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Chapter I

THE CURRENT GLOBAL RECOVERY AND IMBALANCES IN A LONGER-TERM PERSPECTIVE

Chapter IV

CRISIS AND RECOVERY IN EAST ASIA

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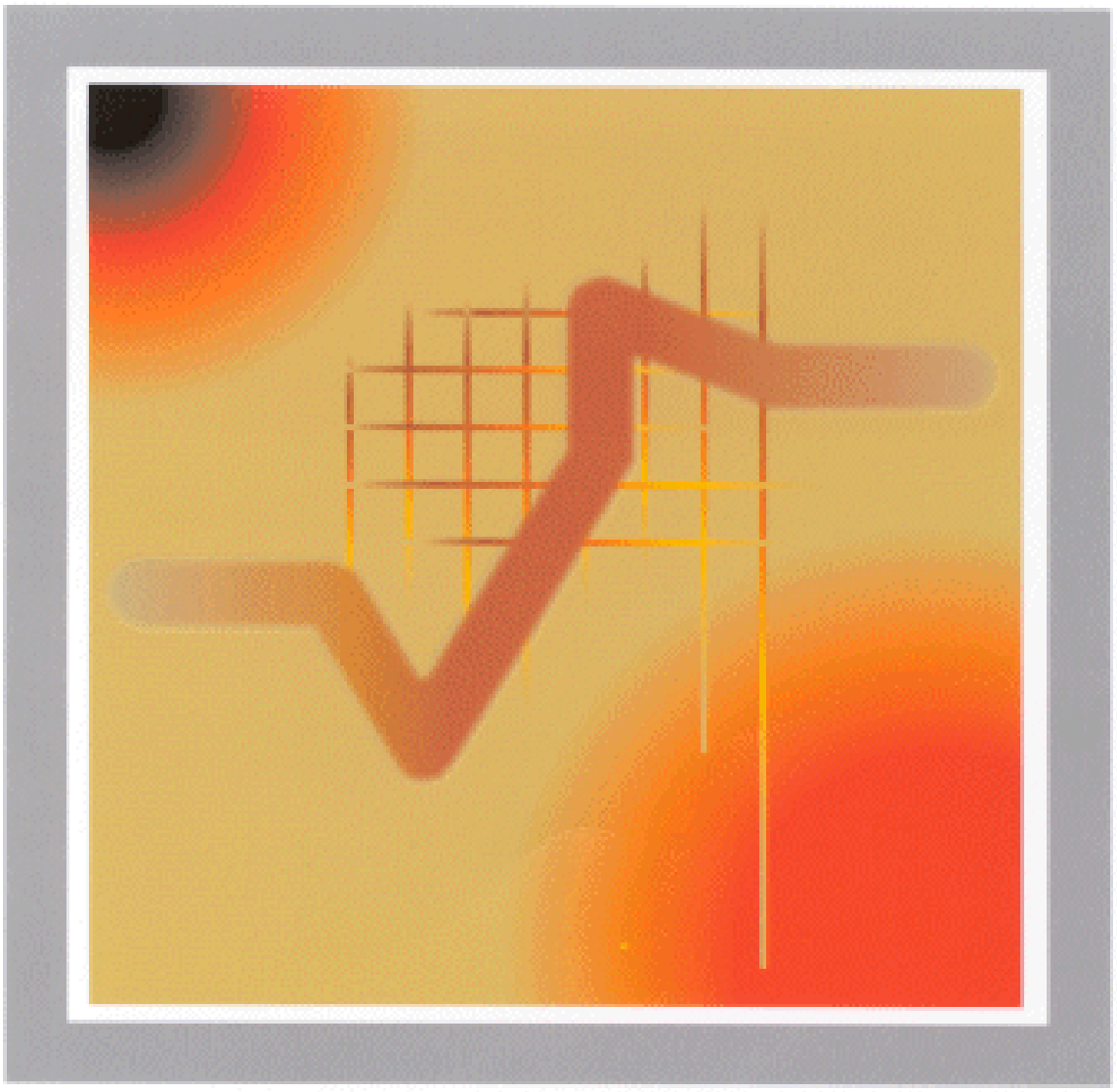

Chapter I

THE CURRENT GLOBAL RECOVERY AND IMBALANCES IN A LONGER-TERM PERSPECTIVE

A. Growth and imbalances

Recovery and sustained growth in the global economy has been subject to two challenges since the 1997 Asian crisis, one being on the real side and the other involving the financial sector. The first threat was the impact on developed economies of the expected sharp increase in competitiveness and exports from East Asia as the crisis-stricken economies benefited from massive currency devaluations, requiring large swings in trade balances. The second threat was that of a global collapse of financial markets as a result of the rush to liquidity following the Russian debt default in late summer 1998. Both developments gave rise to widespread forecasts of a global slowdown and concerns over a risk of recession.

In the event, neither of these threats materialized and the global economy appears to be enjoying sustained expansion. The threat from a deluge of exports from East Asian countries in that period was largely offset by the collapse of their financing systems and asset prices, as a result of which the initial adjustment was based not on increased exports but on massive cuts in imports. Even when exports increased in volume, the effect on earnings was more than offset by falling export prices, while the decline in imports of primary materials compounded a downward trend in world commodity prices that had already started in 1996. The net result was an increase in the purchasing power of consumers in developed countries that allowed demand and output to expand rapidly in conditions of price stability.

In the absence of price pressures, the United States Federal Reserve allowed the economy to grow at a rate exceeding by far what it considered to be the potentially non-inflationary level, thus enhancing the productive potential and the rate of non-inflationary growth. Growth continued at rates that were not only above forecasts but, at more than 4 per cent, double of what was considered as the maximum potential. Indeed, the potential growth rate has now been revised upward, from around 2.5 per cent to more than 3 per cent, in view of what appears to be a stable annual increase in labour productivity to rates above 2 per cent.[1]

The consequences of the fall in primary commodity prices were especially acute in the Russian Federation, where tax receipts and foreign exchange earnings had become almost totally dependent on commodity trade. The decline in export revenues led to the default on interest payments on government debt and a collapse of the rouble. Since many developed-country financial institutions were exposed either directly or indi-

rectly, the insolvency of the Russian Government threatened global financial stability; there was a loss of confidence in all but the most secure financial investments, and the funding of all but highly secure government paper dried up. United States government securities thus became the refuge of risk-averse investors and commanded a large liquidity premium.

In this instance the Federal Reserve not only refrained from raising interest rates, but also acted quickly to reduce them to counter the rising risk premium and the sale of financial assets, thereby averting the threat to global growth of the contagion implicit in the linkages between national financial markets. This monetary easing, which was extended into 2000 through efforts to counter the risks of a systemic breakdown that was feared on account of the "Y2K computer bug", did much to allow the United States economy to continue to function as the engine of world growth, in particular by providing markets for the recovering East Asian economies. In the second half of 1998 those countries had already started to benefit from accommodating domestic fiscal and monetary policies and had finally unleashed the export potential implicit in their large devaluations and excess capacity, producing record current-account surpluses.

Thus, the factors that countered the two threats to the global economy during 1998–1999 have served to accelerate growth in the United States. They also led to a sustained inflow of capital into that country in excess of its current-account deficits, as international investors sought the security of dollar assets. The attractiveness of the dollar, together with the concentration of new issues of internet technology companies in the United States, helped to produce a sustained increase in asset prices that has provided the basis for increases in both private investment and private consumption expenditures. Rapid growth and a rising dollar have resulted in a growing current-account deficit as the United States acted as "buyer of last resort" from the rest of the world. This combination of a rising current-account deficit and a strong dollar is reminiscent of the early 1980s, when it was widely considered to be unsustainable and was the source of the "hard landing" of the dollar in 1986–1987.

As in the 1980s, the Japanese surplus has been the major counterpart to the United States deficits, but now there are substantial differences that serve to reinforce the current imbalances. The first and most obvious is that the United States growth differential vis-à-vis the rest of the world is now underpinned by private spending and productivity gains due to a new Schumpeterian technological epoch, and the government is a net saver. In Japan, growth is negligible and the attempt to combat falling prices and stagnant private spending is creating rising government deficits and debt. As a result, the supply of United States government bonds that serve to satisfy the increased global preference for dollar assets is declining, while the supply of Japanese government bonds, which do not, is increasing. In such conditions the natural result is for rates on United States bonds to fall and on Japanese bonds to rise, creating expectations of gains on the former and losses on the latter. Such expectations have largely offset the recent attractiveness of Japanese equities to foreign buyers and supported the flow of funds from Japan to the United States. Since Japanese financial institutions hold a large proportion of domestic bonds, any substantial increase in domestic interest rates will lead to large capital losses, impede the process of reconstruction of the financial system and reduce lending to the private sector.[2]

The East Asian crisis and recovery have also reinforced the demand for dollar assets. The current-account surpluses generated in the region are seen as necessary not only to provide the funds to repay the short-term dollar debt, but also to satisfy the increased liquidity preferences of these countries in the form of larger international reserves as a buffer against future crises. Thus, the claims on the United States generated by its trade surpluses are willingly held as dollar assets to provide a defensive liquidity cushion. High United States interest rates favour the holding of reserves in dollars, the more so in view of the large losses sustained on holdings in the newly issued euro assets. Reserves are further supplemented as countries intervene to sell their currencies against the dollar to prevent unwanted real appreciations which might choke off the recovery process.

Thus the East Asian region, which has the world's largest export surplus, through its tendency to hold those surpluses in dollar assets, has provided support for the dollar but made it difficult for the United States to reduce its deficits. As the recovery continues, imports will rise and current-account surpluses will shrink, but capital flows to the region are likely to increase. Since

the volatility of capital flows was the major reason for the earlier crisis, it is likely that these countries will continue to hold larger proportions of their capital inflows as reserves, maintaining the increased demand for dollar assets as risk and liquidity hedges.[3]

Europe is the other major region with a current-account surplus. Growth in EU has in general not been sufficient to bring about reductions in unemployment, although there are some important exceptions. Europe has lagged behind the United States in the exploitation of new technologies in communications and computing to increase productivity. Consequently, there are now substantial differences between labour productivity growth in Europe and the United States, constituting a reversal of the post-war trend for European productivity to dominate. One way to overcome this lag has been to acquire United States companies or to start up operations in the United States; indeed, the United States has become a net recipient of FDI. While European FDI flows to that country more than tripled from 1995 to 1998, reaching more than $160 billion, the flow in the opposite direction rose from $50 billion to $70 billion.[4] Since many United States firms are now truly global corporations, they are considered as global investments, and European portfolios have increased their holdings of United States equities. This process was given a further boost by the introduction of the euro, which eliminated the benefits from diversification of assets denominated in other EU currencies.

Neither the strength of the dollar vis-à-vis the euro nor higher United States interest rates has done much to reduce current imbalances in trade, growth and capital flows between Europe and United States. Since the strong dollar is due to foreign demand for dollar assets, it supports consumption in the United States by feeding through to household wealth, given the relatively high share of equity in household portfolios, as well as by increasing purchasing power. Thus, high interest rates are not very effective in preventing overheating through their effect on domestic demand and the dollar. On the other hand, since in EU trade with the rest of the world is a small proportion of GDP, one can expect little expenditure switching from the United States to Europe as a result of the weakness of the euro. By contrast, to the extent that the strong dollar induces the European Central Bank (ECB) to raise interest rates, domestic sources of growth may be dampened and the restructuring of the EU slowed. It thus appears that the strength of the dollar exacerbates the differential in demand growth between EU and the United States.

Persistence of similar imbalances between the United States and Europe in the 1960s contributed to the breakdown of the Bretton Woods system. At that time the dollar was weak in the presence of large outflows from the United States on account of non-commercial transfers linked to political and military objectives. These flows were accompanied by a persistent budget deficit, a positive growth differential and a negative interest differential with Europe. The United States wished to avoid using higher interest rates in support of the dollar in order not to slow growth, and the weakness of the dollar made little contribution to the correction of external imbalances. There was no agreement on whether the appropriate policy was the reduction of the United States' budget deficit and growth or an increase in European demand and growth. Unwilling and unable to act on exchange rates, the United States introduced a wide variety of capital controls. The impasse was eventually resolved by abandoning the Bretton Woods system and taking the dollar off gold.

In the current situation, the equivalent fiscal measure to reduce United States trade deficits would be an increase in its budget surplus. While this might have been the policy response in the era of Keynesian fine-tuning of the 1950s and 1960s, it is no longer considered desirable; nor is the use of expansionary fiscal policy considered desirable by EU in the light of the Stability and Growth Pact. Thus, the entire burden of adjustment is placed on monetary policy, i.e. a rise in interest rates in the United States relative to those in EU. But, if such adjustment simply increases the attractiveness of dollar assets and further feeds the bubble in equity prices, it may become self-defeating. The increased role of the dollar as a reserve currency and the closer integration of global capital markets thus constrain the effectiveness of United States monetary policy in cooling the economy and reducing its trade deficits. What might be required in the present context is a reverse interest equalization tax to reduce the return to non-residents on their holdings of United States assets.[5]

In any case, adjustment in global imbalances through a relative rise in United States interest rates is unlikely since most emerging markets need

to follow suit in order to retain capital inflows. More fundamentally, ECB has started to increase interest rates in an attempt to ward off anticipated inflationary pressure, even though growth in EU is barely 3 per cent and the decline of the euro has hardly affected prices. It is clearly unwilling to follow the Federal Reserve lead in attempting to discover if potential growth rates could be raised by a more accommodating policy.

