Fiscal Outcomes and the East Asian Economic Crisis

*J. Edgardo Campos and David Jay Green**

Introduction

The crisis touched off a wave of soul searching as East Asian officials grappled with sudden reversals in economic fortune and a lack of confidence in previous policies. The problems were often handled through the use of *ad hoc* measures offering at best a temporary solution. The crisis clearly revealed two weaknesses of public expenditure management systems that should be addressed by reforms.

The first is the need to improve fiscal flexibility — the capacity to alter the level and mix of spending quickly in response to policy shifts. The public expenditure management system must be able to move smoothly to accommodate changes in spending plans while still meeting national priorities. This will require a number of changes, including:

— The real nature of public sector assets and liabilities needs to be better understood and acknowledged. The crisis snowballed as private liabilities became public knowledge and were assumed by the public sector. A tracking system for public sector contingent liabilities, such as the debt of state–owned enterprises (SOEs) and foreign borrowing by the private sector, would provide a more accurate sense of public sector indebtedness and serve as an early warning device for fiscal planning.

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— It may be advisable to have contingency plans for official lines of credit to be used when expansionary fiscal policy is necessary but cannot be supported by private or domestic capital sources. This would demand some longer–term, ongoing dialogue between regional governments and between the regional governments and international organisations.

— A more flexible cash management system is needed to ensure that the impacts of external or internal shocks are not aggravated by sub–optimal cash release mechanisms.

To support this increased flexibility, it may be necessary for the international community to establish emergency support systems that disburse funds rapidly and do not demand the extended processing time required for normal lending programmes. The mechanisms of such systems are beyond the scope of this chapter, but we demonstrate that they are needed.

Elements of the Crisis

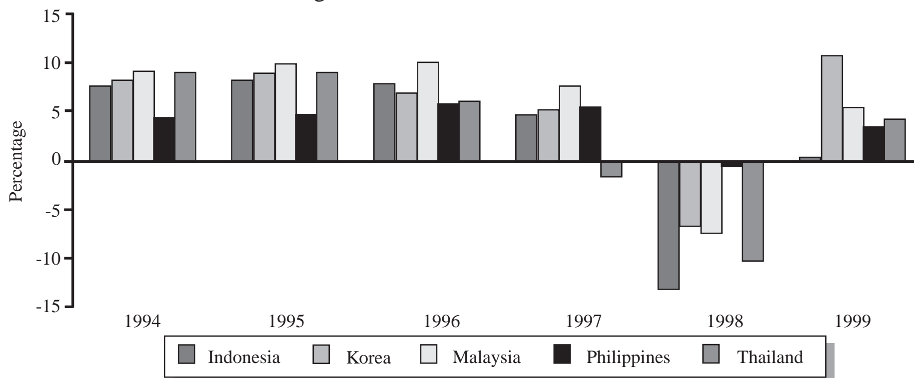
In August 1997, a massive depreciation shook the currencies of Thailand, Indonesia, the Republic of Korea (henceforth Korea), Malaysia and the Philippines. The sudden, relatively unexpected large shifts in the exchange rate were met with determined but somewhat futile efforts by the governments to reverse or dampen the fall in the local currencies. The external shock was first apparent in Thailand, but the problems spread rapidly throughout most of the region. The regional contagion was testimony to the convergence of policy and performance in the region as well as to the speed at which global capital markets reassess positions[1].

The sharp currency movements were presaged by a build–up of debt denominated in foreign exchange, especially by the private sector. The debt build–up ultimately came to be viewed as unsustainable and signalled a withdrawal of foreign capital and capital flight by domestic investors. The resulting fall in the domestic currency reinforced a lack of international confidence in the ability to repay the large foreign–denominated debts and led to successive waves of further depreciation. The terms–of–trade shock rocked a financial sector which was already over–exposed to foreign exchange debts and lacked the institutional skills and capacity to contend with the pressures that accompany liberalised financial markets.

In the short run, the massive depreciation had relatively little impact on the dollar value of exports from the economies hit by the crisis, partly because of the concurrent weaknesses in both regional markets and markets such as Japan. Imports fell considerably, partly as a result of the depreciation of the local currency, but also as a matter of import "compression" — weaknesses in import demand due to domestic recession and the credit constraints. The latter initially reflected the tight monetary policy pursued to reverse or slow the free–fall of the currency. Later on, slack imports resulted from the collapse of financial markets and the emerging private sector debt overhang that constrained further credit extension from traditional suppliers.

The swift deterioration in enterprise solvency for both financial and non–financial firms resulted in a collapse of investment, particularly in construction, but also, as systemic problems developed, in all other investment areas. Constraints on exports also emerged as a result of financial sector weaknesses, further depressing national income. The net result was a regional recession, plaguing a set of countries hitherto known as Tigers or Tiger Cubs for their consistent growth (see Figure 1).

Figure 1. **Economic Growth in East Asia**



Aggregate Fiscal Outcomes and the Crisis[2]

The Impact on Revenue

In the five countries, the initial impact of the crisis was a shortfall in projected revenues as tax efforts faltered owing to rising enterprise insolvency, shrinking trade flows and decreased personal income. Public revenue collection was naturally responsive to aggregate income, as more than one–half of pre–crisis domestic revenues flowed from income and value–added taxes. In most countries, tax collection fell more than proportionally to the drop in income, and spending and total revenue effort (tax–to–GDP ratio) declined. The dependence upon trade taxes also ensured that revenues would weaken with the crisis.

