00	2.20	5.00	5.00								
Average CMI	3.59	2.44	1.87	2.13	2.43	3.31	3.05	2.60	4.53	4.80								
Average	2.66	2.14	1.47	1.68	2.35	2.83	2.16	1.81	2.92	3.46	1.04	1.41	1.48	1.66	2.89	3.07	2.00	2.00
Overall Change in Intermediate Index	Decrease		Increase		Increase		Decrease		Increase		Increase		Increase		Increase		Same	

Notes:

* Product Market Intermediation
** Labor Market Intermediation
*** Capital Market Intermediation

Table 5. **Intermediation indices for Indian groups**

Each cell reports the average response of the group respondent to the questions in the category (as specified in Table 3). The average PMI is the simple average of the values in the sub-categories within product market intermediation. Average LMI and Average CMI are constructed similarly. In all cells, values of '1' indicate a minimal intermediation role for the group, and values of '5' indicate a maximal role for the group.

Group Number	*1*		*2*		*3*		*4*		*5*		*6*		*7*		*8*		*9*	
	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997
PMI*																		
Group Brand	1.00	1.33	1.67	1.67	4.33	4.33	1.00	4.00	2.33	4.00	4.00	4.00	3.00	3.00	1.00	3.67	3.33	3.33
Alliances	1.33	2.00	4.00	3.33	2.50	2.50	1.00	3.17	3.33	4.00	4.00	4.00	2.00	2.00	1.00	4.00	1.00	2.33
Intra-Group Sales	1.00	1.00	2.00	2.00	2.00	2.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Average PMI	1.11	1.44	2.56	2.33	2.94	2.94	1.00	2.72	2.22	3.00	3.00	3.00	2.00	2.00	1.00	2.89	1.78	2.22
LMI**																		
Recruiting	1.00	1.00	1.00	2.00	1.00	1.00	2.00	3.00	n.a.	2.00	4.00	3.00	2.00	2.00	3.00	5.00	5.00	5.00
Mobility	1.50	1.50	2.00	2.00	1.50	1.50	1.50	1.50	n.a.	2.50	2.00	2.00	2.00	2.00	1.50	3.50	1.00	1.00
Compensation	n.a.	n.a.	n.a.	n.a.	1.00	1.00	1.00	1.00	n.a.	4.00	n.a.	2.00	1.00	5.00	n.a.	1.00	1.00	1.00
Average LMI	1.25	1.25	1.50	2.00	1.17	1.17	1.50	1.83	n.a.	2.83	3.00	2.33	1.67	3.00	2.25	3.17	2.33	2.33
CMI***																		
Interfacing with Intermediaries	5.00	4.80	n.a.	4.60	5.00	5.00	4.90	4.20	5.00	3.00	1.00	1.00	5.00	4.60	3.20	1.30	2.50	2.20
Managing Internal Finances	1.40	1.40	1.40	1.80	1.40	1.20	3.80	3.80	1.40	2.60	4.00	4.00	1.20	1.80	2.40	3.40	2.00	2.20
Scope Changes	2.00	2.25	n.a.	n.a.	2.00	2.00	2.33	2.50	4.83	4.43	3.00	2.75	3.40	2.67	2.83	3.50	2.33	1.57
Average CMI	2.80	2.82	1.40	3.20	2.80	2.73	3.68	3.50	3.74	3.34	2.67	2.58	3.20	3.02	2.81	2.73	2.28	1.99
Average	1.72	1.84	1.82	2.51	2.30	2.28	2.06	2.69	2.98	3.06	2.89	2.64	2.29	2.67	2.02	2.93	2.13	2.18
Overall Change in Intermediation Index	Increase		Increase		Decrease		Increase		Increase		Decrease		Increase		Increase		Increase	

Notes:

* Product Market Intermediation
** Labor Market Intermediation
*** Capital Market Intermediation

Table 6. **Changes in group identity**

Each cell reports a response with possible values ranging from 1-5, with ‘1’ representing the lowest possible value of "group identity" and ‘5’ representing the highest possible value. The questions used to determine these reponses are as detailed below. The average level of group identity is a simple average of the three category averages summarized immediately above it. Values are reported for each group in each of two periods. The CEO's assessment of changes in group identity is an independent measure ranging from ‘1’ which implies that group identity has decreased radically, to ‘5’ which implies that group identity has strengthened radically.

Chile

Group Number	*1*		*2*		*3*		*4*		*5*		*6*		*7*		*8*		*9*	
	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997	1987	1997
Extent of Board Interlocks	5.00	5.00	1.00	1.00	5.00	5.00	3.00	2.00	5.00	5.00	3.00	3.00	5.00	5.00	2.00	2.00	3.00	2.00
Extent of sharing across activities	1.93	1.93	1.23	1.23	2.54	2.54	1.47	1.07	2.07	2.15	2.46	2.46	1.31	2.00	2.36	2.91	1.85	1.85
Extent of family involvement across activities	3.77	3.77	1.31	2.07	2.71	2.71			2.85	2.38			1.62	1.62	2.45	2.45		
Average level of group identity	3.57	3.57	1.18	1.43	3.42	3.42	2.24	1.54	3.31	3.18	2.73	2.73	2.64	2.87	2.27	2.45	2.43	1.93
CEO's assessment of change in group identity	Increase (4)		Same (3)		Same (3)		Decrease (2)		Decrease (2)		Increase (5)		Increase (4)		Increase (5)		Increase (5)	

Table 6. **Changes in group identity** *(cont'd)*

India

Group Number	*1*		*2*		*3*		*4*		*5*		*6*		*7*		*8*		*9*	
	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997	1990	1997
Extent of Board Interlocks	1	1	n.a.	n.a.	3	3	2	2	2	2	2	2	2	2	1	3	3	3
Extent of sharing across activities	1	1.3	1.6	1.6	4.1	4.1	1.5	2.4	2.2	3.3	2.4	2.7	1.7	1.8	1	2.7	2.3	2.4
Extent of family involvement across activities	3.8	3.8	n.a.	n.a.	n.a.	n.a.	1.5	3.9	2.5	2.5	n.a.	n.a.	1	1	3.7	3.7	2.8	3.3
Average level of Group Identity	1.93	2.03	1.60	1.60	3.55	3.55	1.67	2.77	2.23	2.60	2.20	2.35	1.57	1.60	1.90	3.13	2.70	2.90
CEO's assessment of change in group identity	Increase (4)		Increase (4)		Increase (4)		Increase (5)		Increase (5)		Increase (5)		Increase (5)		Increase (5)		Increase (4)	

Questions used to determine measures of group identity

How extensive is common board membership among the group companies?

Options range from <20%, 20-40%, 40-60%, 60-80%, >80%, coded from 1 to 5 respectively. Thus a code of '2' implies that between 20% and 40% of the board members of a group company sit on the boards of other group companies

For each of the following different activities, please indiate the extent of sharing at the group level for the activity in question.

An option of '1' corresponds to no sharing, with the activity in question performed entirely by individual companies, while an option of '5' indicates that the activity is performed entirely at the group level for all group companies. Activities included: R&D, Procurement, Production, Marketing, Brand Development, Quality Maintenance, Sales, Distribution, Finance, Human Resource Development, Government Relations, Managing Alliances/Foreign Technology Partners

For each of the following different activities, please indiate the extent to which family members are involved in the activity in question.

An option of '1' corresponds to no involvement by the family member(s), while '5' corresponds to dominance of the family members' opinions in the activity in question. Activities included: R&D, Procurement, Production, Marketing, Brand Development, Quality Maintenance, Sales, Distribution, Finance, Human Resource Development, Government Relations, Managing Alliances/Foreign Technology Partners.

Overall, how would you say that the strength of ties among group companies has changed since 1987?

An option of '1' indicates that the strength of ties has decreased considerably, '3' indicates no change, while '5' indicates that the strength of ties has increased considerably.

Table 7. **Regression results**

The table reports the results of the following regression:

Change in Firm Performance = $\alpha + \beta$ * log of Assets
+ γ * Change in intermediation index for the firm's group
+ δ * Change in identity index for the firm's group
+ D1 - D14 * Industry dummies
+ ε

The regressions are estimated separately for Chile and India. We allow the error term to be correlated across observations common to a group, following Moulton (1986, 1990). Performance is measured using both pre-tax ROA and an approximation to Tobin's Q. Pre-tax ROA is defined as {net income + interest* (1-tax rate)}/{total assets}. The Tobin's Q approximation is defined as (market value of equity + book value of debt + book value of preferred stock)/(book value of assets). The change in performance is measured between 1988 and 1996 for Chile, and between 1990 and 1995 for India. Changes in intermediation index and identity index are measured at the group level for each firm, as reported in tables 4, 5 and 6. Each firm is assigned a two-digit SIC industry code based on its business description, and industry dummies for each firm are included in the regression (the coefficients on the dummies are suppressed in the results reported below).

Specification	i Chile	ii India	iii Chile	iv India
Dependent Variable	ROA	ROA	Tobin's Q	Tobin's Q
Constant	0.47*** (5.45)	-0.03 (-1.36)	2.38** (2.11)	1.24 (0.42)
Log Assets	-0.03*** (-5.45)	-0.01 (-1.66)	-0.14 (-2.12)	0.04 (0.15)
Change in Intermediation	0.16*** (7.20)	0.07** (2.68)	0.98*** (6.09)	-1.30 (-0.88)
Change in Group Identity	-0.02 (-0.20)	-0.01 (-0.38)	0.32 (0.74)	-1.40 (-0.94)
Industry Fixed Effects	Included	Included	Included	Included
Number of Observations	32	94	18	55
R-squared	0.41	0.29	0.77	0.35
F	160.73***	9.10***	82.02***	1.35

Notes:

1. *** Significant at the 1% level
2. ** Significant at the 5% level

2.3 DISCUSSION OF PAPERS BY JUNGSOO LEE AND TARUN KHANNA

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There are widely differing views on the correct interpretation of the East Asian crisis. At one extreme, it has been suggested that the present difficulties have arisen from a combination of policy errors in financial liberalisation and macroeconomic management compounded by panic induced by maladroit interventions on the part of the IMF (Radelet and Sachs, 1998). At the other extreme, the collapse might be thought to confirm that the East Asian miracle is indeed a myth, as argued by Krugman (1994), and to suggest therefore that substantial structural reforms are required if rapid trend growth is to return and catch-up of the West is to be achieved. In either case, of course, a solution to the financial crisis is needed for the resumption of growth.

As an economic historian, I have some sympathy with both points of view (Crafts, 1998). It is clear that, in the absence of effective regulation of the financial system and in the presence of ill-conceived macroeconomic policy, severe contractions can be experienced in economies that have excellent underlying growth capabilities. The United States in the 1930s is the classic example. In that episode, a revamping of financial regulation and a cleaning-up of bank balance sheets together with a move to expansionary monetary policy saw a resumption of trend growth by the end of the decade and the economy powered ahead to exploit its productivity growth potential in the following three decades.

At the same time, East Asian productivity performance has been somewhat disappointing compared with that of Western Europe in its Golden Age during the 1950s and 1960s, and GDP per hour worked even in the leading Tiger economies still has a long way to go to match that of the leading OECD economies. It might be argued that the developmental state model was better suited to the tasks of mobilising high rates of saving and industrialisation while solving co-ordination problems and reducing transactions costs in the early stages of development, than to the efficient allocation of capital and high total factor productivity in a more mature economy.

Against this background, the two excellent but very different papers in this session, both rooted in modern microeconomics, embody views at either end of the spectrum on which reforms are desirable for the East Asian economies to return to rapid long term growth. Jungsoo Lee argues that there have been important weaknesses in the financial, corporate and government sectors and that strengthening competition together with better corporate governance and much more effective financial regulation and supervision to cope with the consequences of asymmetric information will be required. While the short-term priority is financial reform, including recapitalisation of the banking system along with closure of insolvent institutions and an end to the encouragement of excessive risk-taking, in the longer term getting prices right through greater reliance on market forces is a central requirement. This suggests, at the least, that the "getting prices wrong" approach to development in late industrialisation in East Asia, as praised by Amsden (1989), has had its day.

In contrast, Tarun Khanna draws parallels with countries elsewhere in the world, emphasising the continued usefulness of diversified business groups. He sees these groups as performing important functions of intermediation even if further liberalisation occurs, given the weakness of stand-alone market institutions in the region to solve problems of asymmetric information. His fear is that the crisis will lead to the unwarranted dismembering of the *chaebol* and thus be harmful to investment. He argues that at least some features of the developmental state model will continue to serve countries like Korea well and that an attempt to promote capital markets much more like those of America is premature.

Although Khanna has some good arguments on his side, my sympathies are more with Lee's position. Prompted by writers like Alexander Gerschenkron, economic historians have long recognised that institutional innovation, involving drawing the boundaries of the firm differently than in more advanced countries, may be necessary to overcome the problems of initial backwardness in the context of high transactions costs and weak legal systems. These historians can readily appreciate that the *chaebol* has contributed more to development than merely rent-seeking. At the same time, these are surely second-best solutions and their past successes should not be taken to indicate their continuing optimality. This is hard to maintain in the case of Korea, given evidence of the adverse productivity effects of industrial policy and rapidly declining rates of return to capital. What the present situation reveals is not the undesirability but rather the intrinsic difficulty of making the transition to a more market-based economy, particularly given the pre-crisis political clout of the existing producer groups.

Recent papers in growth economics indicate that there could be significant increases in long term-growth rates from paying attention to microeconomic reforms. On the other hand, the burgeoning literature on political economy warns us that these reforms may be hard to implement. Here surely lies the weak point of Lee's paper. He fails to identify the political opposition to the changes that he advocates and thus to propose ways in which to overcome these obstacles. Yet, the experience of Japan during the 1990s suggests that deciding who is to take responsibility for failure and to bear the various costs of financial restructuring may be too difficult for the process to be seriously undertaken. Accordingly, the paper offers a wishlist rather than a strategy for reform.

These criticisms should not detract from the very high quality of the papers by Khanna and Lee. Both offer important insights and deserve to be widely read.

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2.4 DISCUSSION OF PAPERS BY JUNGSOO LEE AND TARUN KHANNA

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There is little to disagree with the thrust of these two papers. However, it is worth amplifying certain areas of discussion more explicitly. In the first paper, Jungsoo Lee, recognising that the East Asian economic crisis is rooted in several complex factors, places emphasis on weaknesses in the financial and corporate sectors. While the fostering of competition in the affected economies is briefly mentioned as being important, one needs to be more specific, and in doing so recognise the interactions that exist between different factors, policy asymmetries, and policy sequencing. The macroeconomic and financial conditions under which these economies currently find themselves are but a symptom of more fundamental microeconomic problems in product, service and financial markets. Generally speaking, macroeconomists tend to gloss over microeconomic issues such as market structure and the state of competition – markets are *assumed* to be perfect and performing well. In so far as some markets may be imperfect, policies promoting trade liberalisation, deregulation and privatisation are frequently espoused as being able to correct any distortions that may tend to arise. However, although such policies are necessary and no doubt pro-competitive, they are not sufficient to maintain and encourage competition. Markets can remain segmented and have a weak state of competition even if tariff and non-tariff barriers are low or absent, due to such factors as high transportation costs, perishable/non-tradable nature of the products, and strategic business behaviour by firms such that private anti-competitive arrangements significantly reduce the public benefits that otherwise would flow from more liberal trade and deregulated markets.[1]

The lack of effective competition in domestic markets distorts the informational content of price and output signals, which in turn results in wrong investment and output decisions. The various business environment characteristics prevalent in most of the East Asian economies are such that not even entrepreneurs, let alone lenders, investors and policy makers could accurately judge the true value of economic activity, and resulted in less efficient use of investment capital. In Malaysia for example, total factor productivity, which increased at an average rate of 3.2% per annum until 1995, declined subsequently to zero and negative values. The declining trend in industrial productivity and the loss of export competitiveness has been mentioned in several papers including those in this symposium.

There are two sets of business environment factors which interact and mutually reinforce each other to force firms to become efficient. One set is the market for corporate control and corporate governance, and the other set is the nature and extent of competition in product, service and financial markets. Both sets of factors and their legal, regulatory and institutional underpinnings have generally been lacking or weak in the East Asian countries, and have led to the development of several of the characteristics frequently attributed to these economies. The history of tariff and non-tariff barriers, restrictions on foreign ownership, various government interventions such as directed credit and subsidies have led to high levels of domestic industry concentration, collusive business practices and excessive economic rents. This has also created incentives for ownership concentration since on a

risk-adjusted basis firms earn above competitive-level profits. These profits have also fuelled lobbying, 'cronyism', bribery and corruption as owners seek to preserve their preferential economic positions and access to political power. The close ties between the industrial and financial sectors, and the closed nature of these sectors have in turn led to excessive reliance on bank financing of corporate sector economic activity and consequent underdevelopment debt and equity markets. The thinness of the capital market has also made it difficult for small-and medium sized firms to finance growth and increase their scale of operations so that in addition to the high levels of industrial concentration, there is a 'missing middle' in the size distribution of firms.

While encouraging East Asian governments to enact and/or effectively administer existing competition laws will not be a 'panacea' for many of the above type of problems, pro-competitive policies will encourage greater accountability, transparency and efficiency, and in doing so will speed up the process of economic adjustment.

The second paper in this session, by Drs. Tarun Khanna and Krishna Palepu, arrives at the conclusion that contrary to the transaction costs and internalisation theories of the firm, deregulation of product and capital markets in Chile and India has not led the large diversified business groups to specialise and reduce the scope of their economic activities. Indeed, their evidence suggests that these large groups have strengthened their internal structures and processes in ways that enables them to increase their roles as intermediaries in domestic product, labour, and capital markets, and that these actions are associated with improved performance. One explanation offered is that deregulation in these countries has focused on primary markets while restrictions on the operations of markets for intermediaries continue to exist, and only domestic entities are capable of pulling together the necessary capital and management talent to take advantage of the new opportunities being opened up. Another explanation is that despite significant economic policy changes, the existing groups through their ability to earn economic rents, are able to obtain favourable regulatory treatment. These conclusions are consistent with the more general view articulated above about the characteristics and conditions prevalent in East Asian economies. However, additional points are worth considering.

As previously mentioned, trade liberalisation and deregulation do not necessarily imply that increased competition will result in eliminating the various economic distortions – at least not immediately and not all them. Markets take time to adjust and it is possible that the findings of the Khanna-Palepu research have been affected by this. In addition, in the case of India, there was (and remains) intense lobbying against economic liberalisation and powerful industrial lobbies such as the "Bombay Club" have slowed the pace of reforms. Moreover, in both economies effective domestic competition (antitrust) policies have been lacking and the position of entrenched monopolies has not been eroded. The incumbent large enterprise groups can engage in various strategic business behaviour including anti-competitive practices which thwart or make entry of new firms difficult. They also have incumbency or competitive advantages such as first-mover advantages and knowledge of local market conditions.[2] Further, in many developing countries, new (foreign) firm entry often takes place via joint-ventures and strategic alliances with existing firms which can result in the further increased scope of economic activities.[3]

A host of other factors can also be mentioned which have important implications for the findings being reported. For example, there is inadequate information disclosure due to the concentrated ownership and closely held characteristics of enterprises in these economies This not only makes observing and monitoring profitable economic opportunities very difficult, it also impedes the market for corporate control. Also, given the underdeveloped nature of financial and capital markets, the internal capital markets within large industrial conglomerates are likely to be more efficient.[4] And

non-conglomerate or large group-associated firms may incur higher capital costs of entry. In addition, the inter-relationships between the socioeconomic-political elite in these countries often results in mutual forbearance and reciprocity so that they do not enter into each others' areas of interests.

In conclusion, while much needs to be done by way of policy reforms in order to revive economic growth in East Asian economies, an important building bloc that must be put into place is the encouragement of effective domestic market competition in product, service and financial markets. Adoption and proper implementation of competition laws and policies would make a significant contribution towards a speedier and more sustainable economic recovery.

NOTES

1 See KHEMANI, R.S. and M. DUTZ (1995), "The Instruments of Competition Policy and Their Relevance for Economic Development", *PSD Discussion Paper*, The World Bank, Washington D.C.

2 See OSTER, S (1990), *Modern Competitive Analysis*, Oxford University Press, for a general discussion of these concepts.

3 See WAVERMAN, L., W. COMANOR and A. GOTO (editors) (1997), *Competition Policy in the Global Economy*, esp. Ch.6 on 'Strategic Alliances', Routledge, London/New York.

4 See LEWELLEN, W. (1971), "A Pure Financial Rationale for the Conglomerate Merger", *Journal of Finance* Vol.26, and PENROSE, E. (1959), *The Theory of the Growth of the Firm*, Oxford University Press.

Chapter 3

THE SOCIAL AND POLITICAL SUSTAINABILITY OF REFORMS

3.1 THE ASIAN CRISIS: SOCIAL CONSEQUENCES AND POLICIES*

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Introduction

The East and Southeast Asian crisis, commonly labelled the 'Asian crisis' is evidently having horrendous social consequences, including mass unemployment, expulsion of immigrant workers, large rises in poverty, diminished social services, rising school dropouts, rising suicide rates, divorce and domestic violence. At least on an anecdotal basis, all these and other negative human effects have been recorded in the countries of the region – countries which previously had a sustained record of social and economic improvement.

The ultimate aim of this paper is to identify policies which would ameliorate these effects. In order to do so, it is necessary first, to understand the basis of the previous success in improving social conditions in the region; and secondly, to trace how macroeconomic events have undermined this success in an astonishingly short period. The next section of the paper, therefore, reviews the main factors responsible for the thirty years of improved human development before the 1998 crisis. Section 2 provides an overview of macroeconomic events associated with the crisis and the main links between these events and human conditions. Section 3 surveys the (still limited) evidence on worsening poverty and social indicators in the region. Section 4 discusses policies that would help prevent or offset the deterioration in people's lives, especially those of the poor.

The paper focuses on the five countries most seriously affected by the crisis: Thailand, Korea, Indonesia, Malaysia and the Philippines. Although the crisis first hit Thailand, events in Korea, Indonesia and Malaysia rapidly followed a similar pattern, but the Philippines, whose initial position was markedly different from the others (with a much smaller dependence on short-term capital inflows, and also a much weaker record in economic and social progress), was less seriously affected. As the crisis unfurled over 1997-98, each of the countries adopted a different policy stance, and internal political developments have also varied, with differing consequences for social outcomes. Hence caution is needed about any generalisations put forward below about the region as a whole. Where possible, differences among the countries will be noted.

* We are grateful to Ali Hasan for research assistance

1. Past record of the Asian economies in reducing poverty

In order to understand the ways in which the crisis has affected poverty, it is essential first to analyse the mechanisms by which poverty was effectively reduced in the past because this permits an identification of the mechanisms at play in the crisis. In general, changing poverty levels depend on the rate of economic growth and the way that it is generated and allocated. It is important to differentiate between two types of income: first, *primary* income (or *private income*), i.e. income derived from the economic system, including employment and self-employment, subsistence production and income from assets; secondly, *secondary* income or *social income*, derived from the state via social production of free (or subsidised) goods and services and income transfers (e.g. unemployment benefits). Private transfers – most often within families but also within a local community – can provide another important source of support. Poverty arises when either primary or secondary incomes are inadequate to meet what are considered minimum needs.[1] The first type of poverty may be called private income poverty (PIP) and the second, social income poverty (SIP). PIP depends on how primary income is distributed among households, SIP on how secondary income is allocated by governments to social priorities. Together they determine the relationship between growth and poverty.

Review of past achievements in poverty reduction

Over the past quarter of a century, the South and Southeast Asian countries, with the exception of the Philippines, were highly successful in reducing both PIP and SIP.

Turning first to PIP, apart from the Philippines, each of the countries impressively reduced both rural and urban poverty over these twenty years (Table 1, page 158): in Indonesia PIP was estimated at around 57% of the population in 1970 and had fallen to just 15% by 1990; in Korea in 1984 PIP was estimated at only 4%; in Malaysia private income poverty fell from around 50% in 1970 to 15% in 1990; the Thailand rate fell from 39% at the end of the 1960s to 13% in 1992. The Philippines was the one exception, with poverty rates still at 45% in 1991.[2]

Three factors explain this generally good record on poverty reduction: the rapid growth in output and incomes, the generally high employment elasticity of output growth, and the sustained growth in agricultural productivity. With the exception of the Philippines, the countries enjoyed annual growth in *per capita* income of 6-8% for most of the period. Moreover, the growth was led by labour intensive exports generating a fast rise in employment. For example, in the 1980s Indonesia's manufacturing employment is estimated to have grown by 11% p.a., while that of Korea grew by nearly 6% p.a. and that of Malaysia over 4% p.a. In the Philippines, in contrast, there was slow growth in *per capita* incomes and manufacturing employment fell during the 1980s. In each country, there was also reasonably high growth in agricultural output, contributing to rising rural incomes, both in agriculture and in linked non-agricultural activities. Thus the generally remarkable improvement in PIP was achieved as a consequence both of the high growth in GDP and the composition of that growth, focused on labour-intensive exports which generated employment, leading to a reduction in urban PIP, and agricultural growth which helped reduce rural PIP.

The fast growth in these countries was fairly well distributed among households as a result of the sectoral pattern of growth and its labour-intensity, and consequently the poor overall shared proportionately in the increasing incomes in all countries, but to a greater extent in Indonesia and Korea, both of which had a particularly egalitarian distribution of income initially and showed some

improvement (but with blips) over time (Table 2, page 158). Income distribution in Malaysia, although much less egalitarian around 1970, improved over time. Apart from Thailand, where income distribution was rather unequal in 1969 and worsened over time, the distribution of income (initial and/or change over time) contributed to the improvement in PIP over the quarter of a century, in the sense that it meant that the high growth translated significantly into incomes for the poor. Nonetheless economic growth itself, rather than radical changes in the distribution of incomes, was the predominant influence on the incomes of the poor.

It must be emphasised that the reduction in PIP was due to the workings of the economy *and not to safety net-type schemes aimed at helping the poor*. Generally, there were relatively few specific interventions in place to aid the poor, which is not surprising given that poverty was falling without government intervention directed towards that end.

SIP also fell substantially over the same period (Table 3, page 159). For example, in Malaysia 40% of the population had no access to health services in 1980 and this had fallen to 12% by 1993. In Thailand 34% of the population was without access to safe water in 1980 and by 1994 this had fallen to 19%. In 1965, 78% of girls were not enrolled in secondary school in Malaysia, and by 1993 the proportion had dropped to 39%; in Indonesia 93% of girls did not go to secondary school in 1965 and by 1993 the proportion was 61%.

Good performance on SIP was again due to a combination of high economic growth and its allocation. These countries did not devote a particularly high proportion of their GDP to government expenditure (below 20%, with the exception of Malaysia where the proportion was nearly 30% in the 1980s), although they did have a quite high social allocation ratio (i.e. the proportion of government expenditure going to the social sectors); for example, Thailand spent 16% of government expenditure on the education and health sectors in the 1980s, rising to 28% in the 1990s, while Malaysia had a social allocation ratio above 20%. The social priority ratios (proportion of social expenditure going to priorities for the poor, defined here to include basic health and education expenditure) were also high for Korea and Malaysia (around 70%), moderate for Thailand and the Philippines (around 50%) and quite low for Indonesia (see Table 4, page 160).

While the proportion of GDP going to the social sectors was not particularly high by international standards, fast economic growth meant that social expenditure increased rapidly. For example, it is estimated that expenditure per head on education increased threefold or more in Indonesia, Malaysia, Korea and Thailand between 1980 and 1995, but by much less in the Philippines.[3] Despite this good performance, there remained significant levels of SIP in the Philippines, Thailand and Indonesia, with a quite substantial proportion of the people without access to some basic services, as is apparent from some of the figures given above. But SIP was very low in Korea and relatively low in Malaysia.

PIP remained high in the Philippines and Malaysia, accounting for over a third of the population, and significant pockets of income poverty were present in Indonesia and Thailand in some regions left out by the economic success (e.g. the northeast in Thailand and some provinces in Indonesia, notably West Nusa Tenggara). Those who did remain in poverty over time, the ‘old’ poor (mainly those who failed to gain access to formal sector jobs or modern social services) were largely dependent on traditional support systems, such as the family, the community, and activity in the informal sector, while NGOs (local and foreign) provided some support. By the mid-1990s, the numbers of the ‘old poor’, those households which had not been ‘floated’ out of poverty by the spectacular rise of income and the relatively equitable distribution experienced by most of the

countries under consideration, were generally not large by LDC standards; the 'new poor' created by the crisis potentially represent a more formidable problem.

2. The 1997-8 crisis, macro-developments and social implications

In principle, we need to distinguish the consequences of three types of change associated with the crisis: the immediate effects of the sharp reversal from capital inflows to outflows; policy changes, including those demanded by the IMF; and individual and household responses. The first of these constitutes the source of the problem, while the latter two represent efforts to adjust to it.

The sudden and huge swing in international capital movements led to a domestic financial crisis involving a severe reduction in liquidity, revealing the poor state of bank asset portfolios, threatening bankruptcies among banks, and therefore severely undermining confidence. The liquidity crunch had the immediate effect of reducing finance for investment and working capital leading to numerous bankruptcies and downsizing in the private (and public) sector. The burst bubble in the property and stock markets led to a sharp downturn in investment and reduced purchasing power among elite consumers. The simultaneous currency crises, with exchange rates spiralling downwards, sparked internal inflation and sharply rising interest rates (partly to protect the currency). The former reduced real incomes and consumption further depressing local sales, although incomes of agricultural exporters were favourably affected by the exchange rate depreciation in Thailand.[4] The latter greatly added to the cost of borrowing for working capital, contributing further to the mounting bankruptcies. These effects were the direct consequence of the turnaround in international capital flows.

Policy reactions to these events – led by the IMF for Thailand, Indonesia and Korea – generally made the situation worse, at least in the short run. Very broadly, the immediate policies advocated by the IMF were harshly deflationary, arguing for restrictive monetary policy, involving very high interest rates, and cuts in public expenditures. Moreover, international confidence far from being restored was further undermined by early aspects of the Fund's operations: first, the immediate reaction of the Fund was to recommend the closure of nineteen finance companies in Thailand and several banks in Korea, while generally pronouncing on the seriousness of the crisis; secondly, the institution did not at all act as a lender-of-the last-resort offering immediate and unlimited credit, but made its credit highly conditional, to be disbursed in dribbles, with the total amount available much too small given the potential size of the problem; thirdly, given the source of the crisis – imbalances in the private sector, not the public – and its deflationary consequences even without Fund intervention, the policies advocated seemed clearly inappropriate to many observers and hence were ineffective in restoring confidence.[5] Subsequently, the Fund stance has softened with much less deflationary packages (elaborated in IMF 1998).

For Indonesia, Thailand and Korea both the immediate consequences of the crisis and the policy reactions were in the same direction – leading to private bankruptcies and downsizing in both private and public enterprises, and reductions in the size of the civil service. The only expansionary element was the very large devaluations, which might have been expected to raise export sales. But severe problems in financing working capital, even among exporters, in addition to the depressed markets in Japan, appear to have prevented a substantial rise in exports, although export volumes have risen in some countries. Malaysia has avoided a Fund programme and has refused to be as deflationary in its policy reactions, relying much more on capital controls and instructing its banks to *increase* their lending. But Malaysia too suffered from the deflationary impetus coming from the crisis itself.

With respect to PIP, a severe decline in incomes among all parts of the community followed from the contraction in formal sector output and employment and the rising prices associated with the exchange rate depreciation. The results of the contraction were sudden as were large rises in unemployment, with a consequent increase in PIP. Some reverse migration has occurred as countries (notably Malaysia) eject foreign workers, creating refugees and additional poverty in their countries of origin (as recipients of such ejected workers, Philippines and Indonesia are likely to be most adversely affected in the region).

People working in the urban informal sector, who account for as much as half of the urban labour force in some countries, are not so immediately or severely affected by these developments. But those in the 'modernising' subsector suffer through their linkages to the formal sector and consequently a diminution in their markets for producer and consumer goods. In the traditional part of the informal sector, new entrants from the newly unemployed will depress average incomes there.

The agricultural sector has generally been less affected by the crisis, except for the special situation in Indonesia and the Philippines – indeed the sector gained from improved internal terms of trade in Thailand: in Indonesia a coincidence of drought and forest fires severely curtailed food output, reducing agricultural incomes; in the Philippines, too, drought led to a fall in agricultural output estimated at around 7% in 1998. Reverse domestic migration (back to the rural areas) may contribute to rising rural poverty as wages are depressed by the migrants and income shared with them. This reverse migration is likely to be most marked in Thailand and Malaysia; in Indonesia, it may be less because of the drought impact; in Korea because urban rural links are weaker because of the longer history of industrialisation; and in the Philippines so far the impact of the crisis on the formal sector has been weaker.

Although the reductions in employment do not directly hit the pre-existing poor in the first instance, there are bound to be knock-on effects arising from the reduced dynamism of the formal sector and the price rises associated with currency depreciation, increased indirect taxation, and, in the case of Indonesia particularly, rising food prices resulting from the agricultural crisis as well as disruptions in transport and distribution due to the political crisis. The old poor, especially in the urban areas, are likely to be especially severely affected since, possibly unlike the new poor, they do not have the buffer of prior savings.

There are many ways in which households and individuals adjust to crisis. We have already mentioned the move back into the urban informal sector and into agriculture. Based on experience from the adjustment crisis of the 1980s[6], other responses are likely to include some increase in the female labour force participation rate, especially in the informal sector, while the male participation rate decreases as formal sector employment opportunities fall back. Households also adjust to reduced family incomes by substituting low-cost sources of nutrition for high cost, and by reducing 'luxury' consumption generally. The effects on nutrition are likely to be less marked than effects on income, as low-cost foods form a higher share of consumption. But it is probable that expenditure on items such as education – school uniforms and books – will tend to be cut back.

All in all, household and community adjustments may moderate the negative impact of the crisis, but cannot eliminate it, especially since the adversity is generalised, and in some cases (e.g. Indonesia) exacerbated by other exogenous shocks.

In most of the countries, there are virtually no safety nets for the newly unemployed. The traditional systems that supported the poor in the past – the ability to retreat to subsistence

production, close family links and support from the community – have been seriously weakened with the advent of a dynamic, modern, urban economy. Yet new social security systems suited to a modern industrial economy have in general not yet been put in place. The reliance on a growing economy, which proved to be so successful in reducing poverty over the past twenty years, contained a severe flaw in making no social security provision (or other form of safety net) for the newly unemployed, except for Korea where some unemployment insurance was introduced in 1992 in large enterprises while some workers in Malaysia are covered by State Provident Funds. In Korea, unemployment insurance extends to about one quarter of the jobless – those who have paid sufficient contributions in the past, and they will be covered for a few months on half pay. But most of the newly unemployed workers in Korea, and almost all elsewhere are likely to suffer considerable hardship unless some provisions are put in place; but at a time of crisis it is not possible to introduce comprehensive support systems.[7] The Philippines is an exception: the persistent high levels of poverty have given rise to quite extensive safety net policies such as employment schemes.

Turning to SIP, government expenditure is being reduced, though the extent depends on the policy package ultimately agreed upon. In any event, reduction in the growth rate will have a downward effect on public expenditure. There is likely to be some increase in the proportion of government expenditure going to foreign debt servicing following devaluation, but the effects will be less than in the Latin American case because more of the debt is in the private sector; it is also, probable that a high proportion of government expenditure will be allocated to bail-outs, due to government guarantees, implicit or explicit. The fiscal cost of bail-outs elsewhere in developing countries has ranged from 55% of GDP (Argentina, 1980-1982) to 5% in Malaysia, 1985-88. The fiscal costs of the Mexican 1995 bail-outs were 14% of GDP.[8] Spread over five years, an equivalent commitment would amount to 12-14% of the annual budget. Hence there is likely to be downward pressure on the proportion of government expenditure available for the social sectors.

With the downward pressure on both total government expenditure and the social allocation ratio, SIP is likely to rise in the absence of specific countermeasures. Nevertheless, it seems probable that the short-run deterioration in PIP will be more acute than the deterioration in SIP since SIP usually has its own momentum and is rarely reversed so sharply. Moreover, in principle it is easier to design policies to protect SIP.

3. Evidence of deteriorating human conditions

Falls in *per capita* income, worse falls in consumption, sharply rising unemployment, cuts in social expenditures which have arisen from the crisis and policy reactions to it, all these work to increase poverty and worsen human conditions generally. There is limited data on the macro-changes and almost no systematic evidence on the human consequences. But there are some pointers stemming from NGO and newspaper reports and focus groups surveys conducted by the World Bank. This section attempts to piece together an empirical picture of the changing human conditions from these sources.

Macro-effects

Estimates for the magnitude of the macro decline are somewhat shaky and change frequently, even though the overall direction is agreed upon. There has been a very large fall in GDP; estimated at a catastrophic 15% for Indonesia, 8% for Thailand, 7.5% for Korea in 1998, 5.5% for Malaysia and approximately 1% in the Philippines (partly due to agricultural failure owing to El Niño).[9] In *per*

capita terms, the declines, of course, are even more severe. Estimated falls in industrial production show a larger fall: for example, Korean industrial output in August was 12% below its level a year earlier, and in Thailand 14% (July). A huge switch of resources towards into the external sector for debt servicing has reduced the resources available for domestic use. Thus its estimated that Thailand moved from a current account deficit of 8% in 1996 to a surplus of 12 % in 1998 (i.e. a switch of one fifth of output); for Korea the net switch was 17%; for Malaysia 14%; for Indonesia 7% and for the Philippines 9%.[10] Hence even though it appears that investment has fallen by more than consumption (for example in Korea investment is estimated to have fallen by 35% and consumption by 12.5%, while in Thailand the investment rate was expected to halve over the course of the year), consumption must still have fallen more sharply than GDP to release resources for the external sector.

Reductions in consumption were brought about through a sharp rise in unemployment and a decline in real incomes as inflation outpaced earnings. It is estimated that up to 12 million Indonesians may lose their jobs in 1998, i.e. approximately 12% of those employed. In Korea, the downsizing of chaebols is expected to result in the loss of one and a half million jobs, as 3,000 businesses became bankrupt each month. By May 1998, unemployment had already doubled to 1.5 million and was expected to reach 10% by the end of 1998, over three times the rate at the beginning of the crisis. Unemployment appears to be disproportionately concentrated among the less skilled and lower income workers (with unemployment increasing by 49% among the highly educated and over 100% among those with middle school primary education only; unemployment also rose most for those on daily contracts) (*Korea Times*, 16/03/98). In Malaysia, employment cuts fell initially on the foreign population from Burma, Bangladesh, Cambodia and Indonesia. The government was expected to expel half the 1.8 million foreign workers. In Thailand, the ILO expects unemployment to reach 6% by November 1998 compared with 2% in 1996.[11]

Detailed evidence is available for the change in employment in Thailand to February 1998, compared with earlier years, revealing the composition of the change in the employment situation. Unemployment more than doubled between 1997 and 1998. A breakdown shows that employment fell among both men and women and both rural and urban areas and unemployment rose among all groups (Table 5, page 161). Moreover, the number working less than twenty hours per week doubled in the rural areas and increased more than five-fold in the urban areas, while the number working more than forty hours fell by 15% and 19% for men and women respectively in the urban areas (and less in the rural areas). An industrial breakdown of changes in employment shows there was a rise in services (presumably including the informal sector), agricultural employment was approximately stable (with a rise among men and a fall among women), and the fall was concentrated, as would be expected, in industry and construction. The change in female activity and employment rates did not appear notably different from male, which contrasts with evidence of rising female participation and employment in some adjusting countries in the 1980s.[12] The figures clearly understate the full effect, as the economic contraction developed further after February 1998. Indeed, a mission to Thailand in August 1998 stated that unemployment was expected to reach 4 million in 1998.[13]

The newly unemployed will obviously suffer a drastic loss in income, especially in the absence of any form of unemployment insurance or other state support, which extends only to a minority of workers in Korea. One out of five households in Seoul included someone who had lost a job according to a survey in reported on in May 1998; 36% of these families relied on severance pay and 30% on family members, while 14% said they had no way of supporting themselves. Of those surveyed, 80% suffered a loss in income (*Korea Times*, 13/05/98). Another survey of newly unemployed showed that 40% received no severance pay, either because employers failed to give it, or because they were not entitled to it because they were on short-term contracts. Of those receiving

severance pay, 30% claimed they could not manage for more than six-months (*Korea Times*, 16/03/98). For the rest of the countries in the region, there was effectively no severance pay.

