Impact of the Asian Financial Crisis on the Southeast Asian Transitional Economies

Conference Papers

Regional Conference on the Impact of the
Asian Financial Crisis on the SEATES
21–22 January 1999, Phnom Penh

Cambodia Development
Resource Institute

Cambodian Institute for
Cooperation and Peace

Central Institute for Economic
Management (Vietnam)

Institute of Economics
(Vietnam)

National Economic Research
Institute (Lao PDR)

National Statistical
Center (Lao PDR)

Thailand Development
Research Institute

DEVELOPMENT ANALYSIS NETWORK

WITH FUNDING FROM THE
INTERNATIONAL DEVELOPMENT RESEARCH CENTRE

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Development Analysis Network
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Foreword

Since August 1997, a network of Southeast Asian research institutes—the Development Analysis Network—has been undertaking collaborative work. With initial funding from the United Nations Development Programme, two meetings were held in Bangkok (August 1997) and Hanoi (December 1997), at which a programme of collaborative research was drawn up. The institutes participating in these meetings were the Cambodia Development Resource Institute, the Cambodian Institute for Cooperation and Peace, the National Economic Research Institute in the Lao PDR, the National Statistical Center also in the Lao PDR, the Central Institute for Economic Management in Vietnam, and the Thailand Development Research Institute. As problems arose with UNDP funding, the Development Analysis Network obtained support from the International Development Research Centre for research, a workshop and a conference (held from 19–22 January 1999 in Phnom Penh) on the *Impact of the Asian Financial Crisis on the Southeast Asian Transitional Economies (SEATEs)*. At the workshop, it was agreed to expand the network by adding a seventh member, the Institute of Economics from Vietnam.

This volume consists of a collection of the papers presented at the conference held in Phnom Penh, attended by about 100 participants, and opened by the Cambodian Minister of Finance. Each country paper was presented and discussed in turn. A comparative discussion of the impact of the crisis on the three SEATEs, and of policy responses to it, was then introduced by Toshiyasu Kato of the Cambodia Development Resource Institute. Finally, a panel discussed the lessons of the crisis for future policy-making. The relatively short presentations left plenty of time for contributions from the floor, and the debate was unusually lively.

In general, the main impression gained by conference participants was that, even though the impact of the Asian crisis began to be felt by the SEATEs in 1998,

each was rather more affected by its own domestic crisis. In Cambodia, the July 1997 fighting in Phnom Penh had a major negative impact on the economy. Relaxed monetary and fiscal policies in the Lao PDR exacerbated inflation and the depreciation of the kip. Vietnam's transition to a market economy ran into trouble as inefficient state-owned enterprises and cumbersome domestic rules and regulations impeded the development of the private sector. As for lessons from the crisis, all three SEATEs recognised the need to develop robust financial systems. Thai experience in this respect provided useful insights for the SEATEs, where financial development is still at a relatively early stage.

Meanwhile, it is hoped that the collaboration between these Southeast Asian research institutes initiated by this study will continue. The Development Analysis Network has plans for further research, and there are regional issues enough to keep it going for many years to come.

Martin Godfrey, Research Coordinator
Cambodia Development Resource Institute
July 1999

Glossary

Acronyms

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
AITC	Annual International Training Courses
AMC	asset management company
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BBC	Bangkok Bank of Commerce
BIBF	Bangkok International Banking Facility
BIS	Bank of International Settlement
BOP	balance of payments
BOT	Bank of Thailand
CCEC	Committee for the Coordination of Economic Cooperation with Neighbouring Countries
CDC	Council for the Development of Cambodia
CDRAC	Corporate Debt Restructuring Advisory Committee
CDRI	Cambodia Development Resource Institute
CEPT	Common Effective Preferential Tariffs
CIB	Cambodia Investment Board
CICP	Cambodian Institute for Cooperation and Peace
CIEM	Central Institute for Economic Management
CIS	Commonwealth of Independent States
CPI	consumer price index
CSF	capital support facility
DAN	Development Analysis Network
DTEC	Department of Technical and Economic Cooperation

EU	European Union
FCDI	Forum for the Comprehensive Development of Indochina
FDI	foreign direct investment
FIDF	Financial Institutes Development Fund
FRA	Financial Restructuring Agency
FRAC	Financial Restructuring Advisory Committee
GCS	government cash surplus
GDP	gross domestic product
GMS	Greater Mekong Sub-region
GSP	generalised system of preferences
IDE	Institute of Developing Economies
IDRC	International Development Research Centre
ILO	International Labour Organisation
ILP	Institutional Linkage Programme
IMF	International Monetary Fund
Lao PDR	Lao People’s Democratic Republic
LECS-II	Lao Expenditure and Consumption Survey (II)
MFN	most-favoured nation
MLR	minimum lending rate
MOR	minimum overdraft rate
MRC	Mekong River Commission
NBC	National Bank of Cambodia
NERI	National Economic Research Institute
NEM	“New Economic Mechanism”
NER	nominal exchange rate
NGO	non-governmental organisation
NIS	National Institute of Statistics
NSC	National Statistical Center
NSO	National Statistical Office
ODA	overseas development assistance
QEC	Quadripartite Economic Cooperation
RER	real exchange rate
SCB	Siam Commercial Bank (Research Institute)
SEATE	Southeast Asian transitional economy
SEC	Stock Exchange Commission
SET	Stock Exchange of Thailand
SITC	Standard International Trade Classification
SME	small and medium-size enterprise
SOE	state-owned enterprise
TCDC	Technical Cooperation among Developing Countries
TCTP	Third Countries Training Programme

TDRI	Thailand Development Research Institute
TICP	Thai International Cooperation Programme
TITP	Thai International Training Programme
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	value-added tax
WGEC-CLM	Working Group on Economic Cooperation in Indochina and Myanmar
WPI	wholesale price index
WTO	World Trade Organisation

Introduction

The Asian Financial Crisis and the Southeast Asian Transitional Economies: Impact, Policy Responses and Lessons

Toshiyasu Kato

A recent report by the Asian Development Bank (ADB) declared that the economies hit by the Asian crisis have finally bottomed out and begun to move towards recovery (ADB 1999). It predicts that, after a 7-percent contraction in 1998, the Southeast Asian economies will grow by 0.8 percent in 1999, and more strongly by 2.8 percent in 2000 (Table 1 overleaf). The extent of the recovery will vary among the economies, however. South Korea and the Philippines will grow faster than Thailand, Malaysia and Indonesia, according to the ADB projection. The Southeast Asian economies experienced inflation of 21 percent in 1998, yet are expected to curb this to 8.3 and 6.4 percent in 1999 and 2000 respectively.

Although a large number of studies have examined these crisis-hit economies, relatively little attention has been paid to the impact of the crisis on the Southeast Asian transitional economies (SEATEs)— Cambodia, the Lao PDR and Vietnam. The SEATEs are small relative to other developing Asian economies, yet their role as newly emerging market economies has been growing in recent years. They are expected to play a much larger role in the region in the next decade than ever, since all three SEATEs are likely to accelerate their transition to market economies and integrate themselves with the region through the ASEAN Free Trade Area (AFTA).

Recognising the urgent need to understand the implications of the Asian crisis for the SEATEs, six research institutes in Cambodia, the Lao PDR, Vietnam and Thailand—the Development Analysis Network (DAN)—undertook a collaborative research project in late 1998 which aimed to answer the following questions:

Table 1. Economic Prospects of the East and Southeast Asian Economies

	Growth rate of GDP (annual percentage change)					Change in consumer prices (annual percentage change)				
	1996	1997	1998	1999[1]	2000[1]	1996	1997	1998	1999[1]	2000[1]
Southeast Asia	7.1	4.0	-6.9	0.8	2.8	6.6	5.6	21.0	8.3	6.4
Cambodia	7.0	2.0	0.0	4.0	6.0	9.0	9.1	12.0	10.0	6.0
Lao PDR	6.9	6.9	4.0	–	–	13.0	19.3	90.1	37.0	–
Vietnam	9.3	8.2	4.0	3.7	4.5	4.5	3.6	9.2	8.0	7.0
Thailand	5.5	-0.4	-8.0	0.0	2.5	5.9	5.6	8.1	3.0	5.0
Indonesia	7.8	4.9	-13.7	0.0	2.0	7.9	6.6	58.2	17.0	9.5
Malaysia	8.6	7.7	-6.2	0.7	2.7	3.5	4.0	5.2	4.2	3.8
Myanmar	6.4	4.6	4.0	3.0	4.0	16.3	39.7	50.0	–	–
Philippines	5.8	5.2	-0.5	2.4	4.0	9.1	6.0	9.7	8.5	7.0
Newly industrialised economies	6.3	6.0	-1.4	2.3	4.3	4.3	3.5	3.8	1.1	2.3
Hong Kong	4.5	5.3	-5.1	-0.5	2.0	6.3	5.9	2.8	-1.5	1.0
South Korea	7.1	5.5	-5.5	2.0	4.0	5.0	4.5	7.5	2.0	3.0
Singapore	6.9	7.8	1.5	1.0	4.0	1.4	2.0	-1.5	0.5	2.0
Taiwan	5.7	6.8	4.8	4.9	6.3	3.1	0.9	1.7	1.9	2.6
Other										
China	9.6	8.8	7.8	7.0	6.5	8.3	2.8	-0.8	2.0	3.0
Mongolia	2.4	4.0	3.5	3.5	4.0	58.7	17.5	6.0	9.5	5.0

1 = ADB projections. Source: ADB (1999)

1) *What impact has the Asian crisis had on the SEATEs?* The impact of the Asian crisis on the SEATEs could be both economic and social. The economic impact affects both the real and monetary sectors of the economy, and consumers as well as enterprises. The social impact affects individuals, communities and society as a whole, through loss of jobs, pressures on the livelihoods of the poor and of vulnerable workers, and the deterioration of the social fabric, such as increased crime, child labour and prostitution. The economic and the social impacts are inter-related and equally important.

2) *What policy measures have the governments of the SEATEs taken to respond to the crisis?* The governments of the SEATEs have already implemented, or plan to implement, policies to contain the adverse impact of the Asian crisis on their economy and society. The relevance and adequacy of these policy responses needs to be examined.

3) *What lessons could be drawn from the Asian crisis for future policy-making?* The crisis-hit countries were often praised as the “East Asian miracle” for their remarkable growth and development. The recent crisis has made clear, however, that their tremendous success masked weaknesses and mismanagement in their economies and policies. The Asian crisis thus provides the SEATEs an opportunity to learn from those mistakes, reflect on their own systems and policies, and elaborate strategies for long-term development.

DAN undertook independent studies to seek answers to these questions. The studies of Cambodia, the Lao PDR and Vietnam concentrated on analysis of the actual and

potential impact of the crisis on their economies and societies, using both statistical analysis, special surveys and appropriate case study material. The Thai country paper focused on aspects of the crisis in Thailand which have an actual or potential impact on the SEATEs, in addition to an analysis of the causes of the Thai crisis and its impact on Thailand's economy. Effects on SEATEs may include, *inter alia*, effects on Thai imports of labour, on Thai investment in neighbouring countries, on Thai imports and exports of goods and services, on Thai tourists visiting neighbouring countries, and the diversion of third-country tourists to Thailand.

The current introductory chapter provides a overview of the findings in the four country studies reported in this volume. It also aims to draw a picture of what has happened in the SEATEs as a whole. To do so, economic and social impacts, policy responses of the governments, and lessons for future policy-making are discussed from a comparative perspective. Thailand is used as a yardstick for comparison with the SEATEs.

The structure of this chapter is as follows. Section 1 provides an overview of the origins or causes of the crisis in Thailand. This helps us understand the mechanism of the crisis, and also draw lessons to prevent a recurrence. Sections 2 and 3 discuss the economic and social impact of the crisis on the SEATEs, relative to those in Thailand. Section 4 summarises policy responses of the governments in the SEATEs and Thailand, while Section 5 tries to draw lessons from the experiences of the four countries.

1. Causes of the Crisis: The Case of Thailand

The Thailand country paper (Chapter 4) reviews the causes of the crisis in Thailand. It argues that the crisis was the result of at least four critical factors that were compounded in the economic "boom" that continued until 1995.

The first is foreign exchange liberalisation under the fixed exchange rate system. The Thai government liberalised international foreign exchange transactions with the establishment of Bangkok International Banking Facility (BIBF) in 1993. This measure, aiming to establish Thailand as a financial centre in the region, simplified foreign exchange transactions and facilitated international lending and borrowing. It particularly stimulated out-in activities, *i.e.* lending in domestic markets through borrowing abroad. The Security Exchange Commission Act of 1992 also permitted companies to issue debt instruments overseas without permission from the Security Exchange Commission (SEC). This provided companies, particularly large companies, with access to low-interest foreign funds.

These liberalisation measures caused an influx of foreign capital. This was attributable primarily to the fixed exchange rate system, which eliminated foreign

exchange risks, and high interest rates in Thailand relative to those in developed countries. The sharp increase in public expenditure, while maintaining a balanced budget, also put pressure on the Bank of Thailand (BOT) to maintain high interest rates to control inflation. Consequently, outstanding foreign debt surged from US $44 billion in 1992 to US$91 billion at the end of 1996.

The second factor is weak management of financial institutions. The foreign borrowings would not have been too problematic if financial institutions had properly managed the risks of their borrowing and lending activities. The reality was over-borrowing of unhedged foreign funds and over-investment in many unprofitable sectors such as property development and speculation. Mounting foreign debts and non-performing loans followed. The BOT, the central bank and the sole authority in charge of financial institutions, turned out to be ineffective in supervising and regulating the activities of financial institutions in Thailand.

The third factor is weak governance of the non-bank corporate sector. The phenomenon of over-borrowing and over-investment in the private sector was partly due to weak accounting and supervisory capacity in corporations, including a shortage of experienced auditors. Common practices in companies, such as the mingling of funds among listed and closely held companies of the same family, the use of multiple sets of accounting books, and highly paid rubber-stamp directors, were also noted as an indication of the lack of corporate control and a cause of the crisis.

The fourth factor is the appreciation of the baht and an export slowdown. The real exchange rate of the baht continued to appreciate during the economic boom from 1985. The real appreciation of the baht was due primarily to the continuous and steady increase in price levels in Thailand at higher rates than those in its trading partners. As a result, Thai exports lost competitiveness in international markets, and export growth slowed significantly. Indeed, export growth plunged from 23 percent in 1995 to only 0.5 percent in 1996. Stagnant export growth resulted in the high and persistent current account deficit of between 5 and 8 percent of GDP during the period 1992–96.

All those factors made the Thai economy vulnerable to external and internal shocks. The baht was under speculative attack from international hedge funds for two years after 1996. Despite several BOT efforts to defend the baht from these attacks, massive outflows of foreign capital continued and foreign reserves fell sharply. After severe speculative attacks in February and May 1997, financial institutions ran into trouble as non-performing loans rose, and deposit runs caused a liquidity crunch. The outflow of foreign capital increased further, to the point where foreign exchange reserves were almost depleted. The BOT had no option but to abandon the fixed exchange rate system. Thailand shifted to the floating exchange rate system on 2 July 1997.

2. Economic Impacts of the Crisis

2.1. Foreign Exchange Rates and Prices

The economic crisis in Thailand was triggered by massive outflows of short-term foreign capital after 1996. A drastic depreciation of the baht took place after the Thai government shifted to a floating exchange rate system in July 1997. The so-called "contagion" phenomenon then spread rapidly to currencies in Malaysia, Indonesia, South Korea and other Asian countries. It is thus interesting to ask how and to what extent the foreign exchange rates of the currencies in SEATEs were affected by the contagion (see Table 2 overleaf for a summary of economic impacts).

Our study found that the impact of the crisis on foreign exchange rates varied considerably among the SEATEs. The Lao PDR experienced the largest fluctuations, with the kip losing its value against the US dollar to an even greater extent than the baht in 1997 and 1998. The foreign exchange rate of the kip depreciated dramatically from 1,131 kip to the US dollar in June 1997 to 3,224 kip to the dollar in June 1998 (using parallel exchange rates). Unlike the baht, which bottomed out in February 1998, the kip continued to weaken in the second half of 1998, reaching around 4,700 kip to the dollar in October 1998.

Compared with the Lao PDR, Cambodia was affected only moderately. The exchange rate of the riel depreciated against the US dollar by around 30 percent in the second half of 1997. The riel became stable in the second half of 1998, however, after a period of depreciation before the national election in July 1998. The total depreciation of the riel against the US dollar was around 40 percent from its pre-July 1997 level to December 1998. The impact on the Vietnamese dong was even smaller, reflecting the fixed exchange rate system in Vietnam. The exchange rate of the dong against the dollar was kept at the pre-crisis level throughout 1997, though it was devalued twice in 1998 by a total of 16 percent.

The drastic depreciation of the kip pushed up the domestic prices of imported products, and fueled inflation in the Lao PDR. The consumer price index (CPI) started increasing rapidly, particularly from early 1998, surging by 102 percent in June 1998 from its pre-crisis level in June 1997. The impact on CPI was substantial because around 50 percent of total imports in the Lao PDR came from Thailand in 1997. In addition, lax monetary and fiscal policies in 1997 exacerbated inflation. The growth rate for broad money in 1997 was 64 percent, far exceeding 16 and 27 percent recorded in 1995 and 1996 (IMF 1998). The expansion of direct credit from the Bank of the Lao PDR to finance the building of irrigation systems contributed to the decline of foreign exchange reserves and the expansion of cash circulating in the economy in the second half of 1997 and 1998 (IMF 1998). Policy measures to crack down on parallel exchange markets in May 1997 spurred capital flight, and aggravated the depreciation of the kip.

Table 2. Economic Impact of the Crisis on Thailand and the SEATEs

	Thailand	Lao PDR
1. Monetary sector		
Foreign exchange rates		
- against the US dollar	Large depreciation	Large depreciation
- against the baht	–	Large depreciation
Inflation (1997 / 1998)	Moderate (6.0% / 8.0%)	Extremely high (19.0% / 90.0%)
Foreign private capital inflows	Large-scale outflows	Declining inflows
Interest rates	Increased; recently lowered	Increased
Financial services	Closure of 56 financial institutions; widespread credit crunch	Kip deposits declined sharply
2. Real sector		
Real GDP growth (1997 / 1998)	Slowed; negative (-0.4% / -7.0~8.0%)	Slowed; positive (7.2% / 6.7%)
Export growth	Increased in 1997; slowed in 1998	Slowed; negative in 1997 and 1998
Import growth	Slowed; negative in 1997 and 1998	Slowed; negative in 1997 and 1998
Foreign direct investment	Drastic fall	Drastic fall
Enterprises	Widespread credit crunch; slow recovery of export sector	Slump of wood-related exports
Tourism	Expanding	Less affected
3. Fiscal sector		
Public revenue	Declined	Increased
Public expenditure	Curtailed	Increased, but government counterpart funds curtailed

	Vietnam	Cambodia
1. Monetary sector		
Foreign exchange rates		
- against the US dollar	Small devaluation	Moderate depreciation
- against the baht	Large appreciation	Moderate appreciation
Inflation (1997 / 1998)	Moderate (3.6% / 9.2%)	Moderate (9.0% / 15%)
Foreign private capital inflows	Declining inflows	Declining inflows
Interest rates	–	Increased
Financial services	Overdue bank loans increased	Foreign exchange deposits declined
2. Real sector		
Real GDP growth (1997 / 1998)	Slowed; positive (8.8% / 5.8%)	Slowed; positive (1.0% / 0.0%)
Export growth	Slowed; 21.0% in 1997 and 1.0% in 1998	Increased in 1997; slowed in 1998
Import growth	Slowed, 7.0% in 1997 and -3.0 percent in 1998	Slowed; positive in 1997 and negative in 1998
Foreign direct investment	Moderate fall	Moderate fall
Enterprises	Deterioration in performance of state-owned enterprises	Limited credit crunch; slump of wood and rubber exports
Tourism	Affected	Severely affected
3. Fiscal sector		
Public revenue	Less affected	Declined
Public expenditure	–	Curtailed

By contrast, Cambodia and Vietnam managed to contain the upward pressures on inflation relatively well. Reflecting the lower rate of depreciation of its foreign exchange rate, Cambodia experienced much lower rates of inflation compared to the Lao PDR, recording 9 percent in 1997 and 15 percent in 1998. The two-digit inflation in 1998 was partly attributable to poor harvests due to bad weather conditions. Inflation in Vietnam was kept even lower, at 3.6 and 9.2 percent in 1997 and 1998 respectively.

2.2. Financial Sector

In Thailand, the drastic depreciation of the baht against the US dollar put enormous pressure on commercial banks and finance companies. The problem of insolvent banks and finance companies became acute, as their unhedged foreign borrowing increased dramatically while non-performing loans mounted. Consequently, a large number of financial institutions were closed down in the second half of 1997.

The SEATEs also experienced pressure on the financial sector, though the extent of the impact appears to have been much less than that in Thailand. In the Lao PDR, the massive depreciation of the kip eroded people’s confidence and caused a decline of commercial bank deposits in kip. The emergence of capital flight was also noted. Despite these difficulties, however, none of the banks in the Lao PDR had gone bankrupt as of February 1999. Cambodia also experienced a decline in foreign currency deposits after July 1997, yet only two out of 29 commercial banks in Cambodia, both Thai-owned, closed down their offices in Phnom Penh in the second half of 1998 (one of these banks recently re-opened). In Vietnam, the amount of overdue debt in the banking system increased more rapidly than in the period before the crisis, and eroded confidence among depositors in Vietnam. The problems in the banking sector were partly associated with difficulties recovering loans from state-owned enterprises (SOEs).

The performance of the financial sector in the SEATEs needs be interpreted with caution, however. This is because all three SEATEs are still in the early stages of developing the supervisory and regulatory framework that enhances transparency and accountability in the financial sector. At the moment, only limited information is available to assess the activities of banks. In addition, heavy-handed state intervention, particularly in Vietnam and the Lao PDR, make it difficult to assess the “true” performance of the banks. For instance, the banks in Vietnam receive *de facto* subsidies from the national budget because state funds have been poured into unprofitable SOEs, to which the banks are lending funds.

2.3. Real Sector

The crisis in the financial sector had devastating effects on output growth in Thailand. The closure of many finance companies caused a serious problem of credit crunch, as banks became reluctant to extend loans to companies with deteriorating balance sheets. In addition, increased interest rates aimed at restoring confidence and stability in the financial sector raised the cost of borrowing and discouraged private investment. Credit crunch in the financial sector also hindered a swift recovery of exports, as trade credits became scarce. All of those factors contributed to a large contraction of the Thai economy in both 1997 and 1998.

All three SEATEs experienced a slowdown of economic growth in 1997 and 1998, with the declining trend becoming more apparent in 1998. The adverse impact was, however, relatively moderate compared with that in Thailand.

Despite the major fluctuations of foreign exchange rates and prices, real GDP in the Lao PDR grew by 7.2 and 6.7 percent in 1997 and 1998 respectively. The slowdown of the economy was more apparent in Vietnam, where real GDP growth dropped from 8.8 percent in 1997 to 5.8 percent in 1998.[1] In Cambodia, the adverse impact of the Asian crisis was compounded by the domestic political crisis precipitated by the fighting of 5–6 July 1997. The impact of the external and domestic crises forced Cambodia's real GDP to grow only by 1 and 0 percent in 1997 and 1998 respectively.