In Indonesia, in fiscal year (FY) 1995, GDP–sensitive income and value–added taxes accounted for an average of 52.9 per cent of total domestic revenues. An additional 5.2 per cent came from import duties, which are quite sensitive to national income[3]. ADB staff estimated that, as a consequence of the onset of the crisis, non–oil domestic revenues fell from 12–13 per cent of GDP in FY 1995–FY 1996 to 11.4 per cent in FY 1998–FY 1999. Coupled with the 13.2 per cent decline in GDP in calendar year 1998, this caused a large drop in fiscal resources in both nominal and real terms. Oil revenues fell as well during the crisis period, further reducing the country's capacity to deal with the fiscal crisis.

In Korea there was much more stability in the tax effort: tax collections increased marginally from 16.4 per cent of GDP in 1995–96 to 16.6 per cent in 1997[4]. This is said to be partly due to reforms in the bank secrecy law that prohibited certain practices which previously had allowed under–reporting of income. Despite this improvement in revenue efforts, fiscal resources fell as GDP declined by 5.8 per cent in 1998.

Malaysia also suffered from a significant fall in revenue in 1998. Tax revenue had been rising until 1997, but it fell by 15.5 per cent in 1998[5]. The immediate impact came in indirect tax collection: trade, excise and sales taxes fell 38–41 per cent in 1998[6].

In the Philippines a somewhat milder change occurred as the economy fell off the 5–6 per cent GDP growth rate observed in 1996–97 with a contraction of approximately –0.5 per cent in 1998. Tax collection efforts faltered during this period, however, falling by approximately 1½ percentage points of GDP[7]. This reversed the small but steady increase in the tax effort during the 1990s.

In Thailand, tax collection fell quickly in 1997, with the tax–to–GDP ratio falling from 17.5 per cent in FY 1995–FY 1996 to 16.3 per cent in FY 1997, and the decline continued in FY 1998. The slowing of economic activity was especially noticeable in the fall–off of corporate and property taxes[8]. Combined with the steep fall in GDP, this resulted in a significant decline in public revenues.

The Immediate Call on Budgetary Resources

The initial currency devaluation quickly increased the domestic cost of external debt servicing, placing an immediate strain on public budgetary resources. The impact varied across the region, being greatest in those countries with the weakest overall public sector financial position, especially Indonesia and the Philippines.

In Indonesia, on a current accounts basis, debt service as a proportion of GDP increased from approximately 9 per cent in FY 1995–FY 1996 to an estimated 13.5 per cent in FY 1998[9]. Although this reflected some increase in overall indebtedness, the predominant change resulted from the increased domestic cost of loans denominated in foreign exchange due to the plummeting value of the rupiah, which fell from Rp 2 181 to the dollar in FY 1994 to Rp 7 852.9 to the dollar in 1999. While most of the increased pressure fell upon the private sector, public sector interest payments on foreign exchange–denominated debt rose from Rp 6 000–7 000 in FY 1994–FY 1997 to Rp 11 263 in FY 1998. In 1998 it represented 9.7 per cent of total expenditure, as against 8.1 per cent in the previous fiscal year[10].

The Korean budget also reflected an immediate need to service external debt payments. Budgeted interest payments as a fraction of GDP increased from a relatively constant 0.5–0.6 per cent in the pre–crisis years to 1.1 per cent in 1998 or from 2.2 per cent of total expenditures in 1997 to 4.1 per cent in 1998[11]. (The 1998 figure, however, already included charges for bank restructuring.)

Total external debt in Malaysia rose from 37.5 per cent of GDP in 1996 to 52.1 per cent in 1998, but the debt–service ratio remained relatively stable at roughly 5.5–7 per cent of exports of goods and services[12]. What is more important from the public revenue standpoint, debt–service burdens remained quite small. In 1998, external debt–service charges represented a mere 2.3 per cent of total national government expenditure. Thus, in contrast to the situation in other crisis–affected countries, external debt obligations did not cause as much pressure on the national budget.

In the Philippines, interest payments by the central government rose 28 per cent in peso terms from 1997 to 1998[13]. The increased debt–service requirements were equivalent to 0.5 per cent of GDP. As a measure of the impact on fiscal resources, interest payments as a fraction of national government expenditures rose from 16.6 per cent in 1997 to 19.5 per cent in 1998[14].

In Thailand, on a current accounts basis, debt–service requirements rose sharply as a result of the collapse of the currency and the flight of private capital. In 1997, total debt–service requirements as a proportion of exports of goods and services rose to 15.8 per cent from 12.1 per cent in the previous year and an average of 11.5 per cent in the three previous years[15]. From a public sector standpoint, the change was more manageable — interest expenses in FY 1997 rose to 2.8 per cent of total expenditures against 2.2 per cent in the previous fiscal year[16] — but it did reverse a significant downward trend in interest payments.

The Legacy of the Crisis: Public Assumption of Private Debt

The short–run problems of increased public sector foreign debt burdens, although significant in some cases, pale when viewed against the longer–term problems resulting from the collapse of the financial sector in most countries and the public assumption of private sector debts, particularly those related to banking sector recapitalisation.

Weakness in the banking sector and in the financial sector generally has been an important factor in the crisis, prolonging the impact of the initial changes in exchange rates and debt problems. Banks in Indonesia, Korea and Thailand were widely seen to rely less upon market signals than on government or personal connections when making lending decisions. Lax regulation by the government served to encourage this debilitating behaviour. In the wake of the currency depreciation, many financial institutions were found to have had unhedged foreign currency exposure beyond their ability to service or were overextended to property investors or other firms which proved to have weak or insolvent balance sheets.