A parallel increase in both United States and European interest rates (and an eventual increase in Japanese rates to convince corporations to restructure rather than carry losses at zero interest rates) would have little impact on exchange rates of the currencies of the countries concerned or on trade imbalances, but it would sharply increase the carrying costs of debt in developing countries. Increasingly, developing country economic fundamentals, such as fiscal and current-account balances and the inflation rate, are dependent on foreign interest rates. In some economies (e.g. Argentina and Hong Kong, China) this link is more direct, whereas in others (e.g. Brazil and many East Asian countries) it operates through the external debt burden and capital flows. In all cases, however, higher international interest rates would pose a serious threat to the recovery in emerging markets. In East Asia, where recovery has taken place without any substantial corporate and financial restructuring, higher interest rates will simply make this process more onerous, and the recovery may eventually be stalled by the failure of the domestic financial system to provide finance.

A strong European recovery, which has been expected since 1993, has been repeatedly retarded by rising United States rates because increased integration of financial markets and attempts by ECB to establish credibility have resulted in rising interest rates in Europe also. It is unlikely that growth could accelerate in Europe in the face of a United States downturn accompanied by a slowdown in Latin America and East Asia. Thus, the risks that were identified in the aftermath of the Asian crisis continue to be present.

As noted above, similar unsustainable imbalances were present in the global economy for substantial periods in both the 1960s and the 1980s, before creating serious disruptions in global growth and dampening the prospects of developing countries. In the past, excess savings of the rest of the world were balanced by excess spending by the United States Government, and the demand for United States assets was met by the issue of government securities. Today, it is the United States private sector that is sustaining global spending. Since the government is running a fiscal surplus, the demand for dollar assets due to increased uncertainty over global asset values cannot be met by increasing the supply of risk-free United States government securities but would require the issue of assets by the private sector. The basic question is whether foreign investors seeking liquidity and safety will be equally willing to hold private assets. As long as internet stocks dominate investor attention, large expected gains can offset their risk spread over government securities, and the dollar can become the transaction currency for international equity trading. This tendency will be reinforced by the fact that the integration of Europe's largest equity markets is taking place between London and Frankfurt, thus providing little support to the euro. Further, the movement towards listing many developing-country companies in New York financial markets to ensure sufficient liquidity simply reinforces the tendency for the dollar to become the vehicle currency in the global equity market. Nonetheless, since private debt is not a perfect substitute for Treasury debt, the increasing United States budget surplus can add to the fragility of the current situation and raise the possibility of a "hard landing" for the dollar. In such an event global prospects will depend very much on how monetary policy is conducted and coordinated among the United States, Europe and Japan.

B. Eliminating global imbalances and sustaining growth

Whenever large global imbalances are built up by self-sustaining processes, such as those currently prevailing, uncertainty increases. Current uncertainties, however, are not over the nature of future events, but rather over their timing and implications. There can be little doubt that growth in the United States economy will slow, either of its own accord or induced by continued action on interest rates by the Federal Reserve. By the same token it is certain that the trade deficit will in time be reduced.

It is also likely that the European recovery will be choked off because of a fall in exports as the United States economy slows autonomously, or because the Federal Reserve increases interest rates and ECB mirrors those increases. Consequently, although its economy is equivalent in size to that of the United States, EU is unlikely to take over the role of the United States in supporting global demand. Growth in EU is unlikely to be much above 3 per cent on the basis of domestic demand, and even if it did manage to replicate United States growth rates, it would not generate an external deficit similar in size to that of the United States. Thus, EU cannot replace the United States as the global "buyer of last resort" for the recovering Asian and Latin American economies.

Now that imports in East Asia have recovered to more normal levels, any slowdown in the world economy would once again worsen the external accounts in those countries and render them more dependent on capital inflows. Most countries in the region have built up massive dollar reserves to meet this contingency and they may soon have to use them. Tighter balance-of-payments constraints will bring growth rates back to lower levels. Before the Asian crisis, the region accounted for roughly one half of the annual growth in global demand, and it is unlikely to return to this position, at least in the foreseeable future.

Just as in Europe, Japan has been unable to generate growth based on private domestic expenditure, on the model of the United States, and growth remains dependent on exports. The East Asian recovery has provided a beneficial complement to its fiscal expenditure programmes, but now that growth in East Asia is constrained, recovery in Japan will not be particularly robust, and at any rate too weak to offset the slowdown in the rest of the world, particularly in the United States.

Latin America also depends on global markets. Indeed, outward-looking development strategies in many of these countries depend for their success on mutually reinforcing regional and global growth. A slowdown in United States growth would consequently adversely affect the Latin America economies also.

It is thus evident that optimistic forecasts of a return to global growth at rates above 3 per cent make an implicit assumption about how the decline in United States demand will be compensated for internationally. Obviously, the optimal scenario would be that of a natural decline in United States growth without any further increases in interest rates in either the United States or Europe. If tight monetary policy has to be used to quell the United States' expansion and is also applied in Europe, eventually accompanied by Japan's abandonment of its zero interest rate policy, then indebted developing countries will be doubly burdened by falling export receipts and higher financing costs. If higher interest rates produce financial market turmoil, such as occurred in the global bond market in 1994, which produced losses in net wealth far in excess of the 1987 stock market crash or the Asian crisis, then developing countries could also find themselves severely restricted in their access to private finance. Clearly, a collapse in bond prices would quickly be transmitted to equity prices, which could substantially reduce United States growth as consumers cut

back on their expenditures to meet rising interest and margin payments or adjust to their lower wealth levels. In 1994 high interest rates were accompanied by a decline in the dollar. Normally, such a decline would be beneficial to developing countries. However, if a global financial market turmoil produced a massive shift to liquid assets, it is likely that, as in 1998, the dollar would become the currency of refuge, producing a combination of high interest rates and a strong dollar that was so detrimental to indebted developing countries in the 1980s. While the distribution of financial indebtedness in the present situation is different, and fewer liabilities are held in variable rate form linked to the United States interest rate, a number of countries have direct linkages, either through currency boards or through indexing of debt, allowing a quick and direct transmission of deflationary forces to their economies.

Thus, the prospects for the world economy are not as optimistic as the surprising recovery in 1999 has led many to believe. This much is clear: the remnants of the wreckage of the Asian crisis of 1997 cannot be swept away by another East Asian "miracle" or by the new technologies that appear to be shifting the United States onto a higher potential growth path. An increasingly interdependent global financial and trading system can scarcely function efficiently with only one policy tool, monetary policy, especially without appropriate coordination. The restoration of fiscal policy to the armoury of defensive measures, as well as increased international cooperation, will be required if the full potential of new technologies is to be realized and set the world economy on a higher growth path, thereby enabling developing countries also to achieve sustained increases in per capita income. ■

Notes

1 Already in 1995 the UNCTAD secretariat argued that low estimates of potential growth and high estimates of natural rates of unemployment were due to hysteresis, and that industrial economies could grow much faster without an acceleration in inflation and could reduce unemployment to levels below the estimates of natural rates if appropriate policies were pursued (*TDR 1995*, Part Three, chap. III). See also *Newsweek*, 18 Sept. 1995: 38–39.

2 Around 40 per cent of the existing stock of government bonds is held by government agencies such as the Trust Fund Bureau. About a quarter is in bank portfolios. It has been estimated that a 100 basis point rise in interest rates on long bonds in February 1999 would have produced a capital loss of 1.5 trillion yen for bank holders alone. See IBJ Securities, Economic analysis report: The dual managed system of the moratorium period, *IBJS Research & Reports*, April/May 1999 (www.ibjs.co.jp).

3 On the increased tendency to accumulate excess reserves in emerging markets see *TDR 1999*, chap. V.

4 UNCTAD, FDI/TNC database.

5 Similar measures were used in the past, for instance by Switzerland in the early 1970s, when negative interest was paid on deposits by non-residents to slow capital inflows.

Chapter IV

CRISIS AND RECOVERY IN EAST ASIA

A. Introduction

The speed of recovery in East Asian emerging markets most affected by the financial crisis has astounded the most optimistic observers, even though a Mexican-style V-shaped recovery was widely predicted for most economies in the region. Even institutions such as IMF, which have had first-hand information on the state of the economies concerned and exerted a major influence on the policies pursued in response to the crisis, now see their original projections of economic growth in the region exceeded by a large margin. The Republic of Korea is an outstanding case in point, where the growth rate came close to 11 per cent in 1999, compared to an IMF projection in May 1999 of 2 per cent. The economies of ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) also recovered, growing at an average of almost 3 per cent in 1999, as opposed to earlier IMF projections of a further contraction of activity. The speed of recovery in the region has also belied the forecasts of other institutions and observers, including the UNCTAD secretariat, which disagreed with the orthodox diagnosis and policy response to the crisis.[1]

There are conflicting claims regarding the origin and nature of this recovery. While, on one view, the speed of the recovery represents a vindication of the international policy approach to the crisis, on another it discredits the orthodox diagnosis that these economies suffered from serious structural and institutional shortcomings and that they would be unable to resume growth unless these shortcoming were effectively addressed. Quite apart from apportioning responsibilities and credits, an examination of the recovery process has its own merits in that not only it would help to better understand the causes of such crises but, and more fundamentally, it would also yield invaluable lessons for better management of similar crises when they occur.

The examination of the recovery process in this chapter lends support to a number of conclusions:

- The policy response in terms of monetary tightening aggravated the impact of the currency crisis on the financial and corporate sectors, and served to depress production and employment further without bringing stability. Currencies were stabilized not as a result of increases in interest rates, but of the build-up of reserves due to massive import cuts and the reduction in foreign claims resulting from debt rescheduling and also of the imposition of capital controls. Thus, in retrospect, provision of adequate international liquidity to replenish reserves, together with exchange controls, debt standstill and maturity rollover (i.e. the kind of measures advocated in *TDR 1998*), would have been a much more effective response than a policy of high interest rates.

- The speed of recovery owed a great deal to policies pursued after the initial tightening.

The strong response of the economies concerned to subsequent fiscal and monetary easing suggests that initial policies created an unnecessarily tight squeeze. The economies bounced back rapidly when the policy of austerity was reversed and governments were allowed to play a more positive role in recovery. This policy reversal was brought about by the deepening of the crisis and widespread criticisms, rather than constituting part of a carefully sequenced policy package.

- The speed of recovery was not due to the elimination of structural weaknesses that were given great weight in explaining the crisis. Indeed, despite their subsequent reversal, the raising of interest rates caused serious dislocations in the corporate and financial sectors, aggravating rather than eliminating structural weaknesses. Financial and corporate restructuring has only just started. This suggests that the recoveries are not firmly based and that the structural difficulties may reassert themselves, possibly leading to a W-shaped recovery.

- Although in most countries seriously affected by the crisis per capita incomes are now above or close to prior levels, income appears to be less equally distributed. In particular, employment and labour earnings have lagged behind aggregate income, and poverty has remained considerably above pre-crisis levels. On some accounts it could take East Asia a decade to eliminate the poverty created by the financial crisis. This is consistent with the general pattern observed in emerging markets that boom-bust-recovery cycles tend to be regressive in terms of income distribution and poverty, even when their overall impact on economic growth may be neutral.

- The crisis has longer-term implications for economic development of the region not only because it has led to structural dislocations in the corporate and financial sectors, but also, and above all, because it has laid bare the kind of vulnerability that the region is exposed to as a result of its excessive reliance on foreign markets and capital for economic growth. This may call for a reconsideration of development strategy.

B. The policy response to the crisis and the recovery process

There have been significant differences among the countries regarding both the causes and the evolution of the crisis, as well as the nature and the speed of recovery.[2] While all countries that were seriously affected generally had large short-term and other liquid international liabilities as a result of a surge in arbitrage inflows, their exposure to a rapid exit of foreign capital varied considerably; for instance, in contrast to other countries, in Malaysia short-term external debt was more than covered by international reserves. There were also differences in the use made of capital inflows. In some countries, notably the Republic of Korea, there was excessive manufacturing investment in relation to demand and output, generated by a drive for an export market share at the expense of profitability, while in others, notably Thailand, there was a speculative surge in the property market, supported by capital inflows. Similarly, some private firms in South-East Asia had invested heavily in other non-traded activities, notably in physical infrastructure, with funds borrowed abroad. On the eve of the crisis, macroeconomic fundamentals regarding the external accounts were much less favourable in Thailand than elsewhere in the region. Indeed, the Thai crisis emerged as a typically balance-of-payments one, aggravated by excessive short-term debt and capital-account openness, while the other economies suffered primarily from contagion. The sudden loss of confidence in Thailand appears to have been greatly influenced by three major con-

cerns: the current-account deficit, which had been rising constantly from 1993 onwards to reach 8 per cent of GDP in 1995–1996; the considerable volume of short-term and other liquid foreign liabilities, which exceeded liquid international assets by a large margin; and, to a lesser extent, an appreciated currency.

The balance-of-payments fundamentals were better in the other countries of the region, although many of them were financially vulnerable because of a rapid accumulation of short-term and other liquid foreign liabilities. In particular, in Indonesia there was little currency appreciation, and the current deficit as a proportion of GDP was less than half that of Thailand. At some 4 per cent of GDP, the current-account deficit of the Republic of Korea was not much above the levels of previous decades, and it was already falling. Malaysia had a greater appreciation and moderately larger current-account deficit. The balance-of-payments fundamentals of the Philippines were worse than in both the Republic of Korea and Indonesia, but its external financial vulnerability was much less. While all the currencies in the region came under attack, it was the extent of external financial vulnerability and speculative pressures that were the determining factors in the incidence of the crisis.