2.4. External Sector

The slowdown of economic growth in the SEATEs was partly attributable to the slowdown of exports and inward foreign direct investment (FDI). The Lao PDR experienced a fall of exports in 1997 and 1998, and a drastic fall of FDI, reflecting the crisis in Thailand, its largest trade and investment partner. Vietnam managed to maintain positive export growth even after the crisis, but growth rates plunged from 21 percent in 1997 to only 1 percent in 1998. The decline of FDI in Vietnam appears to have been smaller than that in the Lao PDR, however. Cambodia was in a more fortunate situation, as the recent development of the garment sector mitigated the adverse impact of the crisis. Cambodia's exports expanded in 1997 and slowed only slightly in 1998, due primarily to garment exports to the European Union and the United States, which granted the generalised system of preferences (GSP) status to Cambodia. As regards imports, all three SEATEs experienced declines in 1998.

1 According to more recent estimates by the ADB, summarised in Table 1 above, real GDP in the Lao PDR and Vietnam grew by only 4 percent in 1998. The ADB figures are much lower than those reported in the country papers prepared by the DAN researchers.

2.5. Fiscal Sector

Impacts on the fiscal sector varied considerably among the SEATEs. Although Vietnam's public finance does not appear to have been greatly affected, there were fiscal implications for Cambodia and the Lao PDR. In Cambodia, tariff revenues from imports and foreign aid declined after July 1997, due to the domestic and external crises. As a response, the government introduced austerity measures to curtail public expenditures. In the Lao PDR, the increase in the fiscal deficit was caused by both increased public expenditures and the loss of revenues due to the Asian crisis.

3. Social Impacts of the Crisis

In Thailand the financial crisis turned into a social crisis. Unemployment increased sharply, the number of waged employees plunged, and many Thai migrant workers in other regional economies returned home. In the manufacturing sector, a large number of factories had to curtail working hours as an alternative to laying off workers. Many who lost jobs in urban areas returned to the countryside, reversing the flow of migration from rural-urban to urban-rural. Public hospitals have been overwhelmed by people who can no longer afford private medical services. The number of children dropping out from school has increased as their parents can no longer afford to send them to school.

So far the social impact on the SEATEs has not been as severe as in Thailand. However, our studies revealed some evidence that the crisis had been increasingly putting pressures on people's livelihood and undermining social development in all three SEATEs (see Table 3 overleaf for a summary of social impacts).

In the Lao PDR, unemployment rates have not shown any significant change. However, the social impact came to be felt in urban areas more so than in rural areas. A larger number of household members, particularly spouses and children, have been participating in income-generating activities in the capital Vientiane. People in urban areas have increased working hours in secondary jobs to compensate for the loss of earnings from their primary jobs. Responding to a sharp decline in real wages and earnings due to high inflation, people cut back their overall consumption by eating more vegetables and less meat and fish. The price of medicine and the costs of schooling also increased as a result of high inflation and the depreciation of the kip.

The situation in Vietnam appears to be similar to that in the Lao PDR. Unemployment rates increased, primarily in urban areas, with a slight increase at the national level. Adjustment of labour markets has been also taking place inside firms, *i.e.* the increasing number of idle workers within SOEs. The working hours of waged employees in urban areas reportedly declined as well.

Table 3. Social Impact of the Crisis on Thailand and the SEATEs

	Thailand	Lao PDR
1. Livelihood and consumption		
Unemployment	Increased sharply Migrant labour overseas returned to Thailand	No significant change More household members began to work
Working hours	Declined in the manufacturing sector	Increased for secondary jobs
Wages and earnings	–	Real wages declined sharply
Consumption	–	Declined; more vegetables eaten and less meat and fish
2. Migration		
Domestic migration	Urban-rural migration increased	–
Cross-border migration	Migrant workers in Taiwan and Brunei returned home	–
3. Social development		
Health	Public hospitals overwhelmed	Price of medicine increased
Education	School drop-outs increased	Schooling costs increased

	Vietnam	Cambodia
1. Livelihood and consumption		
Unemployment	Increased in urban areas Idle workers in state-owned enterprises increased	Waged employment declined
Working hours	Decreased for waged employees	Increased for vulnerable workers
Wages and earnings	–	Declined for waged employees and vulnerable workers
Consumption	–	Declined, especially for vulnerable workers
2. Migration		
Domestic migration	–	Rural-urban migration increased
Cross-border migration	–	Migrant workers in Thailand returned home
3. Social development		
Health	Unaffected	Health-care costs increased
Education	–	School enrolment declined

In Cambodia, both the domestic political crisis and the Asian crisis have apparently had an adverse impact on the livelihood of the people. The number of waged employees has declined considerably in Phnom Penh, and real wages have dropped. Those who were most severely hit were self-employed vulnerable workers. The earnings of vulnerable workers in Phnom Penh (scavengers, cyclo drivers, vegetable traders and porters) plunged substantially in real terms. These groups responded to the loss of earnings by increasing their daily working hours. A large number of Cambodian migrant workers to Thailand lost their earning opportunities and returned home. Cambodian migrants who worked as construction workers in Thailand were most severely hit, as the construction sector there has been in deep trou-

ble. Although inflation in Cambodia was much lower than that in the Lao PDR, medical costs (including imported medicine) increased disproportionately due to the depreciation of the riel against the US dollar. Enrolment in lower secondary school has also dropped sharply.

4. Policy Responses

The responses of the governments to contain the crisis varied between Thailand and the SEATEs, reflecting the variation of the extent and nature of the problems each was facing (see Table 4 overleaf for a summary of policy responses).

Thailand, the origin of the crisis and the country hardest hit, has taken the most comprehensive measures among the countries studied. With regard to macro-economic policy, the Thai government tightened monetary policy to restore confidence in the financial sector. It also cut back public spending, following the conditions imposed by the International Monetary Fund (IMF). These tight fiscal and monetary policies were subsequently relaxed, as the urgent need for public spending on social services was recognised. Several measures to reform the financial system have been undertaken as well, most notable of which are the closure of insolvent finance companies and the establishment of capital support facilities (CSFs) for solvent finance institutions. Some state-owned enterprises were privatised, and the laws and procedures for foreclosure and bankruptcy were strengthened.

The overall impact of the crisis on the Lao PDR have perhaps not been as severe as that in Thailand, since output growth rates were still positive. However, accelerating inflation and the continued depreciation of the kip raise serious concerns. The Lao government recently made efforts to tighten fiscal and monetary policies to meet this challenge. For instance, the Bank of the Lao PDR limited issuance of the kip and sold central bank bonds to reduce the kip supply in the non-bank sector. The interest rates of kip savings accounts in commercial banks were also raised to encourage people to save their money in kip. The government curtailed public expenditure on overheads, and introduced some measures to enhance tax revenue, such as raising import tariffs on luxury goods. Despite these efforts, however, these measures did not appear to have borne fruit as of January 1999. This clearly indicates the urgent need for new measures to fight inflation and the slide of the kip.

The Cambodian government responded to the twin crises with both macro and structural policy measures. US dollar auctions were undertaken by the National Bank of Cambodia (NBC) to curb the fluctuation of foreign exchange rates following the crises. This turned out to be fairly successful compared to the Lao PDR, as the exchange rate of the riel became stable after a year of gradual depreciation. Foreseeing a shortage of national revenue due to the decline of trade tax revenue

Table 4. Policy Responses of Thailand and the SEATEs to Contain the Crisis

	Thailand	Lao PDR
1. Macro-economic policies		
Foreign exchange policy	Shifted to managed float system	–
Monetary policy	Tightened; recently relaxed	Tightened; raised interest rates for kip savings accounts
Fiscal policy	Tightened; recently relaxed More spending on social services	Recently tightened
2. Structural policies		
Financial sector reform	Various measures: closure of insolvent finance companies; intervention in troubled companies; introduction of capital support facilities for solvent companies	Merger of commercial banks planned
Enterprise reform	State enterprises privatised; corporate debt restructuring Reform of bankruptcy legislation	–
Foreign trade policy	–	Raised import tariffs on luxury goods
Foreign investment policy	Liberalised foreign shareholding limit in financial institutions	–
3. Social policies		
Labour market policy	Several measures implemented (not reported in the Thai paper)	–
Health and education policies	–	–
Poverty alleviation	–	–
Social safety net	–	–

	Vietnam	Cambodia
1. Macro-economic policies		
Foreign exchange policy	Dong devalued twice; foreign exchange controls tightened	Conducted US dollar auctions
Monetary policy	–	Tightened
Fiscal policy	–	Fiscal reforms; broadened tax base; curtailed public spending
2. Structural policies		
Financial sector reform	–	Improved monitoring system for commercial banks
Enterprise reform	Reform of state-owned enterprises	–
Foreign trade policy	Relaxed restrictions on exports; increased restrictions in imports	Raised import tariffs
Foreign investment policy	Measures to promote FDI	Measures to promote FDI; introduced “open skies” policy
3. Social policies		–
Labour market policy	–	–
Health and education policies	–	–
Poverty alleviation	Measures to protect the poor proposed	Requested emergency food assistance
Social safety net	–	–

and foreign aid after July 1997, the government imposed stringent fiscal discipline by reducing public expenditure. Simultaneously, it introduced several fiscal reforms to enhance the capacity of revenue collection. Both measures contributed to reducing the use of monetary financing of the fiscal deficit. The Law on Investment was reviewed to improve the investment climate in Cambodia. Import tariffs on some products were raised to protect domestic enterprises, but questions have been raised about whether this would benefit Cambodia.

Vietnam's policy responses were centred around reviving high economic growth. Recognising that the high growth in the past was led by the expansion of exports and FDI, the government introduced several reform measures to improve the investment and business environment. The deteriorating performance of state-owned enterprises (SOEs) after the crisis prompted an urgent call to accelerate their "equitisation" (*i.e.* privatisation in Western terminology). The Vietnam paper also points to the growing risks of policy failure if the government continues to pour state funds into inefficient and unprofitable SOEs simply to rescue their workers.

5. Lessons from the Asian Crisis

Although further studies are no doubt necessary to draw concrete and detailed lessons for policy-making, some important points have already emerged from the experiences of the four countries studied.

The Thailand country paper points out that Thailand chose a wrong sequence in its financial liberalisation. It argues that some important policy measures should have been taken *before* the financial sector was opened up to foreign capital, such as the removal of inadequate state intervention in domestic financial markets, the establishment of strict bank regulation and supervision, the adoption of a floating foreign exchange system, and the disclosure of reliable information about bank performance to lenders. It stresses that financial liberalisation under the pegged foreign exchange system is dangerous because it tends to cause over-borrowing in foreign currencies when foreign interest rates are lower than domestic ones.

The Thai paper also points to the importance of establishing good governance in both the public and private sectors. Rampant corruption in the public sector not only increased the transaction costs of business, but also led to mismanagement of policy measures. Several irregularities in business practice and unreliable information disclosed by corporations contributed to the loss of investor confidence. Governance in the public and private sectors should therefore be improved to recover from the current crisis.

The Cambodia country paper also points to the importance of the development of a robust financial system and good corporate governance. It stresses that the

early stage of development of the financial and private sectors in Cambodia should be advantageous, because both the successes and failures of the crisis countries provide useful lessons. For instance, several commercial laws which have yet to be passed in Cambodia could incorporate the experience of Thailand to prevent a similar crisis from occurring in Cambodia. The experience of Thailand also gives insights to the best sequence for financial liberalisation in Cambodia when such markets are established in the future.

It was also argued in the Cambodia paper that, while foreign capital can bring a wide range of benefits to Cambodia, some policy measures should be considered to mitigate the volatile and pro-cyclical characteristics of short-term foreign private capital. To do so, efforts to reduce heavy dependence on foreign capital may be considered, such as mobilising domestic savings is an option to finance domestic investment. It may also be worth considering the prioritisation of investment projects according to their duration. High priority should be given to long-term investment projects that are consistent with Cambodia's development strategies and objectives. Careful consideration of foreign borrowing is needed, not only in the private sector, but also in the public sector. The problems of sovereign debt and risk management will increase as the proportion of grants in total foreign aid declines in the future. Finally, establishing the rule of law and a democratic political regime not only nurtures the emergence of democracy in Cambodia, but is also a critical prerequisite for carrying out economic reforms to respond to external shocks.

The Vietnam and Lao PDR papers also referred to the urgent need for reform in the banking sector. Reform measures may include improving the effectiveness of regulation and supervision, enhancing transparency and the disclosure of information, and upgrading accounting systems and risk management. In Vietnam, the reform of SOEs is deemed essential to revive economic growth. The Vietnam paper argues that the equitisation of unprofitable and inefficient SOEs should be accelerated and preferential treatment of SOEs should be reduced to create a level playing field for private enterprises, particularly small and medium-size enterprises. In the Lao PDR it was recognised that the impact of the crisis was partly attributable to the country's heavy dependence on Thailand in foreign trade and investment. Diversifying trade partners is thus seen as a way to minimise the adverse impact of the problems in Thailand. Good corporate governance was also mentioned as a matter of consideration for reforms to develop an efficient market economy in the Lao PDR.

6. Conclusion

The Asian crisis has had an adverse impact on the SEATEs, but the overall extent of this was much less severe than that in Thailand. Cambodia and Vietnam appear to

have been insulated to some extent from the so-called “contagion” phenomenon, whereas the Lao currency, the kip, was severely affected.

The adverse impact of the crisis on the SEATEs came to be felt more strongly in 1998. Export growth and foreign investment declined sharply in Vietnam and the Lao PDR. Increasing joblessness and falling incomes were found in all three SEATEs. High inflation in the Lao PDR put pressure on people’s livelihoods, particularly the urban population. A large number of Cambodian migrant workers, particularly construction workers, lost their jobs in Thailand and returned home.

The adverse impact of the crisis was compounded by domestic problems in the SEATEs. In Cambodia, the political crisis following the fighting of 5–6 July 1997 had a major negative impact on the economy. Relaxed monetary and fiscal policies in the Lao PDR exacerbated inflation and the depreciation of the kip. Vietnam’s transition to a market economy has run into trouble as inefficient SOEs and cumbersome domestic regulations impeded the development of the private sector.

The governments in all the SEATEs took measures to promote a recovery of exports and FDI. Monetary and fiscal policies were tightened in Cambodia, and more recently in the Lao PDR. Some foreign exchange controls and import protection measures were introduced in Vietnam and Cambodia. Few policy measures to mitigate the social impact have been addressed in the SEATEs, however.

All three SEATEs recognise the development of robust financial systems as a major lesson from the Asian financial crisis. Thailand’s successes and failures in developing and reforming its financial sector give useful insights to the SEATEs, whose financial development is still at a comparatively early stage. Each SEATE has to face up to its own domestic issues as well. In Cambodia, establishing the rule of law and concept of democratic political transition are needed to restore confidence in the economy. Vietnam urgently needs to reform the state sector and provide a level playing field for the private sector. The Lao PDR needs to reduce its heavy dependence on Thailand in foreign trade and investment.

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Chapter One

The Cambodian Perspective

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The financial crisis in Asia erupted in Thailand and spilled over to other Asian countries such as Malaysia, the Philippines, Indonesia and South Korea. Although the so-called contagion of the Asian crisis to the rest of the world seemed to have gone into remission by the end of 1998, it is by no means clear that the crisis and its contagion have really ceased. Some crisis countries, such as Thailand and South Korea, appear to have shown signs of economic recovery, whereas Indonesia continues to face not only an economic slump but also social tension and political uncertainty that were precipitated by the financial crisis.

Cambodia is surrounded by Southeast Asian countries which have been adversely affected by the crisis. Cambodia's neighbours, particularly Thailand, Malaysia and Singapore, have also been its largest trading and investment partners in the past five years. The Asian crisis has thus dramatically changed the external economic environment surrounding Cambodia.

The economic boom in the countries around Cambodia from the late 1980s to mid-1997 was one of the major external factors fostering Cambodia's transition to a

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market economy, reconstruction and development. Indeed, Thailand and Singapore have absorbed a large proportion of Cambodia's exports since the establishment of a coalition government in 1993. Foreign direct investment (FDI) from Malaysia, Singapore and other Asian countries also helped supplement the shortage of domestic savings, investment and human resources in Cambodia.

However, this favourable external environment changed after the Asian crisis erupted. Concerns have been expressed about whether and to what extent the crisis affected Cambodia's economy, and to what extent it had an adverse impact on the livelihood of the Cambodian people, 36 percent of whom live below the poverty line. Social development, particularly health and education, is recognised as a priority issue in Cambodia. How and to what extent has social development been affected by the crisis?

The crisis also raises interesting policy issues in terms of how the government should best respond to external shocks to the economy. What policies has the Cambodian government planned and implemented to contain the contagion of the crisis? What policy lessons can the government learn from the experience of other crisis-hit countries?

The current paper aims to answer these questions. It first analyses the impact of the Asian financial crisis on Cambodia's economy and society. Official data published by the government are used to analyse the impact at the macro level, while field surveys and interviews were conducted to assess the impact at the micro level. Second, the paper discusses various policies of the government to contain the adverse impact of the crisis. Official documents and records, as well as interviews with key government officials, were used to gather information. Finally, some key issues are discussed to draw lessons for policy-making. Special emphasis is given to examining the extent to which those issues are relevant in the context of Cambodia.

The structure of the paper is as follows: Section 1 provides our framework and methodology, within which we analyse the impact of the Asian financial crisis. Sections 2, 3 and 4 investigate the impact of the crisis on Cambodia in three areas—the financial sector of the economy, the real sector of the economy, and social development. Section 5 discusses the response of the government to contain the adverse impact of the crisis. Section 6 discusses policy lessons that Cambodia could learn from the experience of other crisis countries. The final section concludes the paper with a summary of findings.

1. Analytical Framework and Methodology

It is not always possible to isolate the impact of the Asian crisis from other incidents that have had a major impact on Cambodia's economy. The fighting of 5 and

6 July 1997 is the case in point. The fighting was precipitated by the conflict between the two major political parties, and changed the fundamental conditions of domestic economic activity in Cambodia. Confidence in political stability was lost, the security and safety of citizens and enterprises in Cambodia was threatened, and the future political environment became uncertain. The international community responded to the July fighting by either terminating or suspending foreign assistance to Cambodia. Soon after the fighting, ASEAN decided to postpone Cambodia's accession to the grouping, which had been scheduled for the end of July 1997.

The fighting in 1997 had an immediate adverse impact on Cambodia's economy. In addition to the destruction and the looting of many factories and shops around Phnom Penh, the foreign exchange rate of the riel started depreciating against the US dollar, inflation soared, consumption and investment expenditures contracted, tourist arrivals plunged, and the inflow of foreign aid was disrupted. The government introduced austerity measures in public expenditures in August 1997 to respond to an expected shortage of public revenues due to the suspension of foreign aid and the loss of customs revenues. All of these contributed to the contraction of aggregate expenditures in the second half of 1997. Consequently, Cambodia's economy grew by only 1 percent in 1997, much lower than the average annual 6-percent growth of real GDP between 1993 and 1996 (Table 1.1). It should be noted that the fighting had a major adverse impact on Cambodia's economy even before the spill-over of the Asian financial crisis was felt in the second half of 1997.

Table 1.1. Macro-Economic Indicators, 1992–98

	1992	1993	1994	1995	1996	1997	1998[1]
Growth rate of real GDP (1989 constant prices)	7.1	4.1	4.0	7.6	7.0	1.0	0.0
Agriculture	1.9	-1.0	0.0	6.5	2.4	1.2	-
Industry	15.7	13.1	7.5	9.9	18.2	-2.9	-
Services	11.2	7.0	7.5	7.8	7.0	2.6	-
Gross domestic savings (percentage of GDP)	7.3	5.6	4.8	5.4	4.9	4.7	-
Gross domestic investment (percentage of GDP)	9.8	14.3	18.5	21.2	20.4	16.1	-
Growth rates of CPI (final quarter basis)	112.5	41.0	17.9	3.5	9.0	9.1	15.0
Growth rates of money supply (M2)	209.0	40.0	29.4	44.3	40.4	16.0	-
Exchange rates (riel/US$)	1,253	2,470	2,543	2,462	2,624	2,989	3,700
Central government operations (percentage of GDP)							
Expenditure	9.8	11.2	16.5	16.7	16.3	13.9	11.7
Revenue	6.2	5.4	9.6	8.9	9.1	9.7	8.1
Budget surplus/deficit	-3.6	-5.8	-6.9	-7.8	-7.2	-4.2	-3.6
Balance of payment							
Current account balance (US$ million)	-50	-190	-329	-474	-485	-346	-329
Current account balance (percentage of GDP)	-2.5	-9.4	-13.7	-16.1	-15.5	-11.4	-11.6

1 = Estimates. Source: World Bank (1999)

Our analysis of impacts is not intended to isolate the impact of the Asian crisis from other major events. Rather, it tries to identify some impacts on Cambodia that could be attributed to the Asian financial crisis, and to observe and analyse the changes that have taken place since the crisis began. Three major impacts are identified and discussed in this paper: 1) the impact on the financial sector; 2) the impact on the real sector; and 3) the impact on social development.

First, the crisis started with financial turmoil in Thailand, and transmitted rapidly to the financial sector in other crisis countries. It is thus reasonable to begin our analysis by examining whether the contagion spilled over to the financial sector in Cambodia. The impact could take the form of the withdrawal of foreign capital, credit crunch, or the closure of commercial banks that are affiliated with or owned by foreign banks in the crisis countries.

Second, the experience of the crisis countries revealed that the turmoil in the financial sector caused a subsequent contraction of the real sector of their economies. Major deterioration of performance in the crisis countries could adversely affect Cambodia's real economy through two channels: 1) the realignment of foreign exchange rates; and 2) the slowdown of economic growth in the crisis countries. Drastic realignment of foreign exchange rates in the crisis countries could affect the competitive position of Cambodia's goods and services in domestic, regional and world markets. This could potentially affect domestic consumption, production and the flow of foreign trade and investment. In addition, the slowdown of economic growth in the crisis countries could reduce the demand for Cambodia's exports, and possibly the inflow of foreign private investment from the crisis countries. Furthermore, some domestic services, such as tourism, could be affected by the crisis.

Third, the economic crisis in the region and its contagion in Cambodia could put pressure on the livelihoods of the Cambodian people, and adversely affect social development, such as health and education. In particular, the poor and vulnerable groups in both urban and rural areas could be severely hit by the internal and external crises. For instance, the crises could reduce earnings and job opportunities of urban workers on the one hand, and increase the prices of the essential items such as food, medicine and education on the other. In rural areas, migrant workers who live near the Thai border may no longer find as high a demand and wages in Thailand as they used to. The loss of income-generating opportunities in Thailand could motivate them to migrate to towns and cities in Cambodia to seek alternative earning opportunities.

The next three sections analyse the impacts of the Asian crisis within the framework described above. In these sections official government data are used to assess the overall impact. In addition, CDRI has conducted a series of interviews and surveys to generate primary information. These small-scale surveys are in-

tended to assess micro impacts of the crisis, particularly on consumers, enterprises and vulnerable workers in urban and rural areas. The surveys fill the gap between the lack of official data in these areas and the need for timely information for research and policy-making. Although the surveys are small in scale and geographically limited, our experience of monitoring Cambodia's economy reveals their value in current circumstances.

