



## FOURTH ITEM ON THE AGENDA

## The ILO's response to the financial crisis in East and South-East Asia

### Evolution of the Asian financial crisis and determination of policy needs and response

#### Contents

#### I. Introduction

#### II. Evolution of the crisis, its causes and impact

1. [The crisis deepens](#)
2. [Estimates of increased severity, and contagion](#)
3. [The causes of the crisis](#)

#### III. The social impact of the crisis

1. [Employment and wage rates](#)
2. [Poverty](#)
3. [Women workers](#)
4. [Child labour](#)
5. [Migrant workers](#)

#### IV. Determining the ILO policy response to the crisis

#### Appendix

[Table 1.](#) Growth rate of real GDP (% per annum)

[Table 2.](#) The East Asian crisis: Changes in unemployment rates and levels, 1996-98

#### **I. Introduction**

1. In November 1998 the Governing Body discussed the ILO's activities in response to the financial crisis in East and South-East Asia on the basis of an Office paper,<sup>(1)</sup> and requested a more comprehensive analysis of the causes and consequences of the crisis, including an evaluation of the relationship between the ILO and the international and regional financial institutions and ways to promote dialogue and better cooperation between those institutions and the ILO. The Governing Body also requested a more focused view of ILO activities in order to evaluate ILO strategy to date in responding to the crisis and the future direction that the ILO should take.

2. This paper is the first of two intended to provide the Governing Body with the basis for more in-depth discussion. The second paper, *ILO action in response to the Asian financial crisis*,<sup>(2)</sup> reviews specific action taken by the ILO and its constituents over the 18 months since the onset of the crisis.
3. The present paper begins with an analysis of the causes and consequences of the crisis and its social and labour market impacts (sections II and III). The analysis then turns to national policy responses in the most affected countries (the Republic of Korea, Thailand and Indonesia) and to the influence of IMF policy prescriptions on domestic outcomes. The paper concludes with a discussion of the underdevelopment of social institutions and the relevance of ILO assistance in this area. While the paper refers largely to the situation in those three countries, it also covers other countries in the region. Where necessary to avoid confusion, in listings of countries and areas Hong Kong, China and Taiwan, China are referred to simply as Hong Kong and Taiwan.
4. Through its Active Partnership Policy, the ILO's relationship with its constituents in the Asian and Pacific region has been the major factor guiding the ILO's response to the crisis. The Twelfth Asian Regional Meeting in December 1997 called on the ILO to conduct an analysis of the crisis to identify the ILO's response. The High-Level Tripartite Meeting on Social Responses to the Financial Crisis in East and South-East Asian Countries (Bangkok, April 1998) identified four main priorities for ILO action which, in turn, were agreed by the Governing Body in November:
- (a) social protection;
  - (b) employment, enterprise development, and labour market policies;
  - (c) the promotion of social dialogue;
  - (d) the promotion of ILO Conventions.
5. The latest source of guidance for the ILO comes from the Regional Consultation concerning Follow-up on the World Summit for Social Development (Bangkok, 13-15 January 1999). The meeting emphasized the central importance of full and freely chosen employment, for which goal a return to economic growth and reforms leading to macroeconomic stability is vital. The meeting also underscored the importance of strong social institutions, including institutions for social dialogue, in sustaining both the quantity and quality of jobs.
6. While the ILO's constituents in the region have articulated the priority areas for ILO action, it is important to emphasize the relevance of the ILO's existing normative framework and technical capacity. ILO Conventions and Recommendations represent the consensus of its constituents on the normative approach to labour market and social problems. They provide a flexible source of guidance in addressing those problems. ILO Conventions are especially relevant to the growing awareness that the weakness of social and labour market institutions in the Asian region has had a significant bearing on the hardship suffered by workers and their families. Institutional weaknesses that fundamental ILO standards can help redress have played a causal role in the crisis and have magnified its negative effects.
7. Since the Governing Body's 273rd Session in November 1998, the ILO in December published a monograph entitled *The Asian financial crisis: The challenge for social policy*,<sup>(3)</sup> which analyses the social impact of the Asian financial crisis and its policy implications. The policy issues raised are of relevance not only to the crisis-affected Asian countries but also to other emerging economies that are facing similar challenges in an era of rapid economic and financial globalization. An executive summary of the book has been issued for the present session of the Governing Body.<sup>(4)</sup>

## II. Evolution of the crisis, its causes and impact

### 1. *The crisis deepens*

8. The technical report prepared for the High-Level Tripartite Meeting on Social Responses to the Financial Crisis in April 1998 anticipated a worsening of the crisis. Year-end estimates for 1998 show its increased depth and duration and the extent of contagion. In May 1998 the IMF projected, for the four countries affected -- Thailand, Indonesia, Malaysia, and the Republic of Korea -- an average contraction of 2.7 per cent in 1998. In November 1998 it revised this to a figure of 10.6 per cent. Projections of positive growth of 2.5 per cent over 1999 have also now been scaled down to a contraction of 1.4 per cent. The World Bank estimates that 18 per cent of those countries' GDP has been wiped out. Contagion is becoming widespread in the region, with Singapore registering negative growth for the first time, Japan recording a 3 per cent contraction, and growth projections for China for 1999 revised downwards from 9 to 7 per cent. The world economy is also suffering, with world growth now estimated to have halved, from 4 to 2 per cent trend growth for 1998. While financial indicators such as currencies and equities are beginning to improve, there are few signs of real recovery in terms of employment or output. The social implications of the crisis have become enormous, with unemployment, underemployment, and poverty rising steeply.