There is some indication that bankruptcies have been focused more on the small-scale than large-scale sector, because bail-outs are normally concentrated on the large-scale where the knock-on consequences of bankruptcies are more alarming, and political connections stronger. This distributional effect tends to worsen the human costs, since the small-scale firms generally are more labour-intensive and employ people at lower wages with less savings to cushion them.

Those who retained their jobs also suffer as a result of the sharp price rises associated with devaluation and removal of price controls and subsidies. IMF data suggest that inflation rates escalated in Indonesia to an annual rate of 43% for January-June 1998 while the annual rate is expected to be 80%; employees have suffered real wage cuts of 15% or more.[14] Although overall inflation rates appear to have remained moderate for the other affected countries[15], there have been large rises in some basic consumer prices; for example, in Korea petroleum prices were already up by nearly 40% and kerosene prices by 80% by the end of 1997.[16] In Thailand there were sharp rises in food prices in response to devaluation.[17] In one area, it was reported that rice prices had risen by two thirds, cooking oil by a similar amount and sugar by 45%.[18] In the Philippines, some regions show worse price rises than others.[19]

PIP

There is no data for the actual rise in PIP following the crisis, but there are abundant newspaper reports of individual cases of worsening incomes and acute hardship. The deterioration is likely to be worst in the case of Indonesia, where average incomes started relatively low and the loss in output and rise in unemployment is expected to be the greatest, while the agricultural failure is compounding the situation.

Table 6 (page 161) uses World Bank simulations, together with the changes in GDP predicted earlier, to provide very crude estimates of additional poverty in the countries.[20] As expected, the largest increase in poverty rate is in Indonesia, although the level remains below that of the Philippines (and also apparently the other two countries, but this is because a higher poverty line has been used for them). The increase in the poverty rate in Malaysia and the Philippines is more moderate because of the lesser drop in GDP, but we should note that these simulations do not include the consequences of agricultural setbacks in the Philippines. Translated into millions, the situation is far the worst in Indonesia with nearly 20 million additional poor (partly because of the large population in Indonesia) compared with about one million or below in Malaysia and the Philippines and just over two million in Thailand.

Rural incomes

The rural population, while less directly affected by the economic crisis, has suffered strong knock-on effects, through reversed migration and reduced remittances. In Thailand, reverse urban rural migration has been observed; for example, one village reported an increase in population of 15%. In Indonesia, substantially fewer seasonal workers returned to seek work in the urban areas in one area surveyed by the World Bank (Robb, 1998). These additional workers have a downward effect on local wages, and also require support from their families and communities. Moreover, many rural communities depend significantly on urban remittances, which have declined sharply with rising

urban unemployment. For example, in Tulunangun in East Java, Indonesia, one in three villagers were in receipt of remittances (Robb, 1988).

Budget cuts

Government expenditure cuts are in evidence throughout the region, in response to falling revenue and IMF programmes. In Thailand, revenue in the third quarter of 1997 was down 6.4% on the year before, and for the fourth quarter 0.8%, despite the introduction of some new taxes. November 1997 expenditure estimates were 18.5% below those submitted to Parliament in June 1997, with a cut of 15.3% in public health expenditure and 10.7% in education (Siamwalla and Sopchokchai, 1998).

In the Philippines in 1998, the government initially instructed all departments to reduce their budgets by 25% of non-personnel expenditure, affecting both health and education sectors, (although later in the year this instruction was reversed). In the health sector cuts of 26% in expenditure in basic immunisation, and similar cuts in TB and schistosomiasis treatment ensued.[21] Mini surveys indicate shortages of drugs and escalating drug prices (2-3 fold) in West Java, Indonesia. Budget constraints, coupled with rising prices, make it likely that availability of drugs in clinics may be halved. There are reports of cuts in the health budget of a rural clinics of 30% in Northeast Thailand. Rising costs of imported drugs due to currency depreciation have reduced the real value of health expenditures, themselves facing downward pressures. In Indonesia, for example, imports account for 60% of pharmaceuticals, and drug prices reportedly increase by two or threefold (World Bank, 1998a).

Drop-out rates at school

In Thailand, data shows the total number of students in school in 1998 was 3.2% below the 1997 level after a long period of rising enrolments, and reports note sharply increased drop-out rates in schools in Indonesia and Korea, with some indications that dropouts are worse among girls than boys (Mehotra, 1998; OXFAM memo; *New York Times*, 8/6/98, 11/6/98). In Korea, a survey showed that 10% of families with fathers as the prime earner had taken their children out of school due to unemployment, and 12.3% where women were the prime earner (*Korea Times*, 28/9/98). In addition, widespread cuts in private tuition have been reported and University enrolments are severely down in Korea with a registration rate as low as 30% of normal in some departments; there has also been a large increase in the number of students returning from abroad *(Korea Times*, 18/1/98; 18/02/98; 28/02/98).

Malnutrition and other human costs

The increase in poverty and rising food prices, especially in Indonesia, are likely to have led to a rise in malnutrition, although systematic data is not available. However, it was reported that about half the children in Indonesia were malnourished, considerably higher than pre-crisis levels[22], while people in the slum areas of Thailand, Indonesia and Philippines all reported cutting down from three to two meals a day and in some cases to only one (Robb, 1998). Rising infant mortality is reported by the director of UNICEF's Indonesian office.[23]

Other human costs are indicated by evidence of rising female-labour, child-labour, prostitution and begging in Thailand; increased child-labour in Indonesia; rising divorce, suicide rates and the sale

of human organs in Korea (Robb and Zhang, 1998; *Korea Times*, passim). In the Philippines, the Social Weather Station showed a rise in self-reported poverty in September 1997 for the first time in five years, the rise accelerating in December of that year.

In summary, although the picture is patchy, there is clear evidence of worsening poverty – both PIP and SIP – together with other forms of deterioration in human conditions, with the sharpest rises in poverty in PIP; and much of the largest increase in poverty in Indonesia, where an additional twenty million people may have fallen below the poverty line. The difficulty in piecing together the evidence should be noted. Priority must be given to improved monitoring of human conditions in situations of rising distress. This will be discussed further below.

4. Suggested policies to reduce human costs

The objective of all the remedies to be discussed here is to attempt to minimise the human cost of adjustments to the crisis. One critical requirement is to avoid unnecessary losses in GDP and resume an egalitarian growth path as soon as possible, since it is the macro-failure which has been the direct cause of the worsening situation. Specific measures to offset social costs are unlikely to offset the costs imposed by macro-developments, and will certainly not lead to an improved situation for the poor compared with the previous situation. Many analyses of measures to reduce social costs avoid tackling the macro-issues. This is true for example of the World Bank's analysis and prescriptions; in contrast with previous adjustment crises, the World Bank today regards poverty alleviation as central to its remit. Yet the policies advocated – for example in the analysis of the 'Social Consequences of the East Asian Financial Crisis' – do not comment on the macro package. In this section, first we analyse macro-policies from the perspective of reducing social costs; and secondly, we consider specific policies to offset social costs, in the context of macro-deflation.

Macro policies

The macro-situation is the key to determining the extent and duration of the crisis. It is essential to avoid excessive deflation and attempt to achieve recovery as quickly as possible. It is widely acknowledged that the IMF, under the influence of its prior Latin American experience, has tended to overstate the deflationary requirements of crisis management, particularly initially, and has focused excessively on the government accounts, while insisting on restrictive monetary policy. While such measures might have been justified had they succeeded in restoring the confidence of the private sector as they did in Mexico in 1995, their failure to do so prolonged the deflation. Moreover, since (apart from the exchange rate) macro 'fundamentals' were not at fault, the focus on the public sector was inappropriate, and the prime emphasis should have been in restoring private sector confidence through financial sector reforms.

There clearly existed an overall absorption problem which had to be faced since foreign financing had been drastically reduced and current account deficits were quite high. The combined official funds from the IMF/WB/ADB and bilateral donors contributed some additional finance to cover short-term needs, but were inadequate to meet the aggregate needs arising from debt servicing and the current account. However, while it was necessary to eliminate trade deficits and run some surplus to allow for debt servicing, the turnaround within a year to current account surpluses of 12% (Thailand and Korea), and 9% (Malaysia) was excessive. Moreover, it was achieved largely via import compression not export expansion, and hence was very deflationary. Such a huge swing was not necessary; some moratorium on debt payments (preferably negotiated), together with quicker

disbursement of international finance and a larger total could have permitted more gradual and less deflationary adjustment. This would have led to a smaller increase in both PIP and SIP. Both fiscal and monetary policy were responsible for the harsh deflation, but in the short run the monetary squeeze caused the most damage, since it deprived firms of temporary financing that might have allowed more of them to ride out the crisis. The indiscriminate high interest rates and squeeze on lending affected the working capital of exporters and the credit basis of micro-lending, the first making it difficult to overcome the crisis through export expansion, the second further worsening the condition of the low-income group. In general, it appears that small and medium-term firms, almost invariably more labour-intensive than large, have been hit disproportionately by the credit squeeze.

Hence a prime requirement for avoiding such heavy social costs is to reduce the deflationary element in the package – both through fiscal and monetary policy. This would have required (i) a more generous and speedy response by international (multilateral and bilateral) lenders; (ii) some moratorium on debt service including capital repayment through negotiation with international creditors, or, failing that, unilateral decision. In fact successive adjustment packages were significantly less deflationary, but not before there had been big reductions in GDP *per capita* and government expenditure cutbacks, with the social consequences recorded above.

In the longer term current account deficits should be constrained to moderate levels (with 4% of GDP a maximum, and rates of 2-3% preferable on a sustained basis) to avoid a build-up of debt obligations and the consequent vulnerability to speculative attacks. It is noteworthy that the four Asian systems relatively unaffected by the current crisis – China, Chinese Taipei, Hong Kong and Singapore – have been running surpluses or, as in China's case, only a small deficit expressed as a percentage of GDP. Within limits, foreign borrowing is not inappropriate for emerging countries but makes sense only if it is allocated to productive investment as opposed to consumption binges or real estate speculation.

FDI is preferable to short-term portfolio flows for it is less volatile, as shown by the fact that it has been hardly affected by the recent crisis.[24] Countries should therefore take measures to encourage FDI, at least relative to short-term portfolio capital flows, by providing disincentives for the latter along the lines of the one-year deposit requirement (without interest payment) adopted by Chile or some variant thereof. However, it would be politically undesirable and economically second-best to encourage bargain-basement purchases of existing facilities by foreign investors.[25]

Financial sector adjustments

To achieve stabilisation and then resumed growth, there is a need to generate renewed confidence by foreign as well as domestic investors in these economies, in order to avoid further capital outflows and further declines in the exchange rate. As already pointed out, this requires regaining the confidence of foreign private investors in the effectiveness of the reform package. So far this has not been achieved in Indonesia, and only partially elsewhere. Such restoration of confidence would be greatly assisted by much larger standby commitments, including by foreign governments, which may not need to be drawn upon. In the case of Mexico in 1994, such a commitment was provided primarily by the US In Asia it seems appropriate that Japan should play an equivalent leadership role, possible US and IMF objections notwithstanding.

Second, it is necessary to reconsider the fixed exchange rate policies of the past and replace them with managed floats. The fixed rate vis-à-vis the dollar led to unjustified exchange rate appreciation

and made the economies increasingly uncompetitive compared with China and Japan, ultimately generating speculation against the currencies. With more flexible exchange rates it should also not be necessary to maintain such extremely high interest rates, although some rise in real interest rates relative to the pre-crisis situation may be warranted in the short-term to reduce some of the less productive investments, which will help the countries deal with the problem of reducing their absorption.

Third, in each country, instead of either blanket bail-outs or allowing the market to determine the fate of companies through mass bankruptcies, a review of financial institutions and enterprises is needed, distinguishing between good and bad debts, and allowing for mergers, bankruptcies and rescues, as appropriate. In addition, the entire debt situation of each country, and of the major indebted enterprises within it, should be reviewed, swapping short- for long-term debt on as favourable terms as possible. In this context, foreign private investors should be made to share in the costs of adjustment, along with everyone else.

Fourth, consideration should be given urgently to the adoption of Brady Loan-type packages for each country. In the absence of such packages it will be especially difficult for these countries to export their way out of debt, given the size of the short-term debt and the fact that the economies are already highly export-oriented.[26] In the 1980s, Latin American recovery occurred only after such packages were introduced – the long delay (for at least five years from 1982) in introducing them caused prolonged recession and rising poverty. Such delay should be avoided in the Asian case.

Fifth, financial sector reforms are clearly urgently needed, as is generally acknowledged. These include full disclosure of the size of foreign exchange reserves, bank balance sheets and non-performing loans; total foreign currency reserves should be at least as big as total short-term liabilities; orderly bankruptcy procedures and their implementation is needed; also the substitution of objective risk analyses and arms-length credit allocations for political favouritism and government guarantees of private loans; general adherence to BIS recommendations on the adequacy of bank capital reserves must be enforced; and most importantly, local banks must be forbidden to be net debtors in hard currency. However, while it is easy to state these requirements, it is much more difficult to put them into effect, especially in a crisis context. But it does seem that Korea and Thailand have made a start in this direction, especially in the banking sector, while Indonesia seems to have lagged behind, making recovery more difficult.

Sixth, there should be no further liberalisation of the capital accounts at this time, and certainly not before the financial sector reforms have gradually been put in place.

Specific policies to reduce and offset social costs in the context of macro-deflation

While the level of deflation was excessive, its distribution also appears suboptimal from the point of view both of speeding economic recovery and of reducing the human costs. Priority needed to be given to protecting the private consumption of the poor and social expenditures directed towards them. Because the initial share of private consumption of the poor was relatively low as was the share of GDP going to priority social expenditures (i.e. social expenditure on programmes benefiting the poor), it would not be excessively expensive to protect these elements even in the context of GDP decline. This is illustrated in Table 7 (page 162) which indicates that 1% of GDP is sufficient to compensate the bottom 20% for a 10% cut in private and social income, or 2% for a 20% cut. Compensating the bottom 40% of households for a 10% cut in incomes would cost 2-2½% of GNP, and 4-5% for a 20% cut.[27] Assuming the costs of adjustment are being disproportionately borne by the

poor, then the 20% case may be the most relevant in the case of Indonesia, the 10% one for Malaysia, Thailand and Korea and less for the Philippines. The data are illustrative and the methodology can be questioned – especially the way priority expenditures have been defined. Nonetheless, the basic conclusion, if not the details, is valid and important; that well-distributed cuts can avoid hurting the poor without excessive costs even in the worst case (i.e. Indonesia).[28]

These estimated costs assume that any transfers can be strictly targeted to those in need; in practice some benefits are likely to go to some above the poverty line, while administrative costs add to the total. Doubling of the estimates seems in order to allow for this, i.e. costs of around 4% of GDP to offset a reduction of 10% in the incomes of the bottom fifth of the population. However, the greater the 'spillage' in terms of benefits for those above the poverty line, the more the potential for 'clawing-back' the extra income by raising indirect taxes on non-essentials.[29]

The question then should be not whether, but how to protect the poor during adjustment. As far as private income is concerned, the cuts need to be concentrated on luxury consumption of upper income groups and 'luxury' private investment. For social income, military expenditure and some non-essential government investment provide the obvious sources.

The East Asian countries are unusual in having had extremely high investment rates which had risen in the years immediately preceding the crisis. In Malaysia, where the investment rate had been 32% 1981-90, it rose to 45% in 1996; in Thailand, from 31% to 44%; in Indonesia from 30 to 38%; in Korea from 31 to 37%. There is evidence that the quality of investment had been deteriorating with rising ICORs over this period. A considerable portion was in the construction of luxury office buildings, apartment blocks etc. Such 'luxury' investment was to be observed in the public sector as well as the private. Hence if cutbacks are focused in part on such investment, resources can be released to improve the current account and to compensate the poor at little real cost to the economy. But, of course, it is difficult to restrict cutbacks in this way, especially in the private sector: monetary restrictions fall on more productive investment and production as well as less productive; and cutbacks in luxury construction, which have occurred, lead to costs for the poor via rising unemployment. There is no doubt that to ensure the burden of cuts fall where they cost the least, one needs less blunt instruments than aggregate credit restrictions. Credit has to be restricted differentially according to sector, with agriculture, exports and micro-credit protected.

As far as luxury consumption is concerned, higher indirect taxes on non-necessities (i.e. excluding food, medicines, types of fuel used by the poor) and raised tariffs on luxury commodities are needed to restrain such consumption. The latter do not appear to have formed part of existing adjustment packages, apart from increases in petroleum taxes, which fall on rural and public transport as well as private.[30]

With respect to public expenditure on social services and for transfers (see below), what is needed is a reorientation of government expenditure; this will require a major reduction in defence expenditure[31] and a thorough review of government infrastructure projects with strict prioritisation, the cancelling of some clearly uneconomic prestige projects, the postponing of some others, proceeding only with those which have clear priority for economic growth and/or support for social sectors and the poor. However, a major problem for public finance is resource allocation for bail-outs, which, as noted earlier may amount to very large sums. As also noted earlier, if costs are similar to those in Mexico in 1994 (an estimated 15% of GDP), the fiscal costs might amount to around 12-14% of government expenditure over five years.[32] Much depends on the share of the costs borne by the private sector. While such bail-outs may be necessary to protect the economy, the distributional

implications are harsh, since share-holders and entrepreneurs will be the prime beneficiaries. Wherever possible fiscal support for bail-outs should take the form of loans rather than gifts. Nonetheless, with additional taxation on luxury consumption, cuts in military expenditure and some investment, it should be possible to protect priority social expenditures and finance the transfers needed to protect the poor.

Within the private sector a parallel reorientation of private investment is called for – away from real estate and towards new and productive sectors. Such reorientation may be achieved by the use of excise taxes on real estate and differential credit restrictions.

If reduced absorption can be targeted in this way towards low priority investment and consumption of upper income groups, it will reduce the real income cuts faced by low-income groups. In addition, a system of transfers will be needed to help the newly unemployed and to provide some assistance to those – chiefly in the informal sector – whose incomes fall below the poverty line due to reduced demand for their services, increased competition from the newly unemployed and rising prices. Until the crisis there were few mechanisms in place to protect either the old or the new poor, since, as noted earlier, these countries were previously able to rely on a growing economy to float these people out of poverty gradually over time. Therefore, there is an urgent need to introduce some new policies to deal with the human impact of the crisis.

The magnitude of the support needed – in terms of numbers to be covered and duration of the coverage – will depend critically on what happens to the macro-economy, as has been pointed out above. This is the fundamental reason why deflationary policies should be avoided as much as possible, and the focus be put on improved regulatory and financial systems to re-establish confidence in the system. However, while improved macro-policies and a better distribution of cuts could reduce the rise, it would be unlikely to prevent a considerable increase in poverty.

The IFIs – both Fund and Bank – acknowledge the need for social safety nets. The past record of safety nets IFIs have supported elsewhere has been extremely poor – in that the schemes have almost invariably reached only a fraction of those in need. Food subsidies have been narrowly targeted, missing the majority of the poor, while Social Funds and/or special credit schemes have typically covered an even smaller proportion.[33] Moreover, both have tended to be put in place after a considerable time lag.

In this crisis, both the IMF and the World Bank have made a start in supporting policies to protect the poor, with the World Bank taking the lead. Schemes include an extensive scholarship scheme for poor Indonesian primary and secondary school pupils and grants to schools in poor communities; support for food subsidies in Indonesia and some employment schemes in Thailand and Indonesia. It is impossible to find out how much is being done in total. But from the evidence available at this stage, it appears that the right sort of action is being undertaken but is not sufficiently comprehensive. For example, in Indonesia a targeted food subsidy programme was intended to cover 15 million families, but in September 1998 only 2 million families had received food coupons.[34]

What is needed is a *universally accessible* support system, that is, one that is accessible to anyone falling below the poverty line. Such a system would have the following features:

a. Some provision, of one kind or another, to be available for *all* who need it, not limited in coverage by a pre-set expenditure limit.

b. Whatever form it takes, individual support should be set at feasible levels (e.g. at the nationally defined poverty level). This would almost certainly mean a cut in living standards for the newly unemployed compared with their previous situation.

The following types of programme should be considered as part of such a universally accessible support system, to help offset the rise in PIP. What is appropriate obviously depends on the particular situation:

1. Public employment schemes aimed especially at the newly unemployed, in both urban and rural areas. The idea would be that jobs at low wages are available to *anyone* who comes forward. The schemes should contribute to appropriate infrastructure projects in rural and urban areas, in part possibly replacing some of the larger scale schemes that may have to be cut at the national level. In some cases, the military, especially those with engineering skills, could help organise and develop these projects. Support systems of this type have been helpful in adjusting countries elsewhere in the world, for example Chile and Botswana.[35] In the early 19eighties Chile introduced open-ended public works schemes that were effective in reaching as many as wanted employment at the very low wages offered. At one point 13% of the labour force was employed in these schemes.[36]

2. Supply of food relief channelled through the market in order to bring food prices down where there has been significant agricultural failure – notably Indonesia and perhaps the Philippines. Such provision should preferably use domestic buffer stocks, supplemented only if necessary by international shipments of food aid.

3. Provision of food for especially vulnerable elements of the population, such as babies, children and pregnant and lactating women. Such schemes should be located in low-income areas (urban and rural).

4. Protection of pre-crisis credit for medium and small enterprises, and further allocation for very small low income investors, i.e. those without substantial assets for collateral. The latter would be facilitated by requiring commercial banks to set aside a certain proportion of their loans at competitive rates for this purpose. In most cases, they would achieve this by lending to intermediaries such as the previously successful micro-credit institutions in Indonesia (for example, the BKK, KURK and BRI).

5. Local governments and NGOs have an important role to play in assisting the newly unemployed move into the informal sector or back to the rural areas, and in promoting rural linkages, e.g. by providing public works, small credit schemes and information. They may also be able to tap additional local resources.

6. In general, measures to facilitate people's own adjustments are desirable, e.g. subsidies to community organisations providing meals for those in poverty[37] or setting up nurseries to look after the small children of mothers who have been forced to seek work.

7. Information about all measures adopted to reduce PIP should be well publicised, both so that people can take advantage of them and so that they do not have false expectations about the likely extent of state support.

8. The crisis underlines the need for a more self-reliant strategy in the medium run, with a greater focus especially on balanced growth in the rural areas. This implies encouraging

rural non-agricultural activities, including both industry and services, which are usually linked to the agricultural sector as inputs, processing or for rural consumption.[38] To the extent that urban industry and services continue to be relatively favoured by government policy, such discrimination should be removed, and infrastructure expenditures more equitably distributed throughout the country, a process which may be facilitated by a greater degree of decentralisation.

9. In the longer term all countries need to have some modern safety net schemes in place, so that protection is available in economic crises, as traditional support systems weaken with the changed employment patterns of industrialising economies. For those countries where the majority of the labour force has moved into modern sector employment, systems of insurance for the unemployed are appropriate. As noted above, a start has been made in Korea. Such systems would involve small compulsory contributions from employers and employees which would provide some income at a low level, say half their wage income over a transitional period. In less developed economies with smaller formal sectors, emergency employment schemes need to be prepared, ready for use in a crisis. Equally, in industrialising economies a longer term aim should be the provision of small means-tested pensions for those who cannot work (the old and handicapped specifically), as has been effectively introduced in some poor areas (e.g. Tamil Nadu). Such schemes cannot be introduced immediately, given the financial situation, but should be explored after economic recovery. They would ameliorate the human effects of possible future crises.

10. Reform of the legal system is another important, longer-term reform needed to secure greater social justice, contributing to improving both SIP and PIP. Much misery and deprivation originates from human exploitation, either by private groups or the state. The key factor to bring about respect for civil rights is the existence of a fair and equitable judicial system. But resource scarcity, combined with manipulation and collusion by the powerful, has often biased the law in favour of the privileged. Access to the legal system is an important social good, often neglected in the analysis of poverty. It is not only a significant aspect of well-being in itself, but can also be essential to the enforcement of economic rights (e.g. the use of common or traditionally held resources). Legal access for women is particularly important and usually disproportionately weak. The absence of law, order, and judicial services, especially in poor neighbourhoods, severely limits the exercise of individual civil and property rights. In the longer term, review of the legal situation, especially with respect to legal access by the poor, could improve both SIP and PIP with little budgetary expenditure. The first prerequisite is that there exist a comprehensive and equitable system in the nation as a whole; the second, that the physical proximity of courts be sufficient to ensure reasonable access; the third, that poor people be able to procure proper representation in the courts and not be prevented from doing so by the absence of willing legal representatives or excessive costs. There is little systematic evidence available on these issues. A first priority is to collect such information so that the adequacy of legal access can be assessed on a country-by-country basis.

As far as social poverty is concerned, as noted above, there is likely to be a considerable squeeze on expenditures on social priorities, given the pressure on total government expenditure and the demands of interest payments and industry bail-outs. Under these circumstances it is vital that priority services (primary health, potable water, and primary and secondary education) be protected, and that

charges for these services are not introduced, especially at a time when PIP is rising. To achieve this, it will be necessary to (i) resist undue reductions in total government expenditure, (ii) maintain the social allocation ratio, and (iii) improve the allocation within the social sectors towards items which benefit the poor. For example, it is important to maintain primary education, possibly at the expense of government expenditure on universities. Indonesia provided a successful example of selective cuts in government expenditure which protected priorities in the early 1980s.[39]

As pointed out above, the countries in the region differ quite significantly in the proportion of GDP available for government expenditure (the expenditure ratio), in their social allocation ratios and in the proportion of social expenditures going to priorities for human development support. The appropriate policy mix will differ accordingly. Where the expenditure and social allocation ratios are already high, as for example in Malaysia, there is considerable scope for improving performance on SIP by reallocation within the social sectors towards human development-oriented priorities, while it would be difficult to substantially raise expenditure and social allocation ratios. In contrast, where the proportion of GDP going to government expenditure and the social allocation ratio are low, efforts should be made to raise both these ratios. Indonesia is a case where there exists a large potential for raising the expenditure, social allocation and social priority ratios.

An important issue obviously is how the efforts just described to contain the rises in PIP and SIP in the context of the crisis would be financed. The earlier discussion provided pointers: in the first place, a less deflationary fiscal policy would permit more public expenditure in total; secondly, the costs of bail-outs should be shared with the private sector; thirdly, debt service payments should be limited by moratoria and supported by larger short-term financial inflows from multilateral and bilateral channels; fourthly, as implied above, examination of the budgets of any of the countries affected would lead to the conclusion that there remains much 'fat' which could be eliminated, and other projects which could be postponed. These include military expenditure and some large scale prestige projects, mainly on infrastructure. Systematic in-depth reviews would be needed to identify precise candidates for budget reallocation. Potential resources to finance some of the schemes suggested above can undoubtedly be found from such reallocation. It is important to remember that even in a tightly constrained government budget, major savings can usually be made not only in military expenditures but also in administration and in the avoidance of low-priority expenditures of other types.

Revenue-raising efforts by local governments should also be facilitated (e.g. by reducing restrictions on tax raising powers), particularly since they are likely to play a significant role in assisting the newly unemployed. The budgetary cost of compensating for cuts in social priority expenditure are relatively small as noted in Table 7 – less than 2% of the budget. The cost of transfers to protect private income of the poor would be greater – but still only around 11% of the Indonesian budget (the worst case), although this does not include administrative costs of transfers and weak targeting, which could add 100% or more to the total. Allowing for administrative costs, the amount would be 4-5% of GDP. The resource requirements in the other countries are smaller. Unlike the adjusting countries of the 1980s, investment rates are so high that there is a considerable potential for redirecting resources, public and private, towards low-income groups. In Indonesia, for example, the pre-crisis investment ratio was 38%.

Monitoring

Lack of evidence regarding the social consequences of the crisis is apparent from the very piecemeal review in Section 3 of this paper. There has been a similar lack of systematic information, and delays before available information is processed and communicated, in every recent human crisis – including the adjustment situation in the 1980s and human conditions during famine and humanitarian emergencies. Yet in every case, if a system were in place for collection and processing, there exist sources of up-to-date information. For example, data could be collected from hospitals and clinics on malnutrition and child health from schools on enrolments, from newspapers on vacancies, wages etc., as well as the more descriptive observations of NGOs in the field. While such data are obviously not of the same quality or statistical significance as purposefully collected national surveys, it could inform on the human condition with much less delay, permitting the quick development of policies to avoid excessive distress. An urgent requirement is to put a system in place to gather, process and communicate such information – perhaps starting in one country. International agencies might take a lead, or help finance such an effort.

International institutions

The prime responsibility for adjustment to the crisis and protecting the poor clearly rests with the countries themselves, but the international system, influenced by international agencies, sets the constraints within which countries operate and influences the outcome. Thus far, the principal international actor has been the IMF, with the World Bank one step behind.

Any notion of IMF infallibility has become a casualty of recent events. Not only did the Fund fail to warn the countries adequately of impending problems, but its initial response was too much rooted in its prior Latin American experience, regarding the central problem as one of government profligacy in both its fiscal and monetary dimensions. Moreover, both Fund and Bank continue to urge further liberalisation on the capital account, which we believe to be inappropriate at this time. The fact that the IMF quickly had to go to second and third round amendments of its country packages in the region can be viewed as commendable, showing unusual flexibility, but it also meant that it failed to contribute to the early restoration of international confidence. After all, it is generally agreed that it is not the public capital flows made available by the IMF and others – which are small in relation to the total size of short-term debts – but the return of private flows as a consequence of restored confidence which matters. The conclusion from this is that the institution seems ill-equipped to respond to crises that are primarily micro and private sector oriented, given its traditional focus on monitoring and affecting macro and public sector performance. Moreover, by itself (even with additional replenishment) it lacks sufficient resources, and its lending is too conditional, to be a lender-of-the-last resort which will instil confidence.

As noted above, the World Bank has focused centrally on poverty issues, as well as providing support for structural reforms. Yet it is impossible to tackle the issue of poverty during crisis without considering the macro-reforms, and any division of labour which leaves one institution – the IMF – responsible for macro-policies, and others – the World Bank and other UN organisations – for poverty, will tend to result in higher poverty levels than they might be, since poverty implications are not brought into consideration when determining the macro-package. Moreover, even worse, responsibility for the budget is broadly that of the Fund, which tends to limit the size of any compensatory packages. In principle, the IMF is also concerned with poverty – especially in so far as

it affects the acceptability and sustainability of its packages – but it views this responsibility as essentially one of adding social safety net provisions to an otherwise unchanged package.[40]

The IMF and the World Bank appear to be sharing responsibility for the new and urgent activity of providing support for financial sector reform. However, the BIS and some experienced central bankers from outside the region – e.g. Chile, Colombia or some OECD countries – are probably in a better position than the IMF or the Bank to provide advice on the hands-on details of the working out of existing debt and financial sector reforms.

It is also clear that handling such crises requires much greater input of local knowledge than exhibited by the still highly-centralised Bretton Woods institutions. Nuanced advice and assistance cannot be provided by short-term visiting teams. Agencies rooted in the region should take a leading role, in collaboration with local experts, in helping governments develop a specific agenda of reform along the general lines outlined in this paper and in monitoring changes. This would mean a much greater role for Japan, the ADB, UNDP and UNICEF. There would be much advantage in reviving the proposal for the creation of an Asian Fund, previously rejected by the IMF and the US. Such a fund would be in a better position to develop policy packages that are sensitive to local conditions, as well as securing additional financial commitments from countries in the region, including not only Japan but also Australia, Singapore and Chinese Taipei. Finance from the proposed Asian Fund could contribute to debt restructuring and structural adjustment packages developed as a collaborative effort.

Conclusions

The economic crisis has already had very harsh human consequences, which may increase over the next few months. A great deal will depend on how the crisis is handled, and the political consequences that follow. It is clear that while the crisis seems to have had common origins, country reactions have differed greatly. On the one hand, Indonesia's financial and economic crisis and the severe policies required by the IMF to deal with it have precipitated a political crisis, which is worsening and prolonging the effects and weakening the government's ability to react appropriately. Little has so far been achieved in terms of financial reforms. In contrast, both Korea and Thailand have started on such reforms; their interest rates have come down, and there are some signs that the crisis is bottoming out. At the other end of the spectrum, Malaysia has so far managed without adopting IMF policies and has been able to moderate the deflationary response, but not avoid it.

In each case, the magnitude of the human costs will be closely related to the speed and magnitude of adverse developments in the macro-economy. Consequently, this paper has focused quite heavily on the macro-side even though its purpose is to elucidate policies to prevent human costs. The affected economies potentially have the resources to provide for the newly unemployed and others suffering from the crisis. But politically difficult decisions would be needed to secure these resources, including new sources of taxation and drastic reorientation of government expenditure.

The countries all exhibited very little preparation for the sharp adverse movements in incomes of the poor – natural, perhaps, because they had been experiencing such sustained growth and poverty reduction. Hence reactions from them (and from the international community) to cushion people have been slow. For the future (and for other countries) pre-crisis preparation could greatly reduce the immediate human costs – including planned employment schemes, and food policies, as well as the introduction of unemployment insurance.

It is of critical importance that human development is protected during the recession, not only to avoid human suffering but also to facilitate resumed economic growth, since serious undermining of education, health and nutrition will have adverse economic consequences. In general, however, human development indicators tend to be affected more slowly than incomes, in response to fluctuations in economic activity. The Asian economies are in a strong position to preserve and continue their past progress on the human side Moreover, because of their high levels of achievements on human development, they are also in a particularly good position to adapt to economic change and resume economic growth.

NOTES

1 There is much debate on how to define the 'poverty line' and how to measure the numbers who fall below it, including efforts to incorporate some indication of the depth of poverty. This debate will not be considered here.

2 Estimates of poverty vary greatly according to how the poverty line is drawn, the price indices used, and whether households or individuals are counted. These estimates are derived from a variety of surveys brought together by Tabatabai, 1996. The precise figures may easily be disputed, but the direction of change is clear.

3 Some of the increase in expenditure reflects rising salaries for teachers.

4 Siamwalla and Sopchokchai, July 1998.

5 One observer is said to have commented: "We give countries a choice: the wrong advice from the Fund straight away or the right advice from the Bank too late" (quoted in *Financial Times*). Actually, the countries were NOT given that choice, but had to take Fund advice, moreover, the World Bank has refrained from giving any macro-policy advice.

6 For evidence, see Cornia et al, 1987; Stewart 1995.

7 The situation bears resemblance to that of 19th century Britain. When the previous systems for protecting the poor had broken down, the emerging industrial society posed new problems of cyclical and chronic unemployment, and there was as yet no provision for the support of the unemployed. The harsh Poor Laws in Britain of 1834 were a response to parishes' inability or unwillingness to provide for the many migrants associated with the industrial revolution and the enclosure movement. The Poor Laws provided minimal support for the destitute, often in horrendous conditions in workhouses. They did not meet the needs of the 'new poor' created by cyclical industrial unemployment. While the beneficiaries from the Poor Law provisions amounted to less than 3% of the population in 1885, Booth and Rowntree estimated urban poverty at about 30% (see Rose 1986).

8 Caprio and Klingebiel, 1996.

9 Estimate for Korea from Wolf, *Financial Times*, 30/9/98; for Philippines from Philippine government, quoted in *Financial Times* 29/8/98; for Indonesia, by IMF, quoted in *Financial Times*, 21/10/98; and for the rest from the Economist's poll of forecasters, 17/10/98. The United Nations Link forecast for September broadly agree with these, but predict a smaller loss in Malaysia, at 2.3%. These are losses expressed in national currencies; in dollar terms the losses are much greater, ranging from 70% in the case of Indonesia to 21% in the Philippines (*Newsweek*, August 24th 1998).

10 Data from Wolf, *Financial Times*, 16/9/98. IMF 1998 estimates are somewhat lower.

11 Estimates from ILO, *World Employment Report 1998-9.*

12 See Cornia at el. 1987.

13 Mehotra, 1998, p 10.

14 ILO, 1998 predicts a cut of real wages of 15% for 1998 compared with 1997, but others have suggested substantially sharper reductions in wages.

15 IMF, *World Economic Outlook* October 1998. Expectations for Indonesia for annual inflation reported in *Financial Times*, 21/10/98.

16 For Korea, the President of Daewoo Economic Research stated that "Although the official numbers [for inflation] are 10 per cent or so, the way people are feeling it is actually around 40%" (*Korea Time*, 14/03/98).

17 According to Siamwalla and Sopchokchai rise prices more than doubled at one point.

18 Robb and Zhang, February 1988.

19 World Bank, 1998b .

20 Korea is excluded, as it was not covered by the World Bank simulations.

21 Evidence from Department of Health report to NEDA in the Philippines.

22 The Helen Keller Foundation has reported sharply rising malnutrition in Indonesia and increases in maternal mortality; also *Financial Times*, 29/10/98.

23 Reported in *Financial Times*, 29/10/98.

24 A survey of multinational companies by UNCTAD showed that 88% of firms intend to press ahead with or accelerate their existing investment plans in East and South East Asia. While 12 % intend to reduce their investments, a quarter of the firms intend to increase them in response to new opportunities created by the crisis. (*Financial Times*, March 19th, 1998).

25 This does appear to be happening. By June, US business acquisitions were already $8b, twice the previous record in dollars (and a greater multiple in local currencies) (*Financial Times*, 15/6/98).

26 The example of Latin America in the 1980s is instructive. It took eight years or so of economic stagnation before the Brady Plan turned the situation around.

27 The share of income of the bottom 40% of households was 21% in Indonesia, 12.9% in Malaysia, 14.3% in Thailand, 16.6% in Philippines and 19.7% in Korea in recent household surveys.

28 This is also suggested by calculations by the World Bank showing low budgetary costs for restoring consumption of the poor in Indonesia (World Bank, 1998a). The World Bank estimates, however, definitely appear too low.

29 See Cornia and Stewart, 1993.

30 In Malaysia, for example, the proposed 1999 budget raises tobacco and alcohol duties. (*Financial Times* 24-25th/11/98.)

31 Defence expenditure cuts already are underway: in Malaysia defence expenditure was estimated to have been cut by a fifth in 1998, with further cuts planned, with a reduction of over 40% in real terms

in Indonesia, 35% cut in the defence budget in Thailand, and 30% in S.Korea (*Herald Tribune*, 23/4/98).

32 One estimate is for costs amounting to 40-50% of GDP (estimate of Supple at Barclays Capital, quoted in *Economist*, 17/10/98).

33 See Stewart and van der Geest, 1995, for a review of social safety nets; and Cornia and Stewart, 1993, for an analysis of targeted food subsidies.

34 *Financial Times*, 12/13/09/98.

35 See Cornia et al., 1987.

36 See Raczynski and Romaguera 1992.

37 As, for example, the Comedores Populares in Peru.

38 For an analysis of the difference the policy framework can make in this regard see Ranis and Stewart, 1993.

39 See Stewart, 1995, Chapter Eight.

40 See IMF, 1998, which refers to ‘a growing recognition that popular support for traditional adjustment programs has become an essential precondition for their ultimate success’.

