Oxfam International

East Asian ‘recovery’ leaves the poor sinking

October 1998

Executive summary

The economic crisis in East Asia shows no sign of abating. Far from resolving the region’s problems, IMF ‘rescue’ measures have exacerbated their severity, contributing to an economic collapse which parallels in scale the Great Depression of 1929. Real wages have collapsed, remittances to poor rural areas have fallen, and access to basic services is deteriorating. Industry and agriculture alike have been crippled by a credit squeeze. The end result is that the welfare gains built up over three generations of rapid and equitable growth are being destroyed.

The underlying causes of the crisis in east Asia have been extensively discussed. Domestic political mismanagement, corruption and the ‘politicization’ of loans through an unaccountable and non-transparent banking system played a central part. **But the international community has also failed in its response to what is now the single greatest human development challenge of the post-war era. It has also failed to contain contagion effects which have contributed to global recession, brought financial chaos to Russia, and now threaten Latin America with a renewed debt crisis.**

Economic mismanagement on the part of the IMF has reached epic proportions. Undue fiscal stringency, a crippling squeeze on credit, and failure to address the problem of unsustainable debt, have consigned much of East Asia to a vicious circle of declining output and falling investment. **Deflation has been used as a device for achieving balance of payments goals and restoring creditor confidence, giving rise to a full blown recession.**

The poor have borne the brunt of the crisis. **By the end of this year, around 100 million Indonesians will be living in poverty - a fourfold increase over 1996.** As households adjust to lower incomes, the crisis threatens to spill over into the next generation. Over 1.6 million children are expected to drop out of primary school and junior secondary school this year, undermining prospects for shared growth in the future. Throughout the country, reports from Oxfam staff working with poor communities document a tragic story of declining access to health care, increasing malnutrition, and - in Central Java - a distressing growth of child prostitution.

In the Philippines, cuts in the social sector budgets threaten to accelerate the collapse of a public health system already under extreme pressure. Based on estimates from Department of Health data, deaths from malaria are expected to increase by up to 30,000 as a direct consequence of reductions in the preventative health budget, and vitamin supplement programs for children are being withdrawn.

Efforts to protect the poor through social safety nets are welcome, but grossly inadequate. In effect, the World Bank has been left to address the social carnage resulting from

IMF policies which are driving mass unemployment, the collapse of services, and increased malnutrition. As the World Bank report *East Asia: the road to recovery* states: "*The most urgent task ahead is to restore the conditions for robust growth throughout the region*."

Oxfam International shares this assessment. **Without rapid economic recovery on the basis of a more expansionary fiscal policy framework, social safety nets will remain at best marginal, and at worst an irrelevance**. For growth to be translated into poverty reduction, it must be widely shared and based on the participation of the poor. Failure to move rapidly in this direction will pose the risk of social and political instability, including the threat of widespread violence.

The objective of rapid and equitable growth is not consistent with existing macro-economic programs. These are reinforcing recession, while at the same time eroding the social and economic infrastructure on which the poor depend. Fiscal stringency and a relentless credit squeeze is creating a self-reinforcing downward spiral across the region. **Domestic markets are contracting and export capacity is being eroded by a combination of import strangulation and shortages of trade credits**. Because intra-regional trade accounts for over a quarter of the exports of the worst affected countries, the effects have been swiftly transmitted across borders. The upshot is that recession is reinforcing insolvency and the crisis in the banking system, which is in turn undermining exports and output.

The tension between World Bank efforts to reduce poverty and the IMF's adherence to deflationary policy measures must be addressed if the credibility of the Bretton Woods institutions is to be restored. Treating poverty reduction as an appendage to economic reform is inconsistent with the policy commitments of both agencies, as well as being inimical to the interests of the poor in East Asia.

Oxfam International recommends four broad principles for achieving recovery and poverty reduction (see section entitled a Framework for Recovery for more detail):

1. **An independent review of the strengths and weaknesses of IMF interventions to date to identify**

the institutional and policy reforms needed to establish the Fund as a credible agency for responding to financial crises.

