IX The Financial and Economic Crisis in East and Southeast Asia

INTRODUCTION

After two decades of rapid economic growth, many of the countries of East and Southeast Asia entered a period of serious economic and financial crisis in 1997. Between mid-1997 and the spring of 1998, the currencies of four Southeast Asian nations (Indonesia, Malaysia, the Philippines, and Thailand) and of the Republic of Korea fell 40–80 percent against the US dollar, precipitating a financial and economic crisis whose full impacts on the countries and the global economy are still unfolding. As a consequence of the crisis, the gross domestic product (GDP) for East and Southeast Asian countries fell sharply in 1998. Indonesia's GDP declined by 14 percent in 1998; Republic of Korea's by 6 percent, Thailand's by 9 percent, and Malaysia's by 7 percent, while the Philippines had barely positive growth (Severino 1999).

While the initial impact of the crisis was felt mainly in urban areas, where banks closed their doors, factories shut down, and hundreds of thousands swiftly became unemployed, the crisis has also had significant consequences for the agricultural sector and for rural residents in the affected countries. The events raise important questions about macroeconomic policies and the fundamental soundness of governance in Asian economies, the role of international capital and domestic financial markets in Asian development, and the incentives for and role of the agricultural sector in modernizing Asian economies. The policy and governance lessons that are drawn from the experience of

the economic crisis will have profound implications for the future development of rural Asia.

CAUSES OF THE CRISIS: TWO VIEWS

The causes of the financial and economic crisis are complex and will be only briefly summarized here. The two main schools of explanation for the East Asian economic crisis are the "fundamentals hypothesis" and the "financial panic/contagion hypothesis". The fundamentals school argues that the crisis was primarily due to poor financial-market performance and weak financial and corporate regulatory oversight, combined with a deterioration of macroeconomic fundamentals in the region beginning in the early 1990s. The financial panic/contagion hypothesis, while noting that there was deterioration in economic fundamentals in the region, places more emphasis on the role of panic by international investors and inappropriate initial policy responses by countries and by international rescue programs that deepened the crisis beyond what the macroeconomic fundamentals warranted. This school of thought emphasizes the importance of finding the right regulatory framework to reestablish investment confidence. In fact, these alternative theories are not incompatible: the evidence indicates that both a significant deterioration in the macroeconomic fundamentals in the affected countries and investor panic contributed to the onset and depth of the crisis.

The lead-up to the crisis in the most severely affected countries—Indonesia, the Republic of Korea, Malaysia, Philippines, and Thailand—was characterized by an interlinked set of developments beginning in the 1990s. These developments included

- significant real appreciation of currencies and exchange-rate misalignment that diminished these countries' international competitiveness;

- large and growing current-account deficits financed with the accumulation of foreign debt in the form of short-term foreign-currency-denominated and unhedged liabilities;
- excessive short-term lending by international investors in the 1990s, followed by a sharp reversal of the short-term capital flows in 1997, which set off a round of competitive devaluations; and
- overborrowing and overlending in the financial sector, much of it to risky and low-profitability projects.

In addition to the large foreign debt, the East and Southeast Asian economies had a traditionally deep structure of domestic debt due to high internal savings rates, making these economies more vulnerable to foreign shocks (Wade 1998). The massive withdrawal of short-term international capital caused a widespread financial crisis and real or de facto bankruptcies for banks and firms that could not repay the large amounts of foreign-currency-denominated debt. The exchange-rate crisis made things worse, as the currency depreciation increased the real burden of the foreign-currency-denominated debt. Domestic interest rates increased sharply, further contracting the availability of credit to the economy. The withdrawal of international capital, together with the virtual collapse of domestic bank capital, was an enormous contractionary shock to the real economies of the crisis countries.

Development of the Crisis

How did the scenario play itself out? Neither the causes nor the outcomes of the financial crisis are uniform across the affected countries. Following are some of the common elements and some of the differences across the countries. More detailed treatments are available in Corsetti, Pesenti, and Roubini (1998a, 1998b) and Radelet and Sachs (1998). McLeod and Garnaut (1998) provide both a detailed comparative analysis and several country case studies.

Real Appreciation of Currencies

In retrospect, perhaps the leading indicator of looming troubles was the steep appreciation of the real exchange rate (the ratio between prices of tradable and non-tradable goods), which diminished the international competitiveness of the crisis economies. According to Radelet and Sachs (1998), appreciation of the real exchange rate was over 25 percent between 1990 and 1997 for the four Southeast Asian economies and 12 percent for the Republic of Korea (compared to 30 percent between 1987 and 1997). The primary reason behind the real appreciation was the massive inflow of foreign (mainly short-term) capital during this period. External forces also contributed to the real appreciation: the crisis economies linked their nominal exchange rates, in varying degrees, to the US dollar, which appreciated after 1995 relative to other major currencies. The real appreciation undermined the competitiveness of tradable-goods industries, including the rapidly growing export industries.

Other economic developments further weakened competitiveness. In Thailand, for example, there was extraordinarily rapid growth in real wages, due to the drying up of the pool of relatively low-productivity unskilled labor in agriculture; skilled labor for industry also became a bottleneck, because the educational system did not produce enough persons with needed skills (Wade 1998). Between 1990 and 1994, the real wage in Thailand increased by over 9 percent per year (Warr 1998).

The decline in international competitiveness in the crisis economies was shown by the dramatic fall in growth rates of exports across these economies in 1996. Export growth rates in nominal terms fell from an average of 24.8 percent in the five countries in 1995 to 7.2 percent in 1996 (Radelet and Sachs 1998). Indonesia's export position was least affected, experiencing a drop from 13.4 percent in 1995 to 10.4 percent in 1996. Export growth in the Republic of Korea fell from 30.3 percent to 5.3 percent; in Malaysia from 26.0 percent to 6.7 percent; and in the Philippines from 31.6 percent to 17.5 percent. Thailand experienced the most dramatic decline, with a drop in export

growth from 25.1 percent in 1995 to –1.3 percent in 1996 (Garnaut 1998a). This collapse of export growth and the resulting loss of investor confidence in the stability of the Thai baht was the proximate trigger for the speculative outflow of short-term foreign capital from Thailand that precipitated the financial and economic crisis in the region.

Large Current-Account Deficits

Concurrently with the real exchange-rate appreciation, the current-account balances in the region deteriorated. During the 1985-89 period, the current accounts of the five crisis economies were relatively strong, averaging just 0.3 percent of GDP. The Republic of Korea and Malaysia had current- account surpluses of 4.3 percent and 2.4 percent of GDP, respectively, and the largest deficit was Indonesia's 2.5 percent (Radelet and Sachs 1998). Beginning in 1990, however, current-account balances weakened, with a further worsening during 1995 and 1996. In Thailand, the current-account deficit reached 8 percent of GDP in 1996; in Malaysia, 7.6 percent during 1995–96; in the Philippines, 3.7 percent; and in Indonesia, 3.5 percent. In the Republic of Korea, the current account deficit jumped from 1.8 percent in 1995 to 4.8 percent in 1996 (Garnaut 1998a).