Indonesia fell into deeper recession than its neighbours and its recovery has also been weak and disorderly, despite its better initial macroeconomic fundamentals, primarily as a result of the political turmoil brought about by the effects of the crisis on living conditions and the dispute over the causes of the crisis and appropriate policy response, which also involved international agencies. The economic and social effects were particularly disruptive because incomes of a large segment of the population were generally not very much above the poverty threshold. In Thailand and the Republic of Korea policy responses were designed to maintain free movement of capital, using monetary and fiscal tightening to restore confidence. In the Republic of Korea there was a sharp decline of output, despite its more robust and resilient industrial structure and the absence of any significant speculative investment in property and non-performing loans linked to such financing, but recession was even deeper in Thailand. Malaysia's initial policy response was also orthodox, but it subsequently introduced capital controls in order to stabilize its currency and to gain autonomy for an expansionary monetary policy to grow out of the crisis. Compared to Thailand, the decline in output in Malaysia was moderate, and its recovery has also been more robust.

A close examination of the evolution of policies and economic performance in the region reveals valuable lessons regarding the limits of orthodox macroeconomic policies under conditions of payments crisis originating in the capital account, as opposed to traditional payments crises associated with macroeconomic imbalances and difficulties in financing current-account deficits. As discussed in some detail in past issues of *TDR*, increases in interest rates failed to bring currency stability while deepening recession. This was also noted by the Government of the Republic of Korea in a report to the G-20, which referred to "malign side-effects" of high interest rates, including the "accelerated slowdown in real economic activity through the contraction of consumption and investment; the greatly increased incidence of corporate failures; and the further increase in non-performing loans of financial institutions".[3] Indeed, the financial difficulties brought about by sharp currency depreciations and interruption of external credit lines were aggravated by high interest rates, which made the carrying costs of debt unsustainable. With falling domestic sales and export revenues, firms found it impossible to meet their commitments to financial institutions which had already been weakened by the corporate bankruptcies (as in the Republic of Korea) or the collapse of the property market (as in Thailand).

Indeed, evidence suggests that currency depreciation inflicted much less damage on firms than the rise in interest rates and cut-backs in domestic credit lines because many firms with large foreign indebtedness were export-oriented:[4] if credit lines had been maintained, greater competitiveness and growing export revenues would have provided a cushion against rising liabilities in domestic currency as a result of depreciations. In this respect, firms in Asia were in a much better position than those in other emerging-market countries.[5]

While rising interest rates failed to stabilize currencies by restoring confidence, they did so indirectly by making a major contribution to a sharp fall in domestic demand, which, together with the lack of liquidity, produced a decline in industrial production, employment and consumption, leading to massive cuts in imports. In the Republic of Korea, for instance, imports fell from

Box 4.1

THE RATIONALE AND EFFECTS OF CAPITAL CONTROLS IN MALAYSIA

Although, like the Republic of Korea and Thailand, Malaysia experienced a surge in short-term capital inflows in the first half of the 1990s, on the eve of the outbreak of the crisis in 1997 the maturity structure of its external debt was much more favourable than in those two countries, and its reserves were more than enough to cover its short-term foreign liabilities, reaching some 70 billion ringgit, compared to liabilities of 36 billion ringgit (of which some 27 billion were owed by the banking sector). At the end of 1997 total external debt was only 40 per cent of GDP and the debt service ratio was below 7 per cent. Furthermore, although the banks carried a disproportionate share of private-sector financing, with loans amounting to 150 per cent of GDP, the reforms put in place after the mid-1980s had strengthened the financial sector: property loans carried collateral well over 100 per cent, while loans to finance equity positions were no more than 8 per cent of the total. In June 1997 the non-performing loan ratio was not much above 2 per cent, and the risk-weighted capital ratio of the banking system was around 12 per cent, well above the Basle ratio of 8 per cent, while the ratio of provisions to non-performing loans was nearly 100 per cent. On the fiscal side, 1997 was the fifth year of surplus, at more than 2 per cent of GDP.[1]

Despite these relatively favourable financial conditions, the pressures on the Malaysian currency were similar to those in other crisis-stricken countries. The exchange rate collapsed from 2.6 ringgit to the dollar in July 1997 to 4.7 in January 1998, the Kuala Lumpur equity index fell from around 1000 to 300 at its low, and non-performing loans in the banking sector reached over 12 per cent. Clearly, excessive short-term debt was not the main reason. Indeed, even after the crisis broke out there was no substantial capital outflow, such as occurred in the Republic of Korea and Thailand, and reserves never fell below 50 billion ringgit. The main reason was the speculation against the ringgit, facilitated by the existence of an offshore market in Singapore.

As in the other two countries, the initial response to the collapse of the currency and the increase in inflation was a tightening of monetary policy against a background of continued fiscal discipline. As a result, in the first nine months of 1998, GDP was 6 per cent below the corresponding period of the previous year, leading to sharp cuts in imports and a rapid turnaround in the current balance of payments, which reached a surplus of over 12 per cent of GDP. However, unlike the Republic of Korea or Thailand, since Malaysia never suffered from a lack of collateral to meet its short-term foreign commitments, the improved payments situation did not have the same stabilizing effect on its exchange rate. As a result of the impact of the weaknesses in the corporate sector on bad loans, new bank lending fell to almost zero as banks tried to shore up their balance sheets.

In the face of the sharp decline in output, a decision was taken to support the economy through fiscal stimulus and monetary expansion so as to ease the liquidity crunch. But given the weak economic conditions and continued speculative pressures, much of the increased liquidity leaked abroad. To prevent this liquidity drain, a $2 million limit was placed in August 1997 on Malaysian banks' currency swaps with non-residents in transactions unrelated to trade. However, the result was to shift borrowing to the Singapore offshore market. At the beginning of 1998 offshore ringgit deposit rates rose to over 20 per cent, and eventually reached 40 per cent, compared with domestic rates of around 11 per cent. The only plausible justification for such a differential was speculation against the ringgit. The existence of the offshore market thus not only undermined the efforts by the Central Bank to reduce interest rates and expand liquidity in order to support economic activity, but also impeded the stabilization of the currency. The decision was thus taken to close the Singapore market by making offshore ringgit transactions illegal. This market had played a role similar to that of the offshore banking market in the Bangkok International Bank Facility, but unlike the latter, which had been created by conscious steps, it was an historical artifact.[2] Since it could not be directly regulated or controlled by Malaysia, the only alternative was to bring it onshore, which is what the regulations did.

In a series of measures introduced at the beginning of September 1998, domestic banks were prohibited from lending to non-resident banks and stockbrokers, or from engaging in any swap or repurchase transactions with non-residents, to eliminate non-resident ownership of ringgit balances held abroad. In addition, transactions in external ringgit accounts could only be made for the sale and purchase of

Box 4.1 (concluded)

ringgit assets, and balances could not be transferred among non-residents. Finally, since one of the major reasons for holding offshore balances was to hedge commercial transactions denominated in ringgit, domestic residents were required to invoice all external transactions in foreign currency, and the import and export of ringgit notes was strictly limited. As a result, it became impossible to settle ringgit contracts except through Malaysian banks in Malaysia.[3]

These measures designed to insulate domestic interest rates from external rates were combined with a decision to peg the exchange rate, a decision that was greatly influenced by the resumption of the decline of the currency with the onset of the Russian crisis.[4] Indeed, from July 1998 onwards the currency showed a tendency to return to post-crisis lows, even though the measures taken were bearing fruit in improving macroeconomic conditions regarding the fiscal balance, the payments surplus and inflation. Although the fixing of the exchange rate at 3.8 ringgit to the dollar represented a substantial appreciation from the then prevailing market rate, it was consistent with underlying macroeconomic conditions: the foreign account was already well in surplus and threatened to create an excessively strong expansion, foreign reserves were around four months' imports and double the level of short-term foreign claims.

Measures to control capital flows were selective: long-term flows and FDI were not regulated, and the currency continued to be fully convertible for commercial transactions as long as they were undertaken through Malaysian banks. In assessing these measures[5] it is important to recall that they were not introduced in an emergency to control excessive capital outflows, nor were they introduced to support unsustainable macroeconomic policies and conditions, such as rising fiscal and payments deficits and inflation. They were introduced well over a year after the outbreak of the crisis, during which time most of the foreign short-term capital had already left, domestic adjustment had already taken place, the balance of payments had moved into a large surplus, inflation had stabilized, and steps had already been taken to strengthen the financial and corporate sectors. Finally, it was made clear that the controls were temporary, and would be removed so as to allow non-resident holders to exit the ringgit once external conditions had stabilized. In fact, the rapid recovery of the economy allowed the progressive removal of the controls from February 1999.

Thus, those factors which had brought exchange stability and allowed interest rates to be reduced in the Republic of Korea and Thailand were not operating in Malaysia because of the interest rate differentials between onshore and offshore ringgit markets. Consequently, improved macroeconomic fundamentals did not work through greater exchange market stability. The success of the measures taken was confirmed by the fact that when the controls were lifted in September 1999 there was an immediate outflow of only 5.2 billion ringgit, and another 3.1 billion in the rest of the year. In the first quarter of 2000 there was a net inflow of 8.5 billion ringgit, an amount roughly equal to what had flown out at the expiry of the controls.[6] By May 2000 total official reserve assets were $32 billion, over six times short-term debt.[7] In December 1999 Malaysia's long-term foreign currency rating was raised to BBB and more recently the country was returned to the Morgan Stanley Capital International emerging market securities benchmark indices, indicating a normalization of relations with international capital markets.

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1 See Bank Negara Malaysia, *Annual Report 1998*, Kuala Lumpur, 1999: 31-33.
2 Ibid.: 69–71.
3 For a full account of these measures see Bank Negara Malaysia, op. cit.: 214–219; the amendments introduced in February 1999 are documented in the Bank's *Annual Report 1999*, Kuala Lumpur, 2000.
4 For an alternative account that suggests exchange markets in the region had already stabilized when the measures were taken see IMF, *World Economic Outlook*, Oct. 1999, box 2.4.
5 See, for example, the assessment by Bank Negara Malaysia in its *Annual Report 1998*: 61 *et seq*.
6 Bank Negara Malaysia, *Economic and Financial Developments in the Malaysian Economy in the First Quarter of 2000* (www.bnm.gov.my/pub/info/index.htm).
7 See Bank Negara Malaysia, Press Release of 30 May 2000, Detailed disclosure of international reserves as at end April 2000 (www.bnm.gov.my/pa/2000/0530b.htm).

$142 billion in 1997 to $90 billion in 1998; together with a modest expansion in exports, the effect was a rapid reversal in the current balance, from a deficit of $8 billion to a surplus of $41 billion, or a staggering 14 per cent of GDP. The rapid increase in reserves, along with a rescheduling of more than 95 per cent of commercial banks' short-term debt, restored confidence in the currency and finally brought stability to the foreign-exchange market. Simultaneously, the expansionary impact of the current-account surplus on the liquidity of the economy allowed interest rates to be reduced; by the third quarter of 1998 they had returned to their pre-crisis levels.

Thus, it was the sharp recovery in foreign exchange reserves due to the improved current payments situation produced by a slump in imports, together with the declines in foreign claims due to rescheduling of short-term debt, that brought currency stability and the reversal of the tight interest rate policy. While rising interest rates failed to convince investors to hold domestic assets by enhancing their return, the collateral effect of the rise in usable reserves relative to foreign claims reassured foreign holders and stabilized the exchange rate.[6]

In Malaysia, too, the initial response in terms of higher interest rates failed to restore confidence and stabilize the currency while deepening the crisis. In view of continued speculation on the currency, the Government introduced temporary capital controls in September 1998, which turned out to be highly successful in stabilizing the currency and allowing the economy to recover (box 4.1).

In a sense, orthodox policies succeeded in stabilizing exchange rates not by restoring confidence through high interest rates, as intended, but by creating a deep recession. The experience thus suggests that "malign side-effects" of high interest rates could have been avoided by introducing a temporary debt standstill and bringing borrowers and lenders together to reschedule short-term debt, reinforced by a rapid provision of international liquidity to replenish reserves and provide current-account financing, rather than by trying to persuade investors to stay put by means of hikes in interest rates and the provision of funding to bail out creditors while keeping the capital account open.

An additional factor in bringing about exchange-rate stability was the policies adopted by China and Malaysia. Despite the adverse impact on its competitiveness of sharp currency depreciation in many countries in the region, China resisted the temptation of competitive devaluation. Similarly, the Malaysian success in tying its exchange rate to the dollar provided a stable anchor for the region, particularly in view of the importance of intraregional trade and of the stability of the regional pattern of exchange rates. From September 1998 onwards, the won, the rupiah and the baht all first showed stability and then registered moderate gains against the dollar. The Malaysian experience also demonstrates that fixing the nominal value of the currency does not necessarily lead to appreciation, provided that such a policy is accompanied by effective control over capital flows.

