Asia and the Global Crisis
The Industrial Dimension
Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

The original Member countries of the OECD are Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The following countries became Members subsequently through accession at the dates indicated hereafter: Japan (28th April 1964), Finland (28th January 1969), Australia (7th June 1971), New Zealand (29th May 1973), Mexico (18th May 1994), the Czech Republic (21st December 1995), Hungary (7th May 1996), Poland (22nd November 1996) and Korea (12th December 1996). The Commission of the European Communities takes part in the work of the OECD (Article 13 of the OECD Convention).
On 2 July 1997, the Thai government abandoned its efforts to defend the country’s currency. What had been a steady inflow of private capital had suddenly turned into a financial tidal wave fleeing the country. It followed on a range of mounting pressures – in the form of declining asset prices, slowing construction, reduced export growth, a sharp cyclical downturn in world semiconductor demand, a relatively high current account deficit, declining foreign reserves and appreciation of the dollar-tied baht vis-à-vis the yen. Investors initially cheered the move, reversing a long slide in share prices. But their enthusiasm was short-lived. Instead of floating, the baht sank. By January 1998, when it bottomed out, it had lost more than 50% of its former value. Nor was the crisis limited to Thailand.

The story did not end there. Indonesia, Korea, Malaysia and the Philippines were to go down the same road, causing similar damage to their currencies and economies. To a lesser, yet still significant, extent, Chinese Taipei, Singapore and Hong Kong, China (hereinafter referred to as Hong Kong), were also affected. While the first two economies experienced a sizeable devaluation of their currencies, Hong Kong defended its currency peg to the US dollar, albeit at the price of very high interest rates, reduced short- to medium-term growth prospects and a tarnishing of its image as a non-interventionist economy. Having succeeded in defending the value of its currency, the yuan, in the midst of the crisis, China, a major factor in the wider regional economy, struggled to combat slowing growth. The risk of “contagion”, spreading to an ever-widening number of countries, gave rise to growing concerns at the regional and global level. These concerns intensified as Korea succumbed in late 1997, followed by Russia in August 1998 and Brazil in January 1999.

The financial aspects of the crisis have received a great deal of attention at the global level. Indeed, much discussion has taken place on reforming the international financial system so as to deal more effectively with issues related to volatile short-term capital flows. On closer examination, however, it is apparent that the crisis was far more than a financial, or even macroeconomic, phenomenon. There is growing recognition that key structural weaknesses in industry existed in a number of Asian economies, and that these weaknesses were the underlying cause of the crisis. The strong economic performance achieved by these countries during periods of high growth tended to conceal these weaknesses, although the signs were there prior to mid-1997.

Government, industry and trade union officials discussed these and related industry issues at a special session of the OECD’s Industry Committee, on 23 February 1999. It was concluded that the economies struck by the crisis need to complement actions on the financial front with a series of industry-related policy reforms. Other countries in the region, including China, are confronted with similar challenges. Without these reforms, recovery will be slower and the risk of future backlashes will be imminent. For the OECD area, the discussion indicated that the crisis had already had a number of effects on industry, with the possibility that these could become more pronounced, particularly if economic growth in Europe and North America were to slow. At the same time, the ultimate outcome will crucially hinge on the structural policy responses, in Asia as well as elsewhere.
This book has been prepared by the OECD Secretariat based on the proceedings of that meeting. Principal speakers included Dr. Nariman Behravesh, Chief International Economist and Research Director at Standard & Poor’s DRI, and Mr. Peter Unterweger, Head of the Automotive and Mechanical Engineering Department of the International Metalworkers Federation. Their contributions, reproduced on the responsibility of the authors, are included as Annexes 2 and 3. As was the case for the main body of the text, the analysis was initially prepared in January 1999. Updates through May 1999 have been undertaken where appropriate. Substantive contributions were made by Thomas Andersson, Peter Avery, Adrian Connolly and Risaburo Nezu of the OECD Secretariat, and by Dr. Zhang Gang, research fellow at the Stockholm School of Economics. The book is published on the responsibility of the Secretary-General of the OECD. The content draws on and extends the background material as well as the discussions which took place at the meeting, and does not necessarily reflect the views of the OECD or its Member governments. Mention of companies, trade names or commercial products does not constitute an endorsement or recommendation by the OECD or the various bodies mentioned above.
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Chapter 1

OVERVIEW, SUMMARY AND CONCLUSIONS

Introduction

The crisis began during the second half of 1997, when five East Asian countries (Indonesia, Korea, Malaysia, the Philippines and Thailand) experienced a net reversal in private capital flows of more than US$100 billion (or about 11% of pre-crisis GDP). This precipitated sharp declines in the value of these countries’ currencies. After a year of prolonged financial and economic instability in Asia, with considerable social and political repercussions, the crisis took on a global character in August 1998. As pressures mounted against the Russian rouble, financial markets were unsettled worldwide, resulting in a general, sizeable outflow of private capital from emerging markets. The contagion spread to Latin America during the latter part of 1998, forcing Brazil to abandon its defence of its currency in January 1999.

The economies directly affected by the crisis experienced GDP declines of 0.5% to 13.7% in 1998, with further declines anticipated in Indonesia, Malaysia and Russia in 1999 (Table 1). The effects on domestic demand in these countries have been even more pronounced, with declines of up to 26% experienced during 1998. In the case of Brazil, slow growth in 1998 is expected to evolve into contraction in 1999.

Table 1. GDP and domestic demand growth in selected countries, 1997-99

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP growth</th>
<th></th>
<th>Domestic demand growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>3.7</td>
<td>0.2</td>
<td>-3.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.7</td>
<td>-13.7</td>
<td>-3.0</td>
</tr>
<tr>
<td>Korea</td>
<td>5.0</td>
<td>-5.8</td>
<td>4.5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>7.8</td>
<td>-6.7</td>
<td>+0.5</td>
</tr>
<tr>
<td>Philippines</td>
<td>5.1</td>
<td>-0.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Russia</td>
<td>0.4</td>
<td>-4.6</td>
<td>-1.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>-0.4</td>
<td>-8.0</td>
<td>1.0</td>
</tr>
</tbody>
</table>

n.a. = not available.
1. Projections.
Source: OECD (1999a).

The spread of the crisis, with its changing investor behaviour, declines in demand and reshuffling of trade patterns, gradually exerted a major impact on the economic situation and prospects for the majority of non-OECD economies. As of the end of 1998, nearly all the Dynamic Asian Economies were in recession, and growth in China had slowed compared to 1997. Moreover, the crisis in Russia
was having effects throughout the neighbouring region, while in South America, renewed tension over the sustainability of the Brazilian real added to downward pressures on growth. Little, if any, recovery was expected in these non-member economies before the second half of 1999.

Until mid-1998, economic developments remained relatively favourable in North America and Europe, despite the financial turbulence elsewhere. By September, however, the effects of the crisis were becoming increasingly evident in these parts of the world as well. At the same time, there were indications that the already stagnant Japanese economy was deteriorating. These developments led to a change in perception about the balance of risks affecting future economic prospects, which induced authorities in several countries to take action to ease monetary policy and/or improve financial mechanisms at the national or international level. Following these actions, financial market turbulence tended to settle and prospects improved significantly. Between December 1998 and May 1999, GDP growth projections for 1999 for the OECD area were raised by half a percentage point, from 1.7% to 2.2% (OECD, 1998a and 1999a).

At the global level, assessments by the International Monetary Fund (in October 1998) reflected downward revisions in overall world GDP growth for 1998 and 1999. Expectations for 1998 were trimmed from 3.1% to 2%, while the outlook for 1999 was reduced from 3.7% to 2.5%. IMF economists did not rule out further downward revisions, particularly if reductions in private financing flows to emerging market economies persisted. In fact, an interim downward adjustment for 1999, to 2.3%, was announced and then confirmed, in December 1998 (IMF, 1998a) and April 1999 (IMF, 1999), respectively. Reports issued by the OECD (OECD, 1998a) and the World Bank (World Bank, 1998a) also noted the downside risks that continued to be present in current forecasts.

The slowdown in world economic growth parallels experiences in the mid-1970s and early 1980s and 1990s (Figure 1). This particular crisis differs in several respects, however. The crisis hit what had supposedly been some of the most dynamic economies in the world. In less than forty years, a region that had previously been characterised by severe underdevelopment had undergone a remarkable transformation. From being one of the world’s poorest countries, Korea, for instance, had become by 1995 the eleventh largest economy in the world, as well as one of the largest producers of ships and memory chips and the fifth largest car manufacturer. A related aspect concerns the degree to which countries have been affected by the crisis. The five Asian economies had been registering very high collective annual growth rates of slightly less than 6% to more than 9% during 1990-96 (Figure 2). The 8% decline that occurred in 1998 represented an extremely sharp reversal of some 12.5 percentage points in a single year.

**Figure 1. Growth of real world GDP, 1970-2003**

![Figure 1. Growth of real world GDP, 1970-2003](image)

*Source: IMF (1999).*
The origins of the crisis

While the immediate causes of the crisis were financial in nature, there is growing evidence that structural weaknesses in the countries’ industries played an important underlying role. One must bear in mind that the Asian economies are inherently heterogeneous, and display many important differences. Nevertheless, there is no doubt that all the Asian economies considered here had for a long time pursued ambitious development plans, boosting investment in heavy and high-tech industries, such as steel, automobiles and electronics. In many instances, these policies had appeared successful, not least as foreign and domestic investment surged during the 1990s. Investment was facilitated by financial liberalisation, which made foreign capital more accessible to domestic borrowers. This situation contributed to an average annual growth in GDP ranging from 7.8% to 8.7% during 1990-96 in all the crisis economies except the Philippines, where growth attained an average of only 2.8%. These performances can be compared with the modest growth rates of less than 3% recorded by Africa and Latin America. During these seven years, the increase boosted real GDP per capita by more than 40% for all the countries considered, with the exception of the Philippines. Per capita GDP in the OECD area, in contrast, grew by about 9%.

The increased investment was reflected on the balance sheets of domestic companies in the form of rising corporate debt, which was already relatively high by international standards. The high level of investment translated into over-capacity in a broad range of sectors. When this became apparent, asset values began to slide, and the conditions which led to the 1997-98 reversals in capital inflows started to emerge. Signs of these weaknesses were already apparent to some observers, well before the crisis (Box 1).

That the situation was allowed to deteriorate to the extent that it did can partly be attributed to the extremely positive expectations regarding future performance that had prevailed for so long. More fundamental, however, was the lack of mechanisms to disclose what was actually going on. The same policies, incentives and attitudes that had spurred hard work and a strong commitment to success failed to see the danger signals when things went astray. The nature of corporate governance regimes in the East Asian countries, which suffered from a lack of sufficient oversight by banks and regulatory authorities, played a major role in this context. Implicit or perceived government support in the event that favoured projects did not succeed, also contributed to this situation.


Box 1. Early signs of structural weakness

In a 1994 article on *The Myth of Asia’s Miracle*, Paul Krugman questioned the nature of Asia’s economic success. “Popular enthusiasm about Asia’s boom”, he wrote, “deserves to have some cold water thrown on it.” Likening the situation to an earlier fascination that Western academics and politicians had had with the apparent success of the Soviet Union in the 1960s, Krugman observed that Asia’s growth had been fuelled “in large part through an astonishing mobilisation of resources”. This mobilisation, based on a one-time change in behaviour, could not, he argued, be repeated. As a result, there was a likelihood that economic growth, while likely to continue to outpace growth in the West for the next decade and beyond, would not do so at the rate of recent years. Continued growth at those rates would require impressive gains in productivity, something that had been startlingly absent in most of the economies. “From the perspective of the year 2010”, Krugman concludes, “current projections of Asian supremacy extrapolated from recent trends may well look almost as silly as 1960s-vintage forecasts of Soviet industrial supremacy did from the perspective of the Brezhnev years.”

Source: Krugman (1994).

There were a number of downside effects to the aggressive government support of investment in heavy and high-tech areas. Initiatives were often pursued prior to the development of the national technological expertise that was required to support the new enterprises. The result was an increasing reliance on imported inputs and technology in the presence of weak linkages with the domestic economy. Meanwhile, the excessive level of investment led to overheating, rising wages and labour shortages, particularly for skilled workers. Combined with appreciating currencies, this contributed to undercutting competitiveness. Moreover, due to the limitations in technical support, new facilities often operated at sub-optimal levels, and there was a lack of sufficient mechanisms for wider diffusion of new technologies. Combined with a heavy reliance on an ability to absorb and exploit existing technologies, the lack of technical expertise hampered the capacity of firms to innovate. This became increasingly costly as the Asian countries sought to compete in knowledge-based industries, where innovative capabilities are crucial.

The focus on targeted sectors came partly at the expense of small and medium-sized enterprises (SMEs). Since the larger firms relied on imports for technology and inputs, SMEs tended not to form critical links to these firms, either as suppliers or in other ways. At the same time, rising labour costs had a pronounced effect on labour-intensive, low-wage industries. The countries that were to be struck by crisis most probably lost their competitiveness in these industries prematurely.

The effects of the crisis on industry

The financial crisis was a systemic shock that devastated well-managed and poorly run companies alike. Leaving social and political aspects aside, there were five key aspects to the shock in the Asian economies:

- Domestic and regional demand for goods and services collapsed. The hardest-hit sectors included automobiles and construction. As a result, commodities, such as metals and other building materials, suffered sharp declines.
- Higher costs (in domestic currency) for imported inputs.
- Sharply higher repayments (in domestic currency) on foreign-denominated loans.
- Higher domestic interest rates (as governments took action to cushion currency depreciation).
- Limited credit availability (as bankers became cautious about lending, particularly to SMEs).

These five conditions had dramatic consequences and, by mid-1998, large parts of the corporate sector were either insolvent or suffering severe losses.

Faced with a slump in domestic and regional demand, companies could generally be expected to increase exports, as occurred in Mexico in the mid-1990s. In the case of Asia, exports from the crisis economies actually fell slightly in dollar terms, although export volumes did rise. This was clearly related to the extreme financial difficulties experienced, along with the fact that the quite sizeable intra-regional exports in Asia were depressed by the weakening of regional markets. The liquidity crunch had, in fact, a more pronounced effect on imports, which fell by about one-third in the five countries during 1998. This shows up as a pronounced downturn in OECD exports to the five countries. The net result was a hefty US$130 to US$135 billion shift in the five countries’ combined trade balance, which transformed a merchandise deficit of US$50 billion in 1996 into a trade surplus of some US$80 to US$85 billion in 1998.

While the crisis initially had little effect on most OECD countries, its broadening scope and depth eventually took its toll. Economic growth in the OECD area fell from 3.3% in 1997, to an estimated 2.3% in 1998, due largely to the crisis. The impacts on trade have been particularly noticeable in some sectors. For example, the crisis has tended to aggravate weak conditions over a broad range of commodities. Metal prices, already under pressure, fell by between 20% and more than 40% from July 1997 to January 1999, while oil prices fell by nearly 40% between October 1997 and the end of 1998.

In addition to commodities, the crisis has severely affected the steel and shipbuilding industries. In steel, sliding prices and shifts in trade flows have heightened trade tensions, exacerbating the use of antidumping and related measures. In shipbuilding, order books are full, but low prices are putting strain on companies. With shipowners advancing their purchases to take advantage of the low prices, these strains could well significantly increase, as new orders slow. Moreover, the crisis has no doubt played a role in accelerating restructuring and/or consolidation in several industries, leading to a series of mergers and acquisitions.

Interestingly, the effects on OECD countries that have a relatively large resource/commodity component have not been as severe as initially feared. There has also been a favourable effect on companies that use commodities as inputs in their operations. Economic expansion in Australia, for example, strengthened during 1998, rising to its highest level in four years, despite the downturn in commodity markets. The stronger economy led to a corresponding decline in unemployment, which dipped to its lowest level in eight years. In addition to favourable conditions in the construction, retailing and communication sectors, exporters have benefited from a sharp decline in the value of the Australian dollar (vis-à-vis the US dollar). The depreciation has enabled companies to enhance their competitiveness and sales in non-Asian markets. The situation in Canada has been similar. While certain industries were hard hit, a sharp decline in the value of the Canadian dollar in 1997 and 1998 helped to cushion the effects of the crisis on the overall economy. Overall economic growth has remained strong, and unemployment has continued to fall.

Meanwhile, the decline in commodity prices has helped to keep inflation in check in the OECD area more generally, especially in the United States where this may have contributed to holding off an increase in interest rates and extended the duration of the already extraordinarily long-lasting economic boom.
By early 1999, the macroeconomic situation in the Asian economies had improved markedly:

- **Exchange rates** had strengthened and, with the exception of Indonesia, were now at two-thirds to three-quarters of their pre-crisis levels.
- **Interest rates** had eased, generally falling to pre-crisis levels.
- **Foreign direct investment** had risen, surging to record levels in Korea and Thailand in 1998 as investors took advantage of lower costs and favourable liberalisation in investment rules.
- **Stock markets** had rebounded sharply, although values so far remained well below pre-crisis levels.
- **Current accounts** were recording bulging surpluses, replenishing foreign reserves.

These improved conditions enabled companies to operate more effectively and increase production. With domestic demand generally expected to remain weak for some time to come, however, there is likely to be a continued focus on export markets. Indeed, a review of company statements indicates a general intention to explore and expand export markets in 1999. These changing trade patterns are strongly felt by other industrialising countries, including China. An important question is to what extent increased exports will be met by foreign demand and open markets. The Japanese economy has shown signs of recovery, but may nevertheless remain sluggish. The United States has so far served as the main absorber of the increased supply, as well as of foreign capital, which has led to a bulging of the current account deficit. In a situation of negative household savings in the United States, strong demand in that market is highly dependent on continued capital inflows and on the maintenance of the historically high valuation of US stock prices. At the same time as this creates considerable uncertainty about the future strength of that market, growth prospects have so far remained weak in the European economies.

There are, furthermore, risks of increasing deflationary pressures, and of protectionist responses. Competitive pressures could intensify in a growing number of sectors, resulting in more widespread industry restructuring. Recent OECD forecasts indicate that there still are possible scenarios under which OECD growth could grind to a virtual standstill over the coming years.

**Policy implications**

**Crisis economies**

In the wake of the crisis, governments in the five Asian economies have initiated impressive reform programmes, including privatisation of state-owned assets, liberalisation of trade and investment regimes, and strengthening of policies vis-à-vis SMEs. They are also exploring ways to resolve the debt problems facing corporations. In addition, they are working to reform corporate governance regimes, and several of the countries have revised their bankruptcy laws. With the improvement in general economic conditions now under way, however, there are dangers that the reform process will slow down.

The Asian governments must seize the opportunity to ensure that the needed structural reforms are fully implemented. Rather than micro-managing private behaviour, the guiding principle must be to put in place conditions to encourage market-led adjustment, and to address the key barriers preventing these economies from becoming major actors in the global “knowledge-based” economy. While
labour- and capital-intensive manufacturing will remain important, the prime driving force for future
growth and job creation is increasingly “knowledge-based” activities in manufacturing and services.
Even in industries and countries where production has traditionally been highly standardised and
dependent on low costs and wages, new means for the diffusion, adoption and use of technology
increasingly emphasise the crucial role of knowledge in shaping competitiveness (OECD, 1998b;
World Bank, 1999).

In order to manage this situation, governments will increasingly have to adopt policies that promote:

- A highly skilled workforce and an environment that encourages and rewards individuals who
  pursue education and training.
- Innovation, absorption and use of new technology, extending beyond traditional R&D.
- Entrepreneurship.
- Innovative SMEs that can develop strategic links with larger corporations.

As indicated above, the goal should be to create a policy framework which encourages market-led,
spontaneous adjustment towards knowledge-based activities more broadly in the economy. The extent
to which this is pursued will crucially impact on the final outcome of the crisis.

**China**

The crisis affecting the five Asian countries studied has implications for other countries in the region,
such as China. China is particularly important in the sense that its ability to avert the crisis will have a
fundamental impact on the extent to which, and how quickly, Asia and the rest of the world will be
able to rebound. So far, China has been able to deflect most of the financial effects of the crisis, due in
part to its sizeable foreign reserves, large trade and current account surpluses, and also because of the
restrictions that have been maintained on capital flows. But the situation is gradually changing:
imports were beginning to rise in the first quarter of 1999, while exports were slipping rapidly, despite
the Chinese government’s efforts to boost them. Internally, efforts to restructure inefficient loss-
making, state-owned enterprises are stalling in light of slowing economic growth. At the same time, as
inventories of unsold goods rise, there is an urgent need to reduce over-capacity in a broad range of
industries.

In response, the Chinese authorities have initiated an ambitious spending programme to stimulate
economic growth. While this may help to diminish the economic problems facing the country, it is at
best a short-term solution that needs to be accompanied by further and more fundamental economic
reforms. In this regard, the restructuring of state-owned enterprises is one of the most daunting tasks.
Allowing some to go bankrupt will be essential for eliminating over-capacity, although there will be a
social cost. Moreover, creating large conglomerates grouping weak and strong enterprises has appeal,
but, as the crisis in other Asian economies has shown, there are important downsides to such an
approach.

While sharing some of the structural weaknesses typical of most Asian economies, China has a
number of advantages that could facilitate industrial restructuring and serve to address the challenges
of the knowledge-based economy. These are partly associated with the size of the Chinese economy:
China has a highly diversified workforce with huge numbers of unskilled and semiskilled workers, but
also a large pool of highly educated persons. Furthermore, it has a sizeable, diversified domestic
market which could support the development of a range of industries. Finally, there is a large, rapidly growing SME sector.

The above-mentioned factors may enable China to foster development in hi-tech industries while maintaining competitiveness in labour-intensive industries. Nevertheless, in the aftermath of the Asian crisis, it has become apparent that China is not immune to the risk of economic turmoil. Comprehensive efforts are needed to address existing structural weaknesses and to strengthen the operation of market forces in order to foster the development of knowledge-based industries and maintain competitiveness in more standardised production.

**OECD area**

For the OECD area, as mentioned above, the crisis has sharply increased competitive pressures in a number of sectors. These pressures could well rise, setting in motion even more extensive restructuring and prompting calls for protectionist measures, government subsidies, etc. The challenge for OECD governments will be to keep markets open, resist demands for protectionist responses, and, where necessary, develop more effective policies to facilitate industry adjustment, while managing the transition costs. This task takes on special dimensions in Japan, which itself continues to struggle with problems that are similar to those encountered by the newly industrialising countries in Asia hit by crisis. As is also true for China, the performance and stability of the Japanese economy will critically influence the prospects for recovery in the rest of Asia.

In addition, there is room for more productive co-operation between OECD and non-OECD economies as regards a spectrum of structural issues. In particular, there is a need for a more effective exchange of views and experience on how structural policies can improve the conditions for spontaneous change and adjustment while managing the challenges inherent to knowledge creation, innovation and the adoption and use of new technologies. This agenda includes industrial support policies, the design of educational and scientific institutions, SME policies, the preconditions for corporate governance, intellectual property rights, and so on.

While there is now little room for any government to manoeuvre in the area of macroeconomic policy, the microeconomic response to a number of pressing structural issues represents the prime area in which governments can make a difference. As the urgent financial aspects of the crisis subside, it becomes essential that the OECD and non-OECD countries turn their attention to co-operation in such areas. Since there is less of a sense of panic in the structural area, there should be more time to get co-operation right. On the other hand, there is a risk that the lack of apparent urgency may lessen the incentive to make the required effort. Still, it is clear that the long-term growth prospects for Asia as well as its success in building confidence in its revival very much hinge on its ability to signal credible change in the area of structural industry-related policies.

**The challenge for policy design and implementation**

In many instances, governments have a good sense of what needs to be done, but are confronted with considerable difficulties in actually implementing the necessary steps. This may stem from the entrenched attitudes and working methods of bureaucracies, from internal struggles and conflicting interests between separate government departments, from resistance by various societal groups or from an insufficient understanding of how policy can be formulated so as to exert an impact on the expectations and behaviour of actors in the marketplace. The result can be stalemate in reform, too partial reform, inconsistent policies or simply limited confidence in the effectiveness and durability of
policy efforts. In fact, most governments need to move away from a piecemeal approach in order to address deficiencies through an overall policy approach (OECD, 1998b). The basis for a well co-ordinated, comprehensive policy effort pursued in the interest of the economy as a whole is strengthened by transparency and improved information about the rationale for and effects of policy. This realisation is today contributing to improved routines and capabilities in policy evaluation, and to more or less systematic attempts by governments and other actors to compare – or benchmark – policy performance in different areas. It also results in new attempts to sharpen policy design and implementation, inter alia, through public-private partnership. Governments around the world are experimenting with various forms of co-operation and consultation with the private sector and other main stakeholders in society. One of the goals is to better inform governments about market needs, without favouring special interests, and at the same time to build understanding and support for the measures, painful as they may be during the transition period for entrenched groups. To make this possible, it is important to ensure representation of interests covering a broad societal spectrum, including SMEs and service and goods industries which act as customers for other industries. In the same vein, it is important to formulate and implement policies in packages which are broad enough to ensure a sufficient number of winners to make reform politically feasible.

Strengthening the design and implementation of policy is a major challenge for all countries, but particularly for those entering the knowledge-based economy, with its strong reliance on flexibility, creativity and extensive investment in tangible as well as intangible assets. Crisis situations such as that experienced in Asia, where foreign and domestic actors alike have been subjected to a major shock and have experienced a dramatic reversal of previously bright expectations, present additional issues. A scarcity of funds and the risk that the sense of emergency could dominate long-term considerations may impede needed structural reforms. On the other hand, certain painful measures may be politically feasible only in the aftermath of a crisis situation.

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The remainder of this book is organised as follows. Chapter 2 addresses the origins of the crisis as regards structural factors, with particular attention being paid to the special features of the five countries that were most severely affected compared to others in the region. The effects on industry are examined in Chapter 3, which takes stock of developments both across industries and across regions. Policy implications are presented in Chapter 4, where the first part is concerned with the five crisis economies, and the second with the OECD area. In Chapter 5, the focus shifts to China, which shares some of the basic features of the crisis-hit countries and whose ability to address fundamental structural issues will be of considerable importance to the post-crisis period. Finally, focusing on Korea, Chapter 6 highlights the challenges faced by policy makers in restructuring the corporate sector in such a way as to make industry more responsive to market forces.
Chapter 2

THE ORIGINS OF THE CRISIS

Introduction

There has been extensive debate on whether or not the financial crisis in Asia was inevitable. Some observers, including Radelet and Sachs (1998), have argued that the crisis was largely an artefact of external, global forces which made international financial markets prone to panic. It has also been observed that the first attempts to stem the tide of capital outflows in the Asian countries, including the measures “enforced” by the International Monetary Fund, failed partly because they relied on a dramatic increase in interest rates which strangled domestic demand and worsened the situation for the highly indebted private sector in Asian countries.

While financial factors and processes triggered the crisis, it is clear that a number of underlying structural factors played a role in Indonesia, Korea, Malaysia, the Philippines and Thailand (Furman and Stiglitz, 1999). This chapter addresses the role of factors and policies related to industry. A brief background on structural developments in Korea, Malaysia and Thailand is provided. Differences in developments in Hong Kong, Singapore and Chinese Taipei are noted. The key problem areas are then highlighted. Statistical information relating to the topics addressed in the chapter can be found in Annex 1, Tables 1 to 9.

Country profiles

The immediate causes of the crisis were macroeconomic in character. Between 1993 and 1996, the Malaysian current account deficit grew steadily, peaking at nearly 9% of GDP in 1995, before levelling off to around 5% in 1996. In Thailand, the deficit increased from approximately 5% in 1993 to around 8% just before the onset of the crisis. Indonesia also ran progressively larger deficits in the years before the crisis, rising to around 4% of GDP in 1996. In Korea, the sharp fall in the price of semiconductors on the world market contributed to the increase in the current account deficit to 5% of GDP in 1996.

The widening current account deficits were in part driven by developments in the capital account (Yoshitomi and Ohno, 1999), notably the swelling inflows of portfolio investment, while direct investment continued to grow at a more stable pace. The ratio of short-term debt to foreign reserves increased sharply during 1994-97 in most of the crisis countries. In three – Indonesia, Korea and Thailand – the ratio was well over 100% by mid-1997. The high ratios increased these countries’ vulnerability to short-term shifts in investment and lending behaviour. By early 1997, it had become clear that the choice of exchange rate regime throughout much of the region, which effectively pegged domestic currencies to a strengthening US dollar, was a major factor in the widening current account deficits. Depreciation became ever more likely. The devaluation of the Thai baht in July 1997
triggered what was to follow. Investors and bankers became nervous, fuelling a reversal in capital flows in the other countries of the region as well.

On closer examination, however, it becomes apparent that the crisis has been far more than a financial, or even macroeconomic, phenomenon. There is growing recognition that key structural weaknesses in industry had been allowed to develop in a number of Asian economies, and that these weaknesses were the underlying cause of the crisis. It is useful to review some of these developments on a country-by-country basis.

**Korea**

Korea has the highest level of industrialisation among the crisis-affected Asian economies. The country has experienced several decades of very strong economic development. Its annual industrial growth averaged 10.7% between 1976 and 1986, and 8.3% during the decade ending in 1997. The Korean industrialisation process started with the development of labour-intensive light industry in the 1960s; the country then began to emphasise capital-intensive heavy industry, and achieved significant progress in the metal, machinery and chemical industries from the beginning of the 1970s. In the 1980s, high-technology industries, such as motor vehicles, semiconductors and computer chips, gained momentum. During the first half of the 1990s, the share of high-technology industry in the manufacturing sector grew from 18% to 30% in terms of output and from 14% to 42% in terms of employment (OECD, 1998c).

Between 1994 and 1995, Korea enjoyed an investment-led economic boom, although confronted with an increasing problem of excess capacity. In 1996, the main Korean export items were hit by falling prices. The earnings of computer chip manufacturers, Korea’s largest exporters, fell by nearly 90% in that year, while car producers, shipbuilders, steel and petrochemical producers were also affected. There is little doubt that over-capacity in key industries was a major structural weakness of the Korean economy, and that the excessive private debt which contributed to its build-up was a factor in rendering the economy vulnerable to the crisis.

The Korean government played an active role in influencing industrial structure through industrial policy and the easy availability of bank credits to certain industries. A principal characteristic of Korean industry is the dominance of the large diversified conglomerates, the chaebol, which arose as a result of Korean industrial policies. Growth of the chaebol tended to occur at the expense of small and medium-sized enterprise development. Meanwhile, labour shortages and rising labour costs have been eroding the country’s competitiveness in labour-intensive industries such as textiles, in which Korea had built up a leading world position.

As is the case for many countries with low per capita income, limited technological competence makes Korea’s high-technology sectors dependent on more advanced countries for technology imports. Acquiring greater technological capacity is a challenge despite the fact that Korea has achieved a much higher capacity than other Asian developing economies. Its strengths in this respect are rooted in a cultural tradition that places high value on education and on the capacity to adopt and exploit existing knowledge and technology. There has also been intensive public encouragement of research and development (R&D) through government subsidies.
Malaysia

Malaysia’s economic performance has been very strong in the last several decades. Real GDP grew at 8.7% a year between 1991 and 1996, inflation averaged around 3.8% over the same period, and unemployment was low, at 2.5% in 1996. Manufacturing accounted for 34% of GDP in 1997, up from 12% in 1970. Malaysia’s industrial development has been markedly export-oriented, and the share of manufactured exports in total exports increased from 11% in 1970 to 81% in 1997. Despite this impressive performance, Malaysia is confronted with a number of serious structural weaknesses, which were recognised at the beginning of the 1990s in the Sixth Malaysia Plan (1991-95) (Box 2). The Malaysian economy has in essence been overheating since 1991, generating upward pressure on factor prices, with wage increases exceeding productivity gains. In the absence of efficiency improvements, growth was chiefly achieved through capacity expansion, a situation that could not be sustained in the long run. Developments in the 1990s aggravated, rather than addressed, this situation.

Box 2. Industrial restructuring in Malaysia

The Sixth Malaysia Plan identified actions that the country would have to take in order to remain internationally competitive. The prescriptions recognised the need for structural change: this would be engineered through macroeconomic as well as sectoral strategies. The message was the following:

Macroeconomic strategies. Efforts to accelerate the process of industrial development will continue. To remain internationally competitive, Malaysia will have to change the structure of its industry to produce more of the technologically sophisticated and better-quality products in demand in developed countries. This will require designing policies to encourage technological upgrading, diversify the industrial base and promote industrial restructuring and modernisation, especially among small and medium-scale industries. It will also require policies to raise the standards of manufacturing to higher levels of innovation and know-how in production, design and marketing. In particular, the quality of education and training will need to be improved to meet the increasing demand for skilled manpower and to raise the efficiency and productivity of the labour force.

Sectoral strategies. The primary strategy for promoting growth in the manufacturing sector is to widen and diversify the industrial base, as well as to establish greater linkages between new and traditional sectors. Emphasis will continue to be placed on accelerating the growth of export-oriented industries, while at the same time developing the intermediate and capital goods industry, and restructuring and modernising existing industries.

Source: Sixth Malaysia Plan (1991-95).

As much of industry is export-oriented, weak domestic linkages are a main source of concern. Malaysian industry is highly vulnerable to fluctuations in export markets, and domestic needs are largely unfulfilled by Malaysian production. For example, Malaysia imports some 60% of its pharmaceutical consumption. Meanwhile, export industries are highly dependent on imported inputs, ranging from machinery through intermediate components to raw materials. Value added in electronics, for instance, remains relatively low despite the fact that the electronics industry has become dominant in the industrial and export structures. The reliance of Malaysian industry on imported machinery has led the government to impose import substitution policies in this area. Malaysia also has a service-related current account deficit, which is largely due to its reliance on foreign providers of trade-related services, such as shipping. The government has tried to foster a trade-related service industry in order to reduce the service-related current account deficit.
Malaysian labour costs have increased markedly along with the emergence of labour shortages, which have led to substantial imports of labour. Currently, some 1.14 million legal foreign workers constitute 13% of the Malaysian labour force. The future strength of Malaysia’s industry will no doubt be strongly influenced by its technological competence, including the supply of human capital. Malaysia has limited educational capacity, however, and many Malaysian students go abroad to pursue their studies. About 38% of students in tertiary education studied abroad in 1988 (Lall, 1998a). At present about 54,000 students are pursuing tertiary-level courses in foreign institutions. The bottleneck facing the Malaysian educational system is the lack of qualified teachers, rather than the lack of financial resources (World Bank, 1998c) – a situation typical of countries having experienced rapid industrialisation in their most recent histories. As Malaysia moves up the ladder of the value-added chain, the capacity and quality of its higher education system becomes increasingly important.

**Thailand**

Until the onset of the crisis in July 1997, Thailand had experienced decades of impressive economic development. Growth in real per capita income averaged 5% per annum and real GDP grew at about 9% per annum from 1986 onwards, before slowing in 1996. The manufacturing sector, which employs more than 4 million workers, accounts for 29% of GDP and more than 70% of export earnings. Thailand has gradually embarked upon an export-led growth strategy, initially fostering industries that were able to exploit the low labour costs that the country enjoyed in the early stages of its economic development.

Thailand’s industrial development benefited from the relocation of labour-intensive industries by multinational firms from high-labour-cost industrialised countries. This provided Thailand not only with the capital and technologies needed for rapid industrialisation, but also with well-developed channels to large foreign markets. In addition, exports benefited from the privileges of the Generalised System of Preferences (GSP) to which Thailand was entitled as a developing country. Under these favourable conditions, export growth of Thai manufactured goods averaged 24.4% per annum between 1980 and 1990, and 22.9% during the first half of the 1990s. This development involved considerable structural shifts in Thai manufacturing, away from light industries towards heavy, more complex activities.