The virtual collapse of the banking system in several of the countries required active intervention on the part of the government. Agencies were created to assume debt and public sector funds were used to strengthen the balance sheets of the banking sector. Over the longer term, the collapse of the financial sector will act as a constraint on public finances, since private sector debts have become public sector liabilities[17].

The emergence of massive public sector indebtedness reinforces the need for improved public sector accounting of contingent liabilities: future risks must be properly incorporated into today's fiscal balances[18].

In Indonesia, as of early 1999, the non–performing loans of the predominant state banks were estimated at 60 per cent. The net worth of the banking system as a whole is estimated to be negative and corresponding to approximately one–third of total GDP[19]. The restructuring costs likely to be assumed by the public sector are estimated at 58 per cent of GDP.

In Korea, the non–performing loans of the banking sector had grown to nearly 8 per cent of GDP by the end of September 1997, and the system as a whole became insolvent. The fiscal costs of restructuring the banking system were estimated to be of the order of 16 per cent of GDP.

In Malaysia, non–performing loans, about 60 per cent of which are loans for the purchase of real estate or securities, have been increasing since 1996: in 1997, 5.9 per cent of total banking sector loans were non–performing; this figure jumped to 14.3 per cent in 1997 and to 16.8 per cent in 1998[20]. This level is not insignificant, but it is lower than in most of the countries in the region. Consistent with this, the fiscal costs of bank restructuring are also relatively low, being estimated at 10 per cent of GDP.

The banking sector in the Philippines was relatively stronger than in the other countries. There had been less reliance upon unhedged foreign currency borrowing, less involvement with the property sector and less reliance upon leveraged financing. It is also likely that there was less directed lending by the authorities and more reliance upon market institutions. The relative strength of the Philippine financial institutions was partially a result of the difficulties and lessons learned from the early 1980s and the subsequent difficulties in the mid–1980s and early 1990s. The Philippines developed institutions that exerted somewhat stronger supervisory and regulatory control and were less susceptible to systemic errors in judgement. Moreover, the asset market boom affecting property and stock markets in regional neighbours was less prolonged in the Philippines, and thus the country's institutions were not as over–extended as those of its neighbours. As a result, the Philippines was the only crisis–affected country in which the central government assumed no significant amount of banking or financial sector restructuring costs.

In Thailand, where the crisis began, the financial sector has suffered heavily. The non–performing loans of the banking system rose from just under 20 per cent at the end of 1997 to roughly 45 per cent in 1998 and 1999[21]. The government has taken a very aggressive stance on banking sector reform and will likely assume much of the cost of restructuring, estimated at 31.9 per cent of GDP.

Policy Responses to the Crisis

The Initial Policy Stance Was Pro–cyclical

The resulting deterioration in fiscal balance was initially addressed with pro–cyclical fiscal policy, exacerbating the emerging recession. Expenditures were cut and interest rates raised, building confidence that foreign exchange–denominated loans would be repaid. The initial focus of policy actions on maintaining external stability as opposed to maintaining aggregate income compounded the already sharp deterioration in macroeconomic and financial market conditions. Persistent underestimation of the extent of the crisis contributed to the policy dilemma.

The IMF programme for Indonesia called for an initial restriction in public spending. An initial programme targeted elimination of subsidies for fuel and electricity, increases in sin taxes (on alcohol, for example) and general increases in tax efforts, especially for VAT[22]. The FY 1998 budget called for a generally restrictive fiscal policy with total expenditures as a proportion of GDP programmed to fall to 14 per cent from 17.9 per cent in FY 1997 (and 18–19 per cent in the previous two years). In keeping with the fiscal conservatism of this initial policy effort, efforts were directed primarily at lowering expected debt servicing, but development expenditures (which include a wide range of government investment categories) were to fall by 14.3 per cent from the actual expenditures of the previous fiscal year.

In Korea, following the emergence of a fiscal deficit in late 1997, the emphasis in the first half of 1998 was clearly on restrictive fiscal and monetary policy, in line with IMF prescriptions to stabilise the won and the external sector in general. The initial 1998 budget called for an overall central government deficit of 1.7 per cent of GDP, the same as the 1997 level[23].

Although Malaysia moved more quickly than other countries to a counter–cyclical policy stance, its initial focus was also on fiscal conservatism. A press statement by Michel Camdessus, then Managing Director of the International Monetary Fund (IMF), noted approvingly that "Deputy Prime Minister Anwar has appropriately also proposed to rebalance macroeconomic policies. Fiscal policy will maintain Malaysia's strong record by targeting a surplus in 1998, despite the economic slowdown."[24]

The Philippine IMF programme of March 1998 called initially for a slight tightening of fiscal policy to reverse the recession–induced budget deficits expected in 1998: "from a deficit of 0.9 in 1998 to a surplus of 0.9 in 2003"[25]. While the difficulties of tax revenue generation frustrated any restrictive fiscal policy in 1998, the forward programme called for greater pro–cyclical efforts. An increase in the tax effort was expected to account for the greatest part of the change in the fiscal balance.

In response to the problems in tax collection, the government resorted to across–the–board budget cuts of as much as 15 per cent and to the sequestering of appropriated expenditures through "cash rationing". This process resulted in an accumulation of cash payment arrears[26]. One analysis of the government's response noted plans for a 25 per cent cut in the 1998 appropriations for non–personnel expenditures for the

national government and a 10 per cent cut in transfers to local governments[27]. Estimates of the payments arrears accumulated across sectors through mid–1998 are of the order of P108.5 billion ($2.7 billion)[28].