However, currency stability was not sufficient to bring about a turnaround in economic activity. Recovery occurred only when initial policies had been reversed and fiscal deficits and lower interest rates were allowed to operate to offset the massive reduction in domestic private spending. For instance, in the Republic of Korea, the first agreement reached with IMF, in December 1997, insisted on tight fiscal policy, but subsequent agreements recognized the inevitability of a fiscal deficit, setting it at some 0.8 per cent of GDP in February 1998, at 1.7 per cent in May of the same year, and eventually at around 5 per cent from July 1998 onwards.[7] By the second half of the year, the economy witnessed an unprecedented fiscal stimulus, together with interest rates that were nearly half of their pre-crisis levels. Fiscal expansion and growing exports brought about by lower interest rates, liquidity expansion and competitive exchange rates both stimulated demand and reduced constraints on supply, thereby pulling the economy out of recession and giving a strong push forward. Clearly, much of the recovery was of a technical nature, because the decline had been too fast and had gone too far. The discretionary fiscal stance continued to be expansionary in 1999, but rapid growth provided a cyclical fiscal correction, and a second supplementary budget to support low and middle-income groups was introduced to deal with the regressive effects of the crisis.

The rescheduling of foreign debt and the reversal of tight monetary and fiscal policy was not an orderly process. It was pursued much more rapidly in the Republic of Korea than in Thailand and Indonesia; together with the structural factors and initial conditions mentioned above, this difference

of pace goes a long way in explaining why the recession was less deep, and the recovery stronger, than in the latter two countries.[8] In Malaysia, public consumption expenditure grew by over 7 per cent in 1997, but dropped by the same rate in 1998, followed by a rise of over 20 per cent in 1999; the budget deficit rose from less than 2 per cent of GDP in 1998 to almost 6 per cent in 1999. However, what distinguished Malaysia from the other countries was its interest rate policy. From Spring 1998 onwards, the rates were kept relatively low; for instance, in May 1998 the interbank lending rate was 11 per cent, compared to some 19 per cent in the Republic of Korea, 21 per cent in Thailand and 46 per cent in Indonesia. These differences did not simply reflect differences in inflation rates, as inflation was not much lower than in the Republic of Korea or Thailand. However, as continued availability of domestic credit at low interest rates created opportunities for speculation against the ringgit, control over capital flows became essential for stabilizing the currency and initiating recovery (see box 4.1). After the introduction of capital controls, interest rates were reduced further throughout 1999, falling to some 3 per cent in December, compared to 5 per cent in Thailand, 6.7 per cent in the Republic of Korea, and 13 per cent in Indonesia. With hindsight, the competition and challenge posed by the alternative policy approach adopted in Malaysia to the orthodox model, and its success in stabilizing the currency and initiating recovery, appear to have played an important role in the reversal of orthodox policies in the region and in the adherence to more realistic monetary and fiscal policies.

However, the damage inflicted on corporations and the financial system by high interest rates was irreparable. As examined in some detail in *TDR 1998*, monetary tightening aggravated the debt deflation process already under way as a result of the massive capital outflow, leading to widespread bankruptcies. Furthermore, some of the measures introduced to strengthen the financial system in the midst of debt deflation in fact resulted in increased fragility. In the Republic of Korea, for instance, as firms scrambled to reduce their domestic and foreign indebtedness and banks sought to cover their non-performing loans, the Government imposed the BIS capital requirements on banks, making it virtually impossible for firms to obtain even export credits.[9] The resulting loss in income through the virtual cessation of business activity in early 1998 also aggravated the debt deflation process by forcing firms to liquidate assets at fire-sale prices in order to overcome the liquidity constraint, in effect causing serious dislocations in corporate balance sheets. The squeeze on corporations was further aggravated by efforts to reduce leverage as high debt-equity ratios were seen as the root cause of the crisis.

In view of the inability of the banking system to provide liquidity, the financing for business had to come from sales revenues. This puts into perspective the crucial role played by the rise in exports and the relaxation of the fiscal stance in providing finance for the recovery. However, the recovery has been unable to restore the health of the banking system or corporate balance sheets, necessitating continued public intervention in the credit mechanism. In the Republic of Korea, for instance, the Government had to provide large loan guarantees for lending to small and medium-sized firms even in late 1999, when recovery was well under way.

Countries suffering from increased defaults and NPLs have adopted different strategies regarding intervention in the financial system and financial and corporate restructuring (box 4.2). In Thailand, where the authorities adopted a market-based approach towards bad loans in the private sector, restructuring has been slow. In Indonesia, the Republic of Korea and Malaysia a government-led approach has been adopted to bank restructuring: a large proportion of NPLs and of banks under distress have effectively been nationalized, and liquidity support or fresh capital has been provided by the public sector to many banks experiencing financial difficulties. This virtual nationalization has resulted in the Republic of Korea, for instance, in the Government now holding more than 50 per cent of the total shares in the largest surviving banks, three of which account for 25 per cent of total bank lending. Even those banks that appear sound have substantial exposure to subsidiaries (such as leasing companies), whose losses have yet to be recognized on fully consolidated balance sheets.

Thus, contrary to expectations, recovery has taken place without any major financial and corporate restructuring:

> … historical experience suggests that the duration and speed of recovery from financial crises vary considerably from case to case, often depending on how effectively financial sector problems and corporate sec-

Box 4.2

ALTERNATIVE APPROACHES TO THE RESOLUTION OF BAD LOANS

The crisis in East Asia left many financial institutions insolvent. While non-bank financial intermediaries were allowed to fail in a number of countries (e.g. merchant banks in the Republic of Korea and finance companies in Thailand), most countries provided either direct or indirect support for the rescue of banks. Restoring solvency requires financial engineering on both the asset and the liability side of a bank's balance sheet. The losses created by revaluing the bad loans on the asset side must be covered by injecting new capital if the losses lead to a decline in bank capital below regulatory standards. Rescue operations differ in how these adjustments take place.

Recently there have been two major examples of large-scale bad-loan resolution: for thrift institutions in the United States and the banking sector in Japan. The United States experience was not immediately applicable to Asia because of the prior existence of a federally operated deposit insurance fund which had first claim on all bank assets. The primary activity of the regulators was to close the failed thrift institutions and try to realize the highest possible values for the assets underlying the bad loans as rapidly as possible. The task of the United States Resolution Trust Corporation (RTC) was primarily to close banks and realize assets rather than to try to save banks as going concerns through restructuring and recapitalization. In Japan various schemes were introduced to transfer bad loans from bank balance sheets to a government agency which was to attempt to recover the loans, but the initial approach was voluntary and the loans could be returned to banks if they could not be realized.[1]

In the aftermath of the crisis in East Asia, most countries removed bad loans from the balance sheets of the original bank lenders and transferred them to specialized agencies funded by governments, subject to a discount on the value of the loans. The agencies attempted either to collect the debt from the borrower or to take possession of the underlying assets in order to realize their value through sales in the market. As the majority of bank loans were initially extended on the basis of the evaluation of underlying collateral, the process was greatly facilitated. However, the absence of modern bankruptcy laws in many countries impeded the rapid transfer of ownership of the underlying collateral to creditors or the specialized agencies.

The Korean experience

In the Republic of Korea the powers of Korea Asset Management Corporation (KAMCO), created in 1962 as part of the Korea Development Bank, were extended in 1997 to deal with the non-performing loans (NPLs) of financial institutions and assets of distressed companies through the creation of a special fund. In 1999 the Corporation was further empowered to create joint venture asset management companies with the participation of private financial institutions. Its initial capital was provided from government funds.[2]

KAMCO has been highly innovative in approach, using asset-backed securities as well as more traditional means of sales and auctions in disposing of assets. It has also been highly profitable, realizing more from the sale of its acquired assets than it paid for them in the first place, partly because many companies were only facing liquidity problems and were not technically insolvent. Thus, the extremely rapid recovery of the economy brought recovery in the earning power of the assets acquired by KAMCO. In 1999 KAMCO sold NPLs that it had acquired for 4 billion won for over 5 billion won. It is estimated that it has earned an average return of 10 per cent on its portfolio. As a result, it was able to operate on the basis of its own earnings rather than seek additional public funds when it acquired $17 billion of Daewoo bad loans from investment companies.[3]

Thailand's market-based approach

The Thai approach has been closest to that of the United States. A Financial Sector Restructuring Authority (FRA) was created in 1997 in order to deal with the 16 finance companies that had been suspended before the crisis broke out in July, but its operations were extended subsequently to deal with some 90 institutions. It has no other responsibilities and has a limited life of three years to complete its task.[4] The Thai programme is usually described as more market-based than those in other countries because FRA only assesses the viability of the rehabilitation plans submitted by the suspended finance companies. Moreover, restructuring in the rest of the financial sector is taking place outside any formal structure such as FRA and under the informal guidance of the Government and the Bank of Thailand, involving mergers, acquisitions by foreign buyers and closures.

In operations carried out by FRA the Government provided protection to all creditors of the suspended institutions, but their recapitalization or operation by the Authority was never envisaged. The institutions submitting acceptable plans would remain under its surveillance until they were judged capable of

Box 4.2 (concluded)

being returned to private operation and normal supervision by the Bank of Thailand. For others a more active role was envisaged for FRA, involving the appointment of management committees comprising representatives of the Ministry of Finance, the Bank of Thailand and FRA to replace the existing company directors, with the aim of preserving and maximizing the value of the remaining assets on behalf of creditors. These committees had the power to liquidate assets through public auctions, open also to international bidders, or via a liquidator, but again no provision was made for an injection of public capital or takeover.[5] Of the 56 company plans, so far only two have been accepted, which left the assets of the rest to be disposed of. The favoured method of disposal has been through public auction of loan pools, with the Asset Management Corporation (AMC) acting as bidder of last resort to set a floor to prices; for example, in the auction closed on 10 November 1999 AMC was the winning bidder in four out of nine offered tranches.[6] The auctions have been only moderately successful, in part because of widespread opposition to the sale of domestic assets at knockdown prices, and in part because of uncertainties in the existing bankruptcy and foreclosure laws with respect to guaranteeing access to the security on the loans.

The Malaysian approach

Just as Malaysia opted for a different policy response to the crisis, it also took a different, more proactive approach to financial sector restructuring. Two separate agencies were created to deal with the problems of the banking system. *Danaharta* was created as an asset management company to purchase and manage the sale of banks' NPLs. Banks with more than 10 per cent of NPLs were required to sell all such loans, failing which they would have to write down the value of the loans and liquidate them. *Danaharta* was empowered to impose on the borrowers of the loans acquired operating conditions that ensured maximum value recovery. Since sales of NPLs have been affected at market values, they resulted in losses to banks.[7] *Danamodal* was created to deal with such losses via recapitalization of potentially viable institutions. The Government thus became the strategic shareholder in these institutions, which aided the policy of bank merger and concentration pursued in order to create stronger and larger institutions.[8]

The most innovative aspect of the approach was the recognition that the health of the banking system was directly dependent on the health of the corporate sector, and that difficulties had often been caused by the shortage of liquidity rather than insolvency of the borrower – a problem that can be solved by ensuring continued lending to viable companies. Thus, the Corporate Debt Restructuring Committee was created to provide a platform for borrowers and creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings and precipitating insolvency, and to ensure that financing was provided to companies during the process of restructuring so that liquidity shortage was not automatically transformed into insolvency. The scheme also provides a method for avoiding the difficulties caused by a legal framework which was not initially designed for facilitating corporate restructuring. The process is restricted to companies with aggregate bank borrowing of over 50 million ringgit from more than one financial institution. A creditors' committee, representing at least 75 per cent of the total debt of all creditors, must be established, and the creditors must agree to a 60-day standstill to determine the conditions of the company and the possibility of preserving it as a viable business. Stakeholder approval is required for workout proposals for debt restructuring formulated by the process. If there is a failure to reach agreement, *Danaharta* stands ready to intervene by purchasing NPLs to facilitate a workout agreement.[9]

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1 See *TDR 1993*, Part Two, chap. I, sect. B.2. Subsequently a more active approach, closer to the United States model, was adopted, but the process of restructuring has remained extremely slow; see *TDR 1999*, chap. I, sect. B.1(b).

2 For the history of KAMCO see "Company History" (www.kamco.or.kr/eng/overview/main1.htm).

3 See Lee BJ, *KAMCO Pushes Transparency and Speed in Selling Distressed Assets, Reaps 10 Percent* (www.kamco.or.kr/kam); and KAMCO, *Annual Report 2000*, Acquisition result, "NPL Acquisition" (www.kamco.or.kr/eng/report/main.2.htm).

4 For a history of FRA see "About FRA" (www.fra.or.th/home_index.html).

5 See section 30 of "Emergency Decree on Financial Sector Restructuring B.E. 2540" (www.fra.or.th/home_index.html).

6 See "Results of the commercial and other loan sales as of November 10, 1999" (www.fra.or.th/home_index.html).

7 See "An introduction to Danaharta" (www.danaharta.com.my/default.html) and Bank Negara Malaysia, *Annual Report 1998*, Bangkok, 1999: 228–229.

8 See Bank Negara Malaysia, *Annual Report 1998*: 230–231.

9 See Bank Negara Malaysia, "Introduction to CDRC" (www.bnm.gov.my/crdc/intro.htm) and "Terms of reference of CDRC" (www.bnm.gov.my/cdrc/terms.htm); and Bank Negara Malaysia, *Annual Report 1998*: 230–233.