However, growth in Thai exports slowed in 1996. In that year, total exports grew by only 0.3%, and industrial exports dropped by about 1%. Exports of electronic products suffered from a price collapse due to global over-capacity and what was widely viewed to be a cyclical downturn. Meanwhile, exports of labour-intensive light industrial products, such as garments, plastic products and footwear, as well as frozen shrimp, declined markedly. This may have been the first sign that Thailand had lost – to a critical extent – its strength in labour-intensive industries. From 1996, Thai industry experienced reduced profitability, weakened foreign exchange earnings and increasing problems with debt servicing.

Over-investment led to over-capacity. Industrial development took place during a prolonged economic boom, where firms could make profits without improving efficiency or upgrading product quality. While easy credit fuelled expansion in industrial capacity and also in non-core business areas, firms made little effort to upgrade their technology or improve their strategic positions in other respects. Again, this resulted in, on the one hand, industrial over-capacity and, on the other hand, a decline in the competitiveness of Thai industry. Meanwhile, competition intensified in Thailand’s main export markets, especially from countries with lower labour costs.
High-technology industry has grown rapidly in Thailand during the 1990s. Technology-intensive exports increased on average by 31% per year between 1992 and 1995, accounting for 54% of total manufactured exports in 1996, up from 42% in 1992 (Lall, 1998b). The development of high-technology industry in Thailand was built on foreign capital, foreign technology and foreign product designs; final products, moreover, relied significantly on foreign markets. For example, the electronics sector absorbed nearly 40% of foreign direct investment in manufacturing in Thailand between 1995 and 1997 (UNCTAD, 1998a). On average, imported contents accounted for 80% of the value of high-technology exports.

**Other Asian economies**

The crisis did not affect all developing Asian countries similarly. Hong Kong, Singapore and Chinese Taipei, for example, have so far escaped with relatively little damage. One of the reasons for this is that they have managed structural change more effectively during the course of rapid industrialisation. The cultural, linguistic and geographic advantages enjoyed by Hong Kong, Singapore and Chinese Taipei are likely to have contributed to their successful industrial restructuring. Nevertheless, their experience in terms of policy provides useful lessons.

First, these economies not only have sound macroeconomic fundamentals, but also a relatively free entrepreneurial climate. Hong Kong is recognised as the freest market economy in the world and it also has a very flexible labour market. Singapore has a relatively transparent regulatory environment run by a stable government. Chinese Taipei, which used to be known for its interventionist industrial policies, has, since 1980, opted to increase the economy’s receptiveness to market forces (Schive, 1995). Market mechanisms have thus been given a major role in resource allocation and structural adjustment. There is limited policy-induced resource misallocation. Sound macroeconomic management based on prudent fiscal policy and conservative monetary policy have counter-acted a build-up of industrial over-capacity.

Second, governments and private sectors in these economies have attached great importance to investments in human capital and R&D. This becomes particularly important when an economy reaches a certain level of development. For example, in the 1980s when Chinese Taipei’s economy began to mature, public R&D spending increased rapidly, indirect promotion measures to boost venture capital were introduced and profits reinvested in research were exempted from tax. In addition, these economies have adopted policies to attract skilled labour from overseas, particularly highly educated people of Chinese origin from Western countries. Hong Kong and Singapore, which seek to attract mainland-Chinese students from abroad, offer probably the best compensation packages in the world for university faculty. Fluency in English and the fact that the Chinese language is spoken in these parts of Asia are factors which have contributed to success in this regard.

Third, small and medium-sized enterprises have played an important role in these economies. SMEs typically enjoy a relatively high degree of flexibility, which allows them to be quick in responding to changes in market demand and in adopting the most suitable technologies. As SMEs were able to follow market signals by adjusting their product mix and by adopting new production technologies, industrial structures shifted in parallel. Thus, the high level of flexibility in these economies is closely related to their large and very active small-firm sector.

In this respect, Chinese Taipei’s experience is particularly interesting. The *Rules for Promotion of Small and Medium-sized Enterprises*, promulgated in 1967, became law in 1991. This law ensures equal treatment for SMEs in cases where incentives are offered to an industry. It aims to provide a wide range of support measures to SMEs, including market promotion, business co-operation,
promotion of strategic alliances, upgrading of technologies and labour training. Even more important has been the insurance fund for SME credit, which reportedly has been very successful, with a low rate of loan defaults (Schive, 1995). SMEs are often regarded as having a disadvantage in access to information. However, Chinese Taipei’s experience shows that the diffusion of new technology, if it involves no heavy capital investment, and of new products, is particularly rapid in SME-concentrated industries. It is argued that this is because SMEs have an advantage in learning quickly which tends to offset the disadvantage in access to information. However, networking and a critical mass are important conditions for enhancing the learning effect and technology diffusion.

Fourth, massive overseas relocation of labour-intensive production has taken place over the last two decades, as many of Hong Kong’s labour-intensive industries moved their plants to Guangdong, in mainland China, which has become their “backyard workshop”. On the other hand, Hong Kong continues to act as the “front shop” for these enterprises, linking goods to the international market. It is estimated that Hong Kong manufacturing facilities in China today employ up to 4 million workers, more than the total size of Hong Kong’s labour force. Firms from Chinese Taipei carried out similar relocation of labour-intensive production via large investments in mainland China. It is interesting to note that the Chinese Taipei authorities sought to discourage such investments; those that did occur were therefore driven entirely by market forces. Singaporean firms have followed a similar route, investing in Malaysia, Indonesia and China.

**Structural weaknesses**

This brief review of industry-related developments in selected countries indicates that structural factors played a major role in determining the unfolding of the crisis. Indeed, they were the underlying cause. They crucially triggered the inflating of asset prices. As asset values began to decline, the fundamental weaknesses became visible, creating a vicious circle. In other countries, where such problems were much less prevalent, the more favourable structural conditions helped to limit the direct effects of the crisis.

*Why did the differences not show up before?*

It is clear that, prior to mid-1997, there was increasing evidence of the existence of significant structural weaknesses in Asia. For instance, commodity prices were on the decline (Annex 2). As we have seen, some of the governments were aware of these weaknesses and pledged to undertake countervailing measures. Still, foreign capital continued to pour in and overall investment to surge. How is it possible that so little attention was paid to the deficiencies for so long? There are several reasons for this.

The economic performance recorded in the Asian countries during their previous long period of high growth was so strong that it overshadowed the existence of weaknesses in the eyes of investors, policy makers and academics alike. During 1990-96, the rate of economic growth in Indonesia, Korea, Malaysia and Thailand averaged, or exceeded, 8% per year. Together with these countries’ mostly impeccable record of strong public finances and low inflation, this performance was so superior to that observed in other parts of the developing world that any problems were dwarfed in comparison.

Another factor is the interrelated nature of the performance displayed by the different Asian countries. Booming trade in the neighbouring economies boosted demand and raised confidence on the part of foreign and domestic investors. Indeed, as the individual countries developed and production costs increased, capital and industrial capacity was relocated, helping to spur continued growth in the next
generation of developing countries, a phenomenon which in Asia became known as the “flying wild geese”. However, just as the success of the Asian countries was interrelated, so was the danger that they would fall together. This risk of collective failure was particularly difficult to predict.

In addition, another important consideration is the fact that the preconditions for continued success in Asia, as elsewhere, have changed gradually but systematically. This factor is related to the growing hold of the so-called “knowledge-based economy”. Those industries whose shares of production, value added and trade are on the increase in the world economy, tend to be relatively intensive in their use of new technology and knowledge. Furthermore, technology and knowledge are becoming increasingly important as production factors across a widening spectrum of industrial activities, including services. In particular, the widespread adoption of information and communication technology offers enormous new opportunities for accessing and using information on a global scale (OECD, 1999b).

As Asia developed, the individual countries cherished increasing ambitions to compete in more and more technologically advanced industries, where value added was higher and higher wages could be offered to workers. However, some of the conditions and policies which had succeeded in the past became increasingly burdensome and/or redundant. Some of the main problem areas are considered below (see also Box 3 and Table 3).

**Targeting**

First, a number of Asian economies adopted ambitious development programmes targeting investment in heavy and high-tech industries (Table 2). Compared to other developing countries, which had promoted industrial development by substituting for imports, it is true that the Asian countries did encourage industrial output that could be competitive on world markets. Nevertheless, market forces were put to the side.

<table>
<thead>
<tr>
<th>Country</th>
<th>Name and period</th>
<th>Policy goals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>7th Five-year Development Plan (1994-98)</td>
<td>Export promotion via industry targeting (food, clay/glass, machinery, electronics, textiles)</td>
</tr>
<tr>
<td>Korea</td>
<td>Five-year Economic Plan (1993-97)</td>
<td>Deregulation, technology development, human resource development, promotion of foreign direct investment</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Industrialisation Master Plan (1986-95)</td>
<td>Export orientation targeting 12 industries, mainly for capital-intensive industries</td>
</tr>
<tr>
<td></td>
<td>New Industrialisation Master Plan (1996-2005)</td>
<td>Strengthening of inter-industry linkages for automobiles and electronics (industry clustering), improving information infrastructure</td>
</tr>
<tr>
<td>Philippines</td>
<td>Mid-term Development Plan (1993-98)</td>
<td>Encouraging interlinkages between agriculture and manufacturing, industry targeting via the Investment Priorities Plan</td>
</tr>
<tr>
<td>Thailand</td>
<td>7th Five-year Development Plan</td>
<td>Targets six industries (food, textiles, machinery, electronics, chemicals and steel)</td>
</tr>
</tbody>
</table>

*Source: Sakura Research Institute (1998).*
In the case of Korea, for instance, policies sought to promote heavy industry (such as automobile production, steel and chemicals) in the 1970s. These were effectively abandoned during the 1980s, when priorities shifted to the upgrading of technology and the rationalisation of declining industries (OECD, 1996a). The shift in focus is reflected in the country’s development strategy under its 1993-97 five-year economic plan which aimed to make Korea’s industrial structure similar to those of the advanced OECD countries by developing “high-tech” industries. This was to be accomplished through structural policies, including the promotion of science and technology.

While policy shifts have occurred in the other four Asian countries, the use of targeting has continued into the 1990s, albeit to different degrees. Malaysia has implemented strong support policies for some industries (notably steel, machinery and electronics), while targeting in the Philippines and Thailand has been less focused. In these two latter countries, the governments have set up Investment Boards which grant concessions to selected projects. Indonesia’s policies, while less well-defined, have tended to support the food-processing industry and non-oil-related sectors. The textile and automobile sectors have been protected through relatively high tariffs.

The emphasis on heavy industry has contributed to raising the value-added share of manufacturing in GDP in the five economies; reaching levels in excess of 25% in all except the Philippines (World Bank, 1998b). In the case of Indonesia, Malaysia and Thailand, the share has increased significantly since 1980, while it has declined somewhat in the other two countries.

Meanwhile, little attention seems to have been paid to the international situation in each of the targeted sectors, with the result that severe over-capacity has developed in a number of areas. As trade barriers came down, there was a further impetus to competition, making it increasingly difficult to sustain uncompetitive enterprises. This was especially the case in economies where real exchange rates appreciated and costs rose quickly, precipitating attempts to apply targeting as a means of competing successfully in the realm of high-value-added technology- and knowledge-based industries.

**Investment environment**

The problems in industry are closely interlinked with failure in the financial system. With easy access to credit and weak loan criteria, it was relatively simple for companies to borrow money for well- and ill-advised projects alike. This contributed to the development of sprawling, highly leveraged industrial conglomerates. Prior to the crisis, debt was two to three times higher than equity in Indonesia and Thailand for non-financial corporations, with the ratio generally rising during 1995 and 1996. In Korea, the ratio at the end of 1997 was over 500% for the 30 largest chaebol. The high debt leveraging was sustainable as long as capacity utilisation was high; when it tumbled, however, overextended firms found themselves confronting bankruptcy or, at the very least, serious financial difficulties.

The financial sectors of the Asian crisis economies, albeit to varying degrees, are relatively underdeveloped and were unprepared to cope with the challenges posed by increasing capital account liberalisation, the massive inflow of foreign capital, and growing demand for resource allocation through domestic capital markets. Banks and other financial institutions lacked the expertise and experience required for assessing risk and for effectively monitoring firms’ investment and performance. This was made worse by government intervention in resource allocation through targeting, as mentioned above, and by the lack of transparency in corporate governance regimes (see below). The cosy relations that favoured industries enjoyed with the government were often taken as (implicit) guarantees for borrowing, resulting in widespread moral hazard by both borrowers and lending institutions.
Corporate governance

Corporate governance refers to the framework of rules and regulations that shape the extent to which shareholders and other stakeholders can exercise oversight and control over a company. The conditions for corporate governance in the Asian countries have played an important role over the years, shaping success as well as failure. The dominant model in the region is based on close relationships between corporations, banks and governments, leading to a strong commitment by multiple stakeholders to the survival and growth of companies. Accounting tends to be highly non-transparent, however, and the rights of minority shareholders are weak. This situation was further aggravated by the barriers to mergers and acquisitions, both legal and due to business practices and the nature of stakeholder involvement in Asia. Before the crisis took hold in 1997, there were, in fact, relatively few mergers and acquisitions in the region.

Insufficient oversight by banks and regulatory authorities, and the lack of transparency and accountability to shareholders, gave corporations an inordinate amount of discretion in their business decisions, and they were often backed by political support. As a result, a good number of ill-advised investments worked their way into companies’ portfolios. These bad investments have intensified the restructuring that will be required, as there is little hope that such dubious projects can, or should, be made viable. The commitment made by the crisis economies to liberalising trade and investment will, in fact, put further pressure on companies to jettison weak investments.

SMEs

The focus and favouritism towards targeted industries in the crisis economies came at the expense of small and medium-sized enterprises, which generally received relatively little policy attention. Critical linkages between larger firms and SMEs failed to develop, leading to an increased reliance on imported inputs and technology, limiting innovative capacity and impeding spin-offs of new activities and the diffusion of new technologies. This contributed to undercutting the competitiveness of industry in general.

Small firms are of vital importance for several reasons. They tend to be less capital-intensive than large firms, they employ appropriate levels of technology and are flexible and quick to adjust to new demand. At the same time, SMEs are an important source of new jobs for less skilled or experienced workers. This is critical in industrialising countries which need to absorb the surplus labourers leaving the agricultural sector as part of the process of industrialisation. In addition, the existence of a dynamic SME sector is crucial for, and also itself dependent on, a culture of entrepreneurship and creativity since it thrives on individual initiative and increases the variety of options for individuals to venture into new business undertakings.

It is worth noting that SME development has important implications for corporate governance and the functioning of markets. As small firms are unable to exert the kind of lobbying pressures that large firms do, discriminatory intervention in markets is less likely. In economies with large numbers of SMEs, product markets are more likely to function competitively, as price manipulations are made more difficult, while factor markets are likely to be more adaptive to changing economic circumstances. Finally, labour-intensive activities are in line with these countries’ current comparative advantages, and are thus important to their performance in world markets.
Technology, innovation and knowledge

The Asian countries have increasingly begun to compete on the basis of knowledge and technology rather than on low costs. In particular, Korea has invested significantly in this area and has obtained a strong hold in education measured in terms of literacy or share of the population with degrees at various levels. At the same time, it is clear that the Asian countries have run into problems in their handling of the knowledge-based economy, although it should be noted that policy makers worldwide face challenges in this domain. In a recent study, the OECD concludes that most countries continue to rely too heavily on policies fostering research and technology in a limited number of high-technology industries and firms, rather than focusing on policies promoting broad-based diffusion and use of technology that can result in economy-wide productivity gains and job creation (OECD, 1998b).

According to the World Bank (1999), developing countries crucially need to implement policies enabling them to narrow the knowledge gaps that separate the poor countries from the rich. Governments, multilateral institutions, non-governmental organisations and the private sector must work together to strengthen the institutions that can serve to address the information problems causing markets and governments to fail in the area of knowledge generation and use. The creation and use of knowledge requires a long-term perspective. However, the mere recognition that knowledge is at the core of all development efforts can help to reveal solutions to a range of seemingly intractable problems.

As shown in Table 3, some of the greatest differences among the Asian countries prevail in the field of technological skills. The rapidity with which the Asian countries, pushed by industrial policy, shifted their production towards more knowledge-intensive industries, meant that the national technical expertise required to support the new enterprises was not available. Because technical support was deficient, the new facilities operated at sub-optimal levels. Moreover, labour shortages led to rising wages, especially for skilled or semi-skilled workers. Higher wages eroded industrial competitiveness in labour-intensive production. The fact that the currencies of several Asian economies were linked to the appreciating US dollar added further strains.

This situation also contributed to reliance on imported inputs and technology. In favoured sectors, large inflows of foreign investment, with accompanying technology and skills, enabled the Asian economies to rapidly build high-technology industries. Contributions of foreign capital and technology tend to bring pressures to manage the fundamental process of structural change at a very fast pace, that is, to build sufficient technological capabilities before labour costs rise too high. The task is made all the more difficult as skill development requires incentives which can motivate education and learning efforts. The time span during which a low-labour-cost advantage could be exploited was particularly short in the Asian case due to the development strategies of these countries. Aggressive promotion of technology-based industry, full employment and skill shortages all worked to push up labour costs.

At the same time, regulations in the area of mergers and acquisitions, along with the approach to corporate governance widely practised in Asia, presented barriers to FDI in the form of take-overs, increasingly the dominant entry mode into international markets and a main channel for rapid technology transfers. Furthermore, the strategic reliance on absorption of existing technologies rather than on own innovation by Asian firms, coupled with weaknesses in intellectual property right protection, represented a barrier to licensing. As the Asian industries became increasingly competitive, foreign firms were dissuaded from making technology readily available to prospective competitors in the region.

In promoting the use of foreign capital and technologies to build capital- and knowledge-intensive industries, while retaining barriers to such inflows and suffering from weaknesses in own innovation
capacities, labour shortages and rising wages, the Asian crisis economies appear to have misjudged the comparative advantages within their reach. As a consequence, they probably lost their edge in production based on low labour costs prematurely.

Box 3. Industry-related factors in the Asian crisis economies

- Over-capacity created by over-investment in certain sectors.
- Insufficient diversity of industrial structure, including excessive reliance of some industries on export markets.
- High reliance of certain export industries on imports of inputs and machinery.
- Overemphasis on large enterprises to the detriment of small firms.
- Lack of linkages between export-oriented industries and other sectors.
- Lack of industrial linkages between high-technology and supporting sectors.
- Outdated technologies and machinery in many domestic industries.
- Shortages of skills and of technological and managerial competencies.
- Weak transparency and deficiencies in corporate governance structures.

Table 3. Summary of major structural weaknesses

<table>
<thead>
<tr>
<th></th>
<th>Over-capacity¹</th>
<th>Insufficient technological capability²</th>
<th>Unfavourable conditions for SMEs</th>
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</thead>
<tbody>
<tr>
<td>China</td>
<td>++++</td>
<td>++</td>
<td>+</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>-</td>
<td>++</td>
<td>No</td>
</tr>
<tr>
<td>Indonesia</td>
<td>+++</td>
<td>+++</td>
<td>++</td>
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<tr>
<td>Korea</td>
<td>++++</td>
<td>+</td>
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<td>Malaysia</td>
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<td>Philippines</td>
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<td>Singapore</td>
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<td>+</td>
<td>++</td>
</tr>
<tr>
<td>Chinese Taipei</td>
<td>-</td>
<td>+</td>
<td>No</td>
</tr>
<tr>
<td>Thailand</td>
<td>+++</td>
<td>+++</td>
<td>+++</td>
</tr>
</tbody>
</table>

Note: Crosses indicate the degree to which each element is problematic, from relatively low (+) to relatively high (++++). "-" indicates unknown, and "No" indicates no problem.
1. The degree of over-capacity varies markedly across sectors. It provides a rough estimate of the seriousness of the problem in those sectors which are most affected within each economy.
2. This element assesses the degree of technological capability, relative to the stage of each country’s development (i.e., not relative to each other). The rating takes into account the following factors: the level of telecommunication infrastructure, the level of electronics production and consumption, literacy, an index of technological graduates from higher education, the number of patent applications, the number of scientists and engineers in R&D, and public expenditure on R&D (as a percentage of GDP). The evaluation uses the INEXSK methodology (infrastructure, experience, skills and knowledge) [see Mansell and Wehn (1998), pp. 20-44 for further information].
Conclusions

The industry-related factors which contributed to the crisis in the Asian countries are summarised in Box 3. Their impact can be summed up as three major structural weaknesses: over-capacity; insufficient technological capability; and an unfavourable environment for small and medium-sized enterprises. Table 3 provides an estimation of the extent to which these impacts were present in a number of the economies in the region, including those most affected by the crisis.

This situation led to a dichotomous structure; large industries co-exist with small firms which are labour-intensive and sometimes low-technology, and there are insufficient linkages between the two. The build-up of excess capacity was facilitated by lack of transparency in domestic financial markets and large inflows of foreign capital. Potential problems were disregarded because of the countries’ outstanding past performance, and because of the fact that the countries in the region could drag each other down just as they had helped each other to perform in the first class of the development league for so long.
Chapter 3

THE EFFECTS OF THE CRISIS ON INDUSTRY

Crisis economies

The crisis exacted a heavy toll on industry in the five Asian economies most directly affected. Industrial production fell significantly in most of the East Asian region and generally remained relatively low throughout 1998 and early 1999; trade balances shifted as the dollar value of exports declined, while shrinking domestic demand led to an even greater decline in imports. While portfolio investment fled the region, however, inward foreign direct investment displayed only a modest dip, and rose sharply in 1998 in Korea and Thailand. Following the crisis, acquisitions have also for the first time become an important mode of entry into Asia.

In the countries directly concerned by the crisis, companies have had and/or continue to struggle with:

- Sharply lower domestic and regional demand for goods and services.
- Higher costs for imported inputs.
- Sharply higher payments (in domestic currency) on foreign-denominated loans.
- Higher domestic interest rates.
- Limited credit availability (particularly for SMEs).
- Fragile equity markets.

The macroeconomic climate, however, improved markedly in all the crisis economies in late 1998 and early 1999, with positive implications for industry. Equity capital has flowed back and exchange rates have appreciated. Except for Indonesia, by December 1998 exchange rates had reached some two-thirds to three-quarters of their pre-crisis values vis-à-vis the US dollar (Annex 1, Table 10). Stock markets, while substantially below their pre-crisis levels, nonetheless strengthened considerably by early 1999 (Annex 1, Table 11). Interest rates, although relatively high in Indonesia, fell during 1998 (Annex 1, Table 12). By the end of the year, indicative three-month rates were lower in Korea, Malaysia and Thailand than they were during the pre-crisis period. Lower rates will enable businesses to finance operations (including imports and exports) more easily, provided that the banks extend credit. The availability of credit has in fact been problematic, as banks have generally adopted more cautious policies on loans, a development that has made it particularly difficult for SMEs to obtain finance. A number of governments have attempted to ease this problem through the introduction of policies designed specifically to assist SMEs.
With a significant share of *industrial production* destined for consumption in the East Asian region, the economic slowdown markedly reduced overall demand for goods produced in the crisis economies. This contraction has been aggravated by the economic recession in Japan and by problems associated with financing of production and trade. While exports to other areas – particularly the United States – have helped to ease the situation, industrial production fell in almost all of the five countries during 1998 (Table 4). The decline was in marked contrast to the vigorous growth achieved in manufacturing throughout most of the 1990s (Figure 3). In all countries except Indonesia, manufacturing grew faster than GDP during 1996, but then fell back in 1998.

### Table 4. Manufacturing indices in selected Asian countries, by period, 1997 and 1998

1997= 100

<table>
<thead>
<tr>
<th>Period</th>
<th>Indonesia</th>
<th>Korea</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Thailand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan-Mar</td>
<td>94.1</td>
<td>95.3</td>
<td>92.1</td>
<td>95.9</td>
<td>111.0</td>
</tr>
<tr>
<td>Apr-Jun</td>
<td>97.7</td>
<td>102.2</td>
<td>99.3</td>
<td>97.1</td>
<td>103.0</td>
</tr>
<tr>
<td>Jul-Sep</td>
<td>106.0</td>
<td>98.4</td>
<td>104.3</td>
<td>103.4</td>
<td>95.5</td>
</tr>
<tr>
<td>Oct-Dec</td>
<td>102.2</td>
<td>104.2</td>
<td>104.2</td>
<td>103.7</td>
<td>90.5</td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan</td>
<td>84.2</td>
<td>95.6</td>
<td>89.1</td>
<td>91.0</td>
<td></td>
</tr>
<tr>
<td>Feb</td>
<td>88.7</td>
<td>86.9</td>
<td>84.5</td>
<td>92.3</td>
<td>93.0</td>
</tr>
<tr>
<td>Mar</td>
<td>91.8</td>
<td>91.0</td>
<td>94.6</td>
<td>92.9</td>
<td></td>
</tr>
<tr>
<td>Apr</td>
<td>92.3</td>
<td>94.3</td>
<td>82.9</td>
<td>86.3</td>
<td></td>
</tr>
<tr>
<td>May</td>
<td>79.4</td>
<td>90.0</td>
<td>90.5</td>
<td>85.8</td>
<td>87.2</td>
</tr>
<tr>
<td>Jun</td>
<td>87.4</td>
<td>86.5</td>
<td>92.6</td>
<td>88.3</td>
<td></td>
</tr>
<tr>
<td>Jul</td>
<td>86.0</td>
<td>93.0</td>
<td>89.7</td>
<td>86.4</td>
<td></td>
</tr>
<tr>
<td>Aug</td>
<td>83.2</td>
<td>85.1</td>
<td>87.3</td>
<td>86.6</td>
<td>83.9</td>
</tr>
<tr>
<td>Sep</td>
<td>99.7</td>
<td>87.1</td>
<td>88.7</td>
<td>86.4</td>
<td></td>
</tr>
<tr>
<td>Oct</td>
<td>98.5</td>
<td>92.5</td>
<td>87.6</td>
<td>87.9</td>
<td></td>
</tr>
<tr>
<td>Nov</td>
<td>83.9</td>
<td>104.6</td>
<td>89.8</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Dec</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

n.a. = not available.

1. Large and medium-sized firms.
2. Preliminary estimate.
3. Projection.

*Source: Official national statistics.*
Merchandise trade patterns in the crisis economies during 1998 were characterised by falling dollar values of exports and imports. Overall, export volume growth was strong (Annex 1, Table 13), but the increases were largely offset by falling prices (in dollar terms). Imports declined sharply [by 5% in 1997 and 33% in 1998 (January-October)], while exports rose by 5% in 1997 before declining by 4% in 1998. Altogether, between 1996 and 1998 there was a shift of an estimated US$130 to US$135 billion in merchandise trade, transforming an aggregate 1996 trade deficit in the five crisis economies of US$51.1 billion into an estimated US$80 to US$85 billion surplus in 1998 (Annex 1, Table 14). The exchange rate shifts, to the extent that they have not been offset by inflation or corresponding cost increases, along with the sluggishness of domestic markets, provide both a pull and a push towards increased exports. The shifts in imports and exports in 1998 were similar in each of the countries except the Philippines (Table 5), where exports increased by 18% while imports declined to a lesser extent.

Table 5. Change in the dollar value of merchandise exports and imports
From January-October 1997 to January-October 1998, percentages

<table>
<thead>
<tr>
<th>Country</th>
<th>Change in exports</th>
<th>Change in imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>-7</td>
<td>-36</td>
</tr>
<tr>
<td>Korea</td>
<td>-2</td>
<td>-37</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-9</td>
<td>-27</td>
</tr>
<tr>
<td>Philippines</td>
<td>18</td>
<td>-16</td>
</tr>
<tr>
<td>Thailand</td>
<td>-7</td>
<td>-36</td>
</tr>
</tbody>
</table>

Source: IMF (1998b) and official national statistics.
In terms of the structure of trade, somewhat higher shares of exports were generally shipped to the United States and Europe, while smaller shares were generally being imported from these areas. The product composition of exports and imports appears to have changed significantly only in the case of Korea and the Philippines. In the Philippines, the share of electronic products exported and imported rose by 7 percentage points from 1997 to January-September 1998, to 66% and 44%, respectively. In Korea, semiconductor exports fell from 16% to 12% of exports; on the import side, imports of electronic and electrical machinery rose from 17% to 20%, while imports of other machinery and equipment fell from 14% to 10%.

*Foreign direct investment* (FDI) has become an important source of private development financing, and is also an important source of technology, management competence and intensified competition in product and factor markets. The predominant mode of entry worldwide, i.e. acquisition of existing firms rather than the establishment of new ventures, has remained less common in the Asian region, however, due to particularly complex stakeholder issues in firm control. Depressed equity prices and the need for new capital and technology are creating new opportunities for foreign ownership, which should reinforce the upward trend of the 1990s, when the level of FDI grew annually from US$7.2 billion (in 1990) to US$17.0 billion in 1996 (Table 6). In 1997, FDI declined to US$16.3 billion, as modest reductions in Indonesia, Malaysia and the Philippines offset an increase of close to 60% in Thailand (where the financial crisis began). Taking into account the currency depreciation, the volume of FDI may actually have increased significantly in terms of “real” assets. For 1998, FDI (in US dollar terms) increased in at least two of the five countries, rising from US$3.6 to US$7.6 billion in Thailand, and to US$4.7 billion in Korea (January-November 1998), compared to US$2.3 billion for all of 1997.

The benefits of foreign direct investment have been particularly evident in the current crisis, as multinational corporations appear to have continued to support their foreign ventures, maintaining, or even increasing, intended investment in most of the affected Asian economies. Assessments of merger and acquisition activity in Asia indicate that it fell short of expectations in 1998, and may have declined by as much as 20% from the 1997 level. While multinational corporations are very interested in some countries, the pace of entry has been slowed by significant gaps between asking prices and offers, and problems with debt restructuring and debt cross-guarantees.

### Table 6. Foreign direct investment in Indonesia, Korea, Malaysia, the Philippines and Thailand, 1995-97

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Level</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4 348</td>
<td>6 194</td>
<td>5 350</td>
</tr>
<tr>
<td>Korea</td>
<td>1 776</td>
<td>2 325</td>
<td>2 341</td>
</tr>
<tr>
<td>Malaysia</td>
<td>4 132</td>
<td>4 672</td>
<td>3 754</td>
</tr>
<tr>
<td>Philippines</td>
<td>1 459</td>
<td>1 520</td>
<td>1 253</td>
</tr>
<tr>
<td>Thailand</td>
<td>2 002</td>
<td>2 268</td>
<td>3 600</td>
</tr>
<tr>
<td>Total</td>
<td>13 717</td>
<td>16 979</td>
<td>16 298</td>
</tr>
</tbody>
</table>

1. Weighted average.

**OECD countries**

The financial turbulence in emerging markets intensified during the summer of 1998 and has, to varying degrees, affected most OECD countries (see Annex 4 for assessments of the effects on Australia, Canada, the Czech Republic and Turkey). Uncertainty in financial markets in OECD countries resulted in volatile equity prices and, especially in the United States, sharply increased spreads in credit markets. Major stock market indices in Europe, Japan and the United States all experienced sharp declines starting in July-August 1998 that bottomed out in October, with substantial recoveries recorded since that time in all but Japan. The uncertainty caused risk premiums in private capital markets to increase, making it more difficult for industries and firms to raise new money. In general, conditions in financial markets were tighter at year’s end than they were during the first half of 1998.

Growth in *industrial production* was positive through the first three quarters of 1998 in all OECD areas except Japan and Korea. As regards GDP, there has been a slowdown from 3.3% growth in 1997 in the OECD area to an estimated 2.3% in 1998 (Table 7). Expectations are that growth will ease further in 1999 but, as indicated earlier, there is a downside risk which could slow growth significantly. For instance, demand has so far been helped by the continuous strength of the stock exchange, especially in the United States, and there are now concerns about asset inflation and the consequences of the “bubble bursting”.

During 1998, the crisis slowed, or reversed, demand for certain goods and services, while intensifying competitive pressures from lower-cost competitors in the crisis economies. The result was intensifying pressure on some OECD firms and industries to improve competitiveness, by:

- Cutting costs.
- Closing non-competitive facilities.
- Increasing efficiency.
- Realigning their businesses (*e.g.* through divestitures, mergers and acquisitions).

<table>
<thead>
<tr>
<th>Area</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Union</td>
<td>2.7</td>
<td>2.8</td>
<td>1.9</td>
<td>2.4</td>
</tr>
<tr>
<td>Japan</td>
<td>1.4</td>
<td>-2.8</td>
<td>-0.9</td>
<td>0.0</td>
</tr>
<tr>
<td>United States</td>
<td>3.9</td>
<td>3.9</td>
<td>3.6</td>
<td>2.0</td>
</tr>
<tr>
<td><strong>Total OECD</strong></td>
<td><strong>3.3</strong></td>
<td><strong>2.3</strong></td>
<td><strong>2.2</strong></td>
<td><strong>2.1</strong></td>
</tr>
</tbody>
</table>

1. Projection.  
*Source: OECD (1999a).*
The direct trade impact of the crisis on OECD industry has been apparent since the early part of 1998, both in terms of shifts in trade flows, and in the financial reports of enterprises whose businesses have substantial exposure to Asian markets (Annex 1, Tables 10-12). Export volumes from the OECD area to non-OECD countries declined considerably, a major factor contributing to the sharp slowdown in world trade growth that occurred during early 1998 (Table 8). Future exports to Latin American markets, where imports of manufactured items could contract by 9% in 1999, or more, depending on the severity and scope of the recent deterioration of conditions in Brazil, are likely to be particularly sluggish. Import growth in the OECD area has also slowed, albeit to a far lesser extent than for non-OECD countries. For 1999 and 2000, a gradual increase in exports from Asia and other non-OECD areas is expected, resulting in intensifying competition in OECD markets.

### Table 8. Trade growth in manufactured goods

<table>
<thead>
<tr>
<th>Area</th>
<th>1997</th>
<th>1998¹</th>
<th>1999¹</th>
<th>2000¹</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exports:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>European Union</td>
<td>10.3</td>
<td>6.1</td>
<td>4.7</td>
<td>5.4</td>
</tr>
<tr>
<td>Japan</td>
<td>11.6</td>
<td>-0.4</td>
<td>3.3</td>
<td>4.5</td>
</tr>
<tr>
<td>United States</td>
<td>19.6</td>
<td>1.1</td>
<td>2.8</td>
<td>7.2</td>
</tr>
<tr>
<td>Total OECD</td>
<td>12.8</td>
<td>5.3</td>
<td>4.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Dynamic Asia²</td>
<td>8.2</td>
<td>6.0</td>
<td>10.5</td>
<td>6.5</td>
</tr>
<tr>
<td><strong>Imports:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>European Union</td>
<td>9.1</td>
<td>8.1</td>
<td>5.5</td>
<td>5.9</td>
</tr>
<tr>
<td>Japan</td>
<td>3.1</td>
<td>-6.0</td>
<td>2.7</td>
<td>6.1</td>
</tr>
<tr>
<td>United States</td>
<td>17.9</td>
<td>12.7</td>
<td>7.7</td>
<td>5.9</td>
</tr>
<tr>
<td>Total OECD</td>
<td>11.7</td>
<td>7.7</td>
<td>6.4</td>
<td>6.6</td>
</tr>
<tr>
<td>Dynamic Asia²</td>
<td>6.6</td>
<td>-8.3</td>
<td>8.5</td>
<td>7.4</td>
</tr>
</tbody>
</table>

1. Projection.
2. Dynamic Asian economies: Hong Kong, Indonesia, Singapore, Malaysia, the Philippines, Chinese Taipei and Thailand.

The financial crisis affected existing OECD investments in non-OECD areas as well as new investment flows. The effects of the crisis on OECD-based companies operating in the affected economies depended on the nature of the investment. Companies that invested primarily to produce products for local or regional markets often experienced sharp downturns in sales, which, in some instances, may have jeopardised the viability of their operations. In response, producers had to explore the extent to which alternative markets could be exploited, as was the case for Japanese auto firms in Thailand (Box 4).
Box 4. The case of Toyota and Honda in Thailand

The Japanese auto-manufacturer Toyota established operations in Thailand, principally to serve the domestic market. In November 1997, it ceased production for a short period of time in response to declining demand, then resumed operations at a reduced rate, announcing its intention to increase exports. After making a number of modifications to the production process to accommodate export needs, near-normal operation was resumed in January 1998, with expanded shipments to Indonesia, Laos, Malaysia, New Zealand, Pakistan and Portugal. In addition, the company began exporting diesel engines to Japan.

