

## Occasional Paper 33 - Social Impacts of the Asian Crisis: Policy Challenges and Lessons

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# Social Impacts of the Asian Crisis: Policy Challenges and Lessons

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### Table of Contents

[Abstract](#)

[I. Introduction](#)

[II. Origins and Evolution of the Asian Crisis](#)

[III. Social Impact of the Asian Crisis and the IMF Program](#)

[IV. Policy Implications and Lessons from the Asian Crisis](#)

[V. Concluding Remarks](#)

[References](#)

### Abstract

This paper documents the social impacts of the financial crisis in Asia. We provide a general overview of the causes and the evolution of the crisis and highlight the differences as well as the similarities among the affected Asian countries. In particular, the impacts of the crisis on unemployment, real wage, poverty, and income inequality are analyzed using a cross-country data set, which consists of all the countries that have received financial assistance from the IMF over the period from 1973 to 1994. The stylized pattern of employment growth in previous IMF program countries indicates that employment growth is more sluggish in the recovery process compared with other macroeconomic variables. Hence, unemployment rates can remain high for a long period even after the crisis ends in the Asian countries. We also find that the crisis aggravates poverty for marginal groups of the population over a significant period, even though it does not bear a long-term effect on overall income distribution. Policy implications of our findings in building social safety nets in Asia are also discussed.

### I. Introduction

It has already been more than a year since the financial crisis which erupted in Thailand developed into the financial collapse in Asia. It has continued to deepen and broaden more than anyone anticipated. Its contagion has now spread to Latin America and Russia, and is currently making the global capitalist system come apart at the seams. This financial collapse in Asia was also followed by an economic and social collapse. Asian countries are now struggling to escape from the miseries of declining income, rising unemployment, and increasing poverty.

While there has been much recent research on the causes and the economic impact of the Asian crisis, its social impacts have been relatively neglected. To fill this discrepancy, this paper assesses the severity of the Asian crisis and its social consequences. For decades, Asian countries enjoyed high growth, low unemployment rates, relatively equal income distribution, and low crime rates. Therefore, compared with other crisis-hit countries, the social impacts of the crisis - such as rising unemployment and income inequality - have been felt more painfully in Asia and has led to disastrous social consequences. To make matters worse, most Asian countries have not yet developed a meaningful social safety net. This paper documents the social impact of the crisis in the most affected Asian countries, notably Indonesia, Korea and Thailand, and tries to draw policy implications.

Section II begins with a general overview of the cause and extent of the Asian crisis and highlights the differences as well as similarities among Asian countries. The key features of the Asian crisis are large inflows and sudden withdrawals of foreign capital. We review the extent of foreign capital inflows and outflows in these Asian countries and then analyze which factors caused the sudden change in foreign investors' confidence in these economies. The role of financial liberalization and globalization in the eruption of the crisis is closely examined. We also pay special attention to the role of International Monetary Fund (IMF) adjustment programs in handling the Asian crisis. In order to assess the economic and social impacts of the crisis and predict its future development, it is imperative to understand the IMF conditionality attached to its financial support for the Asian countries. Moreover, the IMF adjustment program in Asia is being severely criticized as the "same old belt-tightening adjustment" or "one-size-fits-all approach." The frequent emergency IMF bailouts have also been blamed for contributing to new moral hazards in international lending. To evaluate these criticisms, we review the general characteristics of IMF programs as well as the specific content of programs with Indonesia, Korea, and Thailand.

Section III analyzes the disastrous social impacts of the Asian crisis. We assess the current social impacts of the crisis in Indonesia, Korea and Thailand and then provide a prediction for its long-term development. To make a long-term prediction, the social impacts of the financial crisis are analyzed in a broad historical and international perspective. This paper consults the records of all countries that have experienced a currency crisis and received conditional financial assistance from the IMF during the period of 1973 to 1994. From this cross-country data we draw some stylized facts about the impacts of IMF programs on social variables such as unemployment, real wage, poverty, and inequality. Then we compare these stylized facts with the cases of the three most severely affected countries, namely Indonesia, Korea, and Thailand.

