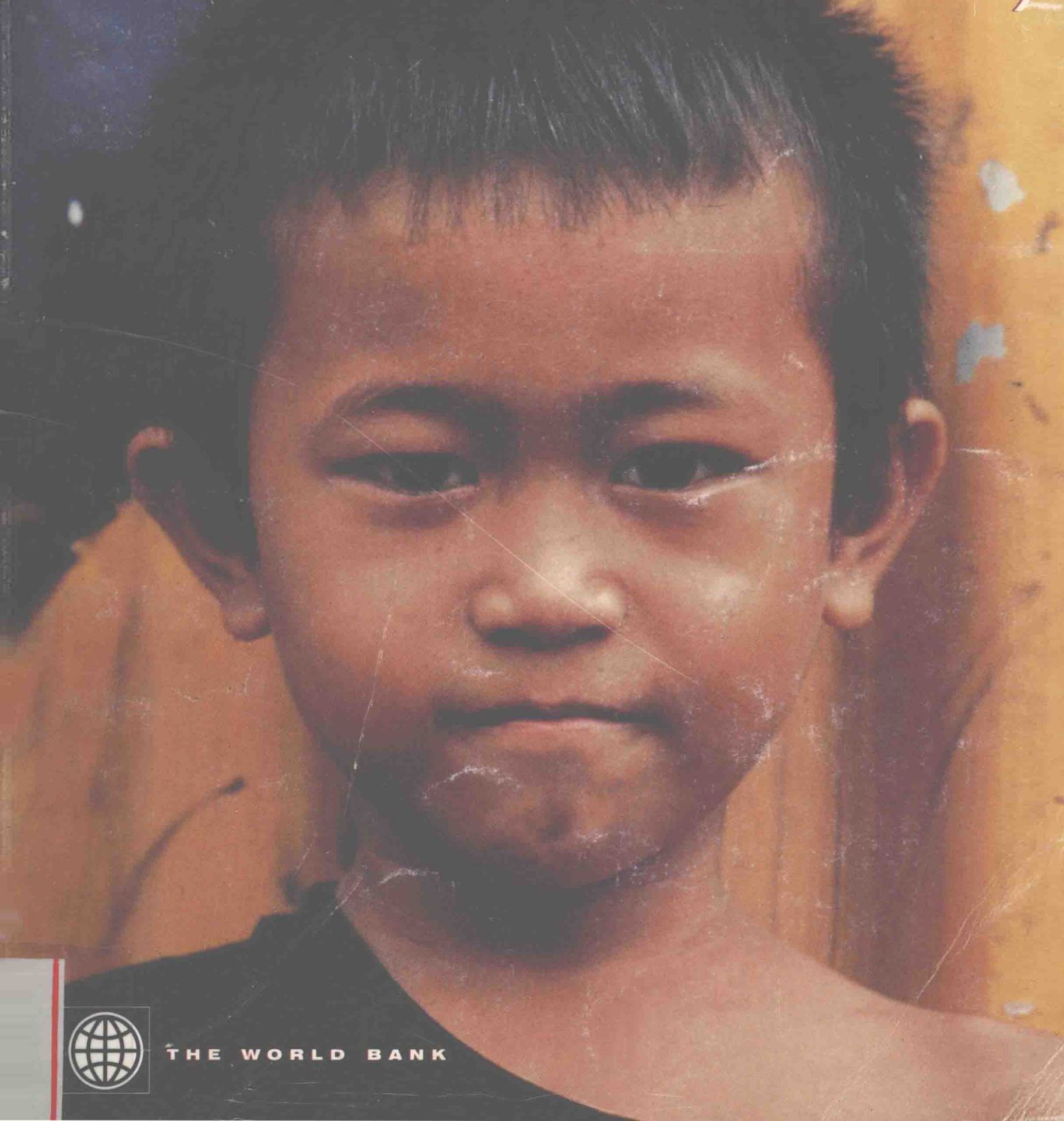


East Asia

The Road to Recovery



THE WORLD BANK



EAST ASIA:

THE ROAD TO RECOVERY



THE WORLD BANK
WASHINGTON D.C.