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Table 1. **Private Income Poverty (PIP) estimates for Asian countries, 1970-93**

Country	Date	Poverty rate[a] %		
		Rural	**Urban**	**Total**
Indonesia	1970	n.a.	51	58
	1980	28	29	29
	1990	14	17	15
	1993	n.a.	n.a.	8[b]
Korea	1980	9	10	10
	1984	4	5	5
Malaysia	1970	59	21	49
	1980	37	13	29
	1989	22	7	15
Philippines	1971	57	41	52
	1985	59	45	54
	1991	52	37	45
Thailand	1975/6	33	22	30
	1980/1	27	8	23
	1992	16	10	13

Notes:

a. National poverty lines, derived from national surveys. May not always be comparable across time, nor across countries.

b. Comparability of estimates questionable.

Sources: Tabatabai, 1996; World Bank, *World Development Indicators*, 1997; World Bank, 1998, *World Development Report*; UNDP, *Human Development Report 1997.*

Table 2. **Income distribution in Asian crisis countries, 1978-1992**

	Dates	Rural	Urban	National
Indonesia	1976	0.361	0.381	0.348
	1987	0.26	0.32	0.321
	1995	n.a.	n.a.	0.342
Korea	1970	0.295	0.386	0.346
	1982	0.306	0.469	0.406
	1988	0.290	0.350	0.336
Malaysia	1970	0.46	0.485	0.499
	1979	0.482	0.501	0.508
	1984	0.444	0.466	0.480
	1989	n.a.	n.a.	0.445
Philippines	1970/71	0.46	0.47	0.46
	1985	0.378	0.442	0.446
	1988	0.378	0.431	0.445
	1994	n.a.	n.a.	0.429
Thailand	1968/9	0.381	0.429	0.429
	1981	0.437	0.427	0.453
	1988	0.443	0.456*	0.478
	1992	n.a.	n.a.	0.462

Note: * 1986 figure

Sources: Tabatabai, 1996; World Bank, *World Development Indicators*, 1997; World Bank, *World Development Report*, 1988/9.

Table 3. **Indicators of Social Income Poverty**

Country	Access to education, % of age-group not in school				% without access to				Infant mortality rate, deaths per 1,000 live births	
	Primary[d]		Secondary		Health services		Safe water			
	1980	1993	1980	1993	1980	1993	1980	1994/5	1981	1995
Indonesia	0	0	71	57	64[b]	57	25[c]	37	105	51
Korea	0	0	22	7	n.a.	0	7[c]	7	33	10
Malaysia	7	7	52	41	40[a]	12	n.a.	10	30	12
Philippines	0	0	36	21	n.a.	29	34[c]	16	63	39
Thailand	1	2	71	63	70	41	34[c]	19	53	35

Notes:

a. 1985/87
b. 1980/86
c. 1983/86
d. Figures of zero for children not attending school are given where gross enrolment rates exceed 100, in fact as some children who are not the 'right' age group attend school, there may be some children not in school even where gross enrolment rates exceed 100.

Source: World Bank, *World Development Indicators*

Table 4**. Social expenditure in affected countries, 1980-95**

Country	Govt. expend % GDP		Educ. expend. % govt.		Health expend. % govt.		Educ. plus health % GDP		Social priorities* as % social expend.	Social priority expend. as % GDP
	1980-90	1990-5	1980-90	1990-95	1980-90	1990-95	1980-90	1990-95	1988	1990-95**
Indonesia	20.2	17.3	8.9	10.5	2.5	2.7	2.3	2.3	18	0.4
Korea	16.6	17	21.5	17.7	1.3	1.1	3.8	3.2	77	2.5
Malaysia	28.9	26.1	16.4	16.6	4.4	5.6	6.0	5.8	68	3.9
Philippines	16.5	19	9.1	10.5	5	3	2.3	2.6	53	1.4
Thailand	16.4	14.9	12.1	19.8	4.2	8.1	2.7	4.2	42	2.0
Av. Asia	19.6	20	10.5	12.3	4.2	4.4	2.9	3.3	n.a.	n.a.

Notes:

* Taken from *Human Development Report* 1991. Includes expenditure on primary health care and basic education (i.e. primary and secondary).
** Applying the 1988 estimates priority ratio to the 1990-95 social expenditure data.

Sources:

World Bank, 1997, *World Development Indicators; U*NDP 1997 *Human Development Report;* UNESCO 1995 *World Education Report* & 1996 *Statistical Yearbook*

Table 5. **Employment and unemployment in Thailand**

	1995	1997	1998
Employment, millions			
Male - rural	11.7	12.0	11.7
Female - rural	8.3	8.6	8.1
Male - urban	5.1	5.3	5.2
Female - urban	4.3	4.5	4.4
Unemployment, millions			
Male - rural	0.7	0.5	1.0
Female - rural	1.4	1.0	1.3
Male - urban	0.1	0.1	0.2
Female - urban	0.1	0.1	0.2
Not in labour force, millions			
Male - rural	3.1	3.3	3.3
Female - rural	5.7	6.1	6.4
Male - urban	1.7	1.8	1.9
Female - urban	3.1	3.1	3.2

Source: Siamwalla and Sopchokchai, 1998.

Table 6. **Simulations of changes in PIP, derived from World Bank estimates**

	Indonesia	Malaysia	Thailand	Philippines
Poverty line*	$1 a day	$2 a day	$2 a day	$1 a day
1997, poverty rate, %	6.6	19.9	14.7	21.5
Poverty rate, %, with 10% fall in GDP, unchanged distribution	13.2	25.7	20.2	29.1
Expected GDP change, 1997-98, %	-15	-5.5	-8	-1
Estimated poverty rate, %, end 1998	16.3	23	18.5	23
Extra poor, millions	19.4	0.7	2.3	1.1

Note:

* The international poverty line adopted in this table differs from the national poverty lines used in Table 1.

Sources: World Bank poverty rate estimates and simulations from World Bank, September 1998; GDP predictions as above; World Bank, *World Development Report* 1998 for population.

Table 7. **Share of lower-income groups and priority social expenditures in GDP**

	Indonesia	Malaysia	Thailand	Philippines	Korea
1.Share of bottom 20% in household income*	8.7 (1993)	4.6 (1989)	5.6 (1992)	6.5 (1988)	7.4 (1988)
2.Share of priority social expenditure in GDP from Table 4	0.4	3.9	2	1.4	2.5
3. Share of *GDP* needed to compensate for 10% cut in:					
- private income of poor	0.9	0.5	0.6	0.7	0.7
- social priority income	0.1	0.4	0.2	0.1	0.3
- *TOTAL*	*1.0*	*0.9*	*0.8*	*0.8*	*1.0*
4.Share of *GDP* needed to compensate for 20% cut in:					
- private income of poor	1.8	1.0	1.2	1.4	1.4
- social priority income	0.2	0.8	0.4	0.2	0.6
- *TOTAL*	*2.0*	*1.8*	*1.6*	*1.6*	*2.0*
5.Share of *GDP* needed to compensate for 10% cut in incomes of lowest 40%,					
- PIP	2.1	1.3	1.4	1.7	2.0
6.Share of government expenditure to meet compensatory requirements, 10% cut					
- PIP	5.2	1.7	3.7	4.2	4.1
- SIP	0.6	1.4	1.2	0.6	1.8
- *TOTAL*	*5.8*	*3.1*	*4.9*	*4.8*	*5.9*
20% cut *TOTAL*	*11.6*	*6.2*	*9.8*	*9.6*	*11.8*

Note:

* Taking the bottom 20% is justified by the fact that the poverty rate is around 20% in each of the countries after the crisis – see Table 6.

Sources: Tabatabai, 1996; Table 2 above; UNDP *Human Development Report*, 1991.

3.2 MANAGING CRISIS AND SOCIAL COHESION

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Indonesia is the largest archipelago nation in the world, with its territory comprising over 17,500 islands stretching along the equator for 3,200 miles, equal to the distance between London and Moscow, or New York and Los Angeles. With a population of 207.4 million people (1998) it is the world's fourth most populous nation after China (1,255 million), India (975.8 million) and the United States (270 million). Indonesia has a wide diversity of traditions and cultures deriving from two major races, Malay and Melanesian, and more than 300 ethnically distinct groups. Four major religions are practised: Islam (87% of the population), Christian Protestantism (6%) and Catholicism (3%), Hinduism (2%) and Buddhism (1%). With these national characteristics it is imperative for Indonesia to nurture social cohesion based on the fundamental principle of "unity in diversity" (*bhinneka tunggal eka).*

During the 30 years (1968-1998) of Indonesian growth, development with equity and stability has been actively pursued. The pendulum of growth has swung from low to high, impacting on equity and social cohesion. However, the Thai monetary crisis has spread to Indonesia, plunging Indonesia into a deep economic, social and political crisis, and jeopardising social cohesion. To overcome this crisis, Indonesia is currently deeply involved in implementing total reform that covers the various economic, social and political dimension of society.

The purpose of this paper is to discuss the attempt to simultaneously pursue the goals of high economic growth, income equality and social cohesion, based on a critical appraisal of development with equity and stability to ensure unity in diversity. Within this context, I look at the role of social safety nets in countering the negative impacts of total reform policy measures, and in facilitating the process of structural adjustment.

1. Growth with equity

It is widely accepted that, until recently, Indonesia's economic performance since 1965 has been one of the best in the developing world. And Indonesia is considered by the World Bank in *The East Asian Miracle* (1993) as one of the 'High-Performing Asia Economies'. In various documents the World Bank has rated Indonesia's economic performance thus; based on its average Gross Domestic Product growth in excess of 6% per annum, inflation averaging less than 10% per year and the incidence of absolute poverty down from 60% to about 14% of total population over the years 1968-1996.

According to the *Human Development Report 1998*, high growth policy has raised:

- GDP *per capita*, from US$211 (1970) to US$720 (1995) (in 1987 US dollars)

– The Human Development Index (HDI) value, from 0.306 (1970) to 0.679 (1995).

Although HDI values for 1960-1992 are not strictly comparable with HDI values for 1995 because of a break in the data series reported in this table, other tables in the 1998 Human Development Report consistently reveal that:

– Life expectancy at birth has increased from 41.2 years (1960) to 64.0 years (1995);

– Infant mortality is down from 139 (1960) to 47 (1997) per 1000 live birth;

– Adult literacy has increased from 56% (1970) to 84% (1995);

– The gross enrolment ratio for all levels (as a percentage of the 6-23 age group) has increased from 51% (1980) to 62% (1995);

– The daily *per capita* supply of calories has gone up from 1,859 (1970) to 2,699 (1995);

– Women's share of the adult labour force (as a percentage of the 15 and above age group) has increased from 30% (1970) to 40% (1995).

Based on these indicators, it is fair to say that Indonesia's growth has not been limited to economic sectors, but has spread to social sectors as well.

Also significant is the fact that the incidence of poverty has fallen from about 67 million or 60% of the total population in 1970, to 26 million or 14% in 1993. Poverty is felt more intensely among the rural population, as compared to the urban. It is important to observe, therefore, that the number of rural poor has dropped faster than the urban poor. The rural poor declined from 44.2 million people, or 40.4% of total population (1976), to 16.4 million people, or 13.1% (1993). In comparison, the urban poor have dropped from 10 million people, or 38.8% of total population (1976), to 9.1 million people, being 14.2% (1993).

Although poverty on the island of Java has been reduced more sharply than that outside Java, population density is higher in absolute terms on this island, so the number of poor in Java is the highest. In terms of *per capita* income, Nusa Tenggara West and East in the eastern part of Indonesia rank the lowest.

Measuring income equality is difficult, because of the under-reporting of income. Therefore an unsatisfactory proxy of income equality is the Gini-coefficient, based on household expenditure data. Based on Hal Hill's, *The Indonesian Economy since 1966* (Cambridge University Press, 1996), this shows a more rapid decline in the rural compared with the urban:

Year	Urban	Rural	**Total**
1976	0.35	0.31	**0.34**
1993	0.33	0.26	**0.34**

These performances have been achieved through a developmental policy that has emphasised:

First, agriculture-cum-rural development to obtain food self-sufficiency, supported by primary sector related industries;

Second, outward-looking, export-oriented economic policy combined with import substitution and import deepening to take advantage of global "outsourcing";

Third, infrastructure development, such as roads, irrigation, transportation, communication;

Fourth, social development, such as family planning, education and health facilities development;

Fifth, specific programmes focused on the poor, such as village development programmes, integrated area development programmes, kampung improvement programmes, small farmer self-help programmes for marginal farmers and the landless, special assistance to backward villages.

Such a development policy requires economic and political stability. A macro policy aimed at controlling inflation must be strictly imposed. Although total development expenditure is larger than potential domestic revenue, foreign assistance makes it possible to balance the budget. And prudent monetary policy makes sure that no excessive money supply is spilled over in the demand for foreign exchange that may depreciate the local currency. In this context, interest rates are kept high to induce foreign capital inflow. The influx of foreign capital and foreign assistance have also made it possible to close the current account deficit in the balance of payments. This combination of non-inflationary budget, prudent monetary policy and capital inflow has been instrumental in sustaining growth with economic stability.

Political stability is obtained by keeping political development under strict control. While general elections have taken place regularly, the political system was tightly controlled by the government's political arm of the "Functional Groups" (*Golongan Karya*, abbreviated "*Golkar*"), with the Armed Forces in Parliament and Government under the leadership of a strong President from 1966-1998. Maintenance of political stability during the development period induced domestic capital mobilisation and inflow of significant levels of foreign capital, creating an environment for unprecedented high levels of growth.

Although high growth has been achieved together with a decline in the incidence of absolute poverty, improved expenditure level of the poor and a marginal improvement in inequality, this does not necessarily mean that a climate has been created that is conducive to social cohesion. Indonesia's achievement of growth with equity and stability has also sown the seeds of discontent, which are gradually eroding society's resilience and cohesion.

2. The irony of growth

It is the irony of growth that successful development with equality and stability at the early stage of growth brings inequality and instability at the next stage of growth. The majority of the poor in Indonesia obtain their livelihood in the rural area from agriculture and exploitation of natural resources. At the early stages of growth, when income *per capita* is at an initially low level, the emphasis of development on areas and sectors where the majority of the population makes their living – agriculture, rural activity and the primary sector – produces a rise in and reasonably equitable distribution of income. At this early stage of development, growth with a rural spirit of *Gemeinschaft* strengthens social cohesion.

Development with rising income *per capita* has its impact on the composition of *per capita* food consumption; according to the World Bank, in 1968-1988 consumption moved away from a diverse range of staple foods comprising rice, maize, wheat, cassava and sweet potatoes, into a less diverse composition *per capita*, with rice increasing by 42.1%, maize by 49% wheat by 188.2%, while cassava has dropped by 22.9% and sweet potatoes by 38.6%. Cassava and sweet potatoes are considered "poor man's food" and less prestigious than rice. To supplement the low salaries of government employees throughout Indonesia and to cope with inflation, rice is distributed as an in-kind salary. This has made rice a staple food in regions which were originally non-rice consumers.

While the demand for rice has significantly increased, its production seems to be at a standstill; in 1992, 11,103,000 hectares harvested yielded an average of 4.34 tons per hectare, whilst in 1997 11,141,000 hectares harvested yielded an average of 4.43 tons per hectare. The managed rice pricing policy of the National Logistical Agency (*BULOG)* subdued excessive rice production by individual farmers. In the course of development, after reaching peak self-sufficiency in rice production in the mid-1980s, food imports increased in volume as well as in value. With an increase in the consumption of wheat, which is not produced domestically, Indonesia is increasingly vulnerable to the problem of ensuring adequate food supply.

In broad terms, development is a function of natural and human resources, capital, technological and managerial skill. During the first stages of development, abundant natural and human resources make agriculture and mining the major engines of growth. With increased availability of capital, technological and managerial skill, development is broadened into industry, manufacture and services. The economic structure thus changes from a primary sector-based economy into one that is based on the secondary and tertiary sector.

This changing economic structure induces migration from the rural to the urban, a movement that has taken place all over Indonesia. Most of the young move to the cities in order to pursue higher studies. Elementary education is compulsory for the 7-13 age group, which is usually followed by entrance into junior and senior high schools. Although higher education does not guarantee employment, the desire for education is nation-wide.

During 1980-1990, the open unemployment rate increased sharply – for university graduates (473%), academy and diploma degree (225%), senior high (127%) and junior high (93%). These groups have moved into the cities, where demand for their skills is limited. Furthermore, Indonesian graduates from abroad are better placed to find employment because they are of a higher standard and have a greater command of foreign languages. Those who can afford to be educated abroad usually come from well-to-do families, which are in most cases non-indigenous and actively engaged in business. This kind of development sows the seeds of discontent.

Globalisation of technology in communications, transport and information has opened out access to information, foreign goods and services. Television has brought CNN and BBC culture into homes, introducing (especially to the young) lifestyle aspirations that the nation cannot afford, but will no doubt pursue. Meanwhile, an increased level of ambition that has not been matched by a similar increase in opportunities, has raised the level of frustration, especially amongst the young.

Due to the concentration of economic power in the hands of a few, well-connected business people, business is conducted through a network of monopolies, oligopolies, cartels, preferential treatment, managed trading and protection from foreign competitors, thus creating the vertical and horizontal integration of business. A network of well-connected conglomerates in co-operation with

the ruling elite has given rise to crony capitalism, which plays a dominant role in the Indonesian economy, and keeps most ordinary business people outside the main stream of development.

Thus the irony of growth is that successful development has given birth to:

- The narrowing composition of food consumption to predominantly rice, which has reached saturation level in extensification as well as intensification, leading to increased imports; the introduction of wheat, a crop that cannot be produced domestically, as a staple food, has also raised imports; increased dependency on imported rice and wheat have made Indonesia vulnerable to global fluctuations in the provision of adequate food supply;

- The transformation of Indonesia's economic structure from a simple primary sector-based economy into a secondary and tertiary sector-based economic structure, that has impacted on the mobility of the people, and alienated the educated young from agriculture and rural activities, drawing them instead to the glitter of the big cities that hold no guarantee of employment;

- Globalisation of communications, transport and information, creating lifestyle aspirations that the nation cannot afford, and a widening gap between ambition and reality that is especially frustrating for the young;

- The rise of crony capitalism has given those connected with the ruling elite a competitive edge but has left the ordinary business people outside the mainstream of development;

- Inability of most channels of political communication, such as Parliament, political parties, the press, to reflect aspirations from below and offer a real discourse of social cohesion.

All of these factors contain seeds of inequality, instability and social discord, making sustained growth vulnerable to crisis.

3. Crisis management

The economic crisis hit Indonesia unexpectedly in July 1997 and in one year, wiped out 30 years of economic achievement. As revealed by the World Bank report *Indonesia in Crisis* (July 1998), the key features of crisis were as follows:

- A collapse of the rupiah exchange rate from Rp. 2,400 (July 1997) to Rp. 15,000 to the US dollar (July 1998), which is the largest currency depreciation ever experienced by a country in the post-World War II era;

- A 23 percentage point drop in growth, from +7.8% (1996/1997) to a projected -15% (1997/1998), a drop that no OECD community has experienced since the Great Depression;

- A US$22 billion reversal of private capital flows, from US$10 billion capital inflow (1996/1997) to capital outflow of US$12 billion (1997/1998) in one year, which is equal to total net private capital inflows over ten years (1985-1995);

- A decline in the price of many important export commodities; the price of oil, Indonesia's major export earning, dropped to its lowest level since 1968, at US$13 a barrel;

- A long drought (1997/1998) due to El Niño with the extensive forest fires and crop failures. This will be followed by La Niña with floods in coming months.

In view of these circumstances, the President voluntarily withdrew from power in May 1998, and was subsequently replaced. The crisis has given voice to forces demanding total economic, social and political reform.

To promote economic recovery, social and political stability, the crisis is being managed along the following clusters of activities.

Strengthening the rupiah

The first requirement is to strengthen the rupiah through appropriate monetary and fiscal policies, by reducing pressure on the foreign exchange market and increasing the supply of foreign exchange. Demand for foreign exchange is strongly affected by the need to repay foreign debt, which has the following composition:

	1993	1997	increase
Total foreign debt (US$billion)	89.5	136.1	52 %
Disbursed and Outstanding public debt	57.1	62.1	8.7 %
Private debt	32.3	74.0	129.1 %
Short term debt	18.8	37.0	96.8 %

During the past four years, prior to the crisis, private short-term debt increased dramatically, induced by a predictable depreciation of the local currency during the past ten years, achieved through managed floating and the relatively low lending rate of foreign currencies aggressively promoted by many foreign creditors. When the rupiah started to depreciate, many lenders took the precautionary step of buying up US dollars in exchange of rupiah.

Of significant note was the "fast in, fast out" behaviour on the country's capital market, by fund managers who drained Indonesia's exchange reserve at the first sign of monetary crisis, plunging the rupiah into deep depreciation. With an open capital account, Indonesia has increased its vulnerability to external shocks. While capital control is considered as having a negative impact on investor confidence, up to now, the agreement between the government and the International Monetary Fund has been limited only to strengthening the monitoring system for foreign exchange transactions as regards capital flows, improving transparency and better access to short-term exposure of the corporate and banking sectors. But how to cope with the unpredictable short-term capital in and outflow is still an unanswered question.

With regard to public debt, in consultation with the Paris Club, the Government of Indonesia has obtained a rescheduling of debt due in 1998.

Tight money policy is the other tool for restraining demand on foreign exchange, by, amongst other things, raising interest rates to up to 60% per annum, postponing large development projects in order to use budget for subsidies on basic necessities and to finance the costs of restructuring the banking system.

High interest rates raised negative spreads between deposit and lending rates and are adding to banks' insolvency and bankruptcy in the corporate sector, thus raising unemployment.

Supply of foreign exchange is expected to increase through exports and inflow of foreign assistance of US$57 billion, to support the structural adjustment programme as agreed with the IMF.

Bank reform

Secondly, private as well as state banks have suffered bad debts and insolvency because of the crisis, and require reform measures such as the following:

- Government-assisted recapitalisation for potentially private banks;
- Resolution of non-viable private banks;
- The merger, reform and recapitalisation of state banks;
- Measures to recover liquidity support, as previously extended to troubled banks by the central Bank Indonesia;
- Strengthening of the banking supervision system.

To implement this programme the Indonesian Bank Restructuring Agency (IBRA) and its Asset Management Unit (AMU) have been created and a new central bank law, which enhances Bank Indonesia's autonomy, is to be submitted to the Parliament. IBRA is responsible for solving the financially troubled banks through recapitalisation, merging, selling or closing them. Whatever the course, depositors are to be fully protected.

The structural adjustment programme, as agreed end October 1997 between the IMF and the Government of Indonesia, was launched by closing 16 private banks without proper precautionary measures to cope with the rush by its customers. Since then Indonesian banks' credibility has been in serious doubt.

To cope with the public rush on these banks, liquidity support was provided by Bank Indonesia to the amount of Rp. 140 trillion or US$14 billion (at the rate of Rp. 10,000 to US$1). Implementation of bank reform is complicated by the fact that many of the ailing private banks are either linked with family and friends of the ruling elite and/or are controlled by non-indigenous citizens. More than 69% of Bank Indonesia's liquidity support is channelled to seven banks of this type.

Enterprise restructuring

Third, restructuring of enterprises is needed, especially of those unable to pay foreign debt due to the sharp depreciation of the rupiah. The Indonesian Debt Restructuring Agency (INDRA) has been created to arbitrate debt settlement between debtors and creditors. Regulation to remove obstacles on debt to equity conversions, and requirements on corporate restructuring transactions have also been set in place. Bankruptcy laws concerning corporate restructuring have been passed, and a Commercial Court has been established.

Restructuring and privatisation of state-owned enterprises is focused on underperforming enterprises, in order to improve efficiency, profitability and service delivery.

Liberalisation of the economy

Fourthly, combined with measures to alleviate poverty, the strategy of structural reform calls for liberalisation of the economy. The import monopoly of the National Logistics Agency over wheat and wheat flour, soybeans and garlic is to be eliminated, as is the administrative retail price for cement, currently set by a cartel of cement producers. Protection of chemicals, metal and non-food agricultural products is to be reduced, and local content regulations on dairy products to be eliminated. Import restrictions on new and used ships are to be abolished. In brief, all quantitative import restrictions, except those imposed for health, safety, environment and security reasons, as well as non-tariff barriers aimed at the protection of domestic production, will be completely phased out.

Punitive export taxes, such as those levied on leather, cork, ores and waste aluminium products, will also be abolished. Export taxes on logs, sawn timber, rattan and minerals will be reduced and appropriate resource rent taxes imposed.

To encourage foreign investment, the list of activities unavailable to foreign investors is to be shortened.

All existing formal and informal restrictive marketing arrangements, such as those for cement, paper and plywood, are to be dissolved. Joint marketing organisations, the assignment of exclusive marketing areas, limitations in production volumes or market shares to individual enterprises are to be dismantled. Traders will have the freedom to buy, sell, and transfer all commodities across district and provincial boundaries, and provincial governments are forbidden to restrict inter- or intra-provincial trade.

Traders are also to be allowed to import sugar and market it domestically, while farmers will be released from the formal and informal requirements for the forced planting of sugar cane. They will also be free to produce higher value-added products.

Behind all these measures is the growing need to eliminate crony capitalism which has distorted the price structure, and to transform this “high-cost economy” into a more open, competitive, efficient and transparent economy.

Political reform

Fifthly, in line with *economic democracy* (that is, the dispersion of economic decision-making power across a broad cross-section of society through the proper functioning of an efficient and transparent economy), there is also the need for *political democracy* (that is, the dispersion of political decision-making power through the proper functioning of a free, just and open political system). In this context, freedom of association and freedom of the press, which are enshrined in the Indonesian Constitution, have been restored. A new law on the electoral and party system is currently being deliberated. And the role of the armed forces in politics is being reviewed. Based on these new laws, free elections are scheduled in May 1999 to elect members of the Parliament, the Provincial Legislative Body and the People's Consultative Assembly which is entitled to elect the President and Vice-President before the end of 1999.

Corruption, collusion and nepotism (popularly known as 'CCN') are highly prevalent in the conduct of government and business, and across the nation there is a growing sense of urgency to wipe out these elements.

By implementing these five strategies for crisis management, Indonesia is on a credible path of reform towards economic and socio-political recovery that incorporates social equity and cohesion.

4. Empowering society

The implementation of this comprehensive policy package has been partly successful in arresting the decline of the rupiah which dropped from Rp. 2,400 (July 1997) to Rp. 15,000 (July 1998) and has recently strengthened to under Rp. 9,000 to the US dollar (November 1998). While this strengthening of the rupiah is well appreciated, its volatile fluctuation makes business impossible. In comparison, Thailand's baht has declined from 20 baht (July 1997) to less than 40 baht to the US dollar, indicating a decline of less than double; in this schema, the exchange value of the rupiah is currently down by nearly fourfold. High inflation and high political instability have contributed to a greater weakening of the rupiah as compared to Asia's other currencies.

Bank Indonesia's one-month central bank certificates bear a 70% per annum interest rate that is descending to below 60% (November 1998). This rate dictates the bank's deposit rate and with a lending rate of less than 30% per annum, the banks are suffering negative spreads between deposit and lending rates which add to the banks' insolvency.

The consumer price index rose this year by 75% between January and September, but for the first time is showing a decline of below 0% in October 1998, raising expectations that the rate of inflation may decline substantially in this fourth quarter of 1998, due to an anticipated stronger rupiah and stable prices of basic necessities.

A weak rupiah combined with high interest rates and high inflation is expected to reduce the growth rate to -15% for the whole of 1998. Its impact on society has already been staggering.

Food security prospects for 1999 are worsening because of reduced production due to:

(1) Two consecutive years of drought 1997 – 1998;

(2) Increased prices of fertiliser and insecticides due to significant depreciation of the rupiah;

(3) Increase in food prices caused by rapid inflation;

(4) Distribution irregularities due to: breakdown in a transportation system that is in need of imported spare parts, the exodus of private Chinese traders to safer places, political instability and general insecurity.

The average monthly price of rice has increased from Rp. 1000 (July 1997) to Rp. 3000 (November 1998) per kilogram, despite intervention by the National Logistics Agency (*Bulog*). In addition to this, the prices of maize, cooking oil, sugar, wheat flour and others have also increased.

To cope with these sharp increases in the price of food, the government is allocating in the 1998/1999 budget a total of Rp. 70 trillion (equal to US$7 billion) to subsidies, including food (Rp. 3.8 trillion), oil (Rp. 27.5 trillion), and electricity (Rp. 8.5 trillion).

To ensure that the very poor have rice, the government is providing poor families with 10 kilograms of rice monthly at a price of Rp. 1,000, or ten dollar cents per kilogram, which is one-third of the market price. The programme starts in September 1998 to reach 5.6 million very poor families and is planned to reach 17 million families nation-wide or about 85 million people.

Rice-paddy production for 1998 is forecast at 45.4 million tons, which is lower than the 49.4 million tons in 1997. However, demand is increasing, according to the "FAO/WFP Crop and Food Supply Assessment Mission to Indonesia" report of October 1998, thus import requirements have increased correspondingly by 5.14 million tons for 1998/1999.

Not only cereals are needed, but foods of animal origin are also important. In a UNICEF-supported programme implemented by 'Helen Keller International' preliminary analysis of data (September 1998) collected in four provinces, Central Java, East Java, South Kalimantan and South Sulawesi shows a decline in the consumption of foods of animal origin. Foods with a higher bio-availability of essential nutrients than foods of plant origin, their deficiency has contributed to the increased prevalence of micronutrient deficiencies. The deficiency of micronutrients, such as vitamin A and iron, contributes to maternal and infant mortality.

In the post-crisis period, anaemia, an indicator of iron deficiency, has increased. Nightblindness, an indicator of vitamin A deficiency, has also increased. Maternal and childhood wasting based on weight for height, a good indicator of food insecurity, has also increased. And it is likely that there is an even higher prevalence of micronutrient deficiencies among already-deficient women and children.

Other key findings from Nutrition Surveillance in South Kalimantan, Sulawesi, East and West Java, by 'Helen Keller International', show the impact of economic crisis on the reduction by more than 50% of milk and egg consumption. In Central Java, the number of underweight children of less than 35 months of age has increased from 8% to 14% and varies across ecological zones. Maternal malnutrition has increased by approximately 5% in two-thirds of Central Java. And anaemia in children has increased by 25-40% to 65% in all zones of Central Java. Rates of diarrhoea in Central Java have doubled in both women and children.

UNICEF Indonesia has also observed an increasing number of maternal deaths in 1998, as compared to 1997, at the District Hospitals of East Java. Also in East Java, increased rates of malnutrition have been detected in paediatric admissions to the largest hospital of Surabaya for the period January-July 1998, as compared to the same period in 1997 and 1996.

The impact of malnutrition and food shortages exacerbated by the crisis, is just beginning to emerge, and may result in a "lost generation" of children born in these hard times and who are estimated to enter the labour market in the year 2015.

Economic crisis has also hit education very hard, especially for the rural poor, as revealed by the Central Statistical Bureau in September 1998. The total population above the age of five attending schools has increased by 0.34%, from 48.2 million (1997) to 46.4 million (1998), but for the rural population school-attendance figures have dropped by -1.62%, from 28.2 million in 1997, to 27.8 million in 1998 – that is, by half a million people. This decline is school attendance is felt by all income groups in Java attending all levels of school, such as elementary, junior and senior high as well as university But for the 40% lowest income group in Java, 32.88% dropped out from universities in 1998 compared with 1997 enrolments. Outside Java, in 1998 nearly all income groups experienced increased school drop-out levels: -1.02% in elementary schools, -2.28% for junior high, and -0.31% for senior high. However, at universities outside Java, the number of enrolments in 1998 increased by 28.50% compared to 1997, indicating that those outside Java cannot afford to attend university in Java and enrol instead in institutions outside Java.

In general, however, the increased drop-out rates are due more to the inability to pay tuition fees, which has also negatively affected the continuation rate from primary school to junior secondary school. Due to a shortage of essential instruction materials and increased prices of books, the quality of schooling has declined. One could also reasonably expect a decline in students' concentration capacity due to dietary deficiencies.

The contraction of the economy because of the crisis has raised the number of unemployed. The Department of Manpower of Indonesia has estimated that total unemployed at the end of 1998 will amount to 13.4 million persons, consisting of 4.4 million existing unemployed, 2.7 million new entries onto the labour market and 6.3 million workers dismissed due to the economic crisis. ILO-UNDP on the other hand has estimated that total unemployed will reach over 20 million by end 1998.

Whatever the estimate, the decline of developmental activities in manufacturing industries, construction, property, and the banking and service sector has reduced possibilities for not only unskilled but skilled labour as well.

Economic crisis has pushed the number of people below the poverty line from 22.5 million persons (1996) to 96.7 million (1998), as estimated by the Central Statistical Bureau. It is clear that the impact of crisis goes beyond the economy *per se*, for it has had severely negative consequences on the quality of life.

To cope with these challenges, the government has launched a social safety net programme covering: (1) activities to ensure adequate food supply; promoting diversification in food consumption, increasing local food production, improving distribution and providing food subsidies for the very poor; (2) employment creation through the development of infrastructure, agriculture, and involving programmes such as "food for work"; (3) basic social services, to provide medicine to rural health centres, food for the poor and school children, scholarships to students to prevent drop-outs,

subsidies for health and education affected by depreciation of the rupiah; (4) assistance to small and medium enterprises in the form of capital, training, development, promotional materials as well as partnerships. Most of these programmes are implemented by the government.

Non-governmental and community organisations, with networks covering Indonesia nation-wide, are engaged in community recovery programmes to strengthen the coping capacities of vulnerable groups of the population most affected by the crisis. This is done by channelling resources to support local, community-based organisations in the implementation of assistance activities, which aim to encourage beneficiaries to help themselves. The programmes are intended to alleviate poverty by providing short-term assistance to those people who are unable to continue their daily socio-economic activities, due to the impact of crisis. This non-government activity augments the social safety net programme funded and implemented by the government and is part of efforts to empower civil society on the basis of the following principles:

- Establishment of a response mechanism that maximises impact through effective intervention;
- Transparent operations with full disclosure of information for public scrutiny;
- Support for interventions that yield sustained benefits to local communities;
- Support for projects which empower communities to further help themselves;
- Equal opportunity for assistance irrespective of race, religion, gender, region or political aspiration.

By conducting social safety net programmes along these principles, and empowering groups in society by helping them to help themselves, it is possible to nurture social cohesion and enhance the social and political sustainability of reform, in order to meet the challenges of the East Asian crisis.

5. Conclusion: reform and social cohesion

At the initial stages of development, the concentration of natural resource exploitation and primary sector development with the involvement of the broad mass of people in the rural area, makes it possible to pursue development with equity and social cohesion. This is especially crucial for countries with diverse cultures, ethnicity, race and religion, and requires corresponding diversity in the approach to development, in order to cater for these differences.

It is the irony of growth, however, that successful development with equity and stability at the early stages of growth may contain the very seeds of inequality, instability and social discord; if the development approach is not sufficiently diverse, but uniform and “top down”, sustained growth will be vulnerable to crisis as indicated by the Indonesian case.

Important underlying causes of the current Indonesian economic crisis are as follows:

(a) The pressure to grow as quickly as possible, and to achieve the status of ‘industrialised economy’ by promoting growth through strong elements of society, but thereby creating a wide income discrepancy;

(b) Continuous and frequent economic successes and achievements breed overconfidence, as per Ivan Petrovich Pavlov's theory of conditioned reflex, and creates disbelief and bewilderment when success turns into failure;

(c) The long reign of the national leader (normally two terms or a maximum of ten years) has created established groups interested in maintaining the lucrative status quo;

(d) Over-concentration of virtually all political, economic and social power in the hands of the ruling elite, an elite which has no power whatsoever in society, has opened the way for authoritarian rule without effective control, check and balances by the people;

(e) Finally, increased abuse of power by the ruling elite for private gain.

Comprehensive policy packages to cope with the economic crisis are necessary, but not sufficient. Economic measures must also settle the underlying causes of crisis and take into account any negative policy implementation impact on equity and social cohesion. In this context, social impact analyses of economic reform and structural adjustments are an imperative prerequisite for the social and political sustainability of reform.

It is necessary to give special consideration to policy efforts that minimise negative impact on social cohesion. In this regard, social safety nets can contribute to strengthening social cohesion if they are based on the principle of empowering community to help itself, and implemented through assistance which is provided equally irrespective of race, religion, gender, region or political aspirations.

With this approach, crisis can be viewed as an opportunity to transform growth into development with equity and social cohesion.

3.3 DISCUSSION OF PAPERS BY FRANCES STEWART AND EMIL SALIM

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First of all, I would like to congratulate Professor Stewart and Mr. Salim for their excellent explorations into the human dimensions of the East Asian crisis, and the responses thereto (Stewart for the region, Salim for Indonesia in particular).

Almost overnight, what had been widely hailed as the East Asian economic miracle has turned into the widely lamented East Asian economic debacle. After making impressive progress not only in economic growth but in poverty alleviation and human development as well, there is now great concern that these gains are being reversed. People are losing their jobs by the millions, governments are being forced to cut back on social services, and poverty is again rising.

Just as there has been a divergence of views on what brought about the Asian miracle, there has also been a divergence, even a diversity, of views on what needs to be done to solve the Asian financial crisis. Through all the discussions, we should never lose sight of the fact that the Asian currency crisis is not just a problem of economies, or of banks, or of slowing economic sectors, or even of governments. It is, most importantly, a problem of *people*, of human lives and families' well-being. And it is not a problem affecting only Asian people of today, but in all likelihood also those yet to be born in the future.

It is thus extremely important and useful that wider forums like this address the human and environmental dimensions of the Asian currency crisis. Focusing on the Indonesian experience is very useful; having been affected most severely, it presents most graphically the various aspects of the human costs of the crisis. However, much evidence remains anecdotal or even conjectural, although efforts to quantify the impacts more systematically are now underway – and this is one important item in the agenda for action, i.e. more systematic monitoring, directed at sharpening the design of appropriate interventions. Rather than cite even more anecdotal evidence, of which there is also much for the Philippines (however, less severely affected by the crisis, the Philippines case does not reflect the severity of the problem) I will focus more on the policy implications of the crisis.

The challenge is not just to restore investor confidence in the region, or to identify and implement so-called safety nets to meet the short-term problems. To my mind, the more telling challenge is to prevent short-term problems from turning into long-term ones, or even permanent ones. And this could very well happen if economic stabilisation measures we undertake today exact long-term costs that impair the future sustainability of economic and social progress.

Social and environmental impacts of the crisis

The caveat must be made that very little empirical data is available at this point on the social and environmental consequences of the East Asian financial crisis. Evidence on most aspects of the issue is at best anecdotal, indicative, and even conjectural. It is only now that researchers and analysts are beginning to formally analyse these impacts. And even then, it is extremely difficult to undertake such empirical analysis in any systematic or comprehensive way, given methodological and data difficulties.

Thus, one of the more prior concerns in the action agenda is establishment of more systematic monitoring of the social and environmental impacts of the crisis, especially as such information would help in the design of efficient and effective interventions to minimise its adverse impacts.

I can identify at least seven mechanisms whereby the financial crisis has had, or can have an impact on sustainable human development:

1. Impacts on economic sectors have led to higher unemployment, lower incomes, and higher prices – thus leading to higher poverty;

2. Lower public sector revenues led to downscaling of social services and public investments in sustainable development – including in human resources development (HRD) which is crucial for the longer term future;

3. The crisis has had adverse impacts on social capital, e.g. increased crime and domestic violence; community co-operation and participation;

4. Cash-strapped firms put aside investments in environmental mitigation (e.g. waste management), or stop the operation of installed environmental mitigation equipment;

5. Short-term concern (by governments) for the restoration of growth may lead to easing up on environmental policy or enforcement;

6. The rush to export their way out of the crisis is exerting pressures on environmentally-sensitive export products in the countries affected.