Large Short-term Capital Inflows

Massive private foreign capital inflows into the East Asian economies, motivated by the strong economic growth prospects and resulting high investor returns in the region, also were the driving force behind the real appreciation of the currencies and growing current-account deficits. Large capital inflows were also driven by

- the liberalization of capital markets in the early to mid-1990s;

- the deregulation of domestic financial systems that facilitated foreign investment;
- the relatively poor financial-sector supervision that allowed domestic banks to take on substantial foreign-currency and -maturity risks;
- stable nominal exchange rates; and
- special incentives provided to foreign investment.

A strong element of "moral hazard" appears to have contributed to the huge expansion in foreign capital inflow. Moral hazard is the possibility that the expectation of future government support will induce an undesirable change in behavior, in this case inducing foreign investors to be more willing to make risky investments because the potential losses were seen as being effectively underwritten by the governments, or by international agencies such as the IMF.

In addition to the large private inflows, Stiglitz (1998) argues that the large amounts of international public lending to the crisis countries were undertaken without due consideration of the standards for risk assessment. Similar to the case for private investment, underlying this lending strategy may have been the assumption that it would be guaranteed by either a direct government bailout of the borrowing institutions or an indirect bailout through the IMF or other international efforts (Corsetti, Pesenti, and Roubini 1998b).

Capital inflows to the five Asian crisis economies totaled $211 billion between 1994 and 1996—$93 billion in 1996 alone—some three fourths of them short-term funds (Radelet and Sachs 1998). By 1996, the ratio of debt service plus short-term foreign debt to foreign reserves was 294 percent in Indonesia, 69 percent in Malaysia, 137 percent in the Philippines, and 123 percent in Thailand (Corsetti, Pesenti, and Roubini 1998b). The rapid growth of foreign short-term capital relative to foreign reserves left the currencies of the crisis economies highly vulnerable to speculative attack through a sudden reversal of capital inflows. In 1997, this reversal of short-term foreign capital inflows occurred, with net private inflows to the five crisis economies falling to –$12.1 billion, representing a swing of $105 billion, or

11 percent of the combined pre-crisis GDP. Fully $77 billion of the decline in inflows came from commercial bank lending (Radelet and Sachs 1998).

Overborrowing and Overlending in the Financial Sector

The high proportion of short-term capital in total inflows was an inherently risky basis for growth; this risk was multiplied by the investment of these funds in speculative and unproductive projects. With the exception of Indonesia, where foreign borrowing was mainly undertaken directly by private firms, foreign capital inflows were to a large degree channeled through the banking system. The average annual growth rate in bank lending to the private sector during 1990–96 was 17 percent in the Republic of Korea, 20 percent in Indonesia, 19 percent in Malaysia, 32 percent in the Philippines, and 22 percent in Thailand. Over this time period, bank lending as a percentage of GDP jumped from 71 percent to 93 percent in Malaysia, from 64 percent to 102 percent in Thailand, and from 19 percent to 49 percent in the Philippines (Corsetti, Pesenti, and Roubini 1998b).

The growth in bank lending was accompanied by a rapid decline in the quality of loans and investments, with a heavy emphasis on speculative real-estate investments (by themselves an indicator of the impending crisis) and other nonperforming investment projects. With the exception of Indonesia and the Philippines, the incremental capital output ratio declined sharply between 1987–92 and 1993–96. In the Republic of Korea, even prior to the onset of the crisis, seven of the 30 largest *chaebols* (conglomerates) were effectively bankrupt, with an average debt-equity ratio of 333 percent for the 30 *chaebols,* compared to about 100 percent for firms in the United States.

The pre-crisis (end of 1996) share of nonperforming loans as a proportion of total lending was 14 percent for the Philippines, 13 percent for Indonesia and Thailand, 10 percent for Malaysia, and 8 percent for Korea. With capital-asset ratios as low as 6–8 percent in these countries (somewhat higher in the Philippines), nonperforming loans were in many cases

already above capital reserves prior to the crisis. The excessive reliance on investment in real estate is shown by the property exposure (property loans as a percentage of total loans) of 25–30 percent in Indonesia and 30–40 percent in Malaysia and Thailand, with a somewhat lower exposure in the Republic of Korea and the Philippines (Corsetti, Pesenti, and Roubini 1998b). Overinvestment in real estate fueled a classic bubble economy in Malaysia and Thailand, and to a lesser extent in the other crisis economies. Real-estate prices continued to rise well beyond levels justified by the productivity of the asset, but with continued price rises, existing investors were rewarded and collateral was created for new loans to finance further investment, until the inevitable crash. This boom was fueled by unrealistic expectations that in turn created the conditions for a crash (Warr 1998).

Why was the performance of these investments so poor? Much of the problem can be attributed to the structure of incentives governing the operation of the corporate and financial sectors in the crisis economies, in particular the pervasive moral hazard problem. On the corporate side, political pressures to maintain high rates of economic growth were sustained through public support for private projects, including direct subsidies and directed credit to favored firms and industries. Underlying profitability and riskiness were often ignored.

Industrial and financial policy was often conducted within networks of personal and political favoritism. With governments seemingly willing to intervene to help troubled firms, markets often appeared to operate under implicit guarantees against adverse shocks. Structural distortions were also pervasive in the financial sector, including weak prudential supervision; insufficient expertise in both banks and regulatory institutions; incentive-distorting deposit insurance schemes; inadequate capital adequacy ratios; nonmarket criteria for credit allocation emphasizing semimonopolistic relations between banks and firms; and corrupt lending practices (Corsetti, Pesenti, and Roubini 1998). These structural distortions were exacerbated by a lack of competition in the financial sector. In all of the crisis countries, weak and inward-looking domestic banks had been

protected by law from more competitive, major international banks. In addition, the lack of global diversification of assets left the financial systems of the Asian crisis economies even more susceptible to economy-wide shocks (Fane 1998).