Thailand also went through a turn–around in fiscal policy stance, as can be seen in the successive reviews of the Thai IMF programme from August 1997. In the letters of intent (LOIs) of 14 August 1997 and 25 November 1997, for example, the fiscal targets called for a small surplus in FY 1998. In these first two LOIs following the onset of the crisis, the overall fiscal balance for the central government and the consolidated public sector were both targeted at a 1 per cent surplus in FY 1998, following the 1 per cent deficit expected in FY 1997. There was a call for tax increases, including a hike in VAT rates from 7 to 10 per cent.

As ADB staff have noted, the IMF programmes in Thailand recursively moved towards lower growth targets as incoming data disappointed earlier hopes. The IMF programme of August 1997 projected real GDP growth for 1998 at 3.5 per cent, but 12 months later the fifth revision in the programme projected a sharp decline of 7 per cent for the year[29].

Policies Became Increasingly Counter–cyclical

Despite the initial programmes' failure to restore exchange rate stability, the policy focus passed to confronting the downward spiral of aggregate demand and production. The initial policy goals were not met, and the costs of ignoring the real impact of the crisis and the costs to the financial sector of high interest rates appeared to be mounting. Fiscal and monetary policy became increasingly counter–cyclical. Plans calling for a quick return to public sector surpluses proved unfeasible in the face of mounting evidence of the need to utilise public funds to support financial sector restructuring.

In Indonesia, public spending in FY 1997 was increased from the budgeted 14 per cent of GDP to 18.3 per cent, despite the continuing deterioration in the exchange rate. For FY 1998, the spending programme changed quite sharply. The LOI of 15 January 1998 speaks of changing a commitment from a target of a 1 per cent budgetary surplus in FY 1998 to a balanced budget. By April 1998, the policy shift was more firmly established and a target of a 3 per cent deficit was adopted[30].

Fiscal policy was also loosened in Korea in the second half of 1998, although there was some apparent stabilisation of the won — the exchange rate had rebounded in early 1998 and had stabilised by the second quarter. This eased the path for expansionary fiscal policy, and the budget deficit for 1998 was raised from an initial target of 1.7 per cent of GDP to a deficit of 5 per cent, a level which was also adopted for the 1999 budget[31].

Malaysia has seen the least conventional policy response, with the government moving sharply and quickly away from an initial policy of restrictive monetary and fiscal measures. Indeed, by March 1998 the thrust of fiscal policy had turned towards

stimulating aggregate demand as against an earlier concern with reducing financing needs, although in April 1998 the government was still planning a public budgetary surplus[32]. By May 1998, it was clear that the government had shifted its focus towards fighting the emerging recession[33]. Current expenditures were reduced, development expenditures expanded, and the annual budget moved into a modest deficit (after many years in surplus). The 1999 budget announced in October 1998 was seen as a definite shift to counter–cyclical policies. A deficit projection of 6 per cent of GDP for the federal government was deemed acceptable[34].

In the Philippines, the IMF–supported macroeconomic stabilisation programme shifted emphasis in mid–1998 to deal more firmly with a weakening economy and less with "external vulnerability", despite the perception that the external situation had worsened in some important respects. Although the 11 March 1998 Memorandum of the Philippines government spoke of relaxing fiscal policy in the near term, its target for the consolidated public sector budget deficit for 1998 was 0.9 per cent of GNP — representing no change from the realised position for 1997[35]. It was expected that this deficit would be transitory and that a balanced fiscal position would be reached in 1999. By early 1999, the need for "a well–measured shift toward a more expansionary fiscal policy stance to stimulate domestic demand" was recognised. The new target for the consolidated public deficit was approximately 3.3 per cent of GNP[36].

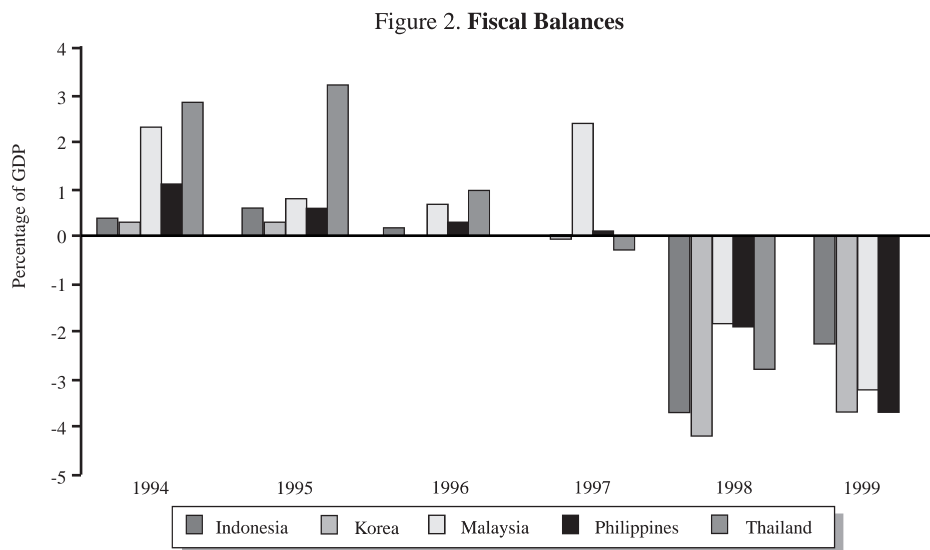
In Thailand, expectations and concerns had shifted by early 1998, but the shift was implemented in a rolling fashion, with each new plan or programme calling for increased public expenditures relative to revenues — i.e. for larger deficits. The LOI of 24 February 1998 called for a FY 1998 central government budget deficit of 1.6 per cent, whereas the target in the two previous LOIs had been a 1 per cent surplus, as noted above[37]. This was subsequently increased to a 2.5 per cent deficit. These deficits were complemented by smaller, but significant, planned deficits for state–owned enterprises. Major changes were also made in the planned deficits for FY 1999: that of the national government was raised to 3 per cent, and an additional 3 per cent was planned to take into account SOEs and the expected costs of financial sector restructuring[38].