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Abbreviations and Acronyms

AMC	Asset Management Company
APEC	Asian Pacific Economic Cooperation
ASEAN	Association of South East Asia Nations
BIBF	Bangkok International Banking Facility
BIS	Bank of International Settlements
CAMELOT	Capital, Assets, Management, Earnings, Liquidity, Operating Environment And Transparency
CD	Certificate of Deposit
CPI	Consumer Price Index
DIP	Debtor-In-Possession
East Asia 5	Thailand, Korea, Indonesia, Malaysia, The Philippines
EU	European Union
FDI	Foreign Direct Investment
FIDF	Financial Institutions Development Fund
FRA	Financial Restructuring Authority
GDP	Gross Domestic Product
GEP	Global Economic Prospects
GNP	Gross National Product
IBRA	Indonesia Bank Restructuring Agency
IMF	International Monetary Fund
KAMCO	Korean Asset Management Company
LPG	Liquefied Petroleum Gas
NBFI	Non-bank Financial Institutions
NEP	New Economic Policy
NGO	Non-governmental Organization
NIE	Newly Industrialized Economies
OECD	Organization For Economic and Cooperation Development
R&D	Research and Development
SET	Stock Exchange of Thailand
SITC	Standard Industrialized Trade Classification
TFP	Total Factor Productivity
TRIS	Thai Ratings and Information Services Co., Ltd.



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Foreword

One year after it began, the economic storm in East Asia is still gathering momentum. The crisis has spread to financial markets around the world and now poses risks to the global economic expansion. Within East Asia, recession threatens to erode the remarkable achievements of East Asia's economic development. Some 370 million people were lifted out of poverty in the two decades after 1975. This is an accomplishment that in all likelihood will withstand even the gale force of this crisis, but there is no question that for tens of millions life will be much worse in the next few years. Deep recession has exposed millions of children to hunger, deprived parents of the means to support their families, and even triggered sporadic ethnic violence in some countries.

The depth of the crisis portends an enduring loss in human potential that will echo for years after this crisis has passed. Children are dropping out of school at an alarming rate. In Indonesia, for example, government officials report that enrollments are down from 78 percent to 54 percent. Economic pressures have forced countless families to split up, pushed teenage girls to enter prostitution, and put elderly poor into life-threatening privation.

For the crisis countries, it will take some time to recover the level of income they previously enjoyed. But how long? Will the region suffer a Latin American-like "lost decade" or will it begin to bounce back next year? The standard of living of a whole generation hangs on the answer to these questions.

In some respects, East Asia's downturn is unique. It has fused a currency crisis, banking crisis, and a regional financial panic into a particularly virulent strand of economic malady. To be sure, its components are well known: credit booms and asset price bubbles associated with poor financial regulation, or financial panics driven more from the herd instincts of investors responding to an isolated and random event rather than underlying fundamentals. Even the well regulated developed countries have experienced these problems. What sets East Asia apart is the harshness and magnitude of its combination of problems: a serial speculative attack on a regional group of countries, provoking

massive capital outflows, simultaneous crises, and recession for a whole region.

It is obviously too soon to provide a definitive review of a drama that is still unfolding. Our objectives in this report were more modest: to take stock of progress in the region, highlight the factors shaping East Asia's future, and suggest broad directions of policies.

The main challenge is to restore broadly shared and sustainable economic growth. The report focuses on a three-pronged strategy:

- *reactivating growth* based upon structural reforms that will allow recovery to take hold sooner and make it enduring;
- *protecting the poor* during the crisis and ensuring they will share in recovery when it comes; and in
- *mobilizing capital* to help jump-start economic growth.

The hard work of implementation lies ahead.

The World Bank's Support

In each country of the region, the World Bank is working in tandem with governments to realize this three-part strategy. The World Bank has pledged nearly \$18 billion to the East Asia crisis countries and disbursed over \$8 billion in loans in the year since July 1997.

