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**POLICY ISSUES FOR THE ESCAP REGION: IMPLICATIONS OF
RECENT ECONOMIC AND SOCIAL DEVELOPMENTS**

(Item 5 (a) of the provisional agenda)

**REPORT ON THE CURRENT ECONOMIC SITUATION
IN THE REGION AND POLICY ISSUES**

Note by the secretariat

SUMMARY*

The economic crisis that began in Asia in 1997 has turned out to be deeper and more long-lasting than had been foreseen. Further, its impact has been widespread, manifesting itself in deep recessions in several countries, and reduced growth rates in many others. In consequence, world trade and economic growth slowed sharply in 1998. There have also been increased volatility and uncertainty in the financial markets, lower commodity prices, and serious problems in the financial sectors of several countries, leading to the phenomenon of the "credit crunch".

Prospects for 1999 point to even slower growth in the world economy. International trade growth is likely to remain flat. With the prevailing uncertainties and acute financial sector problems in several countries, international capital flows are not expected to increase. The performance of developing countries should, nevertheless, improve. Barring any further shocks in the financial markets, declining interest rates, stability in exchange rates and stock markets, improved current account positions, higher foreign exchange reserves and implementation of financial sector reforms should begin to pay dividends in terms of recovery in the real economy towards the latter part of 1999.

As a result of the economic crisis, a number of countries in the region are experiencing severe social problems. With mounting unemployment, the incidence of poverty has increased. The availability or utilization of essential health and education services has been reduced. The ability of governments to address these problems has been constrained by reduced revenue collection and, in some cases, by the budgetary targets envisaged under the bailout packages.

Policies at the national, regional and international levels are needed to overcome the problems that the economic crisis has brought in its wake. The most immediate of these is to revive economic activity. For this the credit crunch has to be overcome, the financial sector strengthened, and the corporate sector restructured. Over the longer term, consideration needs to be given to reforming the international financial architecture so as to minimize the likelihood of the recurrence of such crises in the future.

Governments have to play a critical role in ensuring social protection. With that end in view, budgetary allocations for the social sector have to be preserved and augmented. Among other measures suggested are the establishment of a "social fund"; proper targeting of publicly provided goods and services; strengthening institutional capacity and the information base; involvement of all stakeholders in the design, implementation, monitoring and evaluation of programmes; unemployment insurance schemes; and strengthening the rural and urban informal sectors.

* This document is based on part one of *Economic and Social Survey of Asia and the Pacific 1999*.

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I. RECENT ECONOMIC PERFORMANCE AND PROBLEMS

A. Global economic developments

1. After a growth rate of 3.2 per cent in 1997, the world economy slowed sharply to a rate of 1.7 per cent in 1998. World trade growth in volume terms declined even more precipitately, from 9.7 per cent in 1997 to 3.7 per cent in 1998, while the flow of private finance to developing countries fell in 1998 to about half its level of 1996 and is about 35 per cent less than in 1997. These developments were largely on account of the widespread fall-out of the economic and financial crisis in South-East and East Asia, which has turned out to be much deeper and more long-lasting than had been foreseen a year earlier.
2. Global merchandise trade in dollar values is estimated to actually register a decline in 1998 compared with 1997 because of sharply lower commodity prices. The expected rapid growth in export earnings from the countries experiencing large currency depreciations has not yet materialized, largely owing to the higher cost of imported inputs and the shortage of finance available to the real economy.
3. On the capital flows side, net private capital inflows practically dried up in 1998 for all developing countries. The largest decline was in commercial bank lending. There was also a steep decline in the provision of finance by non-bank creditors and in portfolio equity flows. Flows of foreign direct investment (FDI), however, are estimated to have risen marginally. On a net basis, flows of official development assistance (ODA) have risen, reflecting the expanded emergency assistance provided by the International Monetary Fund (IMF), the World Bank and other multilateral and bilateral sources to several countries in 1998.
4. The impaired asset quality of many financial institutions has forced many of them to cut back on new lending, especially to less creditworthy customers, creating an anomalous situation in which, while interest rates are tending downwards, there is an overall shortage of credit. Many developing country financial institutions, saddled with bad debts, are unable to gain access to outside sources of capital.

