

## **Comparative Social Impacts of the Asian Economic Crisis in Thailand, Indonesia, Malaysia and the Philippines: A Preliminary Report\***

Chalongphob Sussangkarn  
 Frank Flatters  
 Sauwalak Kittiprapas\*\*

### **MACROECONOMIC BACKGROUND**

**W**hile there are many common features, the "macro-economic history" of the crisis differs considerably across the four countries. It is generally agreed that rapid financial liberalization, with inadequate attention to problems of corporate governance and of prudential regulation, together with poor macroeconomic management, and other policy and institutional failures, are common factors underlying the problems of these four Asian economies. In retrospect, it appears that their previous growth had been built, at least in part, on shaky and unsustainable foundations. Differences in the extent of these structural weaknesses have resulted in differences in the depth and breadth of the impacts of the crisis in the four countries. At the broadest level, the severity of the social impact of the crisis depends primarily on the magnitude and length of the shock to aggregate demand and incomes. In other words, it is the magnitude of the macroeconomic shock in the four countries which is the first and most important factor in explaining differences in the extent of the "social impacts" of the crisis among them.

There is general agreement that the macroeconomic collapse started as a crisis of confidence, with the most immediate and devastating "cause" being a massive flight of capital, first from Thailand, and then from Indonesia, Malaysia and, to a lesser extent, the Philippines. In the hardest hit countries, the loss of confidence arose from a large and rapidly increased dependence on short-term private capital flows and corresponding current account deficits. The domestic financial sectors in all countries were suffering from a variety of regulatory and prudential weaknesses that had been hidden or made to appear irrelevant in the face of rapid growth and the seemingly endless appreciation of real estate and stock market assets.

As a result of defending against several speculative attacks on the Thai baht in the early part of 1997, Thailand exhausted her foreign exchange reserves by mid-year, and was forced to abandon the baht's peg to a basket of currencies on July 2, 1997. Capital flight, which had been accelerating through the year based on self-reinforcing negative expectations about the baht, caused corresponding collapses of the stock and property markets. This in turn exposed weaknesses in the financial sector, leading to the eventual closure of many finance companies and a corresponding liquidity crunch throughout the economy.

There was a rapid and generally unpredicted contraction of domestic demand, putting Thailand into a major recession, the likes of which had not been experienced for many years.

Indonesia followed a month or two later. In the first instance, Indonesia seemed to be handling its situation much better than Thailand. It did not go through a long period of denial or a vain and costly attempt to defend the currency; it appeared to act much more quickly and decisively in attacking financial sector weaknesses. Unfortunately, a few key policy misjudgments, together with growing political and social uncertainties associated with the health and political plans of President Suharto, combined to make the currency collapse and cause an economic recession much more severe than that in Thailand.

While Thailand's currency at one point fell by 55 percent of its pre-crisis value, Indonesia's dropped by as much as 85 percent. Indonesia's economic growth in 1998 was about -15 percent; Thailand's was -8 percent. Thailand's annual inflation for 1998 was less than 10 percent; Indonesia's more than 60 percent.

Neither Malaysia nor the Philippines had the levels of accumulated short-term debt liabilities of Indonesia and Thailand. And neither of them suffered as much as these countries, especially in the early days of the crisis. While the

Philippines suffered from some of the general contagion effects of the spreading crisis, it has weathered the crisis remarkably well. In fact, alone among the countries covered here, the Philippines has suffered much less from the current crisis than from the one which afflicted the region in the mid 1980s.

While Malaysia did not have nearly as serious short-term debt problems as its immediate ASEAN neighbors, it did suffer from financial sector weaknesses arising from questionable and often politically motivated lending policies. This, combined with growing and increasingly open divisions within the government about the desirability of Malaysia's exposure to global financial forces, diminished market confidence and led to increasing capital outflows. Directly flaunting "IMF orthodoxy," Malaysia chose to insulate itself from global financial markets through the imposition of direct capital controls. It will be difficult to isolate the effects of these controls from other political and economic factors in Malaysia; but for the moment at least, the jury is still out on the question of their effectiveness.

## **DOMESTIC POLICIES AND POLITICS**

Domestic economic policies have certainly played an important role in determining the size of the aggregate macroeconomic shocks arising from the crisis. While it is too early to give anything other than very preliminary "grades" to the four countries, some conclusions are apparent. The Philippines has certainly suffered the least in aggregate terms from the crisis, while Indonesia has suffered the most, in terms of depth of economic contraction and the likely time required for recovery.