When domestic demand weakened further and proved insufficient to support operations, a temporary halt was made to production of a newly introduced model. Further restructuring and retrenchment occurred, and actions were taken to improve operating conditions. To assist suppliers, the company accepted price increases and provided pre-shipment payments to companies. At the same time, the parent corporation injected an additional 4 billion baht into its Thai subsidiary, which allowed the local company to provide financing support for customers and dealers.

Honda adopted a similar approach in Thailand, as the parent firm injected capital into its subsidiary, increased efforts to export, and accelerated the shifting of certain parts operations from Japanese to Thai facilities.


Firms established principally for the purpose of production and exports, on the other hand, may have been favourably affected by the cost savings achieved through devaluation. The situation may, in fact, have created incentives for expanding or consolidating operations in the region, as in the case of Seagate Technology (Box 5). Whatever their orientation, companies adopted a number of common strategies to strengthen their operations in response to the crisis. A survey of foreign affiliates contacted by the Thai Board of Investment in early 1998 found that most companies were exploring ways to reduce production costs (such as transportation, packaging and inventory). Nearly half had increased their use of local raw materials, and some had laid off employees. Lay-offs appear to have been greatest in mining, metals and ceramics (47% of companies), and lowest in electronics (5%).

Box 5. The case of Seagate Technology

Seagate Technology is the world’s leading independent manufacturer of storage drives for computers as well as tape drives, digital audio tape (DAT) drives and software used in network and client/server applications. Based in the United States, the company has located the majority of its production facilities in Asia. It has been the principal driving force in exports of electronic products from Malaysia and Thailand. The financial crisis affected the production and sales of the company, which experienced currency losses as a result of the devaluations of the Asian currencies. At the same time, these devaluations resulted in a significant reduction in production costs. When the company embarked on a major restructuring of operations in late 1997, it elected to close a plant in Ireland which had been opened in 1995, as production costs were reportedly almost three times higher than those in Asian plants. The company elected to use the surplus capacity in Asia to service European needs.


In addition, the devaluations and corresponding weakness in “crisis” economies, combined with greater openness and reforms to attract direct investment from abroad, provided new incentives for OECD companies to purchase existing facilities, or establish new enterprises, at advantageous prices.
Firms which had already invested in the five countries appeared set to take advantage of the new opportunities. A survey of 500 multinational corporations conducted in February-March 1998 by the International Chamber of Commerce (ICC) and the United Nations’ Conference on Trade and Development (UNCTAD) found that most firms in Europe, Japan and North America planned to maintain their investment levels (55%, 68% and 70%, respectively) in the short to medium term, but a significant share (34%, 19% and 19%, respectively) planned to increase their activities in the region in light of the crisis (UNCTAD and ICC, 1998). Only 10% or so planned to cut back on their plans.

The greatest tendency to increase investment was expressed by firms involved in manufacturing (some 34%). The favourable costs and positive structural reforms that were making investment more attractive in the crisis economies could well have played an important role in the positive assessment. A related survey was carried out by UNCTAD in Malaysia in April and May 1998 with the foreign affiliates of multinational electronics firms. None of the firms surveyed intended to close down or relocate operations (UNCTAD, 1998b). Some had adopted a “wait and see” attitude, while half had seen opportunities to expand operations in light of the crisis. Almost all the respondents viewed cost reduction as a priority. While the confidence of MNCs remains strong, the crisis has undoubtedly served to highlight some of the downside risks associated with investment in the affected countries; restoring confidence may require further institutional reforms at national and international levels.

Sectoral effects

Due to the financial crisis, competitive pressures have intensified in a number of industrial sectors, namely steel, shipbuilding, aerospace, electronics and textiles. So far, direct effects on the automobile sector appear limited to Asia, but the situation could worsen if world markets weaken (thereby affecting potential exports from the Asian region). The financial crisis has also tended to aggravate already-weak conditions in commodity markets, particularly in oil and metals. The fact that relatively few sectors have thus far been affected in the OECD area (apart from Japan and Korea) can be attributed in large part to the strength of the US and European economies, which have been able to accommodate sizeable shifts in trade flows. Signs of slowing growth are therefore cause for concern.

Manufacturing

Steel. Maturing domestic demand and increasing competition from the NIS and emerging non-member economies have presented an ongoing competitive challenge to OECD steel producers in recent years. Despite successful efforts to modernise capacity and close obsolete or unneeded facilities, pressures to adjust have remained great. The financial crisis, by cutting demand in the fastest growing steel markets in the world, intensified these pressures and led to marked shifts in steel trade flows and declining prices. In order to maintain production, many producers expanded marketing efforts in alternative markets, often selling steel at relatively low prices. The resulting significant trade flow movements have been accompanied by rising trade tensions. In response, producers increasingly sought protection through trade actions, usually in the form of antidumping or related sanctions. Protectionist measures became widespread.

The effects on trade have been most noticeable in Europe and North America. Relatively strong steel markets in these areas attracted rising steel imports. As a result, the European Union, which had been one of the largest net exporters of steel, exported very little more than it imported in 1998. US steel imports rose to record levels in 1998, rising 30% in the first ten months of 1998 compared to the same period in 1997. With increasing competitive pressures, spot prices for imports and exports appear to
have fallen during 1998-99 – by over 30% in the case of hot-rolled steel sheets, a major item in international commerce.

The effects on companies and countries have been variable. In the United States, two relatively small steel companies filed for bankruptcy, while credit-rating agencies reduced ratings on two others, indicating a possibility of bankruptcy. Profits at other mills declined. In Europe, demand remained strong, but sharp price declines occurred. In both areas, pressures to adjust will intensify should demand ease. In Japan, the country’s six large steelmakers were expecting group losses for the fiscal year ending 31 March 1999, as production had fallen by more than 10 million tonnes to 93.6 million tonnes in 1998. Each of the Japanese companies had outlined cost-cutting and restructuring steps in response to the market weakness, as the business environment was reportedly the worst in decades. It seems clear that, absent a significant turnaround, further restructuring in the OECD area will be required. The challenge for policy makers will be to facilitate this without sustaining operations that would not be viable in the long term. However, not all OECD producers are being affected similarly. Korea’s POSCO steel, one of the world’s largest producers, earned record profits in 1998, due in part to the favourable effects of the country’s currency devaluation on export earnings, as well as the effects of a restructuring of the company’s operations.

**Automobiles.** The crisis has not significantly affected automobile markets in Europe or North America, as demand and financial performance have been strong, but effects in the Asian crisis economies and Japan have been marked. In the Asian crisis economies, reduced purchasing power, high interest rates and economic uncertainty have forced consumers to cancel or postpone purchases. In Thailand, major declines in production in 1997 were followed by even larger reductions during January-September 1998. Passenger car production was down by some 79%, for example, following a 19% decline in 1997. Similarly, production of transport equipment in Malaysia was down by 52% during January-August 1998, following a 14% increase in 1997. In Indonesia, domestic car sales fell in November for the third consecutive month, to 2 470 units – one-tenth the level attained a year earlier. In Korea, auto sales for Hyundai, Kia and Daewoo were 23% less in 1998 than in 1997, as the domestic market declined by some 50%.

In Asia, the decline in automotive demand in the crisis economies complicated the situation for Japanese producers who were already facing sharply lower demand in their home market. Honda and Mazda, however, were able to report improved financial performance during the first half of fiscal year 1998. While Mitsubishi and Nissan incurred sizeable losses, profits at Toyota eased. OECD producers may now face heightened competition in international markets, as Asian producers expand exports. In Thailand, foreign automakers have already been increasing exports in light of sluggish domestic demand and are expected to continue to do so in 1999, with exports forecast to rise from 60 000-70 000 vehicles to over 100 000. In Korea, exports of automobiles could increase by 11% in 1999.

While markets outside Asia do not appear to have been directly affected by the Asian crisis in any significant way, automobile producers worldwide are nonetheless sensing new pressures to restructure, with a view to coping with raising R&D costs, increasingly demanding customers and a possible contraction in demand. There has been a wave of major mergers, and establishment of new alliances, involving firms in the United States, Europe and Asia, between companies such as Renault, Nissan Motors, Fiat, General Motors, Ford and Volvo, to name but a few.

**Shipbuilding.** The sharp depreciation in the value of the Korean won had a significant effect on competitive conditions in shipbuilding, a sector in which Korea is a major player. Korean conglomerates with shipbuilding interests successfully intensified efforts to fill order books, making sales at highly competitive prices. Shipbuilders in other countries tended to match the lower prices,
precipitating a general decline in prices that cut deeply into the profits of shipbuilders in other areas. At the same time, the price downturn caused many buyers to advance their purchases to take advantage of the lower prices. This has increased the probability of a sharp cyclical downturn in newbuilding demand within the next several years, posing additional challenges for an industry which has long been one of the most highly subsidised in the OECD area.

**Aerospace.** In the aerospace industry, the US firm Boeing cited the contraction of the Asian market as a principal factor leading the firm to reduce production rates for some of its commercial aeroplane programmes. As a result, the company’s workforce is expected to be trimmed by about 20% (38 000 jobs) by the year 2000. Moreover, Airbus, Boeing’s principal competitor, has delayed the introduction of one of its new models for one year due to the crisis. Current sales have not, however, been significantly affected as cancelled orders were reportedly filled by other clients.

**Electronics.** In Japan, sharp declines in semiconductor prices and weak demand in emerging markets have resulted in lower earnings at leading electronics firms during the first half of fiscal year 1998 (April-September). Two firms – Hitachi and Toshiba – incurred losses for the first time since 1950. Prospects for semiconductors are, however, promising as demand is expected to strengthen in 1999.

**Textiles.** In January 1999, US-based firm Burlington Industries – one of the world’s largest and most diversified manufacturers of textile products for apparel and interior furnishings – announced that it would be streamlining its operations and reducing its capacity by 25% in response to a continuing surge of low-priced garment imports, primarily from Asia. The company had been running its lines at less than full capacity during 1998, anticipating that the surge of imports would be only temporary. It has since concluded, however, that the situation will be more enduring.

**Commodities**

Internationally, slower economic growth was accompanied by substantial price declines for commodities. Many commodity prices were already in cyclical decline when the Asian crisis occurred. This, combined with increased supplies, resulted in sharply lower prices which began to recover during the first months of 1999.

**Oil.** The depressive effects of the Asian financial crisis on economic activity was a primary cause for the nearly 40% collapse in oil prices between early October 1997 and the end of 1998. Internally, mild winter weather and increasing Iraqi production added to the downward pressure. Externally, the malaise in commodity markets in general reinforced, and was reinforced by, weak oil prices, especially through paper (futures, options, swaps, etc.) markets. Oil prices are now at a 12-year low in nominal terms, and at levels not seen since the early 1970s in real (inflation-adjusted) terms.

Lower oil and commodity prices have contributed favourably to the terms of trade in most OECD countries. However, they are negatively affecting countries (including some OECD Members) where oil or primary products are important sources of export revenue, and in some cases (notably Russia) contributed to the spread of the financial crisis. The largest effects have occurred in oil-producing states, which have limited crude oil production in an attempt to support oil prices and most have had to make substantial budgetary adjustments to reflect the combination of lower production and significantly lower prices.

Producers in OECD countries are in the process of rationalising their operations in response to the sluggish market. In addition to cutting costs, there have been a series of mega-mergers between large oil companies, and an even larger number of mergers and restructurings of small and medium-sized
firms. These developments are affecting the structure of the industry by, for example, enhancing the market power of the remaining industry participants. The changes may make it easier for these companies to re-enter the upstream production sectors in some major producing countries that have been closed to them for the past two decades.

**Metals.** Demand for construction materials, such as metals, was particularly hard hit by the Asian crisis in the five affected economies, due to slowed, postponed or cancelled investment in new facilities and public projects. In Thailand, for example, production of key construction materials fell by 20% to 41% during January-September 1998 (compared to the same period in 1997). A similar trend can be observed in Malaysia, where basic metal production fell by 30% during January-August. The Korean market is likely to have been similarly affected, as construction activity during the first half of 1998 was 41% lower than the level attained during the same period in 1997; even greater declines were evident in September and October (50% and 52%, respectively). While far stronger in the OECD area, the situation, as indicated above, intensified downward pressures on prices of key metals (Table 9).

<table>
<thead>
<tr>
<th>Product</th>
<th>Price in June 1997</th>
<th>Price in December 1998</th>
<th>Percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nickel</td>
<td>7 062</td>
<td>3 878</td>
<td>-45.1</td>
</tr>
<tr>
<td>Copper</td>
<td>2 612</td>
<td>1 473</td>
<td>-43.6</td>
</tr>
<tr>
<td>Zinc</td>
<td>1 354</td>
<td>959</td>
<td>-29.2</td>
</tr>
<tr>
<td>Aluminium alloy</td>
<td>1 447</td>
<td>1 045</td>
<td>-27.8</td>
</tr>
<tr>
<td>Aluminium</td>
<td>1 568</td>
<td>1 249</td>
<td>-20.3</td>
</tr>
<tr>
<td>Lead</td>
<td>614</td>
<td>501</td>
<td>-18.4</td>
</tr>
<tr>
<td>Tin</td>
<td>5 563</td>
<td>5 255</td>
<td>-5.5</td>
</tr>
</tbody>
</table>

1. Mean cash prices, as established on the London Metal Exchange.
Chapter 4

THE POLICY CHALLENGE

The challenge for the crisis economies

The Asian countries most affected by the crisis are well beyond the stage where they had to concentrate only on how to manage the next few days ahead. They must now succeed in building a long-term basis for recovery and growth. Broad-based support among major stakeholders, comprehensive reform and restored confidence on the part of investors at home and abroad are all crucial for lasting change.

In short, the crisis countries now face four types of structural issues:

- **Addressing weaknesses that existed prior to the crisis.** This is part of the ongoing process of economic development and industrialisation. However, rectifying the structural weaknesses created in the course of economic development and industrialisation has now become more urgent.

- **Responding to the conditions that evolved directly from the crisis.** These include currency devaluations; changing terms of trade; recuperating losses from the simultaneous collapse of domestic demand and access to credit (including the decline in industrial capacity, bankruptcies, unemployment and social unrest); new policies introduced in response to the crisis; and subsequent changes in macro- and microeconomic conditions.

- **Handling the interrelated effects of structural adjustment in the Asian economies.** Even those economies whose industries have been relatively less affected by the crisis, such as Hong Kong and Singapore and Chinese Taipei, will be subject to pressures to adjust to the structural changes taking place in other countries in the region.

- **Implementing longer-term reform for sustained growth.** The restructuring needed in the longer term includes the upgrading of human capital and technological capacity, the building of a more robust financial system and reforms in corporate governance systems to make corporate behaviour and industrial restructuring more responsive to market forces.

Some of the structural challenges will take many years to address. In other areas, such as bankruptcy laws, immediate results are possible. However, the key to addressing the prevalent weaknesses is the comprehensiveness of reform. Only through comprehensive and credible reform can governments in East Asia build the necessary trust to make investors and others judge that their economies and societies have been restructured in such a way as to permanently overcome the deficiencies that allowed economic progress to turn into chaos.
Challenges faced by individual countries

In the following, we first discuss the current policy agenda in each of the five crisis countries, before considering key areas for structural reform.

Indonesia

The recovery of the Indonesian economy has been delayed compared to that of the other crisis economies. GDP dropped by 13.7% in 1998 and by 10.4% in the first quarter of 1999 – by far the weakest performance of all Asian crisis countries in both periods. The extreme difficulties experienced by Indonesia over the past year can be attributed to a combination of several unfavourable factors, including an insufficient number of internationally competitive industrial enterprises, the high level of structural debt, the inadequate guarantee for overseas investors provided by the government, and, last but not least, the instability of the country’s domestic political and social situation.

Domestic consumption does not yet show any signs of picking up, partly due to the severe weakening of purchasing power for most Indonesians (which, as of June 1999, was far below the 1997 level), and also to the continued uncertainty regarding reform and economic prospects. Retail sales remain restrained by a severe lack of financing, and by high interest rates, which, although far lower than their 1998 peak, were still at a relatively high level of 35%-36% during the first quarter of 1999.

Furthermore, the industrial sector has been severely affected by the crisis. In the automobile industry, for example, the Association of Indonesian Automotive Industries estimated that half of the local suppliers to the industry will not survive the crisis; moreover, only 40% of dealerships remain. The industry’s products have become far more expensive due to the cost effect of the currency devaluation on imported parts, which accounted for about 60% of costs before the onset of the crisis.

Industry-related measures have so far been granted limited priority (see Box 11 in Chapter 6 for a description of some of the measures that have been implemented). One action that has been taken involves the planned privatisation of seven state-owned enterprises and five government-controlled private enterprises, including those in steel, telecommunications, mining, agriculture and infrastructure (airports and seaports). In addition, in an attempt to boost investment (which fell by 38% in 1998), in January 1999 the government announced plans to offer tax exemptions of up to eight years for new foreign investment in 22 industries. Industries qualifying for such treatment include textiles, leather, oil refining, rubber processing, electronic components, pharmaceuticals, steel, information technology, oil and mining equipment, and vehicles. In support of the investment stimulus, the government is lifting restrictions on foreign investment in both retail and wholesale trade, while shortening the approval process for new projects.

In July 1998, the government made an attempt to introduce a trade-financing facility to help traders facing difficulties in obtaining letters of credit for imports. However, the US$6 billion fund that was pledged for trade finance by various foreign governments and lending agencies was not made available, as countries committed to contributing the money have not yet disbursed it for fear of abuse by the fund users. Many importers have survived by entering into buyer credit arrangements in which buyers provided credits for imports of raw materials. Well into 1999, capital flight continued and there was virtually no capital coming into the country, apart from a monthly US$1 billion in loans from the International Monetary Fund.
**Korea**

Korea has made great strides toward recovery since the onset of financial crisis in 1997 (KIEP, 1998). Following the acute measures taken in the early phases, a strategy was adopted which aimed at restructuring almost every sector of the economy, with priority placed on swift and prudent reform of the financial and corporate sectors. Measures were taken to ease the credit crunch and cope with rising unemployment. For smaller firms severely affected by lack of credit, the government is to expand credit guarantee facilities through injections of 1.3 trillion won from the World Bank and 1.2 trillion won from the 1999 national budget.

The Korean Government will promote exports by encouraging corporate restructuring aimed at strengthening Korea’s export competitiveness, with priority given to high-value-added and capital-goods industries. Export financing will be expanded in accordance with international norms and standards, and the development of niche markets will be encouraged through the implementation of a cross-export guarantee system with major trading partners. Efforts are being made to attract US$15 billion in foreign investment in 1999. To this end, some ten large investment projects will be given priority attention and a one-stop service for foreign investors will be provided.

Regarding long-term structural adjustments, as indicated earlier the Korean Government plans to direct its development strategy to the knowledge-based economy. In this area, economic policy for 1999 focuses on fostering an environment nurturing knowledge-intensive industries. A comprehensive plan for the development of a knowledge-based economy will be drawn up, emphasising institution building for knowledge-intensive industries, such as standardisation, intellectual property right protection, information technology infrastructure, and investment in research and development. A task force composed of public and private sector representatives will study issues related to the transition to the knowledge-based economy. A range of policy measures will be used to develop an effective technology development system and to reform the educational system to meet future human capital needs.

**Malaysia**

Following a 4.8% decline in GDP in the first half of 1998, the Malaysian Government introduced plans to stimulate the economy during the second half of the year. These included the provision of bank loans to assist SMEs and export-oriented enterprises, and the announcement of a 7 000 million ringgit (US$1 750 million) counter-cyclical fiscal package, with 5 000 million ringgit to be spent on public infrastructure construction.

On 23 July 1998, the Malaysian Government published its National Economic Recovery Plan and announced the liberalisation of the FDI regime. Following this, the restriction on foreign ownership was lifted and 100% ownership was permitted for foreign investors in manufacturing. On 1 September, the government imposed exchange control measures in an attempt to prevent the speculative attacks that had earlier hurt the economy. Although they have since been liberalised, such measures could ultimately have a major negative impact on inflows of foreign capital, including FDI, which seems likely to overshadow the short- to medium-term efforts to attract foreign investment through deregulation. In the case of Malaysia, FDI effects are important as the country’s exports are largely produced by foreign-owned industries. Should the country experience a continuous decline in foreign investment inflows, growth of industrial production may slow.

The government also took a number of measures promoting import substitution. These included measures to encourage the substitution of imported heavy machinery with locally refurbished
products, higher duties on imports of consumer durables, and the expansion of educational facilities in order to reduce the need to acquire higher education abroad. The initiatives include a Skills Development Programme Loan (SDPL) supported by the Asian Development Bank. While helpful in alleviating the impact of the crisis on the poor and the unemployed, this and related programmes also address one of Malaysia’s major structural weaknesses; namely, the lack of technological capacity for long-term structural improvements.

Philippines

Following the financial crisis of 1983-85, the Philippine central bank was recapitalised and financial oversight strengthened. These reforms helped to diminish the effects of the crisis on the financial sector and the general economy. In response to the current crisis, the government has adopted measures to attract FDI; these include permitting foreign land ownership and abolishing restrictions on levels of foreign ownership in the financial sector.

During 1999, the crisis will force firms to restructure in order to become more competitive. The government has given priority to preventing a build-up of excessive corporate debt by making sure that adequate incentives are available to companies. Corporate governance reforms are underway to improve transparency, as are reforms to deter imprudent businesses practices. More effective bankruptcy procedures are being introduced, corporate disclosure requirements are being improved and a systematic effort to monitor the key financial variables of large companies is being developed. The special measures to implement the reforms are being worked out by the Securities and Exchange Commission. One lesson that has been learned from the crisis is the importance of the availability of raw materials. In response, the government is emphasising the development of linkages between key industries and supporting firms and sectors.

Thailand

The fact that the development of intellectual capital and human resources, including the supply of management skills, continues to lag behind industrial development has long-term structural implications for the sustainability of technology-based industry in Thailand and similar countries. In order to address the country’s weaknesses, the Thai Government started to prepare for extensive structural adjustment even before the crisis. An Industrial Restructuring Master Plan (IRP), approved by the Cabinet in January 1998, identified key weaknesses in Thai industry and set directions for structural change during the period between 1998 and 2002 (see Box 6). However, implementation of the plan, which was modified after the crisis, remains a challenge for the Thai Government and business alike.

The goal of Thailand’s industrial restructuring is to enhance competitiveness and to extend the role of Thai industry in socio-economic improvement. This requires continued industrial restructuring in the following areas:

♦ Focusing on the medium and high ends of products in order to generate high value added. This requires building up Thai competence in product design, upgrading technologies and machinery as well as improvements in quality management.

♦ Streamlining industrial production, modifying production processes, improving firm management and business administration in order to reduce production costs and improve delivery time to comply with the customer requirements in the era of globalisation.

♦ Enhancing the knowledge and skills of the industrial labour force, managerial staff and entrepreneurs to allow them to work with new technology and production systems. This is essential for Thai industry to be competitive in the world market for high-quality products.

♦ Creating business partnerships with foreign partners in order to penetrate markets and expand marketing channels as well as to obtain new technologies for Thai industry.

♦ Moving to clean production processes through industrial zoning particularly for certain sectors to manage pollution control and promote the adoption of clean technology. In addition, this will reduce the costs of industrial waste management. Greater attention to the environment is important for improving Thailand’s international image and for international trade negotiations.

♦ Relocating and dispersing industrial activities, especially labour-intensive ones, to regions and rural areas in order to create employment opportunities away from the greater Bangkok area and other major cities, and to provide additional income-earning possibilities for the agricultural labour force and their families. This is important for maintaining the labour force in rural areas and for reinforcing the strength of rural families and society.


Following the crisis, the Thai Government introduced a number of tax measures to facilitate corporate restructuring. These include a reduction of the tax on real estate transfers and a decision not to treat debts written off as capital gains (until end-1999). In addition, the authorities have put in place or proposed measures to recapitalise the banks and promote restructuring of corporate debt. In the medium term, the government seeks to enhance competitiveness through productivity and process improvement, upgrading technological capability, modernising targeted industries, enhancing product development and international marketing, and attracting technology-based foreign investment in strategic industries. Another part of the restructuring plan addresses improvements in social conditions, including upgrading labour skills in targeted industries, strengthening small firms (especially in supporting industries), relocating labour-intensive and low-polluting industries to rural areas, and enhancing the management and control of pollution and the use of clean technologies. Agriculture-based industries, including food processing, will receive special attention. The implementation of the plan will cost an estimated US$1.2 billion over five years, with 80% of funding to be raised through foreign loans.

As a destination for foreign investment, Thailand is better positioned than most of its competitors in the region owing to its political stability and a market-friendly economic environment. Europe, the United States and, in particular, Japan, were the major sources of capital inflow during most of 1998.
In order to attract further inflows of foreign capital, the Thai Government relaxed regulations on visas and work permits and simplified application procedures. Foreign nationals are now allowed to take Thai citizenship and to acquire 100% land ownership in Thailand. A 100% tax exemption has been extended to all foreign investments in export-oriented facilities; previous exemptions applied only to foreign direct investment in zone three (which is the furthest removed from Bangkok).

Thailand is bound to continue to experience difficulties in competing in the low-labour-cost tradeable-goods sector, especially since countries like China will remain strong in this sector. The economy’s performance will significantly depend on how it fares in relatively high-value-added, skill-based industries. To this end, the country is exploring ways to strengthen technological and managerial skill development, partly through reforms in the education system. By 2001, the universities will assume greater responsibility for managing operational budgets. Primary education is to be strengthened as well. Despite the fact that Thailand’s per capita income is twice as high as the average of low-middle income countries, its primary school enrolment rate lags below the average for that group (World Bank, 1998c).

Specific areas of reform

Finance-related reforms. Reforms of financial institutions are already well under way in all five of the countries studied. Improved risk assessment and prudential standards for sound lending practices, coupled with strengthened regulatory, supervisory and auditory controls by governments, will serve to tighten the provision of credit for investment. Reform in the banking sector should permit greater foreign participation; such participation can provide needed capital and expertise. Related reforms are also being carried out in other Asian economies. For example, in November 1998, Singapore announced a series of measures to strengthen the regulations governing stock exchanges, including a unification of the rules applicable to foreign and Singapore-listed firms. The measures also seek to improve transparency by requiring firms to prepare quarterly reviews of company performance. Regulatory changes such as these will help to improve the discipline and competitiveness of the listed firms. Having witnessed the damaging effects of poorly regulated financial markets, China has redoubled its efforts to carry out financial sector reform.

Of most immediate concern is the severe credit crunch which hit firms at the onset of the crisis. Lack of credit has forced the closure of many firms; this has acted to reduce over-capacity but has also destroyed fundamentally viable enterprises which were unable to manage temporary liquidity constraints. A review of the situation indicates that the credit squeeze has affected companies unevenly. In the case of Hong Kong, Korea and Thailand, for example, smaller firms were faced with a far more severe liquidity squeeze than were larger ones. In addition, due to the sharp decline in domestic demand, domestically oriented businesses have found it harder to survive than have their export-oriented counterparts. In response, practically all the Asian crisis economies have introduced policy measures to ease the pressure on SMEs – although with limited success. What is more relevant from a structural perspective, however, is the challenge to improve the long-term supply of market-based finance to the SME sector. Particular attention must now be paid to strengthening venture capital markets, improving financing of the seed and start-up stages of investment, instituting exit mechanisms and second-tier markets which can broaden and deepen the function of formal venture capital, as well as improving conditions for informal venture capital (Andersson, 1999).

Foreign investment and trade. The ASEAN economies are making attempts to accelerate the regional trade liberalisation process, and there are wider attempts in this direction within APEC. Following the crisis, however, investment liberalisation in particular has been given a boost. Liberalisation of foreign direct investment regimes, such as the deregulation of foreign ownership and acceptance of mergers
and acquisitions, is now well under way in Korea, the Philippines and Thailand (UNCTAD, 1998b). This, together with the removal of a range of incentives and disincentives that, in effect, discriminate against foreign investment in certain industries, will help to reduce the scope of policy-led distortions in the general distribution of investment. Allowing majority or total foreign ownership will also facilitate the transfer of technology from parent firms to their local affiliates. Improved access to foreign technology associated with foreign investment will improve the scope for better integrating Asian affiliates into the global network of their parent firms and raise the prospects for finding appropriate areas of specialisation in the international division of labour. Asia’s prospects as a destination of FDI have remained bright and business interest is strong; a recent Confederation of British Industry survey shows that an increasing number of British companies view the Asian economic crisis as a business opportunity.

Despite these advances, much remains to be done in order to make many of the Asian economies more open to newcomers, both foreign and domestic. This applies especially to the service sector, which is particularly affected by a whole range of regulations and restrictions which hamper new businesses and ways of doing business.

**Labour-related reforms.** Reforms in the labour market are urgently needed to increase the ability of the Asian countries to undertake industrial restructuring. At the same time, a country like Korea needs to strengthen its support for the unemployed, not least in order to raise public acceptance for restructuring. On the other hand, the benefits must not harm incentives for individuals to seek and take up new work, which would risk exacerbating problems with long-term unemployment as well as public finances. Labour market flexibility is also needed to enable corporations to withstand pressures for wage increases. This is especially the case as the economic performance of several of the crisis-hit countries is likely to continue to be strongly dependent on their ability to compete in areas where low wages and costs matter, although their structural development has been characterised by rising wages.

The functioning of labour markets and their degree of flexibility differ widely among the Asian crisis countries. Hong Kong provides an example of how labour market flexibility facilitated the weathering of the economic crisis: as unemployment increased in 1998, wages declined. This was an important part of the overall deflation that Hong Kong experienced under its fixed currency peg. Thailand’s labour market has also illustrated a high degree of flexibility in the aftermath of the crisis. In Korea, the labour law reform of February 1998 substantially increased the ability of firms to adjust employment levels to match declining needs. Finally, significant differences in the recognition of the acquisition of formal skills and diplomas, and different contractual conditions hamper mobility between, e.g. the public and private sectors within individual countries, as well as mobility of skilled workers between countries.

**Corporate governance.** Another key issue concerns the reform of corporate governance regimes. Reform efforts focus on improving transparency, the accountability of management and the protection of minority shareholders. The extent to which such changes will reduce the tendency for firms to over-invest remains to be seen. In theory, improved management should be helpful in this regard. Greater reliance on stock markets for raising investment capital should improve the monitoring of manager performance by investors. The greater role played by equity markets will also help to reduce overly high leverage ratios in the corporate sector in countries such as Korea and Thailand. Reforms of corporate governance systems are related to liberalisation of foreign investment regimes and rules governing mergers and acquisitions. However, judging from the slow progress of reform in this area, the complexity of the stakeholder issues involved, and the need for an entirely new legal framework and regulations, successful corporate governance reform is likely to take time. To examine further the challenges in this area, Chapter 6 takes a closer look at corporate governance issues, with emphasis on the Korean situation.
**Innovation systems.** Improving conditions for innovation and diffusion of technology is of major importance for strengthened long-term growth prospects. As noted, the Asian countries have traditionally been strong in the adoption and use of foreign technology. At the development stage that has now been reached, it is crucial to improve own innovative capacity, since this is increasingly important for the ability to interact with and benefit from foreign sources of technology.

There is a need to broaden and readjust the incentives for innovation, which currently emphasise traditional research and development in manufacturing industries. As noted, services and SMEs are becoming increasingly important to innovation, but in these sectors innovative efforts are more diverse and difficult to capture under the traditional heading of research and development.

Beyond this, obstacles to increased innovative capacity may take a number of forms and can be found in various ministerial portfolios, extending far beyond science and technology policy in the narrow sense. Reducing costs for using telecommunications and information technology, and transport may, for instance, be crucial for the effective exploitation of the new opportunities arising from globalisation. Required measures in this respect include telecommunication liberalisation and increased competition to reduce costs of entry and use of information and communication technologies. Several countries in the region have embarked on a broad liberalisation of their telecommunication markets, allowing effective competition in the mobile voice and data telephony segments, and opening the fixed-line basic service market. Nonetheless, there continues to be a wide variation in entry conditions and communication costs (Tarifica, 1998). Furthermore, policy makers have a role to play in allowing domestic demand to catalyse the development of new technologies and services. Government, the business sector, the education system and households all face decisions as to when and how to invest in information technology and services. Public spending on infrastructure, education and R&D can, for example, be an important driving force.

In addition, the challenges include: making education and training more conducive to creativity and entrepreneurship; strengthening the interaction between science systems and industry; removing product market regulations (especially in services) which impede product innovation; removing barriers to entry by foreign firms through acquisition or through the creation of lasting alliances with domestic firms; and reviewing existing rules and practices with regard to intellectual property rights.

A comprehensive and integrated agenda. The key challenge is to improve conditions for knowledge-based activities while not impeding those which have enabled success in labour-intensive industries. The countries in the region have begun to design industrial policies to meet the increased competition which has followed their recovery as well as regional and multilateral liberalisation. For instance, the Malaysian Recovery Plan states that “with the removal of tariffs and non-tariff barriers by 2003 under the CEPT, Malaysia must concentrate on the industries in which it has comparative edge”. In fact, the structural medium- to long-term impact of the crisis is likely to force each economy to become more alert in exploiting – and not deviating from – its true comparative advantage. The result is likely to be increasing international division of labour between countries within the region. In other words, there may be prospects for countries at different levels of development moving towards a more differentiated industrial structure, better complementing each other through increased unrestricted trade, investment, and flows of skilled and unskilled workers within the region, and competing less when it comes to exporting to other parts of the world.

Whether such a more diverse trend can take hold will significantly depend on the extent to which the countries in the region can implement a comprehensive and integrated agenda for making their economies more adaptable and responsive to market conditions. We have seen that government intervention in resource allocation is generally on the decline, while privatisation of state-owned enterprises has accelerated. In this respect, major challenges remain, particularly in China but also in
Indonesia. Korea and most of the other countries in the region continue to face serious challenges with respect to the structure and mode of governance of the existing, large-scale conglomerates. As highlighted above, much remains to be done as regards financial, product and labour market reform, SME policy, innovation policy, etc.

The formulation of an effective policy agenda for increased responsiveness requires serious consideration as to how it can be implemented. Governments in East Asia, like many others around the world, need to become more aware of private sector needs, not for the purpose of favouring incumbents but rather in order to build framework conditions conducive to renewal and experimentation in the economy. New forms of public-private sector partnerships are needed both for getting policies right and for making reform credible. Critical evaluation and feedback of evaluation results into policy making are important for improving the content of policy as well as its credibility. Efforts to improve co-ordination between different ministries within governments and to obtain a better distribution of responsibilities between different levels of public authorities, including regional, local and national, are important areas for reform in order to enhance the capabilities of the policy process itself. The agenda is not for governments to resume responsibility for a greater number of things, but rather for them to become better co-ordinated and more consistent in strengthening the basis for well-functioning institutions and markets.

Implications for policy in the OECD countries

Assisting industry in the crisis economies

The OECD countries have provided various forms of assistance to firms in the crisis economies, including co-ordinated trade financing through official import-export governmental institutions. There are opportunities for expanded co-operation to facilitate corporate and industrial restructuring. This could occur through the sharing of information and experience in areas such as policies conducive to firm start-ups and the expansion of small and medium-sized enterprises, a favourable corporate governance climate and policies fostering the innovation and diffusion of technology.

Added to this is the challenge of improving the combination of policy formulation and implementation, and making policies more consistent and credible. Again, this is essential for enabling the emergence of a more responsive and dynamic private sector, and for building the capacity to manage the globalised economy within which countries are increasingly influenced by each others’ performance. It includes paying attention to less fortunate groups, and considering how to facilitate access to information and knowledge for the most vulnerable users.