Our cross-country analysis shows some stylized patterns of the social impacts of the crisis. For example, we find that employment growth is more sluggish in the recovery process than other macroeconomic variables. This implies that unemployment rates can remain at a higher level for a long period after the crisis, even if output growth, inflation rates, etc., are restored to their pre-crisis level. We also find that the burden of the crisis is distributed unequally. It is the marginal groups such as the poor, the less experienced, the less-educated, women, and young workers who are most severely affected by the crisis. As a consequence, even though the crisis does not bear a long-term effect on overall income distribution, it definitely aggravates poverty for the victimized core group over a significant period. We think these findings have many important policy implications, especially for building social safety nets in these Asian countries during the crisis. Section IV and the conclusion of the paper discuss and summarize the policy implications of our study.

## **II. Origins and Evolution of the Asian Crisis**

Needless to say, the origins and the nature of the Asian crisis are multifaceted and the forms of evolution are significantly different among Asian countries. But they all share one common phenomenon: large-scale inflow of foreign capital and its sudden outflow. In evaluating various hypotheses for the origins of the Asian crisis, it is therefore important to understand what caused the sudden change of foreign investors' confidence in Asian countries. In section II.1, we first review the pre-crisis macroeconomic conditions of Asian countries to see whether they were so aggravated as to justify the sudden loss of foreign investors' confidence. In particular, macroeconomic policies such as fiscal, monetary, and exchange rate management before the crisis will be compared with those of Latin American cases in the 1980s. Section II.2 then examines in detail to what extent the globalization of international financial markets contributed to the changes in the amount and the structure of external liabilities of Asian countries. In this regard, we will try to highlight the differences as well as the commonality among Asian countries in the origins and the evolution of the crisis. After the crisis began, the highly infected countries – Thailand, Indonesia and Korea – requested IMF financial support and are currently under IMF adjustment programs. In Section II.3, we discuss the nature of IMF adjustment programs in general and the contents of the IMF policies for Indonesia, Korea, and Thailand, respectively.

### **II.1 Macroeconomic Conditions and Policies**

Table 2.1 shows the macroeconomic performance of selected Asian countries from the mid 1970s until the onset of the crisis. The first three sub-tables are for the worst-affected Asian countries; the other tables are for the less-affected countries. For comparison, the table includes Mexico and Argentina.

#### **Growth, Inflation, Unemployment and Macroeconomic Policies**

As can be seen in Table 2.1, Asian countries continued their solid growth performance throughout the 1990s. Except for Japan and Taiwan, their average real GDP growth rates during 1990-95 were higher than or at least comparable to their historical averages. It is

noteworthy that even the worst-hit countries – Indonesia, Korea, and Thailand – all experienced average growth rates well above 7% during this period.

The performance was equally impressive in terms of price stability. Except for China and the Philippines, the inflation rates of Asian countries in the 1990s were modest at least by developing-country standards and remained at a one-digit level. Even the inflation rates of China and the Philippines were quite low compared with the hyperinflation Mexico and Argentina experienced before their debt crises in the 1980s. We can also see that China and the Philippines enjoyed virtually full employment prior to the crisis; unemployment rates were less than 3% in these economies.<sup>1</sup> Understandably, the long period of full employment experience is making the current crisis harder to swallow for the workers in this region.

**Table 2.1**  
**Macroeconomic Performance before the Crisis**  
**Selected Economies in Asia and Latin America**

**Thailand**

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	7.0	8.1	9.0	11.6	8.1	8.2	8.5	8.9	8.7	5.5	-0.4
Inflation	9.0	3.1	5.0	6.0	5.7	4.1	3.4	5.1	5.8	5.9	5.6
UE	-	3.2	-	2.2	2.7	1.4	1.5	-	-	-	-
CA/GDP	-5.6	-3.2	-6.7	-8.3	-7.7	-5.6	-5.0	-5.6	-7.9	-7.9	-2.2
Saving	19.6	25.4	34.4	32.6	35.2	34.3	34.9	34.9	34.3	33.7	32.9
Investment	23.6	27.7	40.4	40.2	41.6	39.2	39.4	39.9	41.8	41.7	35.0
Export	14.7	17.6	18.9	14.9	23.2	14.2	13.2	22.7	25.1	-1.3	-
Budget	-5.8	-3.0	3.0	4.4	4.2	2.6	2.1	2.0	2.6	1.6	-0.4
Money	19.3	18.8	18.4	26.7	19.8	15.6	18.4	12.9	17.0	12.6	16.4

RE(US\$)	0.83	1.00	0.97	1	0.99	0.99	0.98	0.94	0.92	0.91	-
RE(Yen)	0.64	0.90	1.09	1	1.05	1.04	1.14	1.20	1.10	0.94	-