## 2. Estimates of increased severity, and contagion

**9.** The evolution of the crisis can be seen in tables 1 and 2. Thailand went from 8 per cent growth in manufacturing production in the second quarter of 1997, to a contraction of 4 per cent in the third quarter, a downturn of 12 per cent. The contraction increased until the second quarter of 1998, when manufacturing shrunk by 15 per cent. Thailand GDP was projected by the IMF to contract by 8 per cent over 1998, but the three quarterly figures for manufacturing available so far indicate an even greater contraction, which is expected to persist over the first two to three quarters of 1999, reaching positive growth only in the last quarter and in the year 2000.

**10.** The financial and real economic contagion reached Indonesia, the Republic of Korea, Malaysia, and Hong Kong, China, some six months after Thailand, in the first quarter of 1998. By the third quarter of 1998, the Indonesian economy had contracted the most, by 17 per cent, followed by the Malaysian and Korean economies which contracted by 9 and 7 per cent respectively, and Hong Kong, with a contraction of 7 per cent. By the last quarter of 1998 the Indonesian *rupiah* had bottomed out, but equity markets were still falling. As a result of this and political uncertainties, the Indonesian economy is estimated to have contracted the most over 1998, by 15 per cent, and is projected to be the last of the affected economies to recover, reaching positive growth only by 2001.

**11.** The Republic of Korea's economy has followed the trajectory of the Thai economy. Both the *won* and the *baht* had recovered considerably in the third quarter of 1998, as had equity prices in both countries, although Thai asset prices recorded the most significant fall. The Korean economy is estimated to have contracted by 8 per cent in 1998, and is expected to contract by a further 1 per cent in 1999, reaching low positive growth only by 2000.

**12.** Malaysia has opted for external payment controls to contain the effects of an expansionary fiscal and monetary policy on its external balances. The Malaysian *ringgit* and equity prices had recovered significantly by the third quarter of 1998. The Malaysian economy is estimated to have contracted by 8 per cent over 1998, and is expected to contract by another 2-3 per cent in 1999, just reaching positive growth by 2000.

**13.** The contagion has extended to Hong Kong, Singapore and the Philippines. Hong Kong's currency has not depreciated, but its equity prices dropped in the third quarter of 1998. Table 1 estimates that the Hong Kong economy contracted by 5 per cent over 1998, and predicts a contraction of another 2 per cent over 1999, reaching positive growth only by 2000. In Singapore both the currency and equity prices have dropped. Table 1 shows that the Singapore economy stagnated over 1998, and predicts a contraction of 1 per cent over 1999, and then a recovery to positive growth over the following three years. The Philippine economy had relatively weaker growth, and this has declined further over the first three quarters of 1998. While the *peso* had recovered considerably by the second quarter of 1998, equity prices kept falling and only began to bottom out in the third quarter. Estimates of the Philippine economy show it stagnating or just contracting over 1998, reaching barely positive growth in 1999 (see table 1).

**14.** China is a major trading partner of the affected economies, and has also been affected, with trend growth of 9 per cent dropping to 7 per cent over 1998, and not projected to increase until 2002 (table 1). The Japanese economy contracted over the first three quarters of 1998, and estimates show a contraction of 3 per cent over the whole year, which is unprecedented in five decades. With its strong trading links in the region, the Japanese economy has a strong impact on all these slumping economies.

**15.** The crisis thus increased in severity over 1998, according to the latest recorded estimates for the third quarter, which show increasing contractions for all countries except Thailand. The geographical extent of the crisis increased, with the whole East and South-East Asian region succumbing over the course of 1998, and evidence of global impact.

## 3. The causes of the crisis

**16.** A number of factors are now seen to have caused, and possibly even exacerbated, the crisis in Asia. The first and most immediately apparent is inappropriate macroeconomic policy. An overvalued pegged exchange rate reduces export competitiveness, which induces a current account deficit and depletes foreign exchange reserves. This depreciates the exchange rate, which the government attempts to maintain, further depleting foreign exchange reserves until the peg is abandoned. The instability of the exchange rate regime prompts capital outflows. The increased foreign currency denominated debt increases bank and corporate obligations, causing a liquidity crunch, and leading to closures, a downturn in growth and retrenchment. This was the initial fate of the Thai *baht* in mid-1997. If this is the principal cause, then the policy that is logically required is to prevent a spiralling of exchange rate depreciation and inflation. This would require a reduction in current account deficits and budgetary deficits through tight monetary and fiscal policies, especially higher interest rates and tight credit controls.