2. **From the outset greater integration of human development and poverty considerations in the**

design of macro economic reforms, and the involvement of civil society in policy discussions. This involves creating an institutional framework within which the IMF and World Bank can provide a more integrated response.

3. The development of 'recovery oriented' responses to financial crisis including:
- More expansionary macro-economic policy.
- Measures to reduce debt.
- Expanding trade credits.
- Coordinated currency interventions.

4. Investment in crisis prevention including:
- Development of effective controls on capital movements.
- Improved transparency and accountability.
- Reducing incentives for high risk capital flows.

For Oxfam International, the past year has underlined the inadequacy of the international community's commitment to poverty eradication. Too often, the crisis is presented by the media as a threat, first and foremost, to 'markets' and financial stability in Europe and the US. The reality is that the poor are bearing the burden of the crisis in the form of increased malnutrition, destroyed livelihoods, the loss of educational opportunities, and declining access to basic services. This short *Briefing* summarizes the scale of the crisis, considers its impact on the poor and outlines the framework for a reform agenda.

Introduction

At last year's annual meeting of the IMF-World Bank, optimism continued to reign. The IMF's *World Economic Outlook* predicted an early return to growth in East Asia, allied to accelerated recovery in Latin America, the transition economies and sub-Saharan Africa. Turmoil in global financial markets was presented as a temporary disturbance which would be swiftly corrected by the accelerated liberalization of markets. Oxfam International rejected the IMF's assessment. We warned that recession threatened to reverse human development gains in East Asia, and that, in the absence of effective international action, contagion effects would spread the region's crisis to other parts of the developing world.

Our assessment erred on the side of understatement. The crisis now gripping East Asia bears comparison in terms of its destructive impact with the Great Depression of 1929. What started as a financial crisis has been allowed to develop into a full-fledged social and economic crisis, with devastating consequences for human development. Previously rising incomes have been reversed, and unemployment and under-employment has reached alarming levels. Rising food prices and falling social spending have further aggravated the social conditions of the poorest.

In Indonesia, the world's fourth most populous country, the advances in poverty reduction achieved over three decades are being relentlessly rolled back. Other countries in the region have suffered less dramatic, but nonetheless massive, reversals. Hopes of a quick recovery have been pushed back into the distant future.

Contagion effects have exceeded the fears of even the most pessimistic commentators. Having swept through Russia, the Asian crisis now threatens to engulf Latin America. The regions' largest economy, Brazil, is struggling to stave off a currency collapse or debt moratorium. If it fails, Argentina and much of the southern cone will follow suit, raising the specter of a regional recession. Looking beyond Latin America, recession in East Asia has contributed to a worldwide slowdown in growth, contributing to rising unemployment and declining government revenues.

There are no easy solutions to the crisis now facing East Asia and the wider global economy. What is clear, however, is that the international response has been inadequate. Indeed, as we argue below, it has exacerbated the severity of the situation, and contributed to poverty. The IMF bears much of the responsibility. Its faith in policy prescriptions based on high interest rates to restore confidence has not been borne out by developments in the real economy. Despite deep devaluations, the squeeze on credit has caused exports to stagnate, contributing to continued pressure on exchange rates and a process of 'import strangulation', with local firms unable to access the technologies needed to increase output.

The impact of flawed policy prescriptions has been compounded by the inadequacy of

international support for recovery. By under-financing the rescue package, northern governments have reinforced the deflationary bias in macro-economic reform. In effect, the IMF has been cast in the role of an international economic firefighter without access to a reliable water supply, operating a poorly designed fire engine, guided by a driver devoid of any sense of direction. The time for major institutional reform, allied to the mobilization of new resources for recovery, is long overdue - and has now been belatedly recognized by the Group of Seven.

The threat of a lost decade

At risk of understatement, the economic prospects for East Asia are bleak. Growth forecasts have been revised downwards on an almost monthly basis. The most dramatic losses have been recorded in Indonesia, where GDP is now expected to contract by 20 per cent. Output in Thailand and South Korea will fall by 6-8 per cent. Other countries in the region - including Vietnam and China - have so far avoided full blown recession, but economic growth has declined in both cases and currency pressures are mounting. On current trends, it is unlikely that recovery will take root by 2002, or beyond.