Table 4.1

CHANGES IN MACROECONOMIC RATIOS OVER RECENT FINANCIAL CYCLES IN SELECTED EAST ASIAN COUNTRIES

(Percentage points)

Country	Boom 1990–1996[a]	Bust 1997–1998	Recovery 1999
Indonesia			
Savings	-1.3	-7.6	-0.8
Investment	3.0	-18.1	-1.0
Budget balance	3.0	-4.4	-4.5
Current-account balance	-2.3	8.0	-1.0
Malaysia			
Savings	6.9	5.9	-1.7
Investment	8.0	-14.8	1.6
Budget balance	4.2	-3.9	-3.9
Current-account balance	-2.6	17.3	-1.3
Republic of Korea			
Savings	-1.9	-0.7	0.7
Investment	4.8	-17.5	6.4
Budget balance	-0.1	-4.4	0.4
Current-account balance	-7.2	17.3	-6.4
Thailand			
Savings	7.5	5.9	-5.5
Investment	13.9	-16.4	1.0
Budget balance	4.6	-5.9	-2.0
Current-account balance	-7.4	20.9	-4.1

Source: World Bank, *Country at a Glance,* various issues (www.worldbank.org/data); ESCAP, *Economic and Social Survey of Asia and the Pacific 2000*, United Nations publication, sales no. E.00.II.F.19, New York, 2000, tables II.14 and II.17.

Note: The ratio of each variable to GDP in the last year of each phase is compared with that in the terminal year of the preceding phase.

a 1991–1996 for Malaysia and 1988–1996 for Thailand.

> tor difficulties … are dealt with. In the current crisis, too, how deftly the financial and corporate sector problems are managed will be important – not only for the strength of the initial pickup in activity, but also for the prospects for sustained recovery.[10]

Indeed, the present recovery is probably more fragile than it may appear. Exports are unlikely to continue at the recent pace to provide either the markets or the liquidity needed to expand production, since the initial surge had one-off elements associated with the sharp swings in exchange rates. In the Republic of Korea, for instance, the trade surplus has virtually disappeared as imports surged with recovery and outstripped growth in exports: during January–May 2000 exports were some 29 per cent, but imports 41 per cent, higher than a year earlier. In Thailand imports rose by 20 per cent in 1999, while exports rose by 9 per cent. On the other hand, despite the recovery in employment and wages in the Republic of Korea, private consumption is following, rather than leading, income growth, and the household savings ratio is expected to rise over the coming years.[11] Private investment in 1998 was 25 per cent lower than in 1996 and is unlikely to regain its past level in the near future; in terms of its share in GDP, gross domestic investment fell by more than 10 percentage points from 1996 to 1999. The same goes for other countries in the region: in both Thailand and Malaysia private consumption rose in 1999 much less than income after sharp declines in 1998, and the share of investment in GDP was around 15 percentage points lower than in 1996 in both countries (table 4.1). In Malaysia, however, there was a sharp rebound in private consumption in the first quarter of 2000, when it rose 14 per cent above the corresponding period of 1999. This was the sharpest increase since the end of 1993. Together with investment, private consumption has become the main factor driving recovery, with the GDP growth rate reaching almost 12 per cent more than in the same quarter of the previous year. Otherwise, recovery in the region appears to be dependent on the fiscal stimulus, at least for the time being. In Thailand, where fiscal deficits are currently 7 per cent of GDP, it has been argued by IMF that "fiscal stimulus has been helpful and, if necessary, should be maintained over the next few quarters through the temporary extension of social spending programs. As the recovery becomes self-sustaining, it will become necessary to begin the task of fiscal consolidation, which is essential to check the growth in public debt".[12] But since domestic public debt is rising rapidly – from less than 16 per cent of GDP in 1996, it is projected to reach 40 per cent at the end of the current year – it is important that a quick transition be attained to a recovery that is driven by private demand.

Not only the speed but also the sources of the current recovery in East Asia are quite different from what was expected on the basis of ortho-

dox diagnosis and interpretation of the crisis. For instance, according to a baseline scenario designed by IMF, recovery in the four most affected countries was expected to be driven primarily by private investment, even though many countries in the region were known to have significant excess capacity, while the contribution of public consumption and the foreign balance to growth was projected to be negative.[13]

In assessing the sustainability of the current recovery, it is important to note that so far global conditions have generally been favourable. The strength of the United States economy has been an important factor in the expansion of exports from the region. On the other hand, unlike in 1997, the recent rise of the dollar did not create serious problems of competitiveness, since the dollar has remained weak vis-à-vis the yen. While the recent increases in United States interest rates put some downward pressure on the East Asian currencies, notably in Thailand and the Philippines, this itself should cause no concern. However, as noted above, external payments are moving towards deficits and maintaining imports will require adequate capital inflows. Similarly, the region is relying on foreign capital to restructure its banks and corporations. Therefore, rising foreign interest rates could pose a dilemma: attracting foreign capital would call for a reversal of the monetary stance and higher interest rates which, in turn, could stifle growth by blocking the transition to a recovery led by private domestic demand and aggravating the difficulties of the banking system.

C. Macroeconomic and labour market indicators over the financial cycle

Large swings in economic activity associated with financial boom-bust-recovery cycles have far-reaching consequences for longer-term growth and development. Surges in capital inflows often lead to a deviation of key macroeconomic aggregates such as savings, investment, fiscal and foreign balances, exchange rates, employment and wages from their longer-term, sustainable levels. Rapid exit of capital and financial crises, on the other hand, tend to lead to overshooting in the opposite direction. The recovery process which restores aggregate income to pre-crisis levels generally results in a different configuration of key macroeconomic variables from those prevailing before the outbreak of the crisis. In this sense, financial cycles in emerging markets appear to be quite distinct from traditional business cycles. First, they tend to result in large shifts in income distribution and poverty, which can only be corrected after many years of growth. Second, the boom-bust process has implications for longer-term accumulation and growth; in some cases the pace of accumulation is expected to be dampened, whereas in others it may accelerate to the extent that the surge in capital inflows supports unsustainable consumption booms.

The remainder of this chapter addresses these issues. In this section an attempt is made to examine the shifts in key macroeconomic aggregates, labour market variables and poverty indicators over the full financial cycle in order to identify broad trends. In this analysis a comparison is made with some earlier episodes of financial crisis in other parts of the developing world, including the Southern Cone crisis in Argentina and Chile in the early 1980s and the crises of the 1990s in Argentina, Mexico, Turkey and Venezuela.[14] It considers the full financial cycle, distinguishing the different periods: before the surge in capital inflows (the *base* period); the *peak* of the boom in capital flows and economic activity; the *crisis* phase, characterized by a rapid exit of capital and a collapse of the currency; and the *recovery* phase, when aggregate income is restored to pre-crisis levels. Although, the duration of each of these phases and the behaviour of key variables therein vary from country to country, there are a number

of common features in the boom-bust-recovery cycles in emerging markets.

1. The boom

Typically, surges in capital flows are associated with the widening of the gap between domestic income and absorption, and with rising external deficits, which often result from the effects of capital inflows themselves.[15] The resource gap usually originates from rising private consumption or investment, but there are also cases where capital inflows serve to finance large and sustained public-sector deficits.

The surge in capital inflows into East Asia started in the early 1990s, in some cases (such as the Republic of Korea) constituting a reversal of the previous capital outflow. By 1996, net annual inflows into the four countries most affected by the crisis had reached some $90 billion. The earlier episodes of surges in capital flows to emerging markets depict a similar picture. In most cases there was a substantial reversal from a net outflow to a net inflow, while in some there was a sharp increase in capital inflows within a short period, usually a single year. Such reversals occurred in Argentina in 1979 and 1991, and in Venezuela in the early 1990s. Chile experienced a fourfold increase in capital inflows in 1978, Mexico a sixfold one in 1990, and Turkey an 18-fold increase in 1990. Such booms lasted from three to seven years, and all ended up with rapid capital flight and financial crisis.[16]

In East Asia the surge in capital inflows was associated with a boom in private investment. In comparison to the base year, investment/GDP ratios in the peak of the financial cycle in Indonesia, Malaysia, Republic of Korea and Thailand were higher by 3–14 percentage points (table 4.1), exceeding 40 per cent in the last two countries. The increase was already from a very high base; investment ratios in the late 1980s were above 30 per cent of GDP. In Malaysia and Thailand, where savings ratios rose by some 7 percentage points during the boom phase in the early 1990s, the increase in investment ratios exceeded the rise in capital inflows as a percentage of GDP. In Indonesia and the Republic of Korea, on the other hand, the surge in capital inflows was not associated with any significant change in domestic savings ratios, with the rise in public-sector surpluses compensating for a small decline in private savings.

By contrast, in the earlier Latin American episodes, surges in capital inflows were invariably associated with a boom in private consumption. Domestic savings ratios declined in all the booms, both during the late 1970s in the Southern Cone and during the first half of the 1990s in Argentina, Mexico and Venezuela (table 4.2). This inverse relationship between external and domestic savings has also been noted by ECLAC: "There is … a considerable degree of substitution between domestic and external savings, particularly when financial flows are volatile, and … variations in external savings are reflected, to a large extent, in increased or reduced public or private consumption."[17] The Turkish boom during 1989–1993, which in some respects resembled the Latin American pattern, was associated with a sharp rise in public spending, resulting in a 3.4 percentage points increase in the public-sector deficit as a proportion of GDP.

In all the four countries in East Asia, the boom was associated with a rapid increase in real wages, but in general labour productivity rose even faster (tables 4.3 and 4.4). In Malaysia and Thailand, real wage earnings in manufacturing rose moderately, on average by less than 5 per cent per annum. In the Republic of Korea the rise was much greater (7.6 per cent per annum during 1989–1996), but productivity growth was twice as fast. The gap between real wages and productivity growth provided some cushion against falling profitability of exports after the mid-1990s. Nevertheless, wages still recorded a sharp increase in dollar terms, particularly where the currency appreciation was large: in Malaysia, for example, wage costs in dollar terms rose by 68 per cent during 1990–1996 and in local currency by 33 per cent.[18] Growth in productivity and wages was associated with a rapid increase in employment; during the boom phase manufacturing employment rose by 43 per cent and 78 per cent in Malaysia and Thailand, respectively, and non-agricultural employment rose by 30 per cent in the Republic of Korea. Unemployment in all three countries practically disappeared, while it was moderate (under 5 per cent) in Indonesia (table 4.5).

By contrast, both the Latin American and Turkish booms were characterized by increases in real wages in excess of productivity (table 4.4).

Table 4.2

CHANGES IN MACROECONOMIC RATIOS OVER RECENT FINANCIAL CYCLES IN SELECTED LATIN AMERICAN COUNTRIES AND TURKEY

(Percentage points)

Country	*Boom*	*Bust*	*Recovery*
Argentina (1980s)	*(1979–1981)*	*(1982–1983)*	*(1984–1985)*
Savings	-8.5	2.0	-1.2
Investment	-5.1	-1.8	-3.3
Budget balance	-5.8	-1.3	2.4
Current-account balance	-9.2	3.7	1.3
Argentina (1990s)	*(1991–1994)*	*(1995–1996)*	*(1997–1998)*
Savings	-2.1	0.5	-0.7
Investment	5.9	-1.4	1.4
Budget balance	0.2	-1.9	0.6
Current-account balance	-6.8	2.3	-3.6
Chile	*(1978–1981)*	*(1982–1983)*	*(1984–1985)*
Savings	-3.2	0.2	7.1
Investment	2.4	-6.6	4.8
Budget balance	3.7	-5.2	0.3
Current-account balance	-10.4	8.6	-2.9
Mexico	*(1990–1994)*	*(1995–1996)*	*(1997–1998)*
Savings	-6.0	8.5	-3.0
Investment	-1.2	1.5	1.1
Budget balance	4.5	-0.2	-1.1
Current-account balance	-4.5	6.4	-3.3
Venezuela	*(1991–1993)*	*(1994–1996)*	*(1997–1998)*
Savings	-11.0	13.0	-12.0
Investment	5.9	-2.6	3.5
Budget balance	-2.3	3.7	-3.9
Current-account balance	-20.4	16.0	-15.5
Turkey	*(1990–1993)*	*(1994)*	*(1995–1997)*
Savings	0.0	0.5	-3.2
Investment	3.7	-1.9	0.5
Budget balance	-3.4	2.8	-4.8
Current-account balance	-4.4	6.5	-4.4

Source: World Bank, *Country at a Glance,* various issues (www.worldbank.org/data); ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean,* various issues.

Note: The ratio of each variable to GDP in the last year of each phase is compared with that in the terminal year of the preceding phase.

In the Latin American episodes growth in labour productivity was relatively slow or even negative (e.g. Venezuela). Moreover, unlike in East Asia, unemployment kept on rising (see table 4.5), as in Argentina and Mexico (and also in Brazil), or stayed high, as in Chile and Venezuela. In addition, in Argentina, Brazil and Mexico rising wages were accompanied by declining levels of formal employment and increases in the labour force in the informal sector.[19]

The policy of reliance on capital inflows to support a consumption-led growth based, at least partly, on rising wages had a populist twist as it helped to correct some earlier distortions in income distribution at the expense of labour. Indeed,

Table 4.3

CHANGES IN REAL WAGES IN MANUFACTURING OVER RECENT FINANCIAL CYCLES IN SELECTED DEVELOPING COUNTRIES

(Per cent per annum[a])

Country	Boom	Bust	Recovery
Indonesia	5.6	-25.1	-
Malaysia	3.4	-1.2	n.a.
Republic of Korea	7.6	-4.9	13.9
Thailand	4.7	-2.3	3.2
Argentina (1980s)	4.1	-5.9	10.9
Argentina (1990s)	0.5	-0.5	-1.0
Chile	16.6	-3.3	-6.9
Mexico	6.2	-11.4	0.5
Venezuela	-3.5	-14.6	15.0
Turkey	16.1	-25.2	2.0

Source: UNCTAD secretariat estimates, based on ILO database (LABORSTA), http://laborsta.ilo.org/cgi-bin/broker.exe; ESCAP, *Economic and Social Survey of Asia and the Pacific 2000*, United Nations publication, sales no. E.00.II.F.19, New York, 2000; ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean,* various issues.