While there has been an enormous exchange of views on the macroeconomic and financial aspects of the crisis, much less has been done on the structural side. There is a growing policy debate in Asia on how improvements can be achieved in this area as well. The OECD and other international organisations can help to identify solutions to joint problems and transfer insights in policy implementation. The OECD Bribery Convention, the principles of Corporate Governance, and the Shipbuilding Agreement are examples of negotiated frameworks seeking to provide coherent rules of the game in special problem areas. Moreover, there is a long tradition of policy reviews and identification of best practices, e.g. in the area of regulatory reform, innovation and SME policies, which could be shared more effectively in Asia and other regions. As regards the World Bank, the latest report on Knowledge for Development (World Bank, 1999) represented a new effort to convey the need for better co-ordinated policies. Clearly, the work of the international organisations is far from sufficient: further regional and bilateral initiatives are required to facilitate and sharpen the exchange of experience on what works and what does not work in policy responses.
**Coping with structural adjustment in OECD industries**

Increasing global competition requires restructuring in certain sectors: closing of non-viable facilities, downsizing, mergers and acquisitions, and other strategies to raise productivity and cut excess capacity. Furthermore, the financial crisis has revealed major weaknesses in the structure and competitive position of certain OECD industries.

The result has been intensified adjustment pressures in OECD industries, albeit to varying degrees. These appear to have been greatest in steel, shipbuilding and commodities, but have also been building in other sectors including automobiles and electronics. There is likely to be a continuous increase in competition as the Asian countries recover and advance in export markets. Indeed, recovery in the non-OECD countries will require open markets and restructuring in the OECD area.

The risks of substantial downside scenarios that have been highlighted in economic forecasts, suggest that the intensification of competition could occur under generally difficult conditions in the world economy. While member countries of the World Trade Organization (WTO) have made substantial and impressive progress in liberalising trade, a major deterioration in the global economic situation can be expected to spur the introduction of protectionist measures, as has already occurred in the case of steel.

Restructuring is accompanied by high transition costs and by distributional effects since winners and losers are not necessarily the same. The result can be considerable political resistance to change. Some of those affected may be in a particularly weak position as regards income, education and alternative employment opportunities. The key challenge for OECD governments is to cope with the transition costs, put in place educational programmes and initiatives for new ventures and for the development of alternative industries which can help to manage the transition costs by facilitating rather than compromising the restructuring process.

Although highly publicised struggles continue in the area of tariffs and traditional non-tariff barriers, the real danger from protectionist measures probably lies elsewhere. Domestic regulations tend to be less transparent, and sizeable public subsidies continue to abound, especially at the local and regional levels. It is crucial that the OECD countries remain collectively committed to foregoing such opaque strategies for preventing rather than coping with structural change. It is also important to ensure that regional trade liberalisation efforts, such as EU, NAFTA and ASEAN, will not further such strategies but will instead serve to complement the formation of an open global trading system.

**Restoring business confidence**

The global crisis has tended to erode business confidence in the financial soundness of certain countries. There is a possibility of vicious or virtuous circles in business confidence, depending on the perceptions which prevail in the longer-term regarding the formulation of framework conditions for business. In particular, the return of foreign direct investment to the Asian region represents a “win-win” proposition for OECD and non-member economies alike, helping the latter to expand their economic base and gain access to foreign capital, technology and know-how. At the same time, continued uncertainty over reform and the economic and social outlook may limit FDI and hamper recovery.
Chapter 5
THE STRUCTURAL CHALLENGE FACING CHINA

Introduction

The financial aspects of the crisis have by and large eluded China, due in part to the country’s sizeable foreign reserves, its growing trade and current account surpluses, and the restrictions that the country maintains on capital flows. However, as has already been noted, China has nevertheless suffered from the crisis, with a marked decrease in exports and economic growth. China is, of course, a very large economic and political force in its own right. Beyond this, however, the extent to which the country will be able to handle the current pressures will be of significant importance for the final outcome of the crisis. China shares some of the structural weaknesses of the crisis economies, and could potentially go down the same road. If that happens, there would be another, perhaps even more dramatic, series of disasters in the world economy. On the other hand, if the authorities were to take a lesson from their neighbours’ misfortunes, a revitalised Chinese economy would lend strong support to recovery in Asia.

In response to the problems encountered over the last years, the Chinese Government has adopted an ambitious programme aimed at stimulating economic growth through public spending, primarily on infrastructure. In addition, the government has accelerated the restructuring of its state-owned enterprises, with a view to increasing efficiency and eliminating the substantial over-capacity that characterises many sectors. It remains to be seen, however, whether these measures are sufficient.

The Chinese economy

In important respects, the Chinese economy differs from those of the Asian countries most affected by the crisis. Whereas the latter are fundamentally market economies, China is still a socialist economy with large state-owned enterprises (SOEs) dominating key industries. In addition to state ownership, a substantial number of activities are owned by collectives. A large number of the rapidly growing township and village enterprises (TVEs) fall into this latter category. Many of these enterprises are owned by Chinese local governments, and they tend to be subject to government intervention (Zhang, 1994). As of 1997, public ownership (i.e. state and collective enterprises) accounted for as much as 63.6% of China’s total industrial output, while private domestic firms and foreign-owned firms each accounted for about 18% of output. Thus, government influence and intervention remain stronger in China than in most other Asian economies.

Compared to the majority of the Asian crisis economies, China has a relatively low level of development measured in terms of per capita income (Annex I, Table 1). The lower income level translates into lower wage costs, providing China with a significant cost advantage in labour-intensive manufacturing. As a result, the share of labour-intensive products is relatively high in both China’s industrial production and its exports. In the case of exports, labour-intensive manufacturing accounts
for over 80% of foreign shipments, while in the domestic economy it accounts for a substantial share of the 40% of GDP contributed by manufacturing (Cable, 1996).

China’s relatively low development level is reflected in the lack of financial depth of the economy. Its history as a socialist planned economy, with resources allocated through a state planning process, helps explain why financial and equity markets were virtually non-existent when Chinese economic reforms started in the late 1970s. In terms of financial depth, measured by the ratio of financial assets to GNP, China lags far behind some of the Asian crisis economies. Stock markets, for example, were introduced in China only at the beginning of 1990s, and the number of listed companies is still relatively low (given the size of the country) when compared to the Asian crisis economies (Figure 4). The underdevelopment of the financial sector not only has important implications for the governance and investment behaviour of China’s industries, but, as discussed below, it also presents an additional challenge in making needed structural adjustments.

**Figure 4. Number of listed domestic companies, selected Asian economies, 1991-96**

![Figure 4](image)

*Source: World Bank (1998b).*

As noted, an important aspect of China’s economy is its size. Because the domestic market is huge, China’s industries are – in relative terms – less dependent on world markets. Exports as a share of GDP are lower for China than for the Asian crisis economies. Moreover, in terms of purchasing power parity (Table 10), China’s trade represented about 7% of its GDP in 1996, substantially below that of other Asian countries. While trade tends to represent a small share of GDP for large economies, in the case of China the relatively low level of economic development and limited openness of its economy also play a role. The size of the economy has led to the development of a diverse industrial structure which includes a large and well-functioning heavy industry sector. This diversity gives the country an advantage over smaller economies, where domestic demand is often not sufficiently large to support such a situation. In smaller countries, companies tend to rely excessively on exports and/or concentrate on a relatively narrow range of industries, as has been the case in most South-East Asian economies. In contrast, China’s diversity has allowed it to develop a highly varied export structure (Cable, 1996).
Table 10. Trade to GDP ratio, 1980-96

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>7.7</td>
<td>7.3</td>
<td>6.6</td>
<td>7.0</td>
<td>7.1</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>126.3</td>
<td>113.6</td>
<td>172.1</td>
<td>219.5</td>
<td>247.6</td>
</tr>
<tr>
<td>Indonesia</td>
<td>24.6</td>
<td>13.8</td>
<td>12.8</td>
<td>12.7</td>
<td>13.6</td>
</tr>
<tr>
<td>Korea</td>
<td>42.5</td>
<td>37.4</td>
<td>40.2</td>
<td>37.0</td>
<td>46.8</td>
</tr>
<tr>
<td>Malaysia</td>
<td>54.4</td>
<td>41.3</td>
<td>49.7</td>
<td>56.5</td>
<td>70.2</td>
</tr>
<tr>
<td>Philippines</td>
<td>14.2</td>
<td>8.9</td>
<td>11.9</td>
<td>14.5</td>
<td>21.3</td>
</tr>
<tr>
<td>Singapore</td>
<td>309.1</td>
<td>215.7</td>
<td>264.5</td>
<td>268.4</td>
<td>316.0</td>
</tr>
<tr>
<td>Thailand</td>
<td>22.9</td>
<td>15.3</td>
<td>25.4</td>
<td>26.9</td>
<td>31.3</td>
</tr>
</tbody>
</table>

Note: PPP = Purchasing power parity.

In terms of human resources, China’s workforce is also highly diversified. Importantly, the skill level of workers has been improving in the last two decades with the country’s rapid industrialisation and increased contact with foreign entities through expanding trade and investment links. In fact, the development of TVEs and the mushrooming of foreign investment have transformed increasing numbers of unskilled workers into semi-skilled and skilled workers. At the same time, China possesses a large pool of well-educated workers, with significantly greater numbers of scientists, engineers and technicians in research and development than is found even in countries with higher income levels (Annex 1, Table 5). This dual structure of the labour force may be advantageous for China in the future, allowing the country to remain competitive in labour-intensive industries, while developing its high-technology industries.

While a great deal of liberalisation has taken place, China has a relatively low degree of openness compared to the Asian crisis economies, in terms of both currency convertibility and capital account transactions. The Chinese currency is not yet fully convertible, a factor that helps to explain why the country was able to weather the Asian crisis with relatively little direct effects. Despite the large inflows of foreign capital that China attracts every year (see Table 11 below), the country’s foreign investment regime is far from liberalised. As explained below, the lessons learned from the experience of the Asian crisis economies seem to suggest that it will take some time before China will be ready to fully liberalise its capital account.

**China’s industrial development since 1978**

From 1949 to 1978, China followed a “Soviet” development strategy, focusing on industrialisation through the development of heavy industry. At the start of the reform process in 1978, the country’s industrial structure suffered from two major imbalances – between light and heavy industry, and between market demand and production capacity, in virtually all industrial products.

Between 1978 and 1998, reforms resulted in a remarkable turnaround from a command-based to a market-based economy. With annual GDP growth averaging 9.8%, industrial output grew by 12.8% a year, transforming the country into the world’s largest producer of cement, steel, fertiliser and coal. High priority was also given to light industry and infrastructure. At the same time, the reforms have resulted in a gradual decline in the relative importance of the state sector, mainly as a result of the development of TVEs and the increase in foreign investment.
**State-owned enterprises (SOEs)**

The share of production accounted for by SOEs in total industrial output has declined from 77.6% in 1978, to slightly over 25% today (Figure 5). Government policy suggests, however, that the state will continue to maintain a dominant role in key industries. Despite their falling share of output, SOEs accounted for over half of gross fixed capital investment during the 1990s (Figure 6).

**Figure 5. China’s industrial output by ownership category, 1978-97**

As a percentage of total industrial output

![Figure 5. China’s industrial output by ownership category, 1978-97](image)

*Source: CEI.*

**Figure 6. China’s fixed asset investment by ownership category, 1990-97**

As a percentage of total

![Figure 6. China’s fixed asset investment by ownership category, 1990-97](image)

*Source: China Statistical Yearbook 1998.*
Township and village enterprises (TVEs)

TVEs have been the main engine of China’s fast growth and the most rapidly growing portion of the industrial sector since the late 1970s. In the pre-reform era, rural industries were developed as a means of expanding industrialisation (without further penalising the already overcrowded urban areas), alleviating rural unemployment and increasing supplies of industrial products in rural areas. In the post-reform period, TVEs have grown rapidly, reflecting local initiatives more than actions by central government. With output increasing at an average of 30% a year over the past two decades, TVEs now account for around 47% of China’s industrial output, up from 9% in 1978 (Zhang, 1997). There are currently over 20 million of these enterprises, with a total workforce of 130 million employees, up from 28 million in 1978.

While a large number of TVEs are owned by local governments, private and co-operative TVEs have grown in number and importance since the mid-1980s. The majority of TVEs are small and medium-sized firms and their products are generally labour-intensive in nature. TVEs dominate the building materials and agricultural machinery industries, and are strong in textiles and garments (accounting for 80% of national output), processed foods and beverages (43%), and coal and cement (40%). Moreover, TVEs now account for an increasing share of the production of the electronics and telecom equipment (17%) and machinery (26%) industries (CIN, 27 March 1998). As discussed below, these firms play an increasingly important role in China’s exports.

Foreign investment

Between 1979 and 1997, China attracted some US$232 billion in FDI (Table 11). Manufacturing absorbed the bulk of this investment (62% in 1997). The foreign investment was aimed at making use of China’s relatively low labour costs and/or taking advantage of the vast potential of the rapidly growing Chinese market. Over 50% of the foreign investment were in the form of joint ventures, but the importance of wholly owned facilities has also increased over time (Broadman and Sun, 1997). Some 42 881 projects involved foreign investment in industrial enterprises, accounting for 21% of China’s industrial output value in 1997.

Table 11. Foreign direct investment in China, 1979-97

<table>
<thead>
<tr>
<th>Year</th>
<th>Utilised FDI and other types of foreign investment</th>
<th>Share of FDI by the Asian economies</th>
<th>Share of FDI by the European economies</th>
<th>Share of FDI by the North American economies</th>
<th>Share of FDI by the world</th>
<th>FDI net inflow as a % of gross domestic investment in China</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979-83</td>
<td>2 683</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>0.73</td>
</tr>
<tr>
<td>1984-90</td>
<td>15 781</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>1.79</td>
</tr>
<tr>
<td>1991</td>
<td>4 666</td>
<td>82.0</td>
<td>6.13</td>
<td>7.5</td>
<td>0.64</td>
<td>3.33</td>
</tr>
<tr>
<td>1992</td>
<td>11 291</td>
<td>89.7</td>
<td>2.86</td>
<td>5.13</td>
<td>0.58</td>
<td>7.37</td>
</tr>
<tr>
<td>1993</td>
<td>27 771</td>
<td>87.0</td>
<td>2.84</td>
<td>8.00</td>
<td>0.78</td>
<td>14.7</td>
</tr>
<tr>
<td>1994</td>
<td>33 946</td>
<td>84.0</td>
<td>4.89</td>
<td>8.12</td>
<td>1.09</td>
<td>15.7</td>
</tr>
<tr>
<td>1995</td>
<td>37 806</td>
<td>81.0</td>
<td>5.99</td>
<td>9.13</td>
<td>1.80</td>
<td>12.7</td>
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<tr>
<td>1996</td>
<td>42 135</td>
<td>79.0</td>
<td>7.15</td>
<td>9.18</td>
<td>2.22</td>
<td>11.6</td>
</tr>
<tr>
<td>1997</td>
<td>52 387</td>
<td>67.6</td>
<td>12.9</td>
<td>7.46</td>
<td>1.49</td>
<td>..</td>
</tr>
<tr>
<td>Total</td>
<td>232 221</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
<td>..</td>
</tr>
</tbody>
</table>

Source: CEI; World Bank (1998b).
Exports

The structure of China’s exports has changed during the past decade, with increased specialisation occurring in labour-intensive products (Fukasaku et al., 1994). As shown in Figure 7, the share of capital goods has also been increasing, while the importance of primary goods has diminished. According to the last annual report of the World Trade Organization, China has become for the first time one of the world’s top-ten merchandise exporters, as well as one of the leading importers of commercial services (CND, 3 February 1999). In terms of specific products, China is one of the world’s largest clothing traders, accounting for 18% of global clothing exports. On the other hand, the share of high-technology products in total exports is relatively low; in fact, it is lower than that of all the Asian crisis economies, except for Indonesia (Annex 1, Table 5).

Figure 7. China’s changing export structure, 1978-93

[Graph showing the changing export structure of China from 1978 to 1993, with categories for mineral-intensive, labour-intensive, capital-intensive, and agriculture-intensive goods.]

Source: Yoshitomi (1996), Table 1.

Factors responsible for the growth in exports include a policy shift towards a more outward-oriented trade regime (Fukasaku et al., 1994), the deregulation of the foreign trade regime, and the gradual devaluation of the Chinese currency. TVEs and the companies that have attracted foreign investment have been the main contributors to the increase in exports. Currently, TVEs are responsible for more than one-third of Chinese exports, up from 10.9% in 1987. In 1997, some 1.1 million TVEs were engaged in exporting. As the TVEs are mainly small and medium-sized enterprises involved in labour-intensive manufacturing, their rapid growth has contributed to the transformation of the Chinese export industry into an internationally competitive producer of labour-intensive goods (Otsuka et al., 1998; Cable, 1996).

Similarly, the share of exports accounted for by foreign-owned firms has risen to more than one-third, up from 3% in 1987. This share is even greater in the coastal regions (over 40%). The majority of exports are labour-intensive manufactured goods (Cable, 1996).
Developments since July 1997 and outlook

In 1998, China took steps to increase foreign and domestic investment, expand fiscal policy, control inflation and promote exports. In particular, the government announced plans to increase investment in fixed assets by 10%, hoping that this would maintain an economic growth rate of 8%. Total fixed asset investment would come to 2 785 billion yuan (US$335.5 billion), of which 38% would be directed to infrastructure, 17% to technical upgrading and 13% to real estate development (Figure 8). The funds devoted to technical upgrading would be used to address some of the major structural weaknesses facing companies. Funds for public spending are to be raised through bank loans, issuance of long-term bonds and overseas capital markets.

![Figure 8. China's investment growth, January 1997-December 1998](image)

These expansionary measures, which were accompanied by the issuance of 100 billion yuan (US$12 billion) in treasury bonds, helped lift China’s GDP by 7.8%. According to the China Statistics Bureau’s bulletin, investment was the most important source of growth in 1998, contributing to 61% of the total, twice the level of 1997. At 11.2%, industrial production increased at a higher rate than GDP. The non-SOE sector grew faster than the SOE sector (Figure 9). Steel output increased by 6.4%, clothing by 7.2% and shipbuilding by 2.2%, respectively, while the electronics, telecommunication and personal computer sectors grew particularly fast during the first ten months of 1998.

The Asian crisis contributed to slowing exports and a decline in foreign investment during 1998. While 0.5% higher than 1997, exports were down sharply on a year-on-year basis in the latter months of 1998 (Figure 10). Manufactured products, which accounted for around 88% of China’s total exports during January-September 1998, increased by 6.4% from the corresponding period in the previous year. Office machines (including computers) (up by 32.5%), road vehicles (including air-cushion vehicles) (up by 22.1%), other transport equipment (up by 33.2%), and essential oils and perfumes (up by 22.7%), grew particularly fast, while clothing, toys, travel articles, plastics and radio recorders also grew reasonably well. Large declines occurred in exports of fertilisers (-51.4%), and iron and steel
(-24.9%), and Chinese shipyard orders collapsed in 1998 (Box 7). For 1998 as a whole, China’s exports grew marginally by 0.5%, and imports declined by 1.5%, reaching US$183.8 and US$140.2 billion, respectively (MOFTEC).

**Figure 9. China’s industrial output growth, January 1997 - December 1998**

Percentages, year-on-year

![Graph showing industrial output growth](image)

*Source: CEI.*

**Figure 10. China’s trade development, January 1997 - December 1998**

Percentages, year-on-year

![Graph showing trade development](image)

*Source: CEI.*
China attained a current account surplus of US$29.3 billion in 1998, which helped boost foreign currency reserves by US$5 billion by the end of the year, to US$144.9 billion (CEI, 21 June 1999).

Foreign investment, which peaked in 1995 at US$90 billion, fell to US$73 billion in 1996 and further to US$51 billion in 1997 (Asian Development Bank, 1998a). Despite this declining trend, China was the biggest FDI recipient among developing economies in 1997 and, on a global basis, was second only to the United States. The Asian crisis appears thus far to have affected investment flows only slightly. In the first eight months of 1998, contracted FDI amounted to US$35 billion and actual inflows to US$27 billion, which was only 1.5% below the figures for the same period in 1997. For 1998 as a whole, approved FDI grew by 2.2% and actually utilised FDI by 0.7%, reaching US$52.1 and US$45.2 billion, respectively (MOFTEC).

At the beginning of 1998, Beijing reclassified priority sectors for foreign investment. High-technology industries will be given priority. The list includes projects in the fields of pharmaceuticals and environmental protection. A Beijing-Shanghai high-speed railway, construction of which should begin in the year 2000, and an information superhighway, are also on the list. Other projects include the development of high-definition television, a computerised financial network and an electric motor car. While China hopes to lure foreign investors to partially finance its rail network, foreign investment will likely amount to only 3% of the US$42 billion that the rail sector needs within the next five years. In support of its investment priorities, imports of capital goods in high-technology areas will be exempt from tariffs, while imports of advanced technology, equipment and raw materials will be encouraged, with a view to boosting the country’s development of agriculture, infrastructure, basic industries and other key industries. Changes have also been made to simplify the approval process for FDI projects.

It should be added that practically all FDI into China takes the form of greenfield investment, with some element of joint ventures, in contrast to the acquisition of existing firms. In the last two years China has made an effort to invite foreign investors to participate in the restructuring of the SOEs. So far, however, there has been a meagre response on the part of foreign investors. In effect, there is still limited openness to mergers and acquisitions. This is partly because the necessary legal conditions are not yet in place, but also because specific corporate governance systems and traditions present considerable barriers to take-overs by foreign firms. This is one factor hampering restructuring and effective uptake and diffusion of foreign technology.

**Immediate outlook**

In December 1998, several high-level meetings were held in Beijing to establish economic strategies for 1999. Trade officials were ordered to promote exports in “a thousand and one ways”. Incentives to increase exports were already adopted in 1998, when the authorities increased the VAT export rebate from 5-7% to 14% (it had been a full 17% several years ago). A further increase in the rebate is reported to be under consideration. The shipbuilding industry was one of the industries to voice strong demand for a higher VAT export rebate (Box 7). Other measures to assist in financing exports are under review. In addition, the regulatory environment will be liberalised, with more enterprises to be granted export and import licences and more companies to be given the authority to enter into contracts with foreign entities.
Box 7. China’s shipbuilding industry: facing international competition

China’s shipbuilding industry is mainly export-oriented and a strong foreign currency earner in recent years. For the China State Shipbuilding Corp., foreign orders and product exports accounted for around 80% of total sales in 1997. The chief problem facing the industry has been the government’s determination to maintain the value of the currency vis-à-vis the US dollar. Chinese shipyard orders collapsed in 1998, as Korean and Japanese shipbuilders cut prices to win new orders, helped by the depreciation of their currencies. The China Shipbuilding Industry Trade Company only received export orders for three small ships and the China State Shipbuilding Corporation secured contracts for 28 ships in the first half of 1998, equivalent in tonnage to only 17% of the 1997 volume. Some large shipyards in China did not win a single export order for the first half of 1998.

Traditionally, Chinese shipyards prefer to build vessels for foreign buyers as they benefit from export financing assistance. As a result, Chinese shipping companies tend to place their orders abroad. Last year, ship buyers continued to place orders with Japanese and Korean shipyards, further weakening the faltering domestic industry. Orders for 14 ships went to Japanese ship manufacturers in June and July 1998. The industry has called on the government for assistance, demanding tax exemptions, currency devaluation and export subsidies to enable them to compete more effectively with their Asian rivals. Thus far, the government has responded by raising the VAT rebate in 1998 for ship exporters from 9% to 14%. Although this has lessened the tax burden on the industry and reinforced export competitiveness, it falls far short of what the industry argues is needed to restore its competitiveness.

Policy makers do not, however, intend to devalue the yuan to boost foreign sales, at least in the near term. Instead, with foreign reserves remaining high, efforts will be made to maintain the currency’s current value. This will put pressure on Chinese industries to restructure.

As regards overall growth, the government has set a target of 7% for 1999 (Zhu, 1999). Total trade (i.e. imports plus exports) is expected to amount to around US$320 billion in 1999 (CND, 3 April 1999), representing a decrease of slightly over 1% from the 1998 level of US$324 billion (CEI). In the face of anticipated weak demand on export markets, domestic demand, including consumption and capital investment, has been given increased attention in order to achieve the short-run growth target. The government thus plans to invest a total of 3.2 trillion yuan, a 12% increase over last year, in fixed assets and to attract US$50 billion in foreign capital.

During the first quarter of 1999, industrial production grew in value-added terms by 10.1% compared with the same period a year earlier. Investment by the state sector and unclassified types of ownership (i.e. excluding collective and private) continued to surge, rising by 22.73%, with infrastructure investment growing by 32.1%, technological upgrading and renovation by 22.4%, and real estate by 29%, during the first two months of 1999. Total trade amounted to US$70.2 billion, an increase of 0.3%. Exports were down by 7.9% to US$37.2 billion, while imports increased by 11.6%, to US$33 billion (CEI, 30 April 1999). Finally, FDI declined by 14.6%, to US$7.3 billion, in the first quarter of 1999, raising the possibility of an overall decline for the full year (Financial Times, 25 March 1999; CEI, 20 May 1999).

In summary, while efforts are being made to stimulate exports, it seems clear that the prospects for the near future are problematic, and China will to a large extent have to rely on growth in the domestic economy to achieve its overall economic objectives. The fiscal stimulus that has been applied is an important initiative that is likely to play a key role in light of the downward pressure placed on the economy by industry restructuring. Such restructuring, painful as it may be, will be critical for long-term sustainable growth. At the same time, the chosen policy approach has a number of limitations: there appears to be an over-emphasis on command strategies and traditional manufacturing rather than a focus on market responsiveness and new industries, including services.
Structural issues

Although China has effectively avoided the global financial crisis, it does present a number of the structural problems that contributed to the turmoil experienced by the five other Asian countries studied. These problems, together with the measures required to address them, are discussed under the following headings: over-capacity; state-owned enterprises; SMEs; technology; and human resources.

Over-capacity

From the mid-1990s onwards, some Chinese industries began to experience serious problems of over-capacity. A 1995 survey of 111 industrial sub-sectors shows that some 24% of sampled industries had capacity utilisation rates below 50%, while 36% had rates ranging from 50% to 70%. Only 9% of the industries attained a rate exceeding 90% (Figure 11). By 1997, over-capacity was a problem for virtually all industries. For some products, such as televisions and refrigerators, production capacity was estimated to be 30% above market demand, while textiles and shoe-making enterprises suffered from huge and growing quantities of unsold products. The situation in the textile industry is illustrated in Box 8.

Figure 11. China’s industry capacity utilisation ratio, 1995

Note: Percentages are based on capacity utilisation data for 111 industrial sub-sectors. 
Source: CEI.
Box 8. China’s textile industry: over-capacity, redundancy and restructuring

China has some 4 000 state-owned textile firms with 4 million workers, representing about 10% of the nation’s industrial workforce. Many of these firms have been losing money in the past three years, accounting for one-fifth of the nation’s total industrial losses (CND, 20 December 1997). The industry, which is burdened with over-capacity and needs technological upgrading, made industrial restructuring a priority for 1998. By the fourth quarter of the year, companies had reduced their workforce by 450 000 persons. More layoffs are expected since this figure represents only 75% of the targeted goal for 1998. According to the State Textile Industry Bureau, the oversupplied domestic market and difficulties in exporting as a result of the Asian financial crisis forced producers to eliminate spindles and seek government subsidies.

The Bureau cut the production of spindles by 4.32 million and plans to remove 10 million more over a three-year period to ensure the future financial viability and competitiveness of China’s textile industry. Some 1.2 million jobs could be lost. The government will provide a 5 million yuan (US$609 000) loan to each textile firm to help the industry upgrade equipment, develop new products and assist laid-off workers. Some 9.73 billion yuan in bad loans to 555 state textile companies have already been written off by the government, which plans to give another 10 billion yuan to the sector.

Textile exports are subject to the international multi-fibre agreement that establishes quotas on exports to different countries. The agreement tended to dampen the effects of the financial crisis on China since the crisis economies were not able to freely expand their foreign sales to third markets (since the exports were bound by the quotas). The expiry of the quota system in 2005 is expected to have a major impact on China’s textile export industry, which will have to compete under free-market conditions, not only on the basis of low cost, but also on the ability to market successfully.

The growing over-capacity has led to redundancies in the industrial workforce. In May 1998, the government concluded that mass layoffs were unavoidable in the processes of SOE reform and economic restructuring. The authorities attributed the prevailing over-capacity to years of reckless, duplicative investment, overproduction and capital starvation. In addition, the fact that inefficient SOEs have not been allowed to go bankrupt in the face of a large number of new non-state-owned entrants has aggravated the problem. Local governments have also contributed to the situation by undertaking duplicative investments in the TVEs; these investments were often unsound as the local authorities lacked experience in investment decision making.

In addressing over-capacity, the central issue for China will be to find ways to discourage over-investment. This will require inter-related reforms and institutional changes. The restructuring of the SOEs is pivotal: allowing loss-making SOEs to go under would diminish the over-capacity problem. Moreover, a reduction of government intervention to permit the market to play a fuller role in resource allocation, at both the central and local levels, would be equally beneficial. This, in turn, needs to be coupled with the development of a modern, transparent banking and financial system, capable of managing risk and allocating resources efficiently. Yet, as illustrated in Box 9, the financial sector reforms and the development of modern capital markets together represent one of the most challenging reforms that remains to be completed in China.
Box 9. Financial reform: a remaining major challenge for China

Although China has made impressive progress in developing financial instruments and institutions during the post-reform period (Mehran et al., 1996), financial reform remains far from complete. Even once the reforms are implemented, the banking and financial sectors will require time to fully implement changes and make them operational. Similarly, it will take time for the government to develop its competence to monitor, supervise and regulate financial markets. The Asian crisis countries’ experiences suggest steps towards capital account liberalisation should follow in “a prudent and sequenced way” (IMF, 1998c), while other reforms are being made. Indeed, their experiences have shown that establishing a sound macroeconomic framework and making appropriate reforms to financial systems are among the basic necessary conditions for a developing country to open up its capital accounts (Camdessus, 1998). Thus, “improvement in the performance of China’s financial sector is of vital importance to the overall interests of reform, development and stability” (Zhu, 1999).

State-owned enterprises

China’s state-owned enterprises (SOEs) represent a major structural weakness. Many of the firms are equipped with outdated machinery and technology producing unmarketable products. Between 40% to 50% of the 64,000 SOEs incur losses that are covered by the state budget. The net loss by large SOEs reached 10.4 billion yuan (US$1.23 billion) during the first quarter of 1998. Despite their losses and a declining contribution to total industrial output, these enterprises have consumed a disproportionately large share of investment capital in recent years (Figure 6). Since 1997, the government has made SOE reform a priority. However, reforms have thus far mainly focused on small and medium-sized firms through de facto privatisation. The privatisations have mainly taken the form of management buyouts and the sale of shares to employees.

In looking for ways to restructure large SOEs, the Chinese authorities have favoured the Korean model of state-led industrialisation. In this context, there is strong ideological support for retaining state ownership in key strategic industries, and support for chaebol-type conglomerates. Until the Asian crisis, the Chinese Government believed that taking fuller advantage of economies of scale (through firm mergers and industry consolidation) would increase efficiency sufficiently to address the problems facing SOEs. State-owned companies in key industries would thereby be transformed into conglomerates. The creation of such conglomerates was seen as a short-cut method to help the country develop heavy and high-tech industries that would be internationally competitive. Culturally, the “big is beautiful” maxim remains deeply rooted in Chinese policy making. The Korean model was seen as dealing with two key problems simultaneously – namely, reforming (or restructuring) large SOEs and establishing the basis for the creation of competitive multinationals. The financial crisis, however, has illustrated some of the potential downsides to this approach. In fact, it now appears that Chinese policy makers are re-examining their strategies for SOE reform, in the light of events in the crisis economies.

Small and medium-sized enterprises

Small and medium-sized enterprises have flourished in China, largely through the development of TVEs, typically owned by local governments. However, the SME sector faces a number of challenges. In particular, the TVEs have long been troubled with low product quality, lack of technological and managerial/marketing expertise and difficulties in attracting well-educated human resources. According to a 1990 survey of 630 TVEs, enterprise managers perceived the above-mentioned difficulties to be more important constraints to further growth than, for instance, physical infrastructure limitations (Zhang, 1997).
In order to enhance the performance and role of SMEs in the economy, it may be useful for the Chinese authorities to look at the experience of Chinese Taipei. This would suggest that a level playing field in a competitive market environment is more important and efficient than government policies and subsidies benefitting favoured companies (Schive, 1995). Further development of Chinese SMEs would, at the same time, require further deregulation. For example, of the 1.1 million TVEs engaged primarily in the production of goods for export, only some 1 200 have licences for exporting directly. Liberalising the trading regime would provide the TVEs with the means to enhance their potential for increasing labour-intensive exports.

**Technology**

Most of China’s industrial enterprises suffer from backward technologies, outdated machinery and/or a lack of technical competence and innovative capacity. For example, although China’s packaging industry grew by an average of 29% a year from 1991 to 1995, some 80% of production was at quality levels significantly below those in developed countries. The industry reportedly loses about 14 billion yuan (US$1.69 billion) a year because 20% of the industry operates with obsolete technology. The lack of technological and innovative capacity occurs across virtually all industries, including labour-intensive sectors. For example, the garment and toy-making industries, two pillars of Chinese exports, suffer from a lack of design capacity, although good design is crucial for export markets. This is hampering the industries’ international competitiveness and is resulting in a low value-added component to exports. Another example, the need for the Chinese steel industry to upgrade technology, is illustrated in Box 10.

**Box 10. China’s steel industry: the need for technological upgrading**

China was the largest crude steel producer in the world in 1997, with 107.6 million tonnes of total output, about 6% of which was exported. Exports, some 80% of which are shipped to Asian markets, plummeted by 38.1% in the first nine months of 1998 due largely to the economic crisis in Asia. In addition to declining demand, producers were disadvantaged by the depreciation of the currencies of Japan and Korea, which are themselves major producers and traders of steel.

A significant structural challenge facing China’s steel industry is to upgrade its technology. This challenge is twofold: first to upgrade existing equipment, and second to acquire new equipment that will enable companies to produce a greater range of high-value-added products. Although a major producer, China currently has to rely on imports of advanced steel products, such as steel sheets for car bodies and refrigerators.

One of the lesson that China may learn from the experience of the Asian crisis economies is that it is important for industrialising economies to remain competitive in labour-intensive industries while upgrading their industrial and export structures towards higher-value-added, more technologically advanced activities. In this regard, it is critical to implement appropriate general technology policies and complementary policies relating to the development of high-technology industries. The experience of the crisis economies suggests that high-technology industries should be developed not only on the basis of foreign capital and technology, but should focus on the developing country’s own technological capability. Moreover, the development of such industries should not be geared solely to exports; there should also be a domestic market for the merchandise produced. In addition, it is important to create upstream and downstream linkages between high-technology and supporting domestic industries. This very much applies to the services sector which continues to be paid scant attention compared to traditional manufacturing.
**Human resources**

The fact that the supply of unskilled and semi-skilled workers is almost unlimited in China implies that the country may enjoy a comparative advantage in labour-intensive industries for a long time to come. However, the experiences of the Asian crisis economies’ show that a rapidly industrialising economy can lose its comparative advantage in labour-intensive industries prematurely. This can occur when labour cost increases reduce the competitiveness of labour-intensive industries, prior to a country’s attaining comparative advantages in other, more capital- and/or knowledge-intensive industries. This appears to be what happened in some of the Asian crisis economies. Their experience suggests that it is important for China to strike a healthy balance between the development of labour-intensive and high-technology industries. This appears to be feasible for China in light of the diversity of its labour force, which includes a sizeable number of well-educated workers as well as the much larger numbers of low and semi-skilled workers.