To what extent are these inter-country differences due to macroeconomic policies? A question raised in several of the papers is whether the macroeconomic crisis has been aggravated by the "harsh IMF package." After the onslaught of the crisis, Indonesia and Thailand both started out as good "pupils" of the IMF, and yet the outcomes have turned out to be vastly different. The Indonesian paper documents how the country's economic program went "off the rails" when the government lost both monetary control and the commitment to systematic structural reforms. Malaysia, by contrast, has tried some less orthodox strategies, especially relative to the "standard IMF prescriptions."

To go much further than this, however, requires some observations about politics. Thailand suffered initially, in the build-up to the crisis, from indecisive and incoherent macroeconomic policies. However, a smooth, legitimate and peaceful change of government, under the rules of a new constitution, brought in a strong macro-economic leadership. Thailand was fortunate to have recently gone through a constitutional exercise, the strength and legitimacy of which was amply demonstrated in the heat of a severe crisis.

By contrast, Indonesia experienced a widely questioned presidential election at a comparable time in its crisis. The regime's political legitimacy was put under severe stress and did not survive. Unfortunately, the existing rules for succession were also questionable, and Indonesia suffered from a year of political and policy uncertainty, which resulted in enormous and devastating social conflicts and upheavals.

In the face of the crisis, Malaysia has managed to transform itself from a stable, well-managed technocratic government with smooth political succession mechanisms to one characterized by a divisive, politicized policy process and uncertain transition. Well-publicized political actions, provocative policy pronouncements and a number of unorthodox policy actions are argued to have increased uncertainty and reduced confidence in Malaysia's economic recovery.

After considerable turmoil at the end of the Marcos era, the Philippines is now benefiting politically and economically from democratic reforms instituted at that time.

## **Avenues of Transmission of Social Impacts**

The principal avenues of transmission of the social impacts of the crisis can be illustrated with a simple diagram ([Figure 1](#)).

Figure 1 shows that the initial capital flight triggered currency depreciation, domestic credit shortages, widespread corporate financial difficulties, and ultimately severe contractions in demand. This decreased both the demand for labor, with consequent effects on employment and/or wages, and government revenues, with predictable consequences for social expenditures. The currency depreciation also put upward pressure on domestic prices of tradable commodities, including food and other basic commodities. Second round, or contagion effects, were felt through falling export demand and foreign currency prices, which put a further drag on incomes and output. The poor are almost inevitably among the chief groups to suffer from falling incomes and employment, rising prices of basic goods,

and deteriorating social services provided through the government budget.

While the contagion effects of economic contraction spread to other Asian economies, the dimensions and depths of the impacts have been different, ranging from the most serious case of Indonesia to the least serious one of the Philippines. Generally, these countries have underestimated the magnitude of the contraction, as a financial crisis has been transformed into a serious economic and social crisis. As a result, these countries have experienced significant increases in unemployment, poverty, and social problems.

### **Impacts on Unemployment and Income**

While effects have differed in magnitude and composition in the four countries, there have been some broad similarities. In the first instance, the labor market impacts have been much more severe in urban than in rural areas. Decreases in employment, hours and wages appear to have been concentrated much more in the formal than in the informal sectors. And within the formal sector, construction and financial services have been especially hard hit.

With the greatest overall economic contraction among the countries examined, it is not surprising that Indonesia has also suffered the sharpest increases in unemployment and poverty. Based on the limited data available, the Indonesian paper estimates unemployment of 9.6 million persons or 10.3 percent of the labor force, assuming 13 percent economic contraction in 1998. These estimates are close to those of the International Labour Organisation (ILO)<sup>1</sup> (9.3 million people unemployed or a 10 percent unemployment rate), and are lower than official estimates which range from 12 million to 15 million persons unemployed.

The crisis has had much more severe effects in urban than in rural areas. There is also evidence of movements of workers from formal and modern sectors into informal and traditional sectors. About 4 million workers have been displaced from the formal sectors. The Indonesian study estimates a 41.5 percent reduction in employment in construction, 21.8 percent in the financial sector, 25.1 percent in trade, and 14.1 percent in manufacturing. By contrast, there appears to have been a slight increase in employment (0.4%) in agriculture. It is expected that the share of the informal sector will increase up to 66.6 percent.