B. Developments in the ESCAP region

5. In Japan, the deep-seated nature of the difficulties, including chronic problems in the financial sector, and the collapse of consumer and business confidence coupled with the impact of this crisis, brought about a sharp recession in 1998 (see table).
6. Australian gross domestic product (GDP) growth remained surprisingly strong in 1998. New Zealand, on the other hand, nearly slipped into recession as it attempted to mitigate exchange rate weakness through higher interest rates. Lower commodity prices also dampened growth significantly in the New Zealand economy.

Table. Selected economies of the ESCAP region. Rates of economic growth and inflation, 1997-2001*(Percentage)*

	Real GDP					19
	1997	1998b/	1999c/	2000c/	2001c/	
Developing economies of the ESCAP region d/	5.8	0.2	3.6	5.0	5.6	
South and South-West Asia e/	4.6	5.3	5.6	6.6	6.9	
Bangladesh	5.9	5.9	3.3	6.8	7.6	
Bhutan	6.6	5.0	7.0	8.1	6.1	
India	5.1	6.0	6.8	7.3	7.5	
Iran (Islamic Republic of)	2.6	-0.3	0.6	2.8	2.7	
Nepal	3.8	2.1	4.5	4.5	..	
Pakistan	1.3	5.4	4.0	6.0	6.0	
Sri Lanka	6.4	5.5	5.7	6.0	6.5	
Turkey	7.5	4.5	4.2	3.5	7.2	
South-East Asia	4.3	-6.2	0.4	2.2	3.6	
Indonesia	4.7	-14.0	-2.2	0.0	2.5	
Malaysia	7.8	-6.0	-1.0	3.5	4.8	
Myanmar	4.6	1.1	2.7	3.0	..	
Philippines	5.2	-0.5	2.6	4.1	4.3	
Singapore	7.8	1.3	0.5	2.4	4.0	
Thailand	-0.4	-7.8	0.9	2.5	3.6	
Viet Nam	8.8	5.8	4.6	6.1	..	
East and North-East Asia	7.0	1.5	4.4	5.7	6.0	
China	8.8	7.8	7.0	7.6	7.3	
Hong Kong, China	5.2	-5.0	-0.5	3.3	3.7	
Republic of Korea	5.5	-6.0	2.0	3.9	5.0	
Taiwan Province of China	6.8	4.7	5.5	6.0	6.2	
Pacific island economies	-3.7	-0.2	5.6	5.1	4.1	
Fiji	-1.8	-3.9	4.5	5.5	4.5	
Papua New Guinea	-5.2	1.5	6.0	5.0	4.0	
Solomon Islands	0.1	-2.8	11.5	6.0	5.0	
Tonga	-1.2	-0.5	4.5	3.0	3.0	
Vanuatu	2.3	3.7	3.0	3.5	3.5	
Developed economies of the ESCAP region	1.0	-2.2	-0.8	1.7	2.0	
Australia	2.8	4.5	2.0	2.4	1.7	
Japan	0.9	-2.7	-1.0	1.6	2.0	
New Zealand	3.2	0.2	1.0	3.6	3.3	

Sources: ESCAP, based on International Monetary Fund, International Financial Statistics, vol. LI, No. 9 (September 1998); Asian Development Bank, Key Indicators of Developing Asian and Pacific Countries 1998 (Oxford University Press, 1998) and Asian Development Outlook 1998 (Oxford University Press, 1998); United Nations, Project LINK World Outlook: Countries and Regions, 30 November 1998; and The Economist

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7. For the crisis economies of South-East Asia, 1998 was perhaps one of the worst years on record. There were large contractions in GDP in several countries, such as Indonesia, Malaysia and Thailand, while GDP growth remained virtually flat in the Philippines and Singapore. The economic expansion of Viet Nam, though decelerating, was a bright spot in the subregion. Barring Indonesia, despite the large currency depreciations, inflation rates remained within single digits. Weak domestic demand helped keep prices in check in all the affected economies. Domestic interest rates began to ease significantly.