### **Indonesia**

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	6.2	5.5	8.0	9.0	8.9	7.2	7.3	7.5	8.2	8.0	5.0
Inflation	15.0	8.1	8.7	7.8	9.4	7.5	9.7	8.5	9.4	7.9	6.6
UE	-	2.6*	-	2.5	2.6	2.7	2.8	4.4	-	4.1	-
CA/GDP	-1.2	-3.5	-2.5	-2.8	-3.4	-2.2	-1.5	-1.7	-3.3	-3.3	-2.6
Saving	19.3	23.2	28.9	27.9	28.7	27.3	31.4	29.2	29.0	28.8	27.3
Investment	19.8	24.3	27.2	28.3	27.0	25.8	26.3	27.6	28.4	28.1	26.5
Export	16.0	0.8	12.7	15.9	13.5	16.6	8.4	8.8	13.4	9.7	-
Budget	-	-1.3	0.05	1.3	-	-1.2	-0.7	-	0.8	1.4	2.0
Money	29.3	27.0	24.9	44.6	17.5	19.8	20.2	20.0	27.2	27.2	-
RE(US\$)	0.45	0.84	0.97	1	1.00	0.99	0.95	0.94	0.92	0.91	1.70
RE(Yen)	0.35	0.77	1.08	1	1.06	1.04	1.09	1.19	1.11	0.94	1.56

### **Korea**

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	7.0	9.6	7.8	9.5	9.1	5.1	5.8	8.6	8.9	7.1	5.5
Inflation	17.6	3.8	6.6	8.6	9.3	6.2	4.8	6.3	4.5	4.9	4.5
UE	-	3.4	2.4	2.4	2.3	2.4	2.8	2.4	2.0	2.0	2.7
CA/GDP	-4.6	2.5	-1.4	-0.9	-3.0	-1.5	0.1	-1.2	-2.0	-4.9	-2.0

Saving	25.7	32.7	35.3	36.1	35.9	35.1	35.2	34.6	35.1	33.3	32.9
Investment	29.4	29.4	36.7	37.1	38.4	36.6	36.0	35.7	36.6	36.8	36.6
Export	22.8	16.7	12.6	4.2	10.5	6.6	7.3	16.7	30.3	3.7	5.0
Budget*	-	-	-0.4	-0.9	-1.9	-0.7	0.3	0.5	0.4	0.3	0.03
Money	30.0	16.8	17.5	17.2	21.9	14.9	16.6	18.7	15.6	15.8	14.1
RE(US\$)	1.02	1.16	0.99	1	1.01	1.02	1.03	0.97	0.93	1.00	1.97
RE(Yen)	0.79	1.03	1.11	1	1.08	1.07	1.19	1.23	1.12	1.03	1.80

### **China**

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	6.0	10.7	10.6	3.8	9.2	14.2	13.5	12.6	10.5	9.7	8.8
Inflation	2.1	9.0	9.9	2.1	2.7	5.4	13.0	21.7	14.8	6.1	1.5
UE	-	2.1	2.6	2.5	2.3	2.3	2.6	2.8	2.9	3.0	-
CA/GDP	0.7	-1.0	1.2	3.4	3.5	1.5	-2.7	1.4	0.2	0.9	2.4
Saving	39.3	35.2	39.7	38.1	38.3	37.7	40.6	42.6	41.0	42.9	40.8
Investment	21.3	29.5	32.0	25.5	27.5	31.2	37.5	36.0	34.7	35.6	35.8
Export	16.5	13.4	19.2	18.2	15.8	18.1	7.1	33.1	22.9	1.6	20.9
Budget	-1.0	-1.7	-2.0	-2.0	-2.2	-2.3	-2.0	-1.6	-1.7	-1.5	-1.5
Money	22.3	26.1	32.3	28.9	26.7	30.8	42.8	35.1	29.5	25.3	20.7
RE(US\$)	-	-	1.05	1	1.05	1.07	0.97	1.17	1.01	0.96	0.95
RE(Yen)	-	-	1.18	1	1.11	1.13	1.12	1.49	1.21	0.99	0.87