In addition, primarily due to the very high rate of inflation, the crisis is estimated to have reduced real wages by 30 percent to 50 percent in 1998. This could have a potentially large effect on poverty incidence. The ILO has estimated that about 48 percent of the population, 98 million people, would be below the poverty line by the end of 1998, compared with official government figures of 39 percent, or 79 million. This compares with a poverty incidence of about 10 percent of the population prior to the crisis. According to the ILO and official estimates, the rural poor account for the major part of the increase in poverty due to the crisis. Recent estimates prepared for the World Bank, however, suggest that the poverty incidence might only have increased to 14 percent over the past year.<sup>2</sup> Clearly, a great deal of work remains to be done before we will be able to fully determine the social impacts of the crisis in Indonesia.

Thailand's experience seems to have differed from Indonesia's. Although the crisis appears to have had greater social impacts in urban areas—particularly rapid employment reduction in the construction and manufacturing sectors, as well as sharply increasing underemployment—the rural economy is also experiencing growing unemployment, particularly in agriculture. On the other hand, services and commerce have gained more employment, but at the same time have experienced growing underemployment due to reduced numbers of hours worked. Of the 1.48 million unemployed persons (4.6% of the labor force) in February 1998, about 33.8 percent used to work in construction and manufacturing, and 27 percent were from agriculture.

It is not only the urban areas, particularly Bangkok, that have been seriously affected by the crisis. Traditionally poor rural areas, such as in the Northeast, have also been affected. Unemployment and declining incomes in Bangkok are largely due to the collapse of the financial, manufacturing and construction sectors, leading to large lay-offs of white-collar as well as unskilled workers. Return migration from Bangkok as a result of the crisis has contributed to rising unemployment in the rural Northeast (8.2%). In addition, rural household incomes have also been affected by reduced remittances from the urban sectors, as well as by higher food prices. These factors have offset the benefits to rural areas of rising agricultural prices. Overall, the National Economic Social Development Board (NESDB) has found the number of poor people to have increased and the income distribution to have worsened during the period from 1996 to mid-1998. According to these estimates, the number of poor persons has increased by about 1 million, with the incidence of poverty rising from 11.3 percent to 13 percent.

In Malaysia, it was estimated that the unemployment rate would rise to 4.5-5.5 percent at the end of 1998, leading to a

substantial decline in real household incomes. According to official estimates from the Ministry of Human Resources, 43,838 jobs were lost from July 1997 to May 1998, and the number of job losses was expected to rise to about 80,000 by the end of 1998. It is also estimated that some 206,000 new labor force entrants would join the existing pool of 200,000 unemployed in the job market.

Income losses are being spread across occupations and sectors. Civil servants are taking pay cuts ranging from 5 percent to 10 percent, and a freeze has been imposed on salary increments for higher categories of civil servants. The non-government sector is likely to face greater income reductions as a result of cuts in salary, overtime pay and other benefits. Not captured in official statistics are small and medium enterprises (SMEs) and the self-employed, which are expected to be hit hard by the crisis and to lose substantial income. The crisis has particularly affected certain sectors and groups. As in Indonesia, urban areas are likely to be more seriously hit than rural areas. And as in Thailand, the construction sector has faced a drastic decline in employment, of which 80 percent are migrant workers. About 1 million migrant workers were expected to lose their jobs and sent home in 1998; another 90,000 were expected to be re-deployed in the plantation and manufacturing sectors, leaving the rest competing in the informal sector with the urban poor. While there are no specific policies for urban poverty, the government does have some programs to assist the poor in rural areas. In addition to migrant workers, who constitute the country's underclass, the country paper noted that the main victims of the crisis appear to have been the new middle class created by the past decade's development.

For the Philippines, the upper and the middle classes, especially those living in urban areas, are likely to be most affected by the crisis. Massive business closures are likely to impose the greatest income losses on middle to upper income groups, with high levels of participation in the formal sector. Thus, income distribution would be expected to be made more equal as a result of the crisis. Moreover, middle to upper income families depend to a large extent on remittances from Filipino workers abroad, who are facing falling employment and incomes (mostly from other Asian countries). In contrast, rural families, which depend more on their own entrepreneurial and agricultural activities, seem to be less affected by the crisis.

### **Drops in Fiscal Revenue and Expenditure**

Sharp contractions in income and employment have had a major impact on government budgets, primarily through declining tax revenues. This, together with decisions to observe strict fiscal discipline, has affected government budget plans and has resulted in cuts in a number of crucial programs. Thailand's social services spending in 1998 was reduced by 35 percent compared with the previous year.