Note: The periods of boom, bust and recovery are as defined in table 4.1.

a Change from the year immediately preceding the period in question to the last year of that period.

most Latin American episodes and the Turkish boom had been preceded by a period of significant erosion of real wages. In Argentina the pre-boom real wage decline had been over 30 per cent in both episodes (1975–1978 and 1986–1989); it was 25 per cent in Brazil (1985–1991), over 40 per cent in Mexico (1984–1988) and Venezuela (1983–1990), and 33 per cent in Turkey (1979–1988). In all these cases there were also large declines in the share of wages in industrial value added.[20] By contrast, real wage reductions were not a feature of the pre-boom phase in East Asia, although there was some decline in Malaysia after the 1985 recession.

In most Latin American episodes, the pre-boom real wage erosion had taken place in an environment of chronic price instability, and the subsequent correction took place in the context of exchange-based stabilization programmes, of-

Table 4.4

INCREASE IN REAL WAGES AND LABOUR PRODUCTIVITY IN MANUFACTURING DURING RECENT PERIODS IN SELECTED DEVELOPING COUNTRIES

(Per cent[a])

Country	Period	Real wages	Labour productivity
Indonesia	(1990–1996)	46	85
Malaysia	(1991–1996)	22	34
Rep. of Korea	(1990–1996)	67	138
Thailand	(1988–1996)	32	32
Argentina	(1979–1981)	13	6
Chile	(1978–1981)	85	23
Mexico	(1990–1994)	35	22
Venezuela	(1991–1993)	-10	-11
Turkey	(1990–1993)	82	66

Source: See table 4.3.

a Percentage change from the year immediately preceding the boom period to the last year of that period.

Table 4.5

RATES OF UNEMPLOYMENT OVER RECENT FINANCIAL CYCLES IN SELECTED DEVELOPING COUNTRIES

(Per cent[a])

Country	Base	Boom	Bust	Recovery
Indonesia	2.5	4.7	5.5	6.4
Malaysia	5.1	2.5	4.9	4.5
Republic of Korea	2.6	2.0	6.8	6.3
Thailand	5.9	1.1	5.3	5.3
Argentina (1980s)	3.3	4.7	5.3	6.1
Argentina (1990s)	7.5	11.5	17.2	12.9
Chile	13.9	9.0	19.0	17.0
Mexico	2.9	3.7	5.5	3.2
Venezuela	10.4	6.6	11.8	11.2
Turkey	8.7	8.0	7.9	6.9

Source: See table 4.3.

a Unemployment in the last year of each of the phases in table 4.1 and in the year immediately preceding the boom ("base"), except for Indonesia, where the base refers to 1990.

ten accompanied by rapid trade and financial liberalization. This populist policy mix thus served to avoid hard policy choices and allowed price stability to be achieved without running into distributional conflicts. However, in some cases, the correction turned out to be excessive, leading to real wage increases at the expense of profits. In Chile during the late 1970s, and in Brazil, Mexico, Turkey and Venezuela during the early and mid-1990s, rising real wages resulted in large declines in the share of profits. So long as the mass of profits was rising, this did not create a problem. However, since such wage-profit configurations depended on capital inflows, the rapid exit of capital and the decline in economic activity laid bare the latent conflicts, often leading to a redistribution from wages to profits.

2. The crisis

The effects of financial crises on key macroeconomic and labour market indicators depend, *inter alia*, on the evolution of these indicators during the boom phase. First, lower investment ratios during the crisis were generally a feature of countries which had experienced investment-led booms, as in East Asia and in Argentina in the 1990s. Declines in investment ratios were dramatic in the four Asian countries, exceeding 15 percentage points of GDP (table 4.1). On the other hand, the Latin American countries, which had consumption-led booms typically experienced sharp declines in consumption, reflected in rising private savings ratios (table 4.2). One exception was Chile in the early 1980s, where, despite a consumption-led boom, the burden of the subsequent adjustment in domestic absorption fell on investment.

Secondly, except in a few cases where the boom had been associated with rapidly rising public spending, the crises led to increases in public-sector deficits (tables 4.1 and 4.2). This was the case in East Asia as well as in many episodes in Latin America, where budgets turned from surpluses into deficits with the outbreak of the crisis. Of all the episodes considered here, it was only in Turkey and Venezuela that the ratio of the public deficit to GDP fell during the crisis. In most other cases where deficits rose, this was due to the effect of cyclical contraction on the budget rather than to discretionary fiscal expansion.

Third, in all cases the crisis led to a sharp turnaround in current-account balances (tables 4.1 and 4.2). In most Latin American countries this took the form of a sharp reduction in the current deficits, whereas in East Asia (as well as in Turkey and Venezuela) there was a shift from deficit to surplus. As a percentage of GDP, swings in the current-account balance often reached double-digit figures. Invariably, the shift was brought about by massive cuts in imports rather than export expansion.

Fourth, labour market conditions deteriorated in all countries with the outbreak of the financial crisis. Indeed, it appears that reduced incomes and employment in organized and informal labour markets have been the main social conduit of the adverse impact of financial crises on poverty and equality.[21] As in other episodes of emerging-market crisis, in East Asia too there was a sharp drop in the demand for urban labour. In 1998 manufacturing employment declined by 17 per cent in the Republic of Korea and 11 per cent in Indonesia, while construction employment fell by 37 per cent in Thailand. The surplus labour was partly absorbed elsewhere as workers crowded into low-wage jobs or self-employment in the urban informal sector, withdrew from the labour force, returned to the land,[22] engaged in part-time or unpaid family labour or, in the case of migrants, returned to their home country. Rising informalization and disguised unemployment appear to have been the trend almost everywhere.[23] In Indonesia the share of informal employment rose and – in contrast to other countries – the participation rate increased, suggesting that declines in wages brought down single-wage families below the poverty level. In the Republic of Korea, the ratio of temporary and daily workers (as opposed to regular employees) to total wage earners rose to 45 per cent in 1998 and 53 per cent in 1999.

Despite such flexibility and generally declining participation rates, unemployment rose everywhere (table 4.5). The sharpest rise was in the Republic of Korea, where the rate peaked at 8.7 per cent in February 1999, affecting particularly unskilled workers.[24] In Thailand it exceeded 5 per cent, whereas in Indonesia the increase continued throughout 1999, reaching 6.5 per cent in the first quarter of 2000. The unemployment rate in Malaysia doubled despite the repatriation of many migrant workers.

Falling real wages had a more serious social impact than rising unemployment in Indonesia and the Republic of Korea; in 1998 alone real wages fell by more than 40 per cent and 10 per cent, respectively. High inflation was the main cause in Indonesia and lower money wages in the Republic of Korea. Evidence from the latter country suggests that production workers, particularly in small- and medium-sized enterprises, were hit hardest by the crisis. Real wage declines appear to have been much more moderate in Malaysia and Thailand.[25]

Declines in wages and growing unemployment combined to produce a sharp increase in poverty throughout the region. In 1998 the number of people living on less than $1 a day was estimated at 65 million in the East Asian economies taken together, 10 million of whom were crisis-precipitated. These figures rise to 260 and 30 million, respectively, if the poverty benchmark is put at $2 a day.[26] Of these countries, poverty appears to have increased most in Indonesia and the Republic of Korea, a critical factor having been a faster increase in food prices than in prices of other consumer goods, particularly in Indonesia, where inflation accelerated rapidly.

The impact of financial crises on wages, employment and poverty was similar in earlier episodes in Latin America. In some cases the adjustment was more in terms of declines in real wages, which exceeded 20 per cent between the peak and the trough (e.g. in Mexico and Venezuela). The decline also exceeded 20 per cent in Turkey. In other Latin American episodes, wage declines were moderate but there were sharp increases in the unemployment rate, in the order of 6–10 percentage points, as in Argentina during 1995–1996 and in Chile during the Southern Cone crisis (table 4.5).

The impact on poverty in Latin America was equally devastating. Although growth during the first half of the 1990s had resulted in a gradual reduction of the high poverty levels inherited from the 1980s, even before the subsequent crises there were still more than 200 million living below the poverty line. One reason for the persistence of such high numbers was that growth in Latin America during the 1990s was generally accompanied by rising income inequalities. Taking into account the adverse impact of financial crises from the mid-1990s onwards, ECLAC estimated that the decade would end with higher levels of poverty than those of the 1980s.[27]

3. The recovery

The speed and sustainability of recovery from a financial crisis in an emerging market depends on how quickly the supply constraints of the economic downturn are overcome, the balance sheets of corporations and banks restructured, and new sources of demand exploited. On the supply side, perhaps the most important constraint arises from the breakdown of credit channels, both domestic and external. On the demand side, domestic private expenditure (both consumption and investment) is unlikely to play a major independent role in the recovery, which would have to rely on autonomous sources of demand, especially exports, which are typically stimulated by sharp currency depreciations. If allowed to operate, cyclical budget deficits can also act as built-in stabilizers.

As noted in the previous section, recovery is well under way in East Asia, even though at the end of 1999 incomes were still below the 1996 levels in Indonesia and Thailand. A comparison of investment ratios shows that, in all four countries, they are currently well below those attained during the peak, as well as below the levels attained before the boom in capital flows. As discussed in the subsequent section, investment ratios in these countries are unlikely to return to the peak levels even after the recovery is completed and productive capacities are fully utilized. In these respects the experience in Latin America was different. There, in most episodes where the boom was consumption-led, recovery in output was associated with a rise in the investment ratio. This was also the case in Turkey, where the boom in capital inflows was associated with fiscal expansion. In such cases, the post-crisis increases in investment often reflected the impact of currency realignment on profitability in the traded-good sectors.

In almost all episodes considered here, post-crisis savings ratios were higher than pre-crisis rates. The recovery in domestic savings was almost invariably due to a rise in private savings, since financial cycles typically lead to a deterioration in public finances. Indeed, except in Argentina during the Southern Cone crisis, post-

crisis public-sector deficits were higher than pre-crisis deficits. An important reason is increased interest payments on public debt, which tend to mount during a crisis, partly as a result of higher interest rates and financial rescue operations. For instance, such payments in 1999 reached almost 4 per cent of GDP in Indonesia and absorbed as much as 30 per cent of tax revenues.[28]

Again, in all the episodes considered here, the domestic resource gap (the excess of investment over savings) was lower in the recovery phase than during the peak phase, as it was also in episodes where post-crisis investment was higher, with a consequent improvement in the current-account balance. Although, as recovery got under way, the trade balance started to move into deficit as imports picked up, the current-account balance always showed considerable improvement over the pre-crisis period. In East Asia, current accounts were still in surplus at the end of 1999, supporting reserve accumulation and debt repayments. However, in none of the Latin American episodes considered here did current accounts register a surplus during the crisis, let alone the recovery. Furthermore, post-crisis current-account deficits were much higher than before the surge in capital inflows, largely because of a deterioration in trade balances arising from rapid trade and financial liberalization.[29]

These shifts in macroeconomic aggregates, notably the narrowing of the domestic resource gap, as well as sharp currency devaluations over the financial cycle, suggest significant changes in income distribution. Indeed, they are often associated with declines in the share of wages in national income. In East Asia real wages have fully regained their pre-crisis level only in the Republic of Korea, while they remain depressed in Indonesia and Thailand. However, in all four countries, employment lagged considerably behind output. In the Republic of Korea at the end of 1999 GDP exceeded the pre-crisis level, but the unemployment rate was higher by more than 4 percentage points. There has been further improvement in the current year, but it appears to be due to declining participation rates; indeed, the World Bank has cautioned that unemployment rates might increase even if participation rates stabilize in the immediate future.[30] Again, in Malaysia GDP was about the same in 1999 as in the pre-crisis peak, but the unemployment rate was higher by 2 percentage points despite the shedding of migrant labour.

The same pattern is observed in almost all other episodes examined here. With the exception of the recovery in Argentina from the Southern Cone crisis, post-crisis real wages were lower than their peaks reached during the boom. Except for the Mexican cycle of the 1990s, this is also true for unemployment rates, which were higher in comparison not only with the peaks, but also with pre-boom levels. Further, for all cases where data are available, the share of wages in value added declined. Thus, the boom-bust-recovery cycles in both East Asia and Latin America appear to have been highly regressive so far as labour income is concerned.[31]

This deterioration in the conditions of labour, particularly among the unskilled, is a major reason why the reduction in poverty levels has so far lagged behind economic recovery in East Asia. Indeed, empirical studies show that there is a significant asymmetry in the impact of growth and crises on poverty in developing countries: the poverty-alleviating impact of a given rate of growth is significantly weaker than the poverty-augmenting impact of a comparable decline in GDP. In Indonesia and the Republic of Korea, improvements in headcount poverty indices, which had taken many years to achieve, were wiped out within a single year, and "returning to the pre-crisis level of poverty … is likely to require more time …".[32] According to the World Bank, under a "slow growth rising inequality" scenario associated with unfavourable global demand conditions, it would take East Asia over a decade to eliminate the poverty created by the financial crisis. Only with a return to a more "inclusive growth" strategy, where annual growth rates are closer to the long-term average for the region and inequality is unchanged, could the fight against poverty be effectively resumed.[33]

The persistence of widespread poverty and declines in wage incomes despite the recovery of output provide *prima facie* evidence that financial cycles result in regressive income distribution. However, it appears that for various reasons related to data problems as well as conceptual difficulties, the standard measures of income distribution cannot always capture such changes. In the Republic of Korea, for instance, the data show that while in the first quarter of 1995 the incomes of the richest 10 per cent were about 7 times those of the poorest 10 per cent, they were more than 10 times higher in the first quarter of 1999.[34] By contrast, Gini coefficients appear to have remained

unchanged in Indonesia and Thailand, despite substantial increases in the poverty-stricken population in both countries.[35]

It is also extremely difficult to assess the equally important impact of financial crisis on wealth destruction, which appears to have hit primarily small- and medium-sized enterprises that provide extended family employment opportunities. The loss of income and employment in these sectors probably increases the share of population dependent on wage labour and brings an increase in formal unemployment. It may also contribute to the rise in saving ratios and explain the lag in consumption observed after the crisis as attempts are made to keep family-owned businesses alive.