### **Hong Kong**

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	9.3	7.2	5.0	3.4	5.1	6.3	6.1	5.4	3.9	4.9	5.3
Inflation	8.6	6.7	9.3	9.7	11.6	9.3	8.5	8.1	8.7	6.0	5.7
UE	-	2.7	2.0	1.3	1.8	2.0	2.0	1.9	3.2	2.8	2.2
CA/GDP	1.9	8.3	4.5	8.9	7.1	5.7	7.4	1.6	-3.9	-1.3	-1.5
Saving	29.7	33.6	33.5	35.8	33.8	33.8	34.6	33.1	30.4	30.6	31.1
Investment	27.8	23.6	28	26.4	26.6	27.4	27.3	29.8	30.5	31.3	32.0
Export	18.0	20.1	15.6	12.3	20.0	21.2	13.2	11.9	14.8	4.0	4.0
Budget	1.5	1.6	1.6	0.7	3.2	2.5	2.3	1.1	-0.3	2.2	3.8
Money	-	-	-	-	-	8.5	14.5	11.7	10.6	12.5	8.8
RE(US\$)	-	-	0.86	1	0.93	0.89	0.83	0.79	0.74	0.72	0.70
RE(Yen)	-	-	0.96	1	0.99	0.94	0.96	1.00	0.89	0.75	0.64

### Japan

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	3.9	4.1	2.1	5.1	3.8	1.0	0.3	0.6	1.5	3.9	0.9
Inflation	6.6	1.4	1.7	3.1	3.3	1.7	1.2	0.7	-0.1	0.1	1.7
UE	-	2.6	2.5	2.1	2.1	2.2	2.5	2.9	3.2	3.3	3.4
CA/GDP	0.4	3.0	2.4	1.5	2.0	3.0	3.1	2.8	2.2	1.4	2.2
Saving	31.9	31.9	32.7	33.5	34.2	33.8	32.8	31.4	30.7	31.3	30.8
Investment	30.9	28.4	30.0	31.7	31.4	30.5	29.5	28.6	28.5	29.7	28.4
Export	10.4	10.4	8.4	5.0	9.5	8.0	6.6	9.6	11.6	-7.3	2.4
Budget	-4.0	-0.4	-0.05	2.9	2.9	1.5	-1.6	-2.3	-3.6	-4.3	-3.4

Money	10.7	9.2	3.1	8.2	2.5	-0.1	2.2	3.1	2.8	2.3	3.1
RE(US\$)	1.31	1.18	0.89	1	0.94	0.95	0.87	0.79	0.83	0.97	1.09
RE(Yen)	1	1	1	1	1	1	1	1	1	1	1

### **Malaysia**

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	7.1	5.4	8.8	9.6	8.6	7.8	8.3	9.2	9.5	8.6	7.8
Inflation	5.3	2.0	3.5	2.8	2.6	4.7	3.5	3.7	3.4	3.5	2.7
UE	-	7.3*	3.6	5.1	4.3	3.7	3.0	2.9	2.8	2.5	2.7
CA/GDP	-2.0	-0.7	-6.2	-2.1	-8.8	-3.8	-4.8	-7.8	-10.0	-4.9	-4.8
Saving	21.6	29.4	31.3	29.1	28.4	31.3	33.0	32.7	33.5	36.6	38.0
Investment	29.4	28.5	37.7	32.4	36.4	36.0	38.3	40.1	43.0	42.2	42.7
Export	15.0	12.0	19.9	17.4	16.8	18.5	15.7	24.7	26.0	5.1	-
Budget	-	-4.0	-0.3	-2.2	0.1	-3.5	-2.6	2.5	3.8	4.2	1.6
Money	20.2	9.2	19.3	10.6	16.9	29.2	26.6	12.7	20.0	25.3	17.5
RE(US\$)	0.68	0.86	0.96	1	1.01	0.95	0.98	0.92	0.89	0.88	1.34
RE(Yen)	0.53	0.78	1.07	1	1.07	1.00	1.13	1.16	1.06	0.91	1.23

### **Philippines**

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	5.6	1.1	2.3	3.0	-0.6	0.3	2.1	4.4	4.8	5.7	5.1
Inflation	11.0	15.4	10.8	12.7	18.7	8.9	7.6	9.0	8.1	8.4	5.1
UE	-	7.2	8.6	8.1	9.0	8.6	8.9	8.4	8.4	-	-