The Onset of the Crisis

The combination of factors described above made the five economies vulnerable to the withdrawal of foreign, short-term capital, while at the same time creating the conditions that induced a radical change in foreign investor expectations with respect to the performance of these economies. The increasing evidence of failures in the financial and corporate sectors, poor export performance, and rapid appreciation in real exchange rates in Thailand and Korea caused increasing concern among foreign and domestic investors. After years of rapid growth, the Thai stock market entered a rapid decline after January 1996. The Korean market followed in the second quarter of 1996. Thus the Thai currency crisis actually started in 1996, with rumors of devaluation of the baht beginning as early as May 1996. A year later, following continued deterioration in Thai macroeconomic fundamentals, speculative outflow overwhelmed monetary authorities and the baht fell sharply. Financial instability then spread through much of East and Southeast Asia during the third quarter of 1997 in what could be called a contagion of radically changed expectations. The collapse of the baht indicated that presumed government guarantees on currency parities, bank solvency, and corporate profitability were no longer secure. This event also forced many international investors to realize that they had a poor understanding of the functioning of the East and Southeast Asian financial markets, with a resulting large increase in the required risk premiums on investment throughout Asia. The increasingly diminished opportunities for trade and investment within the region constituted an additional source of contagion.

The severity of the crisis has varied across the affected countries. Indonesia was the most severely affected, followed

by Thailand, Republic of Korea, Malaysia and the Philippines. Many of the differences could be seen above in the comparison of economic indicators leading into the crisis. At least two broad differences, however, are worth highlighting here. First, the quality of financial institutions and markets was a crucial determinant of the severity of the crisis. Financial institutions were weakest in Indonesia, quite weak in Thailand and Korea, and less so in Malaysia and the Philippines (Garnaut 1998a).

The Philippines had strengthened its financial sector significantly as a result of reforms carried out after an economic crisis in the early 1980s. It also had lower international exposure due to the more recent opening of its economy. The Philippine financial crisis in the early 1980s had been caused by many of the same factors that brought about the current economic crisis:

- supervision and monitoring of banks were poor;
- capital requirements and limitations on lending to related interests were weak;
- politically inspired lending was prevalent; and
- nonbank financial institutions were permitted "without-recourse" lending with essentially no oversight.

Financial reforms begun after the crisis and expanded in the late 1980s and early 1990s led to prudential regulations with respect to minimum capitalization, increasing compliance with capital asset ratios, limits on loans to related interests, and tightening of audit and reporting requirements. Restrictions on the entry of foreign banks were partially eased in 1994. Regulatory improvement and the easing of entry for foreign banks were important factors in the Philippine response to the East Asian crisis. The capital adequacy ratio for Philippine banks ranged from 16.9 percent to 20.2 percent between 1992 and June 1997, allowing the banking sector to weather the crisis comparatively well (Intal et al. 1998).

A second crucial difference can also be seen in the political and policy responses to the crisis. In Indonesia, for example,

policy responses were mostly inconsistent and contradictory. McLeod (1998) cites a number of factors contributing to the mismanagement there:

- genuine confusion about managing a crisis not previously experienced;
- divisions within the government due to President Suharto's reliance on economic policymakers some of whom had become increasingly concerned about policy distortions benefiting his family and close friends, followed by concerns over the post-Suharto political transition;
- ethnic tensions focusing on the role of ethnic Chinese in the economy;
- economic nationalism among some ministers and their departments; and
- general lack of sympathy for the private sector and market processes within the bureaucracy.

The closed political system in Indonesia made it difficult to resolve these internal conflicts, which were therefore reflected in erratic policy responses to the crisis.

In Thailand, the government response to the crisis was better coordinated and managed, mainly due to the government's democratic structure (Warr 1998). The Chavalit government fell in a no-confidence vote in November 1997 as a result of the crisis. The new government of Prime Minister Chuan Leekpai did not have to defend its predecessor's performance during the period leading up to the crisis and instead could devote full attention to instituting a reform package.

In the Republic of Korea, a fortuitously timed presidential election ushered in a new government with a mandate for reform. The legitimizing force of a democratic transition was also apparent in the Philippines, where an orderly transition was accomplished while maintaining relatively stable policy responses to the crisis.

IMPACT OF THE CRISIS

Social Impact of the Crisis

The financial and economic crisis has had severe negative social impacts in the affected countries, including declining incomes and increasing layoffs, rising absolute poverty, increases in malnutrition, increased pressure on already underserved rural areas, declining social services, and threats to education and health status, in particular of children and women. Although all the crisis countries (and at least some other developing countries in Asia and elsewhere) are experiencing negative social effects from the crisis—rapidly transmitted by the strong trade, capital-flow, and migration linkages among the countries—the relative impacts have differed by country. For example, Indonesia's welfare undoubtedly has been hit hardest, while the social sector in the Philippines has fared relatively well (World Bank 1998e). More encouraging evidence emerging in late 1998 and early 1999 has also indicated that the worst early predictions of devastating social impacts throughout the affected countries have not been borne out and that negative social impacts have been to some extent ameliorated by both civil-society responses and government policy.

Declining Incomes

As the financial crisis hit the real economy in the form of near-zero or negative GDP growth, labor-market conditions deteriorated sharply. In addition to substantial retrenchments in the construction, financial services, and manufacturing sectors, there has been an abrupt decline in new hiring, sharply reducing the employment prospects of new entrants into the labor market and the re-employment prospects of displaced workers. The International Labor Organization (ILO 1998) projected that the combined impact of these factors would lead to at least a doubling of open unemployment rates in Indonesia

and Thailand. Ranis and Stewart (1998) estimate that there was a reduction of 10–15 percent in formal-sector employment in Indonesia and Thailand in 1998, and that 1.5 million jobs may have been lost in Korea. By mid-1998, the open unemployment rate in Indonesia was estimated at 17 percent; the rate in the Republic of Korea of 6.7 percent in April 1998 was three times the rate of October 1997 (ADB 1998e). By the end of 1998, however, estimated unemployment in Indonesia had fallen to 7 percent, with labor-market adjustments resulting in falling wages rather than unemployment (World Bank 1999; Severino 1999).

The real wages and earnings of those still employed have fallen due to the decline in labor demand and the increase in inflation caused by the substantial currency depreciation. In Korea, the fall in real wages recorded in the fourth quarter of 1997, immediately after the financial crisis, was 2.3 percent and real wages fell significantly thereafter. Available evidence indicates that real wages in 1998 may have declined by 20–30 percent in Thailand and by 50 percent in Indonesia (ILO 1998; Ranis and Stewart 1998).

The impact has also been severe on the important overseas labor market. The deployment of migrant workers from the Philippines dropped by 23.4 percent in the first quarter of 1998, compared to the first quarter of 1997 (Pernia and Knowles, 1998). There has also been a significant rise in underemployment, both in terms of the hours of work and of wages, due to the increased influx of displaced workers and unsuccessful new job seekers into the rural and urban informal sectors. The larger number of workers seeking a livelihood in these sectors has reduced average incomes.