Household earnings have fallen sharply across the five East Asian countries gripped by the crisis. All income groups have been adversely affected. However, the impact of rising unemployment has been felt most strongly by low-income urban workers, while the rural poor have suffered as a consequence of falling remittances and deteriorating services. Drought has worsened an already dire situation in some countries, causing losses in household income and food shortages.

The facts of the crisis speak for themselves:

- **In Indonesia, the collapse of the rupiah has pushed inflation up towards 80 per cent, with unemployment expected to reach 15 million people by the end of the year.**

- **In Thailand unemployment has risen from 5 per cent to 9 per cent. Poverty is expected to rise by one-third this year**

- **In the Republic of Korea unemployment has almost doubled to 7 per cent, with a projected increase to 10 per cent in prospect as government employment contracts and some of the largest chaebols downsize.**

The longer that recovery is delayed, the situation will become more desperate for households forced into poverty. There is a further danger of poverty being transmitted to the next generation, as the reduction of household incomes and deteriorating services reduces access to schools and health facilities (see below).

Developments in East Asia have been transmitted through the mechanisms of international trade and finance to other developing countries. Average growth rates for developing countries will fall to 2.5 per cent this year, according to recent estimates by UNCTAD, with Latin America and sub-Saharan Africa suffering a slowdown in growth. As a result, the income gap between developed and developing countries will widen, and the international goal of halving world poverty by 2015 will receive what may prove a terminal blow.

The human dimensions of the crisis

Behind the statistics the lives of millions of people are being destroyed. By the end of this year, over 100 million Indonesians will be living below the poverty line - four times as many as in 1996. Unemployment could rise to 15 million in 1998. With food prices rising, mass hunger and child malnutrition have emerged as real fears. Meanwhile, children are dropping out of school in unprecedented numbers. According to Indonesian Government sources, as many as 1.6 million primary and junior secondary school students may be forced to withdraw from school. In real terms, government budgets for health and education have fallen dramatically. In Thailand, the number of primary school children reported not completing their education has tripled over the past year.

Oxfam International has been monitoring the unfolding human tragedy in Indonesia through staff reports from some of the poorest regions in the country. These reports provide an insight into the human consequences of the international community's failure to address the crisis:

- ***In Yogyakarta, Central Java, where Oxfam works with street children, child prostitution is on the increase. Girls as young as ten are now turning to prostitution in a desperate attempt to feed themselves and their families.***
- ***In the outer island of Flores, there has been a steep decline in visits to health centres because families cannot afford to meet fees.***
- ***In West Timor several hospitals and health centres have shut down and basic antibiotics are now unaffordable.***
- ***In Maluku, school attendance has declined by 60 per cent.***

These are some of the direct consequences of economic collapse in Indonesia. They illustrate how what started as a financial crisis has become a human development crisis. But it is not only in countries suffering the deepest recession that the crisis is impacting the poor.

In the Philippines, an IMF program has been adopted in an effort to insulate the economy from contagion through stringent fiscal discipline - a euphemism in this case for reductions in budget allocations for services on which the poor depend. The non-salary element of the health budget, to take a case in point, has been reduced by one third. Allocations to preventative health care budgets for malaria and tuberculosis have fallen by 27 per cent and 36 per cent respectively, and immunization programs by 26 per cent. Several vitamin supplement programs have been withdrawn.

On the basis of data from the department of Health, Oxfam estimates that the reduced provisions for preventative health care programs will result in:

- **An additional 29,000 deaths from malaria**

- **An increase of 90,000 in the number of untreated tuberculosis cases**

- **Almost half -a-million children aged between 12-59 months not receiving Vitamin A supplements**

- **Some 750,000 women aged 15-40 years not receiving iodine supplements**

Nor is it solely East Asia's poor who are suffering the consequences of declining services. In Brazil, for example, the diversion of government revenues to the country's currency reserve in

an effort to stave off devaluation has resulted in cuts in basic social services.