D. Growth prospects and policy challenges

Despite rapid recovery, the concerns raised by the crisis in East Asia over growth prospects for the region have continued to dominate the policy debate. There is a growing opinion that structural and institutional weaknesses laid bare by the crisis need to be corrected, and that development strategies need to be adapted to the realities of globalization if the fight against poverty is to be effectively resumed and the gap with more advanced countries closed. Even then, it may not be possible to replicate the earlier growth performance; it will be necessary to settle for a growth path consistent with the logic of globalization. The financial crisis has, from this perspective, been a cathartic experience setting the stage for clearing away the institutional and policy vestiges of a bygone development era.[36]

The policy advice following from this perspective is clear: achieve much closer integration with the world economy, combined with institutional changes designed to reduce the risks associated with globalization. To that end reforms should aim at reduced state intervention, modernization of corporate and financial structures, deregulation of product and labour markets, and increased openness to foreign corporations, investment and trade. These measures follow from the diagnosis that the crisis occurred largely because government intervention and institutional practices had prevented firms and financial institutions from operating under the discipline of global market forces. Thus, greater openness and liberalization, rather than a retreat from globalization, holds the key to future success. Appropriate macroeconomic and exchange-rate policies, tighter prudential regulation and supervision of the financial system, and greater transparency and improved disclosure of macroeconomic variables, and of corporate and financial data, are essential ingredients of reforms to safeguard against the risks associated with closer integration with the world economy.

From this same perspective, the increased discipline of global market forces over national firms would also help overcome a major shortcoming of the East Asian process of accumulation and growth. The superior Asian performance in the past was based on exceptionally high savings and capital accumulation rather than on productivity growth. But this rapid pace of catch-up growth over the past few decades has been accompanied by excessive rent-seeking behaviour, lack of innovation, inefficient capital markets and institutional sclerosis, all of which have held total factor productivity (TFP) growth below potential. Greater competition brought about by institutional changes and closer integration into the world economy would help raise efficiency. This is all the more necessary in view of prospects of diminishing returns to capital accumulation, and of a tighter labour market that is likely to result from a lowering of what were relatively high participation rates.

According to an exercise undertaken by the World Bank, without faster TFP growth, output

growth per capita associated with the same rate of investment in the next decade as in the 1990s is expected to decline by about 1.0 percentage points in the region. However, this could be more than offset by improvements in the macroeconomic, trade and financial spheres, and in public institutions, which could add as much as 2.0 percentage points in the Republic of Korea and Malaysia, 1.8 points in Thailand and 1.4 points in Indonesia.[37] Institutional reform and greater integration with the world economy are thus seen to constitute the basis of a new "miracle".

However, there seems to be considerable confusion regarding the past role of TFP in East Asia. Indeed, empirical estimates of its contribution to output growth fall within too wide a range to allow meaningful comparisons across countries and to draw firm conclusions for the future growth prospects of the region. For instance, while some studies found that during 1970–1985 developing countries such as Bangladesh, Cameroon, Congo, Pakistan and Uganda had higher TFP growth rates than the Republic of Korea and Taiwan Province of China,[38] the conclusion reached in an earlier World Bank study was totally different:

> What is most striking, however, is how little we are able to account for differences in growth rates between HPAEs [highly-performing Asian economies] and other economies on the basis of conventional economic variables … Controlling for their superior rates of accumulation, the HPAEs still outperform, while sub-Saharan Africa and Latin America underperform the statistical relationship between accumulation and growth, leaving much of the regional difference in per capita income growth unexplained (even though a large fraction of HPAE success is explained). They have been apparently more successful in allocating the resources that they accumulated to high-productivity activities and in adopting and mastering catch-up technologies.[39]

A study undertaken in IMF gives yet different results regarding possible TFP growth in the East Asian countries. It finds that potential (feasible) TFP growth in the Republic of Korea is not much different from the rate attained during 1984–1994; it is moderately higher in Malaysia (0.5 per cent), substantially so in Indonesia (2.5 per cent), but lower in Thailand (0.7 per cent). Projections on this basis show a considerable slowdown in growth of per capita output in the Republic of Korea (to 4.0 per cent per annum) and Thailand (4.9 per cent), little change for Malaysia (4.0 per cent), but an acceleration in Indonesia (6.0 per cent).[40] Clearly, these conflicting views regarding the past and potential TFP growth performance of East Asia, together with conceptual and empirical difficulties associated with this concept, cast serious doubts on the reliability of TFP growth as a guide to policy.

Given that hourly labour productivity in the Republic of Korea is around one half that of the major industrial countries, while in the second-tier NIEs it is much less, there is considerable scope in East Asia for productivity growth and technological catch-up based on structural change, but these are unlikely to come about without rapid investment. Investment and technical progress needed for catch-up growth might benefit from the pattern of regional aid, trade and FDI linkages which were instrumental to growth in East Asia in the 1980s and the early 1990s. In particular, high rates of investment and productivity growth based on a rapid increase in Japanese FDI in the region's information technology sector may play some role in restoring high growth rates.

However, as discussed in *TDR 1996*, the earlier regional growth dynamic hinged on a particular set of macroeconomic circumstances which promoted Japanese greenfield FDI in the region on an unprecedented scale along with a sharp rise in exports to Japan from Japanese affiliates. The resulting "hollowing out" of Japanese industry during the 1990s raises serious doubts about repeating the large outflows of FDI over the coming decade.[41] On the other hand, signs of a convergence in export structure among countries in the region pose the danger of heightened price competition, a tendency which is only likely to be exacerbated by the entry of new competitors from countries such as China and India.[42] Moreover, reliance on regional growth would, in view of the close links between trade and finance, call for more formal institutional arrangements to ensure the stability of financial markets. Equally important, prospects under such a scenario would still depend on robust growth and open markets in the North. In their absence, it is uncertain that there would be sufficient demand to absorb the increased output of IT goods from the region, even with an expansion in intraregional trade.

The financial crisis has shown that excessive reliance on external resources and markets leaves growth prospects in the region vulnerable to po-

tentially sharp shocks and reversals in trade and finance, particularly when integration is not properly managed. Many of the institutions that functioned extremely well under a regime of strict control over international capital flows and investment decisions, including interlocking ownership between banks and non-bank corporations, the concentration of ownership in the hands of inside investors or high corporate leverage, became a source of instability with the dismantling of checks and balances and financial liberalization.[43] While altering these practices may result in undermining some positive entrepreneurial attitudes such as a vibrant corporate culture, a high animal spirit or taking a long view, such reforms would not necessarily guarantee financial stability even if they were accompanied by measures designed to increase disclosure and transparency and to strengthen prudential regulation and supervision of the financial system. The continuing incidence of financial instability and crises in industrial countries with state-of-the-art practices in these areas suggests that such reforms are unlikely to provide fail-safe protection.[44] The appropriate management of integration into the global financial system calls for measures that go beyond information disclosure and prudential regulations, and should include close supervision over private borrowing abroad, as well as tight control over speculative capital flows. As experience has shown, such forms of control are quite compatible with continued access to foreign capital.

Again, the events leading up to the crisis highlight the increased risk of vulnerability to trade shocks. While the emergence of new competitors in labour-intensive products was an important factor in the weakness of export performance for some of the second-tier NIEs, there was a sharp decline in the terms of trade for the first-tier NIEs between 1995 and 1997 which was, in part, due to excess capacity in higher technology sectors, such as semi-conductors.[45] Conditions were further complicated by the re-emergence of imbalances in global demand, the decline in developed country import propensities and instability in the yen-dollar exchange rate in the mid-1990s. These pressures culminated in a dramatic drop in the growth of manufacturing exports throughout the region in 1996 and 1997. Excess capacity continues to be particularly high in the second-tier NIEs and in key export sectors such as the automotive industry, where capacity utilization is as low as 40 per cent.[46] External demand prospects are also less favourable than in the past because of global gluts in some key export sectors as more and more developing countries opt for export-led growth strategies. The cyclical boom in world semi-conductor prices which contributed significantly to the speed of recovery in some countries is expected to enter a downswing in 2002 due to heavy investments in that sector.

The increased vulnerability to trade shocks in manufactures results from far-reaching changes that have taken place in the global economy in the past few decades. International trade flows and prices have become more unstable partly because of increased instability of growth and persistent demand imbalances in the major industrial countries, and partly because of sharp swings in exchange rates and competitiveness. Moreover, as more and more developing countries opt for outward-oriented development strategies, the vulnerability to trade shocks and the risk of fallacy of composition have been increasing. In these respects today's conditions are quite different from those prevailing in the 1960s and 1970s, when only a handful of East Asian countries were pursuing outward-oriented strategies, had easy access to the markets of industrial countries, and faced no major challenge from other third-world producers or from the importing countries themselves. Indeed, the latter showed considerable tolerance of market penetration, thanks largely to cold-war politics.

In view of the increased vulnerability of rapid and inclusive growth to external trade and financial shocks, a more balanced long-term growth path may be desirable for countries in the region, reducing their dependence on foreign markets and resources.[47] In this respect conditions are different for first- and second-tier NIEs.

The Republic of Korea, where less than 10 per cent of the labour force is now in agriculture and per capita income is two thirds the Western European average, has entered a more demanding catch-up stage and is likely to face a rather different growth path from its neighbours in South-East Asia. Its position is similar to that of countries on the Western European periphery (Austria, Finland, Italy and Germany) in the early 1950s. Annual growth rates of some 5–6 per cent could still be expected over the coming two decades, down from some 8 per cent per annum during 1973–1992.[48] Domestic savings are high enough to bring this about without relying on foreign capital. Such a slowdown is to be expected with economic matu-

rity; it occurred, for instance, in post-war Japan, where growth averaged some 8 per cent until the early 1970s, falling to 4 per cent thereafter, before collapsing in the 1990s. Regarding reliance on domestic and external markets, the post-1990 experience of Japan, as well as the post-war experience of Western Europe, hold useful lessons. The Japanese experience highlights the problems associated with heavy reliance on export-oriented industrial growth. Striking a more balanced growth path in the Republic of Korea is unlikely to require as extreme a shift as faced by Japan, since investment opportunities to strengthen competitiveness are still available, given the productivity gaps which exist with industrial economies. Even so, a strategy of greater reliance on domestic markets with stronger social dimensions, of the kind that underlined the successful experience of the Western European periphery during the Golden Age, offers a viable option. The elements of this experience are familiar: a rapid and parallel growth of real wages and productivity, strong growth in domestic demand, including rising public expenditures largely financed by taxation, and increased intraregional trade.[49] Emulation of this experience in the Republic of Korea should perhaps include a rise in the wage share, associated with a reduction in working hours, and an increase in public expenditure on health and education. Since the savings ratio was already very high prior to the crisis, and even allowing for a lower savings ratio over the coming decade as the wage share rises, there should be ample room to raise investment from the crisis levels without relying on foreign capital of the kind which distorted economic development prior to the crisis. A larger domestic market would also stimulate the wider adaptation of new information and telecommunications technologies, which appear to have high social returns. Although, this new investment dynamic would be consistent with closer regional ties, growth could actually be less dependent on foreign markets than in the past.

The position of the second-tier NIEs is somewhat different because the opportunities for catch-up are greater and their external linkages are likely to remain stronger. Their productivity gap with industrial countries is similar to the kind of gaps facing the first-tier NIEs in the early 1970s, and annual growth rates over the next two decades of some 7 per cent may not be unrealistic targets for these countries. At such low levels of income and labour productivity, they are unlikely to suffer from a rapidly diminishing return to capital, so that with a relatively high rate of accumulation they could attain considerable growth in labour productivity and per capita income. With domestic savings ratios over 30 per cent, heavy reliance on foreign savings would not be necessary. With abundant labour (much of it still employed in agriculture, where productivity levels are relatively low) and natural resources, there is considerable scope for structural change away from low-productivity sectors, which could lead to a considerable increase in overall labour productivity. New investment will be needed to upgrade manufacturing activities, including in more technology-intensive sectors, where import dependence is very high, and to ensure that a higher share of value-added from manufactured exports is retained in the domestic economy. In countries such as Malaysia, this would be consistent with a significant reduction in the share of imports in GDP as the domestic value-added content of exports increases. This healthier integration into the global trading system would also be consistent with an emphasis on capital formation in areas such as information infrastructure, transportation and training. Much of this investment would require rising public expenditures. Given the way in which high-tech sectors are organized internationally, industrial, trade and financial policies would be required that bring about the desired growth through a conscious effort by policy makers to direct and coordinate foreign and domestic investments and to develop local technological skills.[50] Thus, contrary to the mainstream view, renewing catch-up in the second-tier NIEs would still require the involvement of a developmental State, albeit with new, and in some respects even more demanding, policy agendas. ■

Notes

1 Compare, for example, the actual growth rates for 1999 in table 2.1 above with the earlier projections given in table 1.4 of *TDR 1999*.

