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Responding to the Global Financial Crisis

Social Consequences of the East Asian Financial Crisis

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Contents

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Context

This paper is a slightly extended version of the essay that forms chapter 5 in the World Bank's report, *East Asia: The Road to Recovery*.[1] It is being produced as a separate, free standing paper, in order to provide wider access to the World Bank's views on the linkages between the financial crisis and the social crisis, in East Asia and elsewhere. It is in particular intended to serve as one of several ways in which the World Bank is attempting to expand its engagement with various institutions and partners, including civil society organizations, concerned with the human impact of the crisis.

Amidst the turmoil in global markets, the human toll of financial crises should remain at the core of policy decisions and responses for countries in economic crisis. At the time of writing, financial upheavals are spreading with alarming speed, with much of East Asia and Russia already engulfed in financial crisis, Latin American under threat, and at least a risk of global recession.[2] The human costs of such a scenario could be greater than the setbacks of the decade that followed the eruption of the debt crisis in Mexico in 1982.

The response to the social fallout from the 1980s debt crisis can best be characterized as too little, too late. The World Bank was one of many culpable parties to this weak response[3]. The introduction of measures to mitigate adverse social effects into adjustment programs only became standard years after the crisis started, and then often in the form of add-ons to structural adjustment programs. By contrast, in the crisis that started in East Asia in 1997, social issues have been placed at the forefront of public and international concern. However, it remains an extraordinary challenge to frame responses that will moderate the social cost of macroeconomic crisis. The effects of economy-wide decline are so pervasive that public action to shore up services and offset income declines for the poor and those newly vulnerable due to economic upheavals is often at best partially effective. Moreover two central areas of impact are still only weakly understood: the distributional consequences of choices over macroeconomic and structural policies; and the inter-relationships between economic shocks and the social fabric, including patterns of social inclusion and exclusion, of the performance of local institutions and of informal community-level coping mechanisms. Yet it is vital that the economic and institutional reforms being designed in the crisis countries serve to mend and repair the social fabric in those countries and support equitable growth when the recovery occurs. Separating economic policy making and social development is a recipe for failure.

The present crisis started in the region that was the paragon of poverty reduction over the past few decades. East Asian societies have experienced a pace of poverty decline, in terms of income aspects of living, but also health and education, that is almost certainly unprecedented in human history, and far quicker than the pace of progress on poverty experienced by the now-industrialized countries in their periods of rapid take-off. They have been praised by many both within East Asia and outside (from Oxfam to the World

Bank) as models of human development for others to emulate, because of the inclusive, equitable pattern of development and the priority to provisioning of some basic social services. However, while the gains were genuine, it is not acceptable to return to a "status quo ante" in the crisis countries. Even before the crisis, there were concerns over gaps and weaknesses in social systems, including concerns over rising inequality, inadequate mechanisms for social protection and weak and corrupt public service institutions, often linked to authoritarian social structures. These have been sharply exacerbated by the crisis. Recognizing the gaps that were pre-existent to the crisis provides the basis for developing longer term priorities for establishing new foundations for social development and new institutions for social protection against future downturns.

The scope and scale of the tasks in the crisis countries is more than can be managed by the governments and people in each country, requiring the involvement of external partners seeking to work towards common goals of renewed growth and poverty reduction. The linkage between economic and institutional reforms on the one hand, and reducing poverty on the other, requires deeper and more effective engagement between the World Bank and various partners, including the diverse organizations of civil society. This paper is designed to present some of the World Bank's views on aspects of the social crisis. It is not intended to be the final word but rather an invitation to further dialogue and consultation at the national and regional level. The World Bank is seeking to work with governments, research organizations and civil society to assess the emerging social impacts, to raise questions about policies and proposed projects, and to work with governments, civil society and other external agents to assess the shifting pattern of vulnerability and the consequences of both the economy-wide shocks and responses to inform and shape future public action. A number of initiatives have been established that are outlined at the end of this paper. The core of the paper that follows explores both the longer-term issues and the crisis for the main affected countries.

East Asia in Crisis: What does this mean for the poor?

> *"It was the rich who benefited from the boom…but we, the poor, pay the price of the crisis. Even our limited access to schools and health is now beginning to disappear. We fear for our children's future" said Khun Bunjan, a community leader from the slums of Khon Kaen, North East Thailand and her husband, Khun Wichai. Khun Wichai recently lost his job in the local factory and his wife is selling less at the local market. As a result they took both their son and daughter out of school and put them to work. "What is the justice in having to send our children to the garbage site every day to support the family?" questions Khun Bunjan. But Khun Wichai thinks he is lucky. His neighbors are sending their children to beg and some girls became prostitutes. Among the older male youths, drug dealing has become an increasingly attractive source of income. Increased competition for survival, frustration and psychological stress are all leading to heightened household and community tension. This tension has led to increased domestic violence and with fewer jobs, neighbors who once cooperated are now competing. Stealing, crime and violence, are on the rise. People are feeling unsafe and insecure. "This breakdown of our community's networks will affect stability," added Khun Bunjan.*

East Asia's economic and social structures are under strain, and decades of unparalleled social progress are under threat. In country after country, growth is declining from an average per capita increase of over 5 percent per annum to negative levels for the next year or so with sharp contractions expected in Indonesia, Thailand and Korea. The poor are being severely hurt during the crisis as demand for their labor falls, prices for essential commodities rise, social services are cut, and crop failures occur in countries experiencing drought. The combined macroeconomic and agricultural shock undercuts fragile coping mechanisms, especially in Indonesia, and could be life-threatening if consumption levels drop sharply. Widespread economic hardships are tearing at the fabric of society: there are food riots and ethnic tensions in Indonesia, farmers are protesting in Thailand, and workers are expressing their discontent in Korea. These signs of social stress are not only politically worrisome but the increasing tensions at the household, and community level are equally damaging, especially for women and children. Children are being pulled out of school and put to work; food is being rationed within the household, and women and girls are frequently the first to sacrifice their portions; and violence, street children, and prostitution are all on the increase. This is the human crisis.

A speedy return to macroeconomic stability and growth through distributionally favorable adjustment policies is the only way to begin to put a floor under the falling incomes of the poor. In the meantime, public action can curb the welfare losses of the poor in the short-term, and help protect their human resource investments. It is essential to ensure that food markets work, to augment the purchasing power of vulnerable households, to cushion the impact of price increases, and to preserve the poor's access to health and education. Strengthening public and private institutions responsible for service delivery is also crucial in both the short and longer-term.

East Asian countries encountered important social challenges even before the crisis. In most of East Asia, social policies developed against the backdrop of political stability, full employment, high household savings, and relatively strong community ties giving governments little reason to plan for downside risks. But even during times of economic growth, three issues were already challenging social policies in East Asia: persistent pockets of poverty and rising inequality, outmoded labor market policies and industrial relations, and rising needs for formal mechanisms to support household security. Growth masked those problems but when the crisis stripped this mask away, the region's persistent social vulnerabilities were sharply revealed.

Progress and Vulnerabilities

East Asian countries have achieved spectacular welfare gains in the last two decades.4 Consistently high growth rates have been translated into quantifiable welfare improvements primarily because growth has largely been inclusive. Public provisioning of social services has been widespread and the productivity of the poor and their employment opportunities have increased enormously. The number of poor has fallen and the severity of poverty has declined. Life expectancy at birth, infant mortality, and literacy have all improved. These achievements are even more impressive when compared with social developments in other regions or developed countries during their decades of industrialization.

Impressive measures of social development

Between 1975 and 1995 poverty in East Asia dropped by two-thirds according to the region's head-count index with respect to the constant US$1-a-day poverty line (in 1985 purchasing power parity terms), and the pace of poverty reduction was faster than in any other developing region. In 1975, six out of ten East Asians lived in absolute poverty according to this standard; by 1995, the ratio had dropped to two out of ten (see table 1). This means that the number of poor people in the region was more than halved, from 720 million to 345 million. Further, the rate of decline accelerated after 1985. The number of people in poverty fell by 27 percent in 1975–85; in 1985-95 the decline was 34 percent.

Changes in poverty levels and rates varied across the region. In 1975, 92 percent of the region's poor lived in China and Indonesia, primarily because they were the two most populous countries. Since then, however, both countries have seen substantial declines in poverty: 82 percent in Indonesia and 63 percent in China. In absolute terms, the number of poor was more than halved in China, and fell by almost three-fourths in Indonesia. As a result, by 1995 the two countries' share of the region's poor had dropped to 84 percent. And although Indonesia's record is remarkable—the head-count declined from 64 percent in 1975 to 11 percent in 1995 (and further by 1997—see below) - Thailand had the largest proportional reduction between 1975 and 1995, from 8 percent to less than 1 percent.

Table 1: Poverty in East Asia, Summary Statistics: 1975–95

Economy	*Number of people in poverty (million)*			*Head-count Index (percent)*			*Poverty Gap (percent)*		
	1975	1985	1995	1975	1985	1995	1975	1985	1995
East Asia	716.8	524.2	345.7	57.7	37.3	21.2	n.a.	10.9	6.4
East Asia (exc. China)	147.9	125.9	76.4	51.4	35.6	18.2	n.a.	11.1	4.6
Malaysia	2.1	1.7	0.9	17.4	10.8	4.3	5.4	2.5	<1.0
Thailand	3.4	5.1	<0.5	8.1	10.0	<1.0	1.2	1.5	<1.0
Indonesia	87.2	52.8	21.9	64.3	32.2	11.4	23.7	8.5	1.7
China	568.9[b]	398.3	269.3	59.5[b]	37.9	22.2	n.a.	10.9	7.0
Philippines	15.4	17.7	17.6	35.7	32.4	25.5	10.6	9.2	6.5
Papua New Guinea	n.a.	0.5	1.0[c]	n.a.	15.7	21.7[c]	n.a.	3.7	5.6[c]
Lao PDR[d]	n.a.	2.2	2.0	n.a.	61.1	41.4	n.a.	18.0	9.5
Vietnam	n.a.	44.3[e]	31.3	n.a.	74.0[e]	42.2	n.a.	28.0[e]	11.9
Mongolia	n.a.	1.6	1.9	n.a.	85.0	81.4	n.a.	42.5	38.6

n.a. not available.
Notes: All numbers in this table (except for Lao People's Democratic Republic) are based on the international poverty line of US$1 per person per day at 1985 prices.
a.: includes only those countries presented in the table.
b.: Data relates to 1978 and applies to rural China only (World Bank 1996d).
c.: Data relates to 1996.
d.: Available data on PPP exchange rates and various price deflators for Lao People's Democratic Republic are not very reliable and lead to anomalous results. The poverty numbers for Lao People's Democratic Republic in this table are based on a national poverty line which is based on the level of food consumption that yields an energy level of 2,100 calories per person per day and a non-food component equivalent to the value of non-food spending by households which are just capable of meeting their food requirements. The US$1-a-day poverty line is based on characteristic poverty lines in low income countries that have comparable basis in food and non-food consumption needs; the poverty numbers for Lao People's Democratic Republic are, therefore, not strictly comparable to those for other countries.
e.: The figures refer to 1984. "Vietnam Household Welfare in Vietnam's Transition" in Macroeconomic Reform and Poverty Reduction, edited by D. Dollar, J. Litvack, and P. Glewwe. World Bank Regional and Sectoral Study, 1998.
Source: Everyone's Miracle?, World Bank 1997.

Between 1973 and 1990, the region saw substantial gains in life expectancy and declines in infant mortality (see table 2). Similarly, access to education expanded—China and Indonesia reportedly joined Korea and the Philippines in achieving universal primary net enrollments. In all four countries, and in Malaysia, secondary net enrollment also expanded beyond 50 percent of children in the eligible age group.

Table 2: Social Indicators in East Asia, 1985-95

Country	Life expectancy at birth		Infant mortality rate (per 1,000 live births)[a]		Primary net enrollment (percent)		Secondary net enrollment (percent)	
	1970	1995	1970	1995	1970	1995	1970	1995
East Asia	**59.4**	**68.8**	**76**	**34**	**na**	**Na**	**na**	**na**
Taiwan, China[a]	69.0	74.8	69	6	na	> 99	75.0	87.4
Korea	60.6	72.0	46	10	> 99	> 99	45.4	93.4
Malaysia	61.6	71.8	45	12	84.1	88.7	25.5	55.9
Thailand	58.4	69.0	73	35	78.6	88.2	18.2	34.9
Indonesia	47.9	63.7	118	51	75.6	> 99	13.0	55.0
China	61.7	69.4	69	34	75.9	> 99	34.7	50.7
Philippines	57.2	66.5	71	39	> 99	> 99	40.4	75.5
Papua New Guinea	46.7	58.5	112	68	30.8	70.0	3.7	13.3
Lao PDR	40.4	52.8	146	104	na	60.0[b]	na	15.0[b, c]
Vietnam	49.36	67.5	111	42	na	91.0[d]	na	45.0[c, d]
Mongolia	52.70	66.4	102	55	na	na	na	Na

Notes: na. Not available

A: Source: Republic of China (ROC), various years.

b: 1993, Source: World Bank, 1995a.

c: lower secondary.

d: Source: World Bank, 1996e.