2. Impact on the Financial Sector of the Economy

The Asian crisis was triggered by massive and rapid outflows of private capital from the crisis countries. In Thailand, for instance, net private capital inflows recorded an annual average of 10 percent of GDP from 1989 to 1995, and remained around 9 percent of GDP in 1996 (Table 1.2). However, the inflow of private foreign capital reversed dramatically in 1997, such that net capital outflows accounted for 13 percent of GDP. A similar pattern before and after July 1997 was observed in the other crisis countries, such as Malaysia, the Philippines, and Indonesia, though the extent was much less than that in Thailand.

Table 1.2. Private Capital Flows (percentage of GDP)

	1983–88[1]	1989–95[1]	1996	1997[2]
Cambodia[3]	-	-	5.4	4.9
Countries most affected by the crisis				
Thailand	3.1	10.2	9.3	-10.9
Malaysia	3.1	8.8	9.6	4.7
Indonesia	1.5	4.2	6.3	1.6
Philippines	-2.0	2.7	9.8	0.5
South Korea	-1.1	2.1	4.9	2.8
Countries less affected by the crisis				
Singapore	5.0	3.8	-10.1	-5.5
Taiwan	0.2	-4.0	-3.2	-3.8
China	1.2	2.5	4.7	3.7

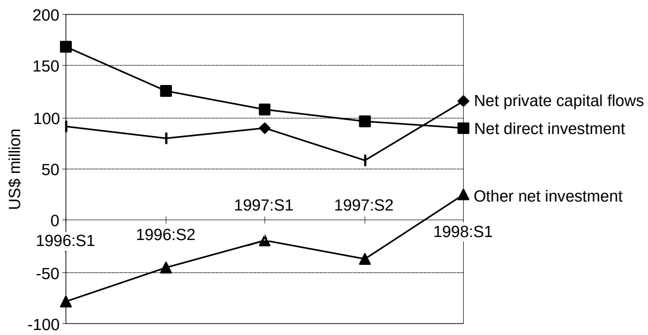
1 = Annual averages. 2 = IMF staff projections. 3 = Actual figures calculated from data from the National Bank of Cambodia. Source: IMF (1997)

The drastic outflows of private capital created a vicious circle in the crisis economies, as their currencies depreciated dramatically and equity prices plunged. A large number of commercial banks and financial institutions suffered from soaring short-term unhedged foreign debt, and mounting unperforming loans. Governments liquidated insolvent financial institutions to restore confidence in the economy. The collapse of the financial sector, coupled with tight monetary policies to curb inflation, pushed up market interest rates in the crisis countries. This had an adverse impact on the real sector in the economy. Many non-financial firms suffered from credit crunch and faced difficulty finding credit even for ordinary operations of production and export. Domestic consumption and investment consequently contracted, and unemployment soared.

Cambodia also experienced a decline in private capital inflows in 1997. However, the scale and the speed of the decline were modest relative to the experience of the crisis countries. For instance, net private capital inflows to Cambodia declined from US$170 million in 1996 to around US$150 million in 1997. In percentage terms relative to GDP, this was a decline from 5.4 percent in 1996 to 5.0 percent in 1997. The extent of the decline was much smaller than that in Thailand, Malaysia and other severely affected Asian countries.

The adverse impact of the Asian crisis instead appears to have been felt more strongly in 1998. First, even though total private capital inflows recovered in the first half of 1998, the proportion of short-term loans increased relative to long-term investment (Figure 1.1). According to the estimates by the National Bank of Cambodia (NBC), net private capital inflows increased by 30 percent from US$89 million in the first semester of 1997 to US$116 million in the first semester of 1998. However, the expansion came from an increase in other net investment, including short-term currency transactions, deposits, loans and trade credit. In contrast, direct investment, which had been a major source of private capital inflows into Cambodia until 1996, continued to decline from US$108 million in the first semester of 1997 to US$90 million in the first semester of 1998. This indicates that the proportion of short-term private capital inflows relative to long-term inflows has been increasing from 1997 to 1998.

Figure 1.1. Net Private Capital Inflows into Cambodia, 1996–98



Second, the Asian crisis has gradually been putting pressure on the banking sector in Cambodia. One of the most notable developments was the decline of foreign currency deposits after mid-1997. Foreign currency deposits expanded rapidly after the operation of private and foreign banks was liberalised in 1991. Since then, foreign currency deposits have comprised the major part of bank deposits in Cambodia, accounting for 90 to 95 percent of total deposits in the past few years. However, this trend reversed after July 1997. The total value of foreign currency depos-

its peaked in February and March 1997, and then started to decline. The decline of foreign currency deposits continued from July 1997 to August 1998, the latest month for which data are available. It should be noted that the internal political crisis appears to have had a major impact on foreign currency deposits—major declines of foreign currency deposits were observed during or after political incidents, for instance, in April 1997 after the 30 March grenade attack on opposition demonstrators, in July 1997 following the July fighting, and in July 1998 before and during the national election.

The decline of foreign currency deposits has been putting adverse pressure on lending in the banking sector. However, the credit crunch to date appears to have been much less severe in Cambodia than in other crisis countries. The total value of outstanding credits increased until May–June 1997, and has since levelled off. The declining trend of credit growth became more apparent after March 1998, when the annual growth rates became negative for the first time. These figures indicate that the impact of credit crunch on the non-financial business sector in Cambodia has not been as serious as the experience in other crisis countries.

Finally, unlike Thailand and other crisis countries, Cambodia did not experience closure of commercial banks until mid-1998. Immediate contagion of the financial turmoil thus did not take place in Cambodia. However, in the second half of 1998, two Thai-owned commercial banks closed their offices in Cambodia, perhaps reflecting the restructuring of banking activities undertaken in Thailand.

To sum up, our analysis revealed that the Asian crisis did not immediately affect the financial sector in Cambodia. However, its adverse impacts came to be felt more strongly in 1998. Why then was Cambodia not immediately affected? First, even though Cambodia had received a large amount of private capital inflows since 1993, the majority of them took the form of FDI. As FDI involves the development of physical facilities and human resources, it tends to take longer for entry/exit decisions to be made than is the case with portfolio investment. Second, Cambodia's financial sector is still at an infant stage, where financial markets for bonds and securities have not yet been established. There is thus no portfolio investment in these markets by foreign and domestic investors. Third, while the banking sector comprises perhaps the only formal financial institution in Cambodia, its role as a financial intermediary to channel savings to investment has been limited. A majority of business enterprises in Cambodia, which are usually small-scale, secure little funding from commercial banks. The turmoil in the financial sector and credit crunch therefore had only a limited impact on the real sector, relative to the crisis countries. Fourth, speculative investment in real estate markets in Cambodia has never been as widespread as that in the crisis countries. Finally, wide circulation of US dollars appears to have acted as a "buffer" to moderate the fluctuation in the foreign exchange rate of the riel.

3. Impact on the Real Sector of the Economy

This section analyses the impact of the Asian crisis on the real sector of Cambodia's economy. Before going into detail, however, the development of the real sector until 1996 is briefly reviewed as a background to the following analysis.

3.1. Real Sector Development before July 1997

The real sector of Cambodia's economy experienced steady growth until mid-1997. Real GDP increased by an average annual rate of 6 percent between 1991 and 1996 (Table 1.1 above). This reasonable performance was led primarily by the expansion of the industrial and the service sectors, even though the agricultural sector continues to play a dominant role in Cambodia's economy. Agriculture comprised 43 percent of real GDP and absorbed almost 80 percent of total employment in 1996.

Cambodia has taken several measures to liberalise international trade since the early 1990s. For instance, tariff lines have been streamlined, and various quantity restrictions have been abolished. Cambodia thus maintains a liberal trade regime.

Cambodia's foreign trade expanded rapidly between 1992 and 1995, stimulated by trade liberalisation and the steady growth of the domestic economy. High economic growth in neighbouring countries also contributed to the expansion of trade. This has, however, led Cambodia to run sizeable current account deficits since 1993, deficits which have accounted for around 12 to 16 percent of GDP between 1993 and 1996. A large proportion of the current account deficit was met by the comparably large amount of unilateral transfers, in the form of foreign aid and grants, during that period.

Cambodia's trade patterns have some notable characteristics and problems. The export structure has been highly concentrated in two products: 1) natural resource-based products (logs, timber and rubber); and 2) light manufacturing products (mainly garments). In 1996, exports of these products (classified as SITC-2 and SITC-8) accounted for 65 percent of total exports in Cambodia (Table 1.3). It should be noted that exports of agricultural products remained at less than 5 percent of the total in 1995 and 1996, despite agriculture's substantial role in domestic production and employment. Cambodia's largest import items in 1996 were machines and transport equipment (SITC-7, including motorcycles, automobiles, televisions and video cassettes), followed by basic manufactures (SITC-6, including construction materials, cement, fabric and steel) and mineral fuels (SITC-3, petrol, diesel oil and lubricants) (see Kato, Chan & Long 1998).

Recent trade performance broken down by country indicates that ASEAN countries are Cambodia's major trading partners, both for exports and imports. In 1996, Cambodia's exports to ASEAN accounted for 67 percent of total exports

Table 1.3. Cambodia's Trade Patterns, 1995–96

	1995	Share (%)	1996	Share (%)
Imports				
1. Food and live animals	77,108	7.2	70,062	7.0
2. Beverages and tobacco	41,767	3.9	46,553	4.7
3. Crude materials, excluding fuels	24,444	2.3	29,785	3.0
4. Mineral fuels	127,001	11.8	142,700	14.3
5. Animal and vegetable oil and fat	3,785	0.4	6,669	0.7
6. Chemicals and related products	57,811	5.4	75,227	7.5
7. Basic manufactures	161,946	15.1	197,005	19.7
8. Machines, transport equipment	249,750	23.2	341,466	34.1
9. Miscellaneous manufactured goods	45,915	4.3	51,151	5.1
0. Goods not classed by kind	285,898	26.6	39,984	4.0
Total	1,075,425	100.0	1,000,602	100.0
Exports				
1. Food and live animals	7,027	4.5	5,644	3.5
2. Beverages and tobacco	3,415	2.2	6,521	4.0
3. Crude materials, excluding fuels	97,326	62.2	75,236	46.1
4. Mineral fuels	-	0.0	60	0.0
5. Animal and vegetable oil and fat	-	0.0	5	0.0
6. Chemicals and related products	591	0.4	194	0.1
7. Basic manufactures	12,676	8.1	18,222	11.2
8. Machines, transport equipment	6,068	3.9	6,286	3.9
9. Miscellaneous manufactured goods	29,460	18.8	29,115	17.8
0. Goods not classed by kind	1	0.0	21,911	13.4
Total	156,564	100.0	163,194	100.0
Re-exports				
1. Food and live animals	7	0.0	20	0.0
2. Beverages and tobacco	205,135	81.6	205,405	89.2
3. Crude materials, excluding fuels	17	0.0	-	0.0
4. Mineral fuels	-	0.0	-	0.0
5. Animal and vegetable oil and fat	-	0.0	-	0.0
6. Chemicals and related products	10	0.0	114	0.0
7. Basic manufactures	-	0.0	-	0.0
8. Machines, transport equipment	46,083	18.3	24,772	10.8
9. Miscellaneous manufactured goods	3	0.0	-	0.0
0. Goods not classed by kind	-	0.0	-	0.0
Total	251,255	100.0	230,311	100.0

Source: Robertson & Pohoresky (1998)

(Table 1.4 overleaf). It should be noted that exports to the European Union (EU) and the United States have increased with the expansion of garment exports following the granting of generalised system of preferences (GSP) status. Cambodia imported about three-quarters of its total imports from ASEAN countries in 1996.

3.2. Macro Impacts: Competitiveness, Foreign Trade and Investment

3.2.1. Competitiveness

Macro impacts of the Asian crisis have been transmitted to the real sector of Cambodia's economy through the drastic realignment of foreign exchange rates of the crisis countries since July 1997.

Table 1.4. Cambodia's Trading Partners, 1995–96 (thousands of US dollars)

	Imports				Exports			
	1995	Share	1996	Share	1995	Share	1996	Share
ASEAN	798,799	74.3	743,728	74.3	300,814	80.3	254,351	66.5
Singapore	529,727	49.3	457,689	45.7	173,475	46.3	116,832	30.5
Thailand	133,728	12.4	137,009	13.7	107,265	28.6	109,167	28.5
Vietnam	109,086	10.1	119,630	12.0	13,674	3.7	24,425	6.4
Malaysia	15,462	1.4	19,714	2.0	2,163	0.6	3,127	0.8
Indonesia	9,091	0.8	9,313	0.9	2,757	0.7	532	0.1
Philippines	1,705	0.2	316	0.0	764	0.2	130	0.0
Lao PDR	1	0.0	47	0.0	-	-	84	0.0
Myanmar	-	0.0	12	0.0	717	0.2	55	0.0
Other Asia and Pacific	191,131	17.8	148,626	14.9	42,572	11.4	32,371	8.5
Taiwan	9,186	0.9	42,925	4.3	21,197	5.7	11,508	3.0
Japan	64,112	6.0	32,619	3.3	7,854	2.1	7,601	2.0
China	28,401	2.6	28,409	2.8	3,548	0.9	5,534	1.4
Hong Kong	58,179	5.4	23,833	2.4	5,288	1.4	5,037	1.3
United States	17,406	1.6	15,495	1.5	4,379	1.2	2,066	0.5
Australia	13,598	1.3	5,210	0.5	308	0.1	617	0.2
New Zealand	249	0.0	136	0.0	-	-	9	0.0
European Union	44,772	4.2	42,660	4.3	24,566	6.6	92,224	24.1
Other	2,603	0.2	1,524	0.2	499	0.1	924	0.2
Subtotal	1,037,304	96.5	936,539	93.6	368,452	98.4	379,870	99.2
Statistical discrepancy	38,122	3.5	64,063	6.4	6,061	1.6	2,896	0.8
Total	1,075,426	100.0	1,000,602	100.0	374,513	100.0	382,766	100.0

Source: Robertson & Pohoresky (1998)

The nominal exchange rate of the Thai baht against the US dollar depreciated sharply after the Thai government adopted a floating foreign exchange rate system in July 1997. In the half-year until January 1998, the value of the baht halved against the dollar. During the same period, the riel also depreciated against the dollar, though this is most likely to have been caused by the fighting of 5 and 6 July 1997. This contrasts with the case of the crisis countries, where rapid and large-scale outflows of short-term foreign capital triggered the depreciation of their currencies. The extent of the depreciation of the riel against the dollar was much less than that of the baht against the dollar. Consequently, the riel appreciated against the baht by around 30 percent between July 1997 and February 1998.

The appreciation of the riel and dollars *vis-à-vis* the currencies of the crisis countries raises concerns about whether and to what extent the competitiveness of Cambodia's goods and services has been affected. Observing nominal exchange rates alone does not fully answer this question, because the relative movement of prices of goods and services in Cambodia and its trading partners also affects competitiveness. A widely used indicator of competitiveness is real exchange rates (RER), which take into account the relative movement of prices.[2]

[2] RER is defined as $E \times P^f/P^d$, where E is the nominal exchange rate (domestic currency units per foreign currency unit), P^f is the price of a foreign basket of goods, and P^d is the price of a domestic basket.

The RER of the riel against the baht and the Singapore dollar are shown in Table 1.5. Thailand and Singapore were selected because they were the two largest trading partners of Cambodia in 1995 and 1996. The RER of the riel against the baht fell by 16 percent from July 1997 to January 1998, indicating the decline of Cambodia's competitiveness against Thailand.[3] By contrast, the RER of Cambodia against Singapore remained at more or less the same level in 1997. While Cambodia's nominal exchange rates depreciated against the Singapore dollar in the second half of 1997, the prices of its goods and services increased more than those in Singapore. Domestic inflation in Cambodia thus offset the gain of competitiveness due to the depreciation of nominal exchange rates during that period.

After January 1998, however, the nominal exchange rate of the riel against the baht started recovering. The RER of Cambodia against Thailand (riel/baht) increased from 65 points in January to 91 points in June 1998. This indicates that the competitiveness of Cambodia against Thailand recovered considerably from February to June 1998. The RER of Cambodia against Singapore remained near pre-crisis levels through this period.

Table 1.5. RER of Cambodia against Thailand and Singapore (index)

	WPI[1]	WPI[1]	CPI[2]	NER[3]		RER[4]	
	Thailand	Singapore	Cambodia	Riel/baht	Riel/S$	Riel/baht	Riel/S$
1997 – January	105	101	106	105	109	104	103
February	105	99	107	106	108	104	100
March	105	99	106	105	106	104	99
April	105	97	108	105	106	102	96
May	105	98	109	106	108	103	96
June	104	97	110	107	108	101	96
July	105	96	117	90	110	81	91
August	111	98	116	87	110	83	93
September	113	99	120	87	117	82	97
October	114	100	121	86	120	80	99
November	116	101	121	85	120	81	100
December	118	101	120	73	115	71	97
1998 – January	123	101	122	65	115	65	95
February	126	101	123	83	123	84	101
March	126	101	124	92	125	94	102
April	124	101	125	94	129	94	105
May	126	101	128	100	134	98	106
June	126	101	131	94	131	91	101

1 = WPI is wholesale price index. 2 = CPI is consumer price index. 3 = NER is nominal exchange rate. 4 = RER is real exchange rate. Source: IMF *International Financial Statistics* (various issues)

3 It should be noted that the appreciation of the riel and US dollar against the baht reduced the domestic prices of imported intermediate inputs in Cambodia, and reduced the cost of Cambodia's products to some extent. This partly offset Cambodia's loss of competitiveness against Thailand.

3.2.2. Foreign trade

Despite the loss of competitiveness of Cambodia's goods and services in the second semester of 1997, the Asian crisis did not affect immediately the export performance of Cambodia. In fact, Cambodia's domestic exports rose by 49 percent and 35 percent in the third and fourth quarters of 1997 relative to 1996. This was mainly due to the expansion of garment exports during that period, when Cambodia was granted GSP status for garments from the EU and the United States. This, together with generous investment incentives and relatively low labour costs, provided strong incentives for foreign investors to locate their garment factories in Cambodia. In addition, the European and the US economies, which are the main destination of garment exports, have not yet been affected severely by the crisis.

The adverse impact of the crisis, however, appears to have become more apparent in 1998. Domestic exports declined in the first and second quarters of 1998 relative to the previous year. This may reflect the fact that some major Cambodian export items, other than garments, experienced a major decline during this period. As is reported below, the volume of exports of wood-related products declined sharply in the first semester of 1998. Interviews with managers of wood-related companies revealed that their exports had faced tough price competition with products from the crisis countries, which had become much cheaper.

With regard to imports, the loss of competitiveness up to January 1998 was expected to increase Cambodia's imports, as the appreciation of the RER against Thailand indicates. On the other hand, the decline of domestic expenditures and income since July 1997 due to the domestic political crisis would be likely to decrease demand for imports. The impact on total imports would thus depend on the extent to which the former dominated, or was dominated by, the latter.

Cambodia's import performance does not appear to have shown a notable change in the second semester of 1997. This is presumably a reflection of the mixed impacts of the two factors discussed above. In addition, Cambodia's imports from the crisis countries did not surge, partly because the severe credit crunch had disturbed normal export activities in the crisis countries, which made it difficult to take advantage of the gain in competitiveness. Cambodia's retained imports, however, declined in the first half of 1998.[4] The recent decline may reflect the depreciation of the riel and the US dollar against regional currencies in the first half of 1998, as the regional currencies bounced back after February 1998. In addition, a sharp decline of economic growth in 1997 and 1998 contributed to the decline of import demand in the first half of 1998. Furthermore, a decline of foreign aid after the fighting of 5 and 6 July 1997 reduced imports related to foreign aid. Finally, the wait-and-see

[4] A considerable proportion of Cambodia's total imports were re-exported to Vietnam, and thus did not enter Cambodia's markets. Retained imports, defined as total imports minus re-exports, is thus a better indicator than total imports to assess the impact of the crisis.

atmosphere that appeared to spread among the Cambodian business community in the approach to the national election in July 1998 may have also contributed to the decline of imports in the second half of 1998.

3.2.3. Foreign direct investment

The inflow of FDI to Cambodia was affected by changes in its competitive position and the slowdown of growth in the crisis countries. The depreciation of currencies in the crisis countries reduced their unit labour costs in US dollar terms, even taking into account high inflation in some countries. Foreign investors looking for an export base considered Cambodia to be less attractive than before. In addition, the slowdown of economic growth in the crisis countries made their investors more cautious about investing in overseas, as they faced problems of credit crunch at home. These factors exacerbated the decline of FDI that had been caused by the political uncertainty prevailing since the fighting of July 1997.

Official data confirm the adverse impact of the crisis on foreign investment discussed above. According to the NBC, the net inflow of FDI plunged to US$200 million in 1997, down from US$290 million in 1996. On a quarterly basis, the inflow of FDI revealed a downward trend from July 1997 to the second quarter 1998. In fact, the declining trend of FDI had already began in 1996, well before the Asian crisis, perhaps reflecting foreign investors' perceptions about the deterioration of Cambodia's investment climate since 1996.

Another source of information regarding foreign investment indicates changing patterns of investment by country and region. According to data from the Cambodia Investment Board (CIB), foreign investment in Cambodia has been dominated by ASEAN countries, China, Hong Kong, Taiwan and South Korea since 1995 (Table 1.6).[5] This pattern has not been greatly affected by the Asian crisis. The extent of the decline in investment from ASEAN countries (Indonesia, Malaysia, Singapore, Thailand and Vietnam) was smaller than that of total foreign investment. Instead, a larger slowdown was observed in total investment from other Asian and Pacific Rim countries, such as Hong Kong, Taiwan and South Korea.

3.3. Micro Impacts: Enterprises and Consumers

This section reports the results of the field studies undertaken by CDRI to investigate the impact of the Asian crisis on Cambodia's enterprises and consumers (Chan,

[5] The investment data from the CIB should be read with caution, because it compiles only projects approved by the CIB rather than projects that are actually implemented. The discrepancy between approved and actual investments can be quite large, as is the case in other countries. The data presented here can best be seen as an indication of the willingness of foreigners to invest in Cambodia.

Table 1.6. Foreign Investment Project Approvals, 1996–98

	Number of investment projects			Registered capital (US$ million)			Fixed assets (US$ million)		
	Jul 95 – Jun 96	Jul 96 – Jun 97	Jul 97 – Jun 98	Jul 95 – Jun 96	Jul 96 – Jun 97	Jul 97 – Jun 98	Jul 95 – Jun 96	Jul 96 – Jun 97	Jul 97 – Jun 98
ASEAN	56	48	46	75	101	83	217	255	259
Indonesia	3	4	5	2	1	3	13	1	3
Malaysia	24	18	16	38	54	61	126	187	181
Singapore	16	18	19	20	36	17	47	38	55
Thailand	12	8	5	15	10	2	30	29	21
Vietnam	1	-	1	-	-	-	0		0
Other Asia-Pacific	97	129	117	111	223	155	145	416	240
China	27	31	34	23	21	72	33	22	100
Hong Kong	23	27	25	10	15	17	25	71	58
Taiwan	28	50	29	67	83	32	74	115	27
South Korea	7	10	7	5	66	9	4	172	20
Others	12	11	22	5	38	26	9	37	35
Europe	22	17	18	53	48	15	204	39	25
North America	7	12	8	4	26	2	4	15	87
Middle East	0	0	1	0	0	1	0	0	0
Total	182	206	190	243	398	255	570	725	611
Change from previous year (%)		13.2	-7.8	-	63.7	-35.8	-	27.3	-15.8

Source: CDRI calculation based on data from the CIB.