As China continues to develop and becomes increasingly outward-oriented, its international competitiveness will depend on the quality of its human resources. While impressive gains have been made in the development of human resources over the past several decades, progress has steadily slowed in recent years, with the school dropout rate rising in certain regions and rural areas. The situation has been caused by increasing inequalities in income, limiting educational opportunities for the poor, and by a deterioration in the quality and capacity of the education system. This deterioration reflects a deficiency in the level of resources devoted to education, and the insufficient priority placed on educational issues (Hossain, 1997). Indeed, China has lagged behind countries such as Korea, Malaysia and Thailand in terms of the relative number of students in higher education. Yet, according to the World Bank (1999), tertiary education would be the most directly relevant to building knowledge for a knowledge-based society. Since investment in education is long-term in nature, with a time lag of some 15 years between the investment and perceivable results, it is critical for China to raise the priority of education policy, with a view to improving the quality, structure and accessibility (to different income groups) of its education system.

In summary, as has been pointed out above, China possesses a number of favourable conditions compared to other Asian economies, which may facilitate addressing its structural weaknesses. The vast size of China’s economy, the diversity of its resources, and the huge potential of the domestic market would seem to provide China with the opportunity of developing a highly diversified industrial structure, consisting not only of labour-intensive production, but encompassing a wide spectrum of industries, including high-technology industries, in order to capitalise on the diversity of its resource base. The resulting industry structure should be less dependent on export markets, which, coupled with the wide diversity of its exports, would limit China’s vulnerability in international markets. However, as discussed above, China faces a number of challenges. In particular, its huge, ailing SOE sector, with its resistance to change, its weak banking sector and its underdeveloped financial market, represent added challenges. Indeed, the outcomes of the SOE and financial reforms will, to a large extent, determine whether China will succeed in overcoming its structural weaknesses.

**Conclusion**

There are signs that the Chinese Government is directing increasing attention to structural issues, and policies are being implemented to address them. These will target over-capacity, the reform of the SOEs, the promotion of SMEs and the development of the IT and high-technology sectors. Although the government has called for a comprehensive strategy of restructuring and technological upgrading,
there remain risks that the state will continue to attempt to address these weaknesses through industry targeting and the fostering of large conglomerates.

The pace of reform slowed in 1998 as concerns about unemployment mounted, but has since intensified in recognition of the importance of establishing enterprises that are internationally competitive. Accession to the WTO makes the restructuring even more important, as the Chinese market will become more open to foreign competition. However, much remains to be done to obtain an economy that is more adaptive and responsive to market conditions.
Chapter 6

CORPORATE FACTORS IN THE CRISIS: THE KOREAN SITUATION

Corporate factors

We have seen that the corporate sector expanded dramatically with the growth process in East Asia, but that its development became associated with various deficiencies, including over-investment and the failure to restructure in a direction in line with conditions for competitiveness. There was also a dichotomy as regards the treatment of large and small firms. These problems partly emanated from misguided industrial and other policies. However, as has also been discussed above, there are important issues with respect to the functioning of the corporate sector itself.

Many of the recent problems encountered in the Asian region are related to specific aspects of the system of corporate governance - the rules and practices designed to overcome the information and incentive problems inherent in large enterprises. While the separation of ownership and control poses a problem to all but the simplest of organisations, this conflict can be mitigated by an effective corporate governance framework. The Asian financial crisis amply demonstrates, however, the difficulties that can arise when corporate governance practices stumble. In an era of increasingly global financial markets, insufficient corporate transparency, for example, allowed firms to expand at the expense of long-term viability and encouraged over-investment in key industries in the region. Rectifying fundamental weaknesses in corporate governance will be crucial to the prospects for truly successful structural reform, based on a more responsive corporate sector.

The following discussion focuses on Korea, in particular, but the underlying structural problems of other economies affected by the crisis, notably Indonesia, Malaysia and Thailand, display considerable similarities. The scope of the discussion is expanded, where appropriate, to incorporate the experiences of other countries in the region.

The Korean case

In 1997, Korea experienced one of the worst financial crises ever to have occurred in an OECD country. Systemic factors allowed large conglomerates (the chaebol) to rapidly expand their debt-financed investments, while the lack of corporate transparency masked the full extent of their credit obligations. This resulted in a highly-leveraged corporate sector, overlapping investments and, inevitably, excess capacity in key Korean industries as well as declining profit levels.

In the 1950s, the then poorly performing Korean economy was characterised by multiple exchange rates, one of the highest rates of inflation in Asia coupled with one of the lowest saving rates, restrictive import licensing and a severely imbalanced external account (Kreuger, 1998). After an initial period in which Korea attempted to stimulate growth by expanding production of import substitutes, rapid development was achieved only once it had been recognised that these policies had
failed in their objective. In order to ensure high economic growth, Korea moved to integrate more fully with the international economy. Resources were directed away from the high-cost production of import substitutes, to high-return export-oriented activities where the benefits in terms of economic growth promised to be much higher.

This change of strategy encouraged a “virtuous circle” (Kreuger, 1998). While the higher returns achieved by exporters led to a rapid expansion of export production, the resulting increase in savings allowed Korea to invest in vital infrastructure, primarily in order to further facilitate the exporting function, but also helping to boost the economy as a whole. In Korea, the authorities relied on the chaebol as the primary drivers of industrial development and economic growth and they soon became widely prevalent throughout the economy. For example, by 1996, 83 of the 100 largest firms in the Korean manufacturing sector belonged to the 30 largest chaebol which, in turn, accounted for nearly 15% of Korean GDP. In the past, the chaebol have been able to maintain a favourable relationship with the Korean Government; this has been a contributing factor in their rapid growth.

In order to maintain overall control, the chaebol relied heavily on debt finance to fund their investment programmes with the result that, throughout much of the corporate sector, debt-equity ratios in Korea have been exceptionally high. This tendency towards high leverage has been somewhat intensified by the government’s role as insurer or underwriter to large investment projects, encouraging banks to take out loans and then bailing them out should they turn bad. With the liberalisation of controls on overseas borrowing, there was a sharp rise in Korea’s foreign debt to US$162 billion, much of it short-term. Following the terms-of-trade shock in 1996, there was a string of insolvencies among the major chaebol in 1997. The serious impact on Korea’s economy, particularly in the banking sector, in the context of the financial turbulence in Asia, led foreign financial institutions to refuse to roll over their loans to Korea, precipitating a foreign exchange crisis at the end of 1997.

The 1990s saw massive inflows of capital into the Asian region, attracted by the expectation that the relatively high Asian growth rates would continue into the future, allowing banks to rapidly increase their lending to the private sector. For example, in 1996, domestic credit in Malaysia expanded, as a percentage of GDP, at an annual rate of more than 22%. Similarly, between 1993 and 1997 domestic credit in Thailand expanded at an average rate of around 20% a year. During the same period, credit expansion in Korea was at the lower, but still significant, rate of about 10%. Much of this debt, in effect, became directed towards the build up of speculative pressures in asset markets. While in the short run higher asset prices allowed borrowers to provide collateral for further loans, there was increasing vulnerability as asset prices fell when the credit boom ended.

When domestic credit expands rapidly, lenders are less able to properly evaluate loan applications. In this way, the lower quality of investments leads to a lower real rate of return on investment. Because much of the debt was short-term and denominated in foreign currency to take advantage of lower interest rates abroad, the economies of the Asian region were exposed to increasingly higher levels of risk. Exacerbating this situation, the commitment to a pegged exchange rate seemed to provide an unwarranted measure of security, protecting borrowers from the need to hedge their debts against foreign exchange risk.

The problems in the financial sector were further worsened by moral hazard problems in the corporate sector created, in part, by government promises of a bail-out, should circumstances change. This encouraged firms to over-invest, directing resources to projects with a higher risk than would have otherwise been the case. When the Asian bubble began to burst, it quickly became clear that existing investment projects were likely to be less profitable than was originally anticipated, resulting in a huge quantity of foreign debt that could not easily be repaid.
The role of corporate governance

By aligning the interests and objectives of managers with those of investors, corporate governance helps shape industrial organisation as well as the mechanisms for allocating funds for investment. In most countries this is supported by the adoption of an institutional and legal framework which determines the allocation of the residual rights of corporate control. However, the means by which this is attained vary widely across countries. In this regard, the corporate governance arena is currently divided between two theoretical extremes, although in practice many countries fall somewhere in between. On the one hand, there are the so-called outsider systems, typical of the United States and the United Kingdom, where share ownership is relatively diffuse and turnover high. These tend to foster a more open and equitable distribution of information. Critics argue, however, that the focus in this type of system can be excessively short-term, reducing overall investment to a level lower than is considered efficient.

Contrasting this is the insider model of corporate governance, which is often associated with the practices prevailing in Japan. Here, the focus is more on building longer-term relationships with at least some of the main stakeholders of the organisation, thereby encouraging greater trust, loyalty and commitment among the various parties. The continuous nature of the relations between these groups, including banks, the workforce, contractors and clients, promotes greater investment in firm-specific assets. However, while undoubtedly closer knit, this system can often be to the detriment of smaller shareholders who may find themselves excluded from the core group.

There are broadly three types of mechanisms which may minimise the agency costs arising from the separation of ownership and control (OECD, 1996b):

- To directly induce managers to carry out efficient management, for example, by means of executive compensation plans.
- To use indirect means of corporate control such as that provided by capital market discipline, for example, through an active take-over market.
- To give more power to shareholders, creditors, institutional investors or other stakeholders by enhancing their institutional rights so that they are better able to monitor the management of those firms in which they have a vested interest.

In the Korean context, however, these mechanisms were deficient or sometimes even non-existent. In this way, governance of the chaebol, Korea’s widely diversified business groups, became subject to major weaknesses. Among other things, the chaebol owners accumulated an excessive stock of debt, much of it short-term, which resulted in excess capacity in some industries, falling prices and declining profits. Relatively little attention was paid to profitability, and the chaebol soon figured among the least profitable organisations in the region. The behaviour and relatively low profitability of the corporate sector in other countries affected by the crisis were rooted in similar, if not identical, issues.

From a corporate governance perspective, the role of financial institutions in Korea has been comparatively modest. While the monitoring of the corporate sector by financial institutions can exert a powerful force on firm management, institutional holdings in Korea are comparatively low. Indeed, in 1997, the combined holdings of all types of financial institution were only 20% of all outstanding shares in listed companies. Of these, commercial banks were the most important group, with holdings of about 10%, a relatively low figure from an international perspective. After the commercial banks, the next most important group consists of the insurance companies, with holdings of about 6% of
shares but, again, when compared with other countries, this figure is low. In addition, collective investment institutions such as pension funds do not exist, and mutual funds have only been allowed since 1998.

The commercial banks, which were largely privatised in the early 1980s, remained subject to a high degree of government influence and suffered from ineffective corporate governance. Due to ownership restrictions, the share ownership of banks is diffuse and there are generally few shareholders. As a result, the government has been able to exert immense pressure on banks and to direct much of their lending activities, often on the basis of political whim rather than a proper evaluation of risk. In addition to the relatively small proportion of share ownership accounted for by the financial institutions, the monitoring role typically exercised by institutional investors has been weakened by two additional factors. First, the control rights attached to a large portion of the shares of the conglomerates are exercised by securities houses attached to the chaebol. Second, and more importantly, shareholder control has been severely limited by regulations obliging financial intermediaries to vote with other shareholders on most issues.

There are other governance agents in addition to the financial institutions but in most cases the effectiveness of these groups has been limited. In this way, private investors form the most important investor group in Korea, accounting for approximately 40% of share ownership in 1997 but, within this investor class, the turnover of ownership is high (80%), indicating short time horizons. The exercise of corporate governance is often associated with the role played by the board of directors. The independent judgement of non-executive directors, in particular, can be crucial in areas such as audit and executive remuneration. However, in the period leading up to the crisis, the practice of electing “outsiders” to the board was not common in Korea. In addition, the role played by foreign investors in corporate governance terms has been limited by legal restrictions on foreign investment as well as by the business culture and business tradition inherent to the Korean stakeholder model of corporate governance and foreign direct investment in Korea.

In summary, while closer monitoring by independent stakeholders can exert a powerful influence on managerial behaviour, both financial institutions and boards of directors in Korea lacked the proper incentives to play anything more than fairly modest governance roles. Coupled with the lack of an active market for corporate control, these factors allowed the comparatively low levels of corporate profitability to continue relatively unchecked.

The process of corporate reform

Improving the standards of corporate governance in response to the crisis should help to provide the necessary institutional framework for the restructuring of the corporate sector. The financial crisis has prompted the governments of the worst-affected Asian countries to strengthen existing corporate governance practices (Box 11). In Thailand, for example, corporate governance reform is being promoted by enhancing the regulatory framework and by the release of a code of best practice for the directors of listed companies. In Malaysia, the government has reacted by strengthening laws relating to shareholder and creditor rights, in an effort to enhance corporate transparency, and by attempting to develop awareness by Malaysian boards of directors of their corporate governance responsibilities.

The election of a new leader has helped the Korean Government push for a total reform of the economy based on the “free market paradigm”, to replace the authoritarian approach of the past. This paradigm requires rehabilitating the financial sector as well as reforming the labour market and restructuring the highly indebted corporate sector. The fundamental direction for the reform of the corporate sector entails strengthening the priority attached to both shareholder value and corporate
transparency as well as improving market discipline. Since they played such a significant role in the onset of the crisis, the reform process is to initially focus on the chaebol. Emphasis has further been placed on reducing the levels of debt and capacity in the corporate sector, promoting exit mechanisms for non-viable firms and enhancing the monitoring mechanisms of various governance agents, both internal and external to the firm.

**Box 11. Corporate factors in other Asian economies**

**Thailand**

Corporate governance reform in Thailand is being promoted by improving disclosure and transparency, strengthening the rights of minority shareholders and enhancing the monitoring of listed companies. In addition, the government has undertaken measures to broaden the role of the private sector and increase the efficiency of the Thai economy.

In order to improve disclosure, the government intends to develop accounting standards that are consistent with international best practice. In order to speed up this process, the Institute of Certified Accountants and Auditors of Thailand has been converted into an independent self-regulating organisation. In addition, the Stock Exchange of Thailand (SET) has announced that the financial statements of those companies whose assets exceed 1 million baht must be prepared in line with International Accounting Standards. With the aim of improving the effectiveness and monitoring role of the board of directors, the SET recently issued a code of best practice for the directors of all listed companies, and listing regulations now require that all boards should include at least two independent directors. Audit committees will be mandatory by the end of 1999.

The legal and institutional framework for voluntary corporate debt restructuring has been progressively strengthened, notably through the introduction of initiatives for invoking inter-creditor and creditor-debtor mediation and arbitration. The Corporate Debt Restructuring Advisory Committee has been established, chaired by the Bank of Thailand and made up of experts in this field. This programme has achieved important results, with about 70 cases having been successfully restructured by the end of 1998. Nevertheless, there is a growing realisation that the process of debt restructuring needs to be accelerated and the reform of bankruptcy laws has been recognised as a key element of this approach.

**Indonesia**

A series of structural reforms have been implemented to improve the efficiency and transparency of the Indonesian economy. In particular, the privatisation programme has been expanded and the procedures for foreign direct investment streamlined. In addition, restrictions on debt-equity conversions have been lifted and accounting and auditing rules improved. In this regard, the Accountancy Development Project of 1998 was set up to develop accounting standards that are consistent with international best practice. Steps have also been taken to improve the governance and supervision of banks.

The monitoring of the corporate sector has been strengthened by improvements to the underlying institutional infrastructure. New regulations have been implemented to clarify the rights and responsibilities of shareholders and the effectiveness of the board has been enhanced by measures designed to impose harsher penalties on board directors. In addition, in an effort to improve investors’ access to information, Indonesia’s securities regulator is currently reviewing possible regulatory changes to improve corporate governance practices. This may include measures to expand the role of independent directors on company boards as well as the wider use of audit committees.
The Jakarta initiative, launched in September 1998, is intended to provide a framework for out-of-court negotiations between creditors and debtors. The aim of this programme is to facilitate the active restructuring of the corporate sector. Important results have been achieved, with more than 100 companies having registered with the Jakarta initiative, representing about 20% of outstanding private sector debt. In addition, a considerably revised bankruptcy law came into effect in August 1998. The aim of this legislation is to ensure that bankruptcy proceedings are both efficient and transparent, and that they provide greater protection for debtors’ assets, while, at the same time, limiting the ability of secured creditors to foreclose during the proceedings and thus reducing the potential for renegotiation. In this regard, improving bankruptcy procedures is recognised as a key element in enhancing the incentives of creditors to agree to a voluntary restructuring of debt without having to resort to formal legal proceedings.

Malaysia

A range of policies, designed to improve the efficiency of the economy and strengthen corporate governance practices, have been introduced by the Malaysian Government. These measures involve strengthening the laws protecting shareholder rights, enhancing disclosure and corporate transparency, increasing the effectiveness of the board of directors and ensuring the enforcement of all relevant laws.

In order to prevent the abuse of minority shareholders by controlling shareholders and other insiders, the Companies Act 1965 is to be revised with the intention of reducing ownership concentration and increasing the reliance of companies on external finance. Accounting, auditing, financial reporting and disclosure standards have also seen recent significant improvements. The revision of these existing standards as well as the enforcement of the fiduciary responsibilities of board directors, allow investors to increase their reliance on the markets.

A Corporate Debt Restructuring Committee was established in August 1998 to provide a framework that enables creditors to negotiate with debtors on a voluntary basis, without resorting to formal bankruptcy proceedings. The next step is to develop credible, transparent and consistent guidelines to increase the incentives for voluntary participation in the process. In addition, an asset management company, Danaharta, was established in 1998 to acquire non-performing loans from banks and assets from distressed companies, in order to accelerate the legal process and minimise the problems associated with a credit crunch.


By frequently intervening to assist business groups on the verge of bankruptcy, the government stifled the operation of a well-functioning exit market. The too-big-to-fail policy of the government had the effect of dramatically reducing the exposure of the chaebol to downside risk. This created a serious moral hazard problem. Coupled with a tendency for chaebol owners to focus on growth at the expense of overall profitability, government intervention made it possible for the chaebol to diversify into areas where they had little experience, and without regard for adequate return. According to a study released by Booz-Allen & Hamilton, the top-three chaebol in 1997 had accumulated well over 100 subsidiaries between them, although much of the profit came from no more than one or two companies within each group. In order to correct these problems, the government has now adopted a policy of no longer standing in the way of chaebol bankruptcies.

Despite legal restrictions, it has been a common practice for chaebol subsidiaries to extend loans to other companies within the same group. Since the onset of the Asian crisis, this practice has had the effect that the failure of one subsidiary is enough to bring down an entire group. In addition, cross-debt guarantees, whereby the debts of one firm are underwritten by another in the same group, have had similar spillover effects. In an effort to reduce the impact and reach of future insolvencies, the
chaebol are now required to eliminate their existing cross-debt guarantees by the year 2000, and have been prohibited from issuing new guarantees as from April 1998. In order to discourage debt financing, as from the year 2000 the government has ruled that interest payments on excessive borrowing will no longer be deductible from taxable income. In addition, since in the period leading up to the crisis, unconsolidated accounts allowed firms to mask both the scale of their debt as well as the lack of profitability, beginning in 1999 the chaebol are now required to prepare combined financial statements that more accurately reflect their true widely diversified nature. In addition, new accounting and auditing rules are to be set in line with internationally accepted standards.

The monitoring role played by institutional investors has been enhanced by the elimination of all voting right restrictions in June 1998. The “shadow voting” principle, in particular, which required financial intermediaries to vote with other shareholders on nearly all issues, has now been abolished. In addition, several measures have been adopted to improve the rights of minority shareholders. In particular, the reduction of minimum holding requirements for class action suits from 1% to 0.01% should provide more minority shareholders with access to legal redress against inefficient management and, in addition, the introduction of a cumulative voting system should increase the representation of minority shareholders on the board of directors.

The responsibility of company directors has been one of the weakest links in the Korean corporate governance system, with the law failing to reflect the true decision-making base within the core of the chaebol. For this reason, proper accountability has been lacking. To address this problem, the law is to be revised so that controlling shareholders are recognised as de facto directors. Moreover, all listed companies are now required to establish committees for selecting external auditors and must appoint at least one outside director to the board. A new regulation, effective from the year 2000, will require that at least one-quarter of the board be made up of outside directors.

One of the main objectives of the reform process, including the reforms of the financial system, the corporate sector and the labour market, has been to create a new environment for foreign investment. Although a market for corporate control acts as a powerful disciplinary device on the management of a firm, in Korea, hostile mergers and acquisitions (M&As) were more or less prohibited. However, the government has recently opened up the capital market and fully liberalised all forms of M&A, including hostile take-overs.

Since the mid-1980s, it has been a major government objective to reduce the concentration of economic power in Korea. The Asian crisis has served to strengthen the government’s resolve in this area, and the chaebol have been urged to focus on their core business activities, eliminating all non-viable businesses. While bankruptcy laws previously provided weak incentives to both debtors and creditors to initiate insolvency proceedings, in February 1998 legal procedures relating to corporate rehabilitation and bankruptcy filing were simplified to facilitate rulings on the exit of non-viable firms and to ensure better representation of creditor banks in the resolution process. In effect, the improved procedures reduced the complicated steps that had previously been required for exit procedures.

In May 1988, creditor banks established a formal review committee to assess the viability of 313 client firms showing signs of financial weakness. Upon completion of this assessment, 55 firms were listed as non-viable. Thus far, 25 have been liquidated, 15 sold, eleven merged and four put into court receivership. Out of those so classified, 20 corporations were affiliated with the five largest business groups. To facilitate the exit of these non-viable corporations, their banks have been prevented from extending new credit, and financial assistance within business groups has been prohibited.

In early September 1998, the top-five chaebol leaders announced plans, the so-called “Big Deals”, for the restructuring of key industrial sectors through mergers and business swaps. The objective of this
exercise was to encourage firms to streamline their activities and focus on core competencies. In time, this should reduce the tendency for overlapping investments and alleviate the problem of over-capacity, a notable feature of key Korean industries prior to the crisis. In December 1998, the leaders of the five largest chaebol reached an agreement on nine key industries, these being automobiles, electronics, semiconductors, petrochemicals, aerospace, rolling stock manufacturing, power plant equipment, vessel engines, and oil refining.

Overcoming barriers to corporate reform

In spite of the Korean Government’s steadfast commitment to the programme of economic reform on all fronts, the implementation of change has been hampered by the resistance of key players in the economy. It would appear that the government has been making more progress in its reform of the financial sector than in the restructuring of the corporate sector. However, since so many of the problems of the financial sector derive from those affecting the corporate sector, an effective transformation of the financial sector will prove difficult without adequately resolving the chaebol issue. While there is widespread recognition that successful reform is required before the Korean economy can fully recover, there are still many obstacles to be overcome.

The chaebol, and in particular the top-five, have resisted restructuring. Although these business groups have been credited with being the driving force behind much of Korea’s rapid economic development, there is now an appreciation that they must undertake radical reform. However, the chaebol’s share of the economy has actually grown since the onset of the crisis. In an effort to defend their holdings, the chaebol in fact increased their level of debt during the summer of 1998. In order to prompt the chaebol into action, the government has viewed it as necessary to threaten them with a credit squeeze.

Encouraging greater concentration in core activities has been an important objective of government policies towards the chaebol. The “Big Deals”, in particular, aim to eliminate excess capacity and consolidate duplicate investments – which should result in significant economies of scale. However, the creation of duopolies in eight industries will increase industrial concentration, raising concerns for the level of competition. In order to maintain competitiveness, the government should ensure that these markets are open to foreign products. Furthermore, strict enforcement of the Fair Trade Act should prevent collusion among the remaining producers.

The reform process has also met with some resistance from the unions. In the past, a job in Korea was considered to be for life and so the concept of “downsizing” is anathema to the vast majority of Korean workers. Furthermore, as the reforms filter through the economy, the unemployment rate has started to rise. Widespread structural reform of the corporate sector, requiring firms to streamline their business activities and focus on core competencies, seems to imply that yet more Korean workers will lose their current jobs. However, Booz-Allen & Hamilton found that about 10% of jobs in Korea are sustained only by restrictive barriers to entry and the longer the reform process is delayed, the higher this figure is likely to climb. In 1998, the government increased its efforts to improve labour market flexibility with 120 000 workers being laid off and another 280 000 taking early retirement. Beyond this, however, it will be important to ensure greater labour market flexibility so that resources can be quickly reallocated to those areas in which they are most required. At least in the short term, higher unemployment appears to be an inevitable consequence of structural reform. The government needs to review unemployment benefits and social safety nets more broadly, so as to raise labour support for the restructuring process as well as to mitigate the social costs, with a view to keeping incentives in line with a well-functioning labour market.
Even the civil service feels threatened by the reform programme. The move away from the authoritarian approach of the past towards conditions closer to a free market system requires that government bureaucrats embrace a new way of thinking and it remains to be seen whether this will be possible. Wider society in Korea has also yet to become fully acclimatised to a rapidly changing world; this is likely to take some time.

Both portfolio and foreign direct investment (FDI) have made significant gains in Korea since the onset of the crisis, albeit from a comparatively low base. However, while foreign investment now exceeds pre-crisis levels, the response by foreign investors to this newly emerging environment was initially rather slow (1998c). There are three major reasons for this. First, given the depth and scale of the crisis, it is likely that investor confidence could be restored only slowly. The herd mentality that prompted investors to withdraw from the region in the first place also operates in reverse. Second, economic reform is still in the early phase, rendering the prospects for the economy rather uncertain and, as a result, foreign investors have proved reluctant to enter the market. Third, inward direct investment, and particularly acquisitions by foreign firms, remain complicated by special features of the corporate governance system in Korea and several other Asian countries, including the strong involvement by multiple stakeholders in the control of firms. The lack of transparency is also an issue in this regard. The absence of cross-debt guarantees from financial reports and the prevalence of off-sheet liabilities can both serve as deterrents to foreign firms.

By focusing on the larger firms capable of delivering Korea’s export-oriented growth strategy, industrial policy until now has overlooked the importance of SMEs. These firms play an important role in innovation and the application of new technology as well as being a major source of job creation and overall labour market flexibility. Indeed, in many OECD countries, the existence of a dynamic SME sector has made possible the development of new industries and new market niches. There are signs of positive results. The rate of new firm start-ups in April 1999 was higher than in (pre-crisis) April 1997. With prospects improving, there are also indications that conditions for SME access to equity capital have improved.

However, Korean SMEs have been hard hit by the crisis. The banks have been forced to reduce their lending and it is mainly the larger firms that have been successful in attracting new finance. In the wake of the crisis, there have been delays in receiving payment from the larger firms for subcontracted work. As a result, SMEs accounted for a disproportionately large share of the rise in bankruptcies in 1998.

The government has responded with a variety of measures. In May 1998, a special task force was set up in each bank with responsibility for analysing the situation of small firms. Out of more than 36,000 firms considered, 95% were successful in having loans maturing by December 1998 rolled over. This should help to alleviate the credit crunch. The government has also provided direct assistance, guaranteeing loans worth 34 trillion won for small firms in 1998. Additional support has been provided through a number of programmes, including the Creation of Small Enterprise Fund, the Technology Credit Guarantee Fund and the Enterprise Promotion Fund for Software. The Central Bank has also contributed to this effort by changing its criteria for setting credit ceilings in order to encourage the banks to increase their support to small firms. In addition, a World Bank loan of US$3.4 billion has been used to help small firms obtain letters of credit to import raw materials.

Even before the onset of the crisis it had become clear that rising labour costs had eroded Korea’s competitiveness in labour-intensive industries. At the same time, notwithstanding large investments in human capital and research and development, it had become equally apparent that Korea still faces fundamental problems in competing with more established industrialised countries in the development of new technologies.
While the chaebol have excelled in the absorption and effective exploitation of existing technologies, weaknesses have become apparent in the ability to develop new technologies. Moreover, an increasingly competitive Korean economy has been confronted with more and more comprehensive strategies in other firms and countries to impede such transfers of technology. Under these circumstances, a competitive position in an increasingly knowledge-based economy would seem to require that Korean firms upgrade their ability to innovate.

By entering new market niches, adopting new technologies and applying less rigid employment practices, new and small firms typically play a vital role in providing economic flexibility and dynamism to the overall economy. In contrast, larger firms, as a result of their greater financial power but also owing to lock-in effects as regards already developed technologies and skills, often lack the incentives to adapt to shifting and sometimes disruptive economic circumstances. In this way, the absence of a thriving SME sector reduces the flexibility and dynamism of the overall economy.

Coupled with the presence of strengths in the adoption and use of existing technologies rather than an effective interplay between science and industry and more radical innovative capacity, the Korean system of corporate governance has promoted marginal improvements but diminished the capacity of industry to identify the need for more dramatic changes in direction. Related to this, the pervasiveness of government has tended to lessen the management skills that should lie in business rather than in bureaucracy. While such gaps in a nation’s skills base can be bridged in part by inward direct investment, barriers to foreign acquisitions have limited this type of input in Korea. Thus, the strategy designed to drive economic growth in Korea, despite its manifold success, helped to foster an economic climate of resistance to pressures for more deep-seated change. It is vital for the future that the current reform process should succeed in building the basis for greater responsiveness in industry.

Conclusions

The Korean Government has responded to the crisis by pushing for extensive reform of the economy. This involves rehabilitating the financial sector as well as enhancing the framework for corporate governance. However, there has been considerable resistance from key players within the economy and a number of obstacles remain. Securing the credibility of new policy efforts and the continued feasibility of reforms, will require that the government engage the various relevant stakeholders in the policy-making process. Broad-based participation of the private sector as well as other key players in the economy is important for transparency and can help in building support for the difficult measures required before the economy can fully recover. Without a full commitment to reform by these various groups, there is the very serious risk that essential reforms may fail as a result of a political impasse. Moreover, encouraging the wider representation of different economic interests in the policy debate not only enhances the formulation of new policies but also ensures that the government is well informed about what measures are most in need of attention.

The real test of the reform process is the extent to which it can elicit a major change in the behaviour of the various stakeholder groups that make up Korean society, including the chaebol and the unions. There are also questions as to whether the “free market” paradigm will filter down to the front line of the civil service and, in addition, whether the workforce can make the necessary adjustments to new, and sometimes painful, labour-market conditions. Furthermore, if managerial incentives are to adequately reflect the principle of maximising shareholder value, the other main stakeholder groups must learn to scrutinise more closely the businesses in which they have a vested interest.

As the Korean Government continues to make headway in its restructuring of the corporate sector, the overall outlook for the economy has seen a remarkable revival. So much so, in fact, that at the
beginning of 1999, Korea became the first country affected by the crisis to be upgraded to the “investment grade” category used by credit-rating agencies. By June 1999 the Korean won had recovered 75% of its value, after the massive depreciation at the end of 1997. In addition, the stock market has continued to rise since the start of the year, following similar gains at the end of last year, and has now reached its pre-crisis level. In response, the OECD has revised its projection for GDP growth in 1999 to 4.5%, up from 1% earlier last year.

In spite of this renewed optimism, Korea continues to face difficult problems and the recovery process remains fragile. Many of the right policy initiatives have been launched, but the depth and scale of the crisis have taken a heavy toll, and the nature of the structural issues embedded in the corporate sector mean that the establishment of a more responsive economy is likely to take time. Overcoming the barriers to reform and advancing mechanisms for corporate restructuring and adjustment will be crucial for sustainable recovery. Until this gains further momentum, there will be limitations to the internal dynamism of the economy and a continued vulnerability to external shocks.
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ANNEX 1. STATISTICAL TABLES

Annex Table 1. Size of selected Asian economies

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Annex Table 2. Long-term structural change in selected Asian economies

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<th>Agriculture value added as a % of GDP</th>
<th>Labour force in agriculture, as a % of total labour force</th>
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<th>Central government revenue as a % of GDP</th>
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1. Shares of GDP.
2. Revenue of governments of all levels.
### Annex Table 3. Structure of output of selected Asian economies

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<th></th>
<th>Gross Domestic Product US$ million</th>
<th>Agriculture value added as a % of GDP</th>
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1. Shares of GDP.  

### Annex Table 4. Growth in output of selected Asian economies

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**Benchmarks for comparison:**  

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### Annex Table 5. Education and S&T statistics 1980-96

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1. Average of males and females. 2. Researchers, 1985-95. 3. Average, 1985-95.


### Annex Table 6. Royalty and licence fees and patent applications 1990-95

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<td>7.7</td>
<td>7.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>-5.0</td>
<td>0</td>
<td>-4.5</td>
<td>1.5</td>
<td>-4.0</td>
<td>-1.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>-15.0</td>
<td>--</td>
<td>-15.5</td>
<td>-3.0</td>
<td>-13.5</td>
<td>-3.9</td>
</tr>
<tr>
<td>Korea</td>
<td>-7.0</td>
<td>-1.0</td>
<td>-6.5</td>
<td>0.5</td>
<td>-6.0</td>
<td>0.6</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-6.4</td>
<td>--</td>
<td>-4.7</td>
<td>-0.5</td>
<td>-4.1</td>
<td>-0.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>-0.6</td>
<td>--</td>
<td>-0.5</td>
<td>2.0</td>
<td>0.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.0</td>
<td>0.2</td>
<td>0.0</td>
<td>0.5</td>
<td>0.3</td>
<td>2.1</td>
</tr>
<tr>
<td>Chinese Taipei</td>
<td>4.0</td>
<td>3.9</td>
<td>4.5</td>
<td>4.0</td>
<td>5.2</td>
<td>5.4</td>
</tr>
<tr>
<td>Thailand</td>
<td>-8.0</td>
<td>--</td>
<td>-7.0</td>
<td>2.0</td>
<td>-6.8</td>
<td>0.9</td>
</tr>
<tr>
<td>World</td>
<td>2.0</td>
<td>2.5</td>
<td>2.0</td>
<td>2.1</td>
<td>1.9</td>
<td>2.5</td>
</tr>
<tr>
<td>Industrialised economies</td>
<td>2.3</td>
<td>2.0</td>
<td>2.2*</td>
<td>1.7*</td>
<td>2.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Germany</td>
<td>2.6</td>
<td>2.5</td>
<td>2.7</td>
<td>2.2</td>
<td>2.4</td>
<td>2.2</td>
</tr>
<tr>
<td>Japan</td>
<td>-2.5</td>
<td>0.5</td>
<td>-2.6</td>
<td>0.2</td>
<td>-2.4</td>
<td>0.4</td>
</tr>
<tr>
<td>United States</td>
<td>3.5</td>
<td>2.0</td>
<td>3.5</td>
<td>1.5</td>
<td>3.4</td>
<td>2.4</td>
</tr>
</tbody>
</table>

* = all OECD Member countries.  