7. Reduced economic opportunities have influenced migration trends (e.g. return of overseas workers; reverse urban-rural migration, especially into coastal areas and uplands) which may have negative impacts on sustainability of development.

Let me elaborate on each one in turn.

Increased income poverty

The single most telling economic variable that has led to a resurgence in poverty is the high interest rates that currency stabilisation efforts have brought about. This has forced dramatic scaling down and closures of productive enterprises, and corresponding loss of jobs, numbering in the millions just in Indonesia alone. Unemployment rates have shot up in the wake of the crisis, from 5% to 17% in Indonesia, from 2.3% to about 8% in Korea, and from 1-2% to 5-6% in Thailand, with smaller but significant increases also happening in the Philippines and Malaysia. The high cost of

consumer credit, along with higher inflation rates brought about by currency depreciation have severely cut purchasing power, especially of the urban and rural poor. Particularly worrisome is the surge in school drop-outs, with children being pulled out of school due to lack of income to shoulder school expenses, or to pull them into the labour force to augment reduced family incomes.

Reduced social income

The misplaced IMF prescription of fiscal tightening that was imposed on countries in the region not only dampened economic growth at a time when it was most needed, but also severely cut into government budgets for essential social services like education, health, social welfare and environmental protection. Not only have direct social services been reduced, but further public investments in HRD and environmental protection have had to be put on hold, if not scrapped altogether. In the Philippines, a uniform 25% cut was imposed on the non-personnel budgets of all government agencies in the face of massive revenue shortfalls due to the economic slowdown. Among other things, this has had the effect of reducing coverage of the government immunisation programme to 58%, in the face also of much higher prices of drugs, most of which are imported. Severe budget-cutting has likewise been done in the other affected countries, with adverse consequences on social programmes. Similarly affected by much higher operating costs are private providers of these social services (i.e. private schools, private hospitals), leading to much reduced service coverage.

Adverse impacts on social capital

There have been widespread reports of increased crime incidence in the region (World Bank 1998), with the violence against ethnic Chinese in Indonesia being an extreme example. Increased incidence of domestic violence has also been documented, presumably arising from increased stress and conflicts over the allocation of very limited household resources (Jordan 1998). Applications for divorce have seen a significant rise in Jakarta (Baillie 1998). Greater incidence of drug abuse has also been reported in Bangkok (Robb and Zhang 1998). An increase in the number of street children has also been cited in the Philippines. The crisis has also had the effect of curtailing another important aspect of social capital, i.e. that of community co-operation and voluntary participation in community institutions. In many places, an attitude of intense competition for limited resources has appeared to replace community co-operation and trust. Volunteerism has been put aside, as people feel the need to work for income to finance basic needs (Robb 1998).

Environmental protection a casualty of cost-cutting

Firms beset with higher operating costs due to high interest rates and more costly imported inputs are likely to put aside investments in more sustainable production technologies or pollution-control equipment. But even where such equipment is in place, it is likely that the need for cost-cutting has led to outright non-operation of such facilities.

Short-term growth vs. environmental protection

Governments faced with the pressure to restore economic growth are likely to be tempted to ease up on environmental policies and standards, or on the enforcement thereof, to the extent that these are

perceived to impair greater economic activities in the short run. An order lifting the log export ban was actually issued in the Philippines, until strong opposition from environment advocates led to its withdrawal. Similarly, there have been strong pressures to forego stringent environmental clearance processes for certain projects argued to be urgent and necessary in the face of the currency crisis.

Increased pressure on environmentally-sensitive exports

It is widely held that the way out of the crisis is for the affected countries to cash in on the increased competitiveness of their depreciated currencies, by exporting even more. This has led to the increased desire to export products with high domestic content, of which the primary product content of many is environmentally sensitive.

Environmental pressures from migration

The reduction in employment and livelihood opportunities in the urban centres has driven people to move back to the rural areas, especially the coastal areas and the uplands. This exerts a new round of stresses on the coastal marine and forestry resources of countries in the region. In the Philippines, greater pressures on already over-fished coastal fisheries is being felt in some areas, while further intrusions into the uplands has been the result of more unemployed lowlanders looking to these areas as a basis for farming and livelihood activities.

Responses to the crisis

How have households, communities, firms, and governments responded to the crisis?

- *Household coping mechanisms:* Higher female labour participation rates (and lower for males); drop-outs (indications of female siblings giving way to males); change in consumption patterns (including higher tobacco, alcohol consumption); migration.

- *Labour-management responses:* for example, the Philippines' agreement on strike moratorium in exchange for layoff moratorium; or wage increase postponements; salary cuts.

- *Community responses:* Such as co-operative efforts to obtain food at lower prices (Thailand), credit at better terms (Philippines).

- As for *government responses*, the following are deemed necessary. Many of them are already being undertaken, at least in some countries in the region:

  - A systematic and effective monitoring system;

  - Unemployment insurance (Korea only) and unemployment assistance (emergency loans, e.g. Philippines SSS);

  - Skills retraining, employment matching services, emergency employment programmes;

- Income maintenance programmes – e.g. direct cash payments, targeted food assistance including food for work, labour-intensive public works (World Bank estimates of cost of transferring US$1 to the poor: US$4-5 in public employment programmes; US$8 with untargeted cash transfers or rice subsidies in Indonesia; US$3.60 with subsidies to low-quality foods consumed mainly by the poor);

- Food and fuel subsidies, e.g. thru-pricing and taxation policies;

- Social services – e.g. free health services to poor; scholarship assistance to needy schoolchildren;

- Careful prioritisation of government social budget (e.g. exemption from 25% freeze in Philippines);

- Adherence to environmental policies and enforcement;

- Encourage/support private/community initiatives – i.e. partnerships with civil society;

Longer term measures to address the crisis and the problems it has brought about include:

- Economic measures (improved banking supervision, management of short-term capital flows, competition policy, etc.);

- Development/improvement of social safety net systems, including unemployment insurance;

- Political reform (as stressed by Salim), particularly to strengthen democratic institutions (including multi-stakeholder participation in sustainable development planning and implementation; tripartism to facilitate smooth employment and wage adjustments to future crises); assert subsidiarity, i.e. taking action/making decisions at the lowest level possible; this needs mutual trust on the part of governments and civil society to forge a working partnership for sustainable development.

How has the International Donor Community responded?

- IMF "bail-out" programmes – they have softened their position on fiscal tightening.

- World Bank, ADB – shared in bail-out packages; support for financial sector reforms; projects for social sectors including scholarships for schoolchildren, support for health services and medicine procurement, microcredit programmes, labour training and retooling, etc.

- UN Agencies – poverty alleviation projects (Poverty Strategies Initiative, support for World Bank's Social Investment Program, vocational training and education.

- Bilateral donors – support for bail-out programmes; projects for poverty alleviation and infrastructure, especially social infrastructure.

I see international donor support being further needed in the following areas:

- Assistance in setting up unemployment insurance schemes;

- Support for South-South technical co-operation schemes in the formulation of social safety nets, monitoring systems, and more generally, development planning, ODA management, etc.;

- Support for promotion of multi-stakeholder mechanisms for sustainable development planning; stronger NGO participation in development processes (need for mutual trust between government and NGOs).

"Consume less, produce more, share more"

Several months ago, I heard some words of wisdom from a Thai politician, who in a speech declared what he believed to be the key to getting over the crisis facing us in the region. He said that what was needed was for us to consume less, produce more, and share more. At first blush, it all sounded so simple-minded, and even trite. Upon closer inspection, however, I realised how profound this prescription really was.

The times indeed call for consuming less, especially with reduced purchasing power. But consuming less also means giving up something for the sake of another – including one who may yet be born in the future.

Producing more, he said, does not merely refer to the production of more material goods – although that is obviously much needed too – but also refers to the production of more spiritual goods – more music, more art, more peace, more spirituality; in other words, goods not only for the body, but also for the mind and the spirit. And as we produce more, and consume less, we find that we are able to share more, and achieve, even in the face of material adversity, an increase in what some have come to call "Gross National Happiness".

Concluding remarks

And so in conclusion, let me declare, in all confidence, that Asia, particularly East Asia, will bounce back. But the quality and especially the *sustainability* of this rebound depends crucially on how well we recognise the human face of the raging financial crisis.

For as I said at the outset, the crisis at hand is not a problem of banks, or of slowing industries, or of governments; rather, *it is a problem of people – of human beings both living today and still to be born in the future.*

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3.4 DISCUSSION OF PAPERS BY FRANCES STEWART AND EMIL SALIM

John Dawkins, Former Treasurer, Government of Australia

In commenting on these papers I wish to emphasise that I speak for no government or political party – I speak as a private citizen only.

The two papers presented are very different in character and content. Frances Stewart, having surveyed the very substantial reductions in levels of poverty in East Asia, goes on to describe the fallout of the current crisis and its effect on the poor. She is critical of the initial intervention strategy of the IMF and makes a number of suggestions as to which measures might be introduced to move these economies forward and provide assistance to the poor.

Emil Salim focuses primarily on Indonesia, describing both the positive and negative effects of a decade or more of economic growth, and identifies the causes of the current crisis. He is extremely critical of the former and current political order and is surprisingly optimistic, not only of the likelihood of political reform but also its likely effect on the economy.

I will concentrate my remarks on Indonesia and in particular on the effects of the crisis on social and political stability.

Social cohesion is generally regarded as a desirable state especially for a developing country. This is mainly because it suggests an absence of the kind of political and social strife so disliked by foreign capital. However we should be suspicious about some of those who promote the virtues of social cohesion.

Politicians frequently extol the desirability of social cohesion, often as an excuse for stifling dissent. Those who disagree with the incumbent political leadership are accused of destabilising the country and threatening its economic progress. That said, there exists a strong case for encouraging cohesion when the alternative is conflict, especially when that conflict can quickly turn to violence. This cohesion is best promoted by the fair distribution of wealth and opportunity, rather than by the rigid enforcement of laws prohibiting dissent.

Opportunity is best secured by economic growth – fair distribution is similarly more achievable in the context of growth. As the pie becomes larger, the shares can grow all round. Importantly, economic growth not only speeds development but is vital for establishing and maintaining social cohesion. In Indonesia, years of rapid growth had greatly reduced the incidence of poverty, as Frances Stewart points out. At the same time a small proportion of the population had become disproportionately wealthy. Emil Salim points to the irony whereby growth promotes inequality, for only some prosper while others remain poor. This is made worse when official dispensations are the prime cause of the enrichment of the few.

Indonesia is not unique in this regard – either in the disparity of wealth or the means of achieving it. What was impressive in Indonesia was the emphasis on assisting the very poor with food subsidies and other instruments. But this achievement does not excuse the excesses in the use and abuse of official power and patronage witnessed over many years. However, it is easy to condemn the abuse but important to acknowledge that official policy was also responsible for lifting millions out of poverty.

There has been an additional factor at work in Indonesia and Malaysia. In both countries, governments were keen to promote the business involvement of the majority indigenous population. While the nature of the policy varied in the two countries the objective was to expand the skills and capital available to this ethnic group. This involved a degree of intervention in the allocation of resources which would not be entertained in more advanced economies and gave rise to opportunities for manipulation and official corruption.

So when the collapse occurred there were good reasons for identifying the many defects in domestic policy as contributory factors. Interestingly, other aspects of policy were not only more conventional but impressively so. Indonesia had commenced unilaterally to reduce tariffs across a wide range of goods, it had liberalised foreign investment rules and in the APEC and AFTA context was at the forefront of moves to create a more open regional market.

Nevertheless it was clear that when the IMF was empowered to respond to Indonesia's request for assistance there existed an agenda which was hostile not only to most domestic policies but to the government itself. It became quickly apparent that the reforms sought were not just economic but political as well. This is not surprising given that democratic institutions were quite underdeveloped in the country. However, what is at issue is the balance and timing required to achieve a return to economic stability and political reform.

IMF and World Bank intervention usually has the following objectives:

- To stabilise the economy;
- To boost confidence;
- To restore capital inflow and reverse the outflow of domestic funds;
- To protect the poor.

In many cases, the means to achieving these objectives is quickly settled through an agreement between the IMF and the government in question about the policy changes to be pursued in return for international financial support for the economy.

It is the initial impact of an IMF programme which can be most effective in achieving the desired objectives. If the programme of reform is quickly agreed upon and funds committed and released, the effect on confidence can be positive and durable. A comparison with the Mexico bailout is instructive; the assistance provided in that case by the US was immediate, generous and flexible. Further, it was solely economic. Any suggestion of political reform was subordinated to the objective of the restoration of economic stability. Indeed there was quite explicit support provided to the Mexican government and on the US side there was a considerable political investment in the success of the venture. Dr Larry Summers apparently used to quip that his human capital was denominated in pesos!

Unfortunately he has not considered his human capital to be denominated in rupiahs – at least not for the present. The agreement between the IMF and Indonesia was slow in coming and rather clumsily given public effect. Without US involvement the availability of sufficient funds was in some doubt. The policy prescriptions seemed inconsistent with the objectives; how, for instance, was the withdrawal of food subsidies expected to help the poor? The initial bounce expected from IMF intervention did not occur and the opportunity was lost. Worse, the IMF had to adjust the programme more than once as defects in the initial programme became apparent.

Disturbingly, little attention was paid to the preservation of social cohesion as the economic programme was being implemented. And perhaps Emil Salim's paper indicates why. Professor Salim believes that political change is the top priority, that those now in power must be removed. This, he expects, will come in the wake of democratic reforms. Social unrest will keep up the pressure for such reform. In such a scenario the economic objectives of stability, confidence and capital inflows become of secondary importance. In some cases their achievement becomes quite impossible. For instance, a key economic objective is to see the return to Indonesia of some US$8 billion of domestic capital. As long as the owners of the funds see their businesses targeted for destruction by unruly mobs, this return of capital is improbable.

In the meantime, the economy is languishing, and with it the prospects of the poor. Over 50 million people have slipped back into poverty. But through their public demonstrations the unhappy impoverished masses may loosen the grip of the current government – or so some people hope.

My own view is that it may have been more desirable to unambiguously put economic priorities first and subsequently encourage political reform. Stability would have returned and the effects on the poor would have been less severe. It seems strange to punish the people for the real and perceived shortcomings of the ruling elite.

Even now it is not clear that the worst is over for the economy and therefore the poorest Indonesians. And it is far from clear that the processes of political change now underway will achieve the desired transfer of power. Even if they do, will they create the kind of tranquillity necessary for a return to economic growth?

The risk is that continuing economic failure may lead to almost permanent social unrest with quite unpredictable results. This should be a matter of great concern, not only to those of us who live in the region but to the wider international community. A successful Indonesia will be a force for regional stability and growth. The alternative is very worrying.

As for the OECD, there may well be a role in assisting reform in Indonesia. There certainly exists a large task in building economic constitutions, in establishing mechanisms for effective fiscal management and for building distribution and transfer mechanisms. Perhaps the neutrality of the OECD gives it a role here in the wake of the less than triumphant success of the IMF and its prime sponsors.

Chapter 4

STRUCTURAL REFORM PROGRAMMES UNDERWAY

4.1 INDONESIA: STRUCTURAL REFORMS: DESIRABLE, NECESSARY, ESSENTIAL?

Saleh Afiff, Former Coordinating Minister for Finance and Economy, Government of Indonesia

Recent economic events have created serious global and regional financial and even political difficulties. The financial crisis that began in Thailand in 1997, subsequently spreading to Indonesia, has now taken on a global dimension of still uncertain severity. Although much about the onset and spread of the crisis is still unclear, there is one aspect of the crisis on which a consensus has emerged; this is a crisis that caught most analysts and policy makers totally unaware. Apparently those specialists who focused on the economies of East Asia were dazzled by the long period of rapid growth. This led them to fall prey to the often-voiced belief that the Asian economies, relying on the somewhat ill-defined term 'Asian values', were so well-managed that they were immune from financial crisis. Whatever the cause of our blindness, the declines in domestic asset markets, the widespread bank failures and corporate bankruptcies, and the depths of the economic contraction that now confronts many of the 'Asian tigers' were totally unexpected. Nor did the myriad of econometric models now widely used provide any better predictions. Indeed a review of such models, by Furman and Stiglitz, found that not one of the models would have led policy makers to become concerned about developing conditions in any of the crisis affect countries. Indeed Furman and Stiglitz conclude that "...the East Asian crisis was a novel event". [1]

Whether this is a correct interpretation of past events remains to be seen. There is, after all, the distinct possibility that the increasing global integration of financial markets will lead to similar crises in the future. But we do know that the collapse of the East Asian economies, and the spread of the financial crisis to Russia and Brazil, has created serious difficulties for the nationals of the affected countries. In Indonesia, and in other Asian countries, we confront growing unemployment, increasing poverty, and a sharp decline in real incomes.[2] On both the economic and social front, much of the progress achieved over the past decade or more will be eroded and it will take some time not only for us to regain rapid economic growth but confidence in our ability to manage our economies.

But if the past year has been difficult for the citizens of the East Asian economies, it has also been difficult for the many economists who once touted the Asian economies as paradigms of sound development and who recommended the East Asian economies as a model of development to be widely emulated. Indeed the economic events of the past year have led to widespread criticism of, and soul searching in, the multilateral institutions that provided assistance and advice to the Asian economies over many years. Some critics wonder why these institutions and their qualified staff did not recognise the weaknesses of the Asian economies. Others have raised powerful arguments against the policy advice now proffered.

Since the IMF often takes the lead in helping economies in financial distress it should come as no surprise that much of the criticism is directed at that institution. It has been accused of misreading the crisis and, at least in the case of Indonesia, of recommending policies that deepened the crisis by feeding the flames of financial panic.[3] Controversy has also erupted over the IMF's insistence on including a wide-range of structural reforms in their economic assistance programmes. Such reforms,

the IMF argues, are a necessary complement to the standard prescriptions of maintaining a tighter financial and monetary stance. Stanley Fischer, in his spirited defence of the IMF, argues that "... to ignore the structural issues would invite a repetition of the crisis".[4] But others differ. Martin Feldstein wrote that "... the International Monetary Fund is risking its effectiveness by [its] recent emphasis on imposing major structural and institutional reforms as opposed to focusing on balance of payments adjustments".[5] There are essentially two questions to be addressed; first, are these criticisms valid and, second, if so, are they valid for the reforms embedded in the IMF's structural adjustment programme for Indonesia?

The IMF's insistence on structural reforms, and the arguments by others that such reforms should not be part of a "standby" agreement, might suggest that policy makers in Indonesia, and elsewhere, were unaware of the need for structural reforms until the crisis brought the issue to the fore. That is clearly not so. Well before the current crisis erupted, policy makers in Indonesia and elsewhere had begun to implement a broad range of structural reform measures. In the mid-1980s, when the Indonesian economy showed few signs of growth, policy makers adopted an active reform agenda focusing on a number of sectors. In doing so the policy makers, often called the "technocrats", reflected an increasing awareness of studies showing that legal and political reforms, all aimed at increasing transparency, reducing corruption, and improving governance, were essential for long-term stable growth. Viewed from this perspective the IMF's current insistence on structural reforms merely moves ahead an agenda that was, at least in part, already underway.

However there is a further issue. When the multilateral organisations move beyond their traditional focus on economic issues, into areas such as political and legal reforms, are they focusing on measures essential for economic recovery or using their current leverage to achieve goals that matter more in the long run?

The question is far from academic and it is therefore important that some understanding is reached of the extent to which structural reforms are essential to the economic recovery of the affected nations. If they are essential, then government should be forced to focus its efforts and political capital on the implementation of such reforms. And there should be no doubt that considerable energy and political capital are required in developing and implementing structural reforms. If, as some have suggested, the current emphasis on structural reforms and improved governance are not essential to Indonesia's economic recovery, but are more a reflection of a current "fashion" in development economics, then a strong focus on such measures misdirects the government's limited implementation capacity from more urgent tasks. In short, are transparency and good governance a necessary, albeit insufficient, condition for successful economic development, or are they merely a distraction?

A brief review of Indonesia's recent economic history amply illustrates the attention paid to structural reforms in the past and it provides evidence of the success the reformers had in changing the economic environment. By nearly any standard one cannot but conclude that the range of reforms implemented in the 1980s and early 1990s was substantial and impressive. No doubt the reform agenda was not completed and from this perspective many of the reforms embedded in the current IMF programme represent a continuation of measures not fully carried through. Others however touch on new areas and some of these are indeed controversial. To understand the role and importance of structural reforms in the Indonesian context, it may be useful to briefly review recent economic history.

When one considers that over the period 1985 to 1997, Indonesia recorded an annual rate of growth of nearly 8%, one of the fastest sustained rates of growth among developing countries, it should come as no surprise that during this period, economic policy makers undertook a wide range of structural reforms. It would have been impossible to achieve these rates of growth without reforming the basic structure and administration of economic policies. It was these very reforms, together with the maintenance of a relatively stable macro economic framework that allowed Indonesia to achieve a rise in real *per capita* incomes at an annual rate of nearly 6%. Perhaps of even greater significance, this policy framework helped millions of Indonesian citizens rise out of absolute poverty and enter the modern labour force. It is has become popular to argue that the management of the economic and political systems in Indonesia ensured that only a few benefited from economic progress and that, as a consequence, the bulk of the population remained impoverished. This flies in the face of widely accepted data. In 1984, 21.6% of the population, or 35 million people, had incomes below the poverty line while by 1996 the proportion classified as poor had declined to 11.4% or 22.6 million persons. Yet even critics who accept the basic numbers point out that there are many "near poor" so that the reported improvement in the poverty numbers is more statistical artefact than reality. To be precise, the "near poor" are defined as those whose income is just above the poverty line. Since the Indonesian poverty line is based primarily on a minimum food consumption level it is quite low in money terms. Hence it is true that those who move out of poverty and move in to the "near poor" category are still very poor. It is also correct that if the government had adopted a higher, and perhaps a more realistic, poverty line one would not see as much improvement in the poverty statistics. But even if one adopted a higher poverty line, the trend in poverty reduction would not change, although the number of persons counted as poor would of course increase. The essential point to note is that the mix of economic policies and reforms resulted not only in rapid growth but also in a substantial improvement in the quality of life.

Although poverty was reduced in both urban and rural areas, there was a substantial reduction in rural poverty where most of the poor reside. Between 1983 and 1996 some 13.1 million rural persons were raised above the poverty line income level while some 4.6 million urban poor rose above the poverty line income level. The sharp reduction in the number of rural poor came about through government programmes that provided adequate inputs, real and financial, for a range of agricultural activities, both rice and non-rice growing. Government not only improved rural infrastructure and provided health and education services to the rural areas, but also initiated an imaginative rural credit programme that has allowed many farmers and small scale entrepreneurs to have access to much-needed capital. The upshot of these policies was a remarkable improvement in the quality of rural life. Over the period 1990 to 1995, the%age of rural households owning television sets more than doubled, reaching 30%, while the percentage of households living in houses with brick walls rose from 30% to 36%. Despite special programmes designed to reach the poor in the more remote areas of the archipelago, deep pockets of deep poverty remain. In general however the improvements in income and welfare were widespread.

It was a combination of astute policy measures and structural reforms that helped Indonesia, not unlike other East Asian economies, to achieve the high levels of domestic savings and investment that underpinned the long period of rapid growth. Yet despite a high domestic savings rate, Indonesia relied on substantial private foreign capital inflows to finance much of its investment. The total value of foreign investment approvals reached a peak of US$39.9 billion in 1995 before declining to just short of US$30 billion in 1996. It is worth noting that rapid inflow continued even in to the first six months of 1997, when private capital inflows reached US$16.1 billion. These achievements were made possible by Indonesian emphasis on sound macro economic policies combined with structural reforms to continuously improve economic efficiency.

The foundations for this extraordinary period of rapid growth can be found in three reform principles adopted late in the 1960s and early 1970s. *First*, the government adopted a "balanced budget" rule, making recourse to deficit financing impossible. Admittedly over time, various schemes were resorted to, such as the use of "off-budget" accounts, thus allowing certain elements of society to circumvent this rule. One unintended consequence of the increasing reliance on the so-called "off-budget" accounts was a reduction in the economic information contained in the budget itself. As a result the budget became less transparent, and much less useful as a macro economic management tool. The use of "off-budget" accounts made it more likely that such funds would be allocated to non-essential activities while avoiding the scrutiny of various supervisory agents. Although various economic policy makers tried to reduce the reliance on "off-budget" accounts such efforts to reassert budget control were, on the whole, unsuccessful. *Second*, since the early 1970s Indonesia has maintained an open capital account. While it is increasingly popular today to question the appropriateness of this policy and our adherence to it, the removal of all exchange controls not only helped increase economic efficiency but it also eliminated many actual and potential opportunities for corruption. And *third*, Indonesia resisted the temptation to peg its exchange rate, choosing instead to allow its currency to float within a very narrow band. Here, too, the objective was to ensure that market forces, rather than administrative fiat, would set the price of foreign exchange. But there were also unintended consequences of this policy; the very success of the managed float, which maintained an exchange rate that depreciated at a slow and often predictable rate, led investors to underestimate exchange rate risks which many have come to regret. The economic policy makers felt that a reasonably strict adherence to these three policy guidelines would result in a stable and sound macro economic framework. And for many years this was so.

Those who have studied the growth of the Asian economies have suggested that the ability to generate rapid growth resulted in part from an adherence to the nebulous concept of "Asian values". At least in the case of Indonesia, reality is more mundane for it is possible to fully account for Indonesia's rapid economic growth without resorting to the concept of "Asian values". Quite simply, the shift from a relatively low growth economy to a high growth economy was achieved through the adoption of a series of structural reforms that affected international trade, banking, and taxation. These reforms dramatically changed the incentives for economic behaviour.

Until the latter half of the 1980s, Indonesia's trade regime, at least as it pertained to manufacture, could be best classified as strongly import substitution biased. *Ad valorem* import duties ranged from zero to 200%, with a large number of specific rates further buttressed by a substantial number of non-tariff import restrictions. In the mid-1980s almost 35% of total imports (by value) were covered by some non-tariff barrier. Exports of a variety of goods were restricted either to ensure that local supplies would be adequate to meet domestic needs or to encourage downstream producers. The result was a trade policy regime characterised by high levels of effective protection that varied widely across different sectors. Not surprisingly, non-oil exports, especially manufactured exports, showed little growth during the period 1979-80 to 1985-86 and the economy remained highly dependent on oil and gas exports.

To try and wean the economy away from import substitution and to increase its efficiency, tariff reductions were of course important. But structural reforms were not neglected. A major step in reforming the trade regime was taken in April 1985 when the government announced a number of decrees all aimed at reducing the cost of clearing goods through Indonesian ports. Under the decree permission was given for a greater use of foreign shipping and port operations were extended to twenty-four hours a day. These measures were important but perhaps most significant, was the decision to assign to a foreign private company the task of assessing duties on imports valued in

excess of US$5,000. With the introduction of the pre-shipment inspection system under the supervision of a private company, import costs fell while tariff revenues rose. The decision to bring in a private company was an admission of the fact that the customs administration was neither fair nor transparent. It was felt that a direct reform of the customs department would be difficult and time consuming so use was made of a private company to handle import customs procedures. But the reform programme also provided for the training of customs staff in modern customs procedures and called for the introduction of an electronic data information system. In the mid-1990s the pre-shipment inspection programme was essentially terminated and customs administration was returned to the existing customs and excise department. Despite reform efforts, the operation of the customs department continues to be a subject of criticism and concern.

A duty drawback facility was established to further reduce the import substitution bias of the trade regime and provide more direct assistance to exporters. The agency assigned the task of assisting exporters was required to work at "arms length" from the exporters, thus reducing the potential for bureaucratic interference. The programme gave exporters access to duty free imports and allowed them to bypass licensing and quota restrictions. This effort was highly successful and recognised as one of the major steps that helped move the economy to an export orientation.

Introduction of trade reform measures continued well into the 1990s, when the concept of duty free zones was extended to cover bonded warehouse manufacturing facilities, making it possible for individual plants to operate essentially as if they were located in export processing zones. This step again reduced the opportunity for bureaucratic interference in an important economic activity.

On the whole Indonesia resorted to a series of measured, but very concrete steps, aimed at reforming its trade regime by successively lowering tariffs, reducing non-tariff barriers, and simplifying administrative procedures. This reliance on a series of incremental policy packages worked extremely well. In contrast any attempt to use a so-called "big-bang" approach, where all the reforms would have been introduced at once, would have run into considerable resistance, not only from the political powers but also from the bureaucrats and even from members of civil society. By definition the process was slow and at times seemed to flag. But in the end it achieved considerable success. The simple average tariff fell to 11.8% while the import-weighted average tariff declined to 6.3%.[6] Even before the implementation of our commitments under the various IMF standby agreements, very few non-tariff barriers remained.

The trade reform measures were supplemented by measures that removed restrictions on foreign private investment. Here too the structural reforms were done well ahead of the recent IMF initiated efforts and nearly all sectors of the economy were opened to foreign investments before the onset of the crisis.

A common theme in these trade and investment deregulation measures was an attempt to reduce bureaucratic interference. This was achieved by finding means of minimising direct contact between the exporter or investor and a bureaucracy that was perceived, fairly or not, as being inefficient and open to side payments. Use of this approach should not be taken to mean that efforts to improve the operations of the civil service were totally lacking. They were not. But civil service reforms take a long time before they become effective and since a more immediate impact was needed policy makers were forced to resort to somewhat indirect means to improve bureaucratic efficiency. There were however costs to using such an indirect reform approach. This indirect reform approach left untouched the issue of civil service reform, an issue I will turn to shortly.

Turning briefly to developments in the banking sector one can only conclude that in Indonesia, as in other East Asian countries, weaknesses in the financial market explain much of our current economic malaise. Despite the current debacle, basic reforms introduced by the government in the late 1980s were sound. The weak link was not one of inaction, but a failure to effectively supervise the reforms and see them fully implemented.

The first serious efforts at reforming Indonesia's banking sector began in 1983 when restrictions on the allocation of bank credits and state bank interest rates were eliminated.[7] The dominant role of Bank Indonesia was reduced and the "Bank Indonesia Certificate" (SBI), a short-term central bank liability that is periodically sold to commercial banks and other financial institutions as a means of reducing the supply of reserve money, was introduced. The introduction of this instrument improved monetary control. An immediate outcome of these reforms was a substantial increase in interest rates paid on deposits and on interest charged for loans, thus improving resource allocation. Although the reforms reduced the role of the state-owned banks, they continued to dominate the financial system.

In late 1988 the government announced a further set of reform measures that allowed new participants to enter the financial markets, broadened the range of financial services, and encouraged the development of both domestic money and capital markets. Entry barriers were sharply reduced and restrictions on the operations of foreign banks were eased. The procedures for establishing branch banks were simplified and the requirements for becoming a foreign exchange bank were relaxed. Licensing of new banks, the opening up of new branches and the entry of foreign banks in the form of joint ventures, all of which had been prohibited or severely restricted, were now permitted.

Viewed in hindsight, with the knowledge that a major contributing factor to economic collapse was a weak banking system, some critics of the deregulation process argue that our banking reforms moved too quickly and went too far. It is now a common argument that the low entry barriers allowed too many banks to open up too quickly. As a result, so it is said, bank supervision was weakened. It is certainly true that bank supervision was weak. But whether that weakness resulted from excessive political interference or from banks' rapid expansion beyond the capacity of Bank Indonesia to effectively monitor them, is far from clear. What is apparent is that here again, policy was focused on attaining an objective – increasing competition in the banking sector – but neglected to reform the supervising bureaucracy. Lowering the threshold conditions under which banks could enter the market served to increase competition and reduced the obstacles that bureaucrats could exercise to prevent the formation of new banks. Indeed many bureaucrats were unconvinced of the merits of opening up the banking sector, arguing that such a vital sector should remain tightly controlled. But had the regulations been more restrictive, those holding this view would surely have delayed the emergence of a more vibrant financial sector.

Whatever we may think of these reforms, today there is little doubt that these measures had a profound impact on the growth and structure of the banking system and on the financial services provided. The relaxation of ownership requirements for new banks, combined with the relatively small capital base required, led to a dramatic increase in the number of banks. The number of private domestic commercial banks grew from 63 in 1988 to 165 at the end of 1995, while the number of foreign joint venture banks grew from only one in 1988 to 41 at December 1995. At the same time the total number of bank offices grew from 9,434 in 1988 to 14,286 by end 1995. This growth was not only in the urban areas but included many new branches of small rural banks, serving rural customers previously excluded from the financial sector. New financial services, such as factoring, consumer credit, venture capital, and securities dealing and underwriting were opened to commercial banks either directly or through subsidiaries.

Like many other emerging economies, Indonesia was moved to strengthen its securities markets in the hope of attracting a larger flow of equity finance. Here too the reform effort was successful. Reforms began with the clarification of regulations governing insider trading and other unsound and unfair practices, laying the foundations for an active capital market. As a result the previously moribund Jakarta Stock Exchange came to life. At the end of 1985, only 24 stocks were listed on the exchange with 0.57 billion shares; by mid-1997, nearly 250 stocks were listed while capitalisation had increased from US$80.4 million to US$77.4 billion. As of 1989 foreign shareholders had been allowed to own 49% of the share of any listed company, except commercial banks, while in 1997 foreign ownership limits were abolished for non-financial institutions. More recently, again at the insistence of the IMF, foreign ownership restrictions have been virtually eliminated.

We can already draw one lesson from our experience with the expansion of the banking system and of the capital markets. Simply put, *deregulation should never be taken to mean an absence of regulation*. As efforts are made to document the weaknesses of the banking system, it is becoming clearer that the issue was not the rapid growth of banks and the lack of supervisory staff but the politicisation of the bank supervision system. Such interference allowed the proliferation of non-performing loans and poorly managed assets. Because banks had violated prudential regulations on inter-firm lending and had engaged in a host of unsound banking procedures, the financial sector amplified rather than dampened the impact of exogenous shocks.

A third area in which reforms were undertaken was in fiscal policy. Here, too, the reforms recognised that a highly complex tax system, relying on high marginal rates, would not only be difficult to implement but would ultimately reduce economic efficiency. The new tax code that was eventually adopted reduced the number of rates to three while shifting to a self-reporting income tax system. The initial reforms were followed by the introduction of a value-added tax and by a reform of the property tax law and collection systems. Indonesia was among the first developing countries to use a value-added tax system.

As in other areas of reform, administration remains problematic but the reforms did succeed in increasing the share of non-oil and gas revenue receipts as a percentage of GDP. Such revenues increased from about 8% of GDP in 1985-86 to nearly 12% in 1996-97. Income tax receipts increased nearly ten-fold over the past decade and now form about 30% of total government non-development revenues. The growth of this revenue source, which has exceeded the receipts from the oil and gas sector since 1993-94, has sharply reduced revenue volatility. Value-added taxes, whose coverage was extended in 1994, have increased seven-fold over the past ten years and now form the second largest government revenue source. Most importantly, the diversification of revenue sources has reduced revenue instability arising from changes in world oil prices and exports. Nevertheless, like other aspects of the restructuring effort the initial impetus was not fully carried forward and tax administration remains an area where further improvements are certainly called for.

On the expenditure side efforts were made to reduce or eliminate the numerous subsidies that burdened the government budget. Over the years agricultural subsidies have been reduced while energy prices have been periodically adjusted to bring them closer to world prices. The aim of these measures was to make the economy more competitive by creating a more “level playing field” which would encourage private sector initiatives. Here, too, much remains to be done.

Serious weaknesses in fiscal policy remained neglected. As already noted, notwithstanding opposition by the economic team, there was a growing reliance on the use of “off-budget” accounts to finance various projects and activities, many of which would not have survived even a cursory

financial or economic analysis. Apart from weakening the budget as an economic management tool, the increasing use of "off-budget" accounts permitted the government to fund unproductive activities, including the infamous high-technology project to develop a passenger jet airplane, that diverted scarce resources, human as well as financial. The IMF's insistence on bringing all such "off-budget" accounts into the general budget is perhaps one of the most sensible and widely supported of the many reform measures.

The reform process, described here in summary fashion, should have created a reasonably robust economic framework. And to some extent it did. For a number of years the reforms resulted in rapid growth with relatively low inflation and improvements in welfare. How then does one explain the sudden collapse?

One argument often heard is that growing corruption eventually undermined all the reform efforts. Measuring corruption is a difficult task and comparing corruption surveys over time is hazardous. In fact, as efforts to measure corruption are of recent origin there are very few long-term corruption indices to look at. However one component of the index reported in the *International Country Risk Guide* purports to have measured corruption over a reasonable time span. However, it shows that the "…assessment of the risk posed by corruption in Indonesia...was lower in the 1990s" than in earlier years.[8] It is well-known that there is widespread corruption in Indonesia, but what role it played in the current crisis is less easily determined. There is no doubt that some of the more egregious examples of corruption diverted resources into non-productive uses or raised costs. And as noted, political interference certainly helped weaken the banking system. But whether corruption was serious enough and widespread enough to have resulted in the current crisis is an issue that deserves further analysis.

A popular explanation of the Asian crisis argues that runs on financial institutions and currencies triggered the crisis and helped spread it. The argument goes as follows: a widespread run on a country's financial institutions will severely disrupt economic activity by weakening the balance sheets of borrowers and creditors, and threatening the flow of credits and the viability of the payments system.[9] In an open economy, such as Indonesia, a simultaneous run on the banks and on the currency weakens the balance sheets of borrowers who have failed to hedge the borrowed funds or have relied on short-term credits to finance long-term investments. Accepting this progression of events suggests that the Indonesian financial crisis was inevitable once the IMF closed sixteen banks without the provision of any guarantee that depositors in the remaining parts of the banking system would be protected, setting off a bank panic.

This explanation is not wrong, it just does not go far enough. Inherent in this explanation is the assumption that the Indonesian economy, and indeed the Asian economies as a whole, was "fundamentally sound". If this was so, these economies could have continued to grow for a very long time were it not for an arbitrary shift in market expectations that interrupted the flow of funds.[10] What this explanation omits is any consideration of the serious weaknesses in governance and policy implementation. Given these weaknesses, sustaining growth would have become more difficult over time. And once growth ceased, and turned into an economic rout, recovery would require that these fundamental flaws be addressed.

What are some of these weaknesses that helped undermine growth?

First, and perhaps foremost, Indonesia's financial institutions engaged in risky and unprofitable ventures. Perhaps this was inevitable. In a banking system where state–owned banks play a significant

role one can expect political interference to be a serious problem. Consequently even after we had initiated our banking reforms, government officials continued to channel loans to favoured firms or activities. Even more problematic, the close links between banks and some of the conglomerates sharply reduced the likelihood that loans would be objectively evaluated. That much is clear. But even without political interference and other pressures it would have been difficult to subject loan requests to even the most rudimentary economic and financial analysis. Data for such analysis is simply lacking. Without strong and effectively enforced disclosure requirements and accounting standards, which are essential if analysts are to make a reasonable estimate of risk, no serious evaluation is possible. This situation was worsened by the presence of collusion and cronyism. Moreover, as already noted, political pressures led bank regulators not to report some of the most egregious violations of the banking laws. This combination of factors makes it easy to understand why the weakening of the exchange rate led to such a sudden and widespread collapse of the banking system and corporate bankruptcies.

Given the characteristics of Indonesia's financial institutions they cannot but fail in their most basic function: to serve as an efficient intermediary that channels savings to their most productive use. Although all investments are risky to some extent, there is considerable systemic danger when savers, whether domestic or foreign, have no real capacity to evaluate the risks associated with investments they are undertaking. In such a situation it is likely that the real cost of capital will be undervalued and the returns on investment overstated. As a result scarce funds will be allocated to low-return, high-risk activities which are bound to fail when economic conditions suddenly change.

