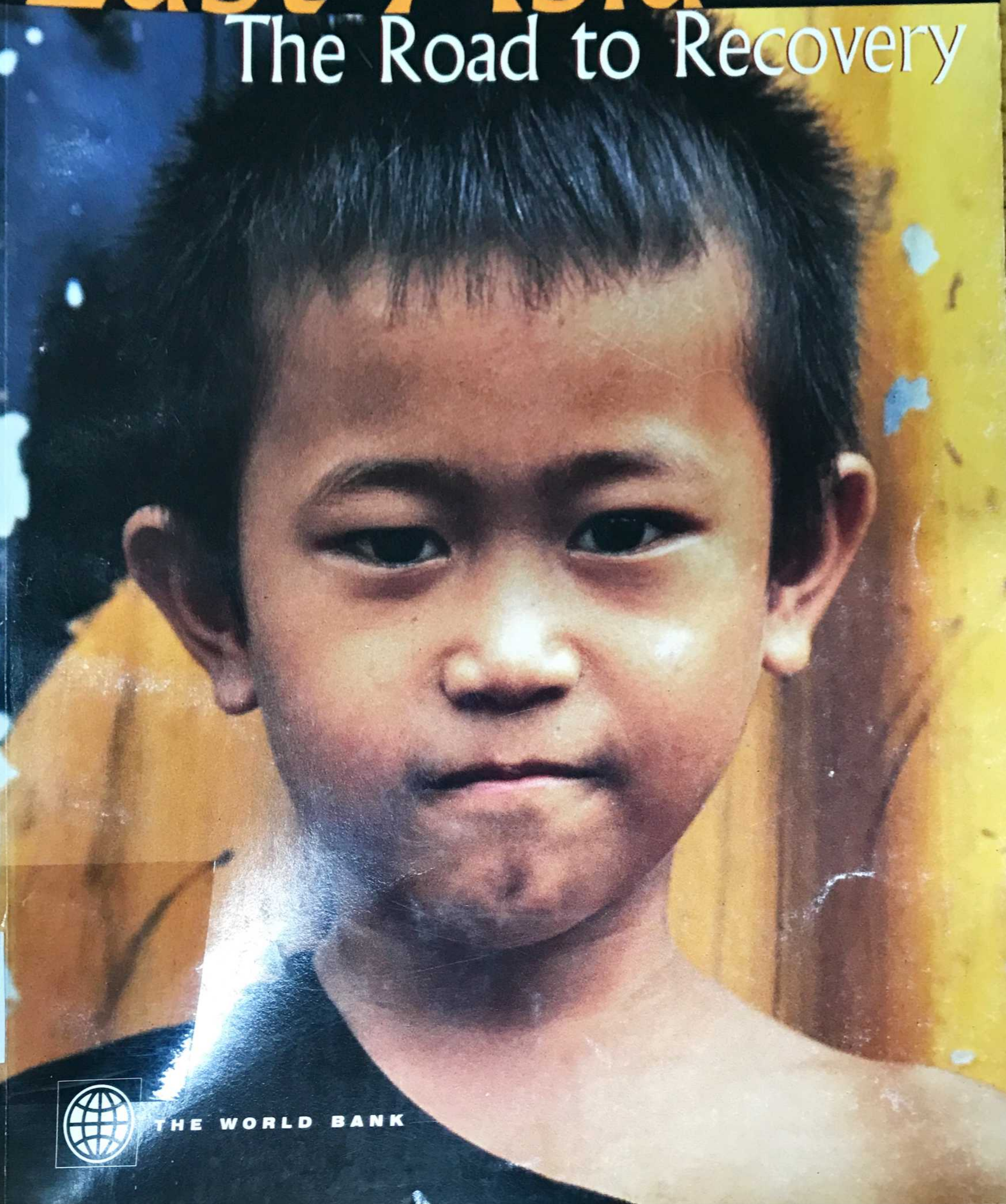
East Asia
The Road to Recovery



THE WORLD BANK

EAST ASIA:

THE ROAD TO RECOVERY

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Contents

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Foreword

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

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

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

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

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

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

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

The hard work of implementation lies ahead.

The World Bank's Support

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

Reactivating growth on the basis of structural reforms is a high priority. The World Bank is helping governments to increase their spending in efficient ways, especially social spending. It has approved 45 major loans to the region in the first year after the crisis. The World Bank has thus helped to finance a more expansionary fiscal position, and the resulting demand will in turn help to create jobs and income. Our focus has not only been on the amount of spending but, even more important, on the *quality of spending*. In preparing and supervising these loans, the World Bank has provided policy advice and technical assistance, a dialogue that is supplemented with a steady stream of economic studies, public expenditure reviews, and conferences involving partners from the private sector and Non-governmental organizations (NGOs). Through its multi-billion dollar structural adjustment programs in Thailand, Indonesia, the Republic of Korea, and the Philippines, for example, the World Bank is helping governments to improve financial sector regulation and supervision while it also helps these governments restructure their banking and corporate sectors. This also means improving corporate and financial disclosure, better management of debt and contingent liabilities, and implementing legal and regulatory reform. Through its project lending, especially to infrastructure, the World Bank is intensifying dialogue to instill environmental safeguards that address the environmental and natural resource problems exacerbated by the crisis. These efforts contribute to the restoration of growth, and growth that can be sustained.

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

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

The task ahead is enormous. The crisis is as important to East Asia as the debt crisis of the 1980s was to Latin America. As that crisis changed irreversibly the economic and political institutions of the day, so too throughout East Asia societies are changing dramatically in ways that none would have predicted only 18 months ago. Virtually all of the countries in East Asia are transforming the old ways of conducting their business and politics. Companies that borrowed freely and frequently using only the collateral of unfolding rapid growth are being subjected to a new discipline. Banks that borrowed in yen or dollars and loaned in local currency using a nod from government as their only hedge, are being subjected to greater supervision. Enterprises and banks are undergoing ownership and organizational changes as profound as those in Latin America during the 1980s or even in the United States during the 1930s. Though it is too soon to say with certainty, companies and banks may well emerge with less concentrated ownership, greater representation and transparency for minority shareholders, including foreigners, and greater discipline from competition in both product and capital markets. Similarly, governments and public governance are changing in historic ways. Even as they shoulder burdens from past implicit guarantees to the private sector, governments are reorganizing themselves to reduce these contingent liabilities and their direct role in resource allocation. They also are assuming new responsibilities. As traditional rural family ties breakdown under pressures of urbanization, societies everywhere in the region are looking to governments for help in ensuring the welfare of the poor, the unemployed, the sick, and the elderly. In the backdrop, a new politics of governance—from Korea in the North to Indonesia in the South—seems to augur a new openness, concern for corruption, and accountability. The journey to recovery, filled with uncertainty to be sure, is set on a historic course that will shape the future of East Asia's children.

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