While budgets for many development programs are being cut, governments, recognizing the necessity of a "social safety net," have begun to develop programs, financed largely by loans from international agencies, to alleviate the adverse impacts of the crisis on vulnerable groups. In Malaysia, 18 percent of the total social sector budget in 1998 was targeted at assisting vulnerable groups via funds for small farmers, micro-credit for small businesses, community and rural health facilities, skill training, and higher education. For Indonesia and Thailand, 1999 will see greater budget allocations to line Ministries and agencies for social programs and public works in order to create more employment and provide necessary public services.

However, as a result of high levels of foreign debts, Malaysia and Thailand are also expected to sharply increase their budgets for debt servicing in 1999. The estimated increases from 1998 are 72 percent for Thailand and 66 percent for Indonesia.

### **Insufficient Safety Nets**

Generally, these Asian countries have not developed formal "Western-style" social safety nets. Mostly, there is limited mandatory compensation in the form of severance pay or other benefits for those who are laid off; there is no unemployment insurance; and other social security benefits for the unemployed are also very limited. Thus, the vulnerable groups in these Asian countries tend to rely primarily on informal and traditional safety nets provided through the family and/or community. The question then is how well these traditional safety nets have been performing and how vulnerable they will be to a steadily worsening economic and social situation and declining family resources.

While additional resources are being allocated for social safety net programs, there remain some fundamental problems, such as inefficient bureaucracies and high levels of corruption. Thus the effectiveness of these allocations and of many public work programs financed by large loans from international aid agencies (i.e., the World Bank, the

Asian Development Bank—ADB, the Overseas Economic Cooperation Fund—OECD) remains in question. This involves issues of "good governance" in both public and private sectors.

There are also discussions of new approaches to social development, which revolve around the idea of constructing new "immune systems" from the ground up. This would involve enhancing social capital and initiatives to support human and natural resource management at the community level. The goal would be to strengthen communities (which have acted as a temporary shock absorber in the crisis), and to improve the social welfare system.

### **Human Capital Deterioration**

There is considerable concern about possibly significant numbers of school dropouts resulting from the crisis, although estimated dropout rates vary. One Indonesian government estimate claims that as many as 1.65 million children would drop out from primary school and 1.11 million from junior secondary in 1998/99, while some Thai estimates for 1997/98 suggest about 100,000 dropouts from primary school and 90,000 at the junior secondary level. There are claims from the Philippines of crisis-induced school dropouts (although the number has not been documented), and reduced female labor force participation. Malaysia is facing a different kind of problem. As the country has a large number of students studying abroad, falling family incomes and reduced government sponsorships have led to a large increase in demand for tertiary education at home. As a result, in 1998 there were 112,000 applications for only 40,222 places available. In other words, 64 percent of students seeking admission into local tertiary institutions cannot be accommodated.

Health problems, both mental and physical, are reported to be increasing as a result of the crisis. Increased stress levels are producing psychological problems, and suicide rates appear to have increased. At the same time as public health care budgets are being cut, lower incomes are forcing many people to shift from the private to the public health care system. Public health systems and the poor are being affected by rising import prices of drugs, vaccines and other medical supplies. There are concerns about the detrimental long-term effects of these problems on the physical and mental development of children.

### **SOCIAL POLICIES**

The country papers and the discussion at the initial project workshop brought to light a number of interesting and important social policy issues. The following are a few of the issues prompted by the discussion so far.

#### **Formal Social Safety Nets**

As mentioned earlier, the formal social safety net systems in the Southeast Asian countries most severely affected by the crisis are almost non-existent. As a result, the social impacts of the crisis have had to be absorbed by traditional family- and community-based systems. Much of the policy discussion that has taken place has concerned the need to develop more formal systems to supplement and deal with inadequacies of the traditional systems that have been placed under enormous strain.

This does not necessarily mean, however, that these countries should attempt to replicate some "model" or some combination of models from more advanced countries. Indeed, it is important to recall that the formal social safety net systems in many countries have been the subject of considerable debate in recent years. In particular, many of the features of these systems are alleged to have resulted in dysfunctional and harmful rigidities and distortions in labor markets, and have often impeded social mobility and increased unemployment. As a result, many Western countries are undergoing serious re-examination of their social safety net programs in order to strike a better balance between the genuine equity concerns they were meant to address, longer-term growth, productivity, and social mobility goals.

Furthermore, as was also observed above, bureaucratic and political systems in emerging economies such as those studied here often suffer from weaknesses that make it very difficult to implement formal, Western-style social safety net systems effectively. The challenge, therefore, is not to simply copy the West, but rather to learn lessons from their experiences, and design systems which both take advantage of and complement as much as possible traditional local systems, and also take account of political and bureaucratic constraints.