**17.** A second factor contributing to the Asian crisis is financial panic. Banks in Thailand, and especially Indonesia, borrowed short-term,

unhedged capital from international markets, and lent it long term to the corporate sector against assets inflated by a bubble element. The banks and the corporate sector were highly leveraged. When portfolio investors perceived the exchange rate regime to be unsustainable, they panicked, reversing the huge inflow and creating an outflow. The panic becomes a self-fulfilling prophecy, since it is created by short-term investors withdrawing capital from indebted, but solvent, borrowers in an environment where there are no lenders of last resort to bail them out. This leads to a liquidity crunch for banks and the corporate sector, with closures and an economic downturn. Since the lack of a significant lender of last resort plays a crucial part in the panic, the implied macroeconomic policy prescription is to protect the economy through lender-of-last-resort activities and provide reassurance. This occurred in Mexico in 1995 when the devaluation of the *peso* left the Government unable to rollover its short-term dollar-denominated debt and on the brink of default. The United States and the IMF bailed Mexico out, with 50 billion dollars to repay the short-term debt, bringing recovery in the following year.

**18.** A third contributing factor to the financial crisis is a complex of financial institutional factors that can be bracketed together as "moral hazard". This occurs when banks borrow on the basis of public guarantees of their liabilities. If these banks are undercapitalized or under-regulated, they can use these funds for overly risky ventures -- lending to borrowers whose assets and ability to repay are so low that the loan can virtually be stolen. The banks and their risky debtors are very prone to failure, triggering downturns in economic activity. So moral hazard is enabled by collusion between the government, banks, and the corporate sector, characterized in the Asian context as "crony capitalism" and instanced by the *chaebol* in the Republic of Korea and the nepotism of the Suharto regime in Indonesia. Further, moral hazard and lack of transparency are strengthened by a relative neglect of basic labour rights. Lack of fundamental democratic rights, among which freedom of association is critical, compounded the lack of transparency of crony capitalism. Public guarantees of banks' liabilities, and lack of prudential regulations, allowed a bubble element to develop, leading to an undercapitalization of banks and over-leveraging of the corporate sector. When the bubble burst, a financial panic ensued, leading to outflows and an economic downturn. This is a causal sequence arising from shortcomings regarding fundamental rights at the workplace. This underlines the relevance of core labour standards as contained in the ILO's 1998 Declaration on Fundamental Principles and Rights at Work and its Follow-up, to preserving healthy economies.

**19.** The policy implications of moral hazard diverge from those for a financial panic, because lender-of-last-resort activities to revive the economy would seem misplaced, as they would simply bail out a corrupt system. Rather, since moral hazard is based on collusion between the government, banks, and the corporate sector, and government intervention has gone wrong, government intervention should be reduced. This would allow a transparent market itself to dictate a better allocation of credit and investment.

**20.** A fourth factor that may have contributed to the Asian crisis appears at first sight to run contrary to the moral hazard factor and its premise of excessive government intervention: the lack of government regulation in financial sectors and investment policies. However, the governments of the region had a good track record of generating very high growth over two decades, and lowering poverty to an unparalleled extent, through judicious regulation and intervention. The problems underlying the crisis arose when the governments deviated from their past policies, principally through poorly managed financial liberalization. In the past, regulatory frameworks had prohibited such investment. It is also widely acknowledged that Thailand and Malaysia were holding a financial liberalization race, each trying to become the region's financial hub. Essentially, the governments liberalized their capital accounts too fast before putting in place a sound regulatory framework. The implied policy need is hence a review to improve the regulation of the financial sector.

**21.** In addition to the primary causes of the Asian crisis, there are indications that a decline in both capital and labour productivity also played a role. In the pre-crisis period there was a decline in the efficiency of capital associated with the high capital inflows into the region. Part of this can be attributed to the diversion of large proportions of domestic and local savings into non-tradeable sectors like real estate, construction, and consumer finance, whose high expected returns plummeted when the asset bubble burst. The share of loans going to the property sector was of the order of 30-40 per cent for Thailand, 20-30 per cent for Indonesia, and 15-25 per cent for the Republic of Korea.

<sup>(5)</sup> Part of the declining efficiency of capital can also be blamed on low technical innovation and the resulting low productivity. Thailand's declining capital efficiency is indicated by its capital output ratio, which more than doubled over the 1990s from 2.5 to 6. For Indonesia, the Republic of Korea and Malaysia, the capital output ratio rose from an average of around 4 to over 5 over the 1990s. The high inflows are also associated with very high interest rates, well above the London Interbank Offer Rate (LIBOR) in Indonesia and Thailand. The high spread increased the inflows, but also created a disincentive against hedging. When capital flows reversed, the banks' liquidity was threatened. They had borrowed short term and lent long term in unhedged funds. The liquidity effect flowed on to domestic firms, and both banks and firms faced closure.