Source: Ahuja and Filmer (1996), for net enrollment rates; World Bank data for life expectancy and infant mortality.

Five factors contributed to the region's social progress and inclusive development.[5] Some could be jeopardized by the crisis.

- *Smallholder-based rural development*. In most East Asian countries, small-scale family farming has dominated agricultural production, and government policies have contributed to an equitable development path by supporting productivity growth on family farms through infrastructure (notably in irrigation and roads), appropriate pricing and other market policies, plus new technologies.
- *Rapid growth in demand for non-agricultural labor*. In all of the region's major economies, except the Philippines, the past few decades have witnessed a massive labor shift—out of agriculture into more productive work such as rural non-farm activities, urban industry, and services. This shift was driven by many factors: agricultural incomes rose, spurring demand for rural non-farm employment, internal economic integration increased, overall capital deepened, and industrial employment grew rapidly. In Malaysia the share of wage workers in industry and services rose from 30 percent in 1960 to more than 60 percent in the 1990s.[6] Since the early 1980s, rural, and then urban industry and service employment has expanded enormously in China. Such changes have been accompanied by large increases in real wages—and by large increases in the incomes of self-employed workers.

- *Widespread public provision of basic education and health services.* Rapid growth in the public provision of schooling was a major element of the region's human resource strategy. Primary schooling expanded rapidly, followed by growth in secondary, and then tertiary education. These efforts contributed to the early achievement of almost universal primary education, complemented by a significant expansion of basic health services, including key preventive services such as immunizations and basic curative care.
- *"Flexible" labor markets and low labor market dualism.* East Asian labor markets are fairly flexible, with fewer institutional or policy-driven rigidities than European or Latin American markets—minimum wage policies are limited; wage-setting practices are flexible, and wages and productivity growth are closely linked. As a result, fewer sharp contrasts existed between formal, privileged workers and rural, informal workers.
- *Upgrading workforce skills and investing in education ahead of demand.* In Korea, education expansion effectively anticipated the changing demands of modern industries and services. Young people with a primary school education were the core of the workforce for the early phases of labor-intensive industrialization. As productivity and wages rose—driven by high levels of capital investment and technological advance—demands shifted first to secondary and increasingly to tertiary graduates. Meanwhile, schooling expanded rapidly enough that skills supplies actually surpassed demands. Between the early 1970s and the late 1980s, this prompted a decline in wage inequality among workers with college, secondary, and primary schooling.[7] While young school graduates tended to enter and remain in industry, older workers were moving out of agriculture directly into services. Rural productivity rose rapidly and the unskilled labor market tightened, prompting a convergence of rural and urban incomes.[8]

But not everything was fine, even in these domains. We turn next to the major pre-crisis issues. For example, Thailand's sharp rise in inequality appears to be partly related to slow growth in secondary education; China's unusually small tertiary education sector could cause future problems. In Indonesia and the Philippines there are concerns about education quality. Some East Asian countries have done very well in terms of health, but by some measures unusually high levels of child mortality exist in Indonesia, Korea and the Philippines.[9] In some cases, labor market policies have been overly restrictive, especially in Korea and China, where insiders are highly protected and state intervention in employment is pervasive. Measures to tackle insecurity are mixed—Korea is following Japan toward a European style, pay-as-you-go, welfare state; China is providing cradle-to-grave protection for state sector employees and their families; Malaysia and Singapore are running large-scale, state-managed provident funds.

Pre-crisis challenges and emerging vulnerabilities

Even before the onset of the crisis, three major vulnerabilities already existed, but they were masked by widespread growth: protracted poverty and rising inequality; concerns about labor rights; and rising demands for formal mechanisms to offset household insecurity. The crisis has aggravated conditions underlying each of these issues. These each have to be addressed in order to build the foundations for a caring and competitive society. The crisis has now made facing these issues imperative for all the countries in crisis.

Persistent poverty and vulnerability

Despite tremendous gains, poverty remains a fact of life for many in East Asia. Poverty is still high in Indochina and Mongolia, reflecting slower growth and recent systemic transition. But even in high growth countries, vulnerabilities remain considerable given the large numbers of households just above the poverty line: in Indonesia, a 25 percent increase in the poverty line results in more than doubling the headcount index, from 11 to 25 percent in 1996. Moreover, absolute poverty persists in certain areas or among certain groups. The poor tend to live in rural areas, have less education and live in households headed by farmers. In addition, some ethnic minorities are disproportionately poor and girls appear to get shortchanged in household resource allocation—particularly in poor households.[10]

Reductions were not uniform across these economies, and poverty remains acute in some regions. For example, in 1990 poverty incidence in Indonesia ranged from 1.3 percent in Jakarta, to 46 percent in West Nusa Tenggara. In the inland province of Guizhou in China, the incidence of poverty in 1992 was 20 times that in the booming coastal province of Guangdong. In Thailand, the northeast has the highest incidence of poverty and the highest concentration of poor people. Even in Vietnam and Lao PDR, where poverty is much more widespread, regional variation is substantial. In Vietnam the incidence of poverty ranges from 34 percent in the southeast to 77 percent in the north-central region.

Are some regions poor because they contain a high concentration of households with characteristics that are strong correlates of poverty? Or are there purely geographic effects? Jalan and Ravallion (1997) suggest that in China geographic effects remain strong even after controlling for household characteristics: households with identical characteristics experience different or even diverging consumption growth depending on location.[11] This finding suggests that policies to augment geographic and community capital are essential to help alleviate poverty.

Rising inequality

East Asia has been credited with achieving “growth with equity” but the facts are more varied. On average, East Asia’s income distribution has remained largely unchanged in the last 15 years, either in absolute terms or relative to other regions. An aggregate index of inequality finds that East Asia is more egalitarian than Latin America or Sub-Saharan Africa but less egalitarian than former socialist countries in Eastern Europe, high-income countries, and South Asia (see table 3).

Table 3: An International Comparison of Inequality
(averaged Gini coefficients)

Region	*1980s*	*1990s*
Eastern Europe	25.0	28.9
High-income countries	33.2	33.8
South Asia	35.0	31.9
East Asia and the Pacific	38.7	38.1
Middle East and North Africa	40.5	38.0
Sub-Saharan Africa	43.7	47.0
Latin America and the Caribbean	49.8	49.3

Note: The total sample includes 108 economies. Although Gini coefficients come from household surveys that satisfy comprehensiveness criteria in terms of both geographical coverage and income sources, they nevertheless include unadjusted data from both expenditure and income distributions. The proportion of income Gini coefficients vary across regions, hampering comparability. Regional averages are unweighted, and changes across the two decades may be due to changes in the composition of the sample. The numbers merely suggest broad orders of magnitude.

Source: Deininger and Squire (1996)

But there was significant variation among countries (see table 4).[12] Inequality has clearly risen in China, Hong Kong (China), and Thailand. It also appears to have inched up in the Philippines between 1985 and 1994, and recent data for 1997 suggest a sharper increase.[13] Only Malaysia shows a slight decline in inequality, although this reflects earlier gains which were partially reversed by a significant rise in inequality in the 1990s. With the exception of China, all four countries now have inequality rates well above the regional average.

Research on China and Thailand suggests two explanations for rising inequality. First, the returns to higher levels of education have increased, which is driving a wedge between highly skilled workers and those with primary or lower-secondary education. Second, spatial disparity in economic prosperity is growing because activity is concentrated in certain areas. The current crisis may increase inequality in access to education and also affect regions differently, further aggravating skills- and geography-based differentials.

Table 4: Inequality in East Asia

<table>
<tr><th rowspan="2">Economy</th><th rowspan="2">Period</th><th rowspan="2">Measure variable</th><th colspan="2">Gini coefficient (percentage points)</th></tr>
<tr><th>First year</th><th>Last year</th></tr>
<tr><td>Hong Kong</td><td>1971-91</td><td>I/H</td><td>40.9</td><td>45.0</td></tr>
<tr><td>Singapore</td><td>1973-89</td><td>I/H</td><td>41.0</td><td>39.0</td></tr>
<tr><td>Taiwan, China</td><td>1985-95</td><td>I/P</td><td>29.0</td><td>31.7</td></tr>
<tr><td>Korea, Rep. Of</td><td>1970-88</td><td>I/H</td><td>33.3</td><td>33.6</td></tr>
<tr><td>Malaysia</td><td>1973-95</td><td>I/P</td><td>50.1</td><td>48.5</td></tr>
<tr><td>Thailand[a]</td><td>1975-92</td><td>E/P</td><td>36.4</td><td>46.2</td></tr>
<tr><td>Indonesia</td><td>1970-95</td><td>E/P</td><td>34.9</td><td>34.2</td></tr>
<tr><td>China[b]</td><td>1985-95</td><td>I/P</td><td>29.9</td><td>38.8</td></tr>
<tr><td>Philippines</td><td>1985-94</td><td>E/P</td><td>41.0</td><td>42.9</td></tr>
<tr><td>Papua New Guinea</td><td>1996</td><td>E/P</td><td colspan="2">50.9</td></tr>
<tr><td>Lao PDR</td><td>1993</td><td>E/P</td><td colspan="2">30.4</td></tr>
<tr><td>Vietnam</td><td>1993</td><td>E/P</td><td colspan="2">35.4</td></tr>
<tr><td>Mongolia</td><td>1995</td><td>E/P</td><td colspan="2">33.2</td></tr>
</table>

Note:
I/P is per capita income, E/P is per capita expenditure, and I/H is income per household. The numbers in this table may be marginally different than those reported in other World Bank reports based on unit record data. For the sake of consistency across countries, we only report Ginis based on grouped data, except for Korea, Singapore, and Hong Kong, (China) which are from Deininger and Squire 1996.

[a] Thailand is the only country for which we can present Ginis based on both expenditure and income distribution. The per capita income-based Gini (I/P) was 42.6 percent in 1975 and 54.6 percent in 1992.

[b] Because of China's size as well as with valuing home production of grain for own consumption, controlling for spatial price variations, and valuing in-kind transfers, the uncertainty associated with Chinese Ginis may be even greater than that for other economies (see World Bank 1997b for a detailed discussion).

Source: Deininger and Squire (1996), and World Bank staff calculations.

High inequality is bad for society for three reasons: it undermines poverty alleviation, it may impede growth, and it can contribute to social tension. For a given growth rate, an increase in inequality tends to lead to slower poverty reduction.[14] Greater initial inequality can reduce economic growth because of imperfect credit markets or through political economy channels. Social tension can result when the benefits of growth accrue unequally to easily identifiable groups—for example, certain regions, ethnic groups, or men and boys—even if these are not major factors in overall inequality. Japan, Korea, and China are notably homogenous societies, but Indonesia and Malaysia have major divides across ethnic lines that have spilled over into significant conflicts in the past—into the blood bath of 1965 in Indonesia and periodic violence against Chinese-Indonesians since, notably in 1998. Yet, both achieved sufficient social understanding and stability to foster high levels of capital investment, especially by ethnic Chinese groups. In Malaysia's case there was a highly managed process of affirmative action for the ethnic Malay population, or Bumiputra (see box 1). Managing inequality is a challenge both for rich and poor countries, because it is not easy to balance incentives for superior individual performance with acceptable levels of inequality which foster poverty reduction and growth.

Box 1: Malaysia's NEP and social inequality

Ethnic rioting came to a head in Kuala Lumpur in May 1969 after a Chinese-dominated opposition won many parliamentary seats from the Malay-dominated ruling coalition. Malays, most of whom were impoverished, reacted violently in fear of losing their political influence. To confront and combat the causes for this uprising, the government launched the New Economic Policy (NEP), an affirmative action plan designed to pull poor Malays back into the mainstream of the country's economic system.

The NEP introduced a series of government regulations, quotas, scholarships, and other privileges designed to help Malays. The results have been impressive: Malay's share of national wealth jumped to 20.6 percent in 1995 from 2.3 percent in 1970. Much of the NEP's success is attributed to education as the number of Malay doctors, lawyers, and engineers increased dramatically. Malaysia's affirmative action policies have not been without controversy and some have observed that the policies helped foster favoritism and inefficiency. Even so, the overall approach clearly succeeded in supporting high levels of investment, low levels of internal conflict, and rapid advancement of all Malaysians, especially the Bumiputra, for more than two and a half decades.

Source: "Far Eastern Economic Review", 5/28/98; "Lessons From Malaysia," by Murray Heibert.

Labor relations

countries in the region sought to maintain relatively unfettered labor markets during the early stages of economic development at the expense of granting workers' rights to bargain collectively. However, the apparent flexibility was in part a product of high growth and the large supplies of labor in agriculture (or abroad for some countries). There was more underlying segmentation than in the common characterization, and also emerging problems of wages outstripping productivity growth in countries with tight labor markets (notably Korea). In some cases highly regulated labor markets developed in the modern sector.[15] Until the late 1980s, labor conditions in the five East Asian economies—Korea, Malaysia, the Philippines, Taiwan (China), and Thailand—were determined unilaterally by employers with or without the assistance of government (Galenson 1992). However, in the late 1980s changes began to affect unions. There were shifts towards more democratic governments, pressures for modern industrial relations brought about by tighter labor markets, and more sophisticated production processes.