Poverty effects have also been transmitted through international commodity prices. While other factors have been at work, East Asia's recession has probably been the single most important factor behind the recent collapse in commodity prices, especially for metals. The region accounts for almost one quarter of world trade, and for around 10 per cent of Latin America's export earnings. Some African countries depend on the region for more than 25 per cent of their export earnings.

For countries such as Mexico and Zambia, where the combination of lost markets and lower prices has reduced fiscal revenues, East Asia's crisis will translate into reduced access to basic services and rising unemployment.

Flawed prescriptions and underlying problems

The underlying causes of the crisis in east Asia have been extensively discussed. Domestic mismanagement, corruption and the 'politicization' of loans through an unaccountable and non-transparent banking system played a central part. Over-borrowing in dollars relation to foreign currency reserves, left companies and banking systems exposed to the effects of interest rate rises and currency devaluation. Large current account deficits, financed by short-term, often speculative, capital flows exacerbated risk. But the catalyst for the crisis was a dramatic shift in financial flows during 1997, the scale of which was unjustified by economic realities.

In 1996, the five most affected countries had net private inflows of $93bn. By the end of 1997, the outflow amounted to $12bn - a change equivalent to 10 per cent of GDP. If the exuberance of the former year was excessive, the panic of the latter year reflected the herd mentality of investors in an increasingly mobile global capital market. Commercial banks and portfolio investors, who had been responsible for much of the earlier surge in lending, led the flight from East Asia.

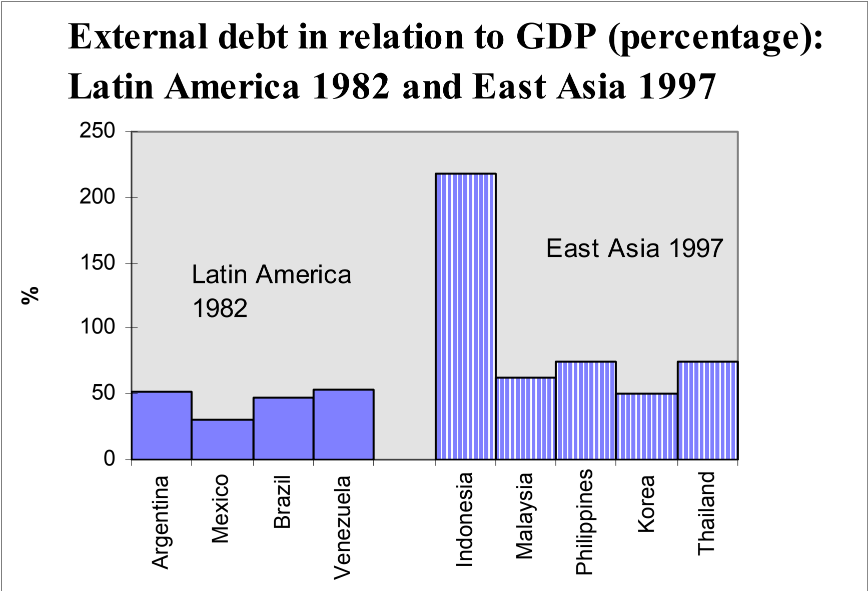
Over $120bn has been mobilized under IMF auspices in response to the crisis. Yet, as the crisis deepens, there is a growing concern over the failure of the rescue effort to produce tangible results. What has gone wrong?