**22.** Evidence also points to a decline in labour productivity. One view is that high export growth was based on traditional labour-intensive products, which became uncompetitive over time due to the appreciation of the real exchange rate, the appreciation of the nominal exchange rate pegged to the dollar, and the entrance of low-wage competitors. However, some studies show that export growth in the region was led by technology-intensive products, so that by 1996, for example in Thailand, exports in the computing sector alone exceeded garments.<sup>(6)</sup> Two factors were crucial. First, exchange rate appreciation affected the entire manufacturing sector, and exports dropped for

both traditional and technology-intensive products. Secondly, while unit labour costs, a major determinant of competitiveness, fell slightly, the decrease was not sufficient when compared with other producers to perpetuate the growth trend in exports. Unit labour costs comprise two major elements: wages and productivity. Much of the region improved in terms of a global ranking of wage competitiveness: for garments, Thailand and the Philippines improved over the 1990s, while Indonesia remained constant.<sup>(7)</sup> However, while the wage component became more competitive or remained constant, unit labour costs' other component -- productivity -- became less competitive. Productivity is estimated to have been weak in the long run, and it worsened over the 1990s in much of the region. Total factor productivity indicates the contribution of technical change to output growth, that is, growth over and above that caused by simple increases in input. The Republic of Korea had a relatively better record of improvement in total factor productivity between 1960 and 1990, but it is still low at 0.25 per cent, while Indonesia is negative. Thailand's growth of total factor productivity had increased over the second half of the 1980s to 3 per cent, but slumped to zero over the 1990s.<sup>(8)</sup>

23. Thus, when an export recession in East Asia was triggered by the world recession in 1995, performance never really recovered because of declining competitiveness in both traditional and technology-intensive products, deriving from declining capital and labour productivity. When the regional currencies depreciated in mid-1997 and capital flows reversed, the liquidity problems of the banks and firms stopped growth instantly, because the growth was based on simple input increases rather than productivity-enhancing technical change. When the crisis struck, growth needed very high investment levels, financed through inflows.

24. A number of factors hence contributed to the Asian crisis. Macroeconomic mismanagement leading to incompatibility between pegged exchange rates and open capital accounts probably triggered the crisis. Elements of financial panic due to a lack of lender of last resort may have exacerbated the crisis. The abandonment of sound government regulation, and over-hasty financial liberalization left the way open for some collusion between the government, banks and the corporate sector, leading to moral hazard and the consequent financial weaknesses of bubbles, a highly leveraged corporate sector, unhedged international borrowing, and an infected portfolio of bad loans. These imperfections in the currency and financial markets were paralleled by declining productivity of capital and labour. Consequently, as the financial crisis plays itself out -- and there are some indications of this recovery in terms of exchange rates, equities and inflation rates -- weaknesses in terms of the competitiveness of capital and labour use may constrain the recovery of output and employment in the economy.

### III. The social impact of the crisis

#### 1. Employment and wage rates

25. The dramatic reversal from economic growth to contraction has had such a major impact on employment in these economies that, 18 months after the onset of the crisis, unemployment is still increasing. As a result, the *social crisis* is defined by the loss of employment, which includes increases in total unemployment, retrenchment, underemployment and the informal sector, and reversals in occupational trends, wage cuts and increasing poverty.

26. In Indonesia steep increases in unemployment and underemployment are being accompanied by food shortages. Estimates collected for the ILO *World Employment Report 1998-99* indicate that 12-15 million people could lose their jobs as a result of the crisis, bringing unemployment to 15 or even 20 per cent, up from 4.1 per cent in 1996 (Appendix, table 2). In Thailand, there was virtually full employment in 1996, with 1.1 per cent unemployed; in 1998 the unemployment rate was estimated at 8 per cent, with 2.8 million new people out of work. In the Republic of Korea, high growth before the crisis had resulted in virtually full employment, with unemployment down to 2.6 per cent. In 1998 it is estimated to have tripled to 7.6 per cent. The total unemployment figures resulting from the crisis in East Asian countries could reach over 20 million (table 2).

#### 2. Poverty

27. Thus, with such high levels of retrenchment, largely uncovered by any form of unemployment insurance, increased underemployment and self-employment, and real wage and income cuts, the earlier declining poverty trends in the region have been reversed. In its pre-crisis high-growth period, Indonesia had managed to lower poverty (defined in Indonesia by a 50c-per-capita-per-day urban norm and a 40c rural norm) to 11 per cent of the population. However, this still left a very large 50 per cent of the population bunched just above this poverty line and below a \$1 per day norm. The crisis has resulted in a radical increase in poverty from 11 per cent in 1997 to 48 per cent by the end of 1998. This has been caused by loss of income and depreciation of the minimum wage's purchasing power from 6.3 kg of rice in January 1997 to 2.6 kg by June 1998. The World Bank has lower alternative projections of poverty, which it estimates will double in urban areas over the next two years, from 6 to 12 per cent using a \$1 a day norm, while rural poverty will increase by half.<sup>(9)</sup> In both Thailand and the Republic of Korea, the crisis is estimated to have increased poverty by 12 per cent, predominantly due to income lost through employment

and wage cuts. Unfortunately, a significant lack of data does not allow any further disaggregation of the impact of the crisis. This shortage of data is a general issue, and more work needs to be undertaken to design and implement methodology for data collection and dissemination.