#### **Private Responsibility for Social Programs**

In the absence of formal publicly provided social safety net programs, the private sector, especially in formal, urban labor markets, has been assigned or has taken over some of the responsibility for their provision. Health care and

retirement savings programs, for instance, are often provided or paid for by firms as part of the benefits of employment. In periods of rapid growth, this can be an effective solution to the absence of public programs. However, when recession strikes, massive layoffs occur, and new jobs are difficult to find, displaced workers are left without vital services just at the time when they might be needed most.

Once again there is the issue of whether responsibility for such programs should be taken over by the public sector, or whether mechanisms can be found to remedy deficiencies in privately-provided programs. Establishing or clarifying conditions under which benefits would be vested in employees, even when they are dismissed or voluntarily leave employment would be one such mechanism for improving the effectiveness of privately-provided programs. Experience is showing that an essential element of reform in this area is improvement in rules and procedures to establish the priority and speedy disposition of the rights of employees in the case of illiquidity or insolvency of firms. Early in the crisis, Thailand increased the minimum number of months of severance pay to which employees are entitled in the case of layoff. This provision seems to have had an important effect in inducing firms to retain workers on reduced hours and/or wages rather than to engage in layoffs. This has provided a kind of safety net in which diminished work and wages are shared among all workers, thus achieving a kind of income sharing that could not have been achieved under any public sector programs.

### **Price Controls and Subsidies to Protect the Poor**

A major source of vulnerability for the poor has been increased in the prices of basic commodities. In Indonesia, where cumulative annual inflation reached as high as 60 percent to 100 percent in late 1998, the cost of essential goods, such as cooking oil, rice, kerosene, basic medicines and public transport, has been a major issue. Since these goods are tradable or have tradable goods as major components of their costs, and many of them are exportable, any attempts to control their prices must also include measures to restrict or control trade in them. For importables, an obvious form of trade measure has been to grant foreign exchange on preferential terms to designated importers. In the case of exportables, export taxes, quotas and bans have been the preferred instruments.

Experience has demonstrated many difficulties in implementing measures such as these. First of all, the subsidy measures have been extremely costly. Subsidizing fuel prices in general as a means of keeping public transport costs low is very expensive. In many cases, and despite the best efforts of external agencies such as the World Bank and the IMF to "budgetize" all subsidies, these costs do not appear in any government budget, but rather arise through price distortions, which penalize domestic producers and/or consumers of the goods in question.

Second, it turns out, in practice, to be very difficult to restrict trade and control prices in an effective and transparent manner. Export taxes, especially when they are 40 or 50 percent, beg to be evaded. In the face of export restrictions and domestic price controls on cooking oil, for instance, domestic supplies simply dried up and disappeared. Preferential access to foreign exchange for particular buyers breeds monopolies and corruption.

In the case of Indonesia, where the economic crisis was accompanied by major social disruptions, often targeted against the Chinese merchant class, high prices and scarcities of basic commodities became a political issue. Chinese traders became scapegoats in attempts to explain away basic economic facts arising from the massive depreciation of the rupiah and massive monetary expansion. Control over many trading activities has become highly politicized, with various special interests fighting for government-sanctioned control of special subsidies to manage the "broken" distribution system. Whatever else might be said for many of these actions and the underlying political processes, they have not done much to help the poor.

Experiences in Thailand and Indonesia illustrate some of the fundamental difficulties in using price regulation to assist the poor. This is especially true of regulation of tradable goods.

### **Market Deregulation and Broad Structural Reform**

A major part of the "IMF program" in Indonesia and Thailand was a major set of structural reforms aimed not only at the banking and financial systems, but also deregulation of domestic markets. In Indonesia the non-financial sector structural reform program was quite extensive. These policies have been criticized on the grounds that they distracted attention from more important macroeconomic and financial policies to deal with the direct causes of the crisis, and from social measures to alleviate the harmful effects of the crisis on vulnerable groups.

The evidence from Indonesia, however, indicates that some of the market deregulation measures successfully redistributed income to groups who traditionally had been among the poorest and most vulnerable in the country, and

who had not shared equally in the rapid growth of the past two decades. Among these measures were those that dissolved monopolistic marketing arrangements and eliminated local taxes and levies on inter-provincial trade in primary commodities, which come primarily from the traditionally poor outer islands. Freeing of trade in basic commodities from these regions, particularly at a time when depreciation of the rupiah was raising their domestic price significantly, has brought unprecedented prosperity to some of Indonesia's poorest people and regions. This is certainly an example of how structural reforms can free markets to achieve high priority social objectives without the need for any further government intervention.

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