Reactivating growth on the basis of structural reforms is a high priority. The World Bank is helping governments to increase their spending in efficient ways, especially social spending. It has approved 45 major loans to the region in the first year after the crisis. The World Bank has thus helped to finance a more expansionary fiscal position, and the resulting demand will in turn help to create jobs and income. Our focus has not only been on the amount of spending but, even more important, on the *quality of spending*. In preparing and supervising these loans, the World Bank has provided policy advice and technical assistance, a dialogue that is supplemented with a steady stream of economic studies, public expenditure reviews, and conferences involving partners from the private sector and Non-governmental organizations (NGOs). Through its multi-billion dollar structural adjustment programs in Thailand, Indonesia, the Republic of Korea, and the Philippines, for example, the World Bank is helping governments to improve financial sector regulation and

supervision while it also helps these governments restructure their banking and corporate sectors. This also means improving corporate and financial disclosure, better management of debt and contingent liabilities, and implementing legal and regulatory reform. Through its project lending, especially to infrastructure, the World Bank is intensifying dialogue to instill environmental safeguards that address the environmental and natural resource problems exacerbated by the crisis. These efforts contribute to the restoration of growth, and growth that can be sustained.

To *protect the poor*, unemployed, and elderly from the social impacts of the crisis, the World Bank has supported basic health, education, targeted food subsidies, and labor-intensive and employment-generating public works. Social fund projects and stay-in-school programs have been introduced in Indonesia and Thailand, and improvements to social safety nets (including labor market, pension reform, delivery of social services, poverty targeting) have been developed in other countries. Over the long-term, the World Bank is working toward improving the social and human sustainability of growth to address the social shortcomings of East Asian development—growing inequality and lack of formal social safety nets such as healthcare and unemployment insurance—while protecting and reinforcing the region's social successes—education, health, and quality of life improvements.

The Bank is redoubling its efforts to *mobilize external resources* for the region. Arguably the World Bank's most important contribution is not in the capital it provides but in helping the region regain the confidence of domestic and foreign investors through sound policies. Restoring confidence in the future is the secret to attracting new capital inflows. Often there is a lag between the time sound policies are adopted and the return of market confidence. The World Bank intends to play a leadership role in mobilizing capital during this period. It will increase its own lending up to the limits of its own prudential regulations as long as the pace of domestic policy reforms warrants. Beyond this, in conjunction with other partners—the International Monetary Fund, the Asian Development Bank, governments, and the private sector—the World Bank will be looking for new ways to mobilize capital to help jump-start growth.

The task ahead is enormous. The crisis is as important to East Asia as the debt crisis of the 1980s was to Latin America. As that crisis changed irreversibly the economic and political institutions of the day, so too throughout East Asia societies are changing dramatically in ways that none would have predicted only 18 months ago. Virtually all of the countries in East Asia are transforming the old ways of conducting their business and politics. Companies that borrowed freely and frequently using only the collateral of unfolding rapid growth are being subjected to a new discipline. Banks that borrowed in yen or dollars and loaned in local currency using a nod from government as their only hedge, are being subjected to greater supervision. Enterprises and banks are undergoing ownership and organizational changes as profound as those in Latin America during the 1980s or even in the United States during the 1930s. Though it is too soon to say with certainty, companies and banks may well emerge with less concentrated ownership, greater representation and transparency for minority shareholders, including foreigners, and greater discipline from competition in both

product and capital markets. Similarly, governments and public governance are changing in historic ways. Even as they shoulder burdens from past implicit guarantees to the private sector, governments are reorganizing themselves to reduce these contingent liabilities and their direct role in resource allocation. They also are assuming new responsibilities. As traditional rural family ties breakdown under pressures of urbanization, societies everywhere in the region are looking to governments for help in ensuring the welfare of the poor, the unemployed, the sick, and the elderly. In the backdrop, a new politics of governance—from Korea in the North to Indonesia in the South—seems to augur a new openness, concern for corruption, and accountability. The journey to recovery, filled with uncertainty to be sure, is set on a historic course that will shape the future of East Asia's children.

Jean-Michel Severino
Vice President
East Asia and the Pacific Region
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Executive Summary

East Asia's financial crisis quickly has deteriorated into an economic and social crisis. Real wages have plummeted, and the region's major cities are filled with idled workers looking for jobs. In the countryside, the combination of drought-parched lands and dried-up rural credit has threatened the livelihood of many. Since this comes after three decades of rapid growth, a whole generation of workers and farmers has never known these hardships, and societies have developed few formal mechanisms to ease their plight.

This study presents an analysis of the crisis, provides a report card on progress within the region, and suggests policy directions that will affect the pace of recovery. *The most urgent task ahead is to restore the conditions for robust economic growth throughout the region.* This is particularly true for Thailand, the Republic of Korea, Indonesia, and Malaysia, where recession has been unrelenting and severe. The other, smaller developing countries in East Asia are feeling the ripples of the crisis, and are fighting off deep recession. The economies of Taiwan (China), Vietnam, and China have so far avoided the recession, but they too have been pushed below their trend-line growth paths.