Tia & So 1998; Chan *et al.* 1999). The field studies include a series of interviews with enterprises conducted in February, May, August, November and December 1998, and seven market surveys from July 1997 to November 1998.

3.3.1. Impact on export-oriented enterprises

Interviews were conducted with enterprises and retailers to investigate micro impacts of the crises. The interviews covered the following industries: garment, wood and wood-processing, rubber, cement, beverages, milk and plastics. The first three are major export-oriented industries, while the other four are import-competing. The interviews were concerned with changes in output, input prices, wage payments, transactions and the difficulties that the companies were facing.

The wood-related industry in Cambodia appeared to have been one of the most severely affected by the crisis. The export performance of wood-related products deteriorated on a large scale. According to official data from the Ministry of Commerce, Cambodia's exports of wood-related products plunged from 65,000 m^3 in the first semester of 1997 to 38,000 m^3 in the second, and then to 11,000 m^3 in the first semester of 1998.

Interviews with wood-related enterprises revealed the nature and severity of the difficulties that some were facing since the crisis began. Two enterprises pro-

ducing and exporting sawn timber and one producer of veneer for export reported that they had been severely affected. The first adverse impact was from a decline of timber prices, the second was the decline in demand for Cambodian sawn timber, which partly reflected the liquidity problems of importers in the crisis countries. The decline in regional demand forced all three companies to scale down their activities. One company laid off two-thirds of its workers in May 1998. Another exporting sawn timber to Thailand and employing about 100 workers reported in May 1998 that it would soon go bankrupt because of the decline in demand.

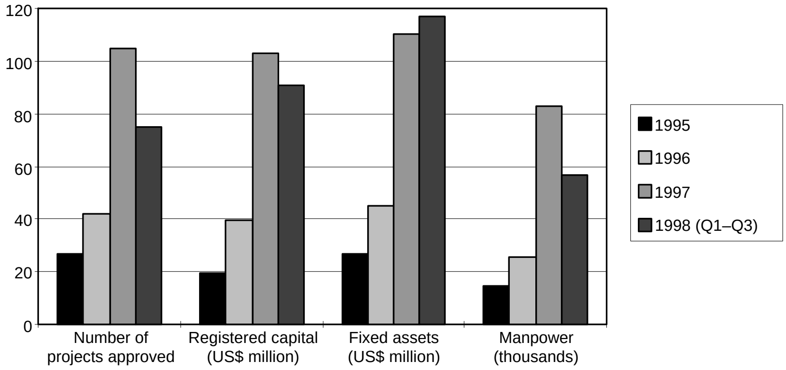
Interviews with four major rubber enterprises that together account for 70 percent of domestic production revealed that Cambodia's rubber industry has also been severely affected by the crisis. Export prices declined by an average of 23 percent, from US$660 per ton in the third quarter of 1997 to US$510 per ton in the third quarter of 1998. The export volume was not affected immediately after the crisis, but its decline became apparent in 1998, as the volume of rubber exports plunged by 36 and 17 percent in the second and third quarters of 1998 respectively.

Interviewees pointed to two main reasons for the decline in prices. First, the price of rubber started to decline in the major destinations of Cambodia's rubber exports, such as Malaysia and Singapore, one year *before* the Asian crisis. The price of rubber in Malaysia denominated in ringgit, for instance, declined by about 15 percent in 1997 and 20 percent in 1998 compared to the price in mid-December 1996. Second, the drastic depreciation of foreign exchange rates in the crisis countries after July 1997 reduced the dollar price of their rubber. The decline in the volume of Cambodia's rubber exports was also partly attributed to the overall decline in demand for rubber as the economies of the crisis countries slowed down.

The decline of both the price and the volume of rubber exports since July 1997 cut the profits of the rubber enterprises, which reported that they had recorded net losses in both 1997 and 1998. The employees of the four enterprises surveyed (over 10,000 workers) have been suffering from a decline in their real wages, because some of the enterprises paid lower nominal wages in 1998 compared to before July 1997 and because the cost of living increased due to inflation of basic food items.

Among major export industries in Cambodia, the garment sector has been much less severely affected by the Asian crisis than timber and rubber. Total garment exports increased even after July 1997—from US$86 million in the first semester of 1997 to US$140 million in the second semester of 1997. The high level of garment exports continued in the first semester of 1998. Investment projects in the garment industry increased significantly during the second semester of 1997, even though some factories were destroyed and looted during the July 1997 fighting (Figure 1.2 overleaf). A major reason for this was the granting of GSP status to garments by the EU and the United States.

Table 1.2. Investment in the Garment Sector, 1995–98



Interviews with several garment factories confirmed that the Asian crisis had had little impact on their production and exports. Some managers expressed concerns, however, that the currency depreciation in the countries affected by the crisis had reduced those countries dollar-denominated labour costs. This made Cambodia's labour costs relatively high and reduced its competitiveness in the region.[6]

3.3.2. Impact on import-competing industries

One Cambodian cement company surveyed reported severe price competition from cheap imported cement, from Thailand in particular. Due to the depreciation of the baht, the price of Thai cement fell to around US$72 per ton in February 1998 from US$105 per ton the previous year. The company had to reduce the price of its domestic cement from US$90 to US$65 per ton during the same period. When the baht bounced back against the dollar after January 1998, the price of Thai cement started to increase again, reaching US$75 per ton in May 1998, and allowing an increase in the price of domestic cement to US$70.

One cement company adopted a coping strategy to reduce production costs by cutting out an intermediate production process of extracting domestic limestone to make cement. Instead, it imported clinker (a semi-finished product) from Thailand. Although this strategy helped the company to survive, it was likely to have an adverse impact on employment in the medium term.

Domestic breweries had also been affected by price competition from imported beer, again particularly from Thailand. One brewery in response launched a new product which was 30 percent cheaper than its original brand. According to retailers in Phnom Penh, the new brand had been gradually increasing its market share.

[6] In most of the garment factories surveyed, workers' wages were paid in US dollars.

The crisis appeared to have led to increased smuggling across the Thai border. Thai beer was smuggled into Cambodia and sold at around US$11 per case in early 1998, compared with US$17 per case the previous year. One Cambodian brewery reported that it had been completely eliminated from the market in two of the provinces bordering Thailand. Its total sales had declined by 50 percent (from the previous year) in the second half of 1997.

The Asian crisis affected soft drink producers in Cambodia, as imported brands became relatively cheap due to the weakening of regional currencies. Almost all respondents who were retailing soft drinks said that there had been a large demand for Thai soft drinks during the Chinese New Year (February 1998), when the Thai baht was at its weakest against the US dollar. Since February 1998, however, locally produced soft drinks had gradually increased their market share again because the baht bounced back and inflation picked up in Thailand.

It was also found that the Asian crisis had adversely affected one major condensed milk producer in Cambodia. The factory reported that the price of white sugar (an essential raw material) imported from Thailand had increased by 60 to 80 percent in US dollar terms in February 1998, because of emergency policy measures by the Thai government to restrict the export of white sugar, considered to be an essential food item. In addition, the company had to cut its wholesale prices to maintain market share. Despite these efforts to compete with imported products, the sales of the domestic brand are reported to have slumped since July 1997. To cope with the situation, the local producer had sold 80 percent of its share holdings in December 1997 to a Swiss dairy company.

A Cambodian plastic producer established in 1994 closed down in late February 1998 due to loss of competitiveness against imported plastic products since the Asian crisis, according to interviews with a board member. Although the factory survived for a few months after the crisis started, it was eventually forced to cease operating as a result of competition with imported plastic products.

3.3.3. Impact on tourism

The tourism sector in Cambodia grew rapidly until mid-1997, at an annual average rate of 20 percent between 1993 and 1996, far exceeding the annual average rate of overall economic growth of 6 percent during the same period. The tourism sector also contributed to an increase in export earnings, with a total value of US$81 million in 1996—about the same as the sum of rubber and log exports in that year (Godfrey 1997). The development of the tourism sector also had a significant economic impact on other sectors in Cambodia. For instance, tourism boosted domestic demand for construction, transportation, the wholesale and retail trade, and even agricultural products.

The tourism sector, however, experienced a dramatic decline in the second semester of 1997. This was primarily caused by the fighting in July 1997. The total number of tourist arrivals at Pochentong International Airport plunged by 50 percent in the second semester of 1997 relative to the same semester in 1996 (Table 1.7). Overall, tourist arrivals declined by 16 percent in 1997 relative to 1996, despite the strong growth in the first semester of 1997. As a result, the growth rate of real GDP of hotels and restaurant declined sharply to -2.5 percent in 1997, down from 22 percent in 1996 (World Bank 1999).

Table 1.7. Passenger Arrivals at Pochentong International Airport, 1995–96

	1995	1996	1997	1998[1]
Number of arrivals				
Tourists	154,686	221,341	185,334	122,797
Business	42,567	63,213	55,597	34,836
Officials	15,526	12,665	14,193	12,406
Total	212,779	297,219	255,124	170,039
Percentage change from previous year				
Tourists		43.1	-16.3	-33.7
Business		48.5	-12.0	-37.3
Officials		-18.4	12.1	-12.6
Total		39.7	-14.2	-33.4

1 = Data are only available for January to October 1998. Source: Ministry of Economy and Finance

Although it is difficult to distinguish the impact of the Asian crisis from other impacts, the stagnation of the tourism sector in Cambodia since July 1997 may be partly attributed to falling incomes in the crisis countries. For instance, tourist arrivals from ASEAN countries declined by 43 percent in the third quarter of 1997 compared to the same quarter in 1996. The number of tourists from ASEAN declined even in the third quarter of 1998, during which period tourist arrivals from other areas increased strongly relative to the previous year.

3.3.4. Impact on consumer spending

Despite the importance of consumption spending as an indicator of general economic activity, Cambodia's national account statistics are reported only once per year. CDRI undertook seven market surveys from July 1997 to November 1998 to supplement the lack of information on consumer expenditures. Vendors in five major markets in Phnom Penh were asked about prices and sales of various consumer goods and services.[7] The surveys also asked vendors how fluctuations in the foreign exchange rates of regional currencies had affected Phnom Penh markets.

[7] About 130 vendors were asked about their views on issues such as the impact of the Asian crisis on their business. The small sample size and limited geographical coverage mean that the results cannot be generalised to the national level. However, these surveys provide a primary source of information that is not available from official data sources.

Market surveys in December 1997 and February 1998 found that the rapid depreciation of the regional currencies, particularly the baht, resulted in a substantial decrease in the dollar- and riel-denominated prices of products imported from the rest of the region, thus raising the competitiveness of foreign, and especially Thai, products. Since most non-food products sold in Phnom Penh markets were imported, consumers enjoyed "benefits" from the Asian crisis in the form of cheaper imported products.

The surveys also found that consumers had not fully benefited from the appreciation of the dollar and the riel against the baht. This is because the baht prices of some Thai products increased after July 1997. All the retailers interviewed reported in February 1998 that their wholesalers had charged higher baht prices for some products. They also reported that they had had to pay higher baht prices to Thai distributors. The extent of the increase in baht prices, however, varied considerably depending on the product. For instance, the price of construction materials, fishing nets, bedding and suitcases increased about 5 percent, while the price of shoes, clothes, groceries, kitchenware and stationery increased between 10 and 30 percent.

The depreciation of the baht from July 1997 to January 1998 made Thai products more competitive than products imported from other countries. Interviews were conducted in February 1998 with two motorcycle companies: one selling the Suzuki brand imported from Thailand, and another selling the Yamaha brand imported from Japan. The depreciation of the baht enabled Suzuki to lower the price of its top range motorcycle from US$1,700 to US$1,200, and it trebled the number sold. Sales of Yamaha motorcycles fell by 60 percent, because the dollar-denominated prices remained at their pre-July 1997 level due to the relative stability of the Japanese yen against the US dollar.

The market survey undertaken in May 1998 found some evidence that consumer benefits from the exchange rate realignment were short-lived. Due to the relative strengthening of the baht after February 1998, the riel-denominated prices of most imported products had risen to more or less their pre-July 1997 levels. Some Thai products were more expensive even than their pre-July level once the riel-baht exchange rate had returned to its pre-July level.

Market surveys also found that baht prices for some Thai products, such as sarongs, increased in February 1998, and remained at similar levels in May 1998. In addition, the riel lost strength against the baht from February to May 1998, as the baht bounced back against the US dollar. The increase in baht prices and the depreciation of the riel against the dollar suppressed the recovery of sales and fuelled inflation in Cambodia from February to May 1998.

The dollar-denominated prices of some imported products from Vietnam, China, Singapore and Western countries were found to be slightly lower in May

1998 than their pre-July 1997 level. However, riel-denominated prices of these imported products increased during the same period, because the depreciation of those countries' currencies against the dollar was far less than that of the riel.

The market surveys also found indications of a low level of consumer spending since July 1997. In the July 1997 survey, vendors were asked about the percentage change of their current sales relative to those before July 1997. Vendors reported that the level of average sales dropped on average by about 60 percent immediately after the fighting of July 1997. The same questions were asked in the subsequent six surveys, which found that market sales continued to stay at around 50 percent of the pre-July 1997 level throughout 1998 (Table 1.8).

Table 1.8. Sales and Earnings in Five Markets in Phnom Penh, 1997–98

	1997		1998			
	September	December	February	May	August	November
Percentage of vendors who reported selling less[1]						
All items	95	90	87	98	93	92
Non-food items	100	95	92	99	92	92
Durable items	100	96	95	100	93	90
Luxury Items[a]	100	100	100	100	100	100
Household items and utility items[b]	100	94	82	100	91	83
Clothing, shoes, bags	100	95	100	100	93	94
Non-durable items and services	87	91	91	93	88	95
Food items	92	81	80	98	94	93
Average amount of sales as a percentage of those before 5–6 July 1997[2]						
All items	40	47	54	48	52	51
Non-food items	34	40	48	45	47	50
Durable items	33	38	46	43	46	44
Luxury Items[a]	24	30	36	45	40	38
Household items and utility items[b]	40	43	54	44	53	50
Clothing, shoes, bags	32	40	46	42	45	44
Non-durable items and services	36	46	56	54	48	56
Food items	44	59	61	54	59	52
Percentage of vendors who reported earning enough to cover their daily expenses[3]						
All items	23	52	68	58	57	58
Non-food items	16	44	60	49	47	57
Durable items	6	43	53	45	44	45
Luxury Items[a]	0	30	29	47	38	33
Household items and utility items[b]	21	53	75	60	54	50
Clothing, shoes, bags	0	43	57	37	44	56
Non-durable items and services	44	36	81	67	59	77
Food items	33	67	80	76	73	60

1 = Is the amount of your sales [more than, the same as, less than] that before 5–6 July 1997? 2 = If less, what percentage are current sales relative to those before 5–6 July 1997? 3 = Are you earning enough money to cover your daily expenses? a = Luxury items include precious stones, gems, gold, jewellery, televisions, cassette players, watches, video-tapes, gifts, etc. b = Household and utility items include kitchenware, plastic containers, blankets, mosquito nets, construction materials, electrical appliances, motorcycle spare parts, etc. Source: CDRI market surveys from September 1997 to November 1998.

Examining the reasons for this given by market vendors, it seems that the crisis partly suppressed the recovery of sales in Cambodia. First, vendors reported that

they had seen fewer tourists in the markets, reflecting the substantial reduction in the number of tourists from the crisis countries. Second, market vendors received far fewer workers, consistent with reports of the temporary closure of enterprises either hit by weak demand for imports from the crisis countries. Finally, the reported reduction in investment projects from the crisis countries contributed to the weak demand for consumption and investment seen by market vendors.

3.4. Impact on the Real Sector—Summary

The Asian crisis has been adversely affecting Cambodia's economy slowly but steadily. The spill-over effects of the crisis have come through two channels—the realignment of foreign exchange rates and the slowdown of economic growth in the crisis countries. Export growth, which had been virtually unaffected until the end of 1997, appeared to slow in the first semester of 1998. Interviews with some enterprises revealed severe competition in the regional market and a sharp decline of exports. Although imports at the macro level have not shown an obvious increase, interviews with enterprises revealed a severe impact on some import-competing enterprises such as cement beverage and plastic manufacturers. Some domestic sectors, such as the tourism industry, have been suffering from stagnation in arrivals, notably from ASEAN and East Asian countries, since July 1997. Consumers, by contrast, enjoyed a decline of US dollar- or riel-denominated prices of Thai products in Phnom Penh markets until January 1998. The benefits from cheaper imported products, however, turned out to be short-lived because of the recovery of the baht after February 1998 and inflation affecting Thai products in baht terms.

4. Impact on Social Development

A growing number of studies have reported that the Asian financial crisis placed enormous pressure on people's livelihoods in the crisis countries (ADB 1998; World Bank 1998). The pressure has been both on household income and expenditures. Falling incomes and the loss of jobs have been reducing total income per household, whereas inflation of essential items has been pushing up the cost of living. It has also been reported that pressures on livelihoods have forced poor households to withdraw their children from school to support their families. The fight against poverty now a huge challenge, despite the enormous success that the crisis countries had achieved until 1996. Pressures on livelihoods have contributed to popular frustration and an increase in social and political tensions in some crisis countries.

This section assesses the impact of the Asian crisis on peoples' livelihood and social development in Cambodia. Here again, it is not always possible to isolate the

impact of the Asian crisis from other impacts such as that of the July 1997 fighting and the decline of agricultural production caused by natural droughts and flooding. The following analysis should therefore be seen as an analysis of the intertwined impacts of the financial crisis in Asia, the internal political crisis after fighting in July 1997, and other shocks to the economy.

4.1. Peoples' Livelihood

4.1.1. Wages and waged employment in Phnom Penh

Labour market indicators suggest that the slowdown of economic growth put pressure on the livelihood of waged employees in Phnom Penh after July 1997. According to the quarterly labour market surveys undertaken by the National Institute of Statistics (NIS), average monthly real wages peaked in the second quarter of 1997, then declined sharply in the third and fourth quarters (Table 1.9).[8] The decline was

Table 1.9. Real Wages and Waged Employment in Phnom Penh, 1997

	1997:Q2	1997:Q3	1997:Q4
Monthly wages at current prices (base: 1997:Q2 = 100)			
Private sector	100	104	93
Government service	100	102	100
International agencies	100	64	69
Total	100	101	97
Monthly wages at constant prices (base: 1997:Q2 = 100; constant prices at July–September 1994)			
Private sector	100	94	82
Government service	100	92	88
International agencies	100	58	60
Total	100	91	85
Waged employment			
Private sector	71,203	57,429	60,062
Government service	65,265	71,074	73,070
International agencies	2,523	3,045	1,781
Total	138,991	131,548	134,913
Percentage of total employment			
Private sector	51	44	45
Government service	47	54	54
International agencies	2	2	1
Total	100	100	100
Wage employment (base: 1997: Q2 =100)			
Private sector	100	103	107
Government service	100	105	108
International agencies	100	64	38
Total	100	102	105

Source: NIS

8 The geographical coverage of the quarterly labour market surveys is limited to Phnom Penh, and the surveys were terminated at the end of 1997 due to the loss of funding. There are no other periodical surveys regarding labour markets at present.

notable in all sectors—in the private sector, government services, and in international agencies and organisations. Waged employment showed a similar pattern during the same period. The economic slowdown precipitated by the July 1997 fighting adversely affected the livelihood of waged employees in Phnom Penh.

4.1.2. Livelihood of vulnerable workers

The poor and the vulnerable are usually the most severely affected by an economic downturn. Surveys of vulnerable workers undertaken by CDRI in Phnom Penh in May, August and November 1998 monitored the change in livelihoods of four occupational groups deemed most vulnerable in the capital (Chan *et al.* 1998; Chan *et al.* 1999)—cyclo drivers, porters, small vegetable traders and scavengers. Thirty workers in each group were sampled and asked about their net daily earnings, working hours/days, and the problems encountered in their day-to-day activities. In the May 1998 survey, a question was also asked about earnings before July 1997, to assess the impact of the twin crises.

The surveys revealed a large fall in the net daily earnings of vulnerable workers in May and August 1998 relative to before July 1997. There were also some indications that recovery had been slow and weak even after the formation of a new coalition government in early November 1998 (Table 1.10). According to the data, net daily earnings fell sharply after July 1997 for all groups. The extent of the de-

Table 1.10. Net Daily Earnings of Vulnerable Workers, 1997–98

	Net daily earnings (riels)					Percentage change[1]			
	Before	1998				1998			
	Jul 1997	Jan	May	Aug	Nov	Jan	May	Aug	Nov
Nominal earnings (riels)									
Cyclo drivers	12,250	9,100	6,975	6,167	6,100	-26	-23	-12	-1
Porters	9,675	6,905	5,415	4,720	4,543	-29	-22	-13	-4
Small vegetable traders	7,050	5,150	3,400	4,767	5,913	-27	-34	40	24
Scavengers	4,155	3,415	3,040	2,610	2,567	-18	-11	-14	-2
Nominal earnings (base: pre-July 1997 = 100)									
Cyclo drivers	100	74	57	50	50	-26	-23	-12	-1
Porters	100	71	56	49	47	-29	-22	-13	-4
Small vegetable traders	100	73	48	68	84	-27	-34	40	24
Scavengers	100	82	73	63	62	-18	-11	-14	-2
Composite index[2]	100	75	59	57	61	-25	-22	-2	6
Real earnings (base: pre-July 1997 = 100)									
Cyclo drivers	100	67	49	42	40	-33	-27	-15	-3
Porters	100	64	48	40	38	-36	-25	-16	-6
Small vegetable traders	100	66	41	56	68	-34	-37	35	21
Scavengers	100	74	63	52	50	-26	-15	-17	-4
Composite index[2]	100	68	50	48	49	-32	-26	-6	3
Consumer price index[3]	100	111	116	121	123	11	5	4	2

1 = Percentage change from the previous period. 2 = Composite index is the average of indexes of the four groups with equal weight. 3 = Official CPI published by the NIS; CPI in June 1997 was used as a proxy for pre-July 1997 CPI.

cline since May 1998 appeared to have slowed, though the decline continued until November 1998 for all groups except small vegetable traders. The sustained decline in earnings has forced vulnerable workers (except small vegetable traders) to work harder than they were before July 1997. It should also be borne in mind that these are nominal earnings—most vulnerable workers also reduced their consumption as a result of the increase in prices, especially rice.