### 3. *Women workers*

**28.** Data on the impact of the crisis on women workers is limited. There are however indications of a disproportional impact of the crisis on women workers compared to men.<sup>(10)</sup> In the Republic of Korea, the labour force participation rate over 1998 declined more sharply for women than for men. Similarly, the decline in women's employment was greater at 8 per cent than it was for men at 5 per cent. Women faced a greater probability of retrenchment: they accounted for 86 per cent of the total number of retrenched workers from banks and financial institutions. Moreover, the casualization of employment was greater for women than for men, with women's share in regular wage employment dropping by 20 per cent compared to the men's share, which fell by 6 per cent.

**29.** In Indonesia women were over-represented in the hard-hit manufacturing sector, with a 45 per cent share, compared to their 38 per cent share in the labour force. In retrenchment women bore a more than proportional share of the burden: 48 per cent of those retrenched were female.

**30.** Thailand has the highest female labour force participation rate among the main crisis-hit countries. In view of the lack of gender-disaggregated data, however, there is only anecdotal evidence indicating that women workers, especially in manufacturing and finance, have been harder hit than men.

**31.** Particular forms of women's work have been harder hit: in the Philippines, 90 per cent of the new homemaker schemes to generate employment and income in some regions were estimated to have closed down. Again, a lack of data hampers further estimation of the impact of the crisis on women.

### 4. *Child labour*

**32.** With the significant decrease in incomes and relapse into poverty child labour has increased. In pre-crisis Thailand, with its very high growth rates, child labour is estimated to have been decreasing by 5 per cent a year.<sup>(11)</sup> As a result of the crisis child labour is now estimated to have increased by 0.35 million. Furthermore, the annual income per child has dropped by B975, which can be expected to induce low-income households to send more children into the labour market.

**33.** There is no direct evidence of any increase in child labour in Indonesia or the Philippines, but primary-school enrolment ratios are dropping, and school drop-out rates are rising. The risk factor for child labour is increasing as families are pressured by the crisis to reduce expenditure.

### 5. *Migrant workers*

**34.** The Asian financial turmoil has revealed the fragility of migrant workers' status in many countries in the region. With the exception of a small minority of highly skilled workers, the vast majority of migrant workers are unskilled and take jobs that are too poorly paid, dirty or dangerous to interest local populations. Typically, they find work in construction, agriculture and domestic service. Most are also illegal entrants, which makes reliable data extremely difficult to gather. Estimates put the total number of migrants in mid-1997 in Hong Kong, Japan, the Republic of Korea, Thailand, Malaysia, Singapore and Taiwan at 6.5 million.<sup>(12)</sup> The crisis has led to large-scale population movements: according to ILO estimates the total number of migrant workers had decreased by approximately 1 million one year into the crisis. In Thailand the number of migrant workers had declined by some 460,000 by mid-1998, in Malaysia by 400,000, and in the Republic of Korea by about 117,000.

**35.** Repeatedly, the main lesson learnt from the crisis has been that there is a strong case for no longer neglecting labour institutions and social protection for labour in Asia. This is of particular relevance to migrant workers. Clearly a migration system characterized by large numbers of undocumented workers is not only objectionable on equity and human rights grounds: it is also a distinct disadvantage when dealing with a crisis. As Malaysia and Thailand have both discovered, expelling illegal workers is more difficult than reducing the size of a documented workforce through natural attrition as work contracts expire.

**36.** In some countries in Asia, particularly Japan, Malaysia, the Republic of Korea, and Thailand, hundreds of thousands of undocumented migrant workers are employed. The crisis has made the international community increasingly aware that by virtue of their weak or non-

existent legal status, these foreign workers cannot secure the minimum economic return or protection that could be expected. This is especially the case in terms of health hazards and safety, freedom of association, fair wages, compensation for injury or illness, and security of employment.

37. The ILO estimates the pre-crisis number of migrant women workers from the region to be approximately 1.7 million. They are primarily engaged in the service sector, domestic work, and the entertainment industry, but some are also in the manufacturing sector. However, lack of data again prevents an adequate assessment of the impact of the crisis on them.

38. As yet there is only sporadic evidence of the impact of the crisis on migration. Pending surveys, it can be projected that net immigration to Malaysia, Thailand and the Republic of Korea, which had increased to 250,000 annually, will have dropped considerably, affecting particularly Indonesian and Philippine migrants. Estimates of Indonesian migrant labour in Malaysia and the Republic of Korea range between 0.2 and 0.3 million.

#### IV. Determining the ILO policy response to the crisis

39. The depth and duration of the Asian crisis were largely unanticipated by the governments concerned, the international financial organizations and most economic analysts. The alarm bells did not ring beforehand because most of the macroeconomic fundamentals in the economies principally affected were sound. The sudden onset of the crisis and its severity led the Republic of Korea, Indonesia and Thailand to move into economic reform programmes with the IMF, with loan commitments of \$58 billion, \$42 billion and \$17 billion, respectively. Until the year 2000 their fiscal and monetary policy, and the restructuring of their financial and economic sectors, will be shaped largely by the terms of this commitment.