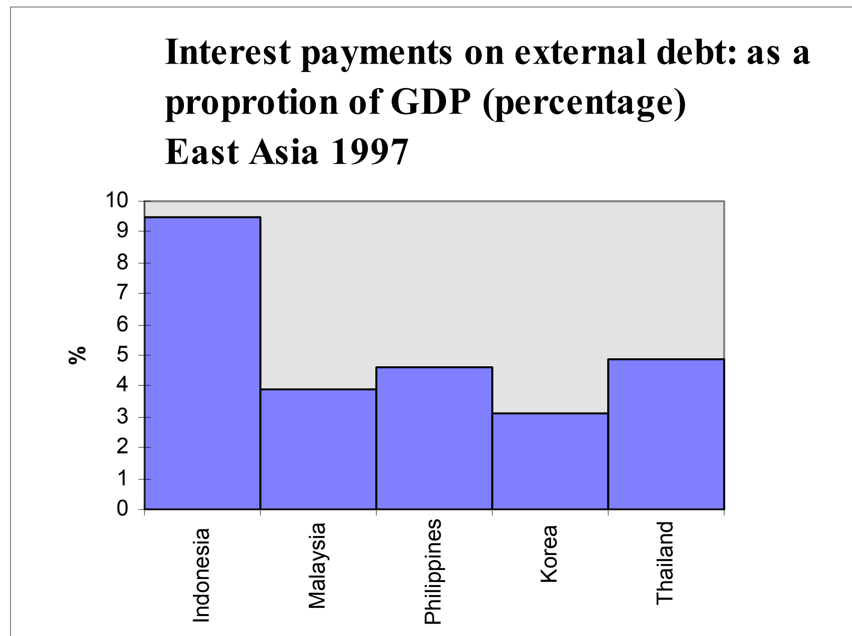
The answer to this question begins with the IMF's insistence at the outset that the crisis was a traditional balance of payments problem, rooted in weak fiscal management and poor banking regulation. This faulty diagnosis led to a lethal prescription of high interest rates, ostensibly to restore investor confidence. Inevitably, it failed to do so. At the same time, the Fund regarded what was clearly an unsustainable debt problem as a temporary liquidity crisis to be resolved through tight fiscal policies, repeating the error which consigned Latin America to a lost decade in the 1980s.

Coupled with high interest rates, amounting to over 100 per cent in Indonesia, domestic firms were faced with a near exclusion from trade credit markets, undermining their capacity to generate output and exports. Import demand collapsed in the face of the credit squeeze and currency devaluations, falling by 30-40 per cent in the worst affected countries. This in turn undermined prospects for recovery. In Indonesia, financing problems contributed to a 35 per cent drop in export earnings for the textile sector due to shortages of raw materials. This illustrates how misplaced fiscal stringency and inadequate attention to investment conditions undermined the potential for recovery and deepened the recession. It has been estimated that around $10 -12bn in trade credits will now be needed to realize the country's export potential.

Trade credits have been provided as part of the rescue effort. Unfortunately, these have often been directed towards the pursuit of commercial advantage on the part of the supplier, rather than economic need. The US, for instance, has linked its $460m allocation to Indonesia to the purchase of American cotton, soybeans, flour, wheat and corn. Australia has provided financing in some of the same areas, as much to protect its market share as to meet the real needs of the Indonesian economy.

The fact that high interest rates have failed to restore confidence in currencies reflects the IMF's failure to address the regions' chronic debt problems. As illustrated by Table 1, these are now more severe than in Latin America at the start of that region's lost decade, with Indonesia now allocating almost 10 per cent of GDP to debt repayments. An outflow of resources on this scale is inconsistent with social and economic recovery. Moreover, the Indonesian government has now accumulated a debt of $110bn, alongside a private sector debt of $83bn, thereby mortgaging the country's future to international creditors.





Source: UNCTAD, *Trade and Development Report*, 1998

As in Latin America, the reduction and rescheduling of accumulated debt is vital especially for Indonesia. Yet the IMF's programs have provided financing to repay creditors, while at the same time imposing conditions which have increased bankruptcies and undermined the investment needed to stimulate recovery. In practice, the Fund's programs have prioritized the claims of commercial bank creditors in the US over the social and economic needs of Indonesia, with devastating implications for poverty.

A pre-condition for sustained recovery is the stimulation of demand, both at a national and regional level. Over one-quarter of trade between the five most affected countries is intra-regional, so that the contraction of demand in one country has been swiftly transmitted to others. Declining incomes and wealth have depressed domestic markets, with the contraction in public spending fueling the downward cycle. The resulting depression is forcing viable companies into a position of insolvency, with between 20-65 per cent of firms in Indonesia, Korea and Thailand now technically bankrupt, according to the World Bank. Recourse to public spending and credit creation in order to stimulate demand is vital if the downward spiral is to be reversed.