Origins of the crisis

Even as growth was improving the livelihoods of the poor, it had begun creating several sources of vulnerability in the mid-1990s. The region's very success—rapid growth, conservative economic management and low indebtedness—made it attractive to private capital. These inflows, while spurring growth, were intermediated through poorly regulated domestic financial systems and helped fuel domestic credit expansion. The pace and pattern of growth, interacting with often-undisciplined capital inflows, produced three weaknesses in the foundation of East Asia's growth:

- Large *current account deficits*, financed with short-term flows, exposed East Asian economies to sudden reversals.

- Liberalization of domestic *financial markets without adequate prudential regulation* and supervision allowed banks and corporations to assume unhedged foreign borrowing positions that left them vulnerable to sudden currency fluctuations.
- *Companies*, in the absence of fully developed bond and equity markets, borrowed heavily from banks to finance their rapid expansion, and in the process became very highly leveraged. This left them vulnerable to interest rate surges.

When markets became worried about the sustainability of the fixed exchange rate in Thailand, capital inflows became outflows. Asset values plummeted—particularly equities and property—and suddenly turned what had been a virtuous circle into a vicious one. Falling asset values reduced wealth and imposed balance sheet losses on financial agents, demand fell, and contracting markets produced greater outflows. Finance stampeded to safe havens, making the situation worse.

Main challenge: Restoring growth

The main challenge today is restoring broadly shared and sustainable growth for the region. Three elements form the basis of a strategy.

Enacting structural reforms to restore high quality economic growth. The only way to reverse the income losses imposed upon the poor is for countries to reactivate economic expansion. But the quality of growth matters. If it is not environmentally sustainable, leaves out the poor, or is cut short because of inadequate structural foundations, recovery will not achieve its promise. A pre-requisite is reactivating demand. Exports are growing slowly because neighboring countries are also in recession, investment is hobbled by systemic insolvency in the banking and corporate sector, and declining incomes and wealth have depressed consumption. In Indonesia, Korea, and Thailand, 20–65 percent of firms are estimated to have balance sheet losses greater than equity. Insolvent, highly leveraged companies cannot service their debt. Non-performing loans in those countries are thus estimated to range from 20–40 percent. The situation has created a self-re-enforcing downward spiral: recession forces corporations to delay or default on bank payments, and, as the amount

of non-performing loans rises, banks' cash flows are squeezed, forcing them to contract new lending to illiquid corporations and call-in even good loans to raise cash, further deepening the recession. This report therefore focuses on structural reforms that will reactivate demand in a sustainable fashion: speeding up the process of financial and corporate restructuring, establishing a better framework for financial and corporate governance, enhancing public sector management, and improving environmental policy. Only by progressing on this combined agenda can countries ensure that growth will be sustainable and of high quality.

Second, *ensuring that low-income groups are protected during crisis and then share in eventual recovery.* If output were to fall by a cumulative 10 percent over the next three years and income distribution worsens by 10 percent, the number of poor people in Indonesia, Thailand, Malaysia and the Philippines would more than double—from some 40 million to more than 90 million. This is an unlikely but still possible scenario, and underscores the importance of renewing growth. The report lays out an agenda of pro-poor fiscal policies, suggests ways to maintain incomes of the poor, and focuses on enhancing social services that cushion the worst effects of recession upon the poor. Reforms in pension systems, labor markets, and education can help incorporate low-income groups into a sustained economic expansion.

Finally, the international community must do what it can to restore *international capital flows*. The region has suffered a massive swing in private capital. Domestic policies that inspire investor confidence are a necessary condition for renewing private capital inflows. With policies in place, a concerted effort to mobilize additional finance would mitigate the pressure on consumption levels in the region and spur growth. If an additional \$10 billion in external finance could be mobilized and it were used to finance an additional fiscal stimulus, it would provide a strong impetus to growth. If some of the spending were focused on low income groups, it could mitigate the worst effects of the crisis. The report does not delve into specific mechanisms for mobilizing finance, a discussion that is transpiring in international fora and elsewhere, but it is nonetheless essential that this challenge be faced squarely.