The surveys also revealed that the number of rural residents moving to Phnom Penh in search of work increased in 1998. In the November 1998 survey, vulnerable workers were asked whether they thought that the number of rural residents coming to Phnom Penh to look for work had increased relative to the previous year. Among 120 interviewees, 65 percent reported that the number had increased. In addition, only 3 percent of cyclo drivers described themselves as permanent residents of Phnom Penh, compared to 10 percent in August 1998 and 15 percent in May 1998. Similarly, only 3 percent of porters reported themselves to be permanent residents of Phnom Penh in November 1998, compared to 23 percent in August and 25 percent in May. The cyclo drivers and porters explained that most rural residents who had come to Phnom Penh earlier had remained working in the capital until the next harvest.

Scavengers, who are mostly Phnom Penh residents, earn the lowest average earnings among the four groups, and also appear to have been the most severely hit by the economic downturn. They reported that the amount of saleable rubbish had fallen sharply because of the decline in overall consumption in the capital. The survey also revealed that the price of saleable rubbish had dropped by 40 to 50 percent in November 1998 compared to earlier in the year.

Traders who buy rubbish from scavengers offered two reasons for the decline in prices. First, some local plastic and glass producers that used recyclable rubbish as inputs closed down because their products could not compete with imported plastic and glass from Thailand and Vietnam after July 1997. The domestic demand for recyclable rubbish therefore went down in 1998. Second, transport costs to export recyclable rubbish to Vietnam significantly increased from the beginning of 1998, due to the increase in the number of checkpoints along the roads to Vietnam where informal fees have to be paid. Since market prices of rubbish were fixed in Vietnam, the informal fees were charged to scavengers' receipts.

4.1.3. Migrant workers to Thailand

A recent study of Cambodian migrant workers to Thailand revealed a significant adverse impact on their livelihoods from the Thai economic downturn (Chan & So 1999). The study was conducted in three districts of Battambang province, in 14 villages with a total of around 3,800 households. It was found that 517 households

had had members migrating to seek labour-intensive work, mostly in construction, deep inside Thailand. Another 669 households had members working for Thai farmers along the Thai-Cambodian border. The study found that the former group of migrants had been negatively affected by the crisis in the Thai economy. Adverse impacts on those working along the border were not as severe (Table 1.11).

Table 1.11. Labour Migration from Battambang to Thailand, 1997–98

	Before July 1997	July 1997 to November 1998	Total
Number of journeys	33	48	81
in which jobs were easily found	29	19	48
in which jobs were not easily found	4	29	33
in which more than half of due payments were not provided	7	28	35
Percentage of journeys	100	100	100
in which jobs were easily found	88	40	59
in which jobs were not easily found	12	60	41
in which more than half of due payments were not provided	21	58	43

Source: Chan & So (1999)

Questions were asked about working trips to Thailand during two consecutive periods—before July 1997 and between July 1997 and November 1998. Jobs were found easily in only 40 percent of the working trips after July 1997, compared with 88 percent before. The migrant workers interviewed mentioned that in 1998 they had seen many buildings under construction left unfinished in large cities in Thailand, and few new buildings started. Early 1998 also saw tougher implementation of a policy to return illegal labour migrants by the Thai authorities.

Moreover, in 58 percent of the migrants' journeys since the crisis they encountered low levels of wage disbursement by their Thai employers, compared with 21 percent of journeys before the crisis. Instead of receiving full payment of their daily wages of 100 to 200 baht, more than half of the migrant workers interviewed were provided only 30 baht per day, barely enough for subsistence. The incidence of this is reported to have increased drastically since late 1997, with reasons cited that: 1) some Thai banks released cash slowly to construction companies, or did not have enough money to disburse to the companies; 2) construction companies had gone bankrupt; and 3) the supervisors stole the wages of the illegal migrant workers.

Facing a decline in the number of jobs available, the increase in the incidence of under-payment, and a tougher policy stance against foreign migrant labourers, the Cambodian villagers interviewed appear to have been discouraged from venturing back to Thailand, at least for the time being. Based on interviews with village chiefs, village development committees and NGO workers in the 14 villages, the largest numbers of villagers were migrating to Thailand in late 1996 and 1997. The total number of long-range migrants in the 14 villages dropped from 605 in 1997 to 169 in 1998. Almost all the migrant workers in these villages returned home between March and July 1998. Some went back to Thailand after participating in the

the July 1998 national election. However, most of them found no work, or were reportedly "cheated" by their Thai employers, who failed to pay them full wages.

The survey also found that each migrant villager had to pay 3,000 baht to the guides or smugglers who took them to work sites deep inside Thailand. Borrowing money to pay this "smuggling fee" appeared to be common among poor migrant workers. Of a total 81 journeys, 77 percent were financed by local moneylenders, who had charged villagers interest rates ranging from 10 to 30 percent per month. In addition, the moneylenders usually demanded collateral in the form of fixed assets, mostly land. If villagers failed to earn enough money, or were caught by the authorities, they returned home empty-handed and often in poor health, which left them in severe debt and often forcing them to sell assets such as land, houses and livestock. Of the 37 households covered by the survey, nine had sold their land or cows, and 17 were in serious debt due to the failure to earn enough money.

4.2. Social Development—Health and Education

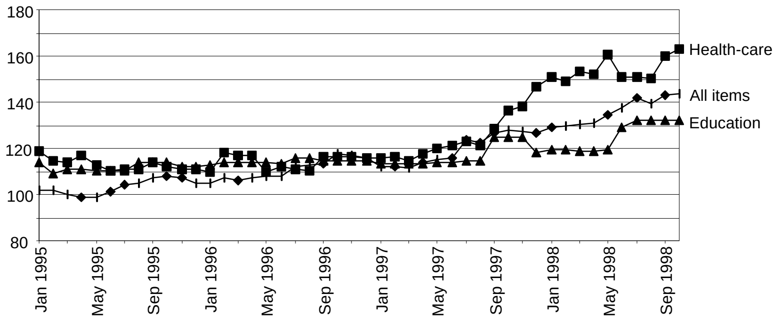
Social development, in particular health and education, is without doubt the top priority for long-term development in Cambodia. The economic downturn precipitated by the twin crises, however, could slow the progress of social development in Cambodia. This section makes an initial assessment of the extent of their impact with available data. As the data currently available are limited, however, further studies are needed to fully assess the impact on social development.

4.2.1. Cost of health-care

One of the channels through which the crises could affect social development is the rise in health-care costs caused by the depreciation of foreign exchange rates. As Cambodia imports almost all its modern medical supplies, including pharmaceutical products, the depreciation of the riel against the US dollar pushed up the cost of health-care, and put pressure on people's livelihoods. The poor, who generate their earnings in riels, were most severely affected by the rise in health-care costs. According to the NIS, the CPI of health-care showed much higher inflation rates than the CPI of all items after July 1997 (Figure 1.3).[9] Inflation in health-care (final quarter basis) surged from 4 percent in 1996 to 21 percent in 1997. The increase in inflation of health-care contrasts sharply with the CPI of all items, which remained at around 9 percent in 1996 and 1997. The cost of health-care continued to increase at even higher rates in 1998. As of October 1998, the cost of health-care had increased by 32 percent compared to the pre-crisis level in June 1997.

[9] Health-care CPI includes medical services (doctor's fees, dental fees, etc.), hospital admission fees, medical supplies, pharmaceutical products and other medical supplies.

Figure 1.3. CPI of Health-Care and Education in Phnom Penh, 1995–98 (index)



4.2.2. School enrolment

The recent studies on the Asian financial crisis revealed that increasing numbers of children had dropped out of school in the crisis countries. The fall of incomes and the increase in the cost of living in the crisis countries have put enormous pressures on the livelihood of poor households, and forced their children into work rather than allowing them to continue with their education.

Despite the importance of assessing the impact of the Asian crisis on Cambodia's schooling, few studies have been undertaken to date. However, data on school enrolment allow an initial assessment to be made. According to the Ministry of Education, Youth and Sports, the total number of children enrolled from pre-school to upper secondary school increased by 3 percent, from 2.3 million to 1996/97 to 2.4 million in 1997/98 (Table 1.12). However, the total level of school enrolment varied between urban, rural and remote areas. Rural areas experienced an increase of 6 percent, whereas urban and remote areas both experienced a decline, of 1 percent and 8 percent respectively.

Table 1.12. School Enrolment, 1996/97–1997/98 (thousands of students)

	Pre-school		Primary		Lower secondary		Upper secondary		Total	
	Total	Girls	Total	Girls	Total	Girls	Total	Girls	Total	Girls
Total (1996/97)	44.8	22.3	1,919.0	860.7	265.9	98.5	61.7	21.6	2,291.4	1,003.1
Urban areas	17.0	8.4	487,2	222.0	152.7	59.7	53.6	19.1	710.5	309.3
Rural areas	27.4	13.7	1,289.8	575.8	111.1	38.1	8.1	2.5	1,436.5	630.1
Remote areas	0.4	0.2	142.0	62.9	2.1	0.6	0.0	0.0	144.5	63.7
Total (1997/98)	43.4	21.6	2,011.8	906.8	229.1	79.8	73.8	25.6	2,358.1	1,033.8
Urban areas	15.1	7.6	514.4	234.8	115.9	43.8	57.2	21.0	702.6	307.1
Rural areas	27.8	13.8	1,366.2	613.8	112.4	35.8	16.6	4.6	1,523.0	668.0
Remote areas	0.4	0.2	131.2	58.2	0.8	0.2	0.0	0.0	132.4	58.7
Percent change	-3.3	-3.4	4.8	5.4	-13.8	-18.9	19.7	18.5	2.9	3.1
Urban areas	-10.9	-9.7	5.6	5.8	-24.1	-26.7	6.7	9.5	-1.1	-0.7
Rural areas	1.4	0.7	5.9	6.6	1.1	-6.0	106.3	88.6	6.0	6.0
Remote areas	-2.9	-11.4	-7.6	-7.3	-60.9	-65.1	0.0	0.0	-8.3	-7.9

Source: Ministry of Education, Youth and Sports

Among the four levels of education, lower secondary schools experienced the largest decline. The total number of students enrolled in lower secondary school decreased by 14 percent, from 266,000 in 1996/97 to 230,000 students in 1997/98. The number of enrolled lower secondary students in urban areas dropped sharply by 24 percent, from 153,000 in 1996/97 to 116,000 in 1997/98. The extent of the decline in the number of enrolled students was much higher for girls than for boys in lower secondary schools in all areas.

It is still inconclusive, however, whether the sharp decline in lower secondary enrolment was caused by the crises or by other factors, such as demographic change, damage to agricultural production caused by natural disasters, the movement of refugees to Thailand following the July 1997 fighting, and so on. One hypothesis could be that children of lower secondary school age are seen as being of working age, and are therefore forced to leave school.

4.2.3. Public expenditure

The tightened fiscal discipline in some crisis countries led to a reduction in public expenditure, including health and education. This undermined the effectiveness of the social safety net that the government provided for the poor and vulnerable.

In the case of Cambodia, fiscal discipline was imposed as an urgent response to the July 1997 fighting. This was primarily related to fears of the withdrawal of foreign assistance, on which the government depended, and the decline of customs revenue from imports. Another concern at that time was the risk of inflation if the government used monetary financing to pay for the loss of national revenues.

The budgetary pressures after July 1997 made it impossible for the government to implement the 1997 Budget Law, which had planned to increase the proportion of expenditures on health and education within total expenditure. The total current expenditure actually spent in 1997 was kept at about 94 percent of the level determined by the 1997 Budget Law (Table 1.13). Expenditures on education, health, and agricultural and rural development were most severely affected by the austerity measures, experiencing 10 to 25 percent cuts from 1997 Budget Law levels. Current expenditures on these sectors in 1997 consequently remained at similar levels, or even declined, compared to 1996. By contrast, actual expenditures on defence and security over-ran the 1997 Budget Law levels by 4 percent.

5. Policy Responses of the Government

This section discusses policy responses of the Cambodian government to contain the adverse impact of the Asian financial crisis on the economy. The government

Table 1.13. Current Expenditures, 1995–98 (billions of riels)

	1995 (actual)	1996 (actual)	1997 (budget)	1997 (actual)	1998 (budget)	1998 (project.)	Actual as percent of total expenditure 1995	1996	1997	1998
Defence and security	386	435	425	440	384	486	58	53	54	52
Education	74	81	91	80	94	110	11	10	10	12
Health	26	44	61	46	62	54	4	5	6	6
Agriculture/rural development	15	19	24	18	24	20	2	2	2	2
Other ministries	165	248	270	231	445	260	25	30	28	28
Total current expenditure	667	827	870	816	1009	931	100	100	100	100

Source: Ministry of Economy and Finance

responded to the Asian crisis and the aftermath of the July 1997 fighting with several policy measures, primarily in the following broad areas: 1) fiscal policy; 2) monetary policy; and 3) structural policy.

5.1. Fiscal Policy—Imposing Strict Budgetary Discipline

5.1.1. Curtailing public spending

The slump in tourism, the decline of customs revenues, and the suspension and termination of foreign aid after July 1997 cut into government revenues. According to the Ministry of Economy and Finance, government revenues from taxes on tourism alone dropped by 25 percent in 1997, down from US$100 million in 1996.

The government responded to the decline in revenue by introducing stringent budgetary discipline. Efforts were made on both expenditure and revenue sides of public finance. With regard to expenditures, the government in October 1997 cut spending on civil administration and expenditures on operation and maintenance by 20 percent to balance the national budget. The Council of Ministers also imposed a ban on the free use of mobile telephones by government officials (other than ministers) in an attempt to economise government resources.

5.1.2. Implementing the law on taxation

Budgetary discipline was also pursued by fiscal reforms intended to increase national revenues. The 1998 budget included fiscal reform measures aimed at broadening the tax base and improving the capacity of tax collection. It also implemented the Law on Taxation, which contained several revenue-enhancing measures.

The introduction of value-added tax (VAT) was a notable development among those policy measures. VAT came into force on 1 January 1999, with the rate set at

10 percent, replacing turnover taxes that had previously been levied. VAT is applied to about 2,000 large firms with variable taxable income, except for food and staple products. Some types of business, such as commercial banks, medical clinics, postal services, non-profit activities and insurance services, are exempt from VAT.

5.1.3. Improving the law on investment

It has been widely recognised that the Law on Investment has contributed to the erosion of the tax base, as it includes too broad a scope for *ad hoc* tax exemptions (Kun 1998). In December 1997, the Council of Ministers adopted a sub-decree on the Implementation of the Regulations for the Law on Investment, which was designed to eliminate some *ad hoc* tax exemptions.

Under the new regulations, tax concessions were to be granted only if investment projects met strict conditions in terms of the location of the project (to encourage investment in remote areas), the size of the project, the number of jobs to be created, the export potential, value-added, use of local resources, training of local workers, and the employment of women and disabled people.

In addition, tax exemptions were to be applicable only to taxes on profits and customs duties. Customs duty exemptions were to be granted only for the following types of projects: 1) export-oriented projects with at least of 80 percent of production designed for export; 2) projects located in a special promotion zone; 3) tourism industry projects; 4) projects in labour-intensive, processing and agri-business industries; and 5) physical infrastructure and energy projects. Products eligible for customs duty exemptions were restricted to construction materials, machinery, raw materials, intermediate goods and packaging equipment directly used in the production process.

5.1.4. Fiscal reforms under the 1999 Budget Law

Fiscal reform measures were also encompassed in the 1999 Budget Law. The reforms further broaden the tax base and improve tax collection. The Council of Ministers approved a proposal to levy taxes on senior government officials' salaries, from minister to under-secretary of state levels. Under the proposal, ministers' salaries are subject to a tax of 10 percent, secretaries of state to 5 percent, and under-secretaries of state to 2 percent.

Efforts have also been deployed to improve the collection of stamp duties and revenues from visas. The authority to use revenues from stamp duties will be transferred from provincial governments to the central government. The Council of Ministers also decided to levy tax on petrol, diesel and lubricants, and transfer the revenues to the Ministry of Public Works and Transport for road maintenance.

5.1.5. Seeking aid resumption

Finally, the government made efforts to seek the resumption of foreign assistance at previous levels. Foreign assistance is critical to maintain fiscal discipline, as almost all development expenditure has been financed by external assistance. After the July 1997 fighting, all US-supported projects were affected by USAID's decision to cut off aid flows (US$35 million). In September 1997, the International Monetary Fund (IMF) decided to withdraw concessional loans because of the government's unsatisfactory implementation of policies to enable it to collect revenue from all logging activities.

5.2. Monetary Policy—Restoring Macro-Economic Stability

The depreciation of the riel against the US dollar began in July 1997, and continued for about one year until the national election in July 1998. The NBC intervened occasionally in the foreign exchange market to stabilise the fluctuation of the riel through the use of auctions of US dollars. This instrument was used to defend the riel against speculative attacks. A notable intervention was undertaken in June 1998, prior to the July national election, when the exchange rate passed 4,000 riels to the dollar. To maintain the value of the riel, the NBC bought US$400,000 worth of riels in dollar auctions. This intervention was fairly successful in restoring stability in the foreign exchange market, as the riel bounced back to 3,900 riels to the dollar and has remained stable at 3,800 since then.

The decline in foreign currency deposits was discussed above in Section 2. The NBC issued two regulations in 1998 to stem the outflow of US dollars and increase confidence in the banking sector. The first regulation, passed in August 1998, stated that the transfer of foreign currency overseas must be performed by the NBC. The second regulation, also issued in August 1998, stipulated that commercial banks and financial institutions had to keep foreign currency deposits received from clients and inter-bank deposits for use within Cambodia.

5.3. Structural Policies

5.3.1. Foreign trade policy—protecting import-competing industries

In February 1998, the government issued a sub-decree to increase import tariffs for 14 types of products, ranging from foodstuffs (noodles, salt) to construction materials (cement, bricks, tiles, metal), and some plastic and rubber products. This measure was taken to protect domestic producers which had lost competitiveness due to the depreciation of the regional currencies, particularly the baht. The import tariffs on most of these products were raised from 0–7 to 15 percent, and for some from 15 to 35 percent.

Concerns have been raised, however, about the desirability and effectiveness of this response. First, even though the measure was said to be temporary, its duration was not clearly defined. As our analysis in Section 3 revealed, Cambodia's competitiveness against Thailand recovered from February to June 1998. The reason for protecting those industries had thus already passed. In addition, raising tariffs goes against the spirit of the ASEAN Free Trade Area (AFTA) and the World Trade Organisation (WTO), and create a scepticism among members of the Association of Southeast Asian Nations (ASEAN) and the WTO regarding the Cambodian government's commitment to liberalise its trade regime. Furthermore, raising import tariffs is likely to exacerbate smuggling activities with little protection for domestic producers. For example, some cement retailers in Phnom Penh reported that the price of Thai cement had remained cheap even after the rise in import tariffs from 7 to 15 percent, due in part to smuggling through former Khmer Rouge zones in the northwest of the country.

5.3.2. Foreign investment policy—improving the investment climate

Cambodia has experienced a decline of FDI since 1996, as recorded in Section 3. In response to the downward trend of investment inflows, the government passed a sub-decree on the Implementation of the Law on Investment in December 1997.

The objective of the sub-decree was to attract high quality investment and to speed up the implementation of projects. New regulations require investors to maintain a 1.5–2.0 percent deposit in the NBC for projects valued at US$1–40 million. The deposits are returned to investors upon the completion of 30 percent of the project. Privileges and incentives granted may be revoked if projects are not implemented in accordance with the agreed schedule, or within six months of the issue of licences. The regulations also ban investors from changing their investment activities and/or transferring ownership without prior approval by the Council for the Development of Cambodia (CDC). In order to prevent debt problems, the sub-decree prohibits recourse to loans that exceed threefold the company's capital, except for priority projects.

5.3.3. Tourism policy—recovering from the slump

In response to the drastic fall in tourist arrivals and the slump in the tourism industry, the government took specific measures to promote foreign investment in the aviation industry. In late 1997, the government introduced an "open sky" policy that ended the monopoly of the national carrier Royal Air Cambodge on domestic flights. Thai-owned Kampuchea Airlines was permitted to resume its services in Cambodia, and two other airlines, President Airlines and Angkor Air, submitted applications to the government for approval.

It was also recognised that the realignment of regional currencies reduced the cost of living in some of the crisis countries in US dollar terms, and diverted visitors to these countries from Cambodia. In response, the government rescinded its decision to impose an additional 10-percent tax on the hotel industry. To attract more visitors to Cambodia, the government also granted a licence to Bangkok Airways to establish direct flights from Bangkok to Siem Reap, where some of Cambodia's most popular tourist destinations are located.

6. Lessons for Future Policy-Making[10]

The Asian countries hit by the regional economic crisis from mid-1997 were often praised as the "East Asian miracle" for their remarkable growth and development. The crisis made it clear that the tremendous success of these countries had masked weaknesses and mismanagement. It also showed that differing government responses to the crisis influenced the effectiveness of counter-measures and the speed of recovery. The Asian crisis thus provided Cambodia an opportunity to reflect on the relevance and effectiveness of its own systems and policies, and to elaborate its strategies for long-term development.

Since the Asian crisis and its contagion effect have not come to a finish, it is perhaps somewhat premature to draw conclusions about the effectiveness of the policy measures undertaken by the governments in the crisis countries. However, some key lessons seem to have emerged already. This section examines three key lessons that are relevant in the context of Cambodia: 1) developing a robust financial system; 2) mitigating the volatility of foreign capital flows; and 3) establishing the rule of law and democracy.

6.1. Developing a Robust Financial System

The Asian crisis disclosed the weaknesses of the financial systems in the crisis countries, particularly their vulnerability to large outflows of foreign private capital. It should be noted, however, that the financial sectors in the crisis countries had been extremely successful throughout the 1980s. Indeed, these countries managed to mobilise domestic savings more than any other developing countries, efficiently allocated these funds to domestic investment, and achieved some of the highest economic growth rates in the world. Government policies and institutional reforms to establish sound financial systems, however, failed to keep pace with the liberalisation of foreign capital flows in the 1980s and 1990s. This is seen as one of major causes of the crisis in these countries.

[10] This section draws liberally on Kato (1998)

Cambodia's financial sector is still in its infancy relative to those in the crisis countries. It was only in 1991 that the banking system was opened up to private and foreign commercial banks. A new Bank Law was adopted in 1996 to set out the framework for modern monetary and banking systems. Given the short history of the modern banking system in Cambodia, it is not surprising that the banking sector has played a minimal role in mobilising domestic savings and allocating investment. The operation of commercial banks is generally confined to Phnom Penh, though a few have established branches in some provinces.

Other financial markets, such as bond and security markets, have not yet been established. Although the National Assembly approved a plan to issue treasury bills in 1997, it will be a major challenge to set the yield of the bills at a level that can attract investors, because confidence in the riel and in the government has not yet been well established.

This under-development is not altogether disadvantageous. Cambodia is in a position learn from the successes and failures of the crisis countries to establish a robust financial system. In doing so, it could achieve the same success as its neighbours while minimising the vulnerability of the economy to large capital outflows.

To this end, at least three issues need to be addressed: 1) establishing a legal framework for sound supervision and regulation; 2) developing a framework for corporate governance; and 3) de-dollarisation.