With unemployment and falling wages hitting the urban middle class the hardest and relatively robust agricultural incomes cushioning some of the impacts on the rural areas (see below), most of the income losses have been incurred by the relatively well-off in urban areas. Thus, in Indonesia, average real per capita household expenditure (a somewhat crude proxy for income, but the only measure available) fell by 30 percent in Jakarta and 42 percent in West Java between August/September 1997 and August/September 1998. But

median expenditures fell by only two percent in Jakarta and by six percent in West Java. This differential decline in mean vs. median expenditures indicates that relatively well-off households suffered by far the largest declines in household expenditures. For all urban households in a nationwide sample in Indonesia, mean per capita household expenditures in urban areas fell by 34 percent and median expenditures by 5 percent, while mean rural expenditures fell by 13 percent and median rural expenditures by 1.6 percent (Poppele, Sumarto, and Pritchett 1998).

Rising Absolute Poverty

The increase in unemployment, declining nominal and real wages, and rapid inflation have increased the number of people with incomes below the poverty level. In Thailand, poverty incidence increased from 11.4 percent in 1997 to 12.9 percent in 1998, meaning that an additional one million people were pushed below the poverty line (Severino 1999). UNICEF (1998) estimates that, in Indonesia, the rural population below the poverty line will have increased from 17 million before the crisis to 24–26 million by the end of 1999. The World Bank (1998a) projects that the poverty rate in Indonesia has increased from 11.3 percent in January 1996 to 14.1 percent in March 1999 (an increase of 5.7 million in the number of the poor), with urban poverty increasing from 5.0 percent to 8.3 percent and rural poverty from 15.0 percent to 17.6 percent. These figures indicate that, although most poverty in Indonesia is expected to remain rural, the share of urban poverty is expected to increase significantly. Recent household survey results appear to confirm the lower estimates of increases in poverty in Indonesia, showing increases in total poverty of 2.8 to 3.4 percent (Poppele, Sumarto, and Pritchett 1998).

Increases in Malnutrition

Food prices were hit especially hard by inflation, with disproportionate impacts on the poor. Food items account for a large share in the consumption basket of the poor: in Indonesia, 71 percent and in Thailand, 55 percent. Moreover, large numbers of people are clustered around the poverty line, especially in Indonesia. Consequently, price increases have led directly to declines in household consumption and increases in poverty levels (Finance and Development 1998).

In Indonesia, the Consumer Price Index (CPI) for food increased by more than 50 percent between June 1997 and March 1998, compared with a 38-percent increase in the general CPI (World Bank 1998d). The overall inflation rate in Indonesia for the whole of 1998 rose to as much as 100 percent (ADB 1998e). In Thailand, the overall price increase was estimated at 10 percent in 1998, food prices increased by 7 percent in the first quarter of 1998, and energy and transportation prices increased by 11 percent. The dramatic increase in domestic food prices reduced both the amount and types of food available to poor households. This change is likely to have adversely affected child development and pregnancy outcomes, as well as to have increased the incidence of diseases like diarrhea (ADB 1998e).

Increased Pressure on Rural Areas

The drastic fall in employment in the urban sectors of the crisis countries has put further pressure on the rural nonfarm and agricultural sectors. A January 1998 Thai government survey of workers returning to rural areas illustrates the pressure placed on rural areas by the crisis. Nearly 200,000 people had returned to the countryside, with the highest proportion returning to the northeast. This migration pattern put pressure on the weakest parts of the Thai agricultural sector; adding further pressure, the north and northeast were hit particularly hard by drought at the end of 1997. Furthermore, remittances from urban areas had played a major role in sustaining living standards in these

regions (ILO 1998). Indonesia has also had a series of relatively poor harvests that have made it difficult for the agricultural sector to support the increased population resulting from reverse migration from urban areas.

Declining Social Services—Threats to Education and Health

There is cause for concern that the severe immediate negative welfare effects may be intensified and prolonged, but there were also some signs of recovery in late 1998 and early 1999, due both to government policy and civil-society responses. The negative social effects of the crisis have been compounded by a lack of social safety nets for the newly unemployed and the newly poor. Traditional social systems that have supported the poor in the past, including the ability to return to subsistence agriculture, close family ties, and community support, have been weakened by the development of a dynamic urban economy (Ranis and Stewart 1998). New social safety-net systems have not been put in place to compensate for the traditional systems.

None of the crisis countries except the Republic of Korea has an unemployment benefit scheme or other social-welfare programs. Most countries do not have national pension schemes to provide protection for old age, invalidity, and survivors. In Indonesia, pensions are mainly provided to civil servants and military; in Thailand, only 10 percent of the labor force is covered by the pension system (Finance and Development 1998). The compulsory savings or provident fund schemes that exist in some of the countries provide only very modest benefits in the form of lump sum payments upon retirement. All of the countries have some kind of health insurance scheme, but coverage is often limited to the working population and the benefits tend to be limited.

Household demand for health services depends on the price of food, medical care, and time, as well as on the productivity of health investments and their perceived benefits.

In addition to increases in the prices of food and medicine, the cost of time of poorer parents may have risen due to the need to hold multiple jobs or carry on time-consuming informal activities (ADB 1998c). As a result of the crisis, total government expenditures on social services have been reduced; instead the share of government expenditure going to the rescue of the financial sector and to foreign debt service has increased. In Thailand, for example, the 1998 budget of the Ministry of Health fell by 10 percent compared to the previous year and the budget of the Ministry of Education fell by 6 percent (Pernia and Knowles 1998). Privately provided social services, which often operate with high foreign indebtedness and rely upon imported equipment, drugs, and other supplies, have also deteriorated; so have local donations. In Thailand, many private hospitals closed, at least temporarily, after the onset of the crisis. In the Philippines, the budget for vaccinations had to be cut (ADB 1998c). Nevertheless, adaptive responses have helped to dampen the negative impact of the crisis on health. In Thailand, recent evidence indicates no adverse impact of the crisis on health outcomes, even though households spent less on health: continued use of public facilities and an increase in use of public assistance and voluntary health-care schemes helped compensate for reduced household expenditures (Severino 1999).

Of particular concern are reductions in investment in human capital formation, like schools and universities, because the effects of such reductions on the long-run growth potential of these countries could well be irreversible. The costs of schooling are likely to increase, especially at the secondary level, because of budgetary constraints for public schools. In addition, child labor is likely to increase due to increased household demand for current income (ADB 1998e). In Indonesia, for example, gross enrollment rates fell from 62 percent to 52 percent at the junior secondary level during the economic shock of 1986–87 and took almost a decade to recover (Atinc and Michael [1998] as cited in ADB [1998e]). But again, government and civil-society responses have helped sustain enrollments in the current crisis. In Thailand, the government allowed tuition fees to be paid in installments, permitted schools to waive tuition fees when necessary, and

introduced vouchers and loans. Neither school drop-out rates nor child-labor rates have increased. In Indonesia, increased resources for schools and scholarships have been effective in reaching the poor. Primary school attendance has been maintained, and only 5 percent of secondary-school children have left to work (Severino 1999).