8. The current accounts of all countries in South-East Asia registered major improvements. This turnaround was largely due to a collapse in imports rather than expansion in exports. There were significant official capital inflows in contrast to private capital outflows. There was some increase in FDI, but this was mostly for the acquisition of existing assets.

9. The economic crisis had a negative impact on growth in East and North-East Asia as well. Hong Kong, China and the Republic of Korea, the two worst affected economies in the subregion, experienced large contractions in output. Although some economies managed to compensate partially for weaker regional demand by an increase of exports to the United States of America and the European Union, the growth of domestic investment and consumption contracted as a result of the credit crunch in the domestic economy, corporate restructuring and the rise in the number of bankruptcies. Exports from economies in this subregion also remained weak and imports fell sharply.

10. Consistent with slower growth, rising uncertainty and demand compression, inflationary pressure in these economies receded. An extreme case was China, where a massive build-up of inventories generated deflationary pressure, and in 1998 prices fell slightly.

11. In most economies of South and South-West Asia, the relative insulation of the financial markets moderated the contagion effect of the regional economic crisis on the domestic economy. Their real sectors were, however, not completely spared. Lower import demand in the crisis countries and lower capital inflows from them, especially FDI, partially affected the pace of GDP growth. In the Islamic Republic of Iran, GDP contracted in 1998 owing to the slump in oil prices. GDP growth rates in other countries remained moderately high. Better agricultural performance and increased budgetary expenditure contributed to the enhancement of economic performance in some of these countries. Inflation rates in the countries of the subregion were either lower, or increased very slightly, in 1998 as compared with 1997.

12. Among the least developed countries, growth was much less robust in South-East Asia than in the South Asian least developed countries. One reason was that FDI flows to these countries slowed as investors from Malaysia, Singapore and Thailand either delayed or cancelled proposed projects. Inflationary pressure increased owing to depreciation of their currencies, strong money supply growth and the shortage of some basic commodities.

13. In contrast, the effects of the economic crisis on the least developed countries in South Asia have been relatively limited. The non-convertibility of local currency, low recourse to foreign private capital inflows and limited commercial debt reduced the direct impact of the crisis on the financial sectors of these countries. The largest least developed country, Bangladesh, suffered from the significant negative impact of the monsoon floods in mid-1998 on the production sectors as well as the physical infrastructure.

14. Except for Papua New Guinea and Solomon Islands, which have substantial trading links with developing Asian countries and, to a lesser extent, Fiji, the crisis did not have a direct impact on the Pacific island economies. However, many of them were affected indirectly to varying degrees because of the impact of the crisis on Australia, Japan and New Zealand, which together absorb a sizeable portion of Pacific island country exports. In addition, the drought associated with the El Niño weather phenomenon affected most Pacific island countries and was largely responsible for their poor economic performance. Pacific island countries have generally recorded deficits on their merchandise trade balance in recent years. Some of them have enjoyed surpluses on services, primarily from tourism and remittances. However, these have not been sufficient to prevent current account deficits.

15. Since the beginning of the transition of the Central Asian countries towards a market economy, 1998 was the first year in which all those countries recorded positive growth. This was supported by the relatively strong performance of both industry and services. Growing private consumption and capital investment provided the stimulus. More prudent fiscal and monetary policies and appreciation of the national currencies helped achieve greater price stability. However, fiscal deficits remained large. In addition, the merchandise trade and current account deficits continued to be a source of concern.

16. The Russian Federation was the sole economy from North and Central Asia that experienced a serious economic downturn in 1998. A combination of falling output, sharply lower export earnings and government revenues and accelerating inflation undermined the fragile macroeconomic stability achieved by that economy in 1997. The debt freeze severely undermined investor confidence.

C. Implications of global developments and immediate prospects for the ESCAP region

17. A number of developments in the world have adverse implications for the ESCAP region. The Japanese economy, weighed under by persistent problems in the financial sector and a collapse of consumer confidence, remains weak.