6.1.1. Establishing a legal framework for the supervision of commercial banks

It is imperative that legislation governing private financial institutions in Cambodia be passed. The Commercial Bank Law setting out the framework for banking regulation, in particular, should be adopted. Although the adoption of this law has already been delayed for more than one year, this could be seen as an opportunity to consider the experience of the crisis countries in the legislation. The adoption and enforcement of a sound banking law will lay the foundation for the development of a robust financial system in Cambodia.

One of the key issues arising from the Asian crisis is non-performing loans accumulated by commercial banks and finance companies. Cambodia should consider adopting regulations that require financial institutions to classify and report their assets in accordance with Bank of International Settlement (BIS) standards.[11] This

[11] The BIS standards provide the following classification of assets: 1) *worthless or irrecoverable assets*, are those that have to written off; 2) *doubtful assets likely to be lost* are receivable assets in arrears for more than 12 months; 3) *doubtful assets* are receivable assets in arrears for more than six months; and 4) *sub-standard assets* are receivable assets in arrears for more than three months. According to the BIS classification, non-performing loans are assets that are worthless, irrecoverable or doubtful.

would strengthen the NBC's supervisory function, because information regarding the holding of non-performing loans in bank assets will help the NBC identify the actual financial condition of commercial banks.

6.1.2. Developing a framework for corporate governance

It is of paramount importance that a legal framework to govern private business corporations be developed. This involves legislating various modern commercial laws and the reform of existing laws, such as those governing business organisations, contracts and arbitration, trademarks, product liability, and bankruptcy. These laws will define the rules that business has to follow in Cambodia's market economy. The adoption of internationally accepted accounting standards is also a necessary prerequisite, not only for accounting purposes *per se*, but also for commercial banks to be able to monitor the performance of their borrowers.

In the context of the Asian crisis, bankruptcy laws deserve special attention. During the crisis, the number of companies going bankrupt soared, leading to a large contraction of production, investment, credit flows, and consequently aggregate output and employment. It has since been recognised that the costs associated with resolving bankruptcies were enormous (Stiglitz 1998a; 1998b).

At the moment, no bankruptcy law exists in Cambodia, and legislation covering this would thus be highly recommended. It would help contain the adverse impact of bankruptcies on various sectors of the economy, and minimise the resulting social costs. A proper bankruptcy law can offer a legal framework for bankrupt and indebted companies to find new funding sources and to repay lenders under an agreed schedule, instead of simply being forced to shut down and hurting workers, shareholders and lenders. Creditors would still have the legal right to get their share of remaining assets from liquidation. A bankruptcy law is also likely to encourage foreign investors to enter Cambodia, because it provides them with a legal framework to recover their business assets in case of bankruptcy.

6.1.3. De-dollarisation

Dollarisation is without doubt one of the major issues in Cambodia's monetary economy because it is so widespread. For instance, a large proportion of financial transactions in Cambodia are undertaken in foreign currencies, especially in US dollars. In the provinces along the Thai border, the baht takes the place of the US dollar as a widely accepted currency. Foreign currency deposits with commercial banks account for more than 90 percent of total bank deposits. US dollars are believed to account for at least 80 percent of the total currency in circulation. The use of the riel is limited to small transactions and wage payments by the government.

Under the current circumstances, dollarisation obviously impairs the effective conduct of monetary policy and the adjustment mechanism of foreign exchange rates in Cambodia. It is also recognised, however, that dollarisation brings some benefits, such as price stability and a large stock of foreign exchange readily available in the domestic economy (Menon 1998). Whether, and to what extent, a robust financial system can be developed in Cambodia with extensive dollarisation intact is still an open question. One could argue that de-dollarisation would take place as Cambodia's financial system is further developed. However, some preparations for eventual de-dollarisation would not be harmful. For instance, changing such conventions as paying wages in the private sector in US dollars is one option.

6.2. Mitigating the Volatility of Foreign Capital Flows

The Asian crisis brought to light the fact that foreign capital is a double-edged sword for developing countries.

It is true that foreign capital has great potential to bring a wide range of benefits to such countries. It can augment a shortage of domestic capital, transfer new and appropriate technology, improve the quality of human resources, and earn foreign currency. It is thus important to establish a favourable investment climate conducive to private sector development. The Cambodian government has highlighted three key policies to encourage this: 1) simple and transparent regulatory systems; 2) effective legal and judicial systems that protect property rights, enforce contracts, and help create an atmosphere of law, order and personal security; and 3) tax systems that are simple and broad-based, with limited exemptions and reasonable and uniform rates (Keat 1998; Hang 1995).

However, the regional crisis has made clear that foreign capital tends to magnify, rather than smooth, fluctuations in developing economies because of its volatile and pro-cyclical characteristics. Stiglitz (1998a) points out these undesirable features, noting that "developing countries seem to get the most private capital when they are growing strongly and need it least, and have a relatively harder time accessing capital in hard times when they need it most."

In addition, inflows of foreign capital are inherently volatile because they are influenced by economic conditions and business cycles in the home countries of foreign investors. For instance, Japan's foreign investment in ASEAN increased dramatically after 1985. This was prompted first by the drastic appreciation of the yen against the US dollar following the Plaza Accord of the G7 countries. The re-alignment of foreign exchange rates weakened the competitiveness of Japanese products, and was a strong incentive for Japanese firms to relocate their production overseas where they could enjoy lower production costs. The increase in real wages in Taiwan and South Korea in the 1980s directed Japanese foreign investment away

from these countries and towards lower-wage countries in Southeast Asia. In addition, the wave of Japanese foreign investment to Asia was pushed by the Japanese economic boom in the second half of the 1980s. All of these factors are beyond the control of small developing countries such as Cambodia.

Cambodia has received large inflows of foreign private capital relative to the size of its economy since 1994. For instance, the net inflows of private capital accounted for 4.9 percent of GDP in 1997. The incentives offered to foreign investors have been among the most generous in the region. The majority of foreign capital inflows to Cambodia have comprised FDI, which tends to be long-term and stable. Given the composition of private capital inflows in Cambodia, a massive outflow of foreign capital is unlikely to happen in a short period of time, as was the case in the crisis countries. This is one of the reasons Cambodia was immediately affected by the crisis. Indeed, other less affected developing Asian countries, such as China, have a similar pattern of foreign capital inflows to Cambodia, and tend to have higher ratios of FDI to total private capital.

There are four considerations for Cambodia to reduce the potentially undesirable characteristics of foreign capital.

The first is to mobilise domestic private savings to finance investment. This would reduce Cambodia's heavy dependence on foreign capital by creating an alternative domestic source for funds. This could be achieved by the development of a robust financial system, particularly the banking sector, as discussed above.

The second consideration is to prioritise investment projects according to the duration of projects. A high priority should be given to projects which make a long-term commitment and are consistent with the long-term development strategies and objectives of the government. The selection or screening of foreign investment projects may reduce total foreign capital inflows to Cambodia, but it would reduce the risk of excess volatility and help channel foreign capital to productive investment.

The third is to consider carefully the risk of opening up Cambodia's financial markets, such as bonds and securities, to the rest of the world when these markets are established in the future. Careful analyses will be required before liberalisation of capital movement to ensure that the domestic regulatory framework is prudent, effective and robust enough to minimise the large risks involved in liberalisation.

Chile's experience of capital restrictions since 1991 is often cited as a successful case in which the inflow of short-term speculative capital (so-called "hot money") has been discouraged, whereas long-term investment in the form of FDI has been promoted (Rajan 1998). First, to discourage short-term speculative capital, portfolio inflows (including foreign loans and bond issues) above US$10,000 are subject to a 10-percent reserve requirement, interest-free, to be deposited at the

central bank for one year. This is an implicit tax if the capital were to remain in the country for a brief period. Second, Chilean firms and banks can tap international capital markets only if two bond-rating agencies rate their paper as high as Chile's own government bonds. Third, any foreign money coming into Chile must remain in the country for at least one year, a requirement that has discouraged many hedge funds and pension funds from investing in Chile. Whether or not this model is suitable for Cambodia's yet-to-be-developed financial markets needs further study.

Finally, careful consideration for foreign borrowing is needed not only in the private sector but also in the government, because the proportion of soft loans and bilateral grants for the government is likely to decline in the future. In this regard, the government needs to conduct proper debt and risk management to avoid macroeconomic instability caused by the mismanagement of the national debt.

6.3. Establishing the Rule of Law and Democracy

The Asian crisis highlighted the fact that economic crises can erupt in any market economy, regardless of its stage of development. Many unforeseeable forces seem to affect the fluctuation of market economies, and even foreseeable forces may be extremely difficult to control. Foreign investors' decisions are the case in point.

Under these circumstances, good governance is a key characteristic for a country to be able to reform and adjust to changing situations. The Asian crisis seems to teach us that capacity for reform can substantially affect the effectiveness of containing and recovering from a crisis. Thailand and South Korea elected new governments soon after the crisis erupted. The transition process was based on the rule of law and was democratic, reflecting the opinion of the majority of the people, who had not been satisfied with the reforms offered by previous governments. By contrast, Indonesia had no mechanism for a democratic transition that reflected people's opinions. The authoritarian regime of former president Suharto blocked swift and effective implementation of appropriate reforms to contain the crisis. In doing so, it undermined the prospect for future economic growth.

The advantages of democratic regimes in carrying out economic reforms are at least threefold (Maravall 1995). First, the legitimacy accorded to leaders elected under democratic regimes means that they obtain the cooperation of their citizens much more easily than the leaders of other regimes. This sense of cooperation allows democratic leaders to implement difficult economic reforms which may in the process impose hardships on their citizens. Second, democratic regimes are more likely to provide a better check and balance mechanism to correct mistakes in reforms, since political oppositions serve as a warning function. Third, democratic regimes open windows of opportunity for further transition when newly-elected governments cannot, for whatever reason, implement necessary reforms.

This suggests that the rule of law and democracy are necessary prerequisites for good governance, *i.e.* that the government is able to respond to various external shocks to the economy in a timely, effective and efficient manner. Among other lessons, the regional crisis clearly demonstrates the advantages of democratic regimes over authoritarian regimes in carrying out economic reforms in the dynamic and changing world economy.

In this regard, Cambodia's national election in July 1998 and the following political developments appear to show some positive signs. A new coalition government emerged out of negotiations between the two political parties with a majority of seats. A third party remains as a political opposition. Despite allegations of fraud in the election from a number of observers, the transition to a new government has generated hope for the emergence of democracy in Cambodia.

All parties are now expected to play their relevant roles in the political arena—*i.e.* that the coalition government takes full responsibility for implementing various reforms, whereas the opposition party plays a check-and-balance function in the process of policy-making. Whether or not Cambodia is able to develop the capacity to reform depends critically on the participation of all, not just some, Cambodians in this endeavour.

7. Conclusion

The current paper aimed to study the implications of the Asian financial crisis for Cambodia, one of the Southeast Asian transitional economies (SEATEs). The impact of the crisis on Cambodia's economy and society were analysed using available official data and a range of surveys. The paper also discussed the response of the Cambodian government to contain adverse impacts of the Asian crisis, and lessons that Cambodia could learn for future policy-making.

Our analysis revealed that the Asian crisis had not had immediate an adverse impact on the financial sector in Cambodia. The decline of private capital inflows was modest in the second half of 1997. This contrasts with the experience of crisis countries that suffered from contagion immediately after the crisis erupted in Thailand. It was argued that Cambodia's under-developed financial markets provided some sort of "cushion" against the crisis and delayed the contagion effects, at least for the first six months of the crisis.

The adverse impact on the real sector was also modest in the second half of 1997. The trade balance did not deteriorate, despite the loss of competitiveness arising from the appreciation of the riel and the US dollar *vis-à-vis* the crisis currencies. This was primarily due to the rapid expansion of garment exports to the EU and the United States, which have not yet been greatly affected by the Asian crisis. FDI

declined, but the speed of the decline was slow in the second half of 1997. Consumers actually enjoyed cheaper products from Thailand, as the riel and the US dollar appreciated drastically against the baht until January 1998.

Our study found, however, that the adverse impact of the Asian crisis came to be felt more strongly in 1998. The decline of foreign currency deposits in commercial banks, which had started in April 1997, continued in 1998 with no significant sign of recovery. Two Thai-owned commercial banks closed down their offices in Cambodia in the second semester of 1998. Despite the recovery of competitiveness of Cambodia's products after February 1998, some domestic producers faced severe price competition with imported products. Some export-oriented enterprises, particularly wood products and rubber, faced a sharp fall in the volume and prices of their exports. This was primarily due to the slowdown of growth and the gain of competitiveness in the crisis economies. The tourism sector continued to suffer stagnant tourist arrivals, in particular from the crisis countries in ASEAN.

The livelihood of the people has been severely affected by the continued stagnation of Cambodia's economy that was precipitated by the internal political crisis in July 1997. The Asian crisis made it more difficult than it may otherwise have been for Cambodia's economy to recover from the ongoing stagnation. Vulnerable workers in the capital continued to earn only about half of the net earnings they had earned before July 1997. Migrant workers to Thailand suffered from a sharp reduction of demand for migrant labour and in the level of wages paid, in particular for those who worked in construction in large cities such as Bangkok.

Our study also found indications that social development, the top priority in Cambodia, has been adversely affected by the Asian crisis. The cost of health-care increased considerably as the foreign exchange rate of the riel against the US dollar depreciated. A sharp decline of enrolment in lower secondary school in 1997/98 raises concerns about an increase of child labour, especially in poor households.

The government's policy responses to the Asian crisis were formulated within the context of policies and strategies for sustainable growth and development in Cambodia. Fiscal discipline was strengthened after the fighting in July 1997 to maintain sound macro-economic fundamentals. Several fiscal reform measures were undertaken or are planned to broaden the tax base and improve the capacity for tax collection. The NBC has taken steps to strengthen the supervision of commercial banks to develop a sound banking system. Some measures were also introduced to curb the outflow of foreign currency from Cambodia. The NBC's occasional interventions in the foreign exchange market helped to stabilise the value of the riel, particularly during the period before the national election in July 1998. Recognising the declining trend of FDI, the government took several measures to improve the investment climate in Cambodia. However, the responses of the government to

the social impact of the crisis, particularly to protect the livelihood of the poor and the vulnerable, have not been notable.

The lessons of the Asian crisis for policy-making in Cambodia warrant further discussion and research. Although it may be somewhat premature, there are a few lessons that Cambodia's authorities may consider. First, it is imperative to pass legislation such as the Commercial Bank Law to lay the foundation for the development of a robust financial system in Cambodia. This should help enhance the supervision of the regulatory authorities, and increase transparency in commercial bank operations. The introduction of internationally accepted standards of loan classification, such as the BIS standards, accounting practices and disclosure rules, is also recommended. Second, the government may consider mitigating the negative impact on the economy of the volatility of foreign capital flows. Finally, the establishment of the rule of law and democracy are prerequisites for the government to be able to respond to various external shocks to the economy in a timely, effective and efficient manner.

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Chapter Two

Case Study of the Lao Peoples' Democratic Republic

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1. Introduction

The Asian financial and economic crisis, which erupted in July 1997 in Thailand, coincided with the floating of the Thai baht. It has since spread to most Asian countries and even affected the rest of the world with global political and socio-economic effects.

The Asian crisis has been widely discussed and analysed to discover its causes and impact. At the same time, countries have formulated and implemented policy responses to the crisis at the national as well as the international level, in order to revive their economies as quickly as possible. However, the crisis is still going on, and it is impossible to predict when it will end.

Some common causes which have been put forward by analysts are: an increase in external debt following excessive private borrowing abroad; over-valuation of local currencies against the US dollar, short-term credits invested in long-term projects and in unproductive sectors (especially in real estate in the case of Thailand, which led to a bubble economy), poor macro-economic management policies; and a weak fundamental economic structure.

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Southeast Asian economies had enjoyed high growth of between 7 and 9 percent per year over the past 15 years, during a period when the US and European economies saw sluggish growth. The World Bank, International Monetary Fund (IMF), Asian Development Bank (ADB), and other international organisations admired East Asia's "Economic Miracle." The success of these economies provided an attractive model for the Southeast Asian transitional economies (SEATEs), and played a significant role towards transformation in the Lao Peoples' Democratic Republic (Lao PDR). The crisis threatens to erode this remarkable achievement in East Asian economic development. It has put pressure on the transitional economies, and contributed to a decline of about 1–2 percent in forecast world economic growth in 1998. Inflation in the region has risen dramatically. In Bangkok, Jakarta and Seoul, governments have changed, banks have closed, businesses built up over the past few decades have gone bankrupt, and millions of people have become unemployed. The social effects of this have been dramatic.

The Lao PDR was in the process of introducing a sound market economy, and Thailand is its largest trade and investment partner. The Asia financial and economic crisis has thus directly and indirectly affected the Lao PDR, though there have been different impacts on each sector. The main purpose of this paper is to investigate the impact of the Asian crisis on the macro level of the Lao economy, and to assess its social effects. In addition, major responses of the Lao government to the crisis, particularly in the economic and financial sectors, for both the short- and long-term, are discussed. The paper concludes with important lessons to be drawn from the Asian crisis.

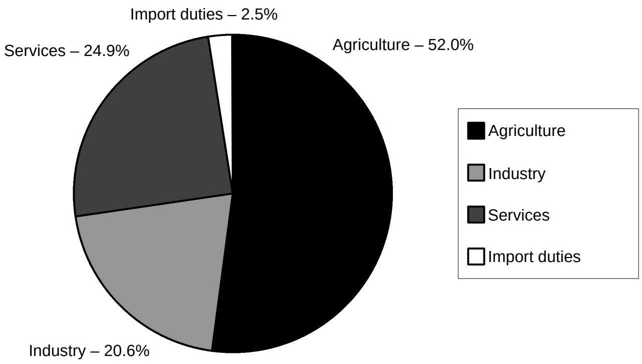
2. The Economic Situation of the Lao PDR Before the Asian Crisis

Since 1986, the Lao PDR has implemented a comprehensive economic reform programme called the "New Economic Mechanism" (NEM) to shift from a centrally planned economy towards a market-oriented economy. During the initial stage of the NEM, the Lao PDR has achieved remarkable success in economic development and macro-economic stability in terms of economic growth, relatively stable price levels and exchange rates, and a considerable increase in foreign direct investment (FDI) inflows.

Thanks to the improved economic environment for private sector development and to strengthening public investment, strong GDP growth has characterised the Lao economy from 1990 to 1997. Over this period, GDP grew at an average rate of 7 percent per year, induced by an average growth in agriculture of 5 percent per year, in industry of approximately 12 percent per year, and in services of about 7 percent per year. Per capita GDP increased from US$211 in 1990 to US$350 in 1995, and to US$380 in 1996.

Agriculture is the dominant sector in the Lao economy. In 1996, agriculture contributed 52.0 percent to GDP, while the share of industry in GDP was 21.6 percent. However, agriculture's contribution to GDP has been gradually declining.

Figure 2.1. Share of GDP by Sector, 1996



Inflation and exchange rates were quite stable between 1992 and 1994, with inflation under 10 percent and the kip-US dollar exchange rate fluctuating between 720 and 730. However, inflation jumped to 19.4 percent in 1995 and 13 percent in 1996 due to the effects of natural disasters and poor macro-level management, compounded by a small domestic production base. Inflation has since undergone slight fluctuations, principally from the impact of severe flooding in 1996 and external economic factors.

Annual government revenues have increased by approximately 15 percent per year, enough to cover the public payroll and current expenditure. Nevertheless, the national budget still suffers from a deficit representing 10–11 percent of GDP.

The environment for economic development in the Lao PDR has been further enhanced by the establishment of a regulatory framework for a market economy. A number of new laws have been adopted and put into effect in recent years, such as the Customs Law, Foreign Investment Law, Labour Law, Budget Law, Bankruptcy Law and Secure Transition Law, Enterprise Law, Domestic Investment Law, Taxation Law, and so on.

Success in the government's open-door policy has been realised through the promotion and development of the private sector's contribution to national development. Over 30 countries have invested in the Lao PDR, in export-oriented hydropower generation, processing industries, services, hotels, construction, telecommunications, trade and mining. Since 1988, the government has licensed total investment worth approximately US$6.8 billion, about half of the licensed capital of

which is invested in hydropower. However, the actual investment is still small, and may represent only 20–30 percent of the registered capital value.

Despite some respectable achievements in economic growth and stability, the Lao PDR still faces a number of challenges which on the one hand promote economic development, and on the other create new risks of hindering the process of economic development and stability.

One of the most critical issues at the macro-economic level, and one connected directly with the crisis, is the trade deficit, which has led to an unstable exchange rate since the introduction of a modified floating exchange rate in August 1995. The Lao PDR had a large trade deficit with Thailand of US$213.2 million in 1996. Because of its long border with Thailand, along which it is difficult to control cross-border trade, informal imports worsen this deficit. Exports are equal to only half of the value of imports, and about 70 percent of exports are concentrated on only two products—timber and other wood products and electricity. Consumer goods remain the most important import item, but grouping all of the imports linked to production processes (such as materials for the garment industry and parts for motorcycle assembly) into an "equipment goods'' category left them almost equal to consumer goods in 1996. Exports declined by 9.6 percent in 1996 compared to 1995. One of the main reasons for this is believed to be the withdrawal by the European Union of generalised system of preferences (GSP) status. This led to a higher trade deficit than initially expected.

The current account deficit, including official transfers, was 12.1 percent of GDP in 1996 and 10.6 percent in 1997. The overall balance of payments in 1996 closed with an estimated surplus of US$45 million. However, there was a shortfall of US$30.5 million in 1997.

The fiscal deficit remained huge at about 10 percent of GDP. This is an issue which the Lao government is still addressing through strengthening of the tax and customs administration to help ensure fiscal sustainability for the future.

The financing of socio-economic development in the Lao PDR has continued to depend heavily on loans, grants and private investment. Foreign loans and investment make up about 20 percent of GDP, while grants amounted to approximately 12 percent. About 80 percent of public investment was funded by foreign capital inflows, due to the low level of government and private domestic savings.

Rapid money growth reflected high growth in private sector credit, a large increase in net foreign assets over 1992–93, and a large amount of foreign currencies entering the country through informal channels. These led to dramatic increases in prices and in exchange rate losses in mid-1995.

3. Impact of the Asian Crisis on the Lao Economy

3.1. Impact on Real Sectors

Due to imbalances in the macro-economy and its poor production base, the Lao PDR was extremely vulnerable to the financial crisis. According to the socio-economic development plan for 1997–98, the main target was to reach a GDP growth rate of 7–8 percent. However, the real GDP growth rate in 1997–98 has been estimated to be only about 6.7 percent, lower than the target. This can be explained by the fact that investment, both private and public, was falling due to increasing production costs, especially in the industrial sector, caused by the depreciation of the kip against the US dollar and the baht, as well as by rapid inflation.

In 1998, the agricultural sector was estimated to have grown by 5.1 percent, which corresponds to the target of 5.1–5.3 percent for 1998, though lower than the growth rate achieved in 1997 (5.7 percent). This suggests that the agricultural sector has been only marginally affected by the crisis. The reason for this is that the government has implemented an irrigation programme to help farmers produce larger rice harvests. In addition, the agricultural sector depends mostly on natural conditions and intensive labour rather than market conditions and financial factors.