Evidence indicates that women are disproportionately affected by all social dimensions of the crisis. The traditional gender difficulties faced by women have been exacerbated by the crisis. In addition, women tend to be the first ones laid off when companies feel the pressure of labor costs, girls are pulled out of schools before boys, and women face increasing difficulties in providing social services for their families. On the other hand, women tend to find work in the informal sector more easily, they tend to work in the less affected export-oriented sectors, and they are sometimes substituted for more expensive men's labor (World Bank 1998d; ADB 1998e).

Impact on the Agricultural Sector

The financial and economic crisis has had a mixed impact on the agricultural sector and evidence is still limited on the net effects of the crisis. The large currency depreciations increased the competitiveness of the agricultural export sectors, inducing higher production and income generation in those sectors. In the 14 months ending in September 1998 the Republic of Korea's real exchange rate depreciated by 24 percent, Malaysia's by 29 percent, the Philippines' by 27 percent, Thailand's by 22 percent, and Indonesia's by 58 percent (IMF 1998a). But even in the export sectors, financial-market problems have severely hampered operations. Expansion of exports is dependent on the availability of trade credit, which has been limited in the aftermath of the crisis. Other agricultural sectors, especially those that rely on the domestic market to sell their outputs and/or on imported production inputs, may have been badly harmed by the crisis. Indonesia's livestock industry was hit hard, with production reported to have contracted by

30 percent in the first six months after the crisis began. This contraction was due to dependence on imported feeds, which doubled or tripled in price as a result of the devaluation; the sharp drop in consumer demand; and the bankruptcy and closure of many livestock enterprises (UNICEF 1998).

The economic and financial crisis has had a large impact on the world prices of some agricultural commodities of which the Asian countries are large producers, like rubber. Thailand, a country less affected by the El Niño-induced drought than Indonesia, for example, experienced substantial increases in exports of agricultural commodities after domestic demand fell following the significant rises in consumer prices between the first quarter of 1997 and the first quarter of 1998. But average increases in agricultural export volumes of nearly 40 percent—more than twice the volume growth of exports as a whole—were partially offset by substantial declines in the dollar prices for most of these commodities (McKibbin and Martin 1998, cited in World Bank 1998d).

The long-term impact on agriculture could also be large, but to date forward-looking analyses show mixed results. Noland et al. (1998b) analyze the effects of the Asian crisis based on a computable general equilibrium (CGE) model consisting of 17 regional models, each with 14 sectors (three of them agriculture), and five primary factors of production. The authors find no large, long-term changes in agriculture, as this sector is more regulated than manufacturing, for example. The greater part of the external adjustment comes from declines in imports rather than increases in exports.

Stoeckel et al. (1998) also use a CGE model to assess the long-term impacts of the crisis on agriculture. They find that Asian currency devaluations provide no clear boost to agricultural production in the crisis countries. Agricultural output is projected to decline by 10 to 15 percent in the Republic of Korea, Thailand, and Indonesia, due to higher capital costs and other investment constraints on agriculture, declining agricultural productivity, and falling domestic consumption. Agricultural exports are projected to increase, with growth varying widely by country due to country differences in

imports of agricultural inputs and the varying relative price changes between agricultural commodities. The agriculture sectors in the Philippines and Malaysia have been (and will continue to be) least affected, whereas Indonesia has experienced the largest negative effects on agriculture of the Asian developing economies. Negative impacts on agricultural production, consumption, and trade are likely to last until investor confidence is restored and capital flows and interest rates recover.

Rosegrant and Ringler (1998) explore the potential long-term global impact of the crisis on food supply and demand based on a comparative analysis of three alternative scenarios using IFPRI's International Model for Policy Analysis of Agricultural Commodities and Trade (IMPACT). The baseline scenario reflects the conditions prevailing before the onset of the crisis. In the "severe Asian crisis scenario," long-term real currency devaluation and sharp drops in long-term income growth rates in the region are postulated, whereas in the "moderate Asian crisis scenario" it is assumed that the long-term income growth rates will recover to closer to pre-crisis levels.

Global cereal demand in 2020 is expected to decline by 74 million mt (3.0 percent) in the severe crisis scenario and by 19 million mt (0.8 percent) in the moderate scenario, compared with the pre-crisis baseline scenario results. In Asia, the contraction will be slightly larger, 4 percent in the severe crisis scenario and 1 percent in the moderate. Repercussions will be larger for the livestock sector, which is more price- and income-sensitive. The most serious impact of a severe crisis will be on the food security of Asian developing countries. In the severe crisis scenario, the number of malnourished children in the group of developing countries is projected to increase by 15 million, from 143 million to 158 million by 2020. In the moderate scenario, the increase would still be 3 million. In the severe crisis scenario, the number of malnourished children will increase by 11 million in South Asia, by almost 3 million in the PRC, and by 2 million in Southeast Asia.

The long-run effects of the crisis on agriculture remain uncertain, in particular whether the countries can convert the ongoing agricultural export boom to long-term growth in production and trade. The long-term outcome will be determined by the balance between the impacts of the price effects due to real exchange-rate depreciation—which should boost agricultural production and trade—and the investment effects due to the sharp drop in income and contraction of the financial sector—which will tend to depress agricultural production and export growth. CGE models may well underestimate the dynamic impact of the restored competitiveness of agriculture due to real exchange-rate depreciation and structural reforms and overestimate the negative effects of the slowdown in investment on the agricultural sector, particularly if GDP growth continues to recover more quickly than had been feared at the onset of the crisis.

LESSONS FOR POLICY

In addition to causing severe short-term problems, the financial and economic crisis has revealed policy and institutional shortcomings that will challenge the East and Southeast Asian economies beyond the crisis period. Many of these problems are equally relevant to other regions in Asia. The new initiatives that evolve must help policymakers respond both to the crisis and to longer-term, revealed structural problems.

Social Services and Social Safety Nets

As noted above, the crisis countries do not have strong safety nets in place to sustain or enhance the welfare of poor or vulnerable groups in times of economic crisis; even basic social services in health and education are threatened. The immediate

problem is to preserve existing economic and social services for the poor, while in the longer term building stronger social safety nets. Key social sectors include health, employment, and education.