Second, there was a strong presumption in the financial and business community that neither investors nor lenders would ever bear the full cost of any corporate or bank failure. This belief was fostered by the close links between powerful business groups, who also often controlled individual banks, and the government. Investors and bankers were led to assume that the government would eventually bail them out if they got into trouble even in the absence of explicit government guarantees. Government actions often spoke louder than any written agreement. For example, special tariff protection was offered to the consortium that invested in a major petrochemical plant and trading restrictions were enforced on other products to assist selected industrialists. All of this suggested that the government would not allow some of the leading conglomerates or banks to fail. As Krugman recently observed, when government actions suggest that there is an explicit guarantee against either bank or corporate failures, such implicit guarantees can trigger asset price inflation and make the financial system vulnerable to collapse.[11] In other words, lenders made funds available at rates that did not adequately reflect risk, encouraging an excessive expansion of low rate of return activities.

And *third*, although Indonesia did not peg its exchange rate, as did some other Asian countries, it did rely on a *managed float* that was contained within a relatively narrow band. Borrowers were led to believe that the expected losses from currency depreciation would be less than the cost of hedging foreign borrowings. For many years this proved to be correct. The consequent mispricing of foreign credits, combined with the increased supply of funds in the global financial markets, contributed to very large capital inflows and created vulnerability for firms with substantial foreign exchange exposure. When we were forced to abandon our managed float, the depreciation of the rupiah created unmanageable debt burdens that effectively bankrupted a substantial portion of our corporations.

Some analysts have argued that the reforms that powered the economy during its period of high growth ran out of steam by the 1990s. As result the initial reforms were never carried through to their logical conclusion. A strong case can be made that the reform process slowed down, although it

would be difficult to measure this. Those who hold that "reform fatigue" set in by the early 1990s suggest that this was due to two factors; on the one hand, already entrenched capitalists saw the early reforms as opening up further opportunities for financial gain. On the other, vested interest groups considered further reforms, such as removing the ban on log exports or eliminating the wheat import monopoly, as more serious threats to their economic survival.[12] By the early 1990s, the economy was in a period of rapid growth and thus it became increasingly difficult to persuade the political power base that without further reforms, growth would not be sustainable. In the Indonesian political context, reforms were not possible without strong and consistent support from the highest authorities. Such support, which had been crucial in the early stages of reform, now faded and with it the prospects of further reforms.

The IMF-sponsored programmes to resuscitate the economy now call for a substantial number of structural reforms. Some have criticised these structural reforms as beyond the normal scope of any adjustment programme and beyond the ken of IMF economists.[13] In part this criticism is a misreading of history. As far back as 1979, the IMF "...began to condition its lending to a greater extent than before on market-oriented reforms".[14] Nevertheless it is the *extent* and *scope* rather than the mere presence of structural reforms in the Indonesian programmes that are perhaps open to criticism. To what extent are such criticisms justified and to what extent are these reforms vital to Indonesia's economic recovery?

It is probably useful to classify the reforms into three groups; (i) those reforms that were needed as a signal to the market that "business as usual" was coming to an end; (ii) structural reforms generally recognised as essential if Indonesia is to become reintegrated into the global economy and regain access to private capital flows; (iii) reforms that go to the heart of Indonesia's socio-economic structures. Within each of these categories one can make further distinctions and undoubtedly some reforms are not so easily categorised. Nevertheless we can use this broad classification scheme as a rough analytic framework.

Among the reforms that were marginal in terms of their economic impact, but important in terms of their political and social ramifications, one would probably include the abolition of the clove marketing board, elimination of the garlic monopoly, and the removal of special privileges given to the "national car".[15] While cloves are an important agricultural crop in parts of Indonesia and an important input into local cigarettes, one can question whether any investor or hedge fund manager was unduly concerned about Indonesia's clove monopoly. Much the same is probably true for garlic. The issue of the "national car" is a bit more complex. But here, too, the total impact on foreign investment or trade that resulted from the duty and tax exemptions given to this project was likely to be small. Yet in an important way each of these reforms, and others that fall into the same category, were significant. They provided a clear signal to the market that the government was willing, albeit under pressure from the IMF, to tackle the issue of nepotism, cronyism and corruption.[16] After the first standby agreement had been concluded, the markets expressed concern about the government's real commitment to reform, this well before the government began to vacillate on the issues such as the closure of the sixteen banks, or the resumption of previously postponed projects. This feeling that the government was not seriously committed to tackling the economic problems was strengthened by the failure of the government to address some of these relatively unimportant monopolies which had apparently become an important signal of reform credibility. And credibility is of overwhelming importance in any effort to stem capital flight.

The second set of reforms is more broadly recognised as being necessary. These reforms are concerned with "getting the institutions right".[17] Here, one would include such items as the

restructuring of the banking system and reformulating the budget so that the "off-budget" expenditures and revenues are fully accounted for. Other measures recognised as necessary would be improving Bank Indonesia's operations, and ensuring that the privatisation of state enterprises was carried out in a transparent manner. In addition, the IMF insisted on further reductions in both tariff and non-tariff barriers and an end to various trading monopolies, including the important restrictions on log exports.

Most of these reform measures carried forward the deregulation programme begun in the mid-1980s. One may question the speed with which the IMF insisted on carrying out these reforms, some of which would be difficult to implement quickly, and one may quibble about some of the measures, but few would argue about their overall importance.

Indeed the issue of how quickly to implement reforms is not easily settled. Economic conditions may not allow policy makers much leeway in deciding on the pace of reforms; the answer to the question of what is the optimal speed for supporting a collapsing banking structure is simple – as fast as technically possible. Yet other reform measures should probably be pursued more slowly. Privatisation is a case in point. Here, as in some other areas, there is a need to first develop an institutional capacity that can support the reform effort. Yet one should not forget that delays in carrying out reforms, especially those involving fairly substantial changes, might allow opposition to the reforms to emerge.[18] For a reform process to succeed it must be shown to create benefits for a substantial portion of society and must be carried out before opposition to the reforms can be mounted. This was certainly the case with the trade reforms in Indonesia, which generated support among industrialists and even workers who benefited from the development of export industries, but which were eventually slowed down because vested interest found ways of blocking further reforms. And it is also true of the reform measures which led to the abolition of the clove monopoly; higher incomes for clove farmers were rapidly created, making it difficult for anyone to reintroduce the clove monopoly in the future.

One could argue that a necessary, though not sufficient, condition for support to emerge before vested interests can regroup, is that the reforms be carried out rapidly in order to yield benefits quickly. Rapid implementation of reforms whose benefits will only become apparent after some time will, in all likelihood, lead to a feeling that the reform measure created only costs with no commensurate benefits. In the final analysis the rapidity with which the reforms are implemented in Indonesia will depend on their complexity and the political support they can generate. And as time passes and the economy appears to be reaching an equilibrium, the pressure to "do something" to stop the economic slide will fade. However, despite outside pressure, a measured reform effort may, in the longer term, be as effective as a rush to quickly reform all aspects of the economy.

Finally, there are the structural reforms that deal with the core issues of how an economy, and indeed a society, structures itself. Such reforms are important but their effective implementation requires careful preparation because the success of such measures depends critically on the development of a supporting political and social infrastructure. Consider for example the establishment of an independent central bank; there is some evidence that such a move is desirable in terms of lower inflation and better exchange rate management, but the issue is far from settled.[19] For regardless of the presumed benefits of central bank independence, one should ensure that such a move has social consensus on what is important in monetary policy. In Germany there is, or least was until recently, a strong commitment to keeping inflation low, and a strong, independent central bank was seen as a guarantor of this outcome. However, other societies view the role of monetary policy differently and are willing to allow for a trade-off between, say, inflation and economic expansion. It

is unclear whether Indonesia has established a consensus on monetary policy that would support a strong and truly independent central bank. For central bank independence to lead to lower inflation and better monetary policy, the governor of the bank must be free to operate within agreed-upon guidelines, independent of the Minister of Finance, the legislature, or the executive. And it should be noted that increased central bank independence is neither a necessary nor a sufficient condition for low inflation. Instead, central bank independence must be combined with consistent anti-inflationary fiscal policies. If there is a lack of co-ordination between the central bank, the Ministry of Finance, and the legislature, the central bank will not be able to maintain credibility in its implementation of monetary policy. On balance it is far from clear that such a high degree of central bank independence is compatible with the current Indonesian view on government structure and responsibilities.

Much the same can be said about the target to adopt various legal measures, including competition laws and reforms of the bankruptcy law. While the latter law may be an essential input into corporate debt restructuring, the rapid move to adopt some form of competition law is more difficult to justify. Here again there must be some social consensus on what role competition should play in society. Some societies are strong in their belief that competition will bring about a reasonably optimal distribution of economic benefits. Other societies, and perhaps this includes Indonesia, are less convinced of the efficacy of the competitive model and hence are much more tolerant of anti-competitive behaviour. While it is easy to decry the role of the "conglomerates" in the Indonesian economy it is less easy to reach consensus on the degree to which competition should be the basis for Indonesia's economic life.

It is also important to remember that before laws can be effective and assist economic development, there must be a legal structure to support them. A recent review of the issue of legal reforms and economic development noted that "...if the law's administrative infrastructure is sufficiently weak, even good rules may be simply ignored".[20] It is probably fair to conclude that effective legal reform depends ultimately upon developing a competent judicial system and that inevitably takes time. None of this should suggest that moving forward on these issues is not important. It most assuredly is. But the issue is one of timing and of appropriateness.

Finally, let me briefly discuss three structural reforms that seem to have been neglected in the current reform efforts.

First, and high on the list of importance, is much needed civil service reform. Much of the current civil service structure, and indeed of the government structure itself, still reflects an earlier development state when it was assumed that a strong, centrally-planned economy was necessary for economic growth. Indonesia has moved away from this model, as has most of the world, but our bureaucratic structures still do not reflect this change. And, as Haggard and Webb note, "Developing a bureaucratic apparatus that is reasonably well insulated from corruption and political power typically requires more than short-term reform efforts. Socialisation to professional norms and institutional reforms are usually long-term processes".[21] This is all the more reason to use the current reform movement to begin this longer-term process.

Second, a similar argument can be made for educational reform. While Indonesia made tremendous strides forward in raising literacy and school enrolment rates, progress on improving the quality of education to reflect the skills needed by a modern society have been allowed to lag. Again this is a long-term reform process but one that is neglected at a very high future cost.

Third, there is a need to consider the issue of regional decentralisation and fiscal responsibility. For various reasons, economic and political power have become highly centralised in Indonesia. This must change not only to capture the economic benefits of decentralised decision-making but also to reduce political tensions between the economic and political centre and the provinces. Even though there is a growing recognition that decentralisation is needed there is as yet no decentralisation programme. Decentralisation of expenditures can only be undertaken when systems are in place to ensure accountability. Developing accountability at the local level is important if the benefits of decentralisation are to materialise.

These reforms are not part of the current agenda, but that is perhaps as it should be. There is a potential danger in entrusting such reform measures to multilateral institutions whose traditional focus is on economic factors and whose country expertise may be insufficient to deal with more complex issues. This is probably most true of the IMF, whose involvement with any specific country is usually precipitated by an economic crisis, and often short-lived. But Peter Murrell recently pointed out that this same phenomenon is also true of multilateral institutions such as the World Bank and the regional development banks, whose involvement with client countries generally extends over a longer time frame. He writes that:

> "The World Bank undertakes most of its transactions with individual countries that have enormously different histories, politics, cultures, economic structures, and economic problems. Yet the Bank's organizational philosophy gives no emphasis to the notion of a country expert. Indeed, the organizational structure of the Bank denigrates those involved with one country for too long. This culture undoubtedly reflects legitimate concerns about the risks of staff becoming too deeply engaged with a country whose policies they must evaluate dispassionately. [Only] if legal centralism and neoclassical economics are the prevailing philosophies, specialized knowledge of a country is almost irrelevant".[22]

There should be little doubt that much of the structural reform programme now in place in Indonesia is important. Indeed, many of these reforms follow on and complete the deregulation policies that were successfully implemented in the past. The ability to once again move forward on economic deregulation and restructuring was certainly helped by the onset of the Asian crisis. Indeed it is sometimes argued that "bad times make for good policies" but in fact the reality of reform is more complex. A crisis is no guarantee that the remedial actions taken will be sustained or institutionalised. What is sure is that as the crisis winds down, the urgency of reform lessens and the political resistance revives. This confronts any reforming government with a difficult choice; it can move rapidly to adopt changes and risk the possibility of making serious policy errors, or it can move more slowly and see support for structural reforms fade. What is needed is a strong sense of those reforms that are urgently needed if the economy is to regain its economic footing, compared to those reforms that are important but will contribute little in the short run. Finally, and of equal importance, there are reform measures that take time to be developed but that are necessary for long-term growth. Such reforms are easily overlooked in times of crisis, when there are so many urgent tasks at hand, and are easily postponed when growth resumes since they do not seem vital in the short run. Yet neglecting these reforms will weaken the prospects for achieving sustainable growth.

NOTES

1 Jason Furman and Joseph Stiglitz, "Economic Crisis: Evidence and Insights from Asia", Draft paper prepared for the Brookings Panel on Economic Activity, Washington DC, 3-4 September, 1998.

2 For example, the most recent national accounts data for Indonesia suggest that real per capita incomes will decline by 15.1% in 1998 while the 1998 ILO country report (*Employment Challenges of the Indonesian Economic Crisis)* estimates that unemployment will rise from 4.7% in 1997 to 7.2% by mid-1998.

3 Jeffrey D. Sachs and Steve Radelet are among the more vocal critics. They have been particularly critical of the IMF's insistence, in the first standby agreement, that Indonesia abruptly shut sixteen banks. In their view this step, undertaken without having created an adequate safety net, merely served to set off a full blown financial crisis. Cf. Jeffrey D. Sachs and Steve Radelet, "The Onset of the East Asian Financial Crisis", *Development Discussion Papers*, Harvard Institute for International Development, Cambridge, MA (1998). But other analysts have also castigated the IMF policies as inappropriate, overly harsh, and not sufficiently focused on the underlying problems.

4 Stanley Fischer, "In Defense of the IMF", *Foreign Affairs* (July/August 1998).

5 Martin Feldstein, "Refocusing the IMF", *Foreign Affairs.* (March/April 1998

6 Tariff changes announced on 18 September, 1997.

7 The Indonesian financial sector reforms are fully described in David C. Cole and Betty F. Slade, *Building a Modern Financial System. The Indonesian Experience*. Cambridge, UK: Cambridge University Press (1996).

8 Furman and Stiglitz, *op cit*, p. 47. This is perhaps less surprising than it may seem. Perceptions about corruption are undoubtedly biased depending on whether an economy is booming, as was Indonesia until mid-1997, or growing slowly, as was Indonesia in the early 1980s. In a slow growing economy it is easy to suggest that all problems result from corruption; in a rapidly growing economy it is just as easy to forget the prevalence of corruption.

9 See for example, "Asia's Financial Crisis: Lesson and Policy Responses". Ramon Moreno, Gloria Pasadilla, and Eli Remolona. *Working Paper PB98-02*, Economic Research Department, Federal Reserve Bank of San Francisco (July 1998).

10 See for example Jeffrey D. Sachs and Steven Radelet, "The Onset of the East Asian Financial Crisis". *HIID Development Discussion Paper* (March 1998). If the argument is correct than it follows that providing liquidity support to the banks that faced a bank run would have stemmed the crisis.

11 Paul Krugman, "What Happened to Asia?", Unpublished research paper (January 1998).

12 Analysis of the wheat monopoly showed its costs to the economy but efforts to deal with the problem were repeatedly frustrated.

13 See for example the criticisms of the IMF programs in the World Bank's *Global Economic Prospects* (Washington, DC, 11 December, 1998).

14 Jean Waelbroeck. "Half a Century of Development Economics: A Review Based on the Handbook of Development Economics", *The World Bank Economic Review* (Vol. 12, No. 2) May 1998, p. 341.

15 See for example Robinson and Rosser for a thorough review of the various IMF reform measures and their impact on the social and political elites. Richard Robinson and Andrew Rosser. "Contesting Reform: Indonesia's New Order and the IMF", *World Development*, Vol. 26, No.8 (1998) pp. 1593 – 1609.

16 Robinson and Rosser *op. cit*. note that in the first IMF agreement of 31October, 1997 the IMF "...was unable to persuade the Indonesian government to abolish either the national car project or the clove monopoly" (p. 1600). On the issue of the national car, the only concession made was that the government would abide by any forthcoming WTO decision on the national car project.

17 This term seems to have been used first by Oliver E. Williamson in "The Institutions and Governance of Economic Development and Reform", *Proceedings of the World Bank Annual Conference on Development Economics* (1994) pp.171 – 197.

18 These issues are more fully discussed in Stephan Haggard and Steven B. Webb, "What Do We Know About the Political Economy of Economic Policy Reform?", *The World Bank Research Observer* (Vol. 8, No. 2) July 1993, pp. 143 – 168.

19 There is a vast, and rapidly growing, literature on the presumed benefits of central bank independence. For example, Alberto Alesina and Lawrence H. Summers, "Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence", *Journal of Money, Credit and Banking*, Vol. 25, No. 2 (May 1993) pp. 151 – 162, argue that central bank independence leads to lower inflation and higher growth. But Alex Cukierman, Steven Webb, and Bilin Neyapti, "Measuring the Independence of Central Banks and Its Effect on Policy Outcomes", *World Bank Economic Review* Vol. 6, No. 1 (1992) pp. 353 – 398, reach a different conclusion. They find little evidence that the purported relationship between central bank independence and lower inflation holds for developing countries.

20 Richard A. Posner, "Creating a Legal Framework for Economic Development", *Research Observer* (Vol. 13, No. 1) February 1998, pp. 1 – 13.

21 Haggard and Webb, *op cit*, p. 153.

22 Peter Murrell. "Comment on 'The Institutions and Governance of Economic Development and Reform,' by Oliver Williamson", *Proceedings of the World Bank Annual Conference on Development Economics* (1994), p.204.

4.2 MALAYSIA: RESPONDING TO THE ECONOMIC CRISIS

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The speed and severity of the contagion effects of the East Asian financial crisis caught many by surprise. The flotation of the baht on 2 July, 1997 set off corresponding depreciations in the currencies in the ASEAN region before moving northwards to Korea. The currency crisis led to the collapse of the stock market and asset prices, as the countries were drawn into the whirlpool of business failures and economic devastation. The crisis has demonstrated how closely the currency and stock markets in the region are interlinked and how the political and economic circumstances of neighbouring countries affect one another.

At the start of the Asian crisis, many analysts thought that it would probably ebb away rather quickly in the manner of the Mexican financial crisis of 1995. The US president, Bill Clinton, was certainly not alone when four months into the crisis he dismissed the Asian financial crisis as 'a few small glitches in the road'. This has turned out to be a gross underestimation of the virulent Asian flu that not only overwhelmed the Asia-Pacific region, but is now threatening to engulf the world.

In his article, "Saving Asia: It's Time to Get Radical", Krugman[1] noted that the current Asian crisis is even more devastating than the early years of the Depression or even the tequila crisis of Latin America in 1995. In the first quarter of 1998, Hong Kong's economy shrank by 2.8% and the Korean economy contracted by 5%. The Malaysian economy contracted by 2.8% in the first quarter of 1998 and 6.8% in the second quarter. According to some estimations, Thailand's GDP will contract by 7%, while Indonesia's economy will shrink by 15% this year. The Monetary Authority of Hong Kong had to fight hard to avert speculative attacks on the Hong Kong dollar, and there were looming fears that China might devalue the yuan.

From Asia, the financial crisis spread to other countries, which faced currency crises of varying severity. The reverberations of the Asian financial crisis affected countries such as Chile, Argentina, Mexico, Brazil, South Africa, Australia and Canada. Up to October 1998, the world witnessed the devaluations of the South African rand, Indian rupee, Canadian dollar and Chilean and Mexican pesos, and the dramatic devaluation of the Russian rouble which came with the *de facto* default on some US$40 billion of government debt. The latest twist to the financial crisis was the fall of Long-Term Capital Management and the bailout that ensued, which raised disturbing questions about the health of the world's leading banks.

Exposure to the Asian crisis

Before the crisis, the Malaysian economy bore many favourable features. It enjoyed high GDP growth averaging 8-9% per annum, as well as low inflation and unemployment. For five successive years before the crisis, the country posted budget surpluses. Public debt was brought down through

pre-payments and external debts were well managed, with relatively low short-term debt obligations. At June 1997, Malaysia had a relatively low external debt amounting to 42 % of GDP and at end 1996 the debt-service ratio was low, at 6.1 % of exports. The main agent for economic growth was the private sector, while the government concentrated its efforts on creating favourable conditions for the prospering of businesses.

The banking sector was healthy, with non-performing loans (NPLs) at only 3.6% of total loans at June 1997. The nation's saving rate was and still is one of the highest in the world at 38.5% in 1996. The current account deficit was around 5% of Gross National Product (GNP) in 1996. Although the external current account deficit was high at the time of the crisis, this was the result of high investment rather than consumption. In contrast to the other crisis-hit countries in the region, foreign direct investments (FDIs) rather than short-term inflows dominated the capital inflows into Malaysia. After providing for cyclical adjustment for FDI cover, the current account imbalance has not been found to be excessive.

Despite these favourable features, there were some disturbing signs leading up to the crisis. Economic growth was above potential output and there were signs of decreasing efficiency in the economy. There was also excessive credit expansion to the non-tradable sectors, especially property and purchase of stocks and shares, which averaged around 30% per annum.

Malaysia was not spared the contagion that led to the collapse of confidence and the withdrawal of capital from the region. The sudden reversal of capital inflow brought in its wake currency and stockmarket crises. From a bustling, dynamic economy that was growing annually at 8-9% in real terms, Malaysia faced a severe economic contraction, the first in thirteen years.

Malaysia's financial crisis first started with the depreciation of the ringgit following its flotation barely two weeks after the flotation of the Thai baht. On 14 July, 1997, the ringgit was allowed to depreciate to RM2.61 to US$1 and slipped gradually to RM3.00 on 2 September. As regional prospects worsened, and with the collapse of the rupiah upon the calling into question of Indonesian President Suharto's health, the ringgit fell to an intraday low of RM4.88 on 7 January, 1998. The ringgit recovered with the regional stock market rally after the Chinese New Year/Hari Raya Puasa holidays in February 1998. Following poor local corporate performance and negative developments in Japan, the ringgit again weakened, reaching RM4.16 on 8 July 1998.

The turbulence at the Kuala Lumpur Stock Exchange (KLSE) was closely tied to the ringgit depreciation. Although the KLSE started declining in the early part of 1997, the fall started in earnest with the depreciation of the ringgit. The series of measures adopted in August 1997 failed to stop market panic. From the high of 1,271 on 25 February, 1997, the KLSE composite index (KLCI) plunged to 477 points on 12 January, 1998. The market recovered briefly in March 1998 before declining again starting from 2 April, 1998.

Malaysia was badly hurt by the financial crisis for the following reasons: first, it has a highly open economy, where the share of foreign trade in GDP is more than 170%. Second, contagion effects contributed to the fall in asset prices, exchange rate deterioration, and collapse of confidence. The ringgit shrank by 40% against the US dollar (see Figure 1, page 226). The Kuala Lumpur Composite Index (KLCI) fell by two-thirds from February 1997. Over RM600 billion of market capitalisation was lost on KLSE, equivalent to twice the size of GNP. Third, there is a large outstanding stock of private domestic debt relative to GDP.

Effects of the crisis

The fall in the exchange rate and collapse in the stock market hit businesses hard. The financial system was affected by increasing business failures, while the size of Malaysia's foreign debt obligations, although smaller than the other crisis-hit Asian countries, was inflated. The ringgit depreciation helped to improve the current account balance as exports grew faster than imports. The growth in exports was largely from non-resource based manufacturing industries, which contributed 80% of total exports. However for some firms, there seemed to be capacity constraints on the expansion of production, and many of the exports had high import content.

As for primary commodities, the ringgit depreciation benefited palm oil producers, but had little effect on the rubber producers because rubber prices were quoted in ringgit. The sectors heavily dependent on imported machinery and materials were worst hit by the currency depreciation. Consumer and producer prices had risen, and so had the value of external debt exposure.

The weakened, unstable ringgit resulted in the following:

- Higher domestic prices due to rising costs of imported intermediate goods;
- Higher value of external debt exposure;
- Depressed domestic private investment;
- Worsened economic growth prospects.

Policy response

Early on, Malaysia adopted a series of policy measures to deal with the financial crisis and stabilise the economy. In October 1997 and December 1997, the government announced policy measures to reduce the current account deficit, strengthen the balance of payments and fiscal account, improve competitiveness, and increase monetary and financial stability. Although Malaysia did not turn to the IMF for financial assistance, some of the policies to restore market confidence and arrest the slide of the ringgit were developed with advisory input from the IMF and the World Bank.

The 1998 Budget announced on 17 October 1997 encompassed the following measures:

1. Reduction of Federal Government expenditure by 2%, deferment of mega projects, and review of public agencies' purchases of foreign goods.
2. On the financial aspect, prudential standards were strengthened with the classification of non-performing loans in arrears from six to three months, greater financial disclosure by banking institutions, and increasing general provision to 1.5%.
3. The Credit Plan was introduced to limit overall credit growth to 25% by end-1997 and 15% by end-1998. In providing loans, banking institutions were to give priority to productive and export-oriented activities.

On 5 December 1997, the government announced an additional policy package, for regional instability had proved to be more protracted than earlier anticipated. These policy measures were

aimed at strengthening economic stability and instilling confidence in the financial system. There were concerns about the large current account deficit and high private sector debt amounting to 169% of GDP in 1997. Hence, there was the need to prudently manage public sector finances while curbing excesses in the private sector. The policies were as follows:

1. Reduce the current account deficit to 3% of GNP in 1998.

2. Trim Federal Government expenditure by 18% in 1998.

3. Stricter criteria for approvals of new reverse investment, and deferral of the implementation of non-strategic and non-essential projects.

4. More emphasis placed on good corporate governance.

5. Enhanced disclosure of information of corporations and closer scrutiny for corporate restructuring.

These measures were followed by further policy announcements in February and March 1998. The measures adopted in February 1998 included raising Bank Negara Malaysia's three-month intervention rate from 10% to 11%, and reducing the statutory reserve requirement (SRR) by 3.5% of eligible liabilities to 10%.

On 24-25 March 1998, the government adopted pre-emptive measures to counter emerging financial problems by making it necessary for banks to shore up their capital-adequacy positions at the first sign of trouble. Structural reforms undertaken in the financial sector included more transparency and disclosure for banks and companies. Although government expenditure was reduced by 18%, Malaysia accepted a RM1 billion loan from the World Bank for social and poverty-related projects. The main measures adopted were as follows:

1. Bring loan classification standards (including three months for non-performing loans) up to those of best practice.

2. Require 20% provisioning against the uncollateralised portion of substandard loans.

3. Increase minimum risk-weighted capital ratio (RWCR) of finance companies from 8% to 10% with interim compliance of 9 %.

4. Increase minimum capital funds of finance companies from RM5 million to RM300 million and subsequently to RM600 million.

5. Expand capital adequacy framework to incorporate market risk.

6. Reduce single customer limit from 30% to 25% of capital funds.

7. More intensive and rigorous supervision including conducting monthly stress tests on individual banking institutions.

8. Aggregate statistics on non-performing loans (NPL), provisions and capital position of commercial banks, finance companies and merchant banks. Financial institutions are to

report and publish key indicators of financial soundness, such as NPL, capital adequacy etc., both at bank level and on consolidated basis.

Preparation of the National Economic Recovery Plan

Once it became clear that the regional crisis was deeper and more serious than earlier anticipated, and that Malaysia was rapidly sinking into a recession, the government established, on 7 January 1998, the National Economic Action Council (NEAC) as a consultative body to Cabinet to deal with the economic problems. The purpose of the NEAC is to make recommendations to the government on how to restore the economy and prevent it from sliding into recession.

After having assessed Malaysia's unique situation, the NEAC prepared a comprehensive National Economic Recovery Plan (NERP). This plan was drawn up after extensive consultation with many people representing federal and state government leaders, senior and retired government officials, industry heads and representatives, trade unions, professional associations, media, women's organisations, non-governmental organisations, and multilateral agencies such as the World Bank and IMF.

The NERP presented a framework for action to counter the negative effects of the ringgit depreciation and stock market collapse, and recommended wide-ranging proposals for economic stabilisation and structural reform. This Recovery Plan comprises six objectives, 40 lines of actions, and over 580 recommendations.

As its starting point, the Recovery Plan takes stock of the country's financial and real economic sectors in order find new ways to strengthen them, and thus attempt to rectify systemic weaknesses that hampered growth prospects. There are six objectives in the Recovery Plan (see Box 1 overleaf):

1. Stabilising the ringgit;
2. Restoring market confidence;
3. Maintaining financial stability;
4. Strengthening economic fundamentals;
5. Continuing the equity and socio-economic agenda;
6. Revitalising adversely affected sectors.

Box 1. **Plan For Action**

Objective 1: **Stabilising The Ringgit**
Appropriate choice of exchange rate regime
Encourage the usage of local currencies
Increase external reserves
Adopt a balanced interest rate policy

Objective 2: **Restoring Market Confidence**
Improve transparency and regulatory environment
Establish rules for assisting industries and companies
Increase consistency of policies
Adopt liberal and market-based policies
Improve public relations
Improve the dissemination of economic information

Objective 3: **Maintaining Financial Market Stability**
Preserve the integrity of the banking system
Establish agencies along the lines of FDIC/RTC
Recapitalise the banking sector
Monitor closely overall credit expansion
Improve the capital market
Develop the PDS market

Objective 4: **Strengthening Economic Fundamentals**
Increase the quality of investments
Improve the balance of payments
Maintain a balanced public sector financial position
Maintain an appropriate monetary policy
Maintain price stability
Increase labour competitiveness

Objective 5: **Continuing The Equity And Socio-Economic Agenda**
Alleviate the hardship from poverty
Address the issues on Bumiputera equity ownership
Expand employment opportunities
Expand tertiary education
Address the problem of graduate unemployment
Control the influx of foreign workers
Gear up state corporations to face the crisis
Revamp co-operatives and co-operative banks
Protect environment for sustainable development

Objective 6: **Revitalising Affected Sectors**
Resource-based industries:
Mining and petroleum
Manufacturing
Information technology
Motor industry
Construction
Property
Infrastructure
Transportation
Freight forwarding
Tourism
Industrial development finance institutions
Insurance and reinsurance

Source: National Economic Recovery Plan: Agenda For Action

Let me examine these objectives in further detail.

Objective 1: Stabilising the ringgit

A volatile ringgit makes business planning and investment decisions difficult, and is a major dampening factor on the stock market. Business and individuals will have to hedge against future ringgit movements to reduce risk, while foreign investors withdraw from the stock market for fear of losses due to falling stock prices and foreign exchange. To strengthen the ringgit, the following lines of actions are proposed:

1. *Appropriate choice of exchange rate regime.* Under the first line of action, the Plan recommends an exchange rate regime that provides flexibility but reduces volatility. The measures outlined include the following:

- It may be necessary for the ringgit to move within an exchange rate band against a trade-weighted basket of currencies that is reviewed regularly;

- There should also be an early warning system that identifies well ahead of time negative developments on the financial and currency markets;

- On the international front, the country should work towards obtaining international agreement on more transparency and greater disclosure in the operation of investment funds, as well as stronger international surveillance for an orderly international monetary system.

2. *Encourage the usage of local currencies.* Malaysia's exports should increasingly be quoted in the currency of the country concerned, in line with the Bilateral Payment Agreements with other countries. In addition, the mechanics for bilateral and multilateral payment arrangements for trade among ASEAN countries should be worked out quickly.

3. *Increase external reserves.* The Recovery Plan proposes that Malaysia should aim to increase external reserves equivalent to at least five months of retained imports, which will help to build confidence in the ringgit. Reserves are normally accumulated from a healthy balance of payments and positive current account position. There are also other measures to increase the reserves, including urging Malaysian individuals and corporations to sell off part of their assets overseas, reducing or temporarily suspending reverse investment, and using loans or issuing bonds to augment the reserves.

4. *Adopt a balanced interest rate policy.* The reduced fiscal spending and tight monetary policies adopted during the early stage of the crisis were appropriate in response to the high current account deficit, depreciating ringgit, and asset inflation. Once the ringgit stabilises, there is more scope to reduce interest rates. High interest rates are damaging for business and would not necessarily attract inflows of funds. The nominal interest rates should be kept above the inflation rate for real interest to be positive and for savers to receive a positive return for their deposits so that funds do not go offshore in search of higher returns.

Objective 2: Restoring market confidence

The loss of confidence has prolonged the currency crisis. Accordingly, restoring market confidence is an important step towards stabilising and strengthening the currency. Confidence can be affected by many factors, including the resilience of the financial sector. Market confidence is also related to stabilising the ringgit, which is undervalued in times of low confidence.

With the objective of shoring up confidence, the Recovery Plan proposes six lines of action, which include improving the regulatory environment, and the transparency and consistency of government policies. In addition, there are recommendations on improving public relations and the news media, and the dissemination of economic information. The recommended lines of actions are as follows.

1. *Improve transparency and the regulatory environment.* Transparency means 'letting the public know' and allowing various parties to make informed investment decisions.

There should be more frequent release of economic data and stronger enforcement by regulatory authorities, such as the Securities Commission (SC) and KLSE. The campaign against corruption should continue, and Malaysia should be committed to an excellent regulatory environment.

2. *Establish rules for assisting industries and companies in trouble.* The Malaysian government recognises that some industries and corporations of national and strategic importance require assistance. Some industries recently invested heavily in facilities and equipment, manpower and technology as part of their long-term development plan. The Recovery Plan outlines the rules regarding assistance to ailing industries, based on criteria such as national interest, strategic interest, and equity considerations under the New Economic Policy (NEP) and the National Development Policy (NDP):

   – Industries and business activities in the national interest are those that provide benefits to a wide cross-section of the population and help raise their living standard. Strategic industries and businesses include those that contribute to the growth of a specific sector or/and provide important support for other industries and businesses. An example of such an industry is the national car project.

   – There should be no bailout of individual investors or lenders using public funds, except for industries and corporations in key, strategic sectors of national interest.

   – In a rescue involving public funds, private investors and lenders must also 'tighten their belts'.

3. *Increase the consistency of government policies.* There was the perception that there were too many conflicting policy statements and rapid changes of policy directions during the crisis, which made matters worse rather than better. In order to increase the consistency of government policies, the Recovery Plan proposes the following.

   – Have proper consultation with interested parties before formulating and making public announcements;

   – Announcements should be properly co-ordinated and accompanied with more detailed and realistic guidelines;

   – There should also be regular meetings between agencies (such as Bank Negara Malaysia, the Ministry of Finance, Securities Commission, and Kuala Lumpur Stock Exchange) and with foreign fund managers.

4. *Adopt liberal market-based policies.* Measures include limiting price control to essential goods and for a limited period only, as well as liberalising the foreign ownership of property; provided they are funded from a foreign source, foreigners can now acquire landed property with value exceeding RM250,000.

5. *Improve public relations* in order to enhance the image of the country both domestically and overseas. There should be adequate notice for any change in rules and regulations in KLSE.

6. *Improve the dissemination of economic information.* There is a need for key agencies to publish reliable and timely economic statistics at regular intervals. In addition, the Statistics Act, 1965, should be reviewed taking into consideration the present situation and future trend of the economy.

Objective 3: Maintaining financial market stability

Financial market stability is the linchpin of an economy. A crumbling financial system can cause widespread panic and very quickly lead to the collapse of an entire economy. For this reason, the Recovery Plan places special and urgent attention to addressing the weaknesses of Malaysia's financial system. These have arisen from rapid credit growth and high exposure to property and stock markets, high leverage with large short-term domestic debt, and increasing non-performing loans.

Based on the three-month NPL classification, non-performing loans as a percentage of total loans had risen from 3.6% at the start of the crisis in July 1997 to around 12% in September 1998. The size of NPLs is expected to increase to 16% end 1998 (or RM74 billion) and 20% by end 1999 (or RM100 billion). The NPL position could deteriorate further depending on the speed at which banking woes are addressed.

To maintain financial market stability, the NERP proposes the following lines of action.

1. *Preserve the integrity of the banking system* by closer surveillance of banks and the improvement of non-performing loans (NPLs), encouraging bank mergers, and addressing worsening collateral and non-performing assets.

2. *Establish agencies along the lines of RTC and FDIC.* The Asset Management Company[2] has been formed to take over banks' bad debts, a function performed in the United States by the Resolution Trust Corporation. The establishment of a Federal Deposit Insurance Corporation-type agency would insure deposits and maintain public confidence in the banking system.

3. *Recapitalise the banking sector*. The recapitalisation of the banking sector should proceed at the same time as efforts to remove NPLs from banks, in order to ensure that the capital adequacy ratio for individual banks does not fall below the minimum 8%.[3] The government should issue RM20 billion worth of long-term bonds and inject these funds into banks.

4. *Closely monitor overall credit expansion* through more flexible implementation of the overall Credit Plan target and developing a bond market for large infrastructure projects. Rigid adherence to the Central Bank lending guidelines and the severe credit crunch had deepened the financial problems of the corporate sector.

5. *Improve the capital market* by strengthening the regulatory framework and addressing the weaknesses of market participants and activities. Among measures proposed are:

   – Strengthening of the regulatory framework; an institution such as the Financial Reporting Foundation should prepare a new framework for corporate governance;

- Market regulators, such as KLSE, SC and Registrar of Companies (ROC), must act firmly and decisively against regulatory breaches;

- KLSE must ensure that the new client asset protection framework is implemented as quickly as possible;

- Consolidate the current stockbroking industry through mergers, take-overs and closures, and make greater efforts to create a vigorous fund management capability in Kuala Lumpur;

- Allow securities borrowing and lending programmes to improve settlement efficiency in the securities market and assist in the development of the derivatives market;

- Consider a circuit-breaker mechanism and expeditiously deal with the abuse of 'put and call' transactions to restore public confidence;

- In the medium-term, address the growing domination of the Central Limit Order Book International Market (CLOB) in order to restore KLSE as the market place for the trading of Malaysian equities.

6. *Developing the private debt securities (PDS) market.* As a result of the fledging private debt securities market, Malaysian corporations became too reliant on bank loans, which are not suitable for the financing of long-term projects. Recommended measures for dealing with this issue include the following:

   - Make the holdings of government bonds and PDS by the commercial and merchant banks exempt from the statutory reserves requirement and liquidity ratio;

   - Commercial and merchant banks should play a more active role in the trading of PDS;

   - Continue to promote PDS among foreign fund managers, who should be allowed to purchase PDS irrespective of their sources of ringgit;

   - Other measures include introducing shelf registration for corporate bonds, increasing institutional participation, facilitating a more active repurchase agreements (REPO) market, reviving the benchmark programme, and reducing the issue approval time for corporate bonds to not more than three months.

Objective 4: Strengthening economic fundamentals

Although Malaysia has generally good economic fundamentals, the Recovery Plan acknowledges that there are many areas that could be improved. Some of the measures proposed to strengthen economic fundamentals include increasing the quality of investments, improving the balance of payments, and maintaining a balanced public sector financial position.

1. *Increase the quality of investments.* From indicators such as total factor productivity (TFP) and incremental capital output ratio (ICOR), it appears that the quality of

investments in the country could be further improved. Streamlining and cost reduction would increase the efficiency of investments. Large-scale investments with high import content should be prioritised since they require a large amount of capital and place the external balance under pressure.