### Annex Table 8. Annual wages in manufacturing and rates of increase 1985-90 and 1990-94

<table>
<thead>
<tr>
<th></th>
<th>1985 (US$)</th>
<th>1990 (US$)</th>
<th>1994 (US$)</th>
<th>1985-90 (%)</th>
<th>1990-94 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>286</td>
<td>317</td>
<td>340</td>
<td>2.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>4 808</td>
<td>9 161</td>
<td>15 160</td>
<td>13.8</td>
<td>13.4</td>
</tr>
<tr>
<td>Indonesia</td>
<td>921</td>
<td>674</td>
<td>1 001</td>
<td>-6.1</td>
<td>10.4</td>
</tr>
<tr>
<td>Korea</td>
<td>3 476</td>
<td>9 353</td>
<td>14 295</td>
<td>21.9</td>
<td>11.2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3 375</td>
<td>3 240</td>
<td>4 555</td>
<td>-0.8</td>
<td>8.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>1 257</td>
<td>1 802</td>
<td>2 857</td>
<td>7.5</td>
<td>12.2</td>
</tr>
<tr>
<td>Chinese Taipei</td>
<td>3 832</td>
<td>9 826</td>
<td>14 469</td>
<td>20.7</td>
<td>10.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>2 392</td>
<td>3 522</td>
<td>4 917</td>
<td>8.0</td>
<td>8.7</td>
</tr>
</tbody>
</table>

### Annex Table 9. Hourly labour costs in apparel manufacturing and rates of wage increase

<table>
<thead>
<tr>
<th>Country</th>
<th>1990 (US$)</th>
<th>1993 (US$)</th>
<th>1995 (US$)</th>
<th>Percentage increase 1990-95</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>0.26</td>
<td>0.25</td>
<td>0.25</td>
<td>-0.8</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>3.05</td>
<td>3.85</td>
<td>4.32</td>
<td>7.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.16</td>
<td>0.28</td>
<td>0.33</td>
<td>15.6</td>
</tr>
<tr>
<td>Korea</td>
<td>2.46</td>
<td>2.71</td>
<td>3.29</td>
<td>6.0</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.56</td>
<td>0.77</td>
<td>1.59</td>
<td>23.2</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.46</td>
<td>0.53</td>
<td>0.72</td>
<td>9.4</td>
</tr>
<tr>
<td>Singapore</td>
<td>2.43</td>
<td>3.06</td>
<td>4.01</td>
<td>10.5</td>
</tr>
<tr>
<td>Chinese Taipei</td>
<td>3.41</td>
<td>4.61</td>
<td>5.18</td>
<td>8.7</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.63</td>
<td>0.71</td>
<td>1.11</td>
<td>12.0</td>
</tr>
</tbody>
</table>


### Annex Table 10. Average monthly exchange rates for Indonesia, Korea, Malaysia, the Philippines and Thailand, by specified periods, 1997 and 1998

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>2 403</td>
<td>7 630</td>
<td>68.5</td>
</tr>
<tr>
<td>Korea</td>
<td>877</td>
<td>1 212</td>
<td>27.6</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2.50</td>
<td>3.80</td>
<td>34.2</td>
</tr>
<tr>
<td>Philippines</td>
<td>26.33</td>
<td>39.05</td>
<td>32.6</td>
</tr>
<tr>
<td>Thailand</td>
<td>25.62</td>
<td>36.20</td>
<td>29.2</td>
</tr>
</tbody>
</table>

Source: Pacific Exchange Rate Service.

### Annex Table 11. Stock exchange indices in Indonesia, Korea, Malaysia, the Philippines and Thailand, by specified periods in 1997 and 1998

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>725</td>
<td>394</td>
<td>46</td>
</tr>
<tr>
<td>Korea</td>
<td>745</td>
<td>575</td>
<td>23</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1070</td>
<td>577</td>
<td>46</td>
</tr>
<tr>
<td>Philippines</td>
<td>2799</td>
<td>1969</td>
<td>30</td>
</tr>
<tr>
<td>Thailand</td>
<td>521</td>
<td>355</td>
<td>32</td>
</tr>
</tbody>
</table>

1. Opening quote in week beginning on indicated date.  
Source: Yahoo! Inc.
### Annex Table 12. Three-month interest rates in Indonesia, Korea, Malaysia, the Philippines and Thailand

<table>
<thead>
<tr>
<th>Country</th>
<th>April-June 1997</th>
<th>Highest average monthly rate (month attained)</th>
<th>Recent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>13.6</td>
<td>81.0 (Aug 1998)</td>
<td>44.4 (Dec 1998)</td>
</tr>
<tr>
<td>Korea</td>
<td>12.6</td>
<td>23.1 (Jan 1998)</td>
<td>7.7 (Dec 1998)</td>
</tr>
<tr>
<td>Malaysia</td>
<td>7.6</td>
<td>11.1 (Jun 1998)</td>
<td>6.7 (Nov 1998)</td>
</tr>
<tr>
<td>Thailand</td>
<td>11.7</td>
<td>19.3 (Jan 1998)</td>
<td>6.7 (Nov 1998)</td>
</tr>
</tbody>
</table>

1. Interbank rate.
2. CD rate.

Source: Bloomberg L.P., and official national statistics.

### Annex Table 13. Change in the volume of exports of Indonesia, Korea, Malaysia, the Philippines and Thailand during 1998

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>32.8</td>
<td>19.1</td>
</tr>
<tr>
<td>Korea</td>
<td>35.0</td>
<td>24.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Philippines</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Thailand</td>
<td>14.3</td>
<td>12.5</td>
</tr>
</tbody>
</table>

n.a. = not available.


### Annex Table 14. Aggregate imports and exports of Indonesia, Korea, Malaysia, the Philippines and Thailand, by specified period, 1996-98

<table>
<thead>
<tr>
<th>Period</th>
<th>Exports</th>
<th>Imports</th>
<th>Trade balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>334.0</td>
<td>385.1</td>
<td>(51.1)</td>
</tr>
<tr>
<td>1997</td>
<td>351.3</td>
<td>364.0</td>
<td>(12.7)</td>
</tr>
<tr>
<td>Jan-Oct:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>290.9</td>
<td>309.6</td>
<td>(18.6)</td>
</tr>
<tr>
<td>1998</td>
<td>279.9</td>
<td>208.5</td>
<td>71.4</td>
</tr>
</tbody>
</table>

Source IMF (1998a) and official national sources.
Annex Table 15. Imports to the G7 countries\(^1\) from Indonesia, Korea, Malaysia, the Philippines and Thailand, by commodity, 1996

US$ million

<table>
<thead>
<tr>
<th>Item (HS chapter and description)</th>
<th>1996</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>85: Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles</td>
<td>48 946</td>
<td>48 214</td>
</tr>
<tr>
<td>84: Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof</td>
<td>24 357</td>
<td>27 835</td>
</tr>
<tr>
<td>27: Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes</td>
<td>13 125</td>
<td>12 445</td>
</tr>
<tr>
<td>62: Articles of apparel and clothing accessories, not knitted or crocheted</td>
<td>6 229</td>
<td>6 153</td>
</tr>
<tr>
<td>44: Wood and articles of wood; wood charcoal</td>
<td>6 318</td>
<td>6 138</td>
</tr>
<tr>
<td>61: Articles of apparel and clothing accessories, knitted or crocheted</td>
<td>5 248</td>
<td>5 383</td>
</tr>
<tr>
<td>40: Rubber and articles thereof</td>
<td>5 901</td>
<td>5 174</td>
</tr>
<tr>
<td>87: Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof</td>
<td>4 040</td>
<td>4 611</td>
</tr>
<tr>
<td>03: Fish and crustaceans, molluscs and other aquatic invertebrates</td>
<td>4 440</td>
<td>4 094</td>
</tr>
<tr>
<td>64: Footwear, gaiters and the like; parts of such articles</td>
<td>3 862</td>
<td>3 473</td>
</tr>
<tr>
<td>90: Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof</td>
<td>2 931</td>
<td>3 106</td>
</tr>
<tr>
<td>94: Furniture; medical and surgical furniture; bedding, mattresses, mattress supports, cushions and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified; illuminated signs, illuminated name-plates and the like, etc.</td>
<td>2 867</td>
<td>2 870</td>
</tr>
<tr>
<td>71: Natural or cultured pearls, precious or semi-precious stones, precious metals, metals clad with precious metal, and articles thereof; imitation jewellery, etc.</td>
<td>2 243</td>
<td>2 425</td>
</tr>
<tr>
<td>16: Preparations of meat, fish or crustaceans, molluscs or other aquatic invertebrates</td>
<td>2 052</td>
<td>2 081</td>
</tr>
<tr>
<td><strong>Total, all merchandise</strong></td>
<td>167 110</td>
<td>168 396</td>
</tr>
</tbody>
</table>

1. Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Source: OECD, Trade database.
Annex Table 16. Exports from the G7 countries\(^1\) to Indonesia, Korea, Malaysia, the Philippines and Thailand, by commodity, 1996

<table>
<thead>
<tr>
<th>Item (HS chapter and description)</th>
<th>1996</th>
<th>1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>85: Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles</td>
<td>40 507</td>
<td>43 870</td>
</tr>
<tr>
<td>84: Nuclear reactors, boilers, machinery and mechanical appliances; parts thereof</td>
<td>42 744</td>
<td>37 899</td>
</tr>
<tr>
<td>87: Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof</td>
<td>11 912</td>
<td>9 511</td>
</tr>
<tr>
<td>90: Optical, photographic, cinematographic, measuring, checking, precision, medical or surgical instruments and apparatus; parts and accessories thereof</td>
<td>7 615</td>
<td>7 476</td>
</tr>
<tr>
<td>88: Aircraft, spacecraft, and parts thereof</td>
<td>4 689</td>
<td>7 399</td>
</tr>
<tr>
<td>72: Iron and steel</td>
<td>6 269</td>
<td>6 101</td>
</tr>
<tr>
<td>29: Organic chemicals</td>
<td>5 160</td>
<td>4 916</td>
</tr>
<tr>
<td>39: Plastics and plastic products</td>
<td>4 384</td>
<td>4 364</td>
</tr>
<tr>
<td>73: Articles of iron or steel</td>
<td>2 874</td>
<td>2 611</td>
</tr>
<tr>
<td>38: Miscellaneous chemical products</td>
<td>2 183</td>
<td>2 339</td>
</tr>
<tr>
<td>10: Cereals</td>
<td>2 958</td>
<td>1 648</td>
</tr>
<tr>
<td>28: Inorganic chemicals: organic or inorganic compounds of precious metals, of rare-earth metals, of radioactive elements or of isotopes</td>
<td>1 541</td>
<td>1 597</td>
</tr>
<tr>
<td>27: Mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes</td>
<td>1 921</td>
<td>1 559</td>
</tr>
<tr>
<td>48: Paper and paperboard; articles of paper pulp, paper or paperboard</td>
<td>1 607</td>
<td>1 481</td>
</tr>
<tr>
<td><strong>Total, all merchandise</strong></td>
<td>169 415</td>
<td>165 425</td>
</tr>
</tbody>
</table>

\(^1\) Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Source: OECD, Trade database.
Annex Table 17. G7\(^1\) trade with Indonesia, Korea, Malaysia, the Philippines and Thailand, 1997 and by specified period in 1998 – monthly averages

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>April-June</td>
<td>July-September</td>
</tr>
<tr>
<td><strong>Exports to five Asian countries:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>324</td>
<td>203</td>
<td>152</td>
</tr>
<tr>
<td>France</td>
<td>1 249</td>
<td>768</td>
<td>752</td>
</tr>
<tr>
<td>Germany</td>
<td>613</td>
<td>372</td>
<td>389</td>
</tr>
<tr>
<td>Italy</td>
<td>453</td>
<td>199</td>
<td>n.a.</td>
</tr>
<tr>
<td>Japan</td>
<td>6 176</td>
<td>3 650</td>
<td>3 570</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4 601</td>
<td>3 207</td>
<td>2 935</td>
</tr>
<tr>
<td>United States</td>
<td>626</td>
<td>337</td>
<td>299</td>
</tr>
<tr>
<td><strong>Total of above</strong></td>
<td><strong>14 043</strong></td>
<td><strong>8 737</strong></td>
<td>n.a.</td>
</tr>
<tr>
<td><strong>Imports from five Asian countries:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>452</td>
<td>444</td>
<td>503</td>
</tr>
<tr>
<td>France</td>
<td>1 043</td>
<td>1 006</td>
<td>1 055</td>
</tr>
<tr>
<td>Germany</td>
<td>504</td>
<td>517</td>
<td>531</td>
</tr>
<tr>
<td>Italy</td>
<td>297</td>
<td>392</td>
<td>n.a.</td>
</tr>
<tr>
<td>Japan</td>
<td>4 600</td>
<td>3 499</td>
<td>3 449</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>6 115</td>
<td>6 181</td>
<td>6 893</td>
</tr>
<tr>
<td>United States</td>
<td>994</td>
<td>975</td>
<td>1 042</td>
</tr>
<tr>
<td><strong>Total of above</strong></td>
<td><strong>14 005</strong></td>
<td><strong>13 013</strong></td>
<td>n.a.</td>
</tr>
</tbody>
</table>

n.a. = not available.

1. Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Source: OECD, Trade database.
ANNEX 2. INDUSTRIAL ASPECTS OF THE GLOBAL FINANCIAL CRISIS

Dr. Nariman Behravesh

Chief International Economist and Research Director
Standard & Poor’s DRI

Slide presentation

Outline of presentation

• Origins of crisis
• Industrial implications
• World outlook: base case
• Worst case scenario

Multiple, overlapping crises

• Burst investment bubble in Asia
• Banking crisis in Japan
• Political crisis in Russia
• Macroeconomic imbalances in Latin America
• Frothy equity and bond markets in the United States and Europe
• Too much leverage everywhere
Tracking the ASEAN crisis – How much potential demand has been lost? 5.8 million over the next 5 years. 1996 level will not be reached in 2003.

Around 1.1 million units lost every year 1998-2002

Worldwide steel capacity

1989

- Other: 24%
- W. Europe: 22%
- USA: 15%
- FSU: 19%
- China: 7%

938.2 million tonnes

1998

- Other: 24%
- W. Europe: 21%
- USA: 19%
- FSU: 14%
- China: 12%

1,040.2 million tonnes

Primary commodity prices have collapsed since Asian crisis

- CRB Futures Index has fallen nearly 20% to lowest level in more than 20 years.
- Global demand is weak
- Producers still generally increasing output – need revenue and hard currency
- Large inventory overhang
- Medium-term prospects are weak due to over-capacity and efficiency improvements

CRB Futures Index

Standard & Poor’s DRI
Selected commodity prices since the Asian crisis
(US dollars per unit)

<table>
<thead>
<tr>
<th>Commodity</th>
<th>July 97</th>
<th>January 99</th>
<th>Percent</th>
<th>Lowest Since</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coffee (100 pounds)</td>
<td>200.41</td>
<td>110.71</td>
<td>-47</td>
<td>2006</td>
</tr>
<tr>
<td>Copper (troy oz.)</td>
<td>2,446.07</td>
<td>1,433.03</td>
<td>-41</td>
<td>1983</td>
</tr>
<tr>
<td>Brent Crude (barrel)</td>
<td>18.52</td>
<td>11.12</td>
<td>-40</td>
<td>1985</td>
</tr>
<tr>
<td>Nickel (tonne)</td>
<td>6,857.07</td>
<td>4,281.00</td>
<td>-38</td>
<td>1985</td>
</tr>
<tr>
<td>Sugar (100 pounds)</td>
<td>12.13</td>
<td>6.30</td>
<td>-31</td>
<td>1993</td>
</tr>
<tr>
<td>Rubber (100 pounds)</td>
<td>51.62</td>
<td>35.03</td>
<td>-24</td>
<td>1992</td>
</tr>
<tr>
<td>Aluminium (tonne)</td>
<td>1,596.07</td>
<td>1,219.68</td>
<td>-24</td>
<td>1994</td>
</tr>
<tr>
<td>Gold (troy oz.)</td>
<td>333.78</td>
<td>287.31</td>
<td>-11</td>
<td>1980</td>
</tr>
<tr>
<td>Wheat (100 bushels)</td>
<td>435.89</td>
<td>361.36</td>
<td>-16</td>
<td>1996</td>
</tr>
<tr>
<td>Cocoa (tonne)</td>
<td>1,737.05</td>
<td>1,561.36</td>
<td>-10</td>
<td>1997</td>
</tr>
<tr>
<td>CRB Futures Index</td>
<td>256.199</td>
<td>192.759</td>
<td>-26</td>
<td>1992</td>
</tr>
</tbody>
</table>

Crude oil prices have fallen by more than 40%

- Asian demand is still weak, inventories remain high, and the relative fiscal news is mixed
- OPEC’s production restraint is waning (65-70% compliance Nov-Jan)
- OPEC’s March 23 meeting will likely result only in further pledges of full compliance – Saudi Arabia’s position
- There are signs of a minor non-OPEC supply response, but markets will likely remain soft in the medium term
- Countries negatively impacted: OPEC members, Mexico, Russia, Colombia

Copper prices have fallen by more than 40%

- Demand hurt by weak construction market
- Chile and Indonesia sharply increased capacity in 1996
- Increasing share of production is being sold below operating costs, but no one wants to shut in
- Inventories have tripled since Asian crisis
- Japan plans to run smelters at full capacity in 1999
- Countries negatively affected: Chile, United States, Indonesia, Australia, Peru
Nickel prices have fallen by nearly 40%

- Stainless steel demand down sharply; electronics demand weaker
- Inventories have increased more than 20% since the Asian crisis
- Three large, low-cost pressure acid leach operations are starting in Australia
- New capacity will keep market over-supplied in medium term
- Countries negatively impacted: Russia, Canada, Australia, New Caledonia, Cuba

Aluminum prices have fallen by 25%

- Demand weak from container and transportation markets
- World output was up by around 2% in 1998
- Despite high costs, Russia is likely to increase 1999 output to earn hard currency
- Major aluminum producers: United States, Russia, Canada, China, Australia
- Major bauxite producers: Australia, Guinea, Jamaica, Brazil, China

Why a Mexican-style recovery is unlikely for Asia

- In 1995 70% of Mexico’s exports were to the United States
- Close to 50% of Asia’s trade was intra-regional
- Japan is not the locomotive of growth in the region
- Crises triggered by excess supply are far worse than those triggered by excess demand
Have the risks of a world recession risen?

- Parts of the world economy are already in recession
- What if the United States can’t continue to act as an importer of last resort?
- The potential for policy mistakes is high:
  - Too tight monetary policies
  - Protectionism
- World recession probability:
  - 25% in July
  - 30%-35% in October
  - 25% in December
**Real GDP growth – World - October 1998**

![Chart showing real GDP growth over several years from 1995 to 2005.](chart)

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**Good luck needed for world economy to avoid recession**

- US stock market does not correct sharply
- US households rebuild savings balances gradually
- US inflation stays low
- The yen declines slowly
- The Japanese economy does not implode
- No recession in core Europe
- The US slowdown and the recovery in the rest of the world are synchronised
- The contagion effect from Brazil is limited

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**Revisiting the worst-case scenario: sequence of events described in July 1998**

- Japanese financial meltdown?
- Deep Japanese recession (depression)?
- Free fall of yen
- Chinese devaluation
- Russian devaluation ✓
- Brazilian devaluation ✓
- Recessions in other emerging markets ✓
- Plunge in stock market ✓?
Conclusions

- Excess capacity and weak prices in the commodities and manufacturing sectors will persist for at least another two to three years
- The impact on industrialised countries (except Japan) will be muted
- The impact on most emerging markets will continue to be severe
- In the near-term, the risks remain predominantly on the downside
ANNEX 3. TRADE UNION POLICIES FOR ECONOMIC RESTRUCTURING AND CRISSES

Mr. Peter Unterweger

Head of the Automotive Industry and Mechanical Engineering Department
International Metalworkers Federation

Introduction

The current crisis, although it may seem like a great storm sweeping across the global economy, is not a natural phenomenon. It is a result of policy – the so-called Washington Consensus – which has been pursued for decades by multilateral organisations such as the Bretton Woods institutions, the OECD and the WTO. Although the crisis began in Asian financial markets, it has now affected the entire world economy as a result of the global commodity and financial markets that dogged pursuit of liberalisation had forged over the preceding decades.

This paper will deal with the sectoral impacts of that crisis and propose appropriate policy responses. The key points are:

- Metal industries have long been a focal point of competitive pressures and have undergone extensive restructuring during the past two decades.
- During this period, metalworkers in developed and in many developing countries experienced job cuts and stagnating or declining incomes.
- A neo-liberal policy mix of restrictive economic policies and market opening pressures, particularly for capital markets, were a principal cause of the current crisis.
- The economic crisis is intensifying a backlash against ideologically driven liberalisation that ignores social impacts.
- Rhetorically fighting protectionism and simply restoring business confidence will not allay the backlash, nor will it put the world economy on track to democratically governed, equitably shared and sustainable economic growth.

1. This is an edited extract from a paper that Mr. Unterweger submitted to the OECD on the Asian crisis. The full original text is available on request.
2. Institutional affiliation; the views expressed in this paper are solely those of the author.
3. The Consensus refers to an ideology that champions limited governmental economic intervention, except in the field of monetary policy, where governments would seek to control inflation by influencing interest rates.
Economic change requires painful social and economic adjustments in developing as well as developed countries; policies must ensure an equitable sharing of the burdens of change and provide assistance to those affected.

The economic crisis presents us with the opportunity for a new approach: democratically decided change strategies for employment and for sustainable growth and development.

New change strategies must address all relevant social and economic factors, including institutions, their state of development and other unique characteristics of the society concerned.

Asia: a crisis of globalisation

The multiple causes and the evolution of the crisis have been described elsewhere. Let us simply note that the case for Asian “crony capitalism”, economic mismanagement, etc., as the prime causes of the crisis has been effectively rebutted by a number of prominent economists, financiers and statesmen (Stiglitz, 1998; Unterweger, 1998).

Two principal points should be reiterated. First of all, the crisis could not have taken place without the more-or-less coerced opening of Asian financial markets. It should be noted that the Washington Consensus pushed for open capital accounts although there is little or no evidence that this helps economic growth and development (Stiglitz, 1998).

Moreover, it has now become common wisdom that the financial institutions of the Asian economies were underdeveloped and ill-prepared for this opening. Although largely true, this had long been known, just as it was evident that Asian financial structures were highly leveraged and that governments played a crucial mediating role in ensuring their stability. Capital account opening eliminated the governments’ stabilising role and allowed the speculative and over-capacity “bubbles” to develop (Wade and Veneroso, 1998). Against this background, it is Western policy makers, investors and the Bretton Woods institutions that shoulder primary responsibility for the crisis.

Secondly, the crisis was spread by the global financial market, which had been created by new technology and the Washington Consensus. The early, optimistic explanations made much of the relatively small trade flows that linked the crisis economies to the developed world. But, in fact, it was largely the investors’ flight to safer investments in North America and Western Europe that spread the crisis to other emerging markets such as Russia and Brazil, and ultimately even to the developed countries (Unterweger, 1998). It took an outstanding example of Western “crony capitalism” – the Long-term Capital Management rescue – and a succession of interest rate cuts in North America and Western Europe to at least temporarily avert a financial meltdown in the developed world.

Indeed, the longevity of the Asian crisis is not surprising because a crucially important underlying factor is over-investment. In the years preceding the crisis, huge over-capacities in autos, steel and electronics were built up in the crisis economies, and it will take time to rationalise over-capacities and to restructure the financial systems that contributed to their creation (Behravesh, 1999). It should be noted that over-capacity is tied to two central thrusts of the Washington Consensus:

- The promotion of export-led development.
The neglect of domestic demand growth in the developing economies and its throttling (by fiscal and monetary restrictions) in the developed countries – over-capacity arises from insufficient demand.

Finally, it must be noted that the recessions which took hold in the crisis economies in the wake of financial panic, were intensified by the prescriptions of the International Monetary Fund. The conditions of IMF aid – high interest rates and fiscal austerity – further depressed the afflicted economies. Lack of commercial credit (to buy parts and raw materials, etc.) and astronomical interest rates drove even healthy firms into bankruptcy.

At the start of the Asian crisis, orthodox opinion was that it would be short-lived and that the impacts on the rest of the world would be minimal. As of early 1999, the contagion has continued to spread, and, despite official optimism, a turnaround in the crisis countries is not really in sight. After numerous revisions, it is now accepted that world economic growth for 1999 will be only a little over half of the already diminished level that was predicted less than a year ago.

**Troubles in Asia continue**

Korea is the largest of the economies directly touched by the crisis. In the first months of the IMF policy regime, 10 000 Korean workers a day were losing their jobs; by September 1998, 100 companies a day were shutting their doors (KCTU, 1998a).

In a country “which enjoyed virtually full employment before the crisis, output is expected to contract by 8% in 1998, and by 2% in 1999, reaching only low positive growth in 2000. Unemployment in 1998 is expected to triple to 9% of the Korean 22 million labour force, leaving 2 million unemployed. Wage increases have slowed from their high of 7% in 1996 to 4% in 1997, and are expected to turn into cuts of 2% over 1998. Unemployment levels will keep rising during 1999 to reach 11% of the labour force, before falling to 9% in 2000, when real wage rate increases also just turn positive.”(ICFTU, 1999).

The metal industry, which is at the centre of the Korean economy, took the brunt of the burden. Auto production in 1998, for example, declined by about one-third, and for 1999 there will be a small increase at best. Hyundai acquired the bankrupt Kia Corporation, and Daewoo took over the much smaller Ssangyong. Moreover, Samsung’s ambitious plans to enter the auto industry were dashed at the very moment its first products began to roll off the assembly line – it reportedly will swap its new auto plants for Daewoo’s electronics operations (FIOM, 1999a).

After sharp declines in 1998, the crisis economies are likely to continue contracting in 1999, and China’s economy is expected to grow at a rate far below what is needed to absorb the increasing labour force and the laid-off workers from state-owned enterprises. By the end of 1999, more than 27 million people will be unemployed in the crisis economies and, if China is considered the total rises to 45 million (ICFTU, 1999). China has resisted devaluation, but exports to its neighbours are shrinking, and its financial structures are shaky. A Chinese devaluation could set off another downturn in the Asian economies.

Brazil succumbed to financial market pressures in January 1999, allowing its currency to “float”. During 1998, Brazil lost more than 110 000 industrial jobs, of which more than 20 000 in the auto industry alone. The unemployment rate rose to 9% – its highest level since 1992. Forecasts for 1999 GDP growth range from an optimistic +0.3% to –3.5%, which would add 700 000 and 3.6 million respectively to the unemployment rolls. Domestic vehicle sales are expected to fall by 22%, or by
more than 300,000 units. The Brazilian steel industry will either be hit by US antidumping duties or will have to voluntarily restrict shipments to the United States.

**Growth slows in Western Europe and North America**

Fortunately for the world economy, North American and Western European economies grew strongly in 1997-98. One shudders to think of the consequences of the Asian crisis had this not been the case. Nevertheless, the concerns expressed by the OECD in recent analysis over “substantial downside risks” are entirely justified. The US consumer, who has provided the backbone of the long expansion, cannot spend much more. At year-end 1998, the savings rate was negative, and there were concerns that consumer optimism based on the booming stock market might fast evaporate.

In 1999, another engine of world economic growth, Western Europe, is expected to decline. The council of economic experts in Germany, for example, expects economic expansion to slow from 2.75% in 1998 to 2% in 1999. Moreover, growth in North America in 1999 is expected to be lower than a year earlier.

The metalworking industries, including engineering and vehicles, will play a major role in the slowdown. Forecasts put 1999 metal industry growth in the 3.5%-5% range, which is about half of the 1998 growth rate. Slowing overall exports (including metal products), due to the Asian crisis, are one of the factors in the decline. (Details on the EU vehicle and engineering industries are provided below.)

**Sectoral impacts**

**Auto industry**

The OECD has correctly noted powerful tensions among the world’s steel, ship and commodity producers, and “growing tensions” in the automobile and electronics industries. Steel problems are discussed in the following section on “Trade tensions”, but the situation in the vehicle sector also appears ominous.

World vehicle sales, after declining by 2.7% in 1998 due to Asian and South American problems, are expected to fall by a further 2.3% in 1999 as Western Europe and North America are reached by the trend (Table 1). The South American auto industry, which declined by almost 17% in 1998, is expected to shrink by another 15% (or more) in 1999, as the Brazilian and Argentinean economies continue to deteriorate. Some recovery is forecast for Japan and the Asia-Pacific region.

The already powerful pressures in the auto industry will only be intensified by the downturn that has already begun. Even before the crisis, excess production capacity was massive, especially in Asia. Moreover, strong demand during 1997-98 only masked related over-capacity in Western Europe and North America. In South America, ambitious investment programmes continue to proceed.

As a result of these pressures and the 1998 merger of Daimler-Benz and the Chrysler Corporation, merger mania has gripped the industry. The wave of Korean mergers and acquisitions has already been mentioned. In addition, Volvo has announced the sale of its passenger car division to Ford, and is driving a realignment of forces in the heavy truck industry. Renault will take a stake of almost 37% in Nissan, and practically every day brings new rumours or announcements of discussions between major automakers. BMW, Fiat, Peugeot and Mitsubishi are all in vulnerable positions. Unlike the Daimler-
Chrysler case, the announced and potential mergers/alliances will involve companies with substantial product-line overlap, which is likely to lead to drastic rationalisations.

Table 1. World unit vehicle sales (‘000)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Europe</td>
<td>14 403</td>
<td>15 027</td>
<td>16 028</td>
<td>15 389</td>
<td>14 524</td>
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<tr>
<td>NAFTA</td>
<td>17 013</td>
<td>17 419</td>
<td>17 997</td>
<td>17 290</td>
<td>17 260</td>
</tr>
<tr>
<td>South America</td>
<td>2 463</td>
<td>2 805</td>
<td>2 335</td>
<td>1 978</td>
<td>2 597</td>
</tr>
<tr>
<td>Japan</td>
<td>7 061</td>
<td>6 725</td>
<td>5 910</td>
<td>6 200</td>
<td>6 730</td>
</tr>
<tr>
<td>Asia-Pacific*</td>
<td>6 363</td>
<td>6 049</td>
<td>4 518</td>
<td>5 043</td>
<td>5 648</td>
</tr>
<tr>
<td><strong>World total</strong></td>
<td><strong>51 116</strong></td>
<td><strong>52 166</strong></td>
<td><strong>50 753</strong></td>
<td><strong>49 609</strong></td>
<td><strong>50 634</strong></td>
</tr>
<tr>
<td>Western Europe &amp; North America</td>
<td>33 454</td>
<td>34 747</td>
<td>36 280</td>
<td>34 649</td>
<td>33 854</td>
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<tr>
<td>Rest of World</td>
<td>17 662</td>
<td>17 419</td>
<td>14 473</td>
<td>14 960</td>
<td>16 780</td>
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</table>

Year-to-year percentage changes

<table>
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<tr>
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<th>Western Europe</th>
<th>NAFTA</th>
<th>South America</th>
<th>Japan</th>
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<tr>
<td></td>
<td>6.3</td>
<td>3.2</td>
<td>3.0</td>
<td>3.1</td>
<td>4.0</td>
</tr>
<tr>
<td></td>
<td>4.3</td>
<td>2.4</td>
<td>13.9</td>
<td>-4.8</td>
<td>-4.9</td>
</tr>
<tr>
<td></td>
<td>6.7</td>
<td>3.3</td>
<td>-16.8</td>
<td>-12.1</td>
<td>-25.3</td>
</tr>
<tr>
<td></td>
<td>-4.0</td>
<td>-3.9</td>
<td>-15.3</td>
<td>4.9</td>
<td>11.6</td>
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<tr>
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<td>-5.6</td>
<td>-0.2</td>
<td>31.3</td>
<td>8.5</td>
<td>12.0</td>
</tr>
<tr>
<td><strong>World total</strong></td>
<td><strong>4.7</strong></td>
<td><strong>2.1</strong></td>
<td><strong>-2.7</strong></td>
<td><strong>-2.3</strong></td>
<td><strong>2.1</strong></td>
</tr>
<tr>
<td>Western Europe &amp; North America</td>
<td>5.3</td>
<td>3.9</td>
<td>4.4</td>
<td>-4.5</td>
<td>-2.3</td>
</tr>
<tr>
<td>Rest of World</td>
<td>3.6</td>
<td>-1.4</td>
<td>-16.9</td>
<td>3.4</td>
<td>12.2</td>
</tr>
</tbody>
</table>

* Excludes Japan; includes Australia and New Zealand.
Source: Economist Intelligence Unit.

Machinery and equipment

Another industry sending out distress signals is mechanical engineering which, similar to the auto industry, has been the focal point of global pressures for many years (FIOM, 1998). Competitive pressures have led to a continuing wave of mergers and acquisitions, which began even earlier than in the auto industry. In Western Europe, the output of this industry grew by 5.9% in 1998, but forecasts for this year are for less than half that rate. According to the industry association ORGALIME (1998), the reason for the slowdown is growing imports from Asia – primarily from Japan (Financial Times, 1999a).

In the United States, the mechanical engineering sector is also experiencing difficulties. One strong indicator is machine tool consumption; healthy growth in this area is over. After years of decline, consumption increased by an average of 15% per year during the last five years, but for 1999, a 20% decline in sales is expected. Computer chip-making equipment manufacturers are particularly hard hit. In 1998, the state of Massachusetts alone lost 9 000 jobs in this branch (Forrant, 1999).
Developments in the Japanese machinery sector are also negative. Production of general machinery was down by more than 5% in the first nine months of 1998 compared to the same period a year earlier. Industry output had grown in each of the three preceding years. Nor does the future look promising: orders for metalworking machinery over the same period were down by 25%.

**Trade tensions**

There can be no question that tensions in the world economy are on the rise. The obvious strategy of crisis economies is to export their way to economic recovery. But this has been complicated by the problems of the Japanese economy, which is a major factor in the steel, vehicle, machinery and electronics industries. Instead of helping to absorb imports, Japan is maintaining strong exports to counteract its shrinking domestic demand.

For decades the United States has been the world’s buyer of last resort. The impact of the economic crisis on its balance of trade is shown in Table 2. The trade deficit in goods and services in 1998 eclipsed the record set eleven years earlier. The deficit for manufacturing increased by almost 40% and the deficits for metalworking machines, steel and vehicles grew by 47%, 34% and 22%, respectively. The employment impacts are much more severe than the percentages based on dollar figures suggest. Because of the Asian devaluations, each 1998 US dollar buys far more Asian goods than a 1996 dollar, and the volume of imports is therefore correspondingly higher.

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>486.2</td>
<td>658.8</td>
<td>-172.6</td>
<td>551.4</td>
<td>792.4</td>
<td>-241.0</td>
</tr>
<tr>
<td>Auto total</td>
<td>65.0</td>
<td>128.9</td>
<td>-63.9</td>
<td>72.7</td>
<td>150.7</td>
<td>-78.0</td>
</tr>
<tr>
<td>Electrical machinery</td>
<td>57.2</td>
<td>75.5</td>
<td>-18.3</td>
<td>65.4</td>
<td>79.4</td>
<td>-14.0</td>
</tr>
<tr>
<td>Iron &amp; steel mill products</td>
<td>2.7</td>
<td>10.4</td>
<td>-7.7</td>
<td>2.9</td>
<td>13.2</td>
<td>-10.3</td>
</tr>
<tr>
<td>Metalworking tools</td>
<td>5.8</td>
<td>7.5</td>
<td>-1.7</td>
<td>6.3</td>
<td>8.8</td>
<td>-2.5</td>
</tr>
<tr>
<td>Excavating machinery</td>
<td>4.8</td>
<td>3.6</td>
<td>1.2</td>
<td>5.6</td>
<td>5.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Agricultural machinery</td>
<td>3.7</td>
<td>3.6</td>
<td>0.1</td>
<td>4.2</td>
<td>4.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>Oilfield equipment</td>
<td>6.0</td>
<td>0.7</td>
<td>5.3</td>
<td>8.1</td>
<td>1.4</td>
<td>6.7</td>
</tr>
</tbody>
</table>

*Source: US Department of Commerce.*

Such surges in imports cannot fail to increase trade tensions, which have already reached the stage of international disputes in the steel industry. According to union sources, 10 000 US steel jobs were lost in 1998. The union and industry jointly lobbied the US Government to take action against “dumping” of steel from a long list of countries, including Brazil, Japan, Korea and Russia. On 13 February, the US Commerce Department imposed high punitive duties on Brazilian and Japanese hot-rolled steel. New dumping cases related to steel-plate imports were expected to be filed shortly thereafter. Brazil and Russia are expected to negotiate export restraint agreements with the United States to obtain the suspension of these punitive tariffs (*Financial Times*, 1999).
The role of weakness in the Japanese economy is well illustrated by the example of the auto industry. Domestic demand declined by 12.5%, while production fell by only 8.4%. An increasing share of production is exported, mainly to Western Europe (where imports increased by 10.4%) and to North America (a longstanding consumer of Japanese cars). The expected weakening of these markets is bound to further increase trade tensions, and put additional pressure on Japanese producers.