In the health sector, short-term efforts should concentrate on maintaining real spending on health activities that have high public externalities, such as vaccinations and vector control; providing community-based delivery of essential health and nutrition care; spending on regional health centers and subcenters; and providing temporary subsidies for essential drugs during the transitional period of exchange-rate disequilibrium (World Bank 1998d; ADB 1998c). Increased priority in health budgets should be given to women and children, including maternal and child health-care programs, because of the high probability that short-term deprivation of children will cause long-term reduction in physical and intellectual capability and a drop in lifetime well-being and productivity.

In the longer term, health services must be improved in order to ensure quality and cost-effectiveness, while still benefiting the poor. Health-financing schemes in many of the countries are characterized by considerable overlap, inconsistency, inefficient targeting mechanisms, and inequitable distribution of government subsidies. Rationalization of fragmented public health-care programs could yield substantial benefits and better access to those most in need. Rural-urban health-care disparities should also be addressed through redeployment of health-care personnel to rural areas. In Thailand, for example, infant mortality rates in the northern, northeastern, and southern regions are about twice the rate in Bangkok, and the ratio of doctors to patients is only one third the level in the capital (ADB 1998b).

In the employment sector, labor-intensive public employment programs, such as construction of rural roads, sanitation and water facilities, and reforestation and other environmental projects, would stimulate demand and directly benefit the poor (see also Chapter 2). Direct support could be provided for laid-off workers and the unemployed; making

poverty programs more effective would protect the poor in the informal sector. In Thailand, for example, social security for medical care, disability, and education benefits has been extended for a period of six months after loss of work.

As recovery takes place, sounder safety nets should be developed in order to help households improve the management of insecurity related to employment. Unemployment-insurance programs should be developed and extended to a significant share of the population. Funded pension systems or provident funds would create the institutional investors required to provide oversight of corporate governance and would provide greater stability for domestic bond and equity markets. The competitiveness of industry and the flexibility of workers would be enhanced through greater private investment in worker training, which could be encouraged through tax deductions for training (ADB 1998b; World Bank 1998d).

In the education sector, it is essential that real spending on primary schools—the level of education that most directly benefits the poor—be sustained; in addition, targeted subsidies linked to incomes—such as exist in Thailand and Indonesia, see above—should be provided to maintain participation rates in primary and secondary schools. In the longer run, improvements in the education system are essential in order to maintain and improve the quality and flexibility of the labor force and to foster international competitiveness. Educational bottlenecks have developed due to the relative neglect of secondary education in Thailand, upper secondary and college education in the PRC, and the relatively weak quality of education in much of the Philippines and Indonesia.

Institutional and policy reforms are required in education in order to provide the right skills for full participation in the increasingly knowledge- and information-intensive global economy. In addition to developing a sounder foundation of literacy, communication, numerical and analytical skills, curriculum reform at primary and secondary levels should emphasize team-building, flexibility, and adaptability (World Bank 1998d). At the same time that quality of education is improved, access to education must be made more equitable.

In Indonesia, the 1996 enrollment rate for junior secondary education was only 30 percent of the lowest-income quintile, compared to 90 percent for the highest quintile (ADB 1998c). Long-term targeted scholarship programs could ameliorate the disparity in access to education.

Good Governance

As noted above, the East Asian crisis countries performed well right up to the crisis in terms of many macroeconomic fundamentals. But the onset of the crisis underlined the necessity to broaden the concept of "fundamentals" to include the quality of the legal system, regulatory capacity, and intercountry cooperation (Soesastro 1998). Breakdowns in governance, including rapid growth in corruption and poor institutional performance, were fundamental causes of the crisis. Good governance implies that authority is based on the rule of law, that its policies are transparent, that it is accountable to society, and that it is based on institutions and not on individuals (Soesastro 1998). Although the most immediate governance problems in the crisis countries have involved financial and corporate oversight, the crisis exposed significant weaknesses in governance in most sectors of the economy. International cooperation, through forums such as APEC and ASEAN, is an important avenue for broadening the acceptance of good governance. In the end, however, good governance must result from efforts internal to each society, rather than external moral suasion or pressure.

Institutional reform to provide good governance is a complex and long-term process that requires both improvement in public administration and public-sector management and movement toward more diversified delivery of services that is responsive to stakeholders. Public-sector management should be improved to enhance transparency and accountability, improve efficiency and effectiveness, and reduce the opportunities for corruption. Management information systems, audit functions, and procurement systems should be upgraded to strengthen the

capacity of governments to monitor expenditure; ensure control over disbursements; and reduce costs, fraud, and abuse. Pay increases and improvement in employment conditions for civil servants can reduce the incentives for illicit behavior. Improved procedures for recruitment and promotion would help avoid the abuses of patronage, nepotism, and favoritism and help foster the creation of an independent, meritocratic civil service (ADB 1998d).

Reform is also necessary in the relationship between the public sector and the recipients of public-sector services. A diversified approach to delivery of services that would involve government, civil society, and religious institutions can help reduce the risks of relying on only one delivery channel (World Bank 1998d). To diversify delivery successfully, it is important also to reform the "demand side" for services. Generation of effective demand for public services and monitoring of public-sector performance is enhanced by a pluralistic society with rights to associate and to organize interest groups that have access to information on government services and programs. Governments could reduce implementation problems and enhance public support for their programs by easing access to information and allowing affected communities the opportunity to voice their concerns. Decentralization of services to local or community-based institutions can be an important component of good services, but should not be seen as a panacea. Local elites may have weaker technical resources at their disposal and greater opportunities for corruption and lack of transparency.

Nongovernmental organizations (NGOs) can play an important role in good-governance reforms in both the supply and demand for services. Traditionally, NGO activity has concentrated on the supply side: delivering services or assisting the public sector in operating its programs. But NGOs are increasingly becoming involved in the demand side: helping communities articulate their concerns and preferences; negotiating with official bodies in order to amplify the community "voice"; and mixing technical operational skills with information-intensive communication, advocacy, and networking skills to enhance the influence of poor people (Clark 1993).

Effective NGOs can improve governance in several ways:

- by encouraging government ministries to adopt successful approaches developed within the voluntary sector;
- by educating and sensitizing the public about their rights and entitlements under public programs;
- by acting as a conduit to the government for public opinion and local experience;
- by collaborating with official bodies;
- by influencing local development policies of national and international institutions; and
- by helping government and donors fashion a more effective development strategy through strengthening institutions, staff training, and improving management capacity (Clark 1991).

NGO involvement is not always a positive force for good governance, however. Mutual distrust between NGOs and government is often deep-rooted. An NGO that operates according to predetermined principles coupled with preset plans of action might both overlook the real needs and desires of local communities and alienate local and national government agencies. NGOs that act in isolation as "missionaries" setting up "mini-kingdoms" can also hinder rather than encourage good governance (Clark 1993).