18. Although the economy of the United States of America displays remarkable strength, capital spending is now tending to slow and manufacturing employment growth has shown signs of flattening out. Export growth is also tapering off and the current account deficit has begun to widen. On the face of it, the European Union (EU) appears to be comparatively better situated. However, the Asian crisis, the debt freeze in the Russian Federation and ensuing stock market volatility have collectively undermined consumer and investor confidence in EU. Meanwhile, weakness in the dollar exchange rate

has reduced EU competitiveness, with some impact on overall GDP growth and the potential to increase imports.

19. On balance, developed country markets will not be a source of strong demand for exports from the region. Of late, intraregional trade had emerged as an important locomotive for the growth of the exports of a number of countries in the region. This locomotive lost much of its steam in 1998 owing to the crisis, and will remain weak for some time to come.

20. A major uncertainty lies in the behaviour of capital flows. The extent to which confidence was undermined in 1998 and the general risk aversion evident in the developed countries do not suggest that non-FDI private capital is likely to start flowing into the region soon on any substantial scale. The recent trends also suggest that FDI flows may remain concentrated in acquisitions of existing assets, rather than creating new production capacity.

21. There are, however, some positive developments within the region. These include a downward trend in interest rates, a degree of recovery and stabilization in exchange rates and stock markets, and increase in foreign exchange reserves. There are, however, concerns regarding the sustainability of these improvements in the light of only limited progress in financial sector restructuring, the continued credit crunch, the still growing burden of non-performing loans and no major recovery of exports. On balance, it is most likely that the region will experience a better growth performance in 1999 compared with its dismal record in the preceding year.

D. Policy issues

22. The seriousness of the crisis has prompted considerable reflection on policy measures to prevent such occurrences in the future. It is self-evident that a wide range of actions are needed at the national, international and regional levels to minimize the possibility of future crises.

National level

23. At the national level, there is general agreement that countries need to be more circumspect with regard to the speed and sequence of opening their capital accounts. Those with open capital accounts need to implement their monetary, fiscal and exchange rate regimes much more flexibly. Other issues that have to be dealt with are the institutional arrangements for financial sector supervision, enactment and enforcement of appropriate legislation and rules of behaviour by private business in both the financial and real sectors, and transparency in corporate governance.

24. Economic recovery is the overwhelming challenge facing the region, especially the crisis countries of East and South-East Asia. Strengthening the financial sector is a central issue in this context, with bad debts, recapitalization of banks, high, albeit falling, costs of financial intermediation and the persistent credit crunch in most of these countries tending to hold up recovery. Large-scale public resources will be needed to solve the problem of non-performing loans, a solution with significant opportunity costs.

25. In the South Asian countries, financial sector problems *per se* are not a serious issue for the real economy, though significant weaknesses exist. The slowness in achieving greater depth in financial markets has been an impediment in diversifying the sources of finance for development. The achievement of higher GDP growth rates has also been constrained by inadequate infrastructure, generally low productivity and, in particular, inefficiency in public sector enterprises. Fiscal improvement is another issue with which most of the countries of the South and South-West Asian regions have been grappling with little success. Despite tax reforms, increases in expenditure have been the major reason for the failure to contain the deficit, leading to growing public debt and increased servicing costs. All these areas need major improvements in order to put the economies on a higher growth path.

26. For the least developed countries, poverty alleviation continues to be the major challenge. To break through the poverty syndrome, the existing pace of GDP growth needs to be accelerated significantly. This will require, among other things, priority action to improve the existing state of physical infrastructure, expand social and human capital, improve export performance, create a more efficient financial system and attract more private foreign capital in the face of falling ODA. While the steady and increased flow of external aid is important, an even more pertinent policy issue for these countries is how the quality and effectiveness of aid can be enhanced.

27. The Pacific island countries face very similar policy issues to those of the least developed countries. One important unique concern relates to the implications of the present land ownership system for agricultural development. Most land in the Pacific is communally owned; this is not very conducive to investment in the sector. In their pursuit of higher economic growth, these countries also face a daunting challenge in balancing the need for the conservation of resources against exploitation to satisfy their current needs.