The industrial sector is estimated to have grown by approximately 8.9 percent in 1998, lower than the target (12 percent) and lower than the growth rate in 1997 (17.3 percent). The decline in the industrial sector was the main cause for the slowdown in GDP growth in 1998. The slowdown in industry was directly caused by the Asian crisis, due to the higher cost of imported materials, equipment and machines, and the fall in demand for industrial products, especially wood products, in both domestic and foreign (especially the Thai) markets. This led to a slowdown in FDI as well as in local investment relying on imported inputs, which would have needed additional capital to realise the expected targets for growth in the sector.

Despite the slowdown in neighbouring countries and in the industrial sector in the Lao PDR in 1998, which were directly caused by the Asian crisis, the service sector in the Lao PDR was estimated to have grown by 10.6 percent, surpassing the target of 9–10 percent, due to an increase in tourism. In general, the service sector has proved to be relatively flexible in the face of the crisis, though some sub-sectors in services, such as trade in imports, have been heavily hit.

3.2. Impact on Exchange Rates and Inflation

External shocks in the Lao PDR's main trading partner Thailand have been a major cause of recent macro-economic instability, especially of the dramatic change in exchange and inflation rates in the Lao PDR.

The value of the baht declined against the US dollar by 64 percent from July 1997 to July 1998, and domestic inflation in Thailand is at present about 12 percent. Unfortunately, the value of the kip has fallen even more, from 978 kip to the dollar in December 1996 to 2,060 kip to the dollar in December 1997, and reaching over 4,000 kip to the dollar in September 1998, when the parallel rate was 4,800 kip to the dollar.

Domestic inflation increased by 103 percent between July 1997 and July 1998, and by 89 percent from December 1997 to July 1998. During the first 10 months of 1998, consumer prices rose by 112 percent.

Price increases were uniform across sectors and major towns. During 1998, the increase in the price of consumer products was closely related to the rate of depreciation of the kip against the baht. The impact of the Asian crisis, and especially of the depreciation of the baht, on the financial sector in the Lao PDR can be explained by the fact that Thailand is the closest trading partner of the Lao PDR. Although about 30 percent of the total export value of the Lao PDR went to Thailand, more than 50 percent of its total import value came from Thailand. These large shares of total imports and exports of the Lao PDR with Thailand mean that changes in the value of the baht can have a considerable effect on the foreign trade sector of the Lao economy. In addition to these official trade data, uncontrolled informal trade along the extended Lao-Thai border has added to a high total trade value, which requires large amounts of foreign currencies.

Because of the high demand for foreign currencies in the Lao PDR and its dependence on Thailand, the depreciation of the baht against the US dollar and other major currencies led to an extreme impact on exchange rates and hyperinflation in the Lao PDR.

3.3. Impact on the Financial Sector

Following the depreciation of the kip, many people lost confidence in the national currency. Consequently, kip deposits in commercial banks have decreased considerably. More and more people have tried to save foreign currencies, especially the US dollar. Although no finance companies or commercial banks in the Lao PDR have gone bankrupt to date, all commercial banks have faced shortages of funds, and liquidity in the banking system has gradually been reduced. This situation has forced commercial banks to adopt new interest rates.

Government revenue continues to increase. In 1998, government revenue accounted for 12.7 percent of GDP; it had been 11.4 percent of GDP in 1997. However, government expenditure has increased more rapidly due to the high costs that have been caused by the Asian crisis, which has led to a worsening budget deficit.

In 1997, the government budget deficit was 10.2 percent of GDP, and it had risen to 11.4 percent in 1998. An austerity policy is currently being implemented to prevent the deficit from worsening.

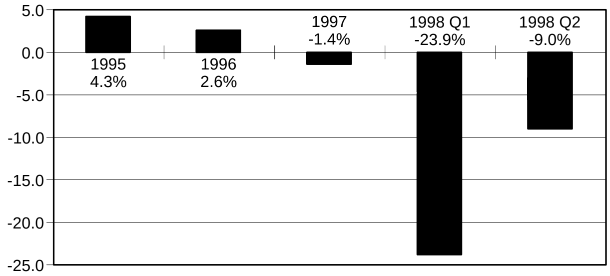
3.4. Impact on Trade

Due to the weak demand for Lao import goods in Thailand, the main trading partner of the Lao PDR, Lao export goods to Thailand, especially logs, timber and other wood products, fell slightly by 1.4 percent in 1997 and dramatically by 23.9 percent in the first quarter of 1998 alone.

In theory, the depreciation of a domestic currency can induce export growth through comparative cost advantage. However, this has not been the case for the Lao PDR because many things were changing at the same time. Since the kip began depreciating, the Lao PDR has earned export revenue from only a few kinds of goods, especially garments which were supported by the European Union's export quotas. The export of garments increased by 41 percent from 1996 to 1997. However, exported garments are mostly produced from imported materials, and the value added is relatively low due to the high costs of inputs.

The Lao PDR's exports should have become more competitive in the world market as a result of the depreciation of the kip, leading to their expansion. The weak response of Lao exports to the favourable exchange rate changes thus may be explained by the fact that the Lao PDR has limited access to the world market beyond its immediate neighbours, which were also in trouble.

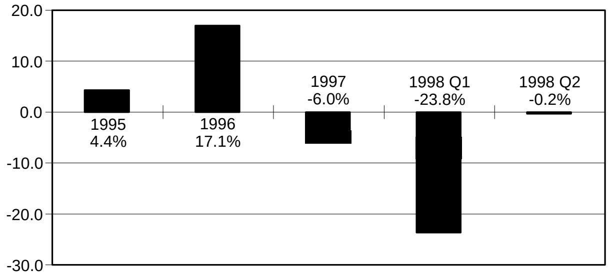
Figure 2.2. Export Growth Rates, 1995–98 (percentage)



The devaluation of the kip against the US dollar and the baht has made imported goods dramatically expensive. As a result, total imports decreased by 6.0 percent over the 1996–97 period, and then dramatically by 23.8 percent in the first quarter of 1998.

Despite the dramatic decrease in the total value of imports, imports of a number of goods continued to increase, especially fuel, construction materials, materials for the garment industry, and motorcycle parts, due to an increase in domestic demand. The increase in the imports of fuel and motorcycle parts was a result of expanded domestic consumption of these products. The increase in materials for the garment industry can be explained by the increase in garment exports. In addition, imports of some consumer goods which have high demand, such as monosodium glutamate and fish sauce, are relatively unaffected by changes in prices.

Figure 2.3. Import Growth Rates, 1995–98



3.5. Impact on Foreign Investment and External Assistance

3.5.1. Impact on foreign investment

Together with other sectors, foreign investment has been greatly affected by the crisis. Although the total registered investment capital continues to show significant amounts, the amount of real capital inflows to the Lao PDR have been severely affected by to the crisis.

The total foreign investment capital registered in the Lao PDR from 1988 to 1998 amounted to US$5.68 billion (excluding domestic share). In addition to this, domestic investors have shared about 18 percent of the total registered investment capital with foreign investors, accounting for US$1.25 billion. Foreign investment projects comprise a total registered investment capital of US$6.93 billion over the 1988–98 period. The most attractive sectors have been industry, agriculture, transportation and communications. About 44 percent of the total registered capital is concentrated in the industrial sector, 32 percent in the agricultural sector, 22 percent in transportation and communications, and 2 percent in trade in services.

Major investors among the 35 countries investing in the Lao PDR are Thailand, the United States, South Korea, Malaysia, Taiwan and Australia. In total, there are 728 projects, of which 224 are Thai projects with a total registered capital of US$2.92 billion. About 42 percent of the total registered investment capital is

from Thailand, making the Lao economy is to some extent dependent on the Thai economy. Investment in the Lao PDR has therefore been unavoidably affected by the financial and economic crisis in Thailand.

The Asian crisis has affected FDI in the Lao PDR most notably in terms of capital inflows, especially capital inflows from Thailand. Foreign investment (excluding domestic shares) increased by about 88 percent from 1995 to 1996, but declined sharply by 88.4 percent in 1997 and by 18 percent in 1998.

The Asian financial and economic crisis has affected a number of foreign investment projects in different respects, as follows:

- The collapse of banking and financial institutions in Thailand has delayed or postponed capital inflows and significant amounts of imported equipment and machines to implement existing projects, such as the Namgnum-III hydropower project and the railway from Nong Khai to Vientiane.
- Because the Lao PDR has a trade deficit with Thailand, the baht has appreciated against the kip even though it lost value against the US dollar. Price increases in Thailand have led to higher costs for imported construction materials, machines, equipment, raw materials (for garment factories, reassembling factories and construction projects, etc.). This has created a burden for investors and discouraged investment in the country.
- The extremely high fluctuation of inflation and exchange rates in the Lao PDR has boosted the price of local raw materials and operating costs, leading to a higher cost of output. For example, the director of one company noted that the cost of local raw materials has gone up and made the cost of his products too expensive for people to buy. He added that his company had faced difficulties in buying US dollars from the bank, being forced to wait for several days while the exchange rate continued to fluctuate.
- The economic crisis in Asia and the financial vulnerability in the Lao PDR has discouraged foreign investors from making decisions about future investments and has delayed the advancement of investment projects in the Lao PDR.

3.5.2. Impact on external assistance

The financial instability in the Lao PDR, especially the depreciation of the kip and hyperinflation, together with the budget deficit, have created problems for the government in terms of providing counterpart funding to implement projects assisted by foreign agencies. The government is supposed to provide counterpart funding worth about 15–20 percent of the total cost of a project (including salaries and local construction materials). However, due to the crisis the government has not been

able to provide the planned counterpart funds for several projects financed by other countries and international organisations. Only about 5 percent of total counterpart funds have been provided by the government. Some projects have been postponed as a result of the government's inability to make contributions.

For 1997–98, the total amount of external assistance to the Lao PDR was US$377.76 million, with 535 grant-funded projects worth U$203.32 million (accounting for 53.8 percent of the total) and loans amounting to U$174.36 million (46.2 percent of total assistance).

Foreign assistance is composed of several types of projects—bilateral, multilateral and NGO-funded. The bilateral projects come from 14 countries, amounting to US$152.96 million (54.5 percent of total assistance). Multilateral projects amount to US$206.06 million (54.5 percent of total assistance), of which U$41.7 million is in grants and US$164.35 million in low-interest loans. Sixty-three NGOs are providing assistance worth US$8.63 million.

Foreign assistance is concentrated mainly in the communications, rural development and agricultural sectors, as illustrated in Table 2.1.

Table 2.1. External Assistance, 1997–98

Sector	Value (US$ million)	Percentage share
Agriculture	28.33	18.5
Industry	52.87	14.0
Communications	101.97	27.0
Rural development	87.62	23.0
Education	28.33	7.5
Health	37.01	9.8

The economic downturn has had an extreme affect on the government budget, leading to cuts in counterpart funding for non-priority projects, so that many projects have been delayed. In addition, the unstable exchange rate has made the amount of counterpart funds larger in kip terms.

External assistance for the Lao PDR in 1998 has remained stable, but the fluctuation of the inflation and exchange rates has led to high operating costs for projects, such that several have had to adjust their budgets and operating costs in order to be able to continue implementation.

4. Social Impact of the Crisis on Households and Individuals

This section assesses the impact of the Asian crisis on the consumption, income, employment, livelihood and services of individuals and households in the Lao PDR. In addition, it discusses the coping mechanisms that families, households and

individuals have adopted in reaction to economic stresses. This discussion includes aspects of adjusting consumption and savings, mobilising additional labour, and changing utilisation of public services. Finally, some future studies are discussed to identify the social problems resulting from the crisis.

4.1. Impact of the Crisis

4.1.1. Consumption

High price increases of consumer goods and services, in combination with modest income increases (as expected in the Lao PDR) may change consumption patterns. Households would be expected to spend relatively more on food while cutting down expenditures on other items. It is not easy to detect such changes, however, as they probably do not occur immediately.

In order to study the social impact of the crisis, the NSC conducted a qualitative "rapid survey of social impact" of households in five provinces (Vientiane municipality, Oudomaxay, Khammuame, Savannakhet and Champasak) from April to June 1998 with support from the World Bank. The main finding of the survey was that the price increases directly affected household living standards, especially among poor households.

The study indicated that households considered increases in prices of basic commodities to be most painful, particularly of food, medicine and clothing. It is interesting to note that urban and rural households ranked these items in the same order, though with different degrees of intensity.

Ninety percent of all urban households ranked food as the most affected item, compared to 51 percent of households in rural areas. The difference does not reflect a wealthier situation for people in rural areas, since most of the food in the countryside is self-produced and barter is still widely used as a mode of exchange (Table 2.2).

Table 2.2. Impact on Household Consumer Spending, 1998 (percentage)

Item	Urban areas	Rural areas	Overall impact
1 Food	90.3	51.8	67.0
2 Medicine	47.3	22.9	32.5
3 Clothing	28.7	28.9	28.8

Although prices have gone up all over the country, the absolute cost of living has become higher in urban rather than in rural areas. At the same time, rural areas have far fewer opportunities for income generation, so that even though costs are lower, slight rises can still put necessities out of reach of much of the population, especially if they are poor.

The level of price increases also depends on the import content of goods and commodities. The price increases of locally produced goods and commodities have been significant, but somewhat lower than those for commodities which are imported or have a high import content. Locally grown food has generally increased in price by between 40 and 60 percent, while the cost of imported items have increased twice as much on average.

In the Lao PDR, the prices of all goods and services continued to rise between 50 and 100 percent on average in 1998 compared to 1997. From the result of the rapid survey, approximately 50 percent of the sampled households perceived prices of food to have increased, 40 percent saw prices of medicine up, and 30 percent thought clothing was more expensive. In urban areas, 64 percent of the households perceived increases in food prices and 46 percent in medicines. In rural areas, the corresponding shares were 42 percent and 38 percent.

Responding to increased prices, households with reduced real income have had to spend less and adjust their consumption patterns, especially for the most affected items such as food, medicine and clothing. The findings from the qualitative survey are that households have decreased their food consumption by 24 percent, consumption of medicine by 17 percent, and of clothing by 35 percent.

Disaggregating the impact by area, we find that 24 percent of rural households had reduced their food consumption, compared to 22 percent of households in urban areas. The drop in consumption of clothing is higher in rural (40 percent) than in urban areas (27 percent). For medicine, the reduction of consumption is almost the same in both urban and rural areas (Table 2.3).

Table 2.3. Reduction in Consumer Spending, 1998 (percentage of households)

Item	Urban areas	Rural areas	Overall
1 Food	22.4	24.4	23.7
2 Medicine	15.7	18.4	17.3
3 Clothing	27.5	40.1	35.2

The NSC also analysed consumption data from the second Lao Expenditure and Consumption Survey (LECS-II). This quantitative survey was conducted from March 1997 to February 1998, and covered almost 9,000 households across the country. The survey gives a somewhat different picture of how consumption spending was affected in urban and rural areas, though it should be borne in mind that the survey period is too close to the crisis to fully reflect its effects.

In this study, we have compared consumption patterns of households before August 1997, considered to be the period before the crisis, and consumption patterns of the same households surveyed from September 1997 to February 1998, *i.e.* referring to the period when the crisis had begun to affect the Lao PDR.

Analysis of the LECS-II data suggests that the food made up 46.9 percent of total consumption in urban areas in the period March–August 1997, and 48.2 percent in the period September 1997–February 1998. In rural areas, the food consumption share dropped from 63.6 to 61.1 percent. The share of housing and medical care was down in both urban and rural areas, but otherwise changes went in various directions. For transport and recreation, the share increased in rural areas.

It is thus difficult to find any impact of the crisis in the LECS-II data. All the changes observed can be explained by other factors, such as seasonal variations in consumption and sampling errors.

The consumer price index (CPI) shows that the price of food and other commodities has risen more in urban than in rural areas. Rural households have less opportunities to access financial facilities, but can rely on self-produced food items. The crisis may thus have affected rural households later and with less strength than households in urban areas (Table 2.4).

Table 2.4. Consumer Spending Patterns from LECS-II, 1997–98 (percentage)

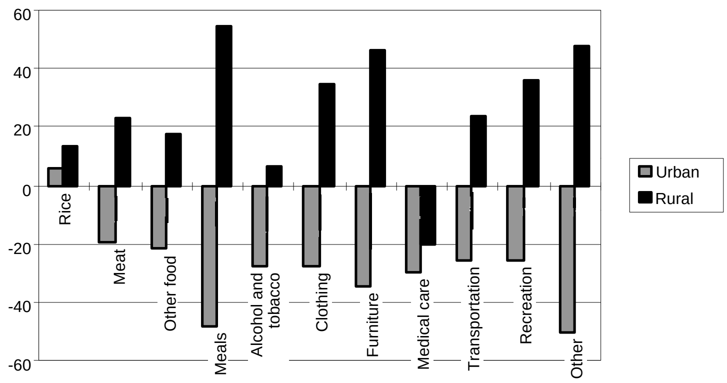
Item	March–August 1997		September 1997–February 1998	
	Urban areas	Rural areas	Urban areas	Rural areas
Food	46.9	63.6	48.2	61.1
Alcohol and tobacco	2.9	2.7	2.9	2.7
Housing (maintenance)	18.6	12.6	19.8	12.8
Medical care	1.9	2.8	1.7	1.9
Transportation	12.6	8.4	12.6	9.6
Education	1.1	0.4	1.2	0.5
Other	17.2	9.5	13.6	11.4
Total	100.0	100.0	100.0	100.0

More than 80 percent of the total population live in rural areas, most of the people living there are farmers, and the majority of their consumption is based on their own products, such as rice, meat, vegetables and other food items. LECS-2 showed that 87 percent of the total gross output in agriculture was for self-consumption. In this case, even if the crisis has affected the rural population, people can still survive. It appears that the high inflation affecting imported goods such as fertilisers, tractors and other agricultural inputs has not yet been matched by similar price increases of agricultural products. The stimulus to increase productivity in agriculture by using more inputs may have received a blow.

Comparing the consumption per household between the two periods of the LECS-II year, and correcting the data so they reflect the same price level, we found an increase in consumption per rural household of 20 percent in real terms, and a corresponding decrease in urban areas. The consumption of rice rose in both areas. Otherwise the trend is clear, with a fall in consumption in urban areas and an increase in rural areas. Consumption per capita in real terms shows the same picture,

increases in rice consumption, by 6 percent in urban and 13 percent in rural areas. With qualifications for the other factors that influence consumption, the LECS-II survey supports the theory that it is the urban population that has been most affected by the crisis, at least in the short term.

Figure 2.4. Percentage Change in Per Capita Consumption, 1997–98



There has been a considerable difference in price increases between various food items. Rice is the single most important food item among the poor, while dairy products and meat are more important among higher income groups. In the initial inflation phase, meat became more expensive while rice prices were relatively stable. This means that the poor were not as severely affected as other groups in the short term. In the long run, however, changes in relative prices may equalise, which will mean the poor being affected to more or less the same extent.

4.1.2. Income

The rapid qualitative survey indicated that urban households were most affected by the crisis, which is most of the formal waged labour sector. Unless this group receives higher wages, it will suffer from the decreased purchasing power of its salaries and wages, particularly government employees.

The rapid survey did not provide information on how income was affected by the devaluation of the kip. Data were gathered on the number of households that had asked their relatives for support—approximately 20 percent of the sampled households had done this, 80 percent of which were seeking support for daily consumption needs.

The LECS-II provides some data on income and main sources of income. The average income per household was 206,100 kip in 1997–98. Urban households had incomes of about 363,600 kip per year, while rural households earned on average

only 173,300 kip. Households in urban areas was thus earning twice as much as households in rural areas.

The main sources income of the Lao people are from agriculture (45 percent), household business (20 percent), wages and salaries (16 percent) and transfers from abroad (13 percent). The crisis has had more impact in urban areas, because the population there is living in a cash economy, and their main income source was mostly wages and salaries, particularly in Vientiane, Luang Namtha, Bolikhamxay, Savannakhet and Attapeu.

Of the total population, more than 80 percent are living in rural areas and their main sources of income are from agriculture (60 percent), small household business (12 percent) and wages and salaries (12 percent). Urban households make income from household business (37 percent), from wages and salaries (24 percent) and transfers (17 percent) (Table 2.5).

Table 2.5. Main Source of Income (percentage share)

	Agricultural income	Imputed rent	Household business	Wages and salaries	Income from property	Transfers	Total
Urban areas	10	6	37	24	17	17	100
Rural areas	60	3	12	12	10	10	100
Total	45	4	20	16	13	13	100

Table 2.6 shows the percentage of total income by source for the two periods of the LECS-II survey (before and during the crisis). It is not altogether surprising that there are large differences, because the harvest season influences the flow of income. It is interesting to note that Lao households receive a lot of support from relatives abroad, and this support does not seem to have diminished. More than 10 percent of an average household's total income comes from this source, and in Vientiane the share is close to 30 percent. Since this, at least to some extent, is income in hard currencies, it may be serving as a safety net for many households.

Table 2.6. Income Sources During LECS-II (percentage share)

	March–August 1997	September 1997–February 1998
Agricultural net income	34	54
Household business	27	13
Wages and salaries	19	13
Income from property	4	1
Transfers from abroad	11	14
Other	5	5
Total	100	100

The income data suggest that the crisis did not affect rural households as much as urban households. In places which are remote and have no access to the market there has been little impact, since households are self-sufficient or barter to trade. Very poor households that are outside the monetarised economy have been largely isolated from the economic crisis.

4.1.3 Employment and livelihoods

The situation with regard to employment is somewhat less clear than that with regard to prices. In an attempt to identify recent changes in labour/employment patterns, which may have been induced by the worsening economic situation, we searched for information relating to labour mobility.

Our study revealed two main findings. First, labour mobility is highest in the private sector and among those who are self-employed, and lowest among government employees and farmers. Second, among those who recently got their present position, relatively few were found in the public sector and among farmers. This suggests that labour mobility is quite low, that government work and farming are no longer available as the main opportunities for work, and that the opening of the market economy is an alternative for increasing numbers of people.

The percentage of government employees who want to change is rather low (8.1 percent). However, both male and female employees in private companies, particularly those in urban areas, expressed more obvious dissatisfaction with their present position, with 32 percent wishing to change. Young farmers of both sexes seemed able to find sufficient incentive and motivation to maintain their traditional ties to the land, with only 31 percent wanting to change work.

The overall level of employment does not appear to have a fluctuated much as a result of the crisis. The percentage of job losses was close to zero, and there had been no large redundancies that we could detect. Part of the reason for this is that the proportion of labour force in the formal waged labour sector is still small. The public sector still provides jobs for more people than does the formal private sector. Although the government has been implementing a gradual reduction in the size of the civil service for several years, there is no evidence that the economic crisis has had an accelerating effect on that process. The key aspect for government employees is not security of employment, but the fact that they have not received pay rises for several years. This has placed them in a less advantageous position *vis-à-vis* employees in the private sector who have seen pay rises.

It also appeared to be the case that though private business has slowed somewhat, it had not experienced a drastic downturn as was the case in other countries in the region. It seemed that the economic transformation which has just begun in the Lao PDR is at such an early stage that the country is not as vulnerable to outside shocks as the more developed economies of other countries in the region. At the same time, economic changes have reached a certain momentum, and there is a general enthusiasm for the private sector which had not been seriously damaged as a result of the depreciation of the kip.