40. The IMF programme is based on six key measures. These include immediate bank closures, the restoration of sound bank adequacy standards, tight domestic credit, high interest rates on bank discount facilities, fiscal contraction, and some non-financial sector structural changes. The fiscal targets of the IMF programmes have changed with the signing of successive letters of intent. Initially a budgetary fiscal surplus of 1 per cent of GDP was called for. This was changed to a balanced budget for the Republic of Korea, and a 1 per cent budgetary deficit for Indonesia. Currently, budgetary deficits of 3-5 per cent are stipulated for these three countries.

41. In Thailand, Indonesia and the Republic of Korea the currency and financial markets have begun to recover, but there has been no clear indication of a response in terms of output because a number of constraints continue to apply:

- The *baht* and the *won* have stabilized against the US dollar, the *rupiah* has gained strength, while the *ringgit* has again been pegged. This has allowed short-term interest rates to come down to pre-crisis levels in Thailand, the Republic of Korea and Malaysia, and to decline in Indonesia. However, banks have been unable to follow with their lending rates because of their large debt overhang problems. Fiscal policy has hence not been reflationary, and firms continue to face a domestic liquidity crunch.
- Net private capital inflows to emerging markets are resuming only very gradually, estimated by the IMF at \$90 billion for 1999. For the East Asian subregion these inflows have remained significantly negative over 1998, at an average of -3 per cent for the Republic of Korea, Taiwan, Hong Kong and Singapore; and an average of -11 per cent for Indonesia, Malaysia, the Philippines and Thailand. With these net outflows, the external liquidity crunch has worsened for firms, rather than improving, and this is projected to continue for 1999.
- Export demand remains constrained for these countries because of their strong export links within the region. Asian exports within the region form 12 per cent of Asia's GDP.<sup>(13)</sup> Exports to Japan from the Republic of Korea, Taiwan, Hong Kong and Singapore comprise an average of 6 per cent of their combined GDP; while for Indonesia, Malaysia, the Philippines, and Thailand, the equivalent figure is 4 per cent. With the East Asian subregion in a major recession and Japan sinking into one, the region's internal export dependence constrains its ability to export its way out of the crisis. Competitive devaluations have so far not helped, precisely because of this regional export dependence, and while there have been improvements in the current account balances of the affected countries, these are only due to severe import compression brought on by the crisis.

42. Several aspects of these IMF programmes have been the subject of controversy. Critics of the macroeconomic framework have claimed that raising interest rates to stabilize currencies, together with the initial fiscal tightening, provoked a greater contraction in the real economy than was necessary. They have also claimed that the high interest rate policy failed to achieve its intended objective of reversing the excessive depreciation of exchange rates. Yet another criticism has been that the abrupt closure of insolvent banks in Indonesia needlessly aggravated financial panic. In response the IMF has defended its position, most recently through a detailed review of its programmes in Indonesia, the Republic of Korea and Thailand.

43. This debate remains unsolved, since it involves some counterfactual arguments and the empirical evidence currently available remains

inconclusive. Moreover, the issues involved remain a central part of the related ongoing debate on financial globalization. Views remain divided on the desirability of financial liberalization and on the required reforms to the international financial system. Subsumed within these issues are questions that have formed part of the policy debate in the wake of the Asian crisis, such as the cost and benefits of capital controls; the relative merits of currency boards and floating exchange rate systems; and the scope for, and potential effects of, expansionary fiscal and monetary policies in moderating crisis-induced recessions.

**44.** It is hence difficult at the present stage to draw any firm conclusions from this policy debate. What is clear, however, is that the recession in the crisis-affected countries has been deeper and more prolonged than most observers originally foresaw. In addition, the prospects for recovery remain uncertain.

**45.** Apart from issues of macroeconomic policy, the earlier analysis highlighted a set of other factors that may underlie the crisis, such as declining levels of productivity for both capital and labour, due to lack of technical innovation. The implied policy instruments are capital and labour market reform to increase competitiveness through technical change that enhances productivity. This implies two things:

- The role of capital markets has to complement that of labour markets. The present tight credit control policy in the capital market is restricting the employment of both capital and labour to expand or even maintain existing levels of production. Any further expansion of production means increasing demand by increasing competitiveness. The only feasible means of increasing competitiveness is by increasing the productivity of both capital and labour through technical change. Technical change requires investment in both capital -- in which technical change is embodied -- and in labour and management skills. Both these forms of investment will be enabled only by better access to credit than at present.
- Increasing labour productivity requires a number of enabling conditions which have been the staple of the ILO's programme, and accord perfectly with the ILO's aim of building institutional capacity in labour markets. The quality of the labour-management relationship at the workplace is fundamental to improving productivity, as is the improvement of social dialogue at all levels. Freedom of association is a prerequisite for these productivity advantages to occur. Singapore and the Philippines offer useful examples of tripartite promotion of productivity enhancement and workplace cooperation. Productivity also relies on the training and skill development of employees and managers, and is related to wage policies, including remuneration incentives. The benefits of investment in human capital and productivity improvements can only be reaped if firms can retain their skilled labour through security of tenure -- and income security when jobs are lost -- through unemployment insurance, so that employees remain attached to the labour market, skills are not eroded, and more productive job matches can be found. Investments in safe workplaces are also investments in productivity improvement.