CA/GDP	-6.5	-0.3	-4.1	-6.1	-2.3	-1.6	-5.5	-4.6	-4.4	-4.7	-5.4
Saving	19.9	18.1	18.6	18.7	18.0	19.5	18.4	19.4	17.8	19.7	21.0
Investment	26.7	20.7	22.4	24.0	20.0	20.9	23.8	23.6	22.2	23.2	25.1
Export	11.9	7.2	14.9	4.0	8.7	11.2	13.7	20.0	31.6	16.7	22.9
Budget	-2.0	-2.8	-1.9	-3.5	-2.1	-1.2	-1.6	-1.6	-1.4	-0.4	-0.9
Money	20.5	21.4	21.5	22.5	17.3	13.6	27.1	24.4	24.2	23.2	26.1
RE(US\$)	0.68	0.91	0.78	1	0.84	0.74	0.79	0.65	0.67	0.63	0.94
RE(Yen)	0.53	0.81	0.87	1	0.89	0.78	0.91	0.83	0.80	0.66	0.86

### Singapore

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	8.0	6.9	8.7	9.0	7.3	6.2	10.4	10.5	8.8	7.0	7.8
Inflation	4.2	1.0	2.7	3.5	3.4	2.3	2.3	3.1	1.7	1.4	2.0
UE	-	3.8	2.4	1.7	1.9	2.7	2.7	2.6	2.7	3.0	2.4
CA/GDP	-8.8	1.8	11.9	8.3	11.2	11.9	7.2	16.0	16.8	15.7	15.2
Saving	33.4	42.0	46.9	44.1	45.4	47.3	44.9	49.8	50.0	50.1	51.9
Investment	38.2	38.1	33.8	31.8	33.3	35.6	35.0	33.6	33.3	36.5	35.4
Export	16.4	12.4	17.9	18.1	11.9	7.6	16.6	30.8	22.1	5.7	0.0
Budget	0.6	4.8	12.2	11.4	10.3	11.3	14.3	13.7	12.0	9.1	10.3
Money	16.2	12.5	12.1	20.0	12.4	8.9	8.5	14.4	8.5	9.8	10.3
RE(US\$)	0.93	1.07	0.92	1	0.94	0.96	0.94	0.85	0.83	0.84	1.01
RE(Yen)	0.72	0.96	1.03	1	1.00	1.01	1.09	1.08	1.00	0.87	0.92

### Taiwan

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	8.5	9.2	6.4	5.4	7.6	6.8	6.3	6.5	6.0	5.7	6.9
Inflation	8.6	1.2	3.8	4.1	3.6	4.5	2.9	4.1	3.7	3.1	1.1
UE	-	1.9	1.5	1.6	1.4	1.5	1.4	1.5	1.8	2.6	2.7
CA/GDP	1.6	12.9	4.3	6.8	6.9	4.0	3.2	2.7	2.1	4.0	2.3
Saving	30.2	35.0	28.2	29.3	29.5	27.8	27.7	27.1	28.0	28.0	27.9
Investment	27.8	20.4	22.8	22.4	22.2	23.2	23.7	22.9	22.9	21.0	21.0
Export	20.2	17.4	9.3	1.6	13.4	6.9	4.0	9.6	20.0	3.7	-
Budget	-	1.3	0.5	0.8	0.5	0.3	0.6	0.2	0.4	0.2	0.2
Money	22.3	24.4	15.0	10.5	19.7	19.6	15.5	15.2	9.6	4.7	-

**\*\* Latin America**

**Mexico**

	79-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	5.9	0.9	2.2	5.1	4.2	3.6	2.0	4.5	-6.2	5.2	7.0
Inflation	26.1	82.5	19.4	26.7	22.7	15.5	9.8	7.0	35.0	34.4	20.6
UE	-	-	-		2.2	-	2.4	-	4.7	3.7	-
CA/GDP	-5.1	1.00	-5.5	-3.2	-5.2	-7.4	-5.8	-11.1	-0.6	-0.6	-
Saving	34.4	24.3	19.6	21.7	20.3	18.9	17.0	17.1	22.7	23.4	-
Investment	23.7	18.6	18.7	18.4	19.2	20.5	18.6	19.3	16.1	17.2	-
Export	29.9	2.5	13.9	17.7	0.7	1.4	9.2	14.2	40.3	22.6	-
Budget	-4.5	-9.3	-0.4	-2.8	-0.2	1.5	0.3	-0.7	-0.6	-	-
Money	49.4	72.6	36.3	75.8	49.3	22.8	14.5	21.7	33.3	26.2	-