28. The banking sector in North and Central Asia as a whole remains underdeveloped and fragile. As a result, it has been unable to provide attractive savings facilities or engage in meaningful intermediation between savers and investors. There is an ongoing need to strengthen banking regulation and supervision. This, in turn, requires broad institutional and human resources capacity-building.

29. In the Russian Federation, following the debt freeze, massive withdrawals by depositors drove interest rates further upward. The immediate challenge is to draw up a credible economic recovery plan and to restore confidence in the banking system so as to enable banks to resume intermediation and help in reinvigorating the economy. In addition, improving the government fiscal performance remains a major issue.

International level

30. At the international level, strong consideration needs to be given to reform of the international financial architecture. Three areas require attention.

31. First, urgent action is required for prompt and adequate provision of liquidity for pre-empting any major crises, minimizing contagion and mitigating their adverse impact. Hence the need for the establishment of a true international "lender of last resort". The international community needs to reach agreement on whether this role should be assigned to IMF, which typically becomes a de facto lender of last resort after a crisis, or a new institution should be created.

32. Second, in view of the increased frequency and intensity of the crises, caused to a large extent by massive capital movements, improving international supervision and regulation through a new body requires serious consideration. In this context, it should be noted that the United Nations Committee for Development Planning has proposed the establishment of a world financial organization (WFO) for finance. A new overseeing body for international capital, with a specific mandate dealing with the monitoring of all short-term cross-border flows, is needed to develop, as in the case of the World Trade Organization (WTO), a rule-based system for overseeing, and eventually regulating, international capital flows.

33. Third, it is also important that a set of principles be agreed upon internationally for resolving issues related to debt workouts. The proposed WFO could provide the institutional framework for achieving such agreement and facilitating specific negotiations between a country in crisis and external creditors.

Regional level

34. There is a strong case for greater regional cooperation in the ESCAP region in the aftermath of the crisis. Issues of financial sector regulation, the establishment of common prudential standards for industry, and the development of early warning systems can be mentioned in this regard. The accord signed by several countries of the region with the Asian Development Bank for the conduct of surveillance is a welcome step. The proposal for the establishment of an Asian Fund could also be an important new initiative in the area of regional cooperation and merits serious examination. The Asian Fund would be a source of extra liquidity, additional to that which is available to IMF at present. This would help improve market sentiment and prevent panic. It could be designed to be quick-disbursing in

nature. Thus, it could help member countries in replenishing reserves as soon as signs of distress became visible. It would thereby minimize contagion. In this context, it is worth noting that the total foreign exchange reserves of the ESCAP region amount to about \$800 billion. Only a small proportion of these reserves would be needed to make a major impact were they to be deployed by the Asian Fund.

II. SOCIAL IMPACT OF THE ECONOMIC CRISIS

A. Selected aspects of the social impact

The impact

35. The economic crisis in East and South-East Asia has transformed itself into a social crisis, particularly visible in such forms as rapidly rising unemployment, the mounting incidence of poverty and deterioration in health and educational services. The countries most affected in this regard are Indonesia, Malaysia, the Republic of Korea and Thailand.

36. Prior to the crisis, economic growth and social development reinforced each other, leading to impressive achievements in both respects. The sharp deceleration in growth in 1997 and 1998 has broken this virtuous circle.

37. The dramatic contractions of output have caused massive retrenchment, dimmed the prospects of new entrants into the labour force to find jobs and reduced the money incomes of those who have been lucky enough to remain employed. In consequence, unemployment and poverty have risen rapidly.

38. Depreciation of national currencies has fuelled inflation. Falling real incomes and increased costs have been responsible for large contractions in private consumption expenditure, including consumption of social services, particularly health and educational services.

39. Government revenues have come under severe strain. As real GDP has contracted, the tax base has shrunk and tax revenues have declined. Options to increase budget deficits have been limited by the conditionalities of the bailout packages negotiated by three of the four countries. Governments have thus had to impose expenditure cuts which have affected adversely their capacity to maintain, far less augment, the level of health and educational services. Simultaneously, there has been a reduction in the supply of these services by a private sector confronted with falling demand, rising costs and lower profits.