Table 3. The Japanese motor vehicle industry, 1998

<table>
<thead>
<tr>
<th>Item</th>
<th>1998 (’000)</th>
<th>Percentage change 1997-98</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registrations</td>
<td>5 887</td>
<td>-12.5</td>
</tr>
<tr>
<td>Production</td>
<td>10 050</td>
<td>-8.4</td>
</tr>
<tr>
<td>Exports:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>to Asia</td>
<td>265</td>
<td>-56.3</td>
</tr>
<tr>
<td>to EU</td>
<td>1 133</td>
<td>10.4</td>
</tr>
<tr>
<td>to North America</td>
<td>1 459</td>
<td>3.3</td>
</tr>
<tr>
<td>to Latin America</td>
<td>450</td>
<td>2.8</td>
</tr>
</tbody>
</table>

Source: Japan Automobile Manufacturers Association.

The situation in the Japanese electronics and machinery sector does not look much better. In electronics, 1998 production declined by more than 6% in spite of continuing strong exports to the United States. This was the first decline in five years. A small upturn is expected for 1999.

The plight of the Japanese machinery industry was described earlier. In this sector, slowing domestic orders have been somewhat offset by exports: domestic orders for March-September 1998 were down by about 32%, while foreign orders increased by 16.5% over the same period.

Worker backlash

Japanese unemployment is at record level, while wage gains are at a historic low. In the United States, family incomes have stagnated for more than a decade and job cuts in steel, machinery and aerospace are reminding workers how insecure their jobs are, even in prosperous times. The much-vaunted employment miracle is based on a huge expansion of precarious, poorly paid jobs. In Western Europe, unemployment remains stubbornly high in spite of a relatively strong economy. The Asian crisis has shattered the living standards of workers in the countries directly concerned, and contagion has aggravated the already serious problems of workers in most transition and developing economies.

In the United States and Canada, popular discontent with liberalisation policies has grown strongly. In 1994, the US Administration barely succeeded in gaining Congressional approval for its North American Free Trade Agreement (NAFTA) against powerful popular opposition, and then only after it had negotiated side agreements on labour rights and the environment. US and Canadian unions had argued strongly that costs are a factor in trade and investment decisions. And, because costs are determined in part by labour and environmental standards, violations of such standards would confer an unfair competitive advantage on the violators. The NAFTA side agreements proved grossly insufficient and a few years later the Administration lost the battle to obtain “fast track” authorisation for expanding the treaty.
In the 1990s, West European metalworkers were engulfed in the wave of industrial restructuring which their North American counterparts had begun to feel a decade earlier. In recent years, unemployment levels have declined only slightly in spite of economic growth, and the forecast economic slowdown will reverse that favourable trend.

In the past, West European metalworking unions have by-and-large benefited from liberalisation, above all within the EU, and consequently have supported further trade and investment liberalisation. But strong growth in imports, continued painful restructuring linked to “outsourcing” to Eastern Europe, and a renewed increase in unemployment as economies slow, stand to erode this longstanding support.

Overall, workers in developed industrial economies have little to show after decades of deregulation. In emerging economies – so far the chief victims of the global crisis – the situation is even less favourable. True, in the Asian “Tiger economies”, significant economic development and improvement in living standards took place, but in other emerging economies, such as Brazil and Mexico, globalisation provided a slow trickle of benefits at best, and drastically lowered living standards at worst. The current economic crisis has reversed decades of development in the Asian crisis economies, has added to the plight of Brazilian workers and left their Mexican counterparts with little hope of improving their declining standard of living.

A dangerous counter-reaction to the shock-therapy policies imposed on these countries by the West is gathering force in the former Soviet republics. Many millions of workers have known only declining living standards and worsening health and social problems since 1989. Anti-democratic, xenophobic and ultra-nationalist political movements are gaining strength at a frightening pace. It is no exaggeration to say that a time bomb, whose explosion would have regional (if not global) repercussions, is in the making. Apart from Poland, virtually all the transition economies are in a precarious situation.

Restrictive economic policies and financial markets are spreading deflation around the world. The resultant dislocations, such as unemployment, are shifted from country to country by desperate attempts on the part of economies in crisis to export themselves out of recession. For the world’s workers, particularly in traditional industries such as metalworking, this is a negative-sum game.

Stephen Roach of Morgan Stanley has described a shift of power from labour to capital, which also involved a shift of income and wealth (Roach, 1997). UNCTAD reports that, while in 1965 the richest 20% of the world’s people earned 31 times more than the poorest 20%, by 1990 this had grown to 60 times. Moreover, the major part of this astounding rise in inequality has occurred since 1980 (UNCTAD, 1997).

While workers’ incomes stagnated and job insecurity grew, even in growing economies, managerial salaries, profits and stock market valuations soared. None of this has been lost on workers. Reality bluntly contradicts the promises of neo-liberal ideologues and in the process creates a crisis of credibility for the neo-liberal policies that have been pursued and the institutions dedicated to their implementation.

Even before the Asian crisis, the heads of the World Economic Forum urged the globe’s political and economic elite to “start taking the backlash against globalisation seriously” (Schwab and Smajda, 1996). Similar warnings were sounded in the pages of Foreign Affairs (Kapstein, 1996). And now, the OECD has expressed concerns that developments such as those discussed above will erode popular support for “liberalisation”.
As much of the literature shows, this is no irrational “protectionist” reflex on the part of popular sectors, but the result of suffering the adverse consequences of globalisation policies that reinforce the advantages enjoyed by the holders of capital. It is high time that the oft-repeated calls for “globalisation with a human face” translate into reality.

A new policy direction

Growing global competition has made industrial restructuring a second focus of trade union policy. Too often, restructuring is undertaken without consultation and negotiation with those most directly concerned. Consequently, trade unions demand negotiations concerning restructuring programmes, and government assistance to the affected workers and enterprises.

In the trade unions’ view, the first order of business for governments and multilateral organisations must be to draw lessons from the failures of the neo-liberal programme. The re-evaluation of this experience by observers from a variety of viewpoints has been outlined in another paper (Unterweger, 1998), but several of the central conclusions are worth repeating here:

- Neo-liberal remedies, and in particular the prescription of open capital accounts and austerity for economies already in crisis, should be stopped.
- Concerted efforts to reflate the world economy – a task for OECD Member states – must speedily be undertaken through monetary as well as fiscal means.
- A new international financial architecture that will prevent, or at least greatly minimise, the chances of a recurrence of such crises must be put in place.

But these economic guidelines do not go far enough. Metalworkers and their colleagues in other industries are not interested in further painful “adjustments” – they expect compensation for years of toil and co-operation. The only effective way to diminish the backlash will be the swift implementation of a new policy framework that will:

- At least partially compensate the crisis victims.
- Make owners and investors share the burdens of “adjustment” and of overcoming crises.
- Allow broad popular sectors an equitable share of economic gains.
- Involve all stakeholders, including trade unions, in the formation of policies and agreements on trade, investment and restructuring.
- Integrate principles of human and worker rights as well as sustainable development in treaties and institutions of global governance.

Trade union policies

The International Metalworkers’ Federation has made the problematic nature of globalisation a focal point of its programmes. The Action Programme adopted in 1997 lists the following priorities:
Strengthening of international co-operation in the economic and monetary field through the co-ordination of:

- industrial policies aimed at boosting productive investment and creating jobs;
- the regulation and stabilisation of financial markets; and
- fiscal policies to prevent the dismantling of social security systems, smooth economic cycles and ensure sustainable economic growth.

- Promotion of fair trade and respect of core labour and environmental standards among nations.

- Prohibition of social dumping, i.e. some countries practice holding down or reducing wages and social costs in order to gain competitive advantages in the global market.

- Integration of developing countries into the world economy through the establishment of fair commodity prices, access to international markets under equitable terms and a socially responsible policy on the part of international lending institutions to foster economic and social advancement (FIOM, 1997a).

These policy guidelines are echoed in the Joint TUAC-ICFTU Statement on the Global Economic Crisis (TUAC-ICFTU, 1998). In connection with the need for economic expansion, this statement lists a number of concrete suggestions for the developed industrial countries:

- Further co-ordinated reductions in interest rates.
- Radical action to recapitalise and reform Japanese banks.
- Targeted expansion of infrastructure investment schemes to support output and tackle structural problems.
- Financial assistance to developing and transition economies in crisis targeted on poverty alleviation, social programmes and debt restructuring.
- Payment of Russian back wages.
- A new international financial architecture.

TUAC-ICFTU have called for the creation of an International Commission on Financial Market Regulation to reform global financial markets. Indeed, calls for such reforms have gone out from a broad range of business, government and labour leaders. Because financial markets are beyond the scope of this paper, the details will not be explored, except for two basic points:

- The right of states to control short-term capital flows to ensure domestic macroeconomic stability must be recognised.
- There must be rapid debt relief for the poorest developing countries (TUAC-ICFTU, 1998).

On the eve of the 1999 World Economic Forum, the International Metalworkers’ Federation called on governments to put the world’s financial house in order (FIOM, 1999b). Financial markets must be
reformed to make them once again the servants of production and real wealth creation instead of being sources of deflation and instability. Without such reforms, efforts to assist crisis economies are likely to be quickly undone by the next tidal wave unleashed by inherently unstable financial markets. Moreover, a new financial architecture is the *sine qua non* for the confidence building which appears to be so high on the agendas of business and government leaders. Unfortunately, judging by the business-as-usual attitude of the representatives of the major economic powers at the 1999 Davos Forum, there is little ground for optimism in this respect.

**Industry-oriented policies**

The preceding decades have brought large-scale upheavals to the world’s metalworking industries. Liberalisation policies have been imposed without heed for their social consequences. Trade unionists have more than a suspicion that these developments are part of a strategy that seeks to lower social safety nets and to make workers and their organisations more pliable to the demands of capital.

There is a clear public responsibility to assist workers and enterprises in restructuring. When restructuring began in the United States, unions called for and obtained “trade adjustment assistance” for affected workers. In addition, the autoworkers union (UAW) was the first to negotiate private “adjustment assistance” programmes for workers who had been laid off and who would most likely never return to their former jobs.

In Japan, a grant-in-aid system is used primarily for employment adjustments. It is increasingly used as a result of the crisis, particularly in the truck manufacturing and steel industries. Concerned about the “hollowing out” of Japanese industry, trade unions in general, and metalworkers in particular, are lobbying hard for an “organic law on manufacturing” that will require companies to maintain the traditional skill and competence base that is needed for domestic manufacturing.

In addition to policies that aim to assist workers and companies, trade unions around the world have proposed sectoral policies. For example, in 1992, the Japanese autoworkers (JAW) published a document that called for a reorientation of the industry to resolve its major problems. For industry, the JAW proposed:

- “Modernisation of the industrial structure” including the relations between vehicle assemblers, suppliers and dealers, the promotion of co-operation and a review of sales practices.
- “Collaborative development of technologies for environmental conservation and safety”.
- Proposals for the company level include:
  - lengthening model cycles and reducing the number of models;
  - shifting from a high-volume to a higher-value-added strategy;
  - reducing working time, including overtime (JAW, 1992).

A number of these themes are echoed in the auto industry policies proposed by trade unions in the European Union, which include:
The development of new transport concepts including environmentally friendly vehicles, and incentives to consumption.

The building of a partnership between the vehicle assembly and supplier industries.

A policy that discourages the building of new production capacity (e.g. a review of tax incentives), and instead assists enterprises to use existing capacity more effectively (incentives for new technology implementation, workforce training, etc.).

An auto policy dialogue at the EU level and a reform of EU decision-making institutions.

Expanding participation and co-determination at the EU level (Overhage, 1998; FIOM, 1999a).

Union participation in decision making

Trade unions around the world believe that positive industrial relations, including negotiations with employers and governments, are critical, not just to meet their members’ needs, but also to create effective production systems. It should be emphasised that negotiations must extend beyond wages, benefits and working conditions to include central aspects of business strategy such as investment, employment and new product development.

The unions must also be involved in the formation and implementation of social and economic policies at the national and international level. A policy dialogue is under way with the Bretton Woods institutions and even the WTO is showing signs of an opening up to trade unions and civil society. Structural adjustment programmes, World Bank projects, and treaties that deal with international trade and investment can no longer be negotiated by governing elites behind closed doors, but must involve broadly representative organisations of civil society, including trade unions.

Working hours

Working hours are also a focal point of trade union policy. The policy calls for the reduction in working hours, and new forms of working-time arrangements. The reduction in working hours to spur employment and enhance the quality of working life is a key plank of the International Metalworkers’ Federation’s Action Programme (FIOM, 1997a).

Beginning in the early 1980s, German metalworkers spearheaded the drive for lower working hours, attaining a 35-hour average working week in 1995. Work-time reduction has also been pursued in the great majority of West European countries (FIOM, 1997b). The OECD’s recent criticism of France for pursuing work-time reductions to enhance employment is another illustration of the divide which separates neo-liberal and union policies.

On the other hand, trade unions have not ignored supply-side concerns. European unions have concluded agreements that permit enterprises to adapt working hours to market demand and to allow more effective plant utilisation. Various systems for banking overtime hours during periods of high demand have been negotiated in a number of European countries.
Policies for developing and crisis economies

The promotion of democracy and sustainable economic growth is the foundation of trade union policies. In our view, democracy is essential to ensuring that government policies reflect the popular interests instead of simply those of governing elites.

Export promotion can no longer be the only means of overcoming economic crises. In developing and emerging economies, domestic demand must be generated by an equitable sharing of developmental gains, and must be buttressed by social safety nets that can act as automatic stabilisers during crises. The expansion of domestic demand in the crisis economies will reduce global competitive pressures and lessen trade tensions. It will also reduce the “transition” costs associated with restructuring and thus reduce opposition to global economic integration.

In addition to economic and technical assistance, debts must be written off or restructured (as appropriate) and World Bank loans and bilateral aid must be speedily made available. This will allow the crisis economies to restart economic growth and build an appropriate institutional framework for development.

### Policies for the crisis economies

International support must be targeted to the countries worst affected by the crisis and the most vulnerable people. The priorities are:

- Protecting education and health budgets, ensuring that the poorest are able to keep their children at school and have access to essential health care.

- Creating and expanding social safety nets to ensure that the under-employed and jobless have a satisfactory income on which to live, and extending ILO-backed child-labour eradication programmes.

- Boosting employment-intensive public works schemes and extending training and job search programmes.

- Restraining prices of essential goods and maintaining the purchasing power of minimum wages.

- Developing sound industrial relations systems through the promotion of tripartite dialogue between governments, employers and unions, based on respect for the ILO’s core labour standards.

(TUAC-ICFTU, 1998).

The last point in the above box touches on a key labour demand: the inclusion of respect for core labour standards in international economic agreements. This demand is based on principle, but it is worth noting that market liberalisation policies have intensified the need for such regulations.

In certain countries, exported development has gone hand in hand with human and worker rights violations in an effort to make low labour costs a quasi-permanent competitive advantage. Such policies have allowed local elites and transnational corporations to enrich themselves while keeping workers and their communities steeped in poverty. On the other hand, a policy that includes raising domestic living standards removes some of the incentive to violate worker and human rights. Trade unions and strong social movements are effective agents for distributing the gains of development.

Recent OECD analysis mentions various types of assistance to the crisis economies to aid corporate and industrial restructuring. These include co-ordinated trade financing, “sharing information and
experiences on … corporate governance structures and policies for enhancing small and medium-sized enterprises.” Such measures should be linked with clauses that guarantee compliance with internationally agreed core labour and environmental standards. The United States, for example, has already included labour standards in its import-export financing legislation, and other OECD countries should do so as well.

While such measures are important, they do not go far enough. Technical, economic assistance alone cannot set in motion the profound changes in processes that are needed. All of the countries on our critical list, Korea’s membership in the OECD notwithstanding, are still developing countries – certainly with respect to the development of an institutional framework that can permit closer integration into the global economy.

As the World Bank’s Joseph Stiglitz (1998) has argued, the piecemeal, technical solutions long advocated by multilateral organisations do not represent an adequate development strategy. In fact, they lead to the kind of trickle-down development described earlier in the case of Brazil. Improving corporate governance structures and enhancing innovation and small and medium-sized enterprises can be ingredients of a development strategy. But they fall far short of building an appropriate institutional framework with the capacity to guide the transformation of their societies – and that, in Stiglitz’ terminology, is what “development” is all about.

Indeed, one of the real opportunities offered by the current crisis is that of turning the page, abandoning uniform, prescribed solutions to developmental and social problems, and adopting a strategic approach that addresses all relevant factors. These, of course, include industrial policies designed for specific sectors such as autos, steel, etc., but such programmes must be subordinated to an overall strategy which defines priorities and sequencing of measures. Above all, the strategy must proceed from a vision of the goal of development, and in that respect, trade unions have no doubt that it must be the raising of living standards throughout the world.

Overcoming the current economic crisis involves more than just rebuilding business confidence. The confidence of the world’s peoples in their institutions of economic governance must be restored. Without an overall, democratically agreed strategy of social and economic change, it will be difficult to avoid the suspicion that new policy initiatives are simply old wine in new bottles, that we are simply using the crisis as a pretext to further advantage the business sector instead of promoting equitable social development.
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ANNEX 4. EFFECTS OF THE CRISIS ON INDUSTRY: COUNTRY ASSESSMENTS

In support of the discussion on the global crisis, delegates representing Australia, Canada, the Czech Republic and Turkey submitted assessments on the impact of the crisis in their respective areas. Edited versions of these submissions follow.
AUSTRALIA AND THE ASIAN ECONOMIC CRISIS

Overview

The countries of the East Asian region include some of Australia’s most important trading partners (for example, Japan and Korea), and account for nearly 44% of total Australian merchandise exports and 37% of merchandise imports. In addition, Australia competes with the East Asian economies in a number of export markets, including Europe and the United States. Therefore, any changes in economic conditions in the East Asian economies will affect Australia’s industry and service sectors.

The global financial crisis has led to a slowdown in domestic demand in many regions, especially in the East Asian region. This has had an adverse impact on Australian firms exporting consumer goods and services, such as dairy products, meat and meat products, iron and steel, textile fibres, petrol and petroleum products, tourism and education services to the region. The increased competitiveness of many of the East Asian economies, due mainly to the fall in value of their currencies, has also affected Australian industries that directly compete with exports from the region, especially manufactures from Korea and Japan (such as steel), and primary products and semi-processed materials from South-East Asia (such as timber, seafood, chemical materials and plastics).

Australian firms supplying building and construction services to the region have experienced a downturn in demand for their services due to the property glut in a number of the East Asian countries. However, major infrastructure developments in China, Hong Kong and Singapore may provide some opportunities for Australian construction firms in the region.

While exports have generally suffered, Australian exporters are successfully continuing to divert exports from Asia to other markets. For the eleven months to November 1998, merchandise exports to Australia’s ten major trading partners in the Asian region were down by 7% over the same period a year earlier, but exports to all other countries rose by 22% over the same period. While the depreciation in the exchange rate against the US dollar and major European currencies increased the competitiveness of Australian exports in these markets, this was not sufficient to compensate for the loss of growth of exports to much of Asia.

Australia’s elaborately transformed manufactures (ETMs) exports also grew slowly due to the impact of the Asian financial and economic crisis. ETM exports rose by 5% in 1997-98, which compares to a pre-crisis rate of 11% during much of the 1990s.

While exports to East Asia generally suffered in 1997-98, exports to Hong Kong, Japan and Chinese Taipei remained buoyant, rising by between 14% and 33%. Exports to China were more subdued, rising by 8%. Korea was the only Asian market to which exports fell (by 10% during 1997-98). For the region as a whole, the trend value of exports was mildly downward. Among individual commodities, those most affected included: non-monetary gold (down 19%), coal (up 11%), metal

4. Submitted by the Australian Department of Industry, Science and Resources.
ores and scrap (up 13%), textile fibres (down 17%), petrol and petroleum products (down 23%), iron and steel (down 40%), non-ferrous metals (up 12%) and live animals (down 67%).

A number of Australian industries have been cushioned from the adverse effects of the financial crisis, particularly those industries that supply basic commodities or inputs to production of Asian exporters. These industries are benefiting from the recent increase in exports from Japan and Korea. In addition, Australian firms providing legal and accounting services and financial consultancies are starting to benefit from the privatisations, acquisitions, mergers and company restructurings that are occurring in the region.

In addition, the slowdown in domestic demand in the East Asian economies has adversely impacted on Australia’s service sector, with the hardest hit areas being tourism and education. This has been partially offset by increased tourist arrivals from other parts of the world such as North America and Europe due to the depreciation of the Australian dollar. Moreover, many educational institutions have attracted students from non-East Asian countries such as India, Bangladesh, Vietnam and China.

The property overhangs in most of the countries in the region have led to asset price deflation and slowed the demand for building materials and construction-related services. This has been exacerbated by the cancellation or deferral of many major infrastructure projects in the South-East Asian economies due to fiscal tightening, and, in some cases, at the insistence of the IMF. On the other hand, China has announced plans to implement a multi-billion-dollar programme to build new infrastructure to stimulate its economy. Both Hong Kong and Singapore have also announced the development of major infrastructure projects. Overall, Australian firms supplying building and construction services to the region are likely to experience a downturn in demand for their services due to the property glut in a number of the East Asian countries.

These potential opportunities make it important for Australia to continue to support and facilitate trade to East Asia and to help Australian exporters maintain market share. Such support is important because liquidity constraints have meant that buyers in some East Asian countries (including Asian exporters that import industrial inputs) are having difficulties accessing trade credits from local banks. As such, the role of credit insurers has become especially critical in facilitating trade. The Export Finance and Insurance Corporation is helping Australian exporters by making available export credit insurance facilities. These include the current A$ 500 million short-term National Interest Credit Insurance Facility for Australian exports to Korea, and the arrangement for Australian exports to Indonesia whereby proposals for short-term cover are assessed on a case-by-case basis. These facilities not only help Australian exporters, but also help Asian buyers to secure essential items such as food and inputs for production.

**Increased international competitiveness**

All of the economies in the East Asian region experienced exchange rate falls (against the US dollar) which have nominally improved their international competitiveness (the exceptions being China and Hong Kong, which have maintained a fixed exchange rate policy). This has led to an increase in manufacturing exports from Japan, Korea and the Philippines, and an increase in exports from South-East Asia that require little import content (such as raw materials and primary products). Exports of manufactures from the worst-affected South-East Asian economies (Indonesia, Malaysia and Thailand) have not recovered since the onset of the crisis due to liquidity constraints, financial sector and other institutional weaknesses and more costly imports of goods used in the production process. Nevertheless, the increase in manufacturing exports from some of the North Asian economies has helped cushion some Australian exporters that supply basic commodities and key inputs to production.
from the impact of lower domestic demand in the region. For example, trade data indicate that exports of coal coke and briquettes, raw hides, cereals and cereal preparations have been resilient since the onset of the crisis.

Based on recent historical evidence (for example, Italy and Mexico), countries experience three years of rapid export growth following major falls in their currency. This indicates that the economies of Indonesia, Malaysia and Thailand should experience strong export growth in the next few years (and Korea and the Philippines should build upon the export growth exhibited in the first quarter of 1998), provided they overcome their financial system problems (such as the liquidity constraints associated with the current crisis).

The increased international competitiveness (relative to the US dollar) of a number of the East Asian economies may also have an impact on Australian firms competing with East Asian suppliers in international markets outside the region. While it is very difficult to quantify this effect, Australian goods and services under threat from such competition include chemical materials and plastics, fish, electrical products, cork and wood, clothing and footwear. However, the Australian dollar has also depreciated in US dollar terms, enabling Australian firms to substantially increase exports to the major markets of Europe and the United States in 1998.

The exchange rate falls that have occurred in most of the economies in the region have implications for Australian firms supplying to the domestic market. This is because such firms now face increased price competition from East Asian imports, leading to increased demand for goods from the East Asian region. The countries from which exports to Australia have most increased were China, Indonesia, Japan, Korea, Malaysia and Thailand. The sectors in which Australia most increased its imports included articles of apparel, footwear, chemical materials and plastics.

In addition, the exchange rate falls have had an adverse impact on Australia’s domestic tourism sector, which is facing increased price competition from Asian destinations. For example, Australian holiday-makers can now take advantage of relatively inexpensive Asian holiday deals.

The improved international competitiveness of the East Asian economies is benefiting Australian consumers of goods and services (both in the general community and in business) as prices fall. For example, Korean manufacturers of small four-cylinder cars have cut prices to increase sales volumes; prices for these types of vehicles have fallen by over A$ 2 000.

**Finance market and corporate sector reforms**

*Finance market reforms*

A number of countries in the East Asian region are embarking on financial market reforms to strengthen their banking sectors. Financial market reforms have already been flagged for China (introduction of competition from foreign companies in the insurance market and financial system changes to make the currency more freely convertible), Indonesia (financial sector restructuring, arranged mergers of banks and privatisation of state-owned banks), Korea (financial sector restructuring and the lifting of restrictions in the foreign bond market), Malaysia (rationalisation of the finance sector), Chinese Taipei (removal of foreign ownership restrictions on most types of financial institutions) and Thailand (closure and disposal of assets of insolvent finance companies, removal of controls to allow foreign banks to acquire 100% ownership of Thai banks, and changes to the financial regulation and supervision of banks).
However, a number of countries are finding it difficult to push ahead with their reform agenda due to fierce domestic resistance. The overall aim of efforts to reform the international financial system should not be to restrict capital flows, but to make them more soundly based and more stable.

Australia has actively supported international initiatives to improve the financial and economic conditions of the countries in crisis. It has participated in financial support arrangements, provided technical assistance and is involved in various international forums working on reforms. The Government set up a Task Force to advise on how Australia could contribute to international financial reform. The Task Force has completed its report, which will be considered by the Government in due course.

Financial market liberalisations present opportunities for Australian legal and accounting services and financial consultancies, especially given Australia’s recent history of deregulating its financial markets and ongoing regulatory reform. They also provide opportunities for Australian firms to supply information technology and financial management systems to financial institutions in countries in the region (such as Indonesia).

Financial market liberalisations also offer opportunities for Australian banks and finance companies to acquire assets in the region – one Australian insurance company has already flagged that it intends to spend around A$ 1 billion on acquiring insurance assets in the region.

**Corporate sector reforms**

In addition to financial market liberalisation, a number of countries in the region are embarking on a series of reforms in the corporate sector. For example, Thailand is introducing new bankruptcy laws to allow insolvent companies to be foreclosed, is lifting foreign investment restrictions on company ownership and is privatising a number of government-owned businesses in the petroleum, electricity, transportation and telecommunication sectors. Other countries in the region in which corporate sector reforms have also been flagged include Indonesia (introduction of bankruptcy laws, privatisation of state enterprises and removal of restrictions on foreign investment in wholesale trade), Korea (lifting of foreign ownership restrictions and changing of corporate governance structures), and the Philippines (relaxation of foreign equity rules in the construction sector).

As with financial market liberalisation, the reforms of the corporate sector present opportunities for Australian legal and accounting services and financial consultancies. There is anecdotal evidence that a number of international accounting firms in the region (particularly in Thailand) are drawing on Australian nationals to help restructure companies.

Corporate sector reforms also offer opportunities for Australian firms to acquire assets in the region. It has been reported that Australian companies are interested in taking an equity position in well-managed, but cash-strapped, companies in Thailand. In addition, several Australian manufacturing companies have moved to establish joint ventures with local partners in Indonesia, while Australian exporters are investing in Malaysia and using it as a base for exporting to other countries in the region (and are also taking equity in some of the locally listed companies).

**Trade liberalisation**

Since the onset of the economic crisis, a number of countries in the region have taken steps to remove or lower barriers to trade. These include Indonesia (removal of energy subsidies, deregulation of trade
in agricultural products and abolition of restrictive marketing arrangements), Korea (tariff reductions on some items), the Philippines (accelerated tariff reductions and the removal of price controls on some petroleum products) and Chinese Taipei (increased competition in intermodal transport).

This trade liberalisation should be of benefit to Australian exporters through improved market access and increased price competitiveness (due to lower tariff rates). This should especially be the case over the longer term as these economies experience a pick-up in economic growth and, hence, increased domestic demand. However, moves by some countries in the region to institute both trade and non-trade barriers could be dangerous. For example, the Malaysian Government is encouraging a “Buy Malaysia First” policy as a result of the economic slowdown while tariffs have been increased in Thailand on products such as automobiles, automotive components and luxury items such as wine and cheese. Increased protectionism would slow overall growth and hence the pace of recovery in the region.

Foreign investment flows into Australia

The current financial situation in East Asia has affected investment flows to the region. Since the onset of the crisis there have been large capital outflows from a number of economies in East Asia, most notably Indonesia, Korea, Malaysia and Thailand. These outflows were caused in part by these economies maintaining foreign investment policies which necessitated over-reliance on debt, particularly short-term debt. These adverse financial conditions have made Australia a safer investment destination relative to other economies in the region, and could be expected to lead to increased investment in Australia from third markets such as Europe and the United States. Chinese investors have also indicated that they are considering a number of investments in Australia (such as gas projects and agriculture).

On the other hand, the economic crisis has had adverse wealth effects on investors in the region through asset price deflation and currency depreciations. The currency depreciations have meant that the cost of investing in many of the East Asian economies is relatively cheaper vis-à-vis investing in Australia, while the corporate collapses that occurred as a result of the crisis have created a number of “bargains” for astute investors. In addition, some investment projects in Australia may be delayed because of the downturn in demand in the region. These factors are expected to lead to lower foreign direct investment from the region into Australia.

The impact of the economic crisis on Australian industry

As noted above, the economic crisis in East Asia is affecting the Australian industry and service sectors to differing degrees. Some, such as tourism, have been badly affected, while others, such as exporters of intermediate goods and suppliers of financial services, are beginning to benefit from the crisis.

Tourism

As a highly discretionary consumer product, outbound tourism from most of the East Asian economies experienced an almost immediate decline in the wake of the financial crisis. For example, statistics show that arrivals from North-East Asia fell by 16% in the nine months to September 1998 compared to the same period in 1997, while those from South-East Asia fell by 18%. More specifically, tourist arrivals from Korea fell by 76%, while arrivals from Indonesia and Malaysia fell by 46 and 23%
respectively. Arrivals from Japan fell by 7% over the same period. This decline has been mainly in the area of group travel. However, this slide has been partially offset by an increase in arrivals from the United States and Europe, as travellers choose relatively cheaper Australian holidays. Despite this offsetting factor, total tourist arrivals in the period January to April 1998 fell by 5%.

Australia’s domestic tourism sector may also be adversely affected by the crisis, as Australian holiday-makers take advantage of cheap Asian holidays. The Tourism Forecasting Council expects the increasing trend in outbound travel to continue as the price of domestic travel is expected to grow at a faster rate than the price of overseas travel and accommodation in the next few years. However, recent data suggest that the growth of outbound travel has slowed, as decreases in departures to expensive North American and European destinations have exceeded increases to Asia. The depreciation of the Australian dollar is also expected to have a dampening effect on the growth of outbound travel to destinations such as Europe and the United States.

In the longer term, industry representatives have indicated that Australia’s prospects remain quite promising, given our current price competitiveness (compared with European and US destinations). Commentators have also indicated that Australia is well placed to pursue opportunities in other tourism-related areas, including in the ecotourism sector. In addition, there are opportunities for Australia to build new markets in countries such as China and India which have not been affected to the same extent as other regional economies.

**Education**

The total number of international students studying in Australia grew very strongly over the course of the 1990s. However, this growth slowed appreciably in 1997 and is forecast to level off in 1998. This is in response to a predicted fall in the number of students from the major source countries of East Asia, especially Korea (-23.7%), Chinese Taipei (-14.6%), Hong Kong (-11.5%), Thailand (-10.4%) and Indonesia (-7.6%). Offsetting these falls is an expected increase in students arriving from other Asian countries such as India and China, as well as from Europe and the Americas.

Australian Education International forecast that the number of international students studying in Australia will increase by 3% in 1999, 6% in 2000 and 9% in 2001, mainly as a result of an increase in students from India, China, Vietnam, Europe and the Americas. This is expected to increase total education and training revenue generated by overseas students from A$ 3.22 billion in 1997 to A$ 4.49 billion in 2001. However, student numbers from Hong Kong, Indonesia, Korea and Chinese Taipei are all forecast to continue to fall over this period.

Some countries in the region (such as Indonesia) are implementing education import replacement policies and programmes which may adversely affect the number of students from the region studying in Australia over the longer term. There is, however, potential for Australian institutions to provide in-house training services (including vocational training and language courses) in a number of occupational categories in countries such as Thailand – particularly as Australia’s competitiveness has increased relative to that of Europe and the United States.

**Legal, accounting and financial services**

There is anecdotal evidence that Australian firms providing legal, accounting and financial services are in demand in some countries in the region (such as Singapore and Thailand), and that international accounting firms are drawing on Australian nationals to help restructure companies. This is not
surprising given Australia’s recent history of working through the property downturn in the late 1980s, deregulation of financial markets and the opening up of companies to international markets. It appears that Australians have the appropriate skills and experience to benefit from the changes that will continue to occur in the region as a result of the crisis. However, the drop in property and stock markets, combined with the global mergers of financial institutions, has lowered demand for financial services in Hong Kong.

Building and construction

The property glut in a number of the East Asian economies (such as Hong Kong, Indonesia, Malaysia, Singapore and Thailand), combined with manufacturing over-capacity, is reducing exports of building materials and construction-related services from Australia to the region. Recent data show that exports of building materials (iron and steel, cork and wood, prefabricated buildings, sanitary plumbing, and so on) fell in the first quarter of 1998 by over 25%. This has also affected exports of housing-related consumer goods such as bedding and furniture, which fell by nearly 40% for the same period. Anecdotal evidence also suggests that Australian building and construction firms in the region (such as CSR and Concrete Constructions) have cut back staff in some countries, while BHP has noted that orders are down and that new steel projects in Thailand have been postponed for two years.

The impact of the downturn in the property market on building and construction firms has been exacerbated by the cancellation or deferral of major infrastructure projects in Indonesia, Malaysia and Thailand. However, the announcement of multi-billion-dollar infrastructure projects in China to stimulate the economy, along with new public works programmes in Singapore, and new rail and road projects and the redevelopment of the old Kai Tak airport site in Hong Kong, may partially offset the effects of the deferral of other infrastructure projects in the region.

Overall, the prospects for the building and construction industries in the region over the next three to four years look grim, as it will take some time for the property glut to be absorbed. For example, industry analysts suggest that it will take up to five years for the economy to absorb the massive oversupply of offices and condominiums in Thailand. A similar situation exists in a number of neighbouring countries: Singapore has an excess supply of residential housing (around 20,000 units), sales of housing in Indonesia have stalled as a result of high interest rates, the property market in Hong Kong remains depressed, and high interest rates have cut demand for property in the Philippines.

The building and construction industry in Australia largely produces non-traded goods, and is therefore not subject to much foreign competition. The impact of the financial crisis on domestic industry is likely to be felt through lower demand for office space and residential property by East Asian investors, along with a downturn in tourism-related construction. Offsetting this, however, is the construction boom being experienced in the lead-up to the Olympic Games in Sydney, and the resilience of the housing sector due to the current low interest-rate environment. Industry analysts expect continued growth in the building and construction industry in Australia for the next two years.

Textiles, clothing and footwear

While the bulk of Australia’s exports of textiles, clothing and footwear are to New Zealand and the United States, substantial export markets exist in Hong Kong and Singapore (and to a lesser extent, China, Japan and Malaysia). The slowdown in domestic demand in East Asia has already started to affect exports of textiles, clothing and footwear to the region. Exports of articles of apparel fell by 38% in the first quarter of 1998 to A$ 15 million, while exports of leather manufactures fell by nearly
45% to A$ 19.5 million and exports of textile fibres fell by nearly 39% to A$ 437 million. Exacerbating this situation is the re-imposition of tariffs on textiles, clothing and footwear products in some regional economies. For example, Korea has increased tariffs from 8% to 13% on many of these items.