Failure to modernize worker–management relations in countries with sophisticated economic and political structures can become costly, as Korea's experience since the late 1980s has shown. If there is no industrial relations system to allow workers to air grievances and resolve disputes, strikes and other forms of job actions, sometimes violent, can become common. One of the challenges facing maturing economies in East Asia is that of managing industrial relations to protect workers' legitimate rights, but avoid granting entitlements that result in resource inefficiencies.

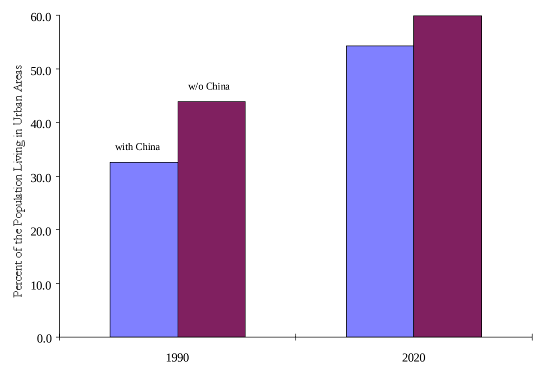
Household risks

Most East Asian households have few formal mechanisms to protect them from risks associated with job losses, disabilities, and aging. Instead, most rely primarily on personal savings and informal family and community links. A few countries in the region have set up formal schemes to address household insecurity, but these cover small portions of the population (state workers in China, large enterprises in Korea, participants in the state provident funds in Malaysia and Singapore)—the only cases where coverage is substantial. The current financial crisis makes glaringly evident the absence of formal provisioning for household security for many households.

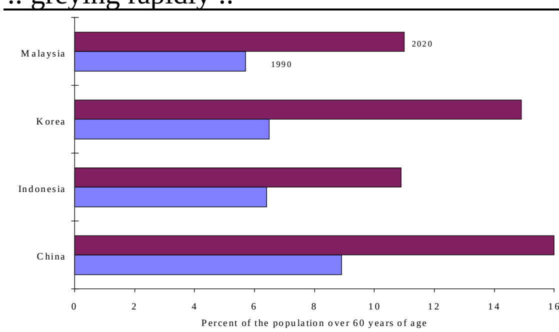
In the face of the crisis, the demands for safety nets are urgent but they will be far more dramatic 25 years from now because East Asian societies are undergoing a rapid demographic shift. East Asian populations are aging, moving into cities, and increasingly working in the formal sector (see figure 1). In France it took 140 years for the proportion of the population over 60 to double—from 9 to 18 percent. By contrast, in Korea, people over 60 will double their share in the population in only 30 years—between 1990 and 2020—and in China the portion of people over 60 will rise from 9 percent to 16 percent of the population during the same period.[16] These changes reflect a swifter demographic transition, and in China, they demonstrate the combined effects of early gains in rural health status and an activist population policy. All three trends will strain informal family-based mechanisms of household protection, and will increase demands for formal, government-mandated schemes.

Figure 1: Urbanization, Aging, and Labor Force Adjustments in East Asia

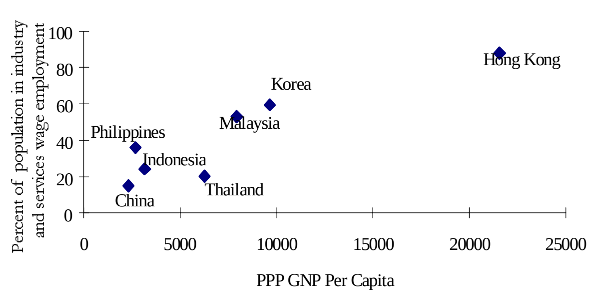
East Asia's population is urbanizing ...



.. greying rapidly ..



.. and increasingly working in the formal sector as incomes rise.



The Social Impact of the Crisis

The economic contraction is affecting the lives of millions, and aggravating social vulnerabilities. It is likely to have many dimensions—falling incomes, rising absolute poverty and malnutrition, declining public services, threats to educational and health status, increased pressure on women, and increased crime and violence. In Indonesia there is also a radical breakdown in social order as an increasingly fragile social equilibrium was brought under intolerable stress by the collapse in economic confidence and fall in incomes.

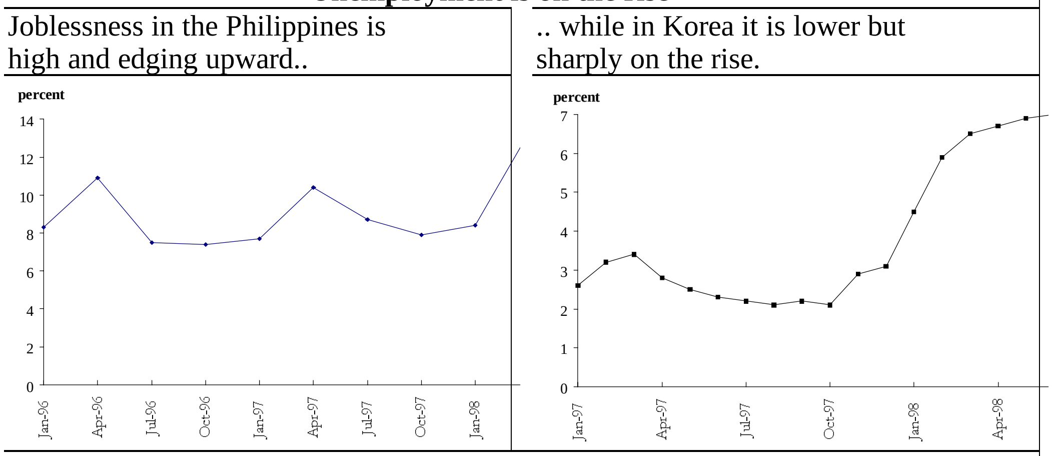
The effects of the crisis are acute in Indonesia, and severe in Thailand, Korea, and Malaysia. The Philippines has been less affected, but also shows signs of worsening social conditions. (After declining steadily for five years, in September 1997 there was a *rise* in self-reported poverty).[17] Trade, capital flow, and migration linkages among countries are hastening the transmission of economic and social effects across the region. While China remains largely insulated, falling regional demand and slowing intra-regional foreign investment are aggravating domestic difficulties. Countries in Indochina are experiencing growth downturns and financial difficulties as the impact of the regional crisis unfolds with a depth and intensity far exceeding previous expectations. The Pacific Islands have also been hit; by far the worst affected is the Solomon Islands where GDP is expected to shrink by 10-12 percent, driven by a collapsing log export market in which export prices have halved.

Effect on households

The economic crisis is hitting households hard in four ways: falling labor demand, sharp price shifts, a public spending squeeze, and erosion of the social fabric. In addition some countries have been simultaneously hit by drought.

Falling labor demand. Economic decline, the corporate crisis, and a credit squeeze are causing lay-offs, real wage declines, weak demand for new labor market entrants, and falling margins in the informal sector. Whether the impact in a given country is primarily through higher unemployment or lower wages depends on societal and economic structures. In Thailand, unemployment has increased by 50 percent since the start of the crisis to 1.5 million (February 1998) and is expected to exceed 6 percent by year-end. In Korea, unemployment reached 7.0 percent in June 1998 and may affect as many as 2 million people during the year, up from 0.5 million last year (see figure 2). In the Philippines, 1 million additional people joined the ranks of the jobless between April 1997 and April 1998, raising the unemployment rate to 13.3 percent. In Indonesia, where some 4.5 million people (4.9 percent) were already unemployed in 1996, official estimates suggest an additional 10 million may lose their jobs by early 1999, although it is likely that many of them will move into low-paying urban and rural informal sector work rather than into open unemployment.

Figure 2
Unemployment is on the rise



Source: Korean and Philippine Authorities

This is *not* essentially an urban shock, despite the high profile of urban unemployment figures. Rural areas will be affected by labor movements, production linkages, and intra-household relationships because of the highly integrated nature of the economies and the declining demand in urban areas. Increased *under*-employment and falling wages may be more widespread and valid indicators of a decline in well-being than open unemployment. In Korea, open unemployment has increased sharply, but family and agricultural workers and labor force drop-outs are also on the rise suggesting substantial increases in underemployment. Data from Western Java (Indonesia) point to a decline in rural real wages by 10 percent between August and December 1997. Available information suggests that workers are returning to their villages from Jakarta and Bangkok. There is an international dimension as well: migrant workers in Malaysia, notably from Indonesia, are also losing their jobs or suffering real wage declines. The Philippines is also vulnerable owing to large numbers of overseas workers. Finally, there is evidence that women are disproportionately targeted for lay-offs as societies regress to traditional perceptions of men as the “primary bread-winners” (see box 2) .

Box 2: In Bad Times, Women Suffer the Most

One key area that is essential for policy making and about which too little is known is the gender aspects of the crisis. There are various anecdotal reports on the burdens that have fallen on women in different countries, but evidence is difficult to find. Given existing research on gender dynamics, it is likely that a combination of social factors, cultural views and changing economic opportunities mean that the financial upheaval has had different impacts on women than on men. As in most of the world, there are long-term biases against women in East Asia: they are generally less powerful than men at home, at work and in politics. Nevertheless, women shared in the massive absolute economic and social gains during the decades of growth, and even enjoyed some reduction in relative disparities, for example in the labor market.[18] But women and girls may be disproportionately hurt by the financial crisis. Women lose their jobs first, and families pull their daughters out of school before sons interference. The particularly hard pressed may sell daughters to brothels. Even before the crisis, girls in Indonesia were six times more likely than boys to drop out of school before the fourth grade. Once girls are removed from school, they rarely go back.

When income shortfalls require reductions in food intake, women and girls sometimes face disproportionate cuts. Social organizations also point to a rise in domestic violence and prostitution. Though gender inequality is not a new problem in the region, the crisis situation has exacerbated the difficulties faced by poor women and girls in East Asia.

To better understand the gender dynamics in the different countries, and between different sectors within these countries, action oriented research needs to be undertaken on issues such as trends in formal employment, changes in educational opportunities, and access to health services. The social cost is often carried by women through reduced food intake at home, or worse through domestic violence that reflects the growing erosion of social capital. Research is especially important at a time of shifting economic relations, as women may find themselves facing unemployment or multiple employment. Anecdotal stories have also presented dramatic images of children who have dropped out of school and who have out of necessity taken to the streets. While programs have been instituted, as outlined in this paper, to keep children in school, the aggregate and disaggregated impacts are unknown. Wildly disparate numbers are cited in terms of the percentage or number of children who have fallen back in to poverty. In order to understand what is happening in the lives of children, new research programs are needed that will provide a clearer and more up to date information. One example is that the particular situation of adolescent girls becomes more uncertain when employment opportunities or further educational programs are cut off, leading to pressure for early marriage, exploitation or harsh working situations. Yet, little is known beyond a few stories about children in garbage dumps and girls forced into prostitution----stories that present stark images of the social costs, but which cannot adequately provide for longer term programs or new policy emphases.

*Sharp price shifts***.** Prices have risen because of exchange rate devaluation, associated increases in the prices of traded goods, and public sector price hikes. In Indonesia, where the exchange rate has depreciated by 80 percent since July 1997, the prices of antibiotics doubled between October 1997 and March 1998 and the consumer price index (CPI) for food increased by more than 50 percent between June 1997 and March 1998 compared to a 38 percent rise for the general CPI. Prices of drugs have risen sharply throughout the region—dramatically in Indonesia, where there are already reports of households postponing vaccinations or use of other drugs; HIV/AIDS patients in the region may be particularly vulnerable. The longer-term effect of these changes is difficult to predict because in most countries the exchange rate appears to have overshot an equilibrium position, and it is hard to know how much will be inflated away or reversed by increased demand for local assets once confidence recovers. But there will clearly be short-run price effects. These will squeeze profits in much of the informal sector, that is generally already facing weak demand in the domestic market.

*Public spending squeeze***.** Public spending is being constrained by revenue falls, the effects of exchange rate changes on interest bills and the need to finance the increasing liabilities of the government in financial sector and corporate restructuring. Budgets were cut initially in all of the affected countries as part of the macroeconomic adjustment process. While fiscal targets have since been adjusted in some countries, public services may still suffer cutbacks creating both short-and-long-run impacts on households. Of particular concern are potentially irreversible effects on investments in human resources. Constraints may also mean funding is cut in areas that have a serious impact on relatively poor households (such as smallholder treecrop investment).

*Erosion of the social fabric***.** Economic stresses are leading to social and political problems. Rapid development has brought rising incomes to most East Asian households in the past decades. It has also led to rapid social change, urbanization, migration, and expansion of schooling. A sudden stop to the rapid growth can be expected to disturb the social equilibrium. Social unrest in Indonesia vividly showed how fragile this equilibrium can be, and how quickly socially repressive societies can be thrown into upheaval once civil society begins to question its leaders' abilities to deliver continued improvements in *economic* well-being—the central source of political legitimacy. At a less dramatic but nevertheless significant scale, social stresses are mounting at both the household and community levels in all crisis countries. Focus group discussions suggest that households with falling incomes are coping by increasing the workload of mothers and by taking children out of school and putting them to work.[19] Economic stresses may also be leading to increased domestic and community violence and resorting to illegal activities such as prostitution and drug trade.