Looking ahead

Recovery is likely to take longer in East Asia than in Mexico and Argentina in 1994-95 because of the problem of corporate and bank insolvency and because of the regional scope of recession, including Japan. The global economy has been so far supportive, but events in Russia and in global financial markets in recent months raise worrisome signs that even that bright spot may be dimming. The recent floods in China also weigh on the region's prospects. An expanding global economy is arguably the most important element in East Asia's recovery.

It would be easy, however, to be overly pessimistic about the region's future. Countries throughout the region are moving swiftly to enact new policies and adopt new, more transparent ways of doing business. They have shown themselves willing to work extraordinarily hard and sacrifice today for benefits tomorrow. Witness the region's continuing high savings rates. If the pace of reform accelerates and if the international community responds positively, the region will soon find itself on the road to recovery.

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chapter one

East Asian Crisis: An Overview

*In mid-October, 21 year old Sugiyanto was still swinging a shovel at a Jakarta construction site. Six months earlier he had made a personal pilgrimage by overnight bus to the capital from the village of Banjarjo in central Java. "On TV, it looked so easy to make money in Jakarta." The money, however, has since dried up. Indonesia's financial crisis has brought many construction projects to a halt. With new jobs scarce, Sugiyanto slunk home to Banjarjo in early November—only to find that his father's rice paddies had dried up too. Months of dry weather have turned the fields in to a parched brown expanse. No work, no monsoon, no escape. For Sugiyanto there's nothing to do all day but slump over a motorcycle, hoping to cadge a few faded bills in return for offering lifts. There are few takers. Villagers would rather spend their money on water.—Margot Cohen, "Unlucky Country," *Far Eastern Economic Review*, December 25, 1997.*

After three decades of remarkable expansion, the economies of East Asia have gone into a tailspin. The once booming economies of Thailand, the Republic of Korea, Indonesia, and Malaysia will contract this year. Singapore, Hong Kong (China) and Taiwan (China), with their strong financial systems and high reserves have, so far, managed to fight off the worst of the contagion, but have seen their export markets and businesses contract. The transition economies, partially protected with their semi-closed capital accounts and low ratios of short-term debt to reserves, have emerged with the added challenges of diminished prospects for exports and capital inflows.

The smaller economies, from Mongolia to Fiji, are buffeted by the storm around them. The Solomon Islands may contract by 10 percent or more in 1998.

The currency and financial crisis has quickly deteriorated into a social crisis. In the past, steady economic expansion provided the underpinnings to the livelihood of the poor, and substituted for a formal social safety net. Today that is gone. Unemployment is rising. Real wages of low-income urban workers have plummeted, and the region's major cities are filled with idled workers looking for ways to make a living. Inflation has risen, with the possible effects of worsening income distribution and further reducing the real wages of low-income groups. To make matters worse, drought has parched much of the region's otherwise fertile land, making it difficult for farmers to take advantage of higher food prices. The effects of falling incomes are felt most severely by poor women and children. Also, in some countries economic pressures have ignited latent social prejudices against minorities and immigrants.

The effects go beyond the poor. The currency fall and crash of the equity markets has wiped out savings of the middle class and newly rich. The decline in equity values in the region has surpassed US\$400 billion since July 2, 1997. Meanwhile, efforts to improve the quality of life of all East Asian citizens through greater social and environmental investments have stalled.

Signs of a new, if fragile, financial stability are appearing in four of the five crisis-affected Asian countries (Korea, Philippines, Malaysia, and Thailand). The Philippine economy has thus far come through with surprising vitality. Thailand and Korea, after suffering collapse in their financial systems, have established firmer values for their currencies and are rebuilding reserves. Indonesia is still fighting to regain a modicum of stability. However, the economic recovery that all had hoped would come soon is not yet in sight. While the prospects are uncertain, it is clear that the changes wrought by the events of 1997 will be as profound as those brought on by the debt crisis in Latin America during the 1980s. Although unemployment in East Asia will probably not reach the levels of some countries in Latin America, a far greater share of the population in East Asia is living just above the poverty line, so any substantial slowdown puts their livelihood at risk. Furthermore, the shock of recession to the middle

class, coming as it did after the most rapid sustained expansion in human history, will undoubtedly be as profound. The end of the 20th century for East Asia is changing the way business is conducted, the way resources are allocated, and the very economic and, in some cases, political governance of countries.