Failed response to the social crisis in Indonesia

The fact that over $1bn has been mobilized in the form of humanitarian assistance for Indonesia alone, underlines the scale of the social crisis. Implemented under the auspices of the World Bank, the Asian Development Bank and various bilateral donors, the assistance covers public works programs, balance of payments support for rice and essential medical goods, and rural development programs.

Such safety-net measures are desperately needed. But they are not even remotely adequate given the scale of the social crisis they are seeking to address. For instance, the World Bank's five year program of grants aimed at keeping children in school will cover, in a best case scenario, less than a third of the children who are expected to drop out. There is also evidence

that the program is failing to target the poorest and most vulnerable. Similarly, the World Bank's Early Childhood Development Program will provide support to 1.2 million infants. Crucial as such support is, in eastern Indonesia over 50 per cent of children under the age of five are now estimated to be suffering from malnutrition.

At best, safety-net measures will have only a marginal impact. They do not offer the prospect of a solution to the crisis. This will require a return to economic growth through the introduction of a macro-economic reform program geared towards recovery. Increased domestic expenditure and lower interest rates are essential in this regard, but both elements are effectively proscribed by IMF conditions.

One of Oxfam International's central concerns in Indonesia is this discrepancy between the macro-economic policy framework of the IMF, and the social policy framework of the World Bank. In effect, these are pulling in different directions. The World Bank is in the hapless position of erecting social safety nets which are collapsing under the weight of rising poverty and mass unemployment resulting from IMF programs.

The challenge is twofold. First, it is crucial that the artificial separation of social and economic policy be ended. Human development and poverty considerations should be integral parts of the macro-economic policy framework, which is currently dominated by narrow - and deeply flawed - financial targets. Second, an institutional framework must be created within which the IMF and the World Bank can provide a more integrated response to financial crisis. The alternative is for the World Bank to continue its present practice of arriving after the event in a largely futile effort to counteract the negative consequences of IMF prescriptions.

A framework for recovery

The East Asian crisis and its transmission to other developing regions has underlined the weakness of international approaches to crisis management in the global economy. Private capital markets have outstripped the capacity of institutions and governments to regulate them in the interests of stability, growth, employment and poverty reduction. It is increasingly widely recognized that new approaches are needed to avert disaster, although there is little consensus on the direction of reform.

Oxfam International recommends four broad principles for achieving recovery and poverty reduction:

1. An independent review of the strengths and weaknesses of IMF interventions to date. The IMF's role in East Asia has failed on several counts. Its programs have attempted to use recession as a device for restoring balance of payments viability. In the case of East Asia, where economies are tightly integrated through trade, devaluation and the compression of import demands has transmitted and multiplied the impact of recession across the region. Evidence to date suggests that the Fund's policy advice has failed, even where it has been most rigorously applied. An independent evaluation, along the lines of the external review of the Fund's ESAF programs, is needed to identify the institutional and policy reforms needed to establish the IMF as a credible agency for responding to financial crisis. Such a review should prioritize an examination of the poverty effects of IMF interventions. If the US Congress were to link its approval for the Administration's request for $18bn additional financing to such a review, it could help to improve both the effectiveness and transparency of the IMF. This would be more constructive than the present approach, which is rooted in a rejection of multilateralism and a

flagrant disregard for poverty in East Asia.

2. Greater attention to human development considerations and the involvement of civil society in policy discussions. The division of labor between the IMF and the World Bank, with the former shaping the macro-economic reform framework and the latter assuming responsibility for social safety nets has become highly damaging. Human development considerations - including the protection of priority social sector budgets, the minimization of unemployment, the maintenance of rural infrastructure, and the monitoring of access to basic services - should figure at the outset in the design of macro-economic targets.

3. The development of 'recovery oriented' responses to financial crisis. Action is needed at several levels:

- More expansionary macro economic policy. The standard IMF response to financial crisis is to shrink domestic demand, using tight fiscal and monetary policies to restrict imports. It is a response which has almost universally lowered investment, reduced output and imports, and locked countries into a vicious cycle of debt deflation. While the Fund has relaxed its fiscal conditions for East Asia, movement in this direction has been too slow and on too limited a scale to support recovery.