*Drought***.** Parts of Indonesia, the Philippines, and Thailand have been hit by drought due to El Niño. While the effects appear to be less adverse than originally feared, in some areas the combined macroeconomic and agricultural shock makes coping particularly difficult. Consumption drops can be life-threatening, especially in Indonesia where distribution channels and markets have been damaged (in part by ethnically focused violence) and foods stocks have dwindled. In the Philippines, the large increase in unemployment between April 1997 and April 1998 was entirely due to the sharp drop in agricultural employment as a result of El Niño, particularly among unpaid family workers and independent farmers. Households that have suffered from repeated droughts for the past several years—for example, in Indonesia's Eastern Islands—are particularly vulnerable as they are likely to have run down their assets and stocks to smooth consumption. The extent of crop failure varies widely and food price rises are magnifying these distributional effects. Higher prices help farm households which can raise surplus food to sell, but hurt long-term food deficit households and farm households temporarily in food deficit because of the drought.

These shocks will affect incomes, well-being, access to services, and will interact with the coping strategies that households adopt to protect their consumption levels (see box 3). The effects on the poor will depend on the depth and duration of the macroeconomic recession and on whether distribution worsens or improves during the crisis. Both dimensions are uncertain. Other episodes of economic contraction provide limited insights into expected trends in distribution. In many Latin American countries, distribution worsened during the economic difficulties of the 1980s, but in Malaysia's most recent contraction in 1984–87, distribution improved enough to prevent a rise in poverty levels.[20]

Box 3: People are Struggling to Get By

Entering the informal labor market. Household income falls in all countries have already forced many families to send more women, children, and elderly into the labor force. In Thailand, NGOs report an increase in child labor, child prostitution, and child beggars. In the slum settlement of Teparak, Khon Kaen, northeast Thailand, women were angry because they had to send their children to the garbage site every day to support the family. In Indonesia, there are reports of children leaving school to join *padat karya* programs (labor-intensive projects).

Migrating. In Thailand, rising urban unemployment is likely to force industrial workers back to their villages of origin. A Tambon representative, in the rural village of Sap poo pan, northeast Thailand, estimated that out of the village population of 260, 40 people had already returned because of the crisis and 70 were still working outside the village, mainly in Bangkok. Returning laborers will increase the competition for jobs, further marginalizing farm laborers who are less competitive. The impact of migration from neighboring countries is still difficult to define. In Cambodia's northwest province, whole communities relied on jobs in Thailand. Focus groups reported that within the last three months, most of these workers are returning because they have lost their jobs and are still in debt.

Cutting down on household expenditure. In slum areas, people reported cutting down from three meals per day to two, or even one. In Indonesia, (Maluku and South Sulawesi) school principals complained that parents were having difficulty paying parent association fees on time, or at all. In Indonesia and the Philippines (Mindanao), teachers reported that children were eating less before coming to school in the mornings and buying less from vendors and that this was affecting students' ability to concentrate.

Turning to illegal activities. In some slum areas in the Philippines and Thailand, people report an increase in crime. The slum dwellers in Bangkok told focus groups that unemployed youth were already turning to selling drugs to support their families. And, in Cambodia, there were reports of increases in the trafficking of women and children.

Source: Rapid social assessments undertaken by Bank staff in collaboration with NGOs in Thailand, Philippines, Indonesia and Cambodia, January-April, 1998.

Future impacts of the crisis on poverty

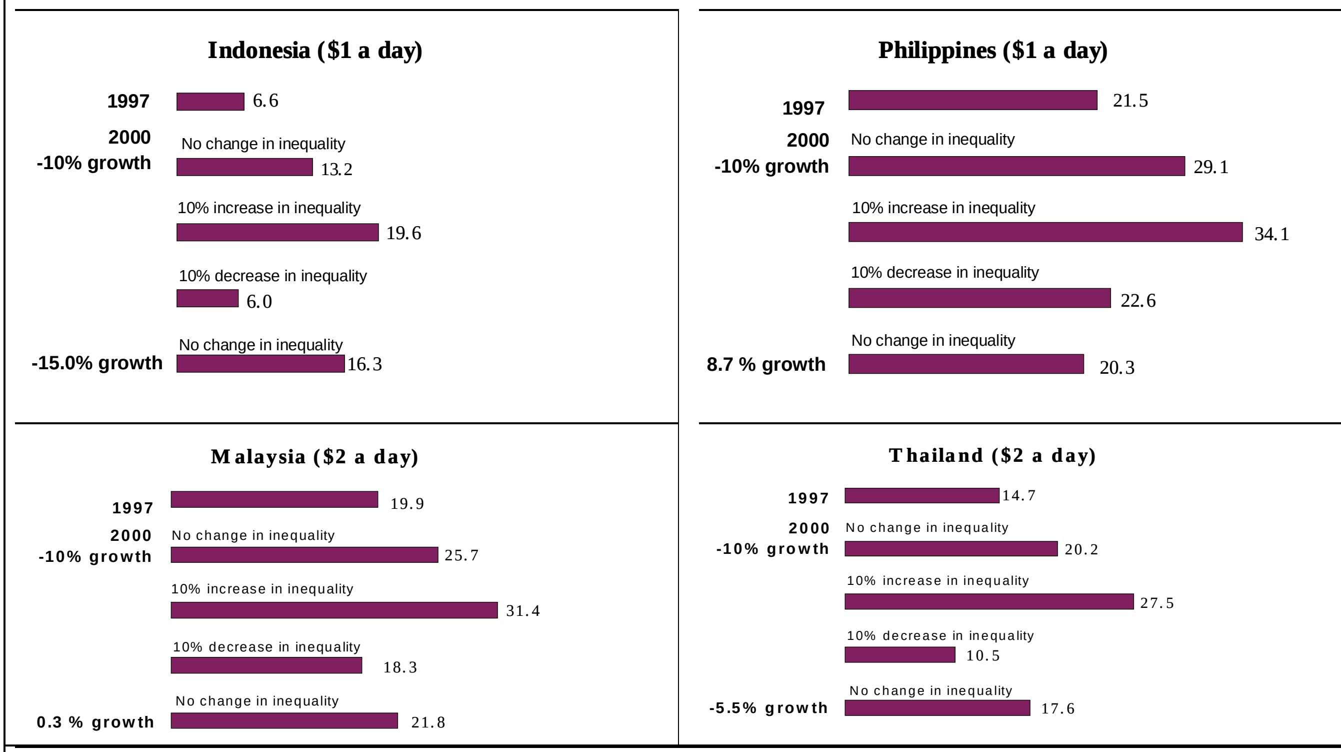
Forecasting poverty is hazardous enough in conditions of stability. So, we simply illustrate potential outcomes for the poor of alternative *assumptions* on growth and distribution for four affected Southeast Asian economies.[21] Results are shown based on two commonly used poverty lines: US$1 per person per day (in 1985 purchasing power prices), which is close to poverty lines used in poorer countries (and close to the Indonesia poverty line) and US$2 a person a day, which is closer to national lines used in middle-income countries. In Malaysia and Thailand there are few people living on less than US$1 a day, but more than 15–20 percent survive on less than US$2 a day. By contrast, in Indonesia and the Philippines half the population still lives on less than US$2 a day.

Poverty is highly sensitive to both growth and changes in inequality; the impact also depends on the initial pattern of distribution. This is explored for four of the crisis countries by examining the consequences of common assumptions for each of them (that is, this is *not* a forecast). First, we stimulate the effect on poverty of a 10 percent fall in aggregate consumption or income between 1997 and 2000 using a poverty line of US$1 a day for Indonesia and the Philippines, and US$2 a day for Malaysia and Thailand. With no change in distribution, poverty would double in Indonesia, and increase by 35 to 50 percent for the Philippines, Thailand, and Malaysia. If, in addition, inequality worsened, there would be a large *additional* effect on poverty. A 10 percent rise or fall in the Gini coefficient—a significant change by past standards—in the distribution of income illustrates the possible orders of magnitude, and would have a major influence on projected poverty outcomes (see figure 3). In Indonesia, for example, a 10 percent worsening in inequality would cause poverty incidence to almost triple—from less than 7 percent (estimated for 1997) to almost 20 percent in 2000. By contrast, if inequality improved by 10 percent, poverty would remain largely unchanged.

We then illustrate the impact on poverty of the most likely growth scenarios for each country for the period between 1998 and 2000 (based on consensus forecasts) with no change in inequality. Country-specific annual growth rates are used for this exercise to calculate poverty incidence in the year 2000 (see figure 3). For Indonesia, the large expected declines in aggregate growth push an additional 10 percent of the population into poverty by 2000 even if there is no worsening in inequality. This is equivalent to a rise in the number of people living under US$1 a day from 13 million (estimated for 1997) to 34 million for 1999 and 2000—compared with 22 million in 1995 and 53 million in 1985 (table 1). Thailand is also expected to be hit hard with a 20 percent increase in the head count index. Malaysia and the Philippines are projected to show milder effects although simulations point to a deceleration of gains in the Philippines, and a reversal of a long-term trend of poverty alleviation in Malaysia. Any worsening in the distribution would aggravate poverty outcomes.

Figure 3: Poverty projections
(poverty incidence, percent)

A 10 percent contraction in aggregate GDP between 1998 and 2000 would add millions to the ranks of the poor. Beyond growth, distributional changes also strongly influence poverty outcomes. But even with no change in inequality, the most likely growth scenarios (1988-2000) imply a halt or a sharp reversal in a 20- year long trend in poverty alleviation.



Note: The growth rates used for simulating poverty incidence refer to cumulative rates over the three-year period, 1998-2000.
Source: Ravallion and Chen 1998.

The scenarios show the powerful influence of overall economy-wide performance on poverty through its impact on both average incomes and inequality. But what can be said about actual short-run distributional outcomes?

It is difficult to draw general lessons from past episodes, since there are no general patterns to distributional changes in periods of contraction. But, it is possible to explore the relationships between short-run sectoral growth expectations and the structure of poverty. This has been done for Indonesia by applying projected sectoral growth rates to the structure of household incomes available from the consumption survey.[22] The simulations assume major declines in construction (-35 percent), commerce (-18 percent) and financial services (-18 percent), and a drought-induced slowdown in agriculture (1 percent), yielding a 12 percent decline in aggregate GDP. They examine only *impact* effects, and do not take account of either household responses or second-round effects, notably in the labor market.

In Indonesia, a 12 percent decline in aggregate GDP in 1998 is estimated to increase poverty from 11 percent in 1996 to 14 percent in 1999, affecting both rural and urban residents. Even if second-round effects are ignored, most poverty in Indonesia would remain rural. Yet the immediate effect of the crisis is expected to be more acute in urban areas, resulting in a significant scale of urban poverty—8 percent in 1999—for the first time in many years (see table 6). Some groups would be particularly hard hit: the construction industry collapse would push poverty incidence among workers' families from 8 percent to nearly 31 percent, but the actual number of people involved is relatively small. Of course, workers and households will respond and move into other labor markets. Java in particular has a high degree of inter-connectedness between rural and urban areas. If agricultural incomes hold up, as the scenarios now indicate, there could be a rise in rural inequality: those with land would gain in relative terms, as those without land suffer from the general collapse in labor demand.

Table 6: Impact effects on poverty in Indonesia
(percentage of population)

	Baseline January 1996	*Forecast 12 percent contraction March 1999*
Rural	15.0	17.6
Urban	5.0	8.3
Total	11.3	14.1

What is the cost of eliminating the crisis-induced increase in poverty through public transfers? We use Indonesia to illustrate magnitudes.[23] In Indonesia, the increase in the poverty gap between 1996 and fiscal year 1988–89 is estimated to be about 1.2 trillion rupiahs, or about 1 percent of 1988–89 budgetary revenues (see table 7). Restoring the poor's consumption to its 1996 levels would require a transfer of this amount. There are many ways this could be done, ranging from a universal (that is, untargeted) cash transfer to various targeted schemes, including some commodity subsidies and employment programs. An untargeted cash transfer, assuming no administrative expenses, would cost about 8 trillion rupiahs; the increased costs reflect the substantial leakages to the non-poor. But is possible to do better. Analysis done for Indonesia puts the cost of transferring US$1 through public employment (*padat karya*) programs at US$3.8-US$5.3; transfers through such programs would thus require 4.6–6.5 billion rupiahs or 3.5–5 percent of budgetary revenues. (see table 7) These are small amounts (as they usually are), especially when compared to the costs of financial sector restructuring, but administrative difficulties can be daunting and the actual costs of effecting such transfers would be very much greater.