**46.** If a return to pre-crisis trend growth does not occur before the middle of the next decade, the challenge of economic and social renewal becomes long term. The earlier impressive gains in employment and income growth and in poverty reduction have already been substantially set back. The weakness and, in some instances, absence of institutions of social protection and social dialogue has exacerbated these reversals. These are major structural deficiencies that have aggravated the social fallout from the crisis and may also have contributed to its cause.

**47.** During the past two or three decades, many countries in South-East Asia have followed a successful economic development model. Broadly speaking, the benefits of this strategy were manifest, perhaps so manifest, so rapid, and so continuous that little need was perceived for effective social protection against the risk of economic crisis. That perception was reinforced by the fact that practically all the countries in question made great progress in solving their most urgent social problems -- poverty and the need for jobs for the fast-growing young labour force. In the event of economic downswings, traditional communities and other social structures would be willing and sufficient to support persons temporarily in need. An additional buffer against the risk of downturn was the growth of a migrant workforce in the fast growing economies who would be the first to go if conditions worsened. Economic success has gradually changed the region's societal structures. The former safety net function performed through family structures can no longer be tapped to the same extent because of the long-term change in production conditions and because family savings cannot replace former income from gainful employment over longer spells of unemployment. One lesson of the crisis is hence that reliance on such informal mechanisms of labour market adjustment is no longer adequate: poverty is now back on the agenda, and for the first time in decades young people cannot find work.

**48.** Nor is there any positive tradeoff in terms of swifter labour market adjustment when individual workers have little social protection and must fend for themselves. While weak social protection makes hardship more acute, more than one-and-a-half years after the crisis began there are no signs of a recovery in the labour market. Too little social protection can work against rapid recovery. Although there is a need to reform financial systems, governments are aware of the massive social costs of such reforms and the effect that they would have on unprotected populations, and are reluctant to move quickly. But when the legal, institutional and financial instruments are in place to soften the social impact, needed reforms can proceed more quickly. Recent evidence confirms that adequate systems of social protection do in

fact provide such economic benefits, beyond their social benefits.<sup>(14)</sup> A broader and deeper look at the economic effects of social protection, and labour market institutions generally, is an area on which greater attention needs to be focused.

**49.** The existence of strong social safety nets and mechanisms of social protection, such as unemployment insurance, would not have stopped the crisis or eliminated economic and social hardship. However, if the past period of virtually uninterrupted growth in the region proves in the future to have been the exception rather than the rule, then there will be an increasing need for the institutional means to weather the social cost of downturns.

**50.** The crisis has awakened the need for ways in which to forge social consensus. Many ILO constituents in East and South-East Asia have taken steps to activate or reactivate mechanisms for social dialogue, and tripartite approaches to difficult economic and social issues have clearly increased since the crisis. Their starting-point is however low. In many countries of the region, the legal and behavioural climate for freedom of association needs to be improved, employers' and workers' organizations are conspicuously weak, as are also the channels for social dialogue if they exist at all. This means that the social costs of the crisis have been unequally shared. Weak social dialogue has played a part not only in the effects of the crisis, but also in its cause: the lack of dialogue allows a climate to develop in which crony capitalism and moral hazard can thrive.

**51.** The lack of transparency, arbitrary political intervention in markets and outright corruption bear witness to the weakness of democratic institutions. As stated above, the underdevelopment of democratic procedures and safeguards makes possible the moral hazard problems that the crisis exposed. It can hence be argued that --

the strengthening of democratic institutions is central to the post-crisis economic model that is required. Free and fair electoral processes, freedom of expression and public debate, the rule of law, and the accountability of elected officials are among the attributes of democracy that are essential for preventing the harmful distortion of market processes by arbitrary government intervention and corruption. The recent crisis has shown such arbitrariness to have not only high economic but also social costs. Thus, the intrinsic value of democracy is strongly reinforced by socio-economic considerations.<sup>(15)</sup>

This analysis is shared by the ILO's constituents in the region who, in the conclusions of the April 1998 High-Level Meeting on the Asian Financial Crisis, endorsed the need to strengthen democracy not only as a good in itself, but as essential to post-crisis recovery.

**52.** The weakness of democratic institutions may have played a role in what has been an economic crisis. It follows that strengthening democracy can improve not just the social or political outcomes, but can also have economic benefits. The political stability and transparency that democratic processes bring are welcome to investors and are a factor influencing their decision to direct funds. The democratic principle most closely associated with the ILO -- freedom of association -- also deserves attention, a fact to which the Organization's endorsement in June 1998 of the Declaration on Fundamental Principles and Rights at Work bears renewed witness. There are excellent grounds for thinking that freedom of association also makes sound economic sense: participation in economic choices by strong, independent and representative organizations of employers and workers might have checked some of the sources of moral hazard and the resulting misallocation of resources.