In most countries the basic tool of expansionary fiscal policy was increased spending. Reduced revenue collection was not seriously considered, for a number of reasons. First, tax collection was falling in any event as the tax base diminished. Given the reliance upon export and enterprise taxes, only cuts in personal taxes would have had any impact on aggregate demand, and thus only a small part of the tax base was a viable target for tax cuts to stimulate the economy. Moreover, personal tax cuts would likely have had little impact on household spending because of the uncertainty about employment and income: such cuts would not have been perceived as affecting long–term disposable income. Finally, the inside lags for lowering these tax rates are no shorter than those for spending increases. Spending programmes were thus seen as procuring a greater impact for a given change in the deficit[39].

The Deterioration in Fiscal Balance

As a result of initial pressures and the movement towards counter–cyclical fiscal policies, the budget balance deteriorated quickly for all of the countries. Figure 2 shows the overall drift towards strong negative balances in a region hitherto characterised by fiscal surpluses. The largest impacts came when policies shifted to fighting the rapidly emerging recessions and to assuming the costs of financial sector restructuring.

Figure 2. **Fiscal Balances**



Note: Indonesia data from ADB estimates, otherwise from ARIC website May 2000. Data do not always correspond to calendar year.

The initial impacts were most severe in Korea and Indonesia. In Indonesia, the national government budget moved from a small surplus before the onset of the crisis to a deficit of 3.8 per cent of GDP in FY 1999. Similarly in Korea, the budget balance tumbled to an average deficit of nearly 4 per cent in 1998 and 1999.

Although Malaysia was hit by the financial contagion, it has had less difficulty in managing its budget. Throughout the 1990s, the country practised prudent fiscal management resulting in budget surpluses. This provided a cushion against the initial impact of the crisis, which was less severe than in other countries: in 1998, the budget fell into a small, controllable deficit of 1.8 per cent of GNP, after a larger surplus in 1997[40]. Malaysia's greater fiscal freedom also allowed it more flexibility in setting overall policy and provided scope for an early swing to more expansionary fiscal policies.

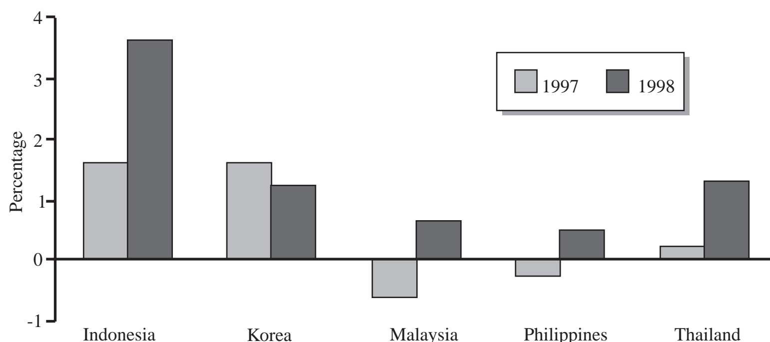
ODA: Assistance at a Price

With the inevitable emergence of abnormally high budget deficits, four of the five countries hit by the crisis were forced to request and rely on extensive official development assistance (ODA), primarily from the IMF, the ADB and the World Bank. The loans were largely policy–based structural adjustment lending intended to support reforms such as the improvement of regulatory and corporate practices. These packages were not, in all cases, quickly or completely made available. The disbursement of loans tied to reform programmes was conditional on the processing of loan documents and on negotiations between government officials and staff from international organisations over the nature, timing and extent of the individual actions.

In many respects, the international agencies are not well positioned to respond to emergency funding needs such as those which emerged in East Asia as policy moved towards counter–cyclical, expansionary fiscal spending. Increasingly, the internal procedures of international organisations call for background studies — for example on the environmental or social impact of any activity — which cannot be conducted in a matter of weeks. International organisations also increasingly require widespread participatory involvement of civil society in project design, which cannot be easily accomplished in a matter of days. These procedural developments, which are intended to procure greater accountability, transparency and participation, may increase the difficulties of providing support in emergency situations where time is the more crucial consideration.

Except perhaps in the cases of Indonesia and Korea, it is difficult to argue that the official assistance provided was commensurate with the kind of spending programmes that eventually emerged, as can be seen in Figure 3 in terms of transfers to the national governments in relation to GDP. In this respect, the rapid shortfall in financing reduced governments' ability to deal with the crisis from a counter–cyclical standpoint, limiting the scope for fiscal policy. Their inability to draw on immediately available and adequate external resources aggravated the impact of the earlier, pro–cyclical policy stance[41].

Figure 3. **Net External Financing of Government Budget as Fraction of GDP**



Source: Data from IMF, except Malaysia from Ministry of Finance.
Indonesia, Thailand are fiscal years.