Financial and Corporate Management

In the short run, the hardest-hit crisis countries face the task of restructuring their devastated financial and corporate sectors. This necessitates the creation of an enabling environment that includes better accounting and disclosure standards, bankruptcy and foreclosure processes, and improved taxation and accounting laws. For the reconstruction of the banking sector, a combination of approaches, including bailouts, assisted mergers, recapitalization and sale, and liquidation and payoff of depositors

has been used. The dimensions of the task of financial and corporate restructuring are immense. The resources required for recapitalization of banks have been estimated to be as high as 20 percent of GDP in Indonesia and Malaysia and 30 percent in the Republic of Korea and Thailand (World Bank 1998e). A fuller treatment of these issues is beyond the scope of this book, but can be found in World Bank (1998d, 1998e).

In the longer term, a critical component of good governance will be the prudential regulation of financial institutions to reduce the possibility of future financial crises. Garnaut (1998b) summarizes the objectives of prudential regulation: accuracy, honesty, and transparency in financial reporting; the avoidance of related-party and other noncommercial transactions; and the maintenance of relatively high capital/asset ratios—higher than the norm for developed countries. Many of the East Asian crisis countries, notably Indonesia, had in place elaborate regulatory structures that were simply too complex to enforce. Prudential regulation should focus on simple, enforceable targets, rather than attempting to regulate a wide range of indicators (Fane 1998). An essential reform component will be allowing the establishment of international banks, both to introduce competition and induce improved management in domestic banks and to diversify the investment portfolios of the banking sector beyond the national economy.

Corporate governance also needs long-term reform. Many of the necessary reforms are similar to those that are called for in the reform of state enterprises in the transition economies. They include monitoring of enterprises by commercial banks, for example. Enhanced disclosure and accounting practices and strengthened enforcement of corporate governance regulations, especially as they relate to capital markets, are also essential components of corporate-governance reform. Moreover, broader private oversight of management, for example through the representation of minority shareholders, should be enhanced. Institutions need to be strengthened so that the areas of analysis of corporate financing and monitoring of firm performance and behavior

are comprehensively covered by a combination of private, semipublic, and public organizations (World Bank 1998e).

International Capital Flows

The East Asian economic crisis raised serious questions about the free convertibility of short-term foreign capital inflows. Stiglitz (1998) recommends temporary controls on capital inflows combined with domestic reforms and greater disclosure to help reduce the frequency and magnitude of shocks. He argues that the benefit of short-term capital is small or even negative, because, unlike foreign direct investment, it does not bring along technology and management innovations. When savings rates are already high and marginal investment is misallocated, short-term capital greatly increases the vulnerability of the economy. Available empirical evidence indicates that foreign direct investment and other long-term, relatively stable investments have significant positive impacts on economic growth, whereas the benefits of short-term capital are small and problematical (World Bank 1998e).

More judicious management of international capital flows should focus on the creation of an environment conducive to long-term investments (and discouraging to short-term capital inflows). Tax incentives and other distortions that favor short-term inflows over long-term investments should be eliminated. Moreover, both prudential regulations on currency positions of banks and strengthened supervision of these regulations and other risk-management procedures are required. Finally, short-term and unhedged borrowing by corporations should be disclosed to reduce the credit risk.

On the other hand, in those Asian developing economies that are plagued by weak institutional capacity and financial systems, controls on short-term capital may well be appropriate. Capital-account restrictions, if put in place, need to be explicit, transparent, and market-oriented (World Bank 1998e). The Chilean approach provides a possible model for market-oriented short-term capital controls in East and Southeast Asia: in Chile,

first of all, 30 percent of all nonequity capital inflows must be deposited interest-free at the central bank for one year. Second, Chilean firms and banks can borrow from international capital markets only if they are rated as highly as Chile's government bonds. Third, any foreign inflows must remain in the country for at least one year (Soesastro 1998).

International Recovery Programs

The type of recovery package appropriate for the East Asian financial and economic crisis has also been widely debated. The IMF has come under severe criticism for the reform programs in Thailand, Indonesia and Korea (the Philippines in 1996 was already in an IMF-supported reform program, which was modified as a result of the crisis; and Malaysia did not seek support from the IMF). The main goals of the stabilization and reform programs were to restore macroeconomic stability and to address financial-sector and other structural distortions in the economy. Contractionary fiscal and monetary policies were central to the program, with a reduction in government budget deficits and contractions in money supply.

A contractionary fiscal policy was implemented to reduce inflationary pressures, but fiscal policy was quickly relaxed to provide funding for social programs and financial restructuring and to partially balance falling aggregate demand. Tight monetary policies were implemented to raise interest rates and reduce capital outflows in order to defend the exchange rate, restore investor confidence, and control inflation. Financial restructuring was implemented through aggressive bank closures and enforcement of capital-adequacy standards, both to send strong signals about the seriousness of reform and to restore the banking system to a solid footing as quickly as possible. Nonfinancial structural changes in the reform packages included cuts in tariffs, reductions in monopoly power, and opening of sectors to foreign investment (Radelet and Sachs 1998).

Critics of the stabilization and recovery programs have focused on the pace of structural reform, fiscal policy, and

monetary policy. Garnaut (1998b) accepts that reform of the financial sector and removal of other structural weaknesses are essential in order to avoid future crises, but argues that it was a mistake to overload the policy agenda in the midst of the crisis with reform issues that were not crucial to immediate recovery objectives. An excessively broad reform agenda can overload political systems. In Indonesia, such an overload prompted the incoherence in the implementation of agreed-upon IMF reform packages and eventually contributed to the political instability that made the recovery process far more complicated. Overloading the political system resulted in a weakening of government credibility and probably contributed to the breakdown of the political system in Indonesia (Garnaut 1998b).

Early bank restructuring policies may also have caused unnecessary economic contraction. In Indonesia, aggressive bank closures appear to have created panic rather than signaling political resolve. A possibly excessive rate of bank recapitalization may have caused an overly strong contraction in lending as banks attempted to meet capitalization targets. The counterargument is that failure to address these structural problems would have been devastating to domestic and foreign confidence and would not have produced the basis for durable recovery (Nellor 1998). Particularly in the financial sector, keeping failing institutions alive through central bank liquidity injections would only have aggravated the banking problem, led to more runs on banks, and made control of inflation more difficult. Instead, a program of closures, mergers, and recapitalization, together with reform of bank supervision, was started immediately in Indonesia, the Republic of Korea, and Thailand (Neiss 1998).