RE(US\$)	2.76	1.46	1.00	1	0.88	0.80	0.75	1.23	1.34	1.06	0.93
RE(Yen)	0.72	1.34	1.14	1	0.94	0.85	0.87	1.57	1.61	1.10	0.86

### Argentina

	75-82	83-89	90-95	90	91	92	93	94	95	96	97
Growth	0.2	0.0	4.9	-1.3	10.5	10.3	6.3	8.5	-4.6	4.2	8.4
Inflation	188.5	755.3	421.5	2314.	171.7	24.9	10.6	4.2	3.4	0.2	0.8
UE	-	5.3	10.5	9.2	5.8	6.7	10.1	12.1	18.8	18.4	-
CA/GDP	-1.0	-4.6	-1.1	3.7	-0.4	-2.4	-3.0	-3.6	-1.0	-1.3	-
Saving	32.8	21.9	17.2	19.8	16.3	15.1	16.4	17.4	18.1	17.4	-
Investment	26.1	18.5	17.0	14.0	14.6	16.7	18.4	20.0	18.0	17.6	-
Export	10.9	4.7	14.8	28.9	-3.0	2.1	7.2	19.4	33.9	13.6	-
Budget	-	-2.4	-0.4	-0.3	-0.5	-0.03	-0.6	-0.7	-0.5	-1.8	-
Money	-	-	230.0	1113	141.3	62.5	46.5	17.6	-2.8	18.7	-
RE(US\$)	-	3.24	0.63	1	0.69	0.56	0.53	0.52	0.52	0.53	-
RE(Yen)	-	3.27	0.70	1	0.73	0.59	0.61	0.66	0.62	0.55	0.50

Note:

1. UE of 1983-1989 for Indonesia and Malaysia is calculated using only data for 1985-1989.
2. Budget data for Korea is a consolidated central government budget.
3. UE of 1983-1989 for Taiwan is calculated using data for 1980-1989.
4. In Mexico and Argentina, CA/GDP was calculated using data for 1977-1982.
5. In Mexico and Argentina, the saving rate was calculated using only private consumption data for 1977-1982.
6. In Argentina, investment was calculated using data only for 1978-1982.

Sources and Definition of Data:

Growth rate: real GDP growth rates, *World Economic Outlook* (IMF).

Inflation: CPI inflation rates, *World Economic Outlook*.

UE: Unemployment rates, *Yearbook of Labor Statistics* (ILO), *International Financial Statistics* (IMF).

CA/GDP: Current Account Balance over GDP, *World Economic Outlook*.

Saving: Private saving rates, *World Economic Outlook*.

Invest: Investment rates, *World Economic Outlook*.

Export: growth rates of export revenue in U.S. dollar terms, *International Financial Statistics*.

Budget: General government fiscal balance over GDP: *World Economic Outlook*.

Money: M2 growth rates (end of year), *World Economic Outlook*, *International Financial Statistics*.

RE: Real exchange rates based on CPI (end of year), *International Financial Statistics* (1990=100).

Data for Latin American countries are from *International Financial Statistics*.

Monetary and fiscal policies have been conservative, too. The growth rates of M2 during the 1990s were in line with their historical averages in the Asian countries, and incomparably lower than those of Mexico and Argentina. The absence of high inflation is indirect evidence of the discipline of monetary policies. Fiscal stance was in general, prudent. Only China and the Philippines incurred persistent fiscal deficits during the 1990s, but the magnitude was very modest at less than 2% of GDP. Note that Thailand, where the Asian crisis first erupted in July 1997, maintained a fiscal surplus every year in the 1990s.<sup>2</sup> This is in sharp contrast with the Latin American debt crisis in the early 1980s. One of the key features of the Latin American debt crisis was the mismanagement of macroeconomic policies – large budget deficits and consequent monetary expansion.<sup>3</sup> To the contrary, the current Asian crisis was definitely not a result of profligate fiscal and monetary policies.