In Indonesia, ODA commitments were quickly forthcoming, and on an unprecedented scale. Following the Indonesian government's request for assistance in October 1997, the ADB committed $3.5 billion, the IMF $10.1 billion, the World Bank $4.5 billion, Singapore $10 billion, etc., for a total of roughly $36.1 billion[42]. The actual disbursement of aid, however, tended to lag behind the developing need for funds. Net official transfers moved from a negative $0.8 billion in FY 1997 to a positive $1.2 billion in FY 1998, a swing of about $2 billion (1 per cent of GDP) or less than 5 per cent of the level of public commitments made[43]. With respect to fiscal expenditures, external financing was estimated to have accounted for 27.4 per cent of the central government deficit in FY 1997[44].

The extent of official assistance to Korea was also unprecedented for East Asia. The total IMF–structured multilateral assistance package put together in late 1997 totalled $58.35 billion on a commitment basis[45]. In contrast to what happened in other countries, funds seem to have been made available rather quickly. By the end of 1997, a financing package of $15.8 billion in callable capital was made available, more than two–thirds of which came from the IMF. External financing covered approximately 93 per cent of the consolidated central government fiscal deficit[46]. Similar, although somewhat smaller packages were made available in 1998. Korea thus received financial resources relatively early on.

In the Philippines, net external financing in 1998 amounted to P12.4 billion — a considerable reversal from the net outflow of P6.4 billion in 1996–97[47]. This represented 24.8 per cent of the total national government financing requirement, a level comparable to that seen in Indonesia. In dollar terms, the actual transfer was well under $0.5 billion. The budget planning had called for considerable reliance upon external financing. Although some of the necessary funding for expanded public sector spending was to be raised in the international capital markets, the bulk was expected to come from official assistance sources. The relatively small amount of net transfers actually made would clearly hinder fiscal policy from moving quickly to counteract output declines.

Malaysia has for the most part shunned significant external financing, as it has been able to raise the requisite funds domestically. In 1998, foreign borrowing amounted to only 16.2 per cent of the domestic borrowing utilised to finance the government's fiscal deficit (as well as an increase in reserves)[48].

Thailand has also received huge infusions of official assistance on a commitment basis. As in Indonesia and the Philippines, about 25 per cent of the central government's budget deficit was financed by external sources in FY 1997[49].

The Impact on Expenditure Allocations

The shift away from a contractionary fiscal policy during 1998 did not immediately provide for strong counter–cyclical spending, except possibly in Korea, but it did allow for a continuation of basic public expenditure patterns, despite the increased debt–service

burdens. As a result of fiscal pressures, some shifts in the spending mix occurred and the initial tight fiscal policy had an impact on government operations. Although each country's situation was quite different, there are some common trends:

— Efforts were made to protect social sector spending.

— Cutbacks were made in administratively easy areas including infrastructure project spending and maintenance.

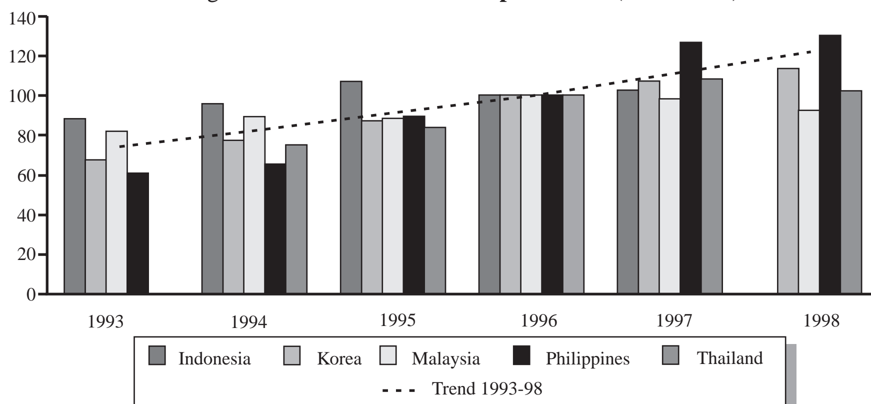
— Capital spending, at first reduced, was then utilised as a means of providing expansionary fiscal support for the economy.

— In cases of extremely strong constraints on fiscal resources, governments have resorted to practices such as sequestering funds, which have resulted in a spending bias. Wage bills, for example, tend to be paid ahead of suppliers, and personnel expenditure needs are met while expenditures for critical items such as operations and maintenance of infrastructure are not.

Social Sector Spending

In general, real public spending in the social sector was preserved or increased during the crisis. Figure 4 shows nominal expenditures — generally the total for education, health, housing and social welfare — adjusted for price changes using the GDP deflator[50]. All of the countries except Malaysia show significant increases in spending from 1996 to 1997. The fact that social spending was maintained testified to the high priority accorded these sectors and to the difficulty of making quick adjustments to these budgets. The picture thereafter is somewhat more mixed, as spending tailed off in 1998 in some cases. Moreover, the simple trend line, extrapolating the spending patterns seen just before the crisis, shows that most countries have not maintained the pattern of strong increases shown in the early 1990s[51].