Table 7: Cost of selected transfers to eliminate crisis-induced poverty in Indonesia

(in current rupiahs)

Increase in poverty gap between 1996 and 1998/99	1.2 trillion
Cost of closing the gap through	
Universal cash transfers[a]	8 trillion
Padat karya-type programs	4.6-6.5 trillion

Notes: [a] Assuming no administrative cost

What can be Done?

There is an urgent need to reduce crisis-induced welfare declines. Much can be learned from successes–and failures–in responding to past crises, notably in Latin America (see box 4). Public action can make a difference in six domains:

- The design of economy-wide policies
- The policy and institutional framework for labor markets and income security
- The level and pattern of economic and social services
- The interrelationship between corruption, institutions and the social fabric
- The central role of public information.

How economic policies affect the poor

All the East Asian crisis countries are experiencing sharp drops in domestic demand. This is especially true of investments which are expected to fall by 10 percentage points of GDP per year, or more. This raises two questions: will future poverty reduction be jeopardized by the loss of productive investment and would compensating expansionary policies help the poor?

Box 4: What can East Asia learn from the experience of Latin America?

Latin America has experienced two major crises in the last 15 years; both began in Mexico and both incurred substantial social costs. In the 1980s, Mexico's debt crisis spread throughout Latin America on the back of trade shocks and weak public finances. In 1995, Mexico's liquidity crisis, with its roots in excessive private lending, spread only to Argentina.

Latin America's two crises hit households hard. In the 1980s, real wages in Argentina and Mexico fell by nearly 40 percent, while poverty increased by more than 30 percent. In Chile, real wages shrank by about 15 percent and unemployment rose by 9 percentage points within a year. In the 1995–1996 crisis, real wages in Mexico fell by more than 30 percent. In Argentina, unemployment rose by 6 percentage points and remained at around 18 percent of the work force for more than two years. As a result, poverty increased by more than 50 percent. Latin American governments responded with a variety of programs, but with the partial exception of Chile, the overall response was too little, too late. What are the lessons?

Solving social problems means putting them at the top of the agenda. Too often in the Latin American crises, policy makers' energy was devoted to restoring macroeconomic stability and implementing structural reform. East Asia has the opportunity to avoid this mistake by putting social issues at the forefront. Drops in income, employment, and public services have widespread and complex social consequences. Therefore, it is important to take action on a wide range of fronts, and make every effort to anticipate these consequences.

Targeting is crucial. Special funds set up in Latin America, designed to cushion the social costs of economic adjustment measures, had mixed success, largely due to poor targeting. Chile’s large public works program was successful, in part because it set wages low enough to ensure that the most needy were the main participants.

Cutting subsidies especially of goods that are essential items to the poor can fuel resistance to needed reforms, unless effectively targeted alternatives are offered. This was the case in the Mexican crisis.

Maintain support for core education and health services, or risk irreversible losses in human investment.

Social funds may be useful alternatives to government safety net programs, but only when the Government really lacks the cohesion or resources to make programs work. Poor targeting, lack of genuine community participation, and long set-up time plagued many of the funds established in Latin America. There is now more knowledge on how to design such funds well. But if established governmental or nongovernmental institutions work reasonably well, as they did in the past in most of East Asia, it is often better to work within that system.

More democratic systems do not hinder reforms. The Latin American debt crisis occurred as democratic rule was being restored in many countries and there were fears that democracy would either hinder painful but necessary reforms, or that the social disruption and violence associated with the crisis would hasten the return of authoritarian rule. Both fears proved groundless. Although the process of adjustment was slowed in some of the countries by granting an independent voice to unions, legislatures and other actors, the policy measures that were finally undertaken worked precisely because they had been endorsed by a more open civil society.

Source: International Herald Tribune, 5/29/98, "East Asia Can Learn From Latin America's Travails", by Nora Lustig and Michael Walton.

Protect investments that help the poor. An 'investment pause,' is a rational response to a shock. In times of significant drops in incomes, it makes sense to smooth consumption over time—allowing more consumption now, at the cost of less in the future. This is of particular value to the poor, or those at risk of large drops in income. Indeed, a pause in investment helps explain why the contractions in Indonesia and Malaysia in 1984–87 occurred without any rise in consumption-based poverty.[24] However, there is a cost in lost future growth in incomes–high levels of investment were at the center of the growth process that brought such extraordinary poverty reduction in the past. While some investments, such as property development, were unproductive, on the whole East Asian countries put their investments to good use.[25]

Different investment categories have different effects on the poor. To reduce poverty it is particularly important to invest in the capabilities of poor children (that if foregone may be irreversible), economic infrastructure in rural and periurban areas, and private investment in labor-demanding activities. The poor have a strong interest in overall policies that provide the confidence and financial sector preconditions for investment, especially in labor-intensive manufacturing and services. They also benefit from protecting public spending for economic and social services that reach the poor, either directly as beneficiaries, or via effects on labor demand during the construction phase.

More expansionary macroeconomic policy can help the poor, but there are tradeoffs. To help reduce poverty there is a strong case to err on the side of expansion. What scale of fiscal expansion is desirable still involves assessing other intertemporal tradeoffs since a more expansionary position could reduce investor confidence, or risk higher inflation and lower future growth prospects. Moderating economic contraction is important for the poor, and may be distributionally favorable.[26] How the fiscal expansion is financed is equally important. Deficit financing would be particularly damaging as there is evidence from the Philippines in the early-1980s, and Brazil from 1980 to the early 1990s, that the poor are the hardest hit by high inflation.[27]

Interest rate policies will have mixed effects on the poor. High interest rates can moderate inflation, restore capital inflows and encourage more labor-intensive new investment, all potentially pro-poor. But in East Asia in 1998, the dominant effects are the short-run consequences of high interest rates on output, and consequently on labor demand, that is central to the welfare of the poor.

Real exchange rate depreciations will help the poor in the long-run but short-run measures are important to cushion the effects of price increases. In the orthodox analysis, real exchange rate devaluation helps the poor because it favors agriculture—the most severe poverty is rural—and (following a period of adjustment) it encourages more labor-intensive investment choices. The evidence from the Philippines from the early 1980s, found that on balance real exchange rate depreciation tended to help the poor. However, these effects are hard to generalize, and price effects are likely to be highly diverse across different groups in the population. Some of the poor are likely to benefit: rice farmers in Thailand, smallholder export crop producers in the Philippines and Indonesia. But many poor households are net consumers of tradable goods. This applies to most in the informal sector. The poorest groups in both Indonesia and the Philippines are rural wage earners. Where drought has hit, many more farmers are net-consumers of food than in a normal year. All of these groups are vulnerable to the price shock: the next section discusses the role of measures on the pricing and labor demand side to offset these effects.

Financial sector bailouts should not spare equity-holders. Financial sector policy matters for the poor; the management of bailouts and effects on microcredit are of particular concern. Dealing efficiently with rotten parts of the financial system will require substantial infusions of public funds—perhaps on the order of 30 percent of GDP. While this is manageable within prudent debt limits, owing to low initial levels of public debt, it diverts vast resources from alternative uses to finance unsound or even corrupt past lending. The loans are mostly gone—whether to real estate follies or foreign bank accounts—and it is standard practice to protect small depositors who are mainly middle income; few among the poor have significant levels of deposits. However, protecting larger depositors to avoid a collapse in confidence is costly. At a minimum, distributional and political economy considerations demand that owners of equity in the financial sector take the hit before taxpayers. This is also more efficient since it reduces incentives for owners to go for high-risk lending strategies in the future.

East Asian countries have a wide range of financial institutions operating in most villages. Indonesia’s BRI Kupedes is one of the world’s largest rural micro-savings and credit programs. The Philippines has a wide array of small-scale programs, and there are significant, if smaller, sectors in Malaysia and Thailand. While many of these cater to better-off rural dwellers, they are sometimes an important part of the village economy. There have been concerns over the consequences of the crisis for the micro-finance movement. A recent survey of micro-finance institutions found that deposits continued to rise in many, possibly because they were sounder institutions and rural savers were shifting out of smaller rural banks.[28] Some institutions enjoyed sustained high repayment rates, others suffered sharp rises in defaults. Efforts should be made to avoid adverse effects of selective deposit guarantees on rural financial services. While short-term measures may be needed to avoid the collapse of micro-finance institutions, sustainability should remain an important medium-term objective.

Invest in institutional transparency and accountability and in the skills of poor people to increase benefits from globalization and temper inequality in the longer term. The crisis has brought distributional struggles into the open. Three areas are likely to be important to tackle longer-term distributional concerns. First, a major societal concern is unfair or corrupt gains among the wealthy and connected. Fostering sound corporate governance structures, open and accountable public sector institutions, competitive procurement and bidding practices will all help, but this is a domain where the issues are often deeply linked to political structures and not amenable to technocractic solutions. Second, there is some evidence that the forces of global integration and technological advance target the skilled, leading to widening wage differences between those with and without education.[29] The appropriate response is not to withdraw from international engagement—countries that do this hurt themselves and their poor in particular—but to support inclusive and high quality educational systems. Third, in the past growth largely bypassed populations living in poor areas. Policies that augment not only human capital, but also community capital, in these areas, may be helpful but in some cases outmigration may be the only effective strategy—as in the series of projects in inner China being supported by the World Bank.[30]

Food, employment, and income security

The economic crisis threatens the livelihood of the poor. When growth resumes, income gains and employment opportunities will expand, but this may take several years and there may be other temporary pauses in future growth. In the short term, the poor must be protected against drastic declines in consumption. Measures should aim at ensuring food security and preserving the purchasing power of vulnerable households. In the long-term, households will need assistance attaining income security during old age, and health and employment shocks, and to reform labor market policies.

Ensuring Food Security

Food prices have increased sharply in most countries and there is evidence of food shortages in parts of Indonesia. Price increases on rice primarily affect the poor. In Indonesia and the Philippines, rice accounts for nearly 20 percent of household expenditures for the poorest one-fourth of households. In Indonesia, it jumps to 30 percent of household expenditures for the poorest decile. A relative increase in rice prices could hurt some of the long-and short-term poor and the non-poor hit by drops in labor demand; but it would protect households and villages that remain in food surplus.

Managing rice supplies to smooth price adjustments and avoid major price hikes may be desirable in the short-term—especially in light of the substantial overshooting of the exchange rate. This could moderate short-term inflationary and political shocks, and would help smooth consumption of poor, food-deficit households in rural and urban areas. But it is costly. In Indonesia, the cost of transferring one dollar to the poorest 15 percent of households through the rice subsidy is estimated at US$8.20—no better than a universal cash transfer.[31] If subsidies were limited to low-quality foods, the poor would benefit and rice transfer costs would be reduced to US$3.60 in Indonesia. Beyond the short term, there is a case for exploring additional mechanisms for targeting food subsidies—for example, through food stamps. While shifting from generalized to targeted subsidies is good policy in general, the Latin American experience shows that it is best not done during times of crisis.

Policies to keep food affordable are only useful if food is readily available. Ensuring that food markets function is fundamental to managing the effects of the drought. But, where markets are breaking down—as in parts of Indonesia—there is no alternative to direct food distribution. A combination of direct delivery to villages, NGOs, or religious organizations, food-for-work programs, and vulnerable group feeding may be desirable.

Sustaining the purchasing power of vulnerable households

Poor households are losing purchasing power due to falling labor demand and rising relative prices of some commodities. The case for rice subsidies was discussed above. Kerosene is the most relevant subsidized fuel for the poor and near poor in most of the region. Evidence from 1990 data for Indonesia indicates that kerosene subsidies are badly targeted to the poor, with an incidence roughly in line with overall income distribution. Some phasing of price increases may be justified on political grounds, but they should not compete with programs targeting the poor.

There are two possible approaches to addressing employment and income losses due to falling labor demand: stimulating demand for labor through labor-intensive public works programs, or providing income support for the unemployed. The question is how to target scarce resources and reduce leakages due to poor administration, graft, and access by non-targeted groups.[32] A combination of targeting techniques will need to be used, including geographic, household-based, and self-targeting.

Promoting public works. If designed properly, employment programs can help sustain the purchasing power of households in the short-term, and address long-term issues of declines in seasonal labor demand, as seen in parts of Indonesia. Indonesia is already expanding *padat karya* schemes and new programs are being launched in Thailand; there is also a long tradition of public employment in the Philippines.

Effective targeting depends on the wage. To ensure that the neediest choose to participate and to generate information on where demand for low-wage work is greatest, local market or lower wages should be used.[33] In Indonesia, for example, ongoing public works programs use a standard Rp7500 wage (in early 1998) that is often above local market wages, especially in depressed labor markets. Under these conditions, there is a greater risk that poor households will be rationed out of the programs. Programs with a high share of wage costs in the total will also be more effective at reaching the poor. Finally, it is not clear whether women have full access to manual work in East Asian public works schemes. This is in contrast to many South Asian schemes, which often have high female participation. These concerns emphasize the need to build in an overall monitoring and evaluation system and to conduct an ongoing assessment of short-term transfer and targeting objectives.