- Debt sustainability. In Latin America, it took seven years to develop a viable strategy for debt sustainability. During the intervening period, the region suffered a social and economic reversal from which it is still recovering. East Asia should not suffer the same fate. The IMF should play a central role in developing a framework for more equitable burden sharing, including a standstill on repayments and arrears accumulation, rescheduling and debt reduction. It is not acceptable for governments to assume the debts of private foreign creditors, as currently happens under IMF programs.

- Trade credits. Recovery prospects in Indonesia have been undermined by credit shortages in potentially viable firms, leading to lost output and employment opportunities. The maintenance and expansion of credit lines which are not tied to the exports of individual creditors should be a core elements in future programs.

- Coordinated currency interventions. At present, IMF rescue packages are developed on a country-by-country basis. However, currency devaluation in one country can lead directly to currency devaluations in other countries, as events following Thailand's devaluation illustrated. Improved co-ordination in stabilizing exchange rates is needed both at the regional level and the international level.

4. Investment in crisis prevention. As the spiraling costs of the bailout packages for East Asia demonstrate, crisis prevention is likely to prove less costly than addressing problems after they have arisen. Once again, several principles would appear important:

- ***Development of effective controls on capital movements.*** The financial crisis in East Asia followed a period of radical capital account liberalization. Failure to develop adequate regulatory frameworks for banking supervision inevitably increased exposure to the risk of collapse. Difficulties in developing such frameworks suggest the need for caution in liberalizing capital accounts, as the World Bank's Chief Economist, Joseph Stiglitz, has pointed out. Moves to reform the IMF's Articles of Agreement with a view accelerating capital account liberalization should be abandoned. From the perspective of averting future crises, there are especially strong grounds for following the Chilean example of imposing reserve requirements on all non-equity

capital flows and explicit taxes to discourage short-term flows of the type which proved so damaging in East Asia. At the same time, capital controls which are used to defend unrealistic exchange rate alignments are unlikely to succeed. At an international level, a tax on short-term capital investments would help to reduce the flow of speculative capital, especially in currency markets.

- ***Improved transparency and accountability.*** There is a powerful case, which can be justified in democratic as well as financial terms, for East Asia to develop more transparent banking systems. But the influence of inadequate information flows in creating the crisis have been over-stated. The signs of over-heating were clearly visible for up to two years before the crisis, and were systematically ignored by investors. Thus while the extension of the IMF's Special Data Dissemination Standard (SDSS) is welcome, its potential benefits have been wildly exaggerated - not least because much of the data in question is already available through the Bank for International Settlements. This suggests that greater transparency is needed on the part of the commercial banks, pension fund and mutual fund managers who were rushing in to East Asia. Commercial banks in particular used a range of devices to obscure their exposure, and hence the obligation to make realistic provisions against loss. Mutual fund and pension fund managers were also exposing their clients' savings to high risk markets, without making adequate provisions. Given the growing volatility of world capital markets and the increasing institutionalization of savings in global funds, the case for strengthened regulation is now overwhelming. Filling the regulatory gap in portfolio flows to developing countries should be a priority. Some form of risk weighted provision for institutional investors should be developed, perhaps under the auspices of the International Organization of Securities Regulators.

- ***Reducing incentives for high risk capital flows.*** Long-term foreign investment can play a constructive role in the development process. But a large and growing share of world capital flows have been of a speculative character, geared towards high turnover trading in volatile equity markets and investment in local finance houses. Foreign commercial banks and, to a lesser degree, private investors are often insulated from risk by IMF bailouts. This in turn encourages moral hazard, with creditors allocating resources imprudently in the knowledge that their interests will be protected. There are various ways to discourage such activity, the most effective of which is to make high risk lending genuinely risky through international rules which provide for a reduction of creditor claims in the event of insolvency. At present the IMF violates market principles by removing risk and transferring adjustment costs from creditors to the poor, for whom debt repayments translate into reduced access to services and lost livelihoods.

For more information, please contact Justin Forsyth at 202.393.5332 or Veena Siddharth at 202.393.5333.

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