Figure 4. **Real Public Social Expenditures (1996 = 100)**

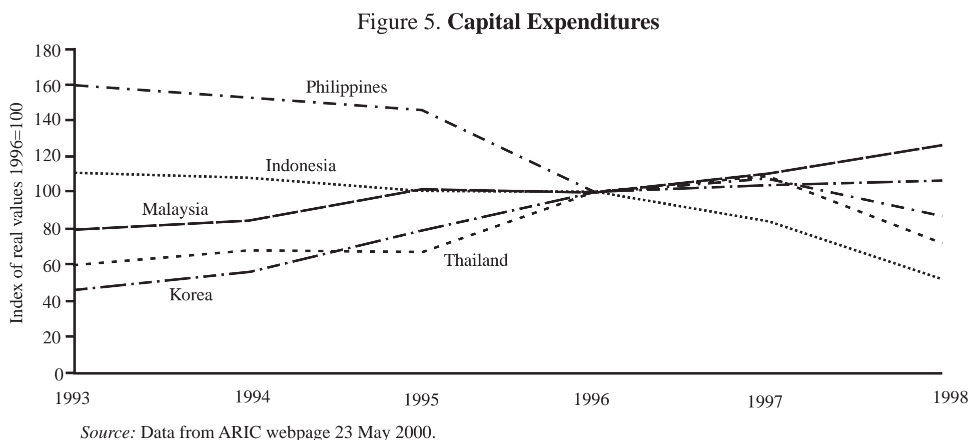


Finally, the increased real resources must be viewed within the perspective of the crisis. Some aspects of the human impact of the crisis can only be addressed with higher social spending. The increase in poverty, although not as large as initially feared, calls for more public health services, financial support for children of poor families to maintain their access to education, and strengthened social safety nets. The expenditures made have likely not been sufficient to meet the increased needs.

Capital Expenditures

As shown in Figure 5, capital expenditures in the poorer countries have fallen off with the financial crisis. Indonesia and Thailand showed the sharpest drops, with expenditures falling by 33 per cent and 38 per cent respectively. In Thailand, the difficulties of utilising fiscal policy to address declining aggregate demand were quite apparent. ADB staff analysis concluded that the shift from a fiscally restrictive policy to an expansionary one occurred only in the last quarter of 1998 — more than one year after recognition of the crisis. Problems included the time needed to restart projects after earlier cancellation[52].

Figure 5. **Capital Expenditures**



Source: Data from ARIC webpage 23 May 2000.

The Philippines showed a smaller fall in capital expenditures after 1997, although the situation may have been aggravated by the cash management system ("cash sequestering") used to counter the fall–off of public revenues (see below). The spending reduction followed a fairly substantial downward trend in public infrastructure investment before the crisis. Overall, although some part of the decrease is due to ongoing decentralisation and to the transfer of expenditures from the central government's books to those of local governments, the crisis exacerbated the existing problems of appropriating funds for capital spending.

In the other two countries there were clear signs of increased capital spending. Malaysia, showing the least fiscal strain and the quickest shift to counter–cyclical spending, managed to increase its spending on infrastructure by nearly 15 per cent. In Korea, increases in capital spending were used as an essential part of the expansionary spending programme, although the increases were much lower than the pre–crisis trend would have suggested.

Coping Mechanisms Distort National Priorities

The financial crisis caused a series of false starts and reversals in fiscal policy. Governments constrained expenditures, then relaxed the constraints and finally opted for large–scale deficit spending — all this in less than one year, within a single budget. Such shifts cannot be accommodated within the normal channels of fiscal decision making, which involve extensive discussions between the executive and legislative branches.

In the Philippines, the fiscal constraints resulted in "cash rationing" by means of placing restrictions on payment authorisations. The rationing was initially applied across the board, constraining different departments equally; later on, it was applied unevenly, giving priority to the larger agencies[53]. This coping mechanism is effective in the immediate sense of meeting a budget, but it often simply results in the accumulation of payment arrears and financial obligations that must be met in the near future. It may also result in increased opportunities for corruption, as creditors jockey for payment[54]. This fiscal control process has been used in the Philippines during other periods of constrained fiscal resources, such as in the early 1990s. During that period, it was also noted that cash sequestering inhibited needed infrastructure investment and biased spending away from areas such as maintenance.

In Indonesia, limited fiscal resources were further constrained by political changes. Internal developments were encouraged by the reform programmes tied to official lending. In particular, steps to address the widespread perception of corruption were difficult to undertake in a context of fiscal policy measures which sharply increased spending. Civil servants became reluctant to continue business as usual lest they be accused later of engaging in corrupt practices. As a result, spending on internationally funded projects has faced particularly slow implementation.

Beyond the National Accounts: the Broader Fiscal Governance Problems

The fiscal impact of the crisis may be much greater than is suggested by the changes in aggregate flows and expenditure allocations of the national governments. Off–budget items are common and in most cases substantial in the countries affected by the crisis. As off–budget activities are not centrally reported or easily monitored, there are considerable uncertainties regarding both overall fiscal flows and expenditure allocations.

In Indonesia, for example, there are particular problems with respect to large–scale off–budget subsidies and "quasi–budget" activities. Off–budget subsidies have long been present for food, petroleum and fertilisers. It is estimated that the subsidies, generally in the form of payments to state–owned enterprises, amounted to as much as Rp 58 trillion in FY 1998. This is equivalent to 5.8 per cent of GDP or 21.5 per cent of total budgeted expenditures. These items are increasingly being included in the budget: in FY 1999, the amount of budget subsidies, especially for sub–market pricing for petroleum products, was equivalent to 19.1 per cent of routine or current expenditures[55]. Indeed, the fiscal crisis is forcing a re–evaluation of the use of subsidies: they are not a cost–effective manner of providing social safety nets and need to be replaced by institutions which have a greater impact on the poor and place less of a strain on fiscal resources. In addition, many fees collected by agencies are never fully recorded. These "quasi–budget" revenues are utilised at the local level for education and reforestation efforts, among other activities.