Public employment programs have dual objectives—to transfer income and improve infrastructure. Chile in the early 1980s, and Korea in the late 1980s, are examples of public works programs that were allowed to fade away as demand fell.[34] Indonesia also has a history of using food and cash for work during periods of adverse shocks, then phasing them out. Several program design issues are relevant:

- *Balance urban and rural programs*. Both programs make sense but an urban bias misses the majority of the poor and may also increase commuter migration, or decrease return migration to rural areas, slowing efficient responses to the shock.
- *Balance cash transfer and productivity*. In the short term, cash transfers achieve the primary objective—to increase security. But over time, programs may become more focused on infrastructure production or maintenance.
- *Balance between male and female beneficiaries*. Programs should be open to participation by women but special efforts may be needed to publicize public works programs, review contracting procedures, and monitor number of jobs given to them. In addition, certain design features—for example, piece rate payments instead of daily rates so women can work in groups and organize childcare—can encourage greater participation by women.
- *Workfare for the non-poor does not alleviate poverty*. Workfare for laid-off factory workers or young work force entrants with secondary or higher education who may choose not to take traditional manual work has little rationale on poverty grounds.

Some individuals and households, especially the disabled and households without adult labor, will fall through the safety net of public employment programs. In the short term, existing community channels, including religious organizations or NGOs, are probably the best source of support for these groups.

Unemployment benefits. With the exception of Korea, countries in the region do not have unemployment insurance schemes which can help sustain individuals temporarily out of work. But this is not the best time to introduce insurance-type unemployment benefits schemes in the crisis-affected countries: benefits cannot be awarded immediately as insurance schemes generally require minimum periods of prior contribution and a waiting period before benefits can be paid; the introduction of payroll taxes and/or individual contributions would increase the cost of labor (or the reservation wage) and hence depress labor demand (supply); new entrants to the labor market who are unemployed would not qualify; and the scheme would largely benefit formal sector employees. Such schemes can be introduced upon a return to more stable economic conditions, but even then attention should be paid to design features that reduce labor market distortions (see box 5).

Box 5: Unemployment Insurance Lessons of International Experience: Minimizing Labor Market Distortions

Unemployment insurance schemes are not effective at addressing structural unemployment issues or large labor demand shocks. They are more suited to conditions of frictional or cyclical unemployment which afford possibilities for pooling risks across individuals or time. Even then, it is important to minimize labor market distortions by:

Observing strict eligibility criteria—prior contribution record, involuntary dismissal, proven willingness to work, acceptable travel time and regional mobility, etc.

Creating a governance structure to prevent politically-driven generosity in benefit levels and raiding of the reserve fund during good times

Limiting benefit duration (say, a maximum of 6 months) and referral to social assistance schemes thereafter

Risk-rating unemployment insurance contributions by economic sector, enterprises, or both, thereby allowing contribution rates to vary as a function of past unemployment rates.

In the short-term, a system of unemployment assistance benefits may be more appropriate. It would aim at alleviating poverty among the unemployed by providing, for a limited time, limited income transfers in the form of flat benefits at near the poverty line. This scheme would have a better distributional impact than an insurance scheme and would also improve efficiency, as the low benefit level would motivate an early return to the labor market and have little impact on the reservation wage. Initially, this benefit could be provided to the unemployed without any means-testing. Later this feature could be adjusted or supplemented by means-tested family, health, and educational allowances. Unemployment assistance benefits can begin disbursing as soon as they are introduced and would be less demanding to administer than an insurance scheme. Nonetheless, targeting is a concern, especially if informal sector workers are to be included, and decentralized mechanisms for administration, including the use of NGOs, will need to be explored.

Training programs also provide some income support during the period of professional reorientation and skill acquisition, even though this is not central to their objectives. However, this is a costly means of transferring incomes with unclear distributional effects.

Reforming labor market policies

The question of international competitiveness may seem moot after the large exchange rate depreciations. But these exchange rate movements have been driven by capital flows and are likely to reverse once confidence is restored. The more fundamental issue is productivity growth which is linked to the workforce skill level. The education system must support increasing access to secondary education, but labor market policies are also important:

- *Encourage private job placement services to supplement inadequate capacity in the public sector.* There has been rapid expansion of public employment offices in Korea, from 53 in 1997 to 113 in 1998 with plans to reach 162 in 1999. This risks undermining the role of private employment services. In 1997 private employment services placed 1.8 million workers compared to 0.3 million by public employment offices. Most workers assisted by private employment offices (83 percent) are engaged in basic and service occupations that usually attract less privileged workers.
- *Exercise caution in launching or expanding active labor market programs.* International experience shows that these programs have little effect on employment probabilities or on future wage profiles. Some programs may be effective for particular categories of workers. Programs should undergo rigorous monitoring and evaluation and respond to feedback on effectiveness.
- *Change the government's role in vocational education and training.* The private sector can also provide both pre- and in-service training. Increased competition among training providers should increase quality, and the government can ensure regulatory oversight and increased choice for consumers—through vouchers, for example.

One of the most controversial issues in the labor market is the role of unions. This is because most East Asian countries have restrictive policies toward them, and there is considerable government involvement in industrial–labor relations. Korea was particularly repressive in the pre-democracy period, and reaped a bitter harvest in antagonistic labor relations. Its experience carries lessons for other societies.

A key challenge for most East Asian societies is designing a regulatory and institutional framework that provides strong rights for freedom of association and avoids granting entitlements that can cause resource inefficiencies or crippling inflexibilities. This framework is likely to mean a more neutral role for governments—essentially setting the rules of the game. It should also encourage the primary locus of union activity to be in the enterprise in which collective action is most likely to help increase productivity and less likely to command monopoly wage increases.[35] There is a role for union confederations where information or dialogue is useful at a sectoral or national level. Developing effective mechanisms for industrial relations is complex, and workers and employers must collaborate, often with state support, especially to design a sound and neutral regulatory framework.

Managing household insecurity in the longer-term

As the financial crisis demonstrates, temporary downturns in economic activity can lower living standards for most households. Unemployment, disability, and old age contribute to poverty in both industrial and developing countries, and worsen poverty among people who are already poor.[36] In most societies, coping with insecurity involves some combination of private savings, informal support, and employer obligations. Governments step in when these prove insufficient. Households may find it difficult to borrow to cover temporary drops in income; community support is ineffective when there is an economy-wide shock; and private markets for unemployment, disability insurance, and old-age pensions are often limited or absent.

East Asian countries have relied on informal income security systems for most households, especially the poorest. Private transfers help reduce inequality by providing old-age support, and alleviating the effects of disability, illness, and unemployment. Increasing urbanization and the growing importance of formal employment have eroded the informal support mechanisms. In addition, there is rising demand for social insurance to deal with household insecurity. A rapidly aging population further strains family-based support. These trends, plus rising incomes, suggest a much greater role for formal insurance in the future.

What kind of model should East Asian society follow to balance caring and competitiveness? The welfare state, created in Europe, is under attack because generous benefits and high taxes are associated with lack of competitiveness, slow employment growth, weak incentives for work, and high unemployment. In European and Central Asian transition economies, universal cradle-to-grave security is waning and in China, the system for state workers is in need of urgent reform. In many South Asian and Latin American developing countries, the model of employment protection for formal workers is also under attack because job security regulations appear to protect insiders at the expense of comprehensive unemployment insurance, which encourages the growth of informal employment.

Countries in the region have an opportunity to develop schemes that avoid the labor market rigidities, inequities, and fiscal problems associated with some models of social security, and they can learn from the abundant array of reforms being undertaken worldwide. The central principle is to minimize adverse labor market and fiscal effects by linking contributions to benefits. Most old-age pensions, certain health risks, and short-term unemployment can be covered under publicly-mandated insurance and savings schemes that embody this design feature, but matching contributions directly to benefits is not always feasible, or desirable. For example, most societies choose to provide for the poorest people far in excess of their potential to contribute—so the protection schemes incorporate an element of income redistribution. Socialized public action could be considered for core pensions for the long-term poor, to cover catastrophic health risks, and to provide social assistance for the destitute.

Maintaining economic and social services for the poor

During the crisis, the poor stand to suffer the most—especially from irreversible losses in potential education and health that will impede their participation in future recovery. Efforts to maintain purchasing power will help, but additional measures are needed to focus on keeping schools and health care affordable for poor households and quality of services intact.

Education

Studies find that public spending on primary schools benefits the poor. Beyond the primary level, incidence depends on the coverage of the education system. In low-and middle-income countries, spending on junior secondary schools is often distributed roughly in line with income. Spending on senior secondary and tertiary education tends to be unequally distributed, and can be even more unequally distributed than income, as is the case in Indonesia.[37] However, *marginal* changes in spending for junior secondary schools—and in richer societies, senior secondary schools—are likely to benefit the poor. Moreover, analysis has found that in the late 1980s, cuts in education spending were associated with significant drops in secondary enrollment However, primary enrollment remained virtually universal. Since the current economic crisis looks much worse than the late-1980s slowdown, there is a strong chance that children in the region will be pulled out of school because of the actual and opportunity costs of schooling. Focus group results from Indonesia and the Philippines show that this is already happening. Also, there is a risk that for some children—especially of poorer households—this shift will be permanent. This suggests the need to:

- Preserve real spending on primary schools, and seek to maintain non-salary spending. In past episodes of adjustment in other countries non-salary spending has been the most vulnerable to cuts during a fiscal squeeze, with potentially high costs in quality.
- Increase targeted subsidies to encourage students to stay in secondary school, linked as closely as possible to income level. Subsidies could be structured as scholarships for the poor—perhaps using a village level mechanism for determining poverty—backed by broader loan-programs to finance fees for the non-poor (see box 6).

Beyond the crisis, the education system will shape the region's future workforce and the competitiveness of its economies. Sustaining high quality and broad-based educational expansion is central to equipping workers with the skills for high productivity manufacturing and service industries, and to train them over the course of a working life.

As noted above, Korea has done exceptionally well in this respect, although recently it has been reassessing its education strategy with the goal of developing more creative and flexible skills. The pressure points in the region probably lie elsewhere, for example, in the relative neglect of secondary education in Thailand, upper secondary and college education in China, and in poor quality education in Indonesia and the Philippines. These issues are only partly a question of government spending priorities, as illustrated by Korea where secondary, and especially tertiary education is mostly privately financed. Institutional and policy reforms are required to foster the high quality schooling which includes the skills that will propel East Asian countries into the knowledge economy of the next century.

High quality schooling requires reforming curricula at the primary and secondary levels to emphasize team building, flexibility, and adaptability which are built on a foundation of literacy and communication skills, plus numerical and analytical skills. To move their economies forward in the early 21st century, East Asia's young people will have to master the multitude of worldwide sources of information and be able to aggregate this knowledge to analyze and solve local economic and social challenges. Thailand and Malaysia are working to reform their education system to provide those skills, and China is also moving in that direction.

Box 6: Preserving the Poor's Human Capital during Economic Crisis: Indonesia's "Back-to-School" Campaign

Impact of the Crisis. In April 1998, focus group discussions and school visits already indicated that poor schools and children were feeling the impact of the crisis. Reduced public funding for education, higher prices of schooling, and lower family incomes are expected to lead to declines in primary and junior secondary school enrollments among the poor. Estimating the impact of the economic crisis on enrollment is difficult as the crisis is unprecedented in terms of magnitude and depth. Econometric techniques have yielded relatively low impact effects ranging from an additional 115,000–260,000 7–12 year olds, and 173,000–270,000 13–15 year old children dropping out over time as a result of a 10 percent fall in per capita income. Estimates from the Government of Indonesia (GOI) point to much larger effects—an additional 890,000 and 640,000 children dropping out of primary and junior secondary schools, respectively, in just one year.

Whatever the precise figures, there is general agreement that the impact of the crisis on poor children will be severe. The strongest evidence comes from the much smaller economic shock of 1986–87 when education expenditures dropped and there were no special efforts to keep children in school; gross enrollment rates fell from 62 percent to 52 percent at the junior secondary level and took almost a decade to recover. Virtually the entire decline came from poor households. Also, non-salary spending per pupil fell sharply from Rp 23,000 (US$18) to Rp 6,000 (US$3) in real terms.

The Response. On July 20**,** GOI launched a 5-year national program to provide scholarships for poor children in basic education and block grants to schools serving poor communities. A coalition of Ministers was formed to support the program. The World Bank is leading a multi-donor effort, which includes the Asian Development Bank (ADB), UNICEF, and bilateral agencies—AusAID, and Asia Europe Meeting (ASEM)—to support the Program. Total cost of the 5-year program is approximately US$382 million, with an ADB contribution of US$86 million, and the remainder from the Bank.

Seventeen percent of the poorest students will receive a scholarship of Rp 240,000 (US$30) in voucher form at the beginning of the school year. This is intended to cover school costs such as notebooks, uniforms, transportation costs, and school fees. Nationally, 2.6 million junior secondary students will benefit (about 17 percent of enrollment). Forty percent of primary and junior secondary schools serving the poorest communities will receive grants of Rp 2 million (US$250) and Rp 4 million (US$500), respectively. A total of 82,000 primary and junior secondary schools will benefit from block grants each year. Schools can use the grants to purchase instructional materials and other teaching–learning supplies, undertake minor repairs, and support poorer students by waiving formal and informal school charges.