2. *Improve the balance of payments.* In the 1990s, Malaysia's current account remained in deficit. If foreign capital inflows are insufficient to finance the current account deficit, the volume of external reserves will fall. This will raise concern about the long term strength and stability of the economy. The country should continue its efforts to improve the balance of payments by strengthening the merchandise account, reducing the services account deficit, and reducing deficit in transfers.

3. *Maintain a balanced public sector financial position.* The downturn in the economy means that Federal Government revenue would be affected. However, the government should continue making investments in physical and social infrastructure to make up for the slack in private sector activities to reduce the severity of the recession. While the government is in principle committed to maintaining a balanced public sector financial position, an exception would have to be made for 1998[4] where deficit financing of the Federal Government budget is justifiable.

4. *Maintain an appropriate monetary policy.* There was very little credit growth in December 1997 and negative credit growth during January-September 1998. There is a need to maintain an appropriate monetary policy to ensure that credit is available for businesses to continue generating economic activities. This is to avoid unnecessary business failures due to the lack of access to funds.[5]

5. *Maintain price stability.* The government is strongly committed to non-inflationary policies. The ringgit depreciation exposes the country to imported inflation. To control inflation, appropriate monetary policy with stricter enforcement and price checks by relevant authorities are essential to ensure regular supply of goods. There should also be supply enhancement measures and reduction in distribution and marketing costs to ease supply constraints and bottlenecks.

6. *Increase labour competitiveness.* To enhance Malaysia's international competitiveness, wage increases should reflect productivity gains. The current employment laws and wage system, which are not pegged to productivity, restrict the adjustment of wages in relation to operating costs and productivity.

Objective 5: Continuing the equity and socio-economic agenda

The equity and socio-economic agenda addresses the need for a social safety net in order to lessen the pain associated with the financial crisis. The economic contraction has badly affected household income, employment opportunities, and Bumiputera share ownership. As less Malaysians go overseas for studies, there is the need to expand tertiary education to satisfy the surge in local demand. State corporations and co-operatives have to be revamped in order to better focus their activities. The commitment to environment preservation should continue despite the pressures of reduced financial resources in the public and private sectors. The nine lines of actions proposed are as follows:

1. *Ease hardship from poverty.* The incidence of poverty is expected to increase from 6.7% in 1997 to 8.0% in 1998, while the number of poor households is estimated to increase by about 22%. Measures recommended include the following:

   – Retain allocation for the development programme for the hard-core poor, i.e. *Program Pembangunan Rakyat Termiskin*, and the provision of micro-credit assistance to petty traders and hawkers in urban areas;

   – Adopt measures to increase opportunities for employment and self-employment, as well as measures to contain price increases, especially of food items;

2. *Address Bumiputera equity ownership.* The economic crisis has affected the Bumiputera share ownership and Bumiputera businesses particularly badly. Bumiputera students are also affected by the reduction in financial assistance provided by the government. Among the recommended measures are:

   – Clarify the government's rationale for allowing the sale of Bumiputera shares to non-Bumiputera buyers;

   – Study the costs and benefits of utilising public-contributed funds, such as the *Permodalan Nasional Berhad*[6], to assist ailing Bumiputera companies;

   – Continue to send Bumiputera students abroad for selective courses;

   – Reinstate post-graduate studies for civil servants at local universities;

3. *Expand employment opportunities.* The unemployment rate is expected to increase from 2.7% in 1997 to 6.4% in 1998. Proposed responses include:

   – Encouragement of self-employment and of greater investment in export-oriented industries that require highly skilled labour;

   – Malaysian embassies and overseas MATRADE offices advised to assist local consultancy firms to bid for international businesses;

   – Review of the Employment Act to encourage flexibility in employment practices.

4. *Meet the challenge of expanding tertiary education.* There is the challenge of meeting local demand for tertiary education as the cost of overseas education rises dramatically and the number of government grants for overseas studies falls.

   – The development allocation for public tertiary institutions should be restored and there should be greater economy in the provision of physical facilities in tertiary institutions.

   – The franchise arrangements between local public and private institutions should be expanded.

   – The off-campus and distance learning programmes should be more cost effective.

- There should be more flexibility in the recruitment of teaching staff and more emphasis on science and technology for Bumiputera students.

5. *Address graduate unemployment.* Given the slowdown in job creation, graduate unemployment will be a problem.

   - The Ministry of Education should co-ordinate the registration and placement of unemployed graduates.

   - New graduates and their employers could be exempted from contributing to the Employees' Provident Fund.

   - Graduates should be encouraged to participate in small business and apprenticeship schemes, and unemployed graduates should be allowed to seek employment overseas.

6. *Control the influx of foreign workers.* There are about 800,000 illegal workers with 400,000 dependants in the country.

   - Policies regarding foreign workers should be reviewed.

   - Foreign workers who cannot be re-deployed should be repatriated.

   - There should be strict enforcement of the Immigration Act, and foreign labour should be charged market rates for using local education and health facilities.

7. *Gear up state corporations to face the crisis.* State Economic Development Corporations (SEDCs) with over-diversified activities and stock market involvement have been affected by the economic crisis.

   - SEDC and State Agricultural Development Corporation activities should be consolidated. SEDCs should facilitate the release of land for low-income housing and small and medium-scale industrial premises.

   - Suitable state land, reserve land or idle land should be used for food production.

   - SEDCs should facilitate large-scale foreign investment in food production and establish more wholesale markets.

   - They should consider using the Johor Corporation as a model for corporatisation.

8. *Revamp co-operatives and co-operative banks.* Co-operatives should reduce their dependence on share investments, adhere to the basic objectives of the co-operative movement and abide by their charter. They should also play an important role in controlling inflation by establishing mini markets and opening up untended land for vegetable and fruit production.

9. *Protect the environment.* With the cut in funds for enforcement of environment laws, the following issues should be given priority attention: air surveillance of open burning, river pollution by illegal factories, smog, industrial pollution, treatment of toxic waste,

degradation and destruction of water catchment areas, tapping of groundwater, and the disposal of solid waste.

– Detailed recommendations are proposed for administrative, legal and institutional improvements.

– The Recovery Plan contains measures to deal with issues pertaining to water, land, forest, agriculture, and industry.

Objective 6: Revitalising affected sectors

The crisis has had wide ranging implications on sector performance and prospects. Many sectors have been adversely affected by rising costs, falling demand, financing problems, and mounting debts. The industries that initiated expansion programmes in previous years are now faced with excess capacity and underutilised equipment and manpower. The Recovery Plan makes recommendations for the twelve sectors adversely affected by the crisis. It also supports the promotion of IT and the Multimedia Super Corridor (MSC) as the path to the future. The Recovery Plan provides specific measures pertaining to the revival of growth in twelve sectors, as follows:

- Primary commodities and resource-based industries
- Mining and petroleum
- Manufacturing and information technology
- Motor industry
- Construction
- Property
- Infrastructure
- Transport
- Freight forwarding
- Tourism
- Industrial development finance institutions
- Insurance and reinsurance

Further measures

The National Economic Recovery Plan was launched on 23 July, 1998 and its recommendations are in various stages of implementation. They include fiscal injection and easing of monetary policy to arrest economic decline. The government has allocated RM7 billion for social projects and RM5 billion for infrastructure projects to revive economic growth. Being of low-import content, these infrastructure projects are consistent with the overall effort to improve Malaysia's current account position.

Following the NERP recommendations, the government has put in place mechanisms to deal with the financial distress of banks and corporations. Danaharta, the Asset Management Company, was incorporated to acquire non-performing loans from banks. The total funding requirement for this undertaking has been estimated at RM15 billion (US$1 = RM3.80). By end 1998, Danaharta will have acquired RM11.25 billion from 11 financial institutions and removed 22% of non-performing loans. Together with the NPLs of Perwira Affin Bank and Sime Bank, Danaharta would have removed RM18.8 billion or 36% of NPLs of Malaysian banks.

Danamodal, the special-purpose vehicle for bank recapitalisation, was established on 14 July, 1998 with a budget requirement of RM16 billion. Part of its funds will come from the lowering of the statutory reserve requirement by the Central Bank from 8% to 4%. Further, the Corporate Debt Restructuring Committee (CRDC) was established to bring together debtors and creditors of

corporations in distress to provide them with a forum for negotiating amicable solutions. This process resembles the "London Approach", and provides a conducive environment for transparent compromise and reorganisation without recourse to court action.

Capital control

Pre-emptive capital control measures were adopted on 1 September, 1998 to regain monetary independence and insulate the Malaysian economy from further global economic and financial decline. As well as minimising the impact of a possible global crisis, these measures create leeway to concentrate on other, demanding macroeconomic development issues, such as preserving recent gains in the stabilisation of the domestic economy, and fostering an environment conducive to the revival of consumer and investor confidence.

The measures adopted are selective in nature and essentially two-pronged:

1. *Prevent the trading of the Malaysian currency*. Bring the ringgit back and put an end to the offshore ringgit markets that are responsible for ringgit volatility. Individuals and corporations are restricted to taking no more than RM1,000 out of the country. Residents can take up to RM10,000 equivalent in foreign currencies, while non-residents are allowed to bring in any amount of foreign currency and take out the same amount. Malaysians can send out more than RM10,000 for any transaction not related to trade or FDI, provided they obtain prior approval from the Central Bank.

2. *Deter market volatility created by short-term capital flight*. Reduce stock market volatility by imposing a 1-year holding period for ringgit assets owned by non-residents, who must park their funds in external accounts. This deters the volatility in domestic financial markets caused by short-term capital flight, especially for equities.

There is no restriction on the repatriation of dividends, interest, rental, commissions, fees, royalties and profits from the sale of assets in Malaysia. Disbursements or repatriation of external account balances are allowed for expatriates and foreign workers in Malaysia, Malaysians working/studying overseas, non-Malaysian students studying in Malaysia, and companies with Multimedia Super Corridor status.

The new capital control policy is not meant to inhibit foreign direct investment or interfere with the repayment of foreign debt. It is to prevent speculation of the ringgit and manage short-term capital flow, which can be destabilising when suddenly withdrawn. In 1997, Malaysia experienced US$9.5 billion net outflows of portfolio equity investment, which amounted to 10% of its GDP. Sudden outflow of funds can wreak havoc upon the whole economy and is harmful to the corporate sector.

The new exchange control measures will not affect the normal conduct of economic activity, and will continue to guarantee the general convertibility of current account transactions and the free flow of foreign direct investment. The changes are fundamentally aimed at containing speculation on the ringgit and minimising the impact of short-term capital inflows that are considered to be the main source of economic problems we now face. Malaysia is interested in long-term FDI, that brings with it technology, skills and market access, and is wary of 'hot money' that increases the country's vulnerability.

These exchange control measures are not new to the country. They have been used before and were dismantled as soon as they served their purpose. Malaysia remains committed to the market mechanism and to liberalisation. But a free market can only operate in a stable and efficient global financial system. However, the country is also aware of the risks associated with capital control, such as the effect on prices, balance of payments, foreign direct investments, the black market, and transfer pricing, all of which must be monitored and addressed.

Immediate effect of the capital control measures

The fixing of the exchange rate at RM3.80 to US$1 has been generally viewed in a positive light by both traders and investors for it provides a degree of certainty in the foreign exchange markets. With the imposition of exchange control regulations, the Central Bank was able to more aggressively pursue policies aimed at aid economic recovery, such as lowering interest rates, injecting greater liquidity into the banking system and enhancing the intermediation process. The reduction in the statutory reserve requirement and interest rates has resulted in easier liquidity in the banking system, making more loanable funds available to borrowers.

Liquidity has eased due to the repatriation of ringgit deposits kept abroad and sale of ringgit assets by foreigners. In September 1998, deposits in external accounts increased by about RM4 billion and the public deposited RM1.5 billion currency notes back into the banking system. The external reserves of Bank Negara Malaysia increased by US$1.2 billion from end-August level to US$21.4 billion as at end-September 1998, adequate to finance 4 months of retained imports. At 15 October, 1998, external reserves stood at US$22.6 billion.

Sentiment strengthened on the Kuala Lumpur Stock Exchange. All price indices showed improved performance since the implementation of the new exchange measures. From the end of August to 16 October 1998, the Kuala Lumpur Composite Index and the Second Board Index had risen by 39.8% and 31.0% respectively.

The above are some positive developments associated with the capital control measures adopted on 1 September, 1998. However, it is too early to judge the full effect of these measures which will not be apparent until they have run their course. The imposition of selective capital controls may be justified as a short-term measure to insulate the economy against the vagaries of global currency volatility. However, it must be accompanied by close monitoring of economic indicators so that any negative developments arising from these measures can be quickly addressed. Malaysia has a track record of policy pragmatism and is not likely to continue using an instrument that has outlived its usefulness.

Liquidity, interest rates and credit growth

Bank Negara has announced the following measures to increase liquidity, lower interest rates, and encourage credit growth:

- The statutory reserve requirement (SRR) was reduced from 8% to 6% on 1 September, 1998 and again to 4% on 16 September. The lowering of the SRR is estimated to inject RM6-8 billion into the banking system and assist in bank recapitalisation.

- The three-month Bank Negara intervention rate has been eased from over 11% to 8%. This is aimed at increasing liquidity and enabling banks to provide loans to the cash-strapped corporate sector. As a result of the recent moves, Malayan Banking Bhd. is cutting its base lending rate from 10.3% to 8.5%, which is lower than the pre-crisis rate.

- The liquid assets ratio requirement for commercial banks has been reduced from 17% to 15%.

- Banking institutions are to achieve a minimum annual loan growth rate of 8% by the end of 1998.

- Danamodal is to complete the recapitalisation exercise within two to six weeks.

- Lending curbs to the property and construction sector have been relaxed and commercial banks are urged to give top priority in lending to these sectors. This is in an attempt to reverse the dismal performance of the construction sector, which shrank by 21% in the first half of the year. The revival of the construction sector will help to generate ancillary activities in manufacturing and services.

1999 Budget

The Budget for 1999 was announced on 23 October, and followed through the central axes of the NERP. The Malaysian economy is expected to contract by 4.8% in 1998 and recover to +1.0% in 1999. Growth will be underpinned by a recovery in aggregated domestic demand, with fiscal and monetary stimulus to revive the economy, as well as a mild improvement in the external sector. The policy of fiscal stimulation by the Federal Government is a departure from the normal practice of adopting fiscal restraint and tight fiscal management. The trimmer public sector adopted in the past had led to a few good years of budgetary surplus and low public debt.

In the 1999 Budget, the Federal Government is expected to incur a larger budgetary deficit of RM16.6 billion or 6.3% of GNP in 1999, compared with a deficit of RM9.6 billion or 3.6% in 1998. The Federal Government budget deficit will be financed from net external borrowings and domestic borrowings. External borrowings will be from multilateral agencies such as the World Bank and the Asian Development Bank, and from bilateral sources such as Exim Banks of developed countries. The funding of the deficit will be complemented by domestic sources given the high gross national savings in 1999 of RM106.8 billion, or 40.5% of GNP.

Conclusion

There are several downside risk factors of the global economy that will have adverse effects on the Malaysian economy. These are the worsening of the crisis in Russia and Latin America, as well as the possibility of a global recession. In Russia, the devaluation of the rouble has triggered a new phase in the emerging-market crisis. The impact of Russia's implosion has spread to Eastern Europe, South Africa and Latin America. Since the beginning of the Asian crisis, about US$115 billion has quit the five major crisis countries – Korea, Thailand, Indonesia, Malaysia, and the Philippines, which is equivalent to 10% of their GDP. The currency depreciations should generate 'automatic

corrections' and help boost exports from the region. However, despite the growth of export volume, the expansion of exports is not commensurate with the amount of currency depreciation.

One reason for the lack of growth in the ASEAN region is that Japan is in a recession. The Japanese economy is closely tied with the five Asian countries mentioned above because 20% of its exports and 40% of its banking capital have been extended as credit to these countries, which are now hit by recession. In addition, about 15 to 25% of the trade of the five Asian countries is with Japan. A depressed Japanese economy will compound the difficulties of the crisis-hit Asian countries in exporting their way out of recession.

The Malaysian government is aware of these risks. If global demand falls as a result of widespread recession, it will be difficult for the economy to register positive growth for 1999. While the country has taken measures to revive the economy, the recovery of a open economy does not depend on the government's policies alone. The international environment will continue to influence the economy's prospects through exports and investment growth, through foreign direct investment. Of key importance, the restoration of confidence is vital for economic recovery. The support and confidence of the corporate sector will be a crucial factor in bolstering the government's efforts to steer the economy back to growth.

NOTES

1 Paul Krugman, "Saving Asia; It's Time to Get Radical", *Fortune*, 7 September, 1998

2 Pengurusan Danaharta Nasional Berhad

3 Danamodal National Berhad, established for bank recapitalisation, will complement the activities of Danaharta.

4 In response to this recommendation, the Federal Government allocated RM7 billion for social services and agriculture and RM5 billion for infrastructure development.

5 In the effort to increase liquidity in the market, Bank Negara Malaysia reduced the Statutory Reserve Requirement (SRR) for banks and financial institutions from 13.5% to 10% in February 1998 and from 10% to 4% in September 1998.

6 National Equity Corporation

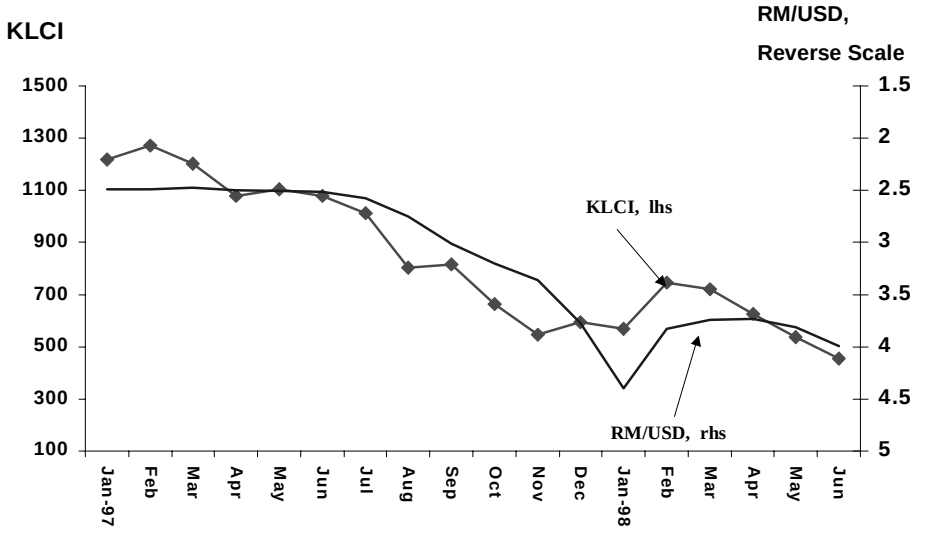
Table 1. **Malaysia: key economic indicators, 1997 - 99**

	1997	1998	1999
Population (million persons)	21.7	22.2	22.7
Labour force (‘000)	9,038.2	9,006.5	9,157.8
Employment (‘000)	8,805.1	9,006.5	8,591.6
Unemployment (‘000)	233.1	8563.3	566.2
Unemployment rate (%)	2.6	4.9	6.2
NATIONAL PRODUCT (% change)			
Real GDP	7.7	-4.8	1.0
(RM billion)	140.7	139.9	135.3
Nominal GNP	9.8	0.4	0.7
(RM billion)	261.1	262.1	264.0
Real GNP	7.8	-5.2	0.9
(RM billion)	132.8	125.9	127.0
Agriculture, forestry and fishery	1.3	-5.9	3.9
Mining and quarrying	1.0	-0.8	1.3
Manufacturing	12.5	-5.8	1.0
Construction	9.5	-19.2	-8.0
Services	8.0	2.1	2.7
Private expenditure [1]			
Consumption	8.1	-5.0	3.7
Investment	11.7	-30.5	3.7
Public expenditure [1]	6.9	-6.2	-6.2
Consumption	7.3	2.3	2.8
Investment	11.9	-0.8	6.1
Gross national savings (% GNP)	39.4	41.9	40.4
PUBLIC SECTOR ACCOUNTS Overall Balance			
Federal Government			
RM billion	6.6	-9.6	-16.1
% to GNP	2.5	-3.7	-6.1
Consolidated Public Sector			
RM billion	15.2	-2.8	-6.5
% to GNP	5.8	-1.1	-2.5
BALANCE OF PAYMENTS (RM bn)			
Merchandise balance	11.3	42.7	33.3
Exports (f.o.b.)	218.7	280.2	281.2
Imports (f.o.b.)	207.3	237.5	247.9
Services account balance	-9.5	-9.7	-9.9
(as % of GNP)	-8.3	-7.4	-7.3
Transfers, net	-3.7	-3.1	-3.0
Current account balance	-14.1	20.0	11.0
(as % of GNP)	-5.4	7.6	4.2
PRICES (% change)			
CPI (1994 = 100)	2.6	5.2	n.a.
PPI (1989 = 100)	1.0	13.5	n.a.

Notes:
1. Excludes stocks

Source: *Economic Report*, 1998/99

Figure 1. **Asset prices and exchange rates, January 1997 - June 1998**



4.3 THE PHILIPPINES: MANAGING STABILISATION AND RECOVERY

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For the last two decades, the Philippines has been the odd man out in the ASEAN region.[1] It is probably the only country that experienced two economic crises in addition to the recent Asian flu – the debt crisis in 1983-85 and the power crisis in 1990-92. Because of the resulting boom-bust pattern of growth of the Philippine economy, it has been dubbed "the sick man of Asia". In contrast, most of its neighbours have posted real GNP growth rates of 7-10% since 1985, which not only led to higher levels of economic development but, more significantly, paved the way for improved social conditions.

As the Asian crisis was unfolding, the Philippines was once again set apart from the rest of ASEAN, this time favourably, as the least affected by the crisis, second to Singapore. Not only has it been a "late-bloomer", which has not experienced the excesses of its neighbours, but the Philippines' past experience in managing crises proved an advantage. This paper examines the effects of the Asian crisis on the Philippine economy and key areas for structural reforms in the near-term.

The paper has four parts. The first section reviews the Philippine experience in dealing with the 1983 debt crisis which paved the way for the implementation of important structural reforms in the financial sector. This is followed by a description of the evolution of the present crisis in the Philippines and its economic and social impact. The third section focuses on the financial and corporate sectors, reviews the structural reform measures so far implemented in these areas and presents key reforms which may have to be undertaken to further strengthen the financial sector in the country. The concluding part discusses other key issues affecting prospects for the Philippine economy.

1. Review of structural adjustments in the Philippines

The recent Asian crisis bears similarities to the banking and debt problems experienced by the Philippines in 1983. The same weaknesses experienced by the economies severely affected by the crisis were present in the Philippines in the early eighties: these included poor financial regulation; errors in economic management; and abuse of power by the political regime manifested by grant of behest loans by government financial institutions to cronies. The resolution to the present crisis using the typical co-operative approach was also adopted then.

The 1983 financial crisis

The eighties is considered a "lost decade" for the Philippines when compared to the economic performance of the other countries in the ASEAN region. The second oil shock combined with poor

commodity prices led to pressures on the balance of payments. However, it was the political situation, triggered by the assassination of Mr. Aquino, which caused capital flight and impaired the ability of the country to finance its obligations. Eventually the government declared a moratorium on its debt obligations on 17 October, 1983.

Compared to the debt level of the severely affected countries in Asia today, the foreign exchange liabilities of the Philippines at that time were moderate. Then, the country's foreign debt stood at US$24.1 billion (Table 1, page 248).

However, with less than a US$1 billion reserves which would not even finance a month's worth of imports, the authorities had no choice but to suspend debt service payments. There were two major differences in the condition of the Philippines in 1983 and that of the ASEAN countries hit by the crisis in the 1990s: (a) Philippine debt was mostly medium and long-term loans; and (b) the bulk of the debt was owed by the public sector (64.6%). By creditor, about 64.1% of the country's debt consisted of loans provided by foreign commercial banks and financial institutions and only 24.2% was from multilateral and bilateral sources. The debt service burden as a proportion of goods and services reached 33.5% and 37% in 1983 and 1984, respectively.

The country's approach to the debt problem was non-confrontational and involved the following steps: (1) the implementation of a comprehensive economic stabilisation and structural adjustment programme under the supervision of the IMF and the World Bank; (2) negotiation with the Paris Club for the rescheduling of the bulk of principal and interest payments on maturing bilateral obligations as well as provision of new export credits; and (3) negotiations with commercial banks for the rescheduling of maturing debts, maintenance of credit lines and acquisition of new financing on a concerted basis in order to keep outstanding obligations current (BSP 1990). Essential to the rescheduling process is the commitment by the government to implement needed structural reforms. After successful talks with the IMF on a standby arrangement which provided SDR 615 million in 1984, restructuring negotiations with the Paris Club creditors followed and were concluded in December 1984, while those with commercial bank creditors were forged a year after.

The restructuring agreements were complemented by voluntary debt reduction schemes, primarily the debt-to-equity conversion scheme, which had the effect of reducing the level of outstanding external debt at the same time that long-term equity investments were generated in priority activities. Similar schemes which were undertaken include: (1) debt-for-debt scheme; (2) debt-for-asset swap; and (3) peso prepayments and offsets.

All of these measures had the following favourable impact: (1) the maturity structure of outstanding debt was lengthened with the ratio of short-term debt to outstanding debt going down from 37.4% in 1983 to 12.9% by 1988: (2) trade financing was resumed after the 1983 disruption; (3) external payment arrears were eliminated by end-1985; (4) the debt service-to-exports ratio improved from 55% in 1984 to 40% in 1988; and (5) investment increased as an offshoot of the voluntary debt-reduction schemes.

The initial response of the Philippine monetary authorities to the crisis was to impose the following capital controls: (1) banks were required to sell all foreign exchange receipts to the Central Bank for placement in a pool; (2) prioritisation and rationing of foreign exchange (e.g. oil imports, trade payments for raw materials, ODA repayments, etc.); and (3) tighter regulations on non-trade foreign exchange outflows. In addition, other modes of importation were encouraged, such as no-

dollar imports, and the treatment of certain imports as equity investments. Because of these restrictions, the eighties were also known as a decade of controls for the Philippines.

The crisis took its toll on the economy. Output growth declined to its lowest level (9.1%) in 1984 and recovered only after more than two years (Table 2, page 248). Inflation averaged close to 50% in the same year while the yield on the bellwether 91-day T-bills rose to 28.2%. The Central Bank bills fetched higher rates of over 30%, contributing to the credit crunch. However, the stabilisation measures were quite successful at lowering the current account deficit from 8.4% of GNP in 1983 to 3.7% in 1984, even generating a surplus by 1986. Inflation was down to negative levels by 1986. Unlike in the present crisis, there was no explicit concern for social safety nets for vulnerable groups affected by the crisis.

Similarly to the Asian crisis, the deterioration in economic conditions exposed weaknesses in the financial system. Hence, two of the biggest government banks – the Development Bank of the Philippines and the Philippine National Bank – were bailed out by the government, and their non-performing assets transferred to an Asset Privatization Trust, to be sold off. In addition, three commercial banks, 128 rural banks and 32 thrift institutions failed from the mid-eighties to 1987 (IMF 1998). From 1984 to 1986, the ratio of non-performing loans to total loans reached over 20%. Financial sector reform therefore necessitated the rehabilitation of the two government banks, which was done under the aegis of the World Bank through a US$300 million Economic Recovery Loan granted in 1986.

Lessons to be learned

There are several lessons which can be drawn from the 1983 debt crisis. First, restructuring agreements have to be worked out immediately. In the case of the Philippines, it took a year before the restructuring agreements with the commercial banks were signed. Furthermore, it was only after the issue of Brady bonds in December 1992, or nine years after the debt crisis, that the Philippines was able to return to the international capital market.

Secondly, multilateral and bilateral assistance has an important role to play in the recovery process. Since foreign creditors and investors shied away from the Philippines during the nine years that it was wrestling with the debt problem, the Philippines' only recourse was to tap the multilateral and bilateral institutions in funding its foreign exchange requirements as well as exporting its goods and services. The Philippines' attempt to grow out of the debt problem partly explains why it has not been able to "graduate" from the supervision of the IMF for the last two decades. As a result, the share of multilateral and bilateral institutions in the total debt outstanding of the Philippines rose from about 24% in 1983 to more than 50% by 1996.

But borrowing from multilateral institutions like the World Bank for balance of payments and budgetary support was mostly in the form of programme or policy-based loans aimed at removing features of the economy, in trade and investment for example, that impeded growth and led to inefficiencies in the economic system. Hence, the country saw significant structural reform programmes implemented during the nine-year period after the 1983 crisis which were embodied in the following structural reform loans: (1) an economic recovery loan; (2) a loan for the reform of the government corporate sector; (3) a financial sector loan; and (4) a debt management loan.

There were also seven standby arrangements signed with the IMF. In addition to the other resources tapped by the country, these arrangements not only entailed short-term macroeconomic

performance indicators but in the 1990s also included policy-based commitments which aimed at opening and liberalising the economy. In the 1990s the World Bank moved away from structural or policy-based lending in the Philippines, and towards more project lending, but the IMF picked up where they left off in imposing some of the remaining reforms in finance, trade and the fiscal sector, for instance, which impeded the liberalisation of the economy. In operational terms, this means that policy conditions are included not only in World Bank agreements but also in IMF letters of intent. Today, in response to the crisis, the World Bank is back to providing programme financing in partnership with the IMF.

Third, the reform process requires strong political will. Similar to the situation in Asia today, the debt crisis somehow led to political changes in the Philippines in 1986 with a bloodless revolution headed by the military with support from the church. It was only after this change in government that the economic recovery of the Philippines started. The period 1986-1991, under then President Aquino, ushered in an era of reform which intensified the opening of the economy and re-established the primacy of the private sector as the engine of economic growth. It was during her term that aggressive measures were implemented to liberalise trade, abolish agricultural market monopolies, deregulate the financial markets, privatise government assets, reform the tax system and implement debt-reduction schemes, which were mostly part of conditions imposed by the multilateral agencies. However, political uncertainties and a string of unforeseen external and internal events slowed down the reform process.

Learning from the lessons of the past administration, then President Ramos marshalled political and social consensus for his reform measures to prevent political pressures and social conflicts from derailing the reform process. He was also quite aggressive in pushing for difficult reforms with the legislature (e.g. oil deregulation). At the same time, there was a consciousness that major structural reform measures could only be implemented within an environment of macroeconomic stability.

Part of the country's success in the 1990s could be traced to the Philippines' return to the international capital market. The issuance of Brady bonds in December 1992 was a turning point for it marked the end of nine-years of debt rescheduling. The Philippines finally grew out of its debt problem. With a new government in which investors had confidence, the successful offering of Philippine bonds in February 1993 paved the way for the issuance of other bonds by the private sector and other government corporations in the international capital market. With renewed interest in emerging markets and the opening up of the economy, the next three years up to 1997 witnessed the financial integration of the Philippines.

2. Impact of the crisis on the Philippine economy

Despite the structural reforms implemented as a result of crisis, the Philippine economy has not been spared from the Asian crisis. The issue of vulnerability to currency crises therefore has to be addressed. The impact of the crisis, however, has so far been less severe than the 1983 debt and banking crisis, partly due to the better economic fundamentals of the country at the time of the currency crisis in mid-1997. Furthermore, the structural reform measures implemented during the last ten years not only opened up the economy but also put in place some safeguards, albeit not perfect, against excesses. There is, however, social displacement that has arisen from the crisis which should be closely monitored and addressed.

Vulnerability of the Philippines to currency crises

Even during the Mexican crisis in 1995, the Philippines was singled out among the ASEAN countries as the most likely next victim of currency speculators. While the Asian crisis did not start in the Philippines, the country was nonetheless next in line after speculators hit Thailand.

Why was the Philippines vulnerable to currency crises? In addressing this issue, the following variables, which could be considered as consistently providing early warning signals of vulnerability to a currency crisis, were examined: (1) real peso exchange rate appreciation; (2) domestic credit growth and the exposure of the banking sector to real estate investments; (3) M2-to-reserves ratio; (4) the financing gap; and (5) the level of short-term debt. The use of the first three indicators was based on the IMF (1998) study which looked at the behaviour of twelve macroeconomic indicators around the time of currency crises for a group of fifty industrial and emerging economies covering the period 1975-97.

The first factor that influences currency risk is the extent to which the exchange rate is overvalued and can be realistically defended. The perception that the Philippine peso was overvalued is a major factor that encouraged speculation on the peso. The IMF finding is that as early as thirteen months before a crisis, an appreciation of the real exchange rate above its normal level, the latter being defined as the average value outside of the sample two years prior to a crisis, can signal a currency crisis (IMF, 1998a). Using this framework, both the nominal and the real effective peso exchange rate have indeed been appreciating prior to the crisis, caused by rising domestic inflation and a strong US dollar. On average, the real effective exchange rate level was 13.4% above the normal level, which in this case is the average for 1994 and 1995.

Another early warning indicator of vulnerability is domestic credit expansion, which has been observed to grow at an accelerated rate in the run-up to the crisis, putting pressure on the exchange rate especially for those countries pegged to a certain currency. Based on the study done by the IMF (1998a), M2, which is composed of narrow and broad money, peaks around eighteen months before the crisis after which the broad money component declines until the crisis, while the decline in the narrow money component extends nine months after the crisis. In the case of the Philippines, broad money was growing by 26.8% and 25.2% as of December 1994 and 1995, respectively. Broad money growth peaked in January 1996 (or around eighteen months prior to the crisis), before steadily decelerating to 14.2% in January 1997. However, unlike the trend in the IMF study, broad money growth accelerated again reaching 24.4% in July 1997, when the crisis hit the Philippines. Since then, the growth of broad money has been decelerating. The decline in narrow money (M1) has been faster compared to broad money.

Looking at the asset side of the monetary survey, the growth in domestic credit to the private sector has been quite high at 43.5% and 51% in 1995 and 1996, respectively. Domestic credit accounts for more than half of domestic output as measured by GDP starting 1996 from about 20% in 1990. While this would look large, the other countries in the region have a higher domestic credit to GDP ratio of over 100% (Table 3, page 249). Thailand posted the highest ratio followed by Malaysia and Korea.

Since 1990, the bulk of commercial banks' outstanding loans have been channelled to the manufacturing sector which, on average, accounts for a third of outstanding loans. However, in 1996, outstanding loans of the combined financial institutions, real estate and business services sector expanded by 97.2%, exceeding the 90% expansion in manufacturing. As a result, its share of total

outstanding loans rose to 21.8% from 16.9% in 1990. The share of loans being channelled to the construction sector also accelerated by 74.2% in 1996, though the sector accounts for only 3.9% of the total outstanding loans during the year.

However, because real estate is mixed in with two other sectors that have also been recently liberalised, it is difficult to determine whether the increase in loans is solely accounted for by the real estate sector. The Central Bank therefore conducted a separate survey of banks which showed that, as of end-September, 1997, real estate loans accounted for approximately 13.7% of total outstanding loans of commercial banks from 11.9% in the previous quarter ending in March 1997. The private sector estimates a higher proportion of loans in the property sector in the affected countries. For instance, JP Morgan (1997) estimates that around 15-20% of loans in the Philippines are in the property sector. This proportion still compares favourably with those of Indonesia (25%-30%), Thailand (30%-40%) and Malaysia (33%) though Korea has a lower proportion of loans to the real estate sector (10%-15%).

Crisis has always been associated with withdrawals of capital inflows, and the banking sector's ability to withstand currency pressures can also be gauged by the extent to which its domestic liabilities are backed up by foreign reserves. This can be represented by the ratio of broad money to official international reserves. Following the framework used by the IMF, the M2-to-reserves ratio expands about 24 months prior to crisis with the ratio growth increasing near the crisis (IMF, 1998a). The ratio however drastically declines a few months after the crisis. In the case of the Philippines, the M2-to-reserves ratio has actually been on the downtrend since January 1996 and was hovering around a close range until the month before the crisis. Based on computations done by Credit Lyonnais (1998), the Philippines had the lowest M2-to-reserves ratio, with Korea recording the highest ratio. In the case of the Philippines, this ratio shot up during the crisis as the level of reserves was dramatically reduced due to speculations on the currency. So far, the ratio hit its lowest level in April 1998.

In addition to the above indicators, Grice (1997) also suggested looking at the way external deficits are funded, using the financing gap as an additional indicator of the amount a country needs to raise externally each year. This is measured by summing up the current account deficit with principal repayments on medium-long term external debt and the short-term debt maturing within twelve months. Of the countries in Asia affected by the crisis, the Philippines in 1997 had the lowest financing gap of US$16 billion while Korea had the largest gap, as of 1996, of US$77 billion.

Looking closely at the issue of debt, one of the reasons why the Asian countries were hit so severely by the crisis was their overdependence on short-term debt. The Philippines' short-term debt of US$5.6 billion at the end of 1996 is still quite manageable when compared to the country's level of international reserves of US$11.6 billion. Malaysia is in a similar situation. However, for the other countries, their short-term debt exceeded their international reserves, making them very vulnerable to changes in investor confidence.

Given the above indicators, it appears that the Philippines is indeed potentially vulnerable to speculative attacks should there be external or internal shocks which would affect investor confidence on the economy. However, the data confirm that the Philippines might be in a better position than its neighbours to cope with the crisis.

Evolution of the currency crisis

Since July 1997, when the Philippine Central Bank (henceforth referred to as Bangko Sentral ng Pilipinas or BSP) decided to let the peso seek its own level, the spot peso-dollar exchange rate movement has undergone six phases:

(1) A gradual depreciation of the currency from P26.40 to one dollar in early July, to a low of P35.65 to the dollar, triggered by the float of the baht and the Malaysian ringgit (July – October 1997);

(2) A period of relative stability in the currency market, calmed by news on the IMF bailout of Indonesia, Korea and Thailand (October – mid-December 1997);

(3) Another round of peso depreciation which saw the peso plunge to its lowest level in January 1998, at P45.42 to the dollar, due to uncertainties over the Indonesian political situation (late December – January 1998);

(4) The peso appreciated after investors recognised the Philippines as the least affected of the crisis-hit countries (February – April 1998);

(5) A slow depreciation of the currency influenced by a combination of domestic events (e.g. the May 1998 nation-wide elections) and renewed external uncertainties led to a slow depreciation of the peso (April – September, 1998); and

(6) Appreciation of the peso as perceptions of the new administration improved (October 1998 – present) (Figure 1, page 254).

From 2 July, 1997 to end-September 1998, the peso depreciated by 66.1%, the second highest rate of depreciation among the five countries affected by the crisis. For the first semester of 1998, the peso was generally stable closer to its pre-crisis level than the baht, the ringgit and the won. However, from July 1998, the confluence of domestic and external uncertainties led to the slow depreciation of the peso closer to January levels while other currencies gradually appreciated. (Table 4, page 249).

Immediate responses to the currency crisis

When the currency crisis which started in Thailand spread to the Philippines, the immediate objective of the monetary authorities was to restore stability in the foreign exchange market by (1) rationalising foreign exchange trading; and (2) tightening liquidity. These “traditional” measures of addressing currency crises had to be complemented by new or innovative approaches. Quick response on the part of the monetary authorities helped in minimising volatility in the market up until August 1998.

Foreign exchange market reforms

To stave off speculative attack on the peso in July 1997, the Bangko Sentral ng Pilipinas (BSP) sought to limit banks’ ability to take foreign exchange positions. While some of the measures implemented were stop-gap in nature, others aimed at further tightening banks’ foreign exchange operations and improving the central bank monitoring system. Some measures, however, restored

controls put in place in the early 1990s, for example, the limit on over-the-counter sales of dollars without documents required, was lowered from US$100,000 to US$10,000.