The lack of transparency reflects some of the basic weaknesses of the governance structure of the countries concerned, and it seems that doubts about this structure exacerbated the public perception of their fiscal and financial fragility. In Indonesia in particular, current reform efforts directly address the issue of improving budget transparency and incorporating off–budget items in the budget. This activity is consistent with the broader trend towards less acceptance of corruption and poor governance in Indonesia. The fiscal crisis has worked in favour of greater transparency in one notable respect: the FY 2000 budget was publicly debated in the legislature — the first such debate since the 1960s[56]. Over time, this will secure more transparency in budget formulation and presentation and more accountability on the side of the government officials responsible for budget preparation and implementation.

Conclusion: the Crisis in Public Expenditure Management

The East Asian financial crisis was a region–wide external shock that, with little or no warning, drastically reduced fiscal resources and exerted overwhelming pressure on public expenditures. Unprecedented increases in official assistance flows were needed to restabilise the countries hit by the crisis. Although clear signs of recovery have appeared in most of these countries, there are still calls upon public fiscal resources for financial and enterprise restructuring. The financing requirements for these and for debt repayment will have major implications for the politics of budgeting in these countries. New fiscal arrangements will have to be developed to cope with this new environment.

There has been considerable debate as to whether the correct policy was followed in this crisis, but all too little discussion concerning the need for new policy instruments to allow governments to implement policy quickly. In particular, new fiscal arrangements are needed to lessen the impact and costs of future crises. These arrangements must support greater flexibility in fiscal policy, allowing the amount and nature of spending to change more rapidly in response to changing needs. In addition, the international community must develop new forms of support that can move rapidly in response to regional financial crises.

Notes

1. On the convergence of policy and performance in Southeast Asia, see Green (1994).
2. International comparisons are sometimes difficult owing to the differing definitions of the fiscal year (FY). In Indonesia, until this year, the fiscal year ran from 1 April to 31 March; using the government's terminology, FY 1995 means April 1994 through March 1995. In the Philippines and Korea, the fiscal year is the calendar year. In Thailand, the fiscal year ends on 30 September; thus FY 1994 designates October 1993–September 1994. In this preliminary paper, an attempt was made to correct for these differences in some illustrations; in others, caution should be exercised in the cross–country comparisons.
3. Sinsiri (1998), Table 4.
4. ADB (1999*a*), p. 4, Table 2.
5. Ministry of Finance (Malaysia) (1999), pp. 80–83.
6. Ministry of Finance (Malaysia) (1999), pp. 82–83.
7. ADB (2000*c*), p. 44, Tables A.13 and A.1.
8. ADB (1998*b*), pp. 6–7.
9. ADB (1999*b*), Appendix, Table 10.
10. IMF (1999*a*), p. 27, Table 24.
11. IMF (2000*a*), p. 15, Table 12.
12. Bank Negara Malaysia (1998), p. 250, Table A.23.
13. ADB (2000*c*), p. 7, Table 6.
14. ADB (2000*c*), p. 44, Table A.13.
15. ADB (1998*b*), p. 24, Table A.1.
16. IMF (2000*b*), p. 29, Table 26.
17. In this section, data on the fiscal costs of bank restructuring are as of October 1999, from ADB (2000*a*), p. 31.

18. Future revenues from reprivatising or selling newly acquired public sector assets are also not being carried on the public books. To this extent, the asset and liability picture may not be as grim as suggested in the section above. However, this merely reinforces the message of the crisis: prospective claims on public revenues should be more accurately reflected in public accounting systems.
19. ADB (1999*b*), pp. 21–22.
20. Bank Negara Malaysia (1998), Table 4.8, p. 153.
21. ADB (2000*a*), p. 25.
22. Material in this section is from Sinsiri (1998), p. 6.
23. ADB (1999*a*), p. 4.
24. IMF (1998*b*).
25. IMF (1998*a*).
26. World Bank (1998), p. i.
27. World Bank (1999), p. 7.
28. World Bank (1998), p. 2, Table 1.1.
29. ADB (1998*b*), p. 3.
30. IMF (1998*d*).
31. ADB (1999*a*), p. 4, Table 2.
32. For the suggestions of expansionary policies, see Bank Negara Malaysia (1998), p. 4. A more conservative characterisation is found in IMF (1998*c*).
33. Bank Negara Malaysia (1998), p. 4.
34. Ministry of Finance (Malaysia) (1999), p. 79.
35. IMF (1998*a*).
36. IMF (1999*c*).
37. ADB (1998*b*), p. 18.
38. *Ibid.*
39. The authors are grateful to Hafiz Ahmed Pasha for calling their attention to the asymmetry between the use of tax and spending.
40. Ministry of Finance (Malaysia) (1999), Table 4.2, p. xxx.
41. Corsetti (1998), p. 52.
42. ADB (2000*b*), p. 17.
43. IMF (1999*a*), p. 44.
44. *Ibid.*, p. 24.
45. ADB (1999*a*), p. 15.

46. IMF (2000*a*), p. 15.
47. IMF (1999*b*), Table 11, p. 15.
48. Ministry of Finance (Malaysia) (1999), Table 4.2, p. xxx.
49. ADB (1998*b*), Table 5, p. 7.
50. See ADB's Asia Recovery Information Center website: http://www.aric.adb.org, June 2000. The trend line is a simple extrapolation of the average values for 1993–96.
51. The impact of the fiscal crisis on social sector spending may be more serious than suggested in this chapter. In some countries, especially the Philippines, much responsibility for social spending has been devolved to local governments, which were also subject to fiscal constraints.
52. ADB (1998*b*), p. 18.
53. Reyes *et al.* (1999), pp. 20–21. There were also cutbacks in transfers to local governments.
54. World Bank (1998), pp. 5–6.
55. ADB (1999*b*), p. 5.
56. ADB (1999*b*), p. 6.

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