Mass Media and Social Mobilization Effort. A nationwide TV, radio, and print media campaign was launched to ensure that parents and communities are aware of the program, to emphasize the importance of remaining in school, and to facilitate transparency in the use of funds and selection of recipients.

Targeting and Selection. Scholarships and grants will be allocated according to the poverty incidence of each district. Given the limitation of the quantitative data, this information will be coupled with local knowledge and the participation of NGOs and other members of civil society in the selection at the local level. Recipients will be selected by committees at district, sub-district, and school levels, which consist of parents, NGOs, other members of civil society, and government representatives.

Ensuring funds reach recipients. In order to ensure scholarships and grants reach intended beneficiaries, the program includes the following features: (i) funds will go directly from the (local) bank to students–schools—no intermediaries; (ii) a mass media campaign down to the village level will inform communities and parents of the program and procedures; (iii) an independent agency will carry out quarterly monitoring; (iv) NGOs–civil society members will monitor the program; and (v) the Government, the Bank, and the ADB will evaluate the impact of the program on school enrollments and transition through focused surveys and the use of SUSENAS.

Health care

Analysis from Indonesia and Malaysia indicates that spending on health centers, and particularly sub-centers, benefits the poor, but spending on hospitals is unequally distributed. There are concerns that price hikes on imported drugs lead to postponing or curtailing drug use, including vaccinations and HIV/AIDS drugs, and that sharp cost increases in private medical services are inducing greater demand for public services (see box 7). This suggests three measures:

- Preserve real spending on public goods or health activities with high externalities, such as vaccinations and vector control
- Maintain spending for health centers and sub-centers, especially for non-salary items
- Provide temporary subsidies for essential drugs, during a transitional period of exchange rate disequilibrium. Such subsidies will likely be weakly targeted to the poor, but they may still be justified in terms of protecting overall human resources.

Box 7: The Crisis and Health: A Common Set of Problems

Medical costs are increasing. Exchange rate depreciations have meant large increases in medical costs given the high import content of pharmaceuticals, including vaccines and contraceptives. In Indonesia, imports account for 60 percent or more of the pharmaceuticals used in the country, and drug prices have reportedly increased two or three fold. This change in relative prices is unlikely to be fully reversed, and will require long-term adjustments in drug consumption patterns.

Private consumption expenditure is falling, particularly among the rising numbers of unemployed. Many households are less able to pay for the out-of-pocket cost of medical care, whether provided by the private sector or by public sector facilities that typically charge nonzero user fees. This is important because private spending finances 50 percent of aggregate health expenditures in East Asia. There is already evidence that private sector users are switching back to the subsidized public sector, while some potential users—especially among the poor—may have to switch to lower quality providers, or even forego medical care entirely.

Public health expenditures are declining. Budgetary pressures can reduce public subsidies, which protect the poor from the increased financial risks of illness. This either increases financial hardship, or reduces use of medical services. Moreover, increased demand for public services from former users of private facilities could divert public subsidies from the poor. In the long-term, cuts in operations and maintenance outlays will also undermine the productivity of the public infrastructure. Reduced public expenditure also threatens priority public health programs, such as immunization against childhood diseases and TB control. Indonesia's past experience with fiscal adjustment in the mid-1980s demonstrates the vulnerability of public health programs to public expenditure cuts.

Institutions, corruption and the social fabric

East Asia's reputation as a model of reasonably efficient institutions and social stability has been shattered by the crisis.

- are public sector institutions so riddled with corruption and cronyism that they can no longer deliver results?
- is there potential for irreversible social breakdown including rising ethnic or other factional violence, and destruction of community and family behavioral norms?

Promoting effective institutions

Corruption and poor institutional performance shoulder much of the blame for the crisis. Corruption is a long-standing feature of most East Asian societies but its profile is on the rise with increasing public attention to international corruption rankings, and high-profile scandals from Japan to Vietnam. In the decades of extraordinary growth, corruption coexisted with reasonably effective institutions, from core macroeconomics management bodies to schooling services. Now most observers are concerned that public institutions are largely ineffective and driven more by private gain than the public good, especially in Indonesia.

Institutional capacity to deliver resources or services effectively is linked to broader governance concerns. Indonesia has a reputation for institutionalized corruption in which big and small officials stole a share of the public pie. Evidence of institutional weakness is scattered, but it ranges from the low quality of education, health, and other services to the widespread concerns over graft and the view that local resource allocations are determined by political power, rather than developmental and social needs. However, East Asia could not have enjoyed the massive advances in social conditions if government services—a major part of this effort—were useless. Careful micro studies are scarce, but reveal a mixed picture. A comparison of public irrigation workers in Korea and India found sharply better performance in Korea.[38] Recent research on local institutions in Indonesia finds reasonable performance of public institutions at the village level—although they are significantly worse than genuine community organizations (preliminary work on the Local Institutions study from World Bank staff and the study team).

Institutional reform is a complex and long-term process and decentralization, though often desirable, is not a panacea especially during the crisis when effective delivery is unusually urgent. In fact decentralization of power to local elites can make things worse, in part because they generally have weaker technical resources at their disposal.[39]

Evidence from reforms in Latin America and elsewhere has emphasized both giving more choice and more voice to the communities who use services.[40] In particular, a diversified approach to delivery of transfers, involving government, civil society and religious institutions, can help reduce the risks of relying on only one channel. Restrictions on local associations should also be lifted to encourage entry and competition. This can be complemented by measures to foster genuine participation of communities in the choice, design, implementation, and evaluation of projects. Social funds were much used in Latin America and Sub-Saharan Africa in response to adjustment. There is also increasing evidence that they perform best when there is genuine participation of local communities.[41] Finally, public and independent information, including monitoring by civil society organizations, is a potentially valuable source of increased accountability.

Responding to a deteriorating social fabric

Responses to the added pressure on social relations within the family and the community vary across different societies (see box 8). It is too early to assess the consequences of social changes, but there are parallels in other communities under economic crisis. Economic decline contributed to rising violence in urban Latin America in the 1980s. Even though much of the region recovered economically in the 1990s, violence remains high, with widespread economic and social costs. Studies in poor urban communities in Ecuador, Hungary, Zambia, and the Philippines found:[42]

- Increased work for women and children
- Increased pressures on women and older girls—mothers work more, so girls must care for younger children
- Increased substitution of private for public services—including in health and education
- Increased street violence, especially amongst young males
- Increased domestic violence, especially in households hit by falling employment or declining incomes.

Box 8: Erosion in Social Capital

Most citizens see the crisis eroding social capital—trust, reciprocity, and networks of support. Nevertheless, in some communities social cohesion may actually strengthen as poor communities discover resourceful ways to overcome their problems. For example, in Davao, Mindanao, Philippines the community initiated a savings scheme to cover the costs of festivals, and a self-policing program (*ronda*) was developed in response to increased crime.

Conflict. In all countries, NGOs identified increased conflict—within the household, the community and society at large. Increased pressure led to a rise in domestic conflict, and "loan sharks" in Bangkok attacked people who could not repay their debts to money lenders. NGOs also expressed concern over the potential for social unrest, a concern which manifested in Indonesia where there has been extensive ethnic violence against the Chinese population, including rape.

Vulnerability and insecurity. In Teparak slum settlement in Khon Kaen, in northeast Thailand, a focus group identified a breakdown in community trust within the last six months. Increased competition for jobs meant that neighbors who once cooperated were now competing. Theft, violence, and other crimes were on the rise. Some children had been forced by their parents to drop out of school to guard their homes because both parents were now working outside and break-ins had increased, and neighbors were often the culprits.

Isolation. All focus groups reported a general feeling of uncertainty and isolation. Many said that although the poor had benefited from improved social welfare, they still felt excluded and felt that they had not received their fair share of the economic growth. Many blamed the rich for the current crisis and were unable to understand why the poor should carry the burden. In Teparak, Khon Kaen, Thailand, a community leader added, "The crisis has happened too quickly and has left us confused, puzzled, and let down. We have been laid off but given no explanation."

Source: Rapid social assessments undertaken by Bank staff in collaboration with NGOs in Thailand, Philippines, Indonesia and Cambodia, January-April, 1998.

The study found varied effects on informal community[43] functioning. Moderate pressure could lead to heightened mutual support—increased use of social capital—whereas severe pressures were more likely breakdown of community-based coping mechanisms.

These substantial costs underline the importance of restoring the national and local economic environment crucial for social functioning. Specific responses could include:

- Identifying the vulnerable groups and focusing action to respond to their needs. For example, heightened pressures on women can be relieved by reducing the demands on their time, such as improving water supply or childcare facilities.
- Facilitating participatory processes mediated by government, NGOs, or religious institutions—both to set local priorities and to support informal networks.
- Supporting innovative action to reach groups at high risk. For example, concerted action by civil society is often the only way to reach children forced into exploitative work. Public action was crucial to reducing child prostitution in the Philippines in some case[44]. In Brazil local groups use theater, music, and other forms of community engagement to reach kids on the streets, diverting them from gangs to more productive forms of social capital.

Box 9.The World Bank's Efforts to Help the Poor

The World Bank is helping governments re-initiate growth to manage the social consequences of the crisis; protect public expenditures targeted for the poor; enhance the quality of social services; improve design and financing of social funds; strengthen social security systems for the unemployed and the elderly; and address key institutional issues. The Bank's most important activities include:

In **Thailand**, a US$300 million loan for a social investment project will fund job creation for the poor and the unemployed through existing labor-intensive government programs; expand training for the unemployed; support low income health insurance schemes, small-scale community projects, and larger municipal projects; and set up a monitoring system to evaluate the impact of the crisis and of public action on the poor. The loan is expected to create roughly one million months of jobs and an equivalent amount of training. Also, a national poverty map will be drawn based on a nationwide systematic participatory assessment which will be an important input for the policy debate on safety net mechanisms

In **Indonesia**, the Bank has restructured some of the existing portfolio to redirect savings to support income generation and meet basic needs (about US$320 million). A Structural Adjustment Loan (SAL) of US$1 billion includes a component to protect the poor through expanded labor-intensive public works programs; actions to ensure the continued availability of key goods with only modest price increases; and initiatives to maintain access to quality basic education and health. In particular, to ensure continued high enrollment rates for children through the first nine years of school, the Government is to provide scholarship funds for 2.6 million needy junior secondary school students. A US$275 million poverty project for rural areas (the Kecamatan Development Project) has been approved, and a similar project is under preparation for the urban poor. Discussions are also underway regarding an agriculture sector adjustment loan to support reforms. The Bank has also intensified analytical and participatory work on poverty to help underpin these two operations and will help finance a follow-up to the Indonesia Family Life Survey (IFLS). This will allow monitoring of the living standards of a sub-sample of households that were already surveyed in 1993 and 1997 and help assess household-level coping strategies in response to the crisis.

In **Korea**, the US$2 billion SAL approved in March 1998 includes an important program on labor markets and social safety nets. The program incorporates measures to increase flexibility in the labor market while extending coverage of unemployment insurance to employees in small-scale enterprises; improve poverty monitoring and protect poverty-related public expenditures; and reform the pension system. A conference in July 1998 focused on lessons of international experience in labor market policies. Another conference will focus on pension fund investment policies. A second SAL for US$2 billion will help deepen these reforms and start addressing issues in health financing and health care.

In the **Philippines**, three new loans (US$79 million) all aiming to increase the incomes of the poor and to provide basic services were approved in March 1998. Two other loans totaling US$130 million are scheduled for approval in the second half of 1998; these projects finance infrastructure development and will increase job opportunities and access to basic services for relatively poor local government units. The Bank has carried out a rapid social assessment to gauge the effects of the crisis and understand household coping strategies. Poverty work scheduled for fiscal 1999 will have access to the results of the 1998 Income and Expenditure Survey (FIES is carried out every three years) and contribute to the early implementation of the Annual Poverty Incidence Survey. This will provide a useful analysis of the short-term impact of the crisis, evaluate the effectiveness of government policies to alleviate poverty, and provide policy directions for the future.

In **Malaysia,** a US$300 million Economic and Social Sector Loan approved in June 1998 will support a reduction in the fiscal surplus from 2.5 to

0.5 percent of GDP by increasing public expenditures for the social sectors. The Loan seeks to protect budgetary spending for education, health, rural infrastructure, and to increase expenditures on social safety net programs aimed at providing direct support to the poor (free housing and food supplements) and income generation through small grants. Longer-term issues about the adequacy of formal safety nets and the governance structure of the Employee Provident Fund will be addressed through a Technical Assistance Loan and economic and sector work. In addition, a CEM is nearing completion—the first since 1993. It includes an overview of poverty and the social safety net in Malaysia, analyzes how the poor may be affected by the downturn, and recommends action to cushion the impact of the crisis on the poor.

In **China**, ongoing work in labor market adjustment focuses on policies needed to address the un(der)employment problem. While the problem is becoming acute largely due to accelerated reforms in the state-owned enterprise sector, the slowdown in aggregate demand, which will be exacerbated by the impact of the regional crisis, is also having an impact. A workshop will discuss the effectiveness of active and passive labor market policies in addressing employment problems.