Critics of the stabilization programs have also argued that monetary and fiscal policy targets in the crisis countries were too stringent, resulting in greater contraction of the economy and harsher impacts on the standard of living than were necessary and deepening the economic depression. In each of the four countries in which a recovery program was implemented, the initial IMF fiscal policies were impossible to meet and the reform programs were renegotiated to relax some

of the targets. The changing targets increased uncertainty over policy responses in the countries, contributing to political instability. Even the revised fiscal targets were contractionary, at least through early 1998, contributing to the plunge in aggregate demand.

In 1998, however, central government fiscal balance targets were relaxed for each of the countries in successive revisions of the recovery/stabilization programs. In Indonesia, for example, an initial target of –1.0 percent (a one-percent deficit) was reduced to –8.5 in a third revision. In Thailand, the target evolved from 1.0 percent to –2.4 percent and in the Philippines from 0.0 percent to –3.0 percent (World Bank 1998e). A general consensus appears to be emerging that initial fiscal targets in the reforming countries were excessively contractionary; fiscal policies should be more flexible, in order to provide some counterbalance to declining effective demand, to strengthen the social safety net, and to accommodate the costs of financial-sector restructuring (Kochlar, Loungani, and Stone 1998).

The use of tight monetary policy to stabilize exchange rates poses even more difficult trade-offs between macroeconomic and financial-sector stabilization objectives. The orthodox contractionary tight-money policies followed under the recovery programs were supposed to stabilize exchange rates and to curb inflationary pressures. High interest rates were to strengthen the exchange rate by making investment more profitable. A stable exchange rate limits the damage to banks and corporations that have large foreign currency debts. But high interest rates can also damage highly leveraged and weak banks and corporations by increasing the cost of debt service, contributing further to excessive credit contraction, and triggering an additional decline in income. Tight monetary policy can therefore also have perverse effects on the exchange rate by reducing investor expectations of future output, demand for money, and interest rates. Given the uncertainty about the behavior of interest rates and exchange rates during crises and the known adverse impacts of high interest rates on economic activity, critics of a tight monetary policy argue for increased flexibility in a situation such as the East Asian financial and

economic crisis, where the financial system is fragile, corporations are highly leveraged, and declines in aggregate demand are large (World Bank 1998e).

Nevertheless, the policies have resulted in exchange rates first stabilizing and then strengthening. Moreover, inflation has been largely contained, with the exception of Indonesia, and interest rates have declined dramatically from post-crisis highs. The exchange rate of the Indonesian rupiah reached a low against the US dollar of 14,900/1 in the first quarter of 1998 and has since strengthened to 7,550/1. The Philippine peso strengthened from 43.87/1 in August 1998 to 40.88/1 in October 1998 and has since continued a gradual downward trend. The Thai baht strengthened from 47.25/1 in the fourth quarter of 1997 to 37.78/1 in October 1998 (IMF 1998b).

Annualized inflation hit 60 percent in Indonesia in mid-1998, but has since declined to an annualized rate of about 45 percent in September 1998 and 30 percent in May 1999. Inflation increased only slowly in the other crisis countries, reaching 10 percent in Thailand and the Philippines and 8 percent in Korea in the second quarter of 1998. In Indonesia, short-term interest rates increased from less than 20 percent at the beginning of 1997 to about 40 percent in late summer of 1997. After a brief decline, they increased to about 60 percent by September 1998, but fell to 30 percent in May 1999. In Korea, the short-term interest rate reached about 20 percent at the end of 1997 and declined to less than 10 percent by September of 1998 and 5 percent in May 1999. In Thailand, the interest rate peaked at slightly above 20 percent at the end of 1997 and came down slowly to below 10 percent by September 1998 and 4 percent in May 1999. In the Philippines, the short-term interest rate dropped during 1998 and 1999, from almost 30 percent at the end of 1997 to below 20 percent by September 1998 and 9 percent in May 1999 (IMF 1998a; Severino 1999).

Moreover, and most importantly, with the improvement in balance of payments, exchange rates, inflation, and interest rates, the East and Southeast Asian crisis economies are moving toward recovery in income growth. The Republic of Korea is projected to have GDP growth of 5 percent in 1999, Malaysia

and the Philippines 2 percent, and Thailand 1 percent, while Indonesia is projected to have a fall in GDP of 2.4 percent over the full year (though real GDP grew at an annualized rate of 1.3 percent during the first quarter of 1999). It is impossible to evaluate fully the tight monetary policy (as well as the full recovery program) in mid-1999, while the impact of the crisis is still being felt.

Tight monetary policy appears to have successfully stabilized exchange rates and interest rates, but additional analysis will be required to assess whether, for example, interest rates could have been reduced more quickly, once the exchange rate stabilized, in order to stimulate growth. It has to be acknowledged, however, that, by the time the IMF was called in to help each country, all the low-cost options had been foreclosed. Important decisions in several complex and painful areas had to be made quickly and without full information. As of mid-1999, the East and Southeast Asian crisis economies appear to have weathered the worst of the downturn, but still face the massive challenges described above, and in an uncertain external environment. Continued slow growth in Japan, a downturn in the economy of the United States, or a large currency devaluation by the PRC could be serious setbacks to recovery.

CONCLUSIONS

The financial and economic crisis in East and Southeast Asia was the culmination of real appreciation of currencies and exchange-rate misalignment that diminished the international competitiveness of these countries; of large and growing current-account deficits financed with short-term foreign capital inflows; of poorly supervised overborrowing and overlending in the financial sector, much of it to risky and low-profitability projects; and of excessive short-term lending by international investors in the 1990s. These were followed by a sharp reversal of the short-term capital flows in 1997, which set off a round of

competitive devaluations. The crisis has had a severe negative economic and social impact, including sharply declining incomes and increasing unemployment, rising absolute poverty, increases in malnutrition, increased pressure on already underserved rural areas, and declining social services and threats to education and health status. The effects on agriculture have been mixed and in the longer term will be determined by the balance betweeen the impact of the price effects due to real exchange-rate depreciation, which should boost agricultural production and trade, and the investment effects due to the sharp drop in income and the contraction of the financial sector, which will tend to depress agricultural production and export growth.

In addition to causing severe short-term problems, the crisis has revealed policy and institutional shortcomings that will challenge the East and Southeast Asian economies well beyond the crisis period. In the short run, it is essential to preserve existing economic and social services for the poor, including health, education, and employment, while in the longer term, stronger social safety nets must be built. Improvement in key institutions is also essential to assure long-term recovery and economic growth. Institutional reform to provide good governance is a complex and long-term process that requires both improvement in public administration and public-sector management and movement toward more diversified delivery of services that is responsive to stakeholders. Good-governance reforms must seek greater transparency and accountability in public-sector activities. A critical component of good governance will be the prudential regulation of financial institutions and corporations to reduce the possibility of future financial crises.