40. The sudden reversal of economic growth has caused a major reduction in the labour force in formal employment. Some of the retrenched labour force have found jobs in the urban informal sector; some have gone back to their villages to earn a livelihood in the rural informal sectors and in agriculture, reversing to some extent the village-to-city migration trends in the pre-crisis years of high economic growth. Nevertheless, open unemployment in all the affected countries has increased substantially. Owing to their relatively weaker position in the labour market, women have been more vulnerable to lay-offs.

41. The mounting unemployment and erosion of real incomes have brought about a sharp increase in poverty. It is estimated that by the middle of 1998, nearly 80 million Indonesians out of a population of 200 million were earning less than \$4 a month, and the number of the country's poor had swelled to 40 per cent from only 11 per cent in 1997. In Malaysia, poverty was estimated to have risen from 6.8 per cent in 1997 to 8 per cent in 1998. In Thailand, the incidence of poverty had increased from 11.4 per cent in 1996 to 15.3 per cent in 1998.

42. The sharp decline in incomes has had a negative impact on the consumption of health and educational services. This was exacerbated by the increase in the prices of imported components of these services during the crisis. Urgent curative care has been given preference, to the comparative neglect of preventive services. Demand for the less expensive government-provided services has replaced that for the relatively expensive and better-quality services provided by the private sector. At the same time, the public sector's ability to cope with the increased demand for its services has been constrained by the increased cost of such services, and the limited budgetary resources available.

43. There is evidence that many of the impoverished people have been compelled to cut their consumption of health services to dangerously low levels. For many in the impoverished groups, the education of children is no longer affordable, leading to drop-outs at all educational levels. The rising incidence of poverty is likely to compound health and educational problems by causing more widespread malnutrition, especially among children. The crisis has also had a considerable impact on the state of reproductive health in some of the countries, with budget cuts forcing many government hospitals to abandon preventive programmes, including contraceptive services.

Responses to the crisis

44. Several governments have implemented programmes and policies to arrest the rapidly deteriorating social conditions. International organizations and donor communities have augmented national capacity in formulating and implementing these programmes and policies.

45. In Indonesia, a major social safety-net programme has been initiated to strengthen the ability to cope of the persons affected by the crisis, especially in the villages and the small towns that have been worst hit. The Government of Malaysia has introduced both direct and indirect measures to arrest the decline in social welfare arising from the economic crisis. The objectives of these measures have been to prevent high inflation, ensure adequate food supply and minimize retrenchment. The Government of the Republic of Korea has responded to the sharp increase in unemployment by setting up a comprehensive unemployment benefits package, including an expanded unemployment insurance system, a subsidized loan programme for the unemployed and for small-scale businesses that had hitherto not needed to borrow funds, active labour market policies and public works programmes. Thailand has launched a very large project, entitled the Social Investment Project, to provide comprehensive assistance to the poor in the form of creation of employment, provision of training, and

access to improved health services during the crisis, as well as to build long-term social capital.

B. Major policy recommendations

46. Governments have to play a critical role in ensuring social protection in the event of a crisis for a variety of reasons, including welfare considerations and widespread externalities associated with the provision of social services. In this respect, the following suggestions are offered for consideration by governments:

(a) Budgetary allocations for social services should be preserved or even augmented through reallocation among various components of public expenditure;

(b) Governments may also wish to establish a formal "social fund" in order to provide those who slide into extreme poverty with minimum income support;

(c) There should be careful targeting of measures initiated by governments such as employment-creation, cash transfer, free or subsidized provision of essential goods and services and credit facilities;

(d) The institutional capacity and information base required to design and implement targeted projects must be strengthened;

(e) The involvement of local governments, non-governmental organizations, other civil society organizations and beneficiaries needs to be secured in the design, implementation, monitoring and evaluation of programmes;

(f) Serious consideration should be given to the introduction of an effective system of unemployment insurance;

(g) The role of the rural sector as well as the urban informal sector as a cushion should be reinforced;

(h) Finally, governments need to review their development strategies seriously and ensure microeconomic efficiency in order to minimize vulnerability to crises in the future.