2 For a fuller analysis of the crisis see *TDR 1998, Part One*, chap. III; and for a more recent account see Akyüz Y, Causes and sources of the Asian financial crisis, paper presented at the Host Country Event: Symposium on Economic and Financial Recovery in Asia, UNCTAD X, Bangkok, 17 February 2000.

3 Ministry of Finance and Economy, the Republic of Korea's crisis resolution and its policy implications (final draft), G-20 Report, Seoul, December 1999: 18.

4 See Choi, Nakgyooon and Du-Yong Kang, A study on the crisis, recovery and industrial upgrading in the Republic of Korea, chapter eleven, in Divor-Frécaut D, Colaçon F and Hallward-Driemeier M, eds., *Asian Corporate Recovery. Findings from Firm-level Surveys in Five Countries*, Washington, DC, World Bank, April 2000.

5 For the case of Mexico see, e.g., *Safeguarding Prosperity in a Global Financial System*: *The Future International Financial Architecture*, Report of an Independent Task Force, Council on Foreign Relations, New York, November 1999: 31 (www.foreignrelations.org/public/pubs/IFA TaskForce.htm).

6 This collateral effect was subsequently recognized by IMF: "These [trade and current account] surpluses will help countries to reconstitute their depleted foreign exchange reserves and thereby restore the confidence of investors in the ability of the authorities to meet normal demands for foreign exchange" (IMF, *World Economic Outlook*, Oct. 1998: 38).

7 For a summary of changes in the contents of the IMF programme during 1997–1998 see Ha-Joon Chang and Chul-Gyue Yoo, The triumph of the rentiers: The 1997 Korean crisis in a historical perspective, Paper presented at the Workshops on the World Financial Authority, Centre for Economic Policy Analysis, New School University, New York, 6–7 July and 20–21 November 1999, table 3.

8 For a relatively up-to-date account of the evolution of various macroeconomic variables in the East Asian recovery process see Asian Development Bank, *Asia Recovery Report: May Update*, Manila, May 2000. Unless otherwise stated, the figures for various policy and performance indicators used here are from that source.

9 According to a survey among Korean firms, local lenders were considered even more restrictive than foreign banks (Choi and Kang, op. cit.: 17).

10 IMF, op. cit.: 41–42.

11 See *OECD Economic Outlook*, Dec. 1999: 96.

12 IMF News Brief No. 00/27, IMF completes final review of Thai Program, 8 May 2000.

13 IMF, *World Economic Outlook*, Oct. 1999, table 2.7. It was not, however, indicated to what extent the expected recovery in private investment would come from a replenishment of inventories and to what extent from fixed capital formation.

14 Most of these episodes were examined in past issues of *TDR*. For the crisis in the Southern Cone see *TDR 1998*, Part One, annex to chapter III; in Mexico and Argentina in 1994–1995, see *TDR 1995*, Part Two, chap. II; see also the discussion of the Brazilian crisis in *TDR 1999*, chap. III.

15 See *TDR 1998*, Part One, chap. III.

16 The date of the beginning of the cycle (the base period) does not change whether one uses net capital inflows (that is, net acquisition of domestic assets by non-residents) or net flows (inclusive of net acquisition of foreign assets by residents). For the definition of these concepts see *TDR 1999*, box 5.1.

17 ECLAC, *Equity, Development and Citizenship*, LC/G.2071(SES.28/3), Santiago, Chile, March 2000: 224.

18 During the boom phase of the cycle it was only in the Republic of Korea, among these four countries, that the divergence between the growth rates of the dollar wages and real wage costs (i.e. nominal wages deflated by the index of wholesale prices) was not large; the cumulative increases from the base to the peak were 114 and 104 per cent, respectively. The corresponding figures were 59 per cent and 44 per cent in Indonesia, and 117 per cent and 34 per cent in Thailand.

19 Industrial employment declined during 1992–1994 in Argentina and 1990–1994 in Brazil and Mexico, while the share of informal employment rose in all three countries; see Amadeo EJ, The knife-edge of exchange-rate-based stabilization: Impact on growth, employment and wages, *UNCTAD Review 1996*, United Nations publication, sales no. E.97.II.D.2, New York and Geneva, 1996. Using a broad sectoral classification, ECLAC estimates that urban informal employment rose from 44 per cent of the total in 1990 to 58 per cent in 1998 (ECLAC,

op. cit., figure 5.1). According to ILO data, manufacturing employment declined by 5 per cent and 8 per cent during the early 1990s in Argentina and Mexico, respectively, and by 10 per cent from 1990 to 1997 in Brazil.

20 In Chile, on the other hand, real wages were on an upward trend from 1975 onwards, but the immediate post-Allende data are not available.

21 This view is shared in almost all recent World Bank publications on the East Asian crisis. See also Diwan I, Labor shares and financial crises (preliminary draft), Washington, DC, World Bank, November 1999. By contrast, according to another study, "incomes of the poor do not fall more than proportionately during economic crises"; see Dollar D and Kraay A, Growth is good for the poor (preliminary draft), March 2000 (www.worldbank.org/research). Studies on income distribution by the UNCTAD secretariat show that the economic crisis beginning in the early 1980s was associated with a rise in the share of the top 20 per cent at the expense of middle classes rather than the poorest 20 per cent. It was also noted that crises could generate a process of "equalizing downwards" in rural economies in Africa, but it is not clear if such results could be generalized to emerging markets facing sharp declines in output due to financial crises; see *TDR 1997*, Part Two, chap. III.

22 However, with the exception of Indonesia, agriculture provided little buffer; see Poapongsakorn N, Agriculture as a source of recovery?, Bangkok, Thailand Development Research Institute, 1999; and World Bank, *Global Economic Prospects and the Developing Countries 2000*, Washington, DC, Dec. 1999: 54.

23 See Asian Development Bank, *Asian Development Outlook 2000*, Manila, 2000: 51; World Bank, *East Asia: Recovery and Beyond*, Washington, DC, 2000: 117–119; and Clerissi G, L'impact de la crise sur le marché du travail en Thailand, mimeo (Les Notes des Postes d'Expansion Économique), Bangkok, Nov. 1998.

24 Data of the National Statistical Office of the Republic of Korea. See also Jong-Il You and Ju-Ho Lee, Economic and social consequences of globalization: The case of South Korea, Working Paper no. 17, New York, Centre for Economic Policy Analysis, New School University, February 2000. Although the official unemployment figure in the Republic of Korea for mid-1999 was around 1.5 million, the Korean Confederation of Trade Unions (KCTU) puts it at 4 million, taking into account workers discouraged from seeking employment.

25 These estimates are from World Bank, *Global Economic Prospects and the Developing Countries 2000*, Dec. 1999, table 2.2. Different estimates for Thailand are given, for example, by Siamwalla A and Sobchokchai O (*Responding to the Thai Crisis*, UNDP Working Paper, Bangkok, May 1998).

26 World Bank, op. cit, table 1.8a. See also World Bank, *East Asia: Recovery and Beyond*, table 1.2.

27 ECLAC, op. cit.: 66. The number of households living below the poverty line in Latin America rose from 35 per cent to 41 per cent from 1980 to 1990, rising in all countries except Chile (ECLAC, *The Equity Gap, Latin America, the Caribbean and the South Summit*, LC/G.1954(CONF.86/3), Santiago, Chile, March 1997, table 1.2). The ratio had declined during 1990–1997, but at 36 per cent it was higher in 1997 than in 1980. During this period the share of the poor rose in both Mexico and Venezuela. On the other hand, in 13 Latin American countries for which data for the same period are available, the Gini coefficient rose in nine and declined in four (ECLAC, *Equity, Development and Citizenship*, March 2000, chap. 2, sect. 3(c)).

28 World Bank, *East Asia: Recovery and Beyond*, 2000, table 5.1 and figure 5.2.

29 See *TDR 1999*, chap. IV.

30 World Bank, *East Asia: From Recovery to Sustained Growth. An Update*, March 2000. The persistence of a high rate of employment despite recovery has been explained, in part, by policy measures to increase the degree of labour market flexibility (Asian Development Bank, *Asian Development Outlook 2000*: 50–51).

31 For a similar conclusion, see Diwan, op. cit.

32 World Bank, *Global Economic Prospects and the Developing Countries 2000*: 54.

33 Under the Bank's first scenario, per capita income growth would reach 4.0 per cent per annum, but inequality would increase by 10 per cent, and there would still be 58.3 million people in East Asia living below $1 per day in 2008, compared with 55.1 million in 1998 (ibid.: 28–36). "Inclusive growth" assumes an annual per capita growth rate of 4.9 per cent, compared to actual growth in East Asia of 5.2 per cent per annum in 1965–1973, 4.7 per cent in 1973–1980 and 6.3 per cent in 1980–1989. On this basis, the World Bank estimates that 18 million people would still be living on less than $1 a day by 2008.

34 Chang and Yoo, op. cit.: 32–33.

35 One explanation is the fact that household surveys on income disregard relative price changes in countries (such as Indonesia) where the poor faced significantly higher inflation than the rich. Another is that household surveys undertaken in 1998 included questions about household incomes during the preceding year (i.e. 1997) and therefore failed to capture the full impact of the crisis. On these empirical issues, see World Bank, *East Asia: Recovery and Beyond*, 2000:114-116.

36 See Crafts N, *East Asian Growth Before and After the Crisis*, IMF Working Paper, WP/98/137, Washington, DC, Sept. 1998; IMF, *World Economic Outlook*, Oct. 1998, chap. III; and World Bank, *East Asia: Recovery and Beyond*, op. cit., chap. 7.

37 World Bank, op. cit.: 144–146.

38 On various empirical estimates of TFP growth see Singh A, The causes of fast economic growth in East Asia, *UNCTAD Review 1995*, United Nations

publication, sales no. E.95.II.D.23, New York and Geneva, 1995: 95–99; and Crafts, op. cit.

39 World Bank, *The East Asian Miracle*, New York, Oxford University Press for the World Bank, 1993: 54.

40 Crafts, op. cit., particularly tables 11 and 14.

41 See Akyüz Y, New trends in Japanese FDI: Post-industrial transformation and policy challenges, in Kozul-Wright R and Rowthorn R, eds., *Transnational Corporations and the Global Economy*, London, Macmillan, 1998.

42 See World Bank, op. cit.: 52–53.

43 See *TDR 1998*, Part One, chap. III; and Akyüz Y, Causes and sources of the Asian financial crisis, paper presented at the Host Country Event: Symposium on Economic and Financial Recovery in Asia, UNCTAD X, Bangkok, 17 February 2000, and the references therein.

44 For a discussion of these issues see Akyüz Y and Cornford A, Capital flows to developing countries and the reform of the international financial system", UNCTAD *Discussion Paper*, no. 143, Geneva, Nov. 1999.

45 For a discussion of some of these pressures, see *TDR 1996*, Part Two, chap. II; Bank for International Settlements, *68th Annual Report*, Basle, 1998: 33–38; Grilli E, The Asian crisis: Trade and trade policy consequences, Buenos Aires, Latin American Trade Network, FLACSO, 1999; Maizels A et al., The manufactures terms of trade of developing countries with the United States 1981–97 (mimeo), Queen Elizabeth House, University of Oxford, March 2000. On the specific details of the Korean electronics sector see Kaplinsky R, 'If you want to get somewhere else, you must run at least twice as fast as that!' The roots of the East Asian crisis (mimeo), Institute of Development Studies, University of Sussex, Brighton, United Kingdom, June 1998.

46 See Asian Development Bank, op. cit.: 4; and JP Morgan, Savings and investment in the crisis economies, *Global Data Watch*, 28 April 2000. Excess capacity also remains a serious problem in some non-tradeable sectors such as real estate, which contributed up to half of overall fixed investment prior to the crisis.

47 See also ESCAP, *Economic and Social Survey of Asia and the Pacific 1998*, United Nations publication, sales no. E.98.II.F.59, Bangkok, 1998; Islam A, The dynamics of Asian crisis and selected policy implications, in Herman B, ed., *Global Financial Turmoil and Reform. A United Nations Perspective*, United Nations publication, sales no. E.99.III.A.8, Tokyo, United Nations University Press, 1999.

48 In Austria, Finland and Italy GDP per hour worked in 1950 stood at around 45 per cent and in the (then) Federal Republic of Germany at around 50 per cent that of Switzerland, the lead European economy in that year. Annual per capita real GDP growth rates in 1950–1973 were between 4 and 5 per cent.

49 See Marglin S and Schor J, eds., *The Golden Age of Capitalism: Reinterpreting the Postwar Experience*, Oxford, Clarendon Press, 1990.

50 See Lowe N and Kennedy M, Foreign investment and the geography of production: Why the Mexican consumer electronics industry failed, *World Development*, 27(8), 1999; Ostry S and Gestrin M, Foreign direct investment, technology transfer and the innovation-network model, *Transnational Corporations*, 2(3), Dec. 1993; and *TDR 1996*, Part Two, chap. II.