In **Cambodia,** a study is underway to examine the impact of the regional crisis on Cambodia and **Lao People's Democratic Republic**, including an analysis of the social impact, in particular through rapid social assessments.

A **region-wide** initiative is being launched to analyze issues in pensions policy and administration. A November 1998 conference will bring together countries of the region to explore common issues and frame an agenda for future work. This would be followed by a conference in the spring of 1999 on governance of pension funds in East Asia.

The central role of public information

This paper has emphasized the importance of understanding the scope and nature of the crisis. A crucial need is to deepen understanding of how the crisis is affecting households and how different actions are ameliorating the social costs. This matters technically because there is much that is not known about the impacts. It matters in terms of governance, as informed public debate about the choices being made should be guided by up to date information. Efforts should provide regular updates on overall welfare and vulnerability to provide accountability for how resources are used. Assessing public actions will provide information which will be included in ongoing redesign of these programs. Public information will provide checks on transfers and underpin an informed public debate on developments, effects of programs, and tradeoffs.

Programs that monitor overall welfare should rely on a mix of instruments:

- *Regular surveys of living conditions and vulnerability* covering wages, unemployment, relative prices, food prices, drought effects, social indicators, and nutritional levels. In many East Asian countries, such short-term information is weak. The Philippines has a Social Weather Station system based largely on subjective assessments. Indonesia recently dropped the quarterly version of its labor force survey because there was little seasonal variation. Thailand still has a quarterly labor survey and Korea's labor survey now takes place monthly.

- *Complementary assessments* of household and commentary conditions using participatory techniques which substantially enrich the understanding of coping strategies. These assessments should form part of the ongoing interaction between hypotheses and data, and could influence the design of survey questionnaires.
- *Use of existing data sets* to match economy-wide trends to the structure of income and spending, and to analyze past household responses to changes in specific parameters, such as price elasticities of schooling costs. In most countries, existing data includes consumption or income surveys.

Monitoring and evaluation of public action are important short-term goals to ensure that intended effects reach targeted groups, and to redesign programs. In the medium to long term monitoring and evaluation help to bring poor regions and groups into the development process. All programs can benefit from combined quantitative and participatory monitoring. Participatory monitoring is particularly valuable for increasing effectiveness by strengthening community involvement, and increasing efficiency by scrutinizing the use and allocation of funds. Public information strengthens accountability. For key programs, especially those with uncertain impacts, structured evaluation that uses samples of participating households and controls is also important for maximizing the benefits of scarce resources. For example, structured evaluation is likely to cover the targeting efficiency of public works, the incidence of new subsidies for education, and the effectiveness of geographic targeting to alleviate poverty.

Conclusion

What began as a currency crisis in Thailand has evolved into a social crisis across the region and beyond. Within East Asia it was initially hoped that the crisis would involve a sharp contraction and sharp recovery—a “V”-shaped response to a shock, as occurred in Mexico after the 1994/95 currency crisis. That alone would have been an unusually severe shock to East Asian households, just as the tequila crisis was a major source of distress to many Mexican households. There are now fears that the crisis will at best be “U”-shaped, with a more prolonged period of contraction, and risks of a lengthy period of working through of structural, social and institutional problems. This is a picturesque way of presenting the tough message that there are no magic bullets or easy solutions to what has become the most serious economic and social crisis in decades.

The crisis has been correctly characterized as a regional crisis, but the development of policies and programs require a recognition that there are diverse issues due to country and localized differences. The disaggregation of social impacts is vital for determining the types of responses to be funded, and how programs should adapt as local conditions change. This applies, of course, with even greater force to assessment of the social consequences of crises in other regions of the world. This requires that donors expand their relationships with civil society organizations both for policy dialogue and for research on social impacts.

While it is important to design responses in the context of diverse local conditions, some general conclusions can be drawn. In the midst of the crisis, there are four domains where a combination of immediate action and exploration of alternatives is central:

- The *distributional effects* of both the shocks and economy-wide responses, between rich and poor, across different socio-economic groups (with particular attention to socially excluded groups), and between men, women and children. This remains both a powerful and ill-understood domain.
- The *potential for direct public action,* especially using public resources, to both reduce income losses due to employment declines and price increases—through various forms of safety nets—and reduce the risk of irreversible losses in human capability through lost education, malnutrition and foregone action in health. Here there is a relatively deep understanding of the policy options and their likely effects, but there are sometimes formidable barriers in their execution, in the context of aggregate fiscal retrenchment (and associated distributional struggles) and institutional weaknesses.
- The *consequences for the social fabric* of economic decline and cutbacks in social services, especially when this is in the context of societies in rapid and turbulent transition from traditional to “modern” social structures. Case-studies have provided increasing evidence of adverse social effects,

from rising violence, to increased prostitution and intensifying pressures on women. But public action to offset these social consequences is rarely undertaken in a systematic fashion.

- The *monitoring and evaluation* of the effects of the both economy-wide and local developments and various forms of public action on individual and community welfare, through both structured quantitative and participatory techniques.
- In previous crises involving the international community, including the World Bank, the primary focus has been on the second domain above, and even this is weakly understood and documented. Action in the other domains has typically been dismal. It is essential that the domestic and international community does better in this crisis.

Confronting the immediate social fallout of the crisis is crucial, but it is of equal importance to shape responses in the context of longer-term development challenges. Some may see the crisis as providing the basis for a fundamental questioning of the model of economic and social development based on international engagement and reliance on markets. This would be mistake. East Asia's success prior to the crisis was not a mirage, and a high proportion of the associated social gains will still be there after the crisis has resolved. However, the fact that East Asia was both a paradigm of success and then the epicenter of the current crisis illustrates a crucial point. The forces of globalization and technological advance provide the *potential* for an unprecedented pace of social advance. But these same forces also carry risks—of pressures for rising *inequality* between those groups equipped to participate in today's global economy and those not so equipped (for lack of skills, lack of access to complementary domestic or foreign capital, or through exclusionary social forces); and of rising *risks* of income and social losses, at an individual, community, national and regional level. The key challenge for social and economic policy at the turn of millennium, is understanding and shaping the policies, institutions and social structures that will help realize the potential whilst managing the risks. Just as there are issues of international financial management to mediate these competing pressures, so there are questions of fostering structures that foster inclusive and equitable social and economic development and provide mechanisms for social protection consistent with societies that are both caring and competitive.

A particular aspect of the lessons from the Latin American experience that has received little attention in many studies is the relationship between political structures and effective reforms. Some of the contributing factors to the crisis in terms of lack of transparency, corruption, cronyism, etc. point to the need for a fundamental opening of decision making in economic policies. It is in part in recognition of this, that the World Bank is encouraging engagement with civil society organizations needs to be deepened and expanded at the center of addressing the social and economic costs. This includes project implementation and research on social costs, but is wider and deeper in terms of finding new ways of bringing diverse parts of civil society into determining responses to the crisis.

In order to better address the social questions, and acknowledging that all organizations involved in the crisis countries need to work together, the World Bank has set up a number of initiatives to support dialogues, information sharing and engagement with civil society. The bulk of this is occurring at a country level, but there are also regional initiatives to foster broader debate and exchange of information. These include a website, moderated dialogues that will be reported on the website, regular country consultations with civil society, various forms of regional consultations and new research partnerships.

In the midst of the crisis, immediate action is required. In this paper we make a range of suggestions where public action can reduce—though almost certainly not fully offset—the severe human costs of an economic crisis that started in currency markets, stock exchanges and banks. However, the paper has also placed considerable emphasis on the inadequacies of both past social responses to crises and of our present understanding of how to do better. This paper has focused on East Asia, but just as the financial crisis has spread to other regions, so all the issues presented here apply to other countries and regions as well. An open process of exploration and exchange is of central importance both for the effective design and implementation of any response, and for the continuing exploration of how to deepen our understanding of the personal and societal effects of crisis, of the options for action, and how to reduce the human toll of future shocks and ensure an inclusive pattern of longer-term development when East Asia emerges from the present troubled times.

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END NOTES

1 World Bank (1998a).
2 See World Bank (1998b) [Global Economic Prospects—forthcoming].
3 Many groups in civil society and some researchers were all too aware of the social effects of the shocks and responses; amongst international agencies, UNICEF, in particular, was ahead in emphasizing their importance.
4 This section draws on Ahuja, and others. (1997).
5 World Bank (1993a); Birdsall and Sabot (1993); Teranishi in Aoki, and others. (1996).
6 World Bank (1995); World Bank (1996a).
7 See Kim and Topel (1995).
8 See Ranis (1995).
9 After controlling for incomes and other characteristics (though in Indonesia this may partly reflect unusually rapid income growth, and the slower response of mortality. See Filmer and Pritchett (1997): Indonesia is an outlier (that is, had high child mortality) after controlling for incomes; the Philippines and Korea were negative outliers after controlling for incomes and a set of other characteristics, including female education and inequality.
10 Ahuja and others, (1997).
11 Jalan and Ravallion (1998).
12These comparisons ignore issues such as equivalence scales and differences in regional cost of living. In addition, the discussion includes Ginis for both expenditure and income distribution. Since income distributions are generally more unequal than expenditure distributions, comparisons are only valid across indices for the same concept (for example, over time). Similarly, we include distributions per household and per individual, which, once again, are not strictly comparable. The figures merely indicate trends.
13 Preliminary analysis of the 1997 survey yields an increase from 45.1 in 1994 to 49.6 in 1997 in the Gini coefficient for family income. The absolute numbers are not to be compared to the data cited in table 4 which are Gini coefficients for expenditure per capita but the trends and magnitude of changes are likely to be similar.
14 It is possible to observe increases in inequality that leave poverty unchanged for a given level of average income. A mean-preserving spread originating from a transfer from an individual above the poverty line will increase inequality but not affect poverty.
15 See Mazumdar and Tzannatos (1998).
16 World Bank (1996a).
17 Based on The Social Weather Station surveys of Filipino’s perceptions of their poverty.
18 See Agrawal and Walton (1996).
19 Robb (1998).
20 See World Bank (1990).
21 Projections are from Ravallion and Chen (1998). The methodology involved updating household data to 1997 using actual or estimated growth in average consumption or income per capita, but assuming no distributional changes since the most recent survey—survey years are reasonably recent: Indonesia (1996), Malaysia (1995), Philippines (1994), and Thailand (1992). Then a range of projections for the

entire distribution was developed by assuming alternative values for growth in the mean level of consumption or income and the degree of inequality. The change in inequality was estimated in terms of the shifts in the parameters of the Lorenz distribution to produce a certain percentage change in the Gini coefficient.
22 This scenario was developed by Benu Bidani, as part of ongoing work on poverty in Indonesia and is discussed in "The Poor in Indonesia's Crisis, (mimeo)," World Bank (1998).
23 "The Poor in Indonesia's Crisis" (draft). World Bank. (1998).
24 See World Bank (1990), Chapter 7.
25 See Sarel (1996): that actually found rising investment efficiency in Indonesia in the past decade.
26 Work on the U.S. finds that unemployment disproportionately hurts the poor (Blinder and Blank). Similar effects may explain some of the recession-linked increases in inequality in Latin America.
27 Blejer and Guerrero (1991); Ferreira and Litchfield (1997).
28 Banking with the Poor Network Newsletter, Issue No. 11, June 1998, pp1–8. Foundation for Development Cooperation, Brisbane.
29 See Wood, Pissarides and Tan, World Bank (1997a).
30 See Staff Appraisal Report for South West Poverty Reduction Project (May 1995) and Qinba Mountains Poverty Reduction Project (May 1997)
31 This is because per capita rice consumption does not vary much across expenditures classes (the bottom 15 percent of the population consumes 13 percent of the rice). Therefore the proportion of the rice subsidy that goes to the poor (and the leakage to the non-poor) is no different from that of a general cash transfer.
32 In some poorly targeted Indian programs 6–7 rupees are spent to transfer one rupee to a poor household. Radhakrishna and Subbarao (1997).
33 See Ravallion (1998), "Appraising Workfare Programs."
34 See Subbarao and others. (1997).
35 Pencavel (1995) and World Bank (1996a).
36 World Bank (1996a).
37 See World Bank (1993).
38 See Wade (1994).
39 World Bank (1997b).
40 See Graham (1998).
41 See Narayan and Ebbe (1997).
42 World Bank (1996b).
43 See World Bank (1995).
44 See World Bank (1996b).

This paper assesses the social impact of the Asian Financial crisis, drawing on the results of studies in six countries, namely, Indonesia, Republic of Korea, Lao People's Democratic Republic, Malaysia, Philippines, and Thailand. The impacts appear to be less than were anticipated early in the crisis. However, it seems to early to draw conclusions about the eventual social consequences.Â However, it seems to early to draw conclusions about the eventual social consequences. Suggested Citation. Knowles, J.C. & Pernia, E.M., Racelis, M., 1999. "Social Consequences of the Financial Crisis in Asia," Papers 60, Asian Development Bank. Handle: RePEc:fth:asdbed:60.