The currency depreciations in the East Asian economies have improved their international competitiveness, with implications for Australian exporters of textiles, clothing and footwear to markets outside the East Asian region (such as New Zealand and the United States). It is also likely to affect Australian firms supplying the domestic market, as shown by recent trade data (it should be noted that a number of Australian manufacturers have based part of their production facilities in the East Asian region, and therefore the data may include imports of these products). For example, imports of leather manufactures from East Asia rose by over 10% in the first quarter of 1998, while imports of articles of apparel and clothing accessories increased by nearly 48% and imports of footwear rose by over 7%. This growth in imports from East Asia is expected to continue over the next two to three years as the countries of the region embark on an export-led recovery. The impact of the improved competitiveness of the East Asian manufacturers on Australian exports of textiles, clothing and footwear outside the region is difficult to determine. However, it would be expected to have some effect, especially in the lower-priced end of the market (which tends to be more price sensitive).

While the increase in exports of textiles, clothing and footwear from East Asia could be expected to increase demand for basic commodities and intermediate goods from Australia (such as wool and cotton), this is not occurring. This is because domestic demand for clothing in East Asia has fallen, and also because many of the East Asian manufacturers are substituting locally manufactured synthetic fibres (which enjoy a considerable price advantage) for natural fibres (such as Australian wool and cotton). For example, 60% of Indonesia’s textile production is for the domestic market, which has collapsed. This has led to much lower demand for Australian cotton. In addition, many of these firms are experiencing difficulties in accessing trade finance, further affecting demand for Australian cotton. Exacerbating this is the switch from cotton to synthetic fibres. A similar situation exists for wool exports to Korea, where a build-up of stocks and spare manufacturing capacity, plus a switch to synthetic fibres, has led to a drop in demand for Australian wool.

The build-up in spare manufacturing capacity in the region, the financial difficulties experienced by some of the larger manufacturers, and currency depreciations have meant that investment opportunities exist for Australian firms. This is particularly the case for Korea, where the International Wool Secretariat sees potential for Australian investors to buy into Korean spinning and garment industries. This would help secure future export markets. In addition, the closure of upstream processing factories in some of the East Asian countries provides opportunities for Australian firms to undertake some of this production in Australia (such as the manufacture of wool tops).

**Pharmaceuticals**

Exports of medicinal and pharmaceutical products to East Asia have remained resilient since the onset of the crisis (at A$ 109 million for the first quarter of 1998), due mainly to a pick-up in exports to Hong Kong and Chinese Taipei. A reason for this could be the depreciation-induced cheapness (relative to Europe and the United States) of Australian exports. This could be expected to work to Australia’s advantage in the short to medium term. However, exports of these products to Indonesia, Korea and Thailand have fallen dramatically, possibly as a result of their exchange rate depreciations which have increased the cost of imports of both pharmaceutical products and the raw materials needed for pharmaceutical manufacture.
The financial difficulties experienced by some of the larger manufacturers, combined with the devaluation of the won relative to the Australian dollar, have meant that investment opportunities exist for Australian firms in the pharmaceuticals sector of Korea.

Imports of medicinal and pharmaceutical products into Australia from East Asia fell by nearly 12% in the first quarter of 1998. This may, in part, reflect a downturn in the supply of inputs to East Asian manufacturers due to liquidity constraints. Combined with more expensive imports from Europe and the United States (due to exchange rate movements), this offers the potential for Australian firms to increase their share of the domestic market in the short term.

**Petrochemicals**

There is excess manufacturing capacity in the petrochemicals sector in East Asia. This is largely a result of over-investment by most countries in the region, which viewed this sector as strategically important. This has led to a stock build-up, poor profitability and low prices for many petrochemical products, especially synthetic fibre raw materials and synthetic resins.

As expected, the low domestic demand in East Asia and the stock build-up by manufacturers in the region, have led to a dramatic fall in Australian exports of petrochemicals and related products to East Asia. For example, in the first quarter of 1998 exports of petroleum, petroleum products and related manufactures fell by over 37%, exports of chemical materials fell by nearly 25% and plastics (primary form) fell by over 40%.

At the same time, Australian imports of these products have risen, probably as a result of the improved competitiveness of East Asian producers, as well as a concerted export push by them to trade out of difficulties. Imports of petroleum, petroleum products and related manufactures increased by 5%, while imports of chemical materials rose by over 6% and plastics (primary form) rose by over 19%.

The outlook for the Australian petrochemicals industry in the next three to four years is not bright, even given the expected lowering of tariffs on a number of petrochemical products in countries such as Thailand. This is because of excess manufacturing capacity and high stock levels in a number of countries (such as Korea), combined with further increased production capacity coming on line in some other countries (such as Thailand). In addition, there is likely to be greater competition from the Middle Eastern countries as they push for enlarged market share, especially in the Chinese market.

**Steel**

Australian exports of iron and steel to the East Asian region (the largest steel export market in the world) fell sharply in the first quarter of 1998 (by over 28%). This could be attributed to falling demand in the building and construction industries and the automobile sector, as well as increased competition from the countries of the former Soviet Union. As a result of this, BHP has postponed new steel investments in the region for the next two years. At the same time, however, Australian exports to other markets have been quite strong, and steel exports in 1997 were a record 3.3 million tonnes. The Australian steel industry has also benefited from exchange rate movements which have seen steel prices rising in Australian dollar terms (although they fell in US dollars).

Australian imports of iron and steel from East Asia have also grown in recent times, partly as a result of increased price competitiveness and rising domestic consumption. For example, imports from ASEAN countries almost trebled in 1997, while imports from China, Hong Kong, Korea and Chinese
Taipei increased by 40% or more. In addition, imports from South Africa and Turkey also increased. This trend continued into 1998, with imports of iron and steel from East Asia increasing by nearly 9% in the first quarter of 1998. This import growth will probably lead to lower domestic steel prices and will assist Australian steel users (although not producers).

In the medium term, the OECD Steel Committee expects steel imports into the region to fall dramatically, largely as a result of rising domestic production. For example, Chinese Taipei is expected to become a net exporter of steel by 1999, while some 18 million tonnes of new capacity are expected in Indonesia, Malaysia, the Philippines, Singapore, Chinese Taipei and Thailand (combined) by 1999. This will mean that capacity in these six countries will be some five times the size of the Australian steel industry. The falling demand for steel imports by the Asian economies, combined with rising exports, will lead to a higher level of competition for Australian steel manufacturers in world steel markets.

**Automotive**

Australian exports of automobiles and automotive components to East Asia fell by over 46% in the first quarter of 1998. This was in response to a slowdown in domestic demand, which also led to a downturn in production in a number of the East Asian economies. An increase in tariffs on some automotive imports may have added to this. Demand for automobiles is expected to remain fairly flat over the next couple of years in several of the East Asian countries. For example, car companies in Korea expect that domestic sales will not regain their 1996-97 levels until 2008, while car imports into Indonesia have ceased, partly as a result of low domestic demand which has led to a build-up in unsold stocks. This will adversely affect the export of automotive components to the region: one manufacturer of automotive engine bearings has reported that its largest individual customer (the Holden Engine Plant in Melbourne) has significantly cut its production schedule for 1998 due to its exposure to the Korean market.

On the other hand, there will be opportunities for Australian component exporters as a result of an export surge by some North Asian manufacturers, partly on the back of improved international competitiveness. For example, Korea is actively cutting prices (in US dollars) to boost export sales. In addition, Thailand expects sustainable export growth in the next couple of years which, combined with trade liberalisations (local content requirements will be rescinded from 1 July 1998 and tariff reductions on components will be accelerated), will provide opportunities for Australian component exporters. However, whether this will be enough to offset the slowdown in sales in the region is problematic (see previous paragraph). Opportunities also appear to exist for Australian firms to buy into Indonesian component companies with a view to supplying the large domestic spare parts market there.

Australian imports of automobiles and automotive components from East Asia dipped slightly in the first quarter of 1998. While imports from China, Japan and Chinese Taipei fell significantly, there was a surge of imports from Korea and Malaysia. While it is beyond the scope of this paper to determine the reasons for this, it could be conjectured that Australian consumers are substituting between similar products because of price (such as the A$ 2 000 price reductions on some Korean-made small four-cylinder vehicles described above).

It is difficult to determine what impact the improved competitiveness of Korean-, Malaysian-, and possibly Thai-, produced vehicles and automotive parts will have on domestic sales of Australian-made vehicles which are typically in the upper-medium segment of the market. Australian producers have around 98% of this market, and this is not expected to alter much in the next year or so. The drop
in price of imported small cars is, however, likely to affect the used-car market (especially for these types of cars). This will benefit consumers.

Likewise, it is difficult to determine the impact on Australian automobile exports of the improved competitiveness of some manufacturers in the region.

**Food**

Australian exports of food, beverages and animal feed to East Asia fell significantly in the first quarter of 1998. The exceptions were cereals and cereal preparations, exports of which increased by nearly 14% (to A$ 64.7 million). Luxury food items suffered the greatest falls. These included live animal exports, meat, dairy products, fish, sugar, coffee, tea, cocoa and beverages. Indonesia, Korea, Malaysia, the Philippines and Thailand were the countries where food imports from Australia were most affected. Australian exporters of dairy products and mineral waters to Korea and South-East Asia report a downturn in exports to these markets.

It is expected that East Asian imports of these products will pick up in line with an economic recovery in the region, particularly in the five countries mentioned above (which suffered the most from the crisis). However, high import duties on some food items in Korea and Thailand, and subsidies to domestic producers in Indonesia, may act as a barrier to more Australian exports entering these markets as their economies improve.

Opportunities exist for Australian companies to supply intermediate inputs into the processed food chain in Thailand, which is the world’s fifth largest processed food exporter – and an industry sector which the Thai Government has highlighted as one which can lead an export recovery. Opportunities also exist for the supply of inputs into food production such as fertilisers and pesticides, and for the supply of inputs into processed foods such as bakery products, wheat noodles and chilled and frozen foods. Australian firms also have opportunities for investment/industrial collaboration in food packaging, aquaculture, farm management and logistics management. The liberalisation of foreign investment in Korea will allow Australian firms to take an equity position in the food subsidiaries of some of the chaebol (which are likely to come on the market as the chaebol sell assets to reduce debt). On the other hand, the downturn in domestic demand as a result of the East Asian crisis has led to the cancellation of some Australian investments in the food sector of Korea.

It should be noted that accounting standards and corporate governance laws in some of the East Asian economies (including Korea) are relatively weak, making it difficult for investors to determine the true financial position of companies. As such, investors need to exercise caution.

The increased competitiveness of food and processed food products being produced and manufactured in Thailand may affect Australian firms supplying to the domestic market. In recent times, Australia has imported a significant amount of seafood and cereal products from Thailand. Any price decreases through increased competition in the domestic market will benefit Australian consumers of these products.
THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON CANADIAN INDUSTRY

Overview

The continuing global financial crisis has slowed Canada’s economic growth by reducing the Canadian trade surplus and lowering international commodity prices. It has also put downward pressure on the Canadian dollar as investors have turned to the stability of the US currency.

Forecasts for Canada’s GDP growth have been revised downwards, with the IMF estimating real GDP growth of 2.8% for 1998 and forecasting 2.25% for 1999, while the OECD is estimating real GDP growth of 3.0% for 1998 and forecasting 2.4% for 1999 and 2.9% in 2000.

Canada’s trade surplus dropped from C$ 3.0 billion in November 1997 to C$ 1.9 billion in November 1998, due primarily to the economic crisis in the Asia-Pacific region.

Sharp declines in commodity prices due to excess supplies and a collapse in demand from the Asia-Pacific area have had a significant impact on Canada’s resource-based industries, which contracted by 5.3% between November 1997 and November 1998. The impact of lower commodity prices has had the greatest effect on the economies of British Columbia and the Prairie provinces due to their relatively greater dependence on natural resources.

The global financial crisis has put downward pressure on the Canadian dollar, which posted a record low on 27 August 1998. The Bank of Canada intervened to stabilise the value of the currency in the summer of 1998, by raising the bank rate by 100 basis points. Subsequently, in the fall of 1998, the Bank matched interest rate reductions in the United States, reducing the bank rate by 75 basis points.

Although economic projections for Canada have been revised downwards, the economy is still in relatively good shape, with a declining debt-to-GDP ratio, continued restructuring in the private sector, low and stable inflation, and a recent surge in the value of the Canadian dollar, which posted its best three-day performance in more than a decade in January 1999.

The Canadian Government believes that a sound policy framework, coupled with structural policies to enhance the flexibility and efficiency of markets, has been, and remains, the most effective way to generate jobs and increase living standards. Recent economic performance and the OECD’s December 1998 Economic Outlook, which projects that the Canadian economy will grow at the fastest rate among the G7 countries in 1999 and 2000, indicates that Canada has an appropriate policy framework in place.

5. Submitted by Industry Canada.
Analysis of the impact of world economic developments on Canada

The Asian crisis has affected the Canadian economy in several ways.

**Decline in exports**

The most direct impact of the Asian crisis has been on Canadian exports to Asia, which have dropped by 35% since early 1997. These exports represented less than 8% of Canada’s total exports prior to the crisis. Nevertheless, the reduction has had a significant effect on the province of British Columbia, which ships a third of its exports to Asia. In the first six months of 1998, exports of forest products and finished building products from British Columbia were down by 50%, and it is estimated that real GDP contracted by 0.8% in 1998.

Canada’s trade surplus has also been affected by the Asian crisis, as roughly one-third of exports draw on the country’s natural resource base. The surplus was C$ 1.9 billion in November 1998, down from nearly C$ 3.0 billion in 1997. Exports to countries other than the United States were down by 16% in November 1998 from November 1997, while imports from these regions were up by 3.7% over the same period.

**Lower commodity prices**

The most significant effect of the crisis has been its negative impact on commodity prices. The Asia-Pacific region is a very large consumer of base metals and other natural resources. Slumping demand in these countries has therefore triggered sharp declines in the prices of commodities which are important to Canada. According to an index published by Finance Canada, as of December 1998 commodity prices were 22.2% lower than in December 1997, and 35.3% lower than their peak in December 1996. Canada’s resource-based industries have been particularly hard-hit by the Asian crisis, contracting by 5.3% from November 1997 to November 1998. The consensus view among private sector forecasters is that this sector will continue to suffer from low commodity prices and stagnant world demand in 1999.

The range of commodities affected has been broad.

**Energy commodities**

**Crude oil prices** were approximately 38.5% lower in December 1998 than a year ago due to lower demand from Asia, and higher production from OPEC and non-OPEC countries in early 1998. The plunge in world oil prices is predicted to reduce the province of Alberta’s economic growth considerably.

**Forest commodities**

**Pulp prices** are down 18.4% from December 1997, reflecting weaker Asian economies and significantly higher production capacities. In December 1998, **lumber prices** averaged US$299.60 per thousand board feet, an increase of 3.2% over December 1997. Prices were sharply lower, however, than the peak of US$408.20 attained in January 1997. This decline, which started in late 1997, is due
to lower housing activity in Japan and other Asian economies. In 1998, strong US housing construction helped to offset this decline. The province of British Columbia is the most affected by these weak commodity prices and weak demand.

**Agricultural commodities**

**Wheat prices** were 7.8% lower in December 1998 than a year ago partly due to decreased demand from China and elsewhere in Asia. The low commodity prices have contributed to a significant drop in the incomes of Canadian wheat farmers. **Hog prices** declined for seven consecutive months (a decline in farm cash receipts of 21.6% in the first nine months of 1998 compared to the same period in 1997), with the December price being the lowest ever recorded by the US Commodities Research Bureau. This is partly due to farmers and large companies in the United States and Canada increasing production capacities several years ago in anticipation of increased demand from Asia. The economic difficulties in Asia and Russia have led to a plunge in demand for pork products, precipitating significant price declines and significant drops in the incomes of Canadian hog farmers.

**Government action**: The Canadian Government announced a short-term farm relief plan in December 1998 which will provide C$ 900 million in loans over the next two years to help farmers through the current income crisis. Provincial participation in the income-based programme would boost the available fund for affected producers across the country to as much as C$ 1.5 billion over two years. The nation-wide programme is designed to be compatible with Canada's international obligations under the North American Free Trade Agreement and the World Trade Organization.

**Base metal commodities**

The base metals sub-index is down by 21.3% from its year-ago level due to significant drops in prices for copper and nickel. Asia has been a major source of base metal consumption growth over the past decade, especially for these two metals. It is anticipated that a global oversupply of copper, nickel and aluminium stocks, caused by the dramatic decline in Asian demand, will continue to put downward pressure on prices well into 1999.

**Mining activity** has also declined as a result of the lower demand for base metals. Some Canadian metal producers have had to rationalise production as a result of the significant decrease in metal prices. Output of service industries associated with mineral extraction was down by 50% from the year-ago level in November.

**Other Canadian industries affected by the global financial crisis**

**Steel**

The Asian crisis has affected the Canadian steel market by increasing the volume of steel from countries like India, Indonesia, Japan, Korea, Chinese Taipei and Thailand. These countries have increased their exports to Canada by anywhere from 113% to 8 000% in tonnage terms from the first eleven months of 1997 to the same period in 1998. At the same time the Asian crisis has led to a significant drop in demand for imports of steel, resulting in declining prices. The increasing supply of steel at reduced rates has led to a worldwide upsurge in the filing of trade remedy cases, in which Canada is increasingly involved.
**Non-ferrous smelting and refining**

The non-ferrous smelting and refining industry, which comprises nearly a third of the Canadian primary metals industry, is expected to continue to deteriorate in 1999. Decreased construction activity in the United States and poor performance in Asia will slow exports and continue to keep prices subdued. The combined effects of lower prices, reduced margins and much weaker demand have precipitated the scaling-down of some facilities across Canada and will force producers to postpone planned expansions.

**Tourism industry**

Due to the Asian crisis, tourism from the Asia/Pacific region has decreased, falling by 20% compared with the third quarter of 1997. This decline has most severely affected tourism in British Columbia, Prince Edward Island and parts of Alberta. However, the effects have been offset by the weak Canadian dollar which has drawn a higher number of American tourists to Canada. This has been the primary factor underlying a 6.5% increase in tourism expenditure for the third quarter of 1998 compared to the same period in 1997.

**Telecommunications**

Sales of computers and advanced telecommunications equipment to Asian markets have been lower as a result of the crisis. The share prices of several Canadian companies with extensive dealings in the region have fallen.

**Increased uncertainty in international financial markets**

Increased uncertainty in financial markets in Asia, Russia, China and, most recently, Brazil makes it difficult to predict the full effects of the crisis. The growing uncertainty may lead to a flight of capital from the affected economies in search of a “safe haven”, with the United States being the main destination. This could put further downward pressure on the Canadian dollar and could undermine confidence in the Canadian economy.

**Policies implemented or in the process of implementation in response to the crisis**

The Canadian Government believes that a sound policy framework, coupled with structural policies to enhance the flexibility and efficiency of markets, has been and remains the most effective way to generate jobs and increase living standards. The Bank of Canada’s interventions to stabilise the value of the Canadian dollar in the summer and fall of 1998 have been consistent with this approach.

The only other measure that the Canadian Government has announced is the C$ 900 million farm relief programme described above.

The Canadian Government has a two-track approach to economic policy in the global knowledge-based economy.
First, the government is building a foundation of macroeconomic stability through:

- A balanced fiscal situation.
- A debt-to-GDP ratio on a downward trend.
- Low inflation.
- Low real interest rates.
- Secure trade access to international markets.

Second, the government is building on this macroeconomic foundation by taking targeted microeconomic actions to improve the climate for higher productivity, income growth and job creation in Canada, so as to ensure that Canada benefits from the global, knowledge-based economy. The main components include:

- **Innovation**: Innovation is the main sustainable source of productivity growth. It provides the new tools and techniques that change the way we do things, that help us use all of our resources in a more effective and sustainable way, and that make the economy more dynamic and prosperous. Improving Canada’s innovation performance is a key objective of the Canadian Government.

- **Human resources**: In today’s global knowledge-based economy, the quality of people’s skills and their ideas is an increasingly important source of competitive advantage. An important objective of the Canadian Government is to increase basic and specialised skills by providing access to higher education and by making lifelong learning critical for individuals and corporations.

- **Trade**: Canada is one of the most open trading nations in the OECD area. Increased access to international trade and investment opportunities for Canadian companies not only results in jobs for the companies but also creates business opportunities in other sectors. An important objective for the Canadian Government is to increase the number of Canadian exporters, especially among SMEs, and to diversify the markets to which they export.

- **Investment**: Improving the conditions for investment by both foreign and domestic sources contributes strongly to economic growth. Investment in R&D is required to create the new products and processes that will increase productivity and make Canada more competitive internationally. Foreign direct investment (FDI) can bring many advantages – job creation, access to new technology, increased R&D investment and improved access to global markets.

- **Marketplace framework policies**: Canada’s marketplace framework laws must be geared to making Canada a leader in the global knowledge-based economy. A fair, efficient and effective marketplace forms the basis for attracting investment, enhancing trade and encouraging innovation. It provides the stability and efficiency required to conduct business while maintaining consumer confidence in the products, services and transactions of the marketplace.

- **Information infrastructure**: Developing a leading-edge information infrastructure, and ensuring that citizens have access to that infrastructure, is central to sustaining productivity growth and to succeeding in the global knowledge-based economy. Canada’s goal is to provide all Canadians with the opportunity to access a world-leading information infrastructure – to make Canada the most connected nation in the world.
Measures to assist industries in the countries directly affected by the crisis

The Export Development Corporation (EDC) provides a wide range of financial and risk management services, including export credit insurance which protects Canadian business in foreign markets from a variety of political and commercial risks.
IMPLICATIONS OF THE GLOBAL FINANCIAL CRISIS FOR CZECH INDUSTRY

The first direct impact of the global financial crisis came in May 1997, when the Czech economy was hit by a currency crisis. A spill-over, or contagion effect, from the crisis affecting the Thai baht played a major role at the time, although macroeconomic developments (such as a current account deficit and GDP slowdown) also contributed to the turbulence. The Czech central bank was forced to abandon the fixed exchange rate regime (with a fluctuation band) that had been pursued for more than six years. The Czech koruna depreciated by 10% and has been in a regime of managed floating since then.

The currency recovered relatively rapidly, rising to its pre-crisis level in seven months. But the price to be paid was rather high, as the Government and the central bank tightened fiscal and monetary policies. As a consequence, interest rates increased, inflation rose (a lagged effect of the currency depreciation), economic conditions slowed substantially in 1997 (GDP growth fell to 1%), and then worsened in 1998, when GDP fell by more than 2%.

Surprisingly, the Russian crisis in the autumn of 1998, and the recent Brazilian crisis, had almost no direct impact on the Czech economy, when measured by exchange rate developments. The koruna actually appreciated during the Russian crisis, and remained overvalued until the end of January 1999. However, there were strong indirect effects, in three respects:

- There was a fast and substantial fall in bond and equity prices on the Prague Stock Exchange as foreign investors compensated for their losses in Russia by massive sales of stocks in Central European markets.

- Due to the Russian crisis, both the sovereign rating of the Czech Republic and ratings of the leading Czech companies were downgraded. Thus, Czech firms lost easy access to international financial markets. Risk premiums for Czech firms grew by 15 to 50 basis points.

- Due to slowed growth in the EU countries, and to the slowdown in international trade in the second half of 1998, Czech exporters have been facing a less favourable climate (the EU countries absorb more than two-thirds of Czech exports).

These trends have had a strong negative impact on the Czech corporate sector. Due to depressed domestic demand and sluggish export growth, the financial situation of many Czech companies has deteriorated substantially. For historical reasons, the Czech corporate sector is strongly dependent on bank credits. The average manufacturing company covers 45% to 50% of its financial needs from own resources, 1% from the capital market, and around 50% through bank credits. In comparison, the figures for EU companies are 70-75% own resources, 5-7% capital market, 20-25% bank credits (predominantly long-term).

As a result, Czech firms are highly sensitive to the price of money, and to the availability of credit. Moreover, Czech monetary policy was very strict during the last 15 months, which has resulted in a

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credit crunch. Only a few dozen blue-chip companies and foreign-owned firms can obtain bank credit relatively easily; other firms face substantial problems.

On the one hand, this situation has created strong pressure for Czech firms to restructure. Some indicators show that microeconomic restructuring accelerated in the last year: overall unemployment increased, employment in manufacturing went down by almost 4%, and the share of higher-value-added products in exports (SITC categories 7 and 8) grew by 2 percentage points to reach 54%.

On the other hand, the weak financial base of Czech businesses is preventing many firms from completing their restructuring exercises. Innovation is impeded by a lack of funds, as can be seen in the stagnation or even slump in fixed capital investment. Statistical evidence shows that firms are trying to maintain investment in machines and technologies, while substantially reducing investment in buildings and infrastructure.

At the same time, Czech firms are facing keen competition, both in domestic and foreign markets, from producers from other emerging markets, especially in steel, chemicals and textiles. This additional factor means that restructuring and a shift to higher-value-added products that compete on the basis of quality rather than price have become even more vital.

The need for restructuring combined with a lack of funds creates strong opportunities for foreign investors seeking long-term engagements, through both direct and portfolio investment. Depressed stock prices provide additional openings.

The Czech Government is striving to build a more supportive environment for both domestic businesses and foreign investors. The steps have thus far included:

- Additional funds to foster exports (credit guarantees, export insurance).
- Special incentives for investors bringing in US$10 million or more.
- Additional funds to support small and medium-sized enterprises.

However, these steps are limited by budget constraints, and can be extended only in a climate in which revenues are rising. Moreover, the relatively high tax burden on the Czech corporate sector remains a serious problem.

The main challenge posed by the current Czech economic situation is that of reviving economic growth. It is crucial to design and implement the right mix of economic policies in order to foster economic growth without substantially increasing the external disequilibrium or speeding up inflation, and to strengthen the conditions for successful restructuring. Such a policy mix should:

- Lead to a further decrease of real interest rates to, or below, the January 1998 level, while at the same time supporting a smooth depreciation of the overvalued koruna.
- Include measures to reduce the direct and indirect tax burden on the Czech business sector.
- Accelerate the improvement of legislation and the strengthening of the institutional framework.
INTRODUCTION

After initially hitting the Asian countries in the middle of 1997, the financial crisis, which later affected Russia, has had a worldwide impact, not only on the developing, but also on the developed countries.

As from July 1998, the international environment deteriorated markedly and the turmoil in capital markets intensified. In addition to a worsening of the underlying economic conditions in Asia, Russia experienced a serious crisis and Latin America was also affected. In this environment, tensions in financial markets have been reflected in volatility in equity prices and an increase in the spread of external borrowing, particularly in emerging markets.

These developments have affected financial markets in Turkey, particularly in terms of foreign trade and growth in the output of industrial firms.

In an attempt to reduce tensions in financial markets, the Turkish Government announced a series of measures aimed at reducing transaction costs and increasing liquidity in the market. Moreover, with the positive impact of the initiatives taken by the United States, Japan and the International Monetary Fund at the global level, tension on Turkey’s domestic financial markets has declined significantly.

The negative effects of the global crisis on Turkish industry were not strong enough to prompt specific measures. Coincidentally, a Three-year Structural Adjustment and Stabilisation Programme aimed at overcoming the serious long-run problems of the Turkish economy, which was prepared in 1997, was implemented in 1998.

THE IMPACT OF GLOBAL CRISIS ON INDUSTRY

General impacts

In the short term, the global crisis has affected industry growth, capacity utilisation, employment and exports. The sectors most affected have been food, textiles and clothing, leather, chemicals, petrochemicals, iron and steel, and the automotive industry. Longer-term implications are being felt in the area of investment; for example, some planned foreign direct investments have been postponed. Furthermore, increases in the cost of finance are expected to affect investment trends negatively.

7. Submitted by the Turkish Government.
Turkish industry has been affected in several ways:

- Decreased domestic demand due to the measures taken in the framework of the Three-year Structural Adjustment and Stabilisation Programme.
- Slowed export growth due to the measures taken by the crisis economies, increased competition from the crisis countries on Turkish export markets, and slower economic growth in the OECD countries.
- Higher interest rates, causing further financial difficulties for industrial firms.

**Output**

The growth rate of value added in industry fell to 1.1% in the third quarter of 1998, from 2.7% in the second and 7.9% in the first quarter, relative to the previous year. This translated into an increase of 3.7% for the first nine months of the year.

The quarterly manufacturing production index increased by 9.5% in the first quarter of 1998 and by 2.2% in the second quarter, before decreasing by 0.9% in the third quarter, relative to the same period of the previous year. The cumulative increase during the January-September period was only 3.3%, down from 11.5% a year earlier. During this period, output declined in the textile and paper and printing sub-sectors, while growth in production slowed significantly in the food, basic metals, chemicals and machinery industries. Over the January-November period, output growth declined to 3.2%.

**Capacity utilisation**

Capacity utilisation rates in manufacturing were 77.5% in the first quarter of 1998, 76.1% in the second quarter and 77.6% in the third quarter. Nonetheless, the capacity utilisation ratio in the third quarter of 1998 was 3.3 percentage points lower than for the same period a year earlier. According to the Monthly Survey of Trends, in November the capacity utilisation ratio in the private sector declined by 6.4 percentage points compared with the previous year, falling to 74%.

**Employment**

The index of production workers in manufacturing increased by 2.8% in the first quarter of 1998, and by 2.6% in the second quarter, but then fell by 0.9% in the third quarter relative to its previous year’s level. The reduction included a 2.8% decline in private sector textile and leather firms. It is estimated that the number of workers laid off during the first three quarters of 1998 was approximately 60 000 to 80 000 in manufacturing, including 40 000 to 50 000 in the textile sector alone.
Foreign trade

Turkey carried out trade to the value of more than US$2.9 billion with the Asian countries in 1997. In comparison, trade with Russia amounted to US$4.2 billion. In addition, the volume of shuttle trade with Russia is valued at some US$6 billion. Due to the magnitude and sectoral composition of exports, the impact of the Russian crisis on Turkish industry was more severe than that of the Asian countries.

The Asian crisis negatively affected Turkish exports to both crisis and developed countries where Turkish industry had been under the pressure from competition by the crisis economies. In some industries, such as iron and steel, where about 30% of exports were shipped to Asian countries, the effects were more serious. On the other hand, industry has benefited from lower input prices for imports from these countries.

In contrast, exports to Russian markets were concentrated in several sectors which were very deeply affected: the textile, ready-made clothing, shoes, food, chemicals, electrical machinery, and automotive industries. Moreover, shuttle trade, which was concentrated in textile and leather products, was also affected, falling by 24% in the first three quarters of 1998, and by 65% in the last quarter.

Although the Asian crisis started in 1997, its effect on Turkish industrial exports was not felt immediately. Industrial exports continued to rise in 1997, reaching US$24.8 billion, up by 13.3% from the previous year. Foreign trade figures for January-September 1998, on the other hand, reflected the impact of the global crisis. During this period, exports increased by only 0.9% in nominal terms, with shipments to the Asian region and the Russian Federation declining by 50.5% and 26.5%, respectively. Excluding Asia and Russia, a nominal increase of around 6% occurred in exports, reflecting higher shipments to the European Union (except to Germany, where exports were affected by the appreciation of US dollar against the German mark) and to the United States. Turkey’s principal exports are industrial products, the major items being food, textiles and clothing, and iron and steel. The decrease in exports of these products due to the economic crisis has had a negative effect on the export performance of the Turkish economy.

In January-September 1998, imports declined by 1.6% in nominal terms. The decline reflected a sharp reduction in the value of oil imports, as well as a decline in domestic demand and output growth.

Sectoral impacts

Food

Basic food production increased by 4.4% during the first nine months of 1998, relative to the same period of the previous year. There was a sharp decline in exports of certain food products between January and November, mainly due to a decrease in shipments to Russia.

Textiles and clothing

The most important manufacturing export sector is textiles and clothing, i.e. the sector most affected by the global economic slowdown. In recent years, large amounts of capital have been invested in this

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8. Shuttle trade refers to trade with neighbouring areas that occurs when tourists purchase and hand carry merchandise back to their home country. The practice, also referred to as “luggage” or “suitcase” trade, is not generally reflected in formal trade statistics.
sector. Developments in domestic and external demand, however, have not been sufficient to use existing capacity. This has resulted in excessive capacity and a reduction in export prices and profits due to heightened competition, causing severe financial hardship for some companies.

Textile production decreased by 1.9% in the half of 1998, and by 9.7% in the third quarter, resulting in a 4.6% decrease over nine months. On the other hand, ready-made clothing production increased by 3.8% in the first quarter, by 1.9% in the second quarter, and by 1.3% in the third quarter of 1998, resulting in a 2.4% increase overall.

Exports of textiles and ready-made clothing increased by 5.2% and 0.9% (in current prices), respectively, during the first ten months of 1998; a slowdown compared to the previous year’s growth. Imports of textiles and clothing decreased by 1.3% in the first ten months of 1998 relative to the previous year.

Leather products

Leather products were particularly hard hit by the Russian crisis because of the decrease in shuttle trade. Production fell by 12% in the first nine months of 1998. During the same period, exports of shoes declined by 10%, leather clothing by 4%, and total leather exports by 3.8% (22% in September alone). Russia accounted for 59.5% of shoe exports and 26.3% of leather clothing exports in 1997.

Chemicals and petrochemicals

Stagnation in the textile, leather clothing and automotive sectors has also negatively affected the chemicals and petrochemical industries (which produce intermediate products). Basic chemicals production increased by 14.8% in the first quarter, by 3.8% in the second quarter and by 0.7% in the third quarter of 1998, resulting in a 6.3% increase over the first nine months. Petrochemicals production, on the other hand, increased by 16.4% in the first quarter of 1998 and by 1.5% in the second quarter, before falling by 3.5% in the third quarter. This translates into a 4.1% overall increase for the first nine months of the year.

Iron and steel

Approximately 30% of the iron and steel sector’s exports were shipped to Asian countries in 1997. In response to the economic crisis, some of the affected countries started to implement economic stabilisation programmes. Nonetheless, as a result of decreasing demand in the region, exports declined by 17.3% during the first nine months of 1998, with exports to Asia down by one-half.

Iron and steel production in 1998 increased by 0.8% in the first quarter, by 0.4% in the second quarter, and by 8.8% in the third quarter, for an overall increase of 3.4% during the first nine months of the year.

Automobiles

In 1998, automotive production increased by 33.0% in the first quarter, by 6.7% in the second quarter, and by 2.9% in the third quarter. In the fourth quarter, however, there was a considerable decline due
to weakened domestic demand. Recent increases in interest rates underlie the decline in demand. The correlation is strong as in Turkey automobiles are considered investment items.

**Measures taken**

The Turkish Government has taken a number of measures to lessen the negative effects of the global crisis:

- Eximbank’s resources were increased in order to meet the financial needs of exporters.
- Measures were introduced to lower the cost of credit, as follows:
  - The Banking and Insurance Transaction Tax was abolished in certain Eximbank transactions.
  - The levy charged on domestic and foreign credits was reduced.
  - Textile producers have been given the opportunity to buy cotton from the Agricultural Sales Corporation Unions at world prices.
  - The Economic and Social Council met to discuss the impacts of the global crisis on production and employment – the decision was that these impacts will be addressed by the employees’ and employers’ organisations, in close co-operation, and if necessary, further measures will be taken.

**Further steps in a global perspective**

To alleviate the negative effects of the economic crisis, it is crucial to increase world trade. Moreover, the stabilisation programmes introduced should not contain measures restricting the trade of goods and services. Countries should continue their trade liberalisation efforts.

Because of the reduction in domestic demand in the crisis economies, a sufficiently high level of external demand is crucial to enable these countries to overcome the difficulties they are experiencing. Trade between the OECD countries and the crisis economies should be enlarged to the extent possible.

Although Turkey has been affected by the global crisis, it has continued to fulfil its engagements under the WTO Agreement, the Customs Union with the EU, and free trade agreements with a number of countries.

A number of countries as well as international financial institutions such as the IMF, have extended financial packages to the crisis economies in order to mitigate the impacts of the crisis. These initiatives should be given the full support of the international community, and should be expanded if necessary.