As the peso continued to lose its value, it was obvious that the pressure on the exchange rate was caused by the unwillingness of dollar holders (e.g. exporters) to sell foreign exchange in anticipation of further peso depreciation. To address this liquidity problem, the BSP and the Bankers Association of the Philippines (BAP) both agreed to contribute to a dollar pool system which could be tapped by corporations, particularly those in the oil and export sectors, to get their dollar requirements. The pool system, however, became operational only for two days – 19 and 22 December, 1997.

More successful than the pool system in providing dollar liquidity was the currency risk protection programme established by the BSP also in December 1997. This programme was essentially a non-deliverable forward facility aimed at easing the strain in the spot market due to demand pressure from borrowers wanting to cover unmatured foreign currency obligations because of fears of further depreciation. Under this hedging facility, the parties agreed that upon the maturity of the forward contract, only the net difference between the contracted forward rate and the market rate would be settled and paid for in pesos. Initially, those to qualify were only corporations with unhedged loan exposures in dollars against pesos. Later, exporters and oil companies with outstanding unhedged foreign obligation were included as eligible subscribers to the facility.

Another, similar, facility was set up, this time with foreign banks. The latter were essentially a currency stabilisation facility whereby foreign banks would sell dollars in the spot market and in return, the BSP would sell the dollars forward on a non-deliverable basis (BSP 1998). Under this scheme, there is no actual dollar outflow but a netting off wherein the differential between the NDF rate and the forward fixing rate is settled in pesos at maturity. Total availments under this programme reached US$131.1 million from January to May 1998 with the BSP realising a net gain of P423.8 million due to the appreciation of the peso.

Through the Bankers' Association of the Philippines (BAP) the private sector also assisted in stabilising the peso. At the beginning of the peso float in July, the BAP suspended the existing volatility band of 1.5% from the closing rate of the previous trading day. However, when the peso continued its downward slide, the BAP again imposed a new three-level, 2-3-4% from a reference rate, volatility band on 7 October, 1997. The band was further widened to 4-5-6 from the base rate at the height of worries over the Indonesian problem. The band was finally lifted on 23 March, 1998 when the exchange rate stabilised.

Monetary policy changes

Complementing the regulatory changes in the foreign exchange market were measures directly aimed at reining in liquidity. The BSP immediately raised its overnight borrowing rate (reverse repurchase agreements) to 32% from 15% at end June 1997 and its overnight lending rate to 34% from 17% the previous month. These rates have since been maintained at around 13% starting February 1998, up to 11 August 1998, during which the overnight RRP rates were again raised to 15%, then to 18% a day after. By 24 August, 1998, the BSP had lowered the rates to 16%. The August round of increases were triggered by the Russian rouble devaluation and uncertainties in the Latin American markets.

Aside from their overnight rates, adjustments in the reserve requirements against peso liabilities of commercial banks were also implemented. Prior to July 1997, the total reserve requirement was

16%, 2% of which was in the form of liquidity reserves. To tighten liquidity, reserve requirements were raised to 21% by end August through adjustments in liquidity reserves which gradually rose from 2% to 8% by end-August 1997. However, higher interest rates were becoming ineffective in stabilising the foreign exchange market and threatening the stability of the banking sector, and reserves were gradually reduced. Hence, from 21% in August 1997, the reserve requirement was reduced to 15% by May 1998 but was again raised to 17% in October 1998.

Part of the increase in interest rates, however, can also be attributed to pressures in the T-bill market, particularly on the 91-day T-bill rate, which serves as a benchmark for commercial paper transactions. Sensing that the national government was in dire need of money, given the low revenue collections due to the slowdown in the economy, bank bids at the weekly T-bill auction gradually rose. From 10.5% in June 1997, the 91-day T-bill rate increased by 169 basis points in July and peaked at 19% in January 1998 before gradually moving southward to hit a low of 14.7% in July 1998. The reduction in rates in the T-bill market as seen in recent months can be partly attributed to the very liquid market in which banks were hesitant to lend. At the same time, as of July 1998, the newly installed Treasury and Finance officials were consciously rejecting bids which would raise interest rates, despite the desperate need to raise revenues. Ironically, during the period when interest rates were on the downtrend, the inflation rate was accelerating; hence, real interest rates were also being reduced to levels even lower than those prevailing prior to the crisis.

While the BSP was lowering its borrowing and lending rates and the Treasury was keeping tab of T-bill rates, banks were slow in reducing interest rates. Prime lending rates rose to over 25% at the start of the crisis, reaching a high of 28.2% in October 1997 from about 14% in June 1997. It was also during this time that the differential between the 91-day T-bill rates and prime rates widened from around 3-4% prior to the crisis to over 8-11%. Understandably, banks were charging a high risk premium to cover for the increasing proportion of non-performing loans in their portfolio. With moral persuasion exerted by the BSP, however, the members of the Bankers' Association of the Philippines forged a "gentlemen's agreement" to lower their lending spreads to 1.5 to 6 percentage points above 91-day T-bill rates from 3-8 percentage points (BSP 1998). This move also brought down lending rates, though not all BAP-member banks followed the agreement.

As a result of the tight monetary policy adopted by the BSP, domestic liquidity growth was reduced from 24.2% in July 1997 to 17.2% as of June 1998. The cautious stance of the monetary authorities was also evident in their attempt to keep the actual base money levels way below the ceilings set under the Extended Fund Facility and the Precautionary Arrangement with the International Monetary Fund.

Impact of the crisis on the economy

On the production sectors

The negative effect of the crisis on the real sector was not immediately evident. For instance, six months after the crisis, industry was growing in real terms by 6.0%, less than a percentage point below its performance during the same period in 1996. By the first quarter of 1998, however, it was obvious that the crisis would have a much deeper impact than initially expected. While interest rates were on the downtrend and the peso-dollar exchange rate was appreciating after January 1998, high production costs and expectations of weak demand combined to depress production. Compounding

the problem was the El Niño effect on the agricultural sector, which recorded one of its worst performances (Table 5, page 250).

As expected, real GDP growth was slower at 1.6% during the first quarter of 1998 from 5.5% for the same period last year. By the second quarter, domestic output declined by 1.2% relative to last year's level for the same period, primarily due to the lower production in agriculture, manufacturing, and construction. In manufacturing, only four out of the twenty firms monitored posted accelerated growth, in contrast with twelve sectors posting declines in output. On the positive side, the services sector still managed to grow at 4.1%, albeit more slowly, led by the transport, communication and storage and the finance sectors. On the industry side, mining and quarrying and the utilities sectors also posted accelerated growth during the period.

The delayed effect of the crisis on production can be partly traced to the slow transmission of the crisis on demand. Surprisingly, investment growth was still hefty during the second semester of 1997 at 12.2%, though slower than the 23.2% recorded during the second half of 1996. By the first quarter of 1998, however, investments had already declined by 9.2% and even further to 14.5% the following quarter, as the high interest rate regime, the uncertainty over currency movements and the difficulty of getting working capital dampened investor interest for expansion (Table 6, page 250). Offsetting the lower investment growth, however, was the relatively strong growth of personal consumption expenditures. Government assurances that the crisis was temporary, in addition to the upward adjustments in minimum wages implemented in 1997 and 1998, would have helped boost consumer confidence during the crisis period.

For 1998, the growth of GDP is projected to slow down drastically to just 1.0% from 5.3% in 1997. The drought is expected to drag down agricultural output by 5.3% in real terms, though the onset of normal weather conditions might bring about improved performance by the fourth quarter of 1998. The effects of the crisis, however, will be most severe in the industry sector, which is projected to have flat growth for the year. Output in manufacturing and construction is expected to decline, though this will be partly offset by the improved performance of the mining/quarrying and utilities sectors. Services, meanwhile, will continue to grow by 4%, buoyed by the relatively better performance of transportation, communication and the finance sector.

On inflation

The onset of the crisis in July 1997 did not immediately translate to higher prices. In fact, the average monthly inflation rate for both food and non-food items even went down during the second semester of 1997. However, two items with higher monthly inflation rates during the period were dairy products and medicines.

The sharp acceleration in the inflation rate started in 1998. Lower agricultural production raised food prices, contributing more than 40% to the increase in inflation during the first half of 1998. However, improved weather conditions combined with prudent fiscal and monetary policies pushed prices down starting July 1998. For the first nine months of 1998, the annual inflation rate averaged 9.4% from 5.5% for the same period last year (Table 7, page 251). Except for fuel, light and water, all the non-food components of the basket posted higher annual inflation rates led by services and housing and repairs. For the whole year, the inflation rate is expected to reach 9.5%.

Unlike past depreciation episodes in the country, however, the flow-on to prices of the sharp depreciation has so far been moderate, for a number of reasons. First, manufacturers were more

concerned about preserving market share than maintaining profit margins by raising prices. Secondly, adjustments in oil prices have been minimal, largely due to the reduction in international crude oil prices, which offset the effects of the peso depreciation. At the same time, the deregulation of the oil industry allowed the monthly adjustment in domestic oil prices, which prevented a large build-up in prices. In effect, oil price changes in either direction were more frequent but in small amounts compared to the past, regulated environment, when adjustments were larger but less frequent. In the Philippine case, domestic oil prices were on the uptrend from June 1997 to January 1998 but declined in succeeding months, with present prices even lower than their pre-crisis levels, except for aviation fuel (Avturbo) and fuel oil. Thirdly, with minimal increases in oil prices, the resulting transport fare hikes and the minimum wage adjustments were also lower compared to the past depreciation episodes.

On the fiscal sector

Prior to the crisis, the fiscal position of the Philippines was considered healthy, with the public sector enjoying a surplus for the first time in 10 years, of P7.3 billion, or 0.3% of GDP in 1996. However, lower domestic and custom tax collections due to the crisis led to reduced revenue collection which, combined with higher interest payments, raised the budget deficit.

As of semester one 1998, the national government had already incurred a deficit of P24 billion due to very poor revenue collection. This prompted the government to seriously review its targets for the year, which was timely considering the change in administration. Given emerging fears of a recession, the new government was less concerned about reducing the deficit to more manageable levels, than the need to ensure that the fiscal sector would not further stifle the slowing economy. It also recognised that poor collection resulted not only from the slowdown in the economy but also from structural problems in the collecting agencies which could not be immediately remedied. Hence, the new targets allowed a deficit of P40 billion (1.4% of GNP) for the national government and a staggering P73.7 billion for the whole public sector. Revenues were set at P466.1 billion, around P65 billion less than the original programme and P5.7 billion less than the 1997 level (Table 8, page 251). Expenditure was likewise reduced by P20.3 billion from the original programme, which primarily affected the non-interest portion of the budget. Given the expected higher domestic interest rates for 1998, interest payments for both domestic and foreign obligations are projected to increase by P29.7 billion from the 1997 level. Capital outlays will be reduced by about P15.1 billion from last year’s level.

On the balance of payments

The currency crisis led to a slower import growth of 14% for 1997, from the previous year's hefty 20.8% expansion. For 1998, imports are projected to be 7.7% lower than the 1997 level. For the first semester of this year, import growth has been down by 12.2%, with about 88% of the decline due to lower imports of raw materials and intermediate goods, plus mineral fuels and lubricants, both of which are reflective of a slowing economy.

The Philippines export performance, however, is still moderately better than most countries in the region. Despite the weaker demand from Asia, exports from the Philippines grew by 18.8% during the first semester of 1998 (Table 9, page 252).

The effects of poor weather were evident in the continued lacklustre performance of non-manufactured exports, though a slight recovery in sugar and other agri-based products was recorded during the period. Electronics exports are holding on the previous year's performance (30.6% growth) with garments exports already posting positive growth, a turnaround from the previous years' decline. On the whole, however, growth of manufactured exports slowed to 19.5% during the period.

In 1998 there was a noticeable shift in export markets towards Europe, which emerged as the second largest export destination of Philippine products, replacing Japan. For instance, the combined share of Netherlands, UK, and Germany for the first seven months was up from 14.6% in 1997 to 17.2%.

The combination of higher export growth and depressed import performance is expected to lead to a substantially lower trade deficit in 1998. Hence, despite the reduction in net services exports and lower transfers, the current account deficit is projected to go down drastically in 1998 to about US$1.0 billion, or equivalent to 1.5% of GNP from the US$4.3 billion deficit incurred in 1997.

On capital inflows, even prior to the crisis in July 1997, there were signs of pressure building up in the capital account. When the crisis struck in July 1997, it was felt immediately on the investment account. The withdrawal of portfolio investments further intensified during the third quarter, averaging around US$800 million per month from about US$400 in 1996. At the same time, resident investments abroad were also accelerating as local investors prepaid their dollar obligations in anticipation of further depreciation of the currency. By the fourth quarter of 1997, portfolio placements were slowing down, with average monthly inflows of about US$360 million from November 1997 to January 1998, compared to a monthly average of over US$600 million during the first quarter of 1997. In February and March 1998, general perceptions began to separate the Philippines from the other countries affected by the crisis, and portfolio investments started to flow back into the country. However in April, fears over the May 1998 election triggered a new exodus of portfolio funds from the country. For the first semester of 1998, net portfolio investments of both residents and non-residents reached US$299 million, a turnaround from the US$351 million net outflows recorded for the whole of 1997.

However, the crisis also triggered new money flows into the country from the IMF and the World Bank. Under the US$1.36 billion standby arrangement approved by the IMF Board in March 1998 for the Philippines, around US$260 million is expected to be drawn during the last quarter of 1998. Another US$1 billion in programme loans is, at the time of writing, being worked out with the various multilateral and bilateral sources.

For 1998, the balance of payments is expected to improve as the slowdown in the economy leads to a better current account position, offsetting the expected reduction in net capital inflows. For the first six months of 1998, the current account was only US$39 million, compared to US$2.2 billion for the same period in 1997. Meanwhile, capital inflows amounted to US$2.7 billion which was half of the first semester 1997 level due to lower availment of medium-term and long-term loans, reduced investment and the decline in short-term capital inflows. Overall, the balance of payments posted a US$1.6 billion surplus from January-June 1998 compared to the US$209 million deficit for the same period in 1997.

For the whole year, the current account to GNP ratio is expected to improve to 1.5% from last year's 5.0%. While the capital account, in turn, will be lower by 38.9%, the overall balance of payments is forecast to reach US$1.1 billion.

On the stock market

The stock market has been in the doldrums since the start of the crisis. The Philippine Stock Index (Phisix) fell by 1424.15 points from 2616.4 before the crisis in July, 1997 to 1192.2 by end-August 1998 or by 45.6% (Figure 2, page 254). As of end-August, the Phisix lost 33.5% of its value at the start of the year. Volume of transactions was also down by 89.3% in the same period. The biggest drop in volume and value occurred in the third quarter of 1998, as the confluence of negative sentiment on both the domestic and external fronts depressed the stock market. Among the sectors listed, in 1998 it was the oil sector that suffered the biggest decline, followed by mining, property, banking and finance, and commercial/industrial.

On the social sector

The crisis is expected to affect the quality and coverage of social service delivery through the lower purchasing power of social sector budgets. Among the commodity items in the consumer basket, medicines, in addition to dairy products (both of which are mostly imported in the Philippines) posted the biggest increases during the second half of 1997 and the first semester of 1998. For medicines, the Bureau of Food and Drugs reported an increase of 10-25% for 24 essential drugs from June-August 1998 (Capones 1998). The peso plunged in 1998 so the increase is anticipated to be higher in 1998 relative to the pre-crisis levels.

The nominal increase in the social sector budget, however, will still be inadequate to cover for the increase in prices in 1998 and 1999 for most of the social sector agencies, except perhaps for education. In real terms, the nominal increase in the budget for social services will translate to an increase of 4.3% and 2.1% for 1998 and 1999, respectively (Table 10, page 252). The real increases are accounted for mostly by the education and manpower budget which comprise more than half of the social sector budget. The budgets for health, social security, welfare and employment, as well as housing and community development, are expected to contract in real terms for the next two years.

While the government will be struggling to maintain levels of health service given the effects of currency depreciation, the Department of Health expects an increase in the demand for government facilities in view of the higher cost of private healthcare providers. Both factors may lead to higher service gaps during the crisis.

On employment

The slowdown in the economy in 1997 and 1998 cannot be attributed solely to the crisis but also to El Niño and the drought. Even in the analysis of employment trends for 1997 and 1998, it was obvious that the higher unemployment rate for 1997 and the first two surveys of 1998 was due to the drastic decline in the number of jobs generated by the agriculture sector. Based on the three Labor Force Surveys (LFS) conducted in 1998, the unemployment rate increased to 10.3% from 9% in 1997 (Table 11, page 252). The higher unemployment rate was due primarily to the decline in jobs available in the agriculture sector in January and April 1998, which was the height of the El Niño. While agriculture recovered in July 1998 with the normalisation of the weather, this was offset by the

decline in employment in the industry sector by 136,000 jobs, the first time since the currency crisis hit the Philippines in 1997. Hence, the higher unemployment rate of 8.9% in July from 8.7% for the same period last year, can be attributed to the negative impact of the crisis on industrial production.

Aggravating the unemployment problem is the repatriation of Filipino workers from the crisis-affected countries in the region, such as Malaysia. Deployment of Filipino workers abroad declined by 12.6%, or 50,484 workers, during the first semester of 1998. Most of the decline can be attributed to the decline in the number of land-based workers coming from Asia, which was down by 37,100 workers (29.4%) from last year's first semester level. The number of sea-based workers also declined by 5,745, or by 6.1%.

In summary, the impact of the present crisis remains manageable and definitely less severe than the 1983 debt crisis (Table 12, page 253). Consequently, the impact of the crisis on the social sector has also been milder than was the case in the 1983 crisis. However, given the huge projected deficit for the public sector and the need to protect social expenditures, the stabilisation process has to focus on the fiscal sector. More efficient tax collection and less leakage through the incentive structure have to be worked out.

3. Financial and corporate sector reforms

The Asian crisis is a financial crisis, and reform programmes in these economies aim at recovery and growth through reform of the financial and corporate sectors.

Banking reforms to address the crisis

As the Asian crisis unfolded, what started as a currency crisis slowly developed into a financial sector problem, partly as a result of the high interest regime in the months following the July 1997 unleashing of the exchange rate in Thailand and in the Philippines. In the case of the latter, fears of an imminent banking crisis similar to that experienced by other countries in the region prompted the imposition by the monetary authorities of new measures to ensure the health of the financial sector. In October 1997, after three months of instituting measures concerning foreign exchange transactions, the BSP issued the following guidelines aimed at strengthening the financial system.

(1) It imposed a stricter definition of past due loans and the treatment of restructured loans; in the determination of past due loans, the number of instalments in arrears was reduced from six to three, and from two to one in cases of loans payable in monthly and quarterly instalments, respectively, before they could be considered past due. Restructured loans were treated as performing or interest income and thus accrued, provided that they had current status, and were fully secured by real estate with loan value up to 60% of the appraised value of the of the real estate security, including improvements thereon.

(2) In anticipation of the deteriorating loan portfolio of banks, the BSP required a general loan-loss provision over and above the provision of probable losses linked to individually-identified bad loan accounts. On top of the existing provisioning requirements, banks were required to put up 2% of the gross loan portfolio, less loans considered non-risk under existing rules to allow for probable losses. The timetable for compliance was accelerated to October 1999 from the original deadline of October 2000. The provisioning requirement was further tightened to include secured loans classified as

"loans specially classified" and substandard among those subject for loan-loss provisioning, which must be complied with by April 1999.

(3) Despite the high capital adequacy ratio of Philippine banks, the BSP raised the minimum capitalisation for new banks by 20% for universal banks, 40% for regular commercial banks and 60% for rural and thrift banks from the mandated requirement issued in 1998. Existing banks were given two years to comply with the minimum capital build-up. On 7 September 1998, stiffer penalties were also imposed on banks unable to comply with these build-up requirements. Meanwhile, incentives were provided to encourage mergers and consolidations.

(4) Stricter rules were set regarding the establishment of new banks.

(5) To improve transparency, the BSP required all banks to post information on interest rates on their loans, including the structure of interest payments on fees and charges. Banks listed in the Philippine Stock Exchange must also disclose the amount of non-performing loans and their proportion in relation to total loan portfolio, amount of classified loans, general loan-loss reserve and specific loan-loss reserves in their quarterly published statement of condition effective December 1998. In addition, the disclosure statement for audited annual accounts required of banks now includes the following: (a) current level of restructured loans both with and without uncollected capitalised interest; and (b) total allowance for probable losses which includes the 2% general provisioning and the provisioning of losses on loan accounts and other risk assets. As of September 1998, banks have been required to mark-to-market their trading portfolios in line with existing market conventions.

(6) To further strengthen the banking system, the BSP submitted to Congress amendments to the General Banking Act to enable the Monetary Board to adopt internationally accepted standards relating to risk-based capital requirements and the definition of clearly unsound practices.

Banking sector performance

The crisis has definitely tested the strength of the banking sector and the financial system in the Philippines. However, there seems to be a consensus so far that while the crisis has hurt the banking sector, the problem has not reached crisis proportions as in other countries.

The level of non-performing loans (NPL) of commercial banks has been growing since the crisis started in July 1997 though a sharp increase was evident in 1998. Of the P1,555.6 billion lent by commercial banks to various sectors, around P149.9 billion are non-performing or an NPL ratio of 9.6% as of July 1998, a big jump from the 1997 level of 2.8% (Figure 3, page 255).

This is however still way below the 22.6% ratio recorded at the height of the balance of payments crisis in 1983-1985. Reserves held by banks as loan-loss provisions (LLPs) stood at 30% of NPLs. Under the BSP ruling, banks are now required to set aside 2% of LLP over and above specific provisions for classified loans.

While the present NPL level is still comfortable, analysts believe that NPL will begin to hurt the banking sector once they reach 12% (Paribas, 1998). There are suspicions that the reported NPL may

not be truly reflective of balance sheet quality and may be muted by debt rollovers, loan restructuring, foreclosure, asset-for-debt settlements and debt-for-equity conversions (DMG; 1998). Distressed companies suffering from liquidity problems rather than solvency are still being extended assistance by banks, in the anticipation that these companies will be able to refinance their obligations once the economy recovers. There is actually a motivation for banks to report low NPL as this would avoid putting up additional loan-loss provisions which can lower earnings. Bank earnings are in fact expected to drop in 1998 relative to the 15% growth in 1997. This will be the result of higher provisioning requirements, in addition to the contraction in loans, thinner margins, slowdown in fee-based business and higher operating costs.

The immediate effect of the peso depreciation was to raise the foreign exchange liabilities of the banking sector. As of December 1997, commercial banks had total liabilities amounting to US$8.2 billion, up by 13.1% from the 1996 level of US$7.2 billion. It was in 1996 when the foreign exchange liabilities of banks jumped by about 70% from US$4.2 billion in 1995. Lured by the lower international interest rates combined with a stable peso, banks floated bonds in the form of floating rate commercial debts (FRCD) starting 1996. However, maturities arising from these floats were still manageable in 1998 (at the time of writing), though obligations were anticipated to rise in 1999.

A source of problems for local banks has been the extension of foreign currency loans to unhedged borrowers. According to the BSP, FCDU loans, before the crisis struck in July 1997, amounted to US$11.9 billion, of which about US$3.6 billion were unhedged. As of December 1997, FCDU loans accounted for 30% of total loans. FCDU loans have since declined to US$10.4 billion as of March 1998, half of which were channelled to exporters. It was observed by the BSP that FCDU borrowers were actually converting their dollar loans to peso loans, which fetched higher interest rates.

Since January 1998, seventeen banks have been ordered closed by the BSP and were placed under receivership of the Philippine Deposit Insurance Corporation (*Business Daily* 1998). Five of these banks were thrift banks while the remaining twelve were rural banks. To date, however, the BSP has granted P17.6 billion in emerging advances and overdraft funding to ailing banks in 1998. Emergency lending which amounted to P13.3 billion, increased by three-fold over the P4.6 billion released for the same purpose last year. Overdraft funds also rose by more than P1 billion over the P3.6 billion released as of end-December 1997.

In September 1998, Standard and Poor's downgraded the ratings of nine commercial banks in anticipation of the deterioration in asset quality and profitability of these banks, though it maintained the ratings of five commercial banks in the Philippines.

Corporate sector performance

The crisis not only affected the financial sector but also the corporate sector, which was beleaguered by problems of credit availability, high production costs and depressed demand, leading to losses for many firms.

In general, bank lending virtually dried up as a result of the crisis, particularly in 1998. Negative sentiment about the economy led to a 6.4% contraction in loans extended by commercial banks during the first semester of 1998. The most affected sectors included wholesale and retail trade, manufacturing, agriculture, fishery and forestry, and construction. However, there were sectors that

continued to enjoy credit growth, including the financial sector, utilities, mining and quarrying, and the transportation and communication sectors.

Data for the top 5000 corporations, collected by the Credit Information Bureau Inc. for 1997, shows that the large depreciation and consequent increase in interest rates affected the profitability of the corporate sector in the Philippines. Reflecting continued strong consumer demand during the first six months after the crisis in July 1997, total sales of these corporations increased by 27% in 1997, with the manufacturing sector continuing to post the highest share in sales (42.6%). Construction, however, posted the largest increase of 46% over 1996 levels, followed by financial intermediation (32.5%) and community and social activities (37.1%).

However, the profitability of many firms deteriorated in 1997, resulting in total losses of P5.7 billion for the top 5000 firms in the country, a huge amount compared to the P50.9 million increase in profits registered in 1996. Companies engaged in financial intermediation bagged the top slot in terms of profitability, contributing 52% of the total profits of the top 5000 corporations, despite the increasing non-performing loans in their portfolio and the additional requirements for loan-loss provisions. Only four sectors recorded an increase in profits – construction (20.2%), the utilities sector (10.4%), education (12.6%) and community and social service activities (8.1%).

The crisis also affected the creation of new business enterprises. Data from the Securities and Exchange Commission shows that new business registrations during the first semester of 1998 declined by 18% compared to the level in 1997. Business capitalisation also contracted by 42% during the first half of this year. Inflows of investments for new corporations went down by 36% to P17.9 billion while those for ongoing firms were down 45%.

On a positive note actual foreign direct investments, in the form of equity in local businesses and remittances of foreign corporations to their branches and headquarters, went up by 7% in the first half of 1998. While cash infusions were the dominant form of direct investment, there was a significant rise in reinvested earnings through stock dividends.

Meanwhile, thirty corporations filed for debt suspensions during the first seven months of 1998, of which eight were either dismissed or withdrawn by petitioners. Relief is being sought for total debt of P91.7 billion, of which about 92.8% is accounted for by one company, Philippine Airlines. Total assets of these companies amounted to P97.9 billion, or an asset-to-liability ratio of 1.08:1.00. Bank exposure of these 22 corporations amounted to P3.8 billion and US$297.4 million while non-bank creditors have total exposures of P619.6 million and US$95.7 million. So far, compared to other crisis-affected countries in the region, corporate distress in the Philippines is not as serious, despite the low profit picture seen in 1997.

Closures (as reported by the Department of Labour and Employment) reached 373 firms as of the first semester of 1998, compared to 184 firms in 1997 for the same period as of August 1998. Around 371 firms have filed notice of permanent closure and 177 for temporary closure. Of the firms which have closed down, more than half (271) are small firms (less than 20 workers). The large firms account for around 15% of those which have closed down.

Remaining structural reforms in the financial and corporate sectors

While the Philippines seems to be the least affected by the crisis, it has nonetheless been obliged to undertake significant reforms in the banking and financial sectors. The World Bank is ready to

grant a banking sector reform loan aimed at strengthening the banking system through the following measures: (1) enhancing banks' ability to withstand shocks by raising capital and encouraging consolidations; (2) addressing the tightening provisioning requirements and strengthening regulatory oversight; (3) reducing disincentives to peso intermediation; and (4) implementing a bank resolution strategy geared towards dealing expeditiously with problem banks.

To date, a very comprehensive set of reforms has already been enforced by the monetary authorities, as mentioned earlier. Among the needed reforms, the following must undergo a fast-track analysis: (1) the bank resolution strategy that will spell out strategies for dealing with insolvent or nearly insolvent banks; (2) the strengthening of government banks; (3) intensified monitoring of troubled banks; and (4) the tightening of requirements in the use of emergency advances from the central bank. In order to hasten the recapitalisation of ailing banks, amendments to laws impeding 100% participation of foreign investors in distressed banks may have to be pushed through Congress.

On the corporate side, incentives must be provided to firms to prevent excessive debt build-up. And measures must be taken to strengthen the corporate sector and avoid future crises. These include: (1) improved transparency and market discipline through more effective bankruptcy procedures, improved disclosure requirements and the systematic monitoring of the key financial variables of large companies; and (2) enhanced supervision and prudential standards in the financial sector. Details for the implementation of the above are being worked out by the Securities and Exchange Commission.

4. Conclusion

In the short run, the Philippines' immediate concerns are to (1) stabilise the economy; (2) moderate output fall; (3) protect those sectors adversely affected by the crisis; and (4) implement banking and financial sector reforms.

As in past currency depreciation episodes, the economy goes though a stabilisation mode for at least eighteen months after the crisis began. It is therefore crucial at this stage to ensure stability in the foreign exchange market as a prerequisite for the return of investor interest. At the same time, the biggest challenge confronting the Philippines is maintaining fiscal stability. With the fall in revenue due to the crisis, the government has only a limited ability to pump-prime the economy to prevent a recession. Even with the present deficit target of P40 billion, financing has been a problem, especially given the unavailability of loans from the international market after the Russian rouble devaluation. Borrowing domestically, however, will probably lead to increasing interest rates. It is therefore important that the new government resolves structural problems in tax collection in order for the economy to get back on its feet. The country's ability to stimulate growth depends on the health of the fiscal sector.

To resuscitate the economy the government must undertake confidence-building measures. Foremost on the list is the need to maintain relatively low interest rates to encourage investment. It is also necessary to market the Philippines more aggressively as an investment site. Assisting domestic export firms to diversify markets will also help. And maintaining relatively healthy export growth will ensure the quick recovery of the domestic economy.

Crises always raise the issue of stabilisation versus growth, as witnessed in the Philippine experience. In 1983, resolution of the country's debt problem was less concerned by the social aspect of stabilisation than is the case today. At that time, IMF assistance gave stabilisation precedence over

growth, which usually comes a year or two after the crisis. As a result, the reform process was received negatively overall. The lesson being that it requires strong political will to implement both a stabilisation package and structural reform measures.

But the approach to the present crisis has been different, with a stronger social consciousness on behalf of the multilateral institutions and a more global approach to the resolution of the problem. However, the twin objectives of safeguarding social expenditures and "fiscalising" the resolution to ailing financial institutions create considerable strain on the fiscal side. Financing is the key to the problem, but the concern for growth through lowering interest rates must be considered. As with the eighties experience, in the medium term, assistance from both bilateral and multilateral sources will have to fill up the slack in private sector inflows into the problem countries.

NOTES

1 ASEAN is composed of Brunei, Darussalam, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam. Cambodia holds observer status.

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Table 1**. Total foreign exchange liabilities*, 1983**
(In million US Dollars)

	1983	
	Level	Share
By Type of Debt	**24,095**	**100.0**
Medium and Long-term	15,080	62.6
Short-term	9,015	37.4
By Borrower	**24,095**	**100.0**
Banking System	8,018	33.3
Commercial Banks	4,056	16.9
Central Bank	3,962	16.4
Public and Private[1/]	16,077	66.7
Public	11,606	48.2
Private	4,471	18.5
By Creditor	**24,095**	**100.0**
Foreign Commercial Banks & Financial Institutions	15,445	64.1
Multilateral Sources	3,783	24.2
Bilateral Sources	2,048	8.5
Supplies and Others	2,819	11.7

Notes:
[1/] Including Red Clause Advances
* Total may not add up due to rounding

Source: Bangko Sentral ng Pilipinas, *Selected Philippine Economic Indicators*, August 1998

Table 2**. Selected economic indicators, 1983-1986**

	1983	1984	1985	1986
Output				
Real GNP (growth rate)	1.70	-9.10	-7.00	3.60
Prices				
Inflation	5.10	46.80	23.40	-0.40
91-day T-bill (WAIR)	14.26	28.24	26.81	14.43
Monetary				
NPL to Total Loans (%)	12.20	21.20	23.10	20.90
External Balances				
CA Deficit (US$, mn)	2,750.00	-1,116.00	-103.00	954.00
CA/GNP	-8.40	-3.70	-0.30	3.30
BOP (US$, mn)	-2,118.00	243.00	2,301.00	1,242.00
GIR (US$, mn)	864.70	886.10	1,087.90	2,506.50
months worth of imports	0.91	1.12	1.52	29.30

Sources: National Statistical Co-ordination Board, National Statistics Office, Bangko Sentral ng Pilipinas, Department of Finance

Table 3. **Vulnerability indicators, 1996**

	Thailand	S. Korea	Indonesia	Malaysia	Philippines
Domestic credit (% of GDP)	155	165	75	168	60
% of loans to property sector	30 - 40	10 - 15	25 - 30	33	13 - 14
Money supply:	10x	12.8x	5.6x	4.88x	3.0x
International Reserves Ratio (1997)					
Financing gap	57.5	77.9	50.8	18.5	16.8
US$bn (1997)		(1996)			
Outstanding external debt	94.9	154.0	135.0	-	49.5
US$bn (1997)					
Short-term debt	43.3	67.5	30.8	8.7	5.6
Reserves	37.7	34.0	19.1	26.9	11.6

Sources: JP Morgan, Deutsche Morgan Grenfell, American Express, Bangko Sentral ng Pilipinas

Table 4. **Rate of depreciation of crisis-affected currencies, 1997-98**
(Local currency per US dollar)

	2 July, 1997	End Sept. 1998	Rate of Dep. (%) July 1997-end Sept. 1998
Philippine Peso	26.38	43.80	66.10
Indonesian Rupiah	2341.92	10638.30	354.30
Thai Baht	24.40	38.99	59.80
Malaysian Ringgit	2.57	3.80	47.80
Korean Won	885.74	1369.86	54.70

Source: Bangko Sentral ng Pilipinas

Table 5**. Gross National Product, S1 1997 - S1 1998**
(Growth rates in %, at constant 1985 prices)

	1997			1998		
	Q1	Q2	S1	Q1	Q2	S1
Agriculture, Fishery & Forestry	**4.9**	**1.8**	**3.4**	**-3.8**	**-11.5**	**-7.5**
Industry	**5.1**	**7.6**	**6.3**	**1.6**	**-1.5**	**0.0**
Mining & quarrying	-13.1	-1.0	-7.3	17.5	6.2	11.7
Manufacturing	2.3	5.3	3.9	2.0	-2.6	-0.4
Construction	21.3	18.5	19.9	-5.0	-2.5	-3.8
Electricity, gas & water	3.8	8.0	6.0	7.2	6.1	6.6
Services	**6.1**	**5.7**	**5.9**	**4.5**	**3.6**	**4.1**
Transportation, communication and storage	8.9	8.2	8.5	8.1	6.6	7.3
Trade	4.9	4.3	4.6	4.1	2.1	3.0
Finance	15.6	12.7	14.1	6.6	5.7	6.1
Ownership dwellings & real estate	4.5	3.8	4.1	2.3	2.1	2.2
Private services	4.7	4.9	4.8	4.2	4.4	4.3
Government services	2	3.9	3.0	2.4	3.0	2.7
Gross Domestic Product	**5.5**	**5.6**	**5.5**	**1.6**	**-1.2**	**0.2**
Gross National Product	**5.4**	**5.3**	**5.4**	**2.0**	**-0.7**	**0.6**

Source: National Income Accounts, National Statistical Co-ordination Board

Table 6**. Gross National Product by expenditure share, S1 1997-S1 1998**
(Growth rates in % at constant 1985 prices)

	1997			1998		
	Q1	Q2	S1	Q1	Q2	S1
Personal Consumption	5.0	5.1	5.0	4.5	4.4	4.4
Government Consumption	0.4	3.3	1.9	-1.4	1.5	0.1
Capital Formation	14.9	7.1	11.1	-9.2	-14.5	-11.7
Fixed Capital	13.3	11.7	12.5	-1.6	-6.8	-4.1
Construction	19.3	14.7	17.0	-1.5	2.3	0.4
Durable Equipment	8.6	8.7	8.6	-1.5	-17.3	-9.0
Breeding Stock & Orchard	11.1	13.1	12.0	-2.4	2.3	-0.2
Exports	22.3	17.2	19.6	11.4	-8.3	1.3
Imports	13.9	9.8	11.7	4.0	-9.2	-2.8
Gross Domestic Product	**5.5**	**5.6**	**5.5**	**1.6**	**-1.2**	**0.2**
Gross National Product	**5.4**	**5.3**	**5.4**	**2.0**	**0.7**	**0.6**

Source: National Income Accounts, National Statistical Co-ordination Board

Table 7. **Annual inflation rates, 1997-98**
(1988=100)

	January-September	
	1998	1997
All Items	**9.4**	**5.5**
Food, Beverages & Tobacco	**8.0**	**3.0**
Non-Food	**11.1**	**8.8**
Clothing	7.9	5.9
Housing & repairs	12.0	9.8
Fuel, light & water	5.7	9.4
Services	14.9	11.4
Miscellaneous	7.9	3.3

Source: National Statistics Office

Table 8. **National Government Cash Programme, 1998**
(In million Pesos)

			1998	Revised
	Actual 1997	Programme with IMF	Revised Programme	1998/1997 % Growth Rate
Revenues	**471,844**	**531,303**	**466,080**	**(1.2)**
(as % of GNP)	(19.5)	(19.7)	(17.3)	
Tax	412,167	498,355	436,033	5.8
Non-Tax	59,678	32,948	30,047	(49.6)
Disbursements of which:	**470,279**	**526,300**	**506,080**	**7.6**
Current Operating Expenditures	371,047	427,569	422,328	13.8
Capital Outlays	95,210	94,672	80,093	(15.9)
Deficit	**1,565**	**5,003**	**(40,000)**	**(265.6)**

Source: Department of Budget and Management

Table 9. **Exports by major commodity group**
(In million US Dollars)

				January-June		
	1997	1996	G.R.(%)	1998	1997	G.R.
I. Non-Manufacture	**2,965**	**2,948**	**0.6**	**1,400**	**1,400**	**-2.8**
II. Manufacture of which	**21,488**	**17,106**	**25.6**	**11,852**	**9,921**	**19.5**
Electronics (include. Parts)	13,052	9,990	30.6	7,727	5,916	30.6
Garments	2,349	2,423	-3.0	1,122	1,087	3.2
Machinery-Transport	2,686	1,296	107.2	1,474	1,233	19.5
Total Exports	**25,228**	**20,543**	**22.8**	**13,904**	**11,700**	**18.8**

Source: Bangko Sentral ng Pilipinas

Table 10. **Social sector expenditure programme, 1997 - 1999**

Social Services	Levels (in million pesos)		
	1997	1998	1999
Education, culture and manpower development	94,954	106,245	112,356
Health	14,154	13,743	14,108
Social security, welfare and employment	20,263	21,124	23,906
Housing and community development	2,438	1,647	1,790
Other social services	767	5,666	4,709
Total	**132,576**	**148,425**	**156,425**

Note: Used CPI as deflator

Source: Budget of Expenditures and Sources of Financing, DBM

Table 11**. Labour and employment indicators, 1998**

	1998			Jan., April & July aver.	
	Jan.	April	July	1998	1997
Labour Force Participation Rate (%)	65.0	68.6	64.9	66.2	66.6
Jobs Generated (’000)	356.0	-270.0	325.0	138.0	556.0
Agriculture	-387.0	-1168.0	19.0	-512.0	-37.0
Industry	102.0	65.0	-136.0	9.0	237.0
Manufacturing	22.0	36.0	-51.0	2.0	48.0
Services	642.0	83.3	441.0	640.0	696.0
Unemployment Level (’000)	2,546.0	4,278.0	2,737.0	3,187.0	2,727.0
Unemployment Rate (%)	8.4	13.3	8.9	10.3	9.0