This study looks at these changes and focuses on policies for a sustainable recovery. It is designed to be a snapshot of where the region stands, a progress report on the enormous changes that have been made in the last year, and an analysis of the remaining obstacles to establishing a firm economic recovery. But, the region cannot be satisfied with a short-lived growth spurt. It must aspire to nothing less than recapturing the lost growth momentum of the last three decades. Subsequent chapters look at those policies. This chapter reviews the gains of the past and the causes of the crisis.

Was the miracle real?

East Asia's achievement of spectacular welfare gains in the last two decades is beyond dispute. Poverty has declined, not only in breadth (the number of poor) but also in depth (severity of poverty). Life expectancy at birth, infant mortality rates, and literacy indicators have all improved in tandem, generating real improvements in peoples' lives. The region succeeded in converting persistently high growth rates into improvements in welfare because growth, supported with widespread social services, created jobs for the poor and enormous opportunities to expand productivity. The miracle was real and tangible.

The region reduced the number of people living in poverty by half in the last 20 years. As figure 1.1 shows, the number of poor living below the international poverty line of US\$1-a-day¹ was reduced from 720 million to 350 million. Moreover, the rate of decline accelerated over the past decade: the total number of people in poverty fell by 27 percent during the period 1975–85, and fell an additional 34 percent during the period 1985–95. This pace of poverty reduction was faster than in any other region of the developing world, and, as a result, the share of the world's poor living in East Asia has declined. While six out of ten East Asians lived in absolute poverty in 1975, roughly two in ten did in 1995.

Within East Asia neither poverty levels nor rates of decline were identical across countries. In 1975, China and Indonesia alone accounted for 92 percent of the region's poor, largely because they were the two most populous countries. Since 1975, however, both countries have recorded substantial declines in poverty, 82 percent in Indonesia and 63 percent in China. In absolute terms, the number of poor decreased by more than one-half in China and fell by almost three-fourths in Indonesia (the head count declined from 64.3 percent in 1975 to 11.4 percent in 1995). By 1995, the two countries accounted for 84 percent of the region's poor. Although Indonesia's record was remarkable, Malaysia had the largest proportional reduction between 1975 and 1995 (95 percent decline, from 17.4 to less than 1 percent) and Thailand was a close second (90 percent decline from 8.1 percent to less than 1 percent).

Propelling these achievements was a high performance engine of economic growth. Several factors lay behind this growth performance. Governments generally:

- Kept inflation low and exchange rates competitive through conservative macroeconomic policies
- Invested in human capital through public expenditures on education

- Encouraged high rates of savings by keeping interest rates positive in real terms and by effectively protecting deposits in financial institutions²
- Limited price distortions
- Encouraged absorption of foreign technology
- Avoided implicit taxation and other biases against agriculture.

Several studies have confirmed that high rates of savings, investment in human capital, and stable macroeconomic policies are key determinants of growth.³

Why did East Asia falter?

Such remarkable economic and social performance made the sudden downward spiral of the East Asian 5 all the more startling. Several structural problems were well known and analyzed prior to the collapse of the Thai baht in July 1997. Did these structural problems finally produce the exhaustion of the East Asian model, much as import substitution in Latin America became fully exhausted during the crisis decade of the 1980s? Or, was the crisis in East Asia the result of short-term macroeconomic mistakes and financial panic, a type of macro-financial accident?

Rapid growth, urbanization, and industrialization were spawning new and difficult development problems prior to the crisis. These were building in three dimensions. First, rapid growth, in the absence of sophisticated financial and capital markets and with a large government presence, left the corporate and financial sectors unusually reliant on financing long-term investment with short-term debt capital (this will be discussed below). Second, economic growth was undermining the traditional protection mechanisms for the unemployed, the sick, and the elderly. East Asia relied on high personal savings and family ties to provide security for its elderly. It came to rely on growth itself to provide an ever more buoyant labor market. The forces of growth, with their demands for an increasingly mobile labor force, migration, and wider scope for personal consumption, were putting strains on traditional ways of solving social problems. In the transition countries of China and Vietnam, the old commune and state enterprise system of welfare was under analogous strains with the spread of markets. In the wealthiest countries, lifetime employment guarantees in the corporate sector were proving increasingly out of tune with