### **Current Account and Exchange Rate Management**

In fact, a sign of disequilibrium is evident only from the behavior of current account balances. The three worst-affected countries – Thailand, Indonesia, and Korea – along with Malaysia and the Philippines, incurred current account deficits persistently in 1990s. In Indonesia and Korea, the size of the current account deficits was modest, but in Thailand and Malaysia, they were well above 5% of GDP. In hindsight, it is hard to deny that the sizable current account deficits contributed to undermining foreign investors' confidence. However, there was good reason to underestimate their significance prior to the crisis. As presented in Table 2.1, these countries were maintaining very high private savings rates and even higher investment rates. The current account deficits during this period reflected shortfalls in savings relative to investment, instead of private or public dissavings.<sup>4</sup> High growth performance in the past decades had taught the Asian people to believe that investment is a virtue and that the current account deficits caused by the investment boom should not ring an alarm. Moreover, as will be explained later, the growing current account deficits in some countries in 1996 were mainly due to country-specific shocks such as the drastic fall in international prices of export items such as semi-conductors, consumer electronics, and petrochemical products.<sup>5</sup> Since the sharp drop of export prices was regarded as temporary, the current account deficits were expected to quickly improve.

The sizable current account deficits in these Asian countries led many to suspect the possibility of mismanaged exchange rates. In fact Dornbusch, Goldfajn, and Valdes (1995) argue that an overvalued peso played a most important role in the Mexican crisis in 1994. However, it is controversial whether the currencies in the Asian countries were significantly overvalued prior to the crisis. Most of the Asian countries effectively pegged their currencies to the U.S. dollar. When the dollar weakened in 1990 and 1995, they all depreciated together with the dollar vis-à-vis the European currencies and the Japanese yen. Conversely, when the dollar appreciated markedly against the yen in mid-1995, they all appreciated sharply against the yen. This pattern can be confirmed in Table 2.1 from the behavior of real exchange rates. The Table reports two real exchange rates - one against the U.S. dollar and the other against the Japanese yen.<sup>6</sup> Between 1990-96 in most Asian countries, real exchange rates against the

U.S. dollar did not change much. But the real exchange rate against the yen depreciated slightly before 1995 and then sharply appreciated beginning in 1995.

In order to judge the extent of overvaluation, we have to look at real exchange rates in trade-weighted terms. However, Table 2.1 shows that the extent of overvaluation in each currency was not large either against the dollar or the yen during the 1990s.<sup>7</sup> For example, prior to its crisis in 1994, the Mexican peso was about 20% and 13% overvalued against the dollar and the yen. However, except for Hong Kong and the Philippines, no Asian country in the Table shows a comparable degree of overvaluation. Therefore, even without estimating trade-weighted real exchange rates, we can conjecture that the real exchange rates in the Asian countries were only mildly overvalued prior to the crisis.<sup>8</sup>

If their exchange rates were not too overvalued, why did export growth in the Asian countries (except the Philippines) begin to slow down in the mid-1990s and then drop sharply in 1996? For example, Thailand's export revenue actually fell by 1% in 1996 after two years of high growth in excess of 20%. In Korea, the growth rates of export revenue changed from 30% to 4% between 1995 and 1996. Several factors contributed to the loss of international competitiveness:

- the devaluation of the Chinese yuan in January 1994;
- added competitive pressure from Mexico after NAFTA and the peso devaluation;
- a decrease of import demand coupled with the downturn in Europe and Japan;
- the world-wide glut and sharp fall of the electronics market (particularly for Korea, Malaysia, and Singapore);
- slow growth in the Asian region itself – including China, Malaysia, and Thailand – after introducing policies to cool down overheating asset markets.

But it is important to remember that currency overvaluation was not a major factor in the loss of international competitiveness prior to the Asian crisis.

### **Policy Mistakes in Handling the Crisis<sup>9</sup>**

We argued that unlike the Latin American countries in the early 1980s, Asian countries had not mismanaged macroeconomic policies prior to the crisis. Fiscal and monetary policies were conservative and the exchange rates were not extremely overvalued. However, this does not imply that the economic policy makers in these Asian countries were not responsible for the current crisis. In fact, by committing a series of policy mistakes in coping with the crisis in 1997, they unnecessarily aggravated the situation and completely lost reputations built on a history of prudent economic management. Among the series of policy mistakes, the crucial ones include their mal-handling of foreign reserves and domestic bankruptcy problems on the eve of the crisis; their unprofessional performance in negotiating with the IMF adjustment program; and inexperience in implementing economic policies within a global context. The followings are examples of each category.