Results from the rapid qualitative survey suggested that the rural poor had been hurt by an over-supply of labour. One of the ways in which poor rural resi-

dents earned either cash incomes or payments in kind was to work during harvest times, particularly during the rice harvest. Several people in Oudomaxay noted that there had been only small increases in the level of in-kind payments for assistance at the harvest, and that this meant increased hardship for those depending on it for subsistence. Since it is mainly the poorest who have no land of their own, or who have some land but produce inadequate amounts of rice for their household needs, the likely effect may be both an increase in the number of people in poverty and in the severity of poverty for those already below the poverty line.

Some families were forced to slaughter their buffalo to sell the meat in order to generate income. Although this provided a short-term safety net, in the long run it seriously decreased these households' ability to generate income through planting and harvesting crops.

In general, people in both urban and rural areas were spending more time and labour to earn income to be able to afford necessities or to be paid in kind.

4.1.4. Services

It is difficult to assess the impact of the crisis on the availability of and access to key social services, mainly because services such as health and education are provided at a consistent level only in major urban areas; rural areas have poor coverage, particularly for health-care.

Since a large proportion of the population does not receive services, it is hard to determine whether these services have deteriorated as a result of the crisis. A quantitative survey on the social impact of the Asian crisis on the Lao PDR showed that 43 percent of sampled villages had no health-care facilities, and 23 percent had no school.

The difficulties in assessing the effect of the crisis on services were well illustrated in interviews conducted in one village in Savannakhet province. Almost all residents who were interviewed said that the harvest last year had been a good one. They had received electricity for the first time and had also upgraded their water (irrigation) system.

This pattern of gradual improvement in basic infrastructure was found in several other areas of the country. These improvements were so significant to the villagers that they completely overshadowed possible perceptions that other services may have deteriorated slightly.

The major discernible effect on services had been an increase in the cost of medicines and education. Cost increases in health-care had affected some people, particularly those with low incomes. However, for those living in urban areas,

access to health-care was more affected. The poor had only partial access to medicines at best, and this does not appear to have changed significantly.

Civil servants also pointed out that the cost of health care had risen. The cost of medicines had doubled, and in some cases more than doubled, as the kip depreciated. Most medicines are imported, so in some cases the cost increased three- or four-fold. Large numbers of people had increasingly became dependent on traditional remedies, but even these had seen substantial price increases, though less than those for imported medicines.

Many households reported that they had difficulties in keeping their children at school, as they were unable to meet the costs of clothing, note-books and other school supplies. Government workers in particular noted that they were spending more to keep their children in school.

4.2. Responding to the Crisis—Household Coping Mechanisms

The economic difficulties discussed above affected different groups and different households to various degrees. Most, however, had been forced to change their behaviour in a variety of ways in order to cope with the additional stresses.

Several kinds of coping mechanisms have been adopted by individuals, households and communities. First, households can adjust consumption and savings in response to reduced income. Second, they can try to expand the supply of labour as additional members of the household try to find work to generate income, or, for those already working, to work longer hours and/or find additional jobs. Third, they can try to reduce or change the pattern of utilisation of public services, such as health-care and education. Fourth, they may try to rely more on remittances from abroad or assistance from relatives.

4.2.1. Adjusting consumption and saving patterns

When the price of a commodity rises, consumption of it may fall, all things being equal. This helps to cushion the blow on household welfare. But the willingness to change consumption depends on the nature of the commodity. Consumption adjustment may differ across income groups. Households may also adjust their savings.

Changing the diet were reported as a means of coping with the crisis by both rural and urban households. The first factor in such a change is consumption of less meat and more vegetables.

Most people in Vientiane reported that they were trying to grow more food of their own, usually in relatively small gardens. A group of government workers said that they were now eating more from their own gardens than in the past. Nonethe-

less, this was insufficient to relieve the strain on the household budget, since almost all the workers reported that their home gardens were only supplementary.

The same group of public workers reported that they had adjusted their consumption by eating less and by changing their diet. Before the crisis, they had eaten much more fish than they were able to do after; they had also reduced their consumption of meat.

Households in rural areas around Vientiane reported that they were eating much less meat than they had before, and that they had cut down on fish consumption. They were eating more vegetables, and spending much less on clothing and luxury goods. Poor households in particular reported great difficulties as a result of the increased cost of food and other basic commodities. Families reported that they had already been eating very little meat, and that their only recourse was to cut down the absolute amount of food they ate. They had cut back expenditures on clothing to almost zero, and had great difficulties in meeting basic needs for their children's education and health-care.

The same patterns were observed in Oudomaxay and Savannakhet provinces. However, through interviews we found that the rural poor faced the most serious situation. In several meetings, we were told that an increasing number of households in the villages were unable to get sufficient rice for their needs. They were caught between price increases, over-supply of labour and seasonal weather conditions (drought, flooding, etc.), which mean that they were often not able to get sufficient work to provide for their basic needs.

4.2.2. Mobilising additional labour

A second area in which adjustments can be made to cope with the economic difficulties facing households and communities is to mobilise additional labour to generate additional income. This can be done in different ways:

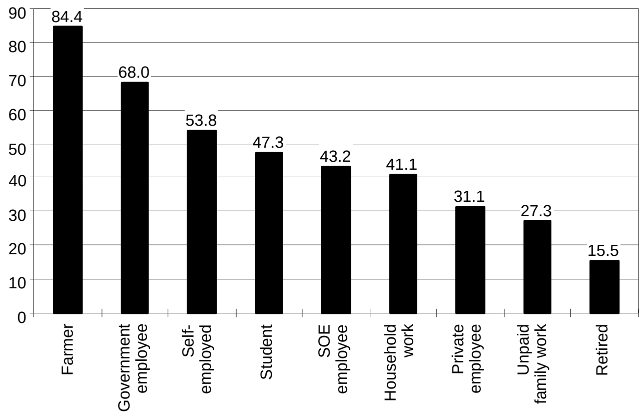
- An individual already working taking on an additional job or work;
- Non-working households members, usually women, taking on employment of some kind;
- Migration of some family members to areas where there are better opportunities to earn more income; and
- Developing new activities.

When the head of a household or an individual receives lower wages (in real terms) he or she is forced to work more (either more hours or taking on additional work) in order to generate a sufficient level of income.

Rural landless farmers have also been forced to try to find additional work. The major source of income for most of the rural landless population is to work as paid labourers on large farms, or to farm a plot of land owned by someone else by paying rent in proportion to the harvest or by paying income earned at the end of season. The financial crisis has increased the costs considerably for both large- and small-plot farmers.

Large numbers of people are now working overtime, or taking on secondary activities. The qualitative social impact of the Asian crisis on the Lao PDR survey indicated that about 60 percent of the individuals in the labour force are involved in a secondary activity, of which 40 percent are engaged on a daily basis. Figure 2.5. shows the level of involvement in secondary activities by category of main economic activity.

Figure 2.5. Engagement in Secondary Work Activities (percentage)



It comes as no surprise that it is government employees (68 percent) who devote most time and effort to secondary activities, given the low salaries and wages paid in the civil service. However, most people felt that they were working more.

Concerns about the failure of civil service salaries and compensation to keep pace with socio-economic realities have been raised by different parties on several occasions. The base salary, varying from a minimum of 26,000 kip to a maximum of 104,000 kip, is enhanced with allowances linked to the position and responsibilities held, number of children, as well as to the cost of living. The system in force does not seem to provide the basic motivation or promote the emergence of an effective human development resource base in the public sector. With the dramatic loss of purchasing power due to the devaluation of the kip, concerns about good governance, both in terms of quality services rendered to public and transparent

management of public resources, are increasing. A possible impact could be an accelerated departure of the most skilful towards the higher benefit packages offered by the private sector or international organisations.

Street vendors reported that their costs had gone up, and that even though they had raised their prices they were earning about the same income as they had before. In fact, with the devaluation of the kip, their real income has dropped precipitously. They reported that they worked more than they had before, but even with this they faced difficulties buying enough food.

Some people from the countryside are migrating to urban areas looking for work, particularly in the garment and construction sectors. Some come to look for work with wealthier families. Most of these labour migrants are women.

In some families, parents had to devote additional time outside the home to generate income. Children were therefore left alone at home more frequently.

4.2.3. Changes in the utilisation of public services

We have noted that the effects of the economic crisis on public services are quite difficult to assess. There have been reports that some families have taken their children out of school because it is difficult for them to keep up with the necessary expenses. Some have reported that they have moved their children from private to public schools that cost less in terms of tuition fees. However without further research it is difficult to know whether such reports are representative, or how much difference there is between urban and rural areas. The rate of school drop-outs, for example, was high in some areas even before crisis.

In most cases, many parents, particularly among poor households, let their children attend school only part-time in order for them to take part in income-generating activities.

The utilisation of health services has dropped with reduced income levels, particularly among poor families. However, it is not only the poor who are changing their use of public services—other groups of people are also affected. With increasing costs of living, those groups that had utilised private health care providers (clinics) have increasingly turned towards public sources of health-care. This means that there will be an increasing demand for public services at the same time as such services are facing budgetary constraints. This threatens to degrade the quality of services provided to the poor and other groups.

Large numbers of people have increased their dependence on traditional remedies, which cost less then imported medicines.

4.3. Future Studies

Our preliminary analysis indicates that in general the effects of the Asian crisis on the Lao PDR have varied between urban and rural areas. In rural areas, the effects vary depending on whether the primary economic activity is subsistence agriculture or production for the market, and also on location, such as along the Mekong River or in mountainous areas.

It is clear that the negative impact of the crisis has been reflected in increased prices of goods and services, currency devaluation, and in changing consumption patterns. There is little doubt that civil servants have experienced the greatest absolute change in circumstance during this period. Those working in the private sector have also been affected, but not to the same extent as public employees. This is because the private sector is able to adjust wages and income levels to take account of the increased cost of living. In rural areas, those who have sufficient land and access to markets have been able to survive the economic effects with less difficulty than those without such assets. Those without land, or with insufficient land to provide for themselves, have had to migrate to find work during the harvest season.

It is difficult to identify the right methodologies to follow up the impact of the crisis on the erosion of the social capital, the utilisation of public services by households and individuals, as well as the effects of business closures and unemployment, particularly the impact on small and medium-size enterprises.

In this regard, it would be interesting to study migration patterns from rural to urban areas as well as from urban to rural areas. A study of the erosion of social capital in both urban and rural areas is also needed.

There have been numerous suggestions that the worsening impact of crisis is causing gender inequalities, such that women are under increasing pressure to work but also face greater threat of unemployment. The development of small and micro enterprises for suburban and rural areas is one means of promoting opportunities that should enable women to play a more prominent role, and thus enhance their social advancement. This is an aspect of the crisis that needs further elaboration, and such development should be analysed in more depth in the future.

5. Major Policy Measures To Stabilise the Economy

The Lao government has considered a range of measures to cope with the economic crisis and to revive the economy in the Lao PDR.

5.1. Short-Term Measures

5.1.1. Financial policies

One of the most important measures to tackle the financial crisis is the monetary policy of the Central Bank. The Central Bank of the Lao PDR has implemented a temporary tight monetary policy by determining a quota for kip supply. In addition, the Central Bank has issued and sold bonds with relatively high interest rates in order to reduce the supply of kip in the non-banking sector. These measures can prevent demand-led inflation.

Savings account interest rates have been adjusted by raising interest rates for kip accounts, to motivate people to save their kip in the banks. This can encourage demand for the kip and to a certain extent can restore people's confidence in the currency in favour of buying foreign currencies. In addition, it has been proposed that the seven commercial banks in the Lao PDR merge into three separate banks, so that they are able to create healthy funds and credit and avoid bankruptcy.

Sound discipline in fiscal policies has been strictly implemented through fiscal austerity and tax adjustment policies. The Lao government has made efforts to reduce a relatively large amount of government expenditures that are not absolutely necessary, such as vehicles, fuel, administrative costs, and so forth. In addition, tax revenue has to be strictly controlled in order to reduce the supply of kip in the business sector and to create revenue for the government. In order to reduce the supply of kip, and to create funds for the state budget, the government has issued and sold government bonds with relatively high interest rates, and begun a government lottery in the form of deposits with a relatively low interest rates valid for up to five years.

5.1.2. Trade policies

In order to reduce the need for foreign currencies, that is, to prevent the depreciation of the kip, it is necessary to restrict some kinds of imports, especially of luxury goods, by imposing relatively high taxes on them. In addition, the government has decided to intervene in the market by introducing a price ceiling (lower than the market price) for some basic goods, especially rice.

5.1.3. Exchange rate policies

The government has continued to implement a floating exchange rate policy which is based on the law of market demand and supply. However, due to the need for a number of imported goods for the purpose of socio-economic development, and the need for foreign currencies among import companies, the government has formu-

lated a special exchange rate for a certain quota of foreign currencies for foreign trade activities with a lower exchange rate than that of the parallel market.

5.1.4. Investment policies

In order to attract investment, including more foreign investment, the government has considered streamlining investment application procedures. In addition, incentives formulated in both the Law for the Management of Foreign Investment and Law of Domestic Management are to be implemented more efficiently.

5.1.5. Changes in consumer behaviour

As imported goods have become more expensive, the government has promoted consumption of domestic goods by declaring that the Lao people should consume Lao goods. In addition, the government has subsidised a number of irrigation projects for farmers.

5.2. Medium and Long-Term Measures

5.2.1. Policies promoting production and services

Based on the development priorities of the Lao government, the food production programme, the commercial production programme, and the service development programme need to be implemented efficiently. This means that more domestic goods and services have to be produced, so that the Lao PDR can be more self-sufficient after 2000, *i.e.* to be able to reduce import dependency (through the adoption of import substitution policies) and to export more goods. In addition, tourism will continue to be promoted by implementing the government's infrastructure priority programme, by preserving Lao costumes, traditions and culture, by protecting the country's geographical features, and by creating suitable and constructive travel regulations for tourists.

In order to realise the objectives of these programs, the investment environment needs to be facilitated in terms of greater incentives for foreign and domestic investors. The private sector should be strongly promoted by free competition under suitable laws and regulations, so that private investors can produce more competitive goods and services for the local market as well as for export.

5.2.2. Local trade policies

Domestic markets have to be developed and extended to the countryside, so that local production and services can be promoted directly and indirectly. Market regu-

lations have to be improved in order to create facilities for trade activities and to promote investments.

5.2.3. Foreign trade policies

Export promotion policies must be implemented to increase the production of goods and services that can be exported to earn foreign exchange and explore niche markets, where value-added Lao products have a comparative advantage. In addition, the Lao PDR will need to make further contact to create more trading partners.

6. Lessons from the Asian Crisis

Since the Asian crisis began, numerous studies, discussions and debates have been undertaken at the micro, macro, national and international levels in order to determine the causes and impact of the crisis. Although each country has uncovered different causes for the crisis, certain overall lessons can be drawn:

- Globalisation of finance and trade can boost economic growth, but it also creates risks and can negatively affect the process of socio-economic development if there are no sound macro-economic policies.
- Debts equal risk if the debts are unproductive. Short-term loans invested for long-term purposes lead to high risks for both borrowers and creditors.
- Transparency in the provision of information is required to make the domestic and international systems function efficiently. A sound functioning market economy depends on adequate data for decision-making.
- Appropriate macro-economic policies, an adequate institutional framework and effective banking regulations are essential to realise the benefits of international capital mobility.
- Good governance for commercial activities is required to efficiently regulate market mechanisms.
- The agricultural sector has been affected by the crisis less than other sectors, and has played a significant role in saving the people during the crisis, especially in countries with an agricultural economy, such as the Lao PDR.
- Countries that have relied on foreign investment and assistance have been hit badly by the crisis, especially if the investor countries were also facing the crisis—the Lao PDR has been an example of this.
- Countries whose foreign trade had relied on only one or a few countries have been affected badly by the crisis if their trading partners faced economic

problems. This has also been true in the case of the Lao PDR. Efforts should therefore be made to create relationships with more trading partners.

- The IMF has learnt that imposing economic and financial austerity measures in a crisis situation leads to a worsening socio-economic crisis, such as further decreases in production and increases in unemployment and social instability.
- It is clear that the Asian financial and economic crisis was caused by both domestic and international factors. Policy responses to the crisis therefore should be made by the governments concerned in cooperation with international agencies in a constructive manner.
- An international early warning network should be created to warn financial institutions of an emerging crisis in good time. In this context, the IMF should concentrate on preventing financial and economic crises instead of dealing with them after they have emerged.
- Countries that depend on exports based on capital and material imports have proved to be unstable. During the crisis it became clear that this led to a debt-trap, and their positions are deteriorating due to the high costs of the imports. Sustainable economic development has to rely more on domestic savings derived from increasing domestic productivity.

7. Conclusion

The Asian crisis has affected economic activities in the Lao PDR considerably. Most notably, it caused a slowdown in the industrial sector, which led to a slowdown of GDP growth. In addition, it caused extremely high inflation and exchange rate fluctuations, which forced up the cost of both imported and local goods, and led to a dramatic reduction in the real incomes of the Lao people. Foreign trade, both imports and exports, declined remarkably. Moreover, foreign investments decreased notably. Government projects financed by foreign assistance faced shortages of counterpart funds from the government.

In order to recover from the crisis in the Lao PDR and prevent a recurrence, the following measures need to be taken:

- The domestic financial and monetary system should be strengthened to promote macro-economic stability.
- Commercial banks have to create incentives for people to save money by adopting appropriate interest rates.
- Government austerity programmes are essential as a stop-gap measure.

- More transparency in both the public and private sectors is necessary to ensure the effective working of the financial market.
- Foreign investment should be attracted by creating more incentives.
- More facilities for tourism should be created.
- Local production has to be promoted both for self-sufficiency and for export.
- Good governance for a sound, functioning market economy is needed.
- Consumption of domestic goods should be promoted.
- The government should help to distribute goods to markets where such goods are in short supply.

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Chapter Three

The Impact of the Asian Financial Crisis on the Vietnamese Economy

Le Xuan Ba, Hoang Van Thanh & Nguyen Dinh Tai[1]

1. Introduction

Vietnam has become more integrated into the world economy since economic reforms began in 1986. Vietnam joined the Association of Southeast Asian Nations (ASEAN) on 28 July 1995, just after the normalisation of diplomatic relations with the United States. Vietnam became a full member of the Asia-Pacific Economic Cooperation (APEC) on 14 November 1998, and is now actively working towards meeting the conditions for joining the World Trade Organisation (WTO) and for the award of most-favoured nation (MFN) status. Membership in ASEAN and APEC and commitments to the ASEAN Free Trade Area (AFTA) create new conditions for the liberalisation of the foreign trade and exchange system, and the establishment of a more favourable environment for foreign investment. Along with these favourable conditions, Vietnam at the same time faces many challenges, especially since the regional financial crisis began in July 1997.

The economic renovation launched more than 10 years ago has brought a range of important achievements for Vietnam's economy, such as effective control over inflation, rapid development of exports, and high growth of GDP. Since 1997, however, worrying signs concerning the structure and efficiency of the economy have emerged: GDP growth has been slowing; domestic savings have not increased; the current account deficit remains high (though the value of imports has fallen sharply

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since the third quarter of 1997); foreign direct investment (FDI) is falling; the performance of the state-owned enterprises (SOEs) and commercial banks has been much lower than that in previous years; and unemployment has been rising fast.

When the financial crisis broke out in Thailand, many Vietnamese economists argued that it would have no or little effect on Vietnam's economy. Their reasons were that the Vietnamese currency was not convertible, that Vietnam still had not developed a stock market, or that the degree of Vietnam's integration into Asian markets was still insignificant. These arguments were proved false when, several months later, the crisis was being felt by everyone in Vietnam.

It is difficult to separate the total negative effect of the regional financial crisis from natural disasters, as well as from internal weaknesses in the economy. The growth rate of GDP had already started to slow from 9.5 percent (1995) to 9.3 percent (1996) and then to 8.8 percent (1997). It is impossible to say that this is directly due to the regional financial crisis. The regional financial crisis, however, probably has been exacerbating the trend towards a slowdown in economic growth.

Under these new conditions it is thus necessary to review past economic performance to assess the economic and social impact of the financial crisis, and then to draw lessons and develop relevant responses to this financial crisis. The objectives of this paper are to contribute to this task.

This paper is organised in three sections. Section 2 analyses the economic impact of the Asian financial crisis on the Vietnamese economy. In this section, the first part briefly reviews past economic performance to assess the impact of the financial crisis on economic development, with a focus on investment and foreign capital inflows as well as foreign trade. The second part considers the responses taken to contain the impact by focusing on recent government policies. Section 3 focuses on the social impact of the Asian financial crisis on Vietnam. The first part studies the social impact of the crisis, and the second part suggests measures to mitigate the negative social consequences. Section 4 suggests lessons for future policy-making, drawn from existing internal weaknesses and based on the responses considered in Sections 2 and 3.

2. Economic Impact of the Regional Financial Crisis

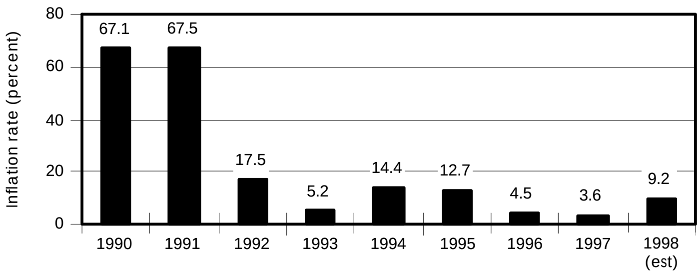
2.1 Past Economic Performance and the Economic Impact of the Crisis

Since economic reforms began in 1986, Vietnam has made successful progress, though it will not be possible to achieve the target of doubling the 1990 per capita GDP by 2000. To double 1990 per capita GDP, the annual GDP growth rate should be 7.2 percent. However, during the 1991–97 period, the annual growth rate of per capita GDP was only 6.2 percent. The GDP growth rate in 1998 was only 5.8 per-

cent, and is expected to be 5–6 percent in 1999. If the economy recovers in 2000, the growth rate is still only expected to reach 6–7 percent. With a population growth rate of 1.8 percent, the growth rate of per capita GDP in 1998 was in effect 4.0 percent, in 1999 it will be at best 4.2 percent, and in 2000 at best 5.2 percent. During the period 1990–97, per capita GDP multiplied only 1.5 times; during the period 1991–2000, it can multiply at best 1.7 times.

The annual average growth rate of GDP in the 1986–90 period was 4.8 percent, in the 1990–95 period 8.2 percent, and in the entire 1986–96 period 7.0 percent. GDP growth recorded its highest rate of 9.5 percent in 1995, and then slowed to 9.3 percent in 1996 and to 8.8 percent in 1997. One of Vietnam's most successful achievements has been inflation control. Since 1996, the inflation rate has been kept at one-digit levels. The higher inflation rate of 9.2 percent resulted mainly from a government price policy that aims to promote agriculture and rural development. Compared to 1997, the price index of food and foodstuffs increased by 12.3 percent, of which the price index of food increased by 23.1 percent and that of foodstuffs by 8.6 percent. Inflation trends are reflected in Figure 3.1.