Source: *1995 Yearbook of Labour Statistics*, Current Labour Statistics (BLES-DOLE)

Table 12. **Selected economic indicators**
1983-1986 and 1996-1998

	1983 Debt Crisis			1997 Currency Crisis		
	1983	1984	1985	1996	1997	1998
Output						
Real GNP (growth rate)	1.7	-9.1	-7.0	7.2	5.8	0.6 [a/]
Prices						
Inflation	5.1	46.8	23.4	8.4	5.1	8.4 [b/]
91-day T-bill	14.3	28.2	26.8	12.4	13.1	15.5 [c/]
Monetary						
M3 (in million pesos)	114,225	122,445	134,533	881,404	1,066,000	1,082,809 [a/]
growth rate		7.2	9.9	15.8	20.9	17.2
NPL to total loans (%)	12.2	21.2	23.1	3.5	4.7	9.6 [a/]
Fiscal Position						
Public Sector	-27.5	-15.7	-32.2	7.3	-22.2	-73.5 [d/]
% of GNP	-7.6	-3.1	-5.8	0.3	-0.9	-2.6 [d/]
National Government	-7.5	-10.0	-11.2	6.3	1.6	-40.0 [d/]
External Balances						
CA Deficit (US$, mn)	-2,750.0	-1,116.0	-103.0	-4,542.0	-4,303.0	-39.0 [a/]
CA/GNP	-8.4	-3.7	-0.3	-5.3	-4.9	-0.1 [a/]
BOP (US$, mn)	-2118.0	243.0	2,301.0	4,107.0	(3,363.0)	1,559.0 [a/]
GIR (US$, mn)	864.7	886.1	1,087.9	11,602.0	8,768.0	9,938.4 [b/]
months worth of imports	0.91	1.12	1.52	2.90	2.00	2.40

Notes:

[a/]As of June 1998
[b/]As of August 1998
[c/]As of September 1998
[d/]As of 29 September, 1998

Sources: National Statistical Co-ordination Board, National Statistics Office, Bangko Sentral ng Pilipinas, Department of Finance

Figure 1. **Evolution of the currency crisis in the Philippines**

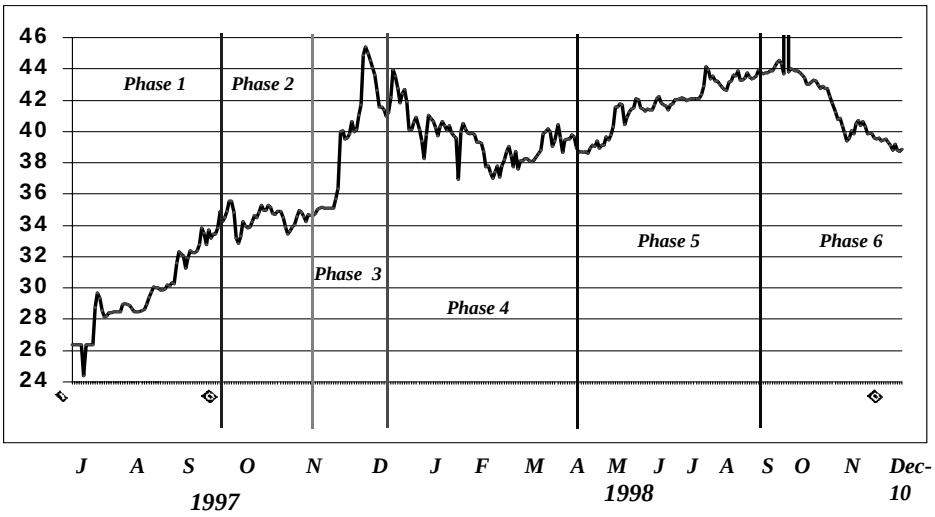


Figure 2**. Stock market transactions, June 1997 - July 1998**

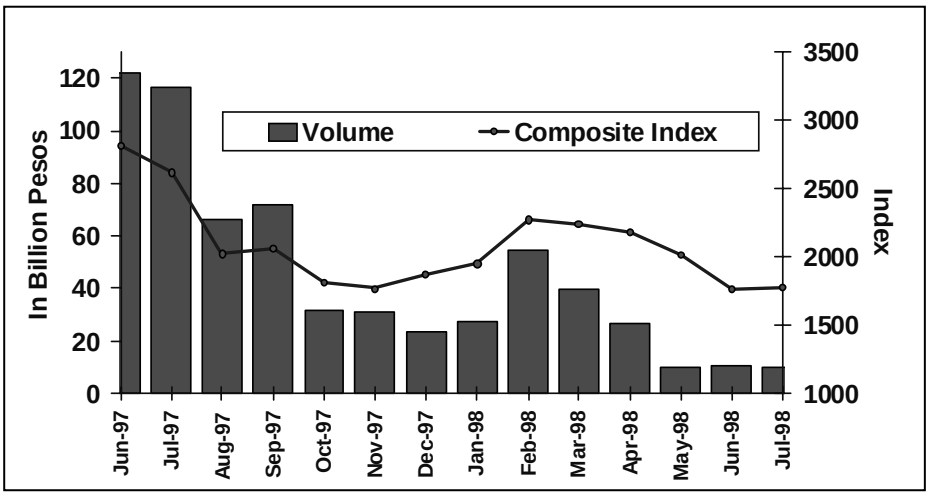
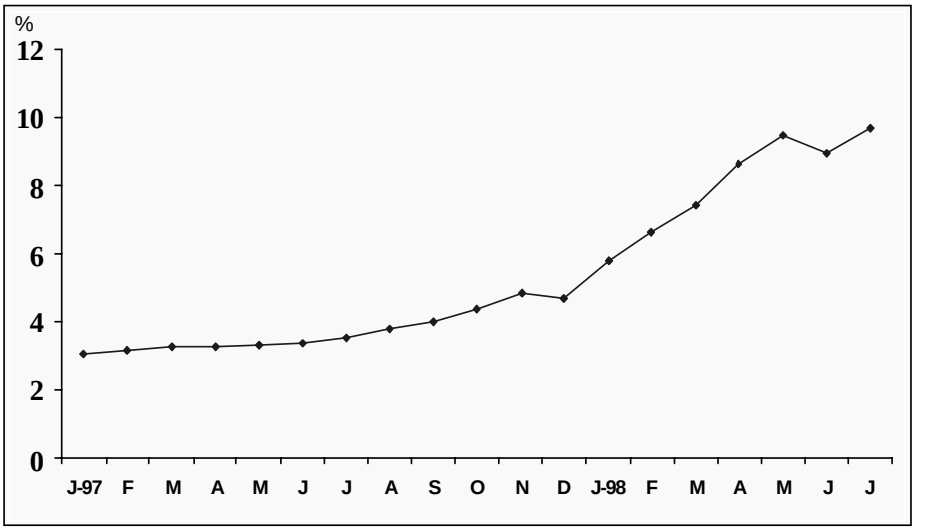


Figure 3**. Rate of non-performing loans to total loans**
1997 - July 1998



Source: Bangko Sentral ng Pilipinas

4.4 THE EAST ASIAN CRISIS: CAUSES AND PROSPECTS

Discussion by Soogil Young, Permanent Representative of Korea to the OECD

Introduction

In my presentation, I propose to provide my own analysis as to the causes of the Asian financial crisis and prospects for recovery from it, with emphasis on those points which, I believe, have not been given due attention in the preceding sessions. This means that I have to begin with a summary analysis of the Korean situation, because there has been no paper presented on Korea, although there have been many sporadic references to its financial crisis.

So my presentation will be divided into two parts – first, I will discuss Korea, and then I will make several general remarks about the Asian crisis as a whole.

The Korean crisis

Korea was hit by the financial crisis towards the end of November 1997. On 4 December, the IMF announced a financial assistance package for Korea, yet the financial currency crisis continued. The presidential election was held on 17 December and Mr. Kim Dae-Jung was elected. Even before he was inaugurated in February 1998, he began to effectively exercise leadership in leading the country out of the crisis; The first thing he did was to give his unreserved endorsement of the IMF prescription of structural adjustment for the Korean economy. The currency market then began to stabilise and the Korean government immediately started negotiations which led to a successful restructuring of the Korean commercial banks' international debt.

At the same time, the government began to undertake a broad range of economic reforms prescribed by the IMF. However, the government did not limit reforms only to those recommended by the IMF, it tried to do much more, calling this an 'IMF-Plus' approach.

Let me first review very briefly the main causes behind the Korean currency crisis.

Parenthetically speaking, the crisis occurred about a year after our accession to the OECD. So in Korea, some suspect that this accession had something to do with it. But, of course, problems were elsewhere, and, as was pointed out by Professor Anne Krueger, the core problem was the weak financial sector which had been subject to government interference and bailouts. This created moral hazard and encouraged financial institutions to neglect appropriate risk management. The weak financial sector was a major enabling factor behind the emergence of the problems of the chaebol. These included excess capacities in many money-losing businesses and excessive accumulation of corporate debt relative to equities. These domestic problems had also been nurtured by changes in the

international environment, in particular an acceleration of movement of international financial capital, especially marked during the 1990s.

These were some of the fundamental causes of the Korean currency crisis, but there were also triggering factors, one of which was the deterioration in the terms of trade, including a very sharp drop in the price of semiconductors, Korea's leading export product. Given the sharp worsening of the current accounts deficit between 1996 and 1997, about two-thirds of the deterioration was accounted for by the worsening of the terms of trade. This was followed by a sharp drop in the growth rate of the economy, causing losses to many corporations, especially chaebol, which in turn led to a series of bankruptcies. There was also contagion from Thailand and Indonesia. In addition, the Korean currency was seriously affected by a substantial devaluation of the new Taiwan dollar in early November.

Viewed from another angle, a major contributing factor in the crisis was complacency, on the part of the Korean government and its political system. The Korean economy had been experiencing very strong macroeconomic performance in terms of growth and this had the effect of masking the economy's vulnerabilities. This lead to the failure of the Korean government, as well as its political system, to take the necessary actions in the face of many emergent problems. Problems had been identified and known, but the government and the political system remained divided and undetermined, and as the number of insolvent firms kept rising, it failed to take effective action and resisted pressure to let the currency depreciate in the face of the worsening of the current account. Even on the eve of the financial crisis, the ruling party failed to support a major financial reform bill submitted by the Administration.

What were the responses of the Korean government during the first few months of the currency crisis? The priority was on stabilising the currency market. The government did this by accepting the high interest rates and fiscal austerity policies which were prescribed by the IMF. We also successfully rescheduled banking sector debt and tried to build up our foreign reserve holdings. This was done in part by utilising the funds that the IMF and other international institutions made available, but also through a massive adjustment of the current account which has recorded increasing amounts of surpluses since November 1997. Further, epoch-making measures were taken to open up the domestic capital market for portfolio, as well as, direct investment.

As a result, the currency began to stabilise in early 1998. In the meantime, the government has continued to pursue a broad range of structural reforms, the core reforms being, of course, financial and corporate. These core reforms have been complemented with labour-market reforms. We are taking a two-pronged approach to labour market reform: on the one hand, there has been an effort to increase the flexibility of the labour market. The focus here has been on doing away with what has essentially served as a lifetime employment guarantee system. At the same time, as a member of the OECD, we have also endeavoured to bring reforming laws and regulations on industrial relations in line with the standards of the advanced OECD countries.

Let me also emphasise various efforts made to open up the domestic economy to the rest of the world: a complete opening of the capital market, opening the market for corporate control and the opening of the product markets, manufacturing and services, to foreign competition. As part of these efforts, we are removing remaining restrictions on foreign exchange transactions. Furthermore we are aiming at strengthening the social safety net, enhancing unemployment insurance, as well as unemployment assistance, and increasing subsidies to the low income bracket. A broad range of

government sector reforms are also in progress, with a dual emphasis: one on the privatisation of state enterprises, and the other on downsizing the government.

The basic aim, as propounded by President Kim, has been to take advantage of this crisis to undertake those structural reforms that have been necessary in any case. He recently introduced the concept of the *Second Founding of the Nation* and this is the ultimate principle behind reforms. As has already been mentioned, present efforts for the *Second Founding of the Nation* go far beyond the IMF-recommended policy package.

What have been some of the difficulties which the Korean government has had to confront in pursuing these reforms? First of all, by their nature, these structural reforms tend to be contractionary during the early phase of their implementation. Furthermore, macroeconomic policies, as prescribed by the IMF, were intentionally contractionary. This has had what I might call a pulverising effect on firms and industries, contributing to greater bankruptcies and unemployment. Fortunately, though, this macro policy stance was eased as of early 1998.

Moreover, there has been labour resistance to the bankruptcies and subsequent unemployment. In order to overcome this labour resistance, President Kim set up a Tripartite Commission for the purpose of recognising workers as social partners in the national effort for economic restructuring. The very profound, fundamental reforms of the corporate and government sector were made part of the whole reform package agreed to by the Commission. At the same time, there was an agreement to expand the social safety net and to reform labour laws to bring them in line with the level of OECD country standards. In order to finance the expansion of the social safety net, the government has decided to accept a budget deficit which is expected to reach about 5% of GDP this year. These are some of the components of the agreement of the Tripartite Commission, negotiated as a means of mobilising the support of labour unions for painful restructuring which will inevitably entail a vast amount of unemployment.

Financial reform has proceeded on schedule and the institutional framework necessary for this purpose is nearly in place. We have begun to tackle corporate restructuring in earnest. Here, we need an injection of new capital to alleviate the corporate debt, as well as industrial restructuring, and we are debating the appropriate speed of this restructuring. The chaebols' demand is that this should be left to market forces. In principle, this seems to be a reasonable position, but it might take too much time. For this reason, the government's thinking is it has a role to play in expediting corporate restructuring. However, the government is agonising over how much leadership and/or assistance it should provide to facilitate the restructuring process. In the meantime, the credit crunch is continuing.

Let me mention some other difficulties. There are a number of uncertainties on the international front. We are all familiar with the uncertainty over prospects for Japan, China and Latin America. There is also concern about the availability of aggregate demand of sufficient magnitude and duration for the products and services which would help Korean firms emerge from the current depression. Domestic demand is grossly insufficient and so far, there has not been enough demand from abroad either. Korea has experienced a massive swing in the current account from a deficit of 5% of GDP in 1996, to a surplus of over 12% expected for 1998, but this remarkable improvement of the current account is coming about through a collapse of imports, while exports have not increased at all. This shows how severe the situation is right now. We have to recover exports to the United States and Europe, as well as to Japan. In this regard, uncertainty over prospects for the recovery of the Japanese economy, as well as the threat of protectionism detected in the US and elsewhere, is causing serious concern.

In Korea today, things are closer to normal than a year ago. The interest rates are down to pre-crisis levels and our foreign reserve holdings have been rebuilt to a record level of US$45 billion at the end of October 1998. This is specifically the amount of usable foreign exchange reserves. The growth rate of the economy was about 5.5% in 1997; it is expected to be about -6% in 1998. We anticipate that it will recover to something like 1-2% in 1999. The current account improvement has already been mentioned.

The most worrying problem is unemployment. In 1997, the unemployment rate was about 2.5% on the average. In 1998, it will be around 8% or even higher, and it is expected to remain high for the next few years.

The Asian crisis

First of all, we know that all the crisis-stricken Asian economies had been growing very rapidly for many years, and that this led to the belief that the economic fundamentals were strong. However, we were looking only at the high growth performance of the economies in question. We now realise that high growth is not necessarily a good indicator of the strength of an economy. Leading up to the crisis, these economies had been growing rapidly to the point of being overheated, which was a major contributing factor to the crisis. In hindsight, this shows the need to re-examine critically the way growth is managed in developing economies. In fact, perhaps development managemnet requires a basic reorientation.

First, I believe that there has been too much emphasis on growth *per se*. For quite some time, the continued rapid growth of these economies has been associated with continued reform drives over broad ranges. But recently, the reform drive has slowed down. In fact, reform has been lacking altogether in the financial sector as well as in the corporate sector. In particular, the government has continued to play a very strong, paternalistic role with regard to these sectors, and has blocked, rather than promoted, any serious reform effort. Elements such as collusion, cronyism, corruption and nepotism have persisted, often masquerading as ‘Asian values’. Overcoming those problems cannot be achieved overnight. It will take time to, on the one hand, purge these unproductive values, and, on the other hand, acquire modern banking know-how and build up the necessary institutional capacity. This will be no easy task, and seems to be an area where international assistance will be very important and most appreciated. In this regard, the OECD can play a very crucial role.

Another common element in the experiences of the crisis-stricken Asian economies is that they all fell victim to sudden and destabilising massive outflows of financial capital. The institutional weaknesses of their banking and corporate sectors made them vulnerable to the destabilising influence of the globalisation of financial capital movement in the 1990s. A question that we may ask here is: after all requisite reforms, will the emerging market economies be capable of coping with future destabilising movements of international financial capital? Will they manage individually? Or will they need a new international financial architecture? If so, what form will this architecture take?

As I remarked earlier, reforms in the Asian economies slowed down for several years leading up to the current crisis. In the final analysis, complacency is the explanation. I have already used this word when discussing Korea. Complacency has been associated with high growth performance. A particular remark I would like to make in this regard is that complacency has been encouraged by the various adulatory remarks made by the rest of the world about the so called “East Asian Economic Miracle”. For this, the international community cannot claim innocence. Another major factor which

contributed to the slowdown of reform in Asia, has been the emergence of entrenched, vested interest groups that are opposed to reforms. These were a result, in part, of economic prosperity and, in part, of democratisation. In the future, governments will have to deal more effectively with these vested interest groups. This problem underscores the need for checks and balances and, most critically, transparency and open debate in national governance.

In a similar vein, just before the crisis occurred, weak and ineffective political leadership in each crisis-stricken economy posed a problem. In some countries, especially Thailand, Indonesia and Korea, lack of political leadership has contributed to changes in government. Malaysia and the Philippines did not have this problem of ineffective political leadership and this is probably one reason why the crisis has been much less severe in those economies. In the final analysis, it appears that governments' ability to mobilise social and political consensus in support of reforms will be a key determinant of their ability to overcome the current crisis and recover their economic dynamism.

There were differences between these countries in terms of specific policy responses. In particular, there was an especially marked contrast between Malaysia and Korea. Korea took an 'IMF-Plus' approach, consisting of a broad range of reforms dedicated to the principles of market and competition, complete opening to the rest of the world, the free floating of exchange rates and conservative macroeconomic policies. In contrast, Malaysia is taking what we may call an 'IMF-Minus' approach, proposing to manage exchange rates, introduce capital controls, pursue expansionary macroeconomic policies and emphasising supply-side enhancement, i.e., industry-specific measures. One approach is not necessarily better than the other. However, here we have an important experiment in progress, and it will be interesting to watch and compare outcomes.

Let me make a few comments about the IMF's prescriptions for economies in crisis. Two components have been controversial: the initial macroeconomic prescription for contractionary policies, and the imposition of structural reforms as bailout conditions. In the Korean case, I believe that, to a degree, the initial prescription of contractionary policies was in part inevitable and in part reflected a wrong growth projection, and in any case it went too far. It was overdone to the extent that, contrary to the original intention, it has had the effect of discouraging investor confidence, instead of encouraging it. It should be added, however, that, at least in the Korean case, the IMF soon became flexible on this matter. After the first few months, this prescription of macroeconomic austerity was eased and replaced by relatively expansionary macroeconomic policies.

Concerning the imposition of broad structural reforms, we believe that the IMF prescription was broadly correct in terms of the structural problems it identified. This has helped Korea acquire the political will to undertake painful reforms which we would not otherwise have been able to undertake, due to opposition from various interest groups. But there also have been some down sides. Overall, the IMF package was good, but it was not perfect. For example, one critical element lacking in the IMF prescription was a solution to the debt weighing on the banking and corporate sectors. The prospects for, and speed of, recovery in the crisis-affected economies will simply depend on how well and how early this debt overhang is overcome. There seems to be a need for the restructuring of private sector debt and especially for capital injection from abroad. This issue still remains to be addressed.

Sustainability of reform is also an issue of critical importance. I agree very much with Ms. Stewart that macroeconomic performance, especially early recovery of the economies, along with national consensus-building, is the key to pushing forward and sustaining these reforms. Equally important in this regard is the adequacy of social safety nets; there is much room for improvement in

their scope and effectiveness, and in the way social assistance packages are administered and delivered. Here, again, international organisations, such as the World Bank and the OECD, can help with funds and advice.

Lastly, a word about the longer-term prospects for these economies. Structural reforms will take time, but growth can recover relatively early. Hopefully, it will begin to do so in late 1999. In the medium to long term, these reforms will help the crisis-affected economies improve the efficient use of their factors of production, in particular the labour force and human capital. This means that, once the crisis has been overcome, dynamism will be returned to the East Asian economies, and the present crisis will be viewed in retrospect a rite of passage from adolescence to a more mature stage of development.

Chapter 5

CONCLUSIONS

5.1 STRUCTURAL REFORMS AND GROWTH

Remarks by Andrew Dean, OECD Economics Department

It is a pleasure and a challenge to try to pull together some of the threads of the discussions on structural reforms and growth and relate these ideas to OECD work. One underlying theme that strikes me about the discussions we have had is *interactions* – of perhaps three sorts:

1. Interactions between economic policy, social policy and political forces;

2. Interactions between different countries and regions (linkages);

3. Interactions, within the economic field, between macroeconomic and microeconomic or structural factors.

Let me say a quick word about each and then perhaps dwell more on the last one.

First, the interactions between economic, social and political forces. The Secretary-General has stressed what he calls a triangular paradigm which he believes is the key to economic and social progress – he believes that there has to be a balance between economic growth, social stability and good governance with countries finding the right balance based on their own social, economic and cultural values. I would suggest that this idea of balance is relevant not just to the OECD economies to which the Secretary-General was initially applying it, but to the broader set of Asian countries we have been considering in the last two days. I will leave this issue there as John Martin will be touching on critical social and political sustainability issues in a moment, but I believe that this triangular balance is relevant to our discussions and must be kept in mind.

Second, the interaction between different countries and regions. Clearly the current crisis, though we have called it the East Asian crisis, has had global repercussions and ramifications. Jungsoo Lee's paper yesterday referred to the many different past episodes of crisis, the recovery times and so on, based on a comprehensive analysis of financial crises conducted by the IMF. It seems to me that the crisis of the last year has not been as self-contained as many, but has had impacts beyond immediate neighbours. Put simply, globalisation, in particular increased financial integration, has given rise to contagion as problems which may have been local in origin have spilt over and hit other markets and other countries. In this way it may be that the sum is greater than its parts. This may complicate the cures but makes finding them no less pressing, if virtuous and not vicious circles are to be created.

Third, and really the main underlying theme running through our discussions, is that there are strong interactions between macroeconomic and structural developments and policies. I think we can see elements of this interaction in all of the papers presented at this symposium.

Anne Krueger's paper, which gives a nice account of how the high growth Asian economies got to where they did, rightly points to three "macro" fundamentals where the four crisis countries came

off the rails – current account deficits, excessive growth of domestic credit and real currency appreciation. She sees these as related to fundamentals – and quickly points the finger at the problems of the financial sector, of the need to recapitalise banks and firms, and ensure more appropriate prudential lending in the future. But facilitating more rapid growth will also require more attention to infrastructure, education, labour markets and corporate governance. The macro-structural link is obvious.

Of course, prior to the crisis these countries had all been doing relatively well despite the now-acknowledged shortcomings in some of these fields. So, as Max Corden pointed out, some of these factors are not central to the crisis, but they would surely be important in improving efficiency and generating better outcomes in the future. This leads me to a question: do crises such as the ones we are discussing take you past a threshold? Practices, institutions, policies that were fine while growth was rapid now have to be rethought, and maybe revised in the post-crisis world. I was reflecting on this, in particular, when thinking about Tarun Khanna's findings on the evolution of business groups in Chile and India, and trying to relate these findings to the East Asian crisis: should these industrial groups exist in the new post-crisis world; should they evolve; and shouldn't the transparency and market disciplines of these groups be improved? I think that we all agreed that corporate governance was important but I didn't hear unanimity about what type – perhaps this is one of the areas where the OECD can indeed help to move the debate further with the development and wide discussion of the draft standards and guidelines document which has been distributed at this meeting.[1]

Shin-ichi Fukuda's paper, with its interesting results about the importance of the growth of capital stock – a source of growth that seems likely to diminish over time – also points to the need to look towards structural reforms to reduce distortions and allow high growth rates to be maintained in the post-crisis period. Another key factor in his analysis, which was stressed by others, was the openness to trade of the East Asian countries, which allowed the initial strong comparative advantage in labour-intensive industries to be maintained.

There was much agreement, too, with the theme of Jungsoo Lee's paper that the root causes of the Asian crisis are structural weaknesses in the governance of the financial and corporate sector, requiring strengthening of the financial sector and reforms in corporate governance and bankruptcy policies. But he pointed out the important fact that restructuring would have distributional consequences.

At this point, I have to recognise, however, that we now seem to have too many different key elements, root causes and decisive factors explaining the crisis. We seem to have overidentification. This takes me back to my main theme; I believe that all these issues are closely linked and thus that policy advice must take full account of the macro-structural interactions that are clearly present in the crisis.

I believe that this view has also come out of this morning's discussion of the particular circumstances in Indonesia, Malaysia and the Philippines. Since these papers and the interesting discussions that followed are fresh in your minds, I will only say a few brief words about them:

- Indonesia: Saleh Afiff's provocative paper, which talks of many structural reforms, may lead us to ask about the priorities in present reforms, in particular which ones are needed most immediately for recovery and which are necessary for efficiency over the longer term (Max Corden's point);

– Malaysia: Victor Wee describes a different route to recovery, but his paper begs the question as to whether capital controls will be advantageous over the longer term and allow restructuring of the ailing banking system; this is a debate that may take some time to resolve although Ambassador Young sees this as a test case which we will be watching with interest;

– Philippines: Ofelia Martin-Templo shows that successful reforms in the wake of crisis can significantly improve an economy's capacity for healthy and sustained real growth; she points to the need to rebuild confidence but is basically optimistic about recovery.

There were many additional threads in our rich discussions and I regret that I cannot cover them all. But I think that many of the views describe different aspects of a complex, multifaceted story. We probably all agree that macro imbalances triggered the crisis, but the crisis then revealed structural weaknesses that need to be addressed to ensure a return to high rates of sustainable growth. I think it is possible to take the position of saying that attention to microeconomic factors is critical (Nicholas Crafts), that sensible financial frameworks are required (Leslie Lipschitz, IMF) or that the crisis is rooted in the performance of the corporate sector (R. Shyam Khemani), while at the same time admitting that the macro situation has to support the recovery – through both external and domestic demand. These all seem to me to be necessary but not sufficient conditions for solid recovery, with different mixes of macro and structural policies required in each country to ensure the return to high growth. On the demand side, however, we all agreed that it is vital that trade be kept open and protectionist pressures in both OECD and non-OECD economies be resisted. This is a key message of the OECD's latest *Economic Outlook*.[2]

Finally, what about the work of the OECD in this area? A first, obvious, point is that Korea is a Member country, for which there is a full surveillance process – an economic survey was published in September, another will be carried out next year – with the role of the OECD being clear.

For non-member countries, however, the OECD is not directly involved in the fire-fighting and the programmes. However the Organisation has much to offer in terms of analysis and experience in OECD countries, good and bad, of financial systems, bankruptcy laws, corporate governance, taxation systems, labour markets, public governance issues and so on, all of which are relevant both to restoring sustained growth and to crisis prevention. This work can undoubtedly help Asian countries in tackling structural weaknesses and can complement the work of the other international organisations. More generally, because of the multi-disciplinary nature of the OECD work – what we tend to call horizontal work – the OECD probably has a unique role in being able to look across these different issues, and examine the macro-structural interactions which we have seen as a key ingredient in the crisis.

NOTES

1 "Draft Corporate Governance Standards and Guidelines", OECD Directorate for Financial, Fiscal and Enterprise Affairs, Ad Hoc Task Force on Corporate Governance, September 1998

2 *OECD Economic Outlook December 1998*, OECD, Paris

5.2 SOCIAL AND POLITICAL SUSTAINABILITY OF REFORMS

Remarks by John P. Martin, OECD Directorate for Education, Employment, Labour and Social Affairs

Much of the discussion at this session concentrated on the macroeconomic responses to the crisis, continuing a theme that dominated much of the discussion on the first day of the symposium. Since my colleague Andrew Dean has already covered this ground in his summary of Session 1, I will not discuss it further.

However, one must begin any discussion of the social aspects of the Asian crisis by acknowledging the key role of economic growth. As both Frances Stewart and Emil Salim reminded us, the past two to three decades have witnessed a dramatic fall in poverty in most of the Asian countries now in crisis, and this was due almost entirely to rapid economic growth rather than extensive public spending on social protection. Truly, this is a graphic illustration of the rising tide of growth lifting all boats. But what should be done now that the tide has gone out, at least temporarily, and many people are left stranded in the mire of poverty?

The social dimensions of the East Asian crisis and what to do about it

It cannot be denied that the crisis has caused severe hardship already for millions. Even if adequate monitoring systems are not fully in place in these countries yet, the examples cited by Frances Stewart and Emil Salim in their papers make the case convincingly that the gains made on the anti-poverty front over the past two to three decades are in serious danger of being reversed, especially in Indonesia. Indeed, the magnitude of the social crisis in Indonesia is stark compared with the other East Asian countries.

At the same time, I would like to highlight two critical stylised facts which are emphasised in Frances Stewart's paper. First, she argues, on the basis of some simulation results presented in Table 6 in her paper, that the amount of public spending which would be needed to offset the worst effects of the crisis on the poor is "low" relative to total public expenditure or GDP, even in Indonesia, the worst-affected country. Her estimates suggest that public spending in the order of 2 - 2.5% of GDP would be sufficient to compensate the bottom 40% of the population for a 10% cut in private and social income, or 4 - 5% for a 20% cut in their income.

These estimates of the direct costs of alleviating the poverty caused by the crisis are surprisingly low to me, and I would have welcomed more discussion of their reliability. I note that the estimates are all based on out-of-date data, relating to the late 1980s for Indonesia, Malaysia, the Philippines and Korea and to 1992 for Thailand. One wonders how the estimates would look if they were based on data for the pre-crisis income distribution. It would seem an urgent task for research to assess the reliability of such ball-park estimates of the direct costs of alleviating the worst effects of the crisis on the poor.

Even if one can question the precise accuracy of Frances Stewart's estimates, she is probably correct in asserting that the direct costs of poverty alleviation are likely to be relatively low in these countries simply because they have relied upon rapid growth in the past to alleviate poverty rather than devoting much public expenditures to social protection. The social safety nets in these countries are hung very close to the ground and they do not catch large proportions of the population.

The second important stylised fact in Frances Stewart's paper which I would like to highlight is her assertion that there is quite a lot of "fat" in the public budgets in these countries which could, and should, be cut first in order to maintain social spending targeted to the poor. She cites as examples of such "fat" public spending on the military, conspicuous investment in "white elephant" public projects, spending on tertiary education as opposed to primary and secondary education, and so on.

It would be important to have some assessment of the validity of this view. Just how much "fat" is available in the public budgets of these countries? Even if is true that such "fat" is non-negligible, just how easy would it be to cut it and switch the resources into helping the poor since strongly entrenched interest groups in these societies would undoubtedly fight hard to defend such "fat" and the poor do not have a powerful political voice?[1]

This bring me to a third issue in the papers and the discussion. Even if sufficient "fat" in public spending exists in these countries and it can be mobilised, and even if adequate lending for social safety nets can be supplied by the international financial institutions and via foreign aid, there would still remain the major problem of translating this into effective anti-poverty programmes on the ground. My colleague, Peter Scherer, posed the very pertinent issue of the imperative need for effective delivery mechanisms at the *local* level if aid is to be relatively effective in helping the poor. Even in the OECD countries which have much more developed systems of social protection that have evolved over many decades, our own research has shown that it is often a struggle to design and implement effective delivery systems at the local level which can supply services tightly targeted to the poor. Developing and implementing such local delivery services is likely to be a much harder task in the Asian countries.

Mr. Salim made the vital point, to my mind, in his comment whereby he stressed the need for democratic reform and legitimacy to go hand-in-hand with economic reforms. Without such reforms, the political will to support needed economic reforms may collapse and the likelihood of developing and implementing effective social safety nets for the poor may well evaporate.

Lessons for the future

Obviously, the first imperative must be to restore economic growth again as quickly as possible. The presumption must be that, just as the tide comes back, rapid growth will resume again in the Asian countries even if there is a question mark about the time lags in this process. That raises the important question of what lessons can be drawn from the present crisis with regard to the future development strategies of these countries so that they can continue to benefit from the fruits of growth while maintaining social cohesion and sustainable development. One common thread in the papers by Frances Stewart and Emil Salim and in the comments by Cielito Habito on them, is that future strategies will have to invest more in developing and implementing systems of social protection which are adapted to the needs of the societies in question, and which have strong democratic support. Korea has certainly taken this lesson to heart; indeed, it had launched this process

before the crisis began. Judging from the interventions made by speakers from the other countries in crisis, they have absorbed this lesson too.

That being the case, what forms of social protection should these countries invest in the future? I dare say that few would dispute the importance of these countries continuing to invest heavily in primary and secondary education and health, not only in terms of expanding the quantity but also the *quality* of such investments. There were also calls for developing the capacity to implement effectively at the local level public works programmes offering low wages, though I cannot avoid adding that the track record of such programmes in OECD countries is not very encouraging, at least in terms of helping the unemployed get back into regular jobs as opposed to giving them income support.

There was also some discussion of the desirability of investing in unemployment insurance (UI) systems. Among the countries in question only Korea has a UI system; even there, the system is very new – it was introduced in 1995 – and the authorities are struggling to expand its coverage and generosity to deal with the sharp rise in unemployment over the past year. But there are question marks over the wisdom of these countries making heavy future investment in the development of UI systems. Such systems are best suited to economies in which formal-sector activity is the dominant mode of production and exchange. This is not the case at present in most of these countries where the informal sector is still a major, if not the most important, mode of production and exchange.[2] Obviously, as growth and development proceed, there will come a point when it is a good social investment for these countries to develop UI systems and the supporting labour market institutions and range of active labour market policies which are needed to complement UI. But they are still some way from this situation.

In sum, there is little doubt that further research and discussion is needed on the issue of the optimal design and implementation of social safety nets in these countries. This is one area of research where OECD advice and expertise could be helpful, to supplement the advice which the International Financial Institutions and other international agencies are giving to these countries, given the long history of social safety nets in our Member Countries.

NOTES

1 In addition, we should not forget that part of current distress is due to the sudden termination of private sector (but often heavily subsidised by the public purse) “white-elephant” projects, leading to high unemployment among workers formerly employed in the construction sector.

2 It should be pointed out that the only two OECD countries which do not have a UI system, Mexico and Turkey, are also characterised by relatively large informal sectors.

5.3 IMPLICATIONS FOR FUTURE WORK OF THE OECD

Remarks by Ambassador Egbert Jacobs, Chairman of the Committee for Co-operation with Non-Members

As Secretary-General Donald Johnston said at the beginning of this Symposium, we at the OECD have both a direct interest as well as a joint responsibility to contribute effectively to a quick and sustained economic recovery in the crisis-affected economies of Asia. The immediate issue for us, i.e. for the Member States, is to determine precisely how this organisation, with neither a lending capacity nor a technical assistance mandate, can complement the ongoing efforts being made by governments and international financial institutions to bring the crisis to an end, reduce the probability of similar financial collapses occurring in the future and ensure that the Asian economies affected by the crisis establish the foundations for sustainable economic and social progress.

A lesson that we might wish to learn from our various intellectual endeavours on what might be called "The Asia Crisis", is that it is time to acknowledge that no-one has a convincing formula for kick-starting a strong economic recovery in the region. What we do know, is that macroeconomic stabilisation efforts need to be underpinned by a range of institutional and sectoral reforms. Importantly, the significance of each reform, and the interconnection between reforms, is not only a matter of analytical debate, it is also different from country to country. One size does *not* fit all.

For the moment, it seems that everyone, including governments, private corporations, and international organisations, is searching for the right balance that could lead to structural and institutional reconstruction. Even if the right balance is identified, there is a further issue of domestic capacity to implement structural and institutional reforms. Partly as a result of the macroeconomic crisis, which has led to a fiscal squeeze, government capacity to act forcefully is very restricted.

This, of course, is nothing new. Complete systemic change has been achieved in the Central and East European transition economies, where the social fallout has also been very dramatic. Nevertheless, both in these transition economies but also in Asia, there are large parts of the economic base that probably should be retained. The relevant questions concern what works, what does not work, and how change should be managed.

With regard to the social dimension, the Symposium highlighted the need to have a proactive social strategy at the outset of any reform programme, which matches to some degree the social consequences of reforms. Clearly, in the context of East Asia, the probable social consequences of the crisis were only superficially appreciated at the start of the crisis. When awareness came, the scale of the task completely overwhelmed governments that found themselves already subjected to an unprecedented fiscal squeeze.

The result was a patchwork of mostly localised initiatives targeted at the identification of the social impact of the deep recession and the provision of basic commodities combined with matching purchasing power for the most needy households. While food aid to some countries has undoubtedly

brought much-needed assistance to impoverished households and regions, effective poverty eradication will require a more convincing framework for channelling social assistance.

Dealing convincingly with social distress is not only a moral obligation, but is also critical from the point of view of rebuilding investor confidence. It is now quite apparent that social distress is an important negative signal to foreign investors. In a world where investors are beginning to look at the broad health of the economy, rather than some set of narrowly defined macroeconomic indicators, social stability has become a key variable in its own right when assessing country risk.

What can the OECD contribute?

Because the crisis was triggered by a loss of investor confidence, one part of the solution must involve rebuilding that confidence. Reforms, in the form of new legal frameworks or institutions or policies, should therefore involve as far as possible the adoption of acknowledged practices. This requires first of all the identification of acknowledged practices, then making necessary modifications of existing practices taking into account the characteristics of the institutional base of each individual country. This exchange of national policy practices and know-how is a particular strength of the OECD, and has been found by Member countries to have tremendous value in important areas of reform such as competition policy, bankruptcy laws, tax policy and regulation of financial markets, just to mention a few examples.

It is understandable that in the current crisis situation, with accompanying acute social distress, countries are tempted by protectionist arguments. Here again, the OECD has considerable experience for the same sentiments have existed historically in many OECD countries as well. Liberalisation in the OECD area has only been achieved after extensive debate and considerable social stress, and sometimes with much foot-dragging. Thus, the OECD is also a repository of worst practices; we have experience with a whole series of directed policies and protectionist policies that have not worked.

OECD experience is especially relevant for Asia, since Member countries have in recent years relied much more on private capital flows than on more stable financial flows from international financial institutions. Maintaining investor confidence is thus a crucial part of the policy stance of Member countries. Policy formulation is no longer made without very careful consideration of the likely reactions of financial markets.

To conclude:

- Sharing policy know-how is now as important as financial and technical assistance;
- Confidence in the economic institutions and policies in these crisis-affected economies requires the adoption of acknowledged practices, tailored to the political and institutional realities which are necessarily country-specific;
- Protectionist pressures in both OECD and non-OECD countries are on the rise. They originate in fears of increased competition resulting from an uncontrolled flow of cheap exports to developed country markets, and from the severe social pressures generated from the economic collapse in several countries of the region. Respectively, these pressures should be resisted.

The OECD has a good grasp of conducting economic policy in such a way as to balance internal political pressures and sectoral interests in a democracy, with the need to ensure stability in financial markets. This experience can be brought to bear on identification and implementation of structural reforms in periods of economy-wide crisis.

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