(1) On the eve of each crisis, when their foreign currency reserves were quickly drying out, the Indonesian, Korean, and Thai governments did not recognize the seriousness of the

problem and wasted a substantial part of foreign reserves in futile foreign exchange market interventions. Such intervention swiftly depleted the official reserves, which in turn started a vicious circle of impairing foreign investor confidence and accelerating capital outflows. It also contributed to the loss of policy credibility and transparency. For example, in early November 1997, Korea's central bank announced that its reserves were around \$30 billion, but foreign investors estimated that actual usable reserves could be as low as \$15 billion, worth only five weeks of imports and only a fifth of Korea's short-term debt. They correctly understood that the announced numbers did not include dollars borrowed in forward market intervention and recalled that Thailand had committed as much as two-thirds of its reserves in that way.

(2) As the symptoms of the crisis developed in early 1997, foreign credit lines to these Asian countries started to decrease or terminate. To restore foreign investor confidence, the Thai and Korean governments pledged they would guarantee the foreign liabilities of domestic financial institutions and bail out troubled private banks. Despite its naïve intention, it was a crucial policy mistake that paved the way for a private banking crisis and then led to a sovereign crisis. This announcement made the previous distinction between sovereign and private problems less clear, and foreign investors began to seriously evaluate the potential fiscal cost in restructuring troubled private sectors.

(3) After the crisis broke out, an unwise and unnecessary discord with the IMF significantly undermined foreign investor confidence and aggravated the situation. Local news media described the IMF not as a counterpart for cooperation but as an invading army. In Korea, presidential candidates placed advertisements in newspapers vowing to renegotiate the IMF rescue pact if elected. In Indonesia, the disagreement over the currency board proposal struck a further blow to deteriorating foreign investor confidence. The economic difficulty was compounded by political uncertainty since the crisis happened during a politically unfortunate time. The three most-affected countries – Indonesia, Korea, and Thailand – all faced general elections during this period, which delayed or made it impossible to implement necessary policy actions.<sup>10</sup>

(4) One example that shows the lack of global economy experience was the Korean government's decision to raise \$US 2 billion just one week after signing the \$US 55 billion IMF package. After signing the package, the government thought that the confidence problem was alleviated and tried to raise new capital through Korea Development Bank's bond sales. Contrary to the government's intentions, the timing of the bond sales surprised foreign investors. They regarded it as a sign of desperation and speculated that the Korean situation was much worse than they had expected. As investors balked at the bond sales and the yield spread increased by more than 200 basis points, the Korean government withdrew its sales plan. But it had already made the market more skeptical about the government's ability to handle the crisis.

In sum, considering the nature of the crisis, one may not criticize Asian policymakers for not being able to prevent the crisis. But we think they are without doubt responsible for unnecessarily aggravating situations by committing a series of policy mistakes in handling the crisis.

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1. It is widely recognized that unemployment statistics in these countries are considerably underestimated. Discouraged workers and the underemployed in informal sectors still account for a large portion of the population. In fact, employment growth rates in these countries were less impressive compared with their unemployment rates.
2. In the cases of Korea and Malaysia, extrabudgetary and quasi-fiscal operations account for a large proportion of public finance so that true fiscal positions were not as tight as the official statistics suggest. For example, in Korea, Cho and Rhee (1995) find that the estimated fiscal deficits were on average twice as large as the announced figures when extrabudgetary special funds and public enterprise operations were included in measuring fiscal balances.
3. Unlike their earlier experience, the fiscal conditions in Mexico and Argentina were healthy during the 1990s.
4. This fact is in sharp contrast with the Mexican crisis that erupted in late 1994. In Mexico, the large current account deficit before the crisis was largely the result of sustained increases in private consumption. See IMF (1997b, pp10-11).
5. For example, Korea's export price index fell by 13% in 1996 alone.
6. The estimated real exchange rates are based on consumer price indices. The rates are normalized so that the 1990 value is equal to 1. A decrease in the index indicates real appreciation of the currency concerned.
7. We are implicitly assuming that the 1990 rate is an equilibrium value, as in Radelet and Sachs (1998b)
8. In fact, the trade-weighted real exchange rates in IMF confirm the same conclusion. See IMF (1998, p8). Redelt and Sachs (1998b) estimate that the real exchange rates appreciated about 25% between 1990 and early 1997 in the crisis-hit Southeast Asian countries. But they conclude that the real appreciations in Asia were relatively modest compared with Brazil and Argentina who have seen real appreciations of more than 40% since 1990.
9. For more detailed information, refer to Park and Rhee (1998).
10. Thailand held a general election in November 1996. Korea and Indonesia held presidential elections in December 1997 and March 1998, respectively.