**53.** Wider social participation in economic decisions could also have eased the negative social impacts of the crisis. Sound labour-management relations and properly functioning tripartite mechanisms help to increase the amount of information available to decision-makers. This is likely to ensure that the costs of decisions are more equitably (and thus more sustainably) borne, and provide the basis for consensus that can lessen social unrest and thereby accelerate the pace of needed reforms. When such participation is curbed or weak, these benefits are lost. Among the many uses of participation, reference was made earlier to the challenge of improving productivity in the recovery process. Several factors are involved, but they include sound systems of workplace cooperation. It is highly unlikely that any high-performance, high-productivity workplace can be sustained without well-developed systems of labour-management cooperation, including workers' participation. The benefits of participation, however, can be sustained only if they are underpinned by the effective recognition of fundamental principles and rights at work.

**54.** The positive relationship of freedom of association to labour market adjustment and economic performance is not difficult to show in theory, as work by the ILO, the World Bank and the OECD supports it.<sup>(16)</sup> It can also be demonstrated in fact. However contentious the dialogue has sometimes been, the experience of the Republic of Korea's Tripartite Commission clearly shows the value of broad social participation in negotiating and supporting change. As the accompanying paper<sup>(17)</sup> describes, a comprehensive investigation of the economic effects of freedom of association and collective bargaining is needed.

Geneva, 23 February 1999.

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15. E. Lee, p. 64.
16. World Bank, *World Development Report, 1995*; OECD, *Trade, Employment and Labour Standards, 1997*.
17. GB.274/4/3.

## Appendix

**Table 1. Growth rate of real GDP (% per annum)**

	ADB		IMF					EIU									
	1991-95	1996	1997 Q1	1997 Q2	1997 Q3	1997 Q4	1998 Q1	11998 Q2	1998 Q3	1998	1999	1998	1999	2000	2001	2002	2003
Thailand <sup>1</sup>	8.5	6.4	7.0	7.5	-4.2	-11.5	-16.8	-15.3	-11.3	-8.0	1.0	-8.0	-1.4	4.2	4.6	4.7	5.2

Indonesia	7.8	8.0	8.5	6.8	2.5	1.4	-7.9	-16.5	-17.4	-15.3	-3.4	-14.8	-2.1	-1.0	2.9	3.5	3.7
Korea (Rep. of)	7.5	7.1	5.7	6.6	6.1	3.9	-3.9	-6.8	-6.8			-7.9	-1.1	4.4	4.5	4.6	5.7
Malaysia	8.7	8.6	9.2	8.4	7.5	6.0	-2.8	-6.8	-8.6	-7.5	-2.0	-6.0	-2.9	0.7	3.2	4.3	5.1
Philippines	2.2	5.7	5.5	5.6	4.9	4.8	1.6	-0.8	-0.1	0.2	2.5	-1.6	0.3	2.2	2.8	4.0	4.2
Singapore	8.6	7.0	4.2	8.5	10.6	3.9	5.6	1.8	-0.7			0.3	-0.9	1.9	3.5	4.7	5.1
Hong Kong, China	5.4	4.9	5.7	6.9	6.1	2.8	-2.7	-5.2	-7.0			-5.2	-2.2	0.6	1.4	2.3	3.3
Japan	1.4	3.9	3.8	1.0	1.7	-0.8	-3.6	-1.8	-3.5	-2.8	-0.5	-3.0	-0.6	0.8	1.6	1.9	2.2
China	12.0	9.7				8.8		7.5		7.2	6.6	7.8	6.7	7.0	7.4	7.8	8.5
Viet Nam	8.2	9.3				8.8					3.5	3.5	5.2	5.0			

<sup>1</sup> For Thailand only, quarterly figures are for manufacturing production, while the annual figures are for real GDP.

Sources: Asian Development Bank (ADB): Asian Development Outlook, 1998.; International Monetary Fund (IMF): *World Economic Outlook*, November 1998; Economist Intelligence Unit (EIU): *Country Forecast*, 4th Quarter, 1998.

**Table 2. The East Asian crisis: Changes in unemployment rates and levels, 1996-98**

	Unemployment rates, per cent			New unemployed, millions	
	1996	1998	Most recent estimates	1998	Most recent estimates
China *	3.0	5.0 to 6.0		3.5	
Hong Kong	2.8	4.8		0.1	
Indonesia	4.1	9.0 to 12.0	15 to 20	4.8 to 7.6	12 to 15
Republic of Korea	2.6	7.6		1.2	
Malaysia	2.5	6.7		0.4	
Philippines	7.4	13.1		1.7	
Thailand	1.1	4.4	8	1.7	2.8
Total				13.4 to 16.2	20.6 to 24.7

\* Urban unemployment rate.

Source: ILO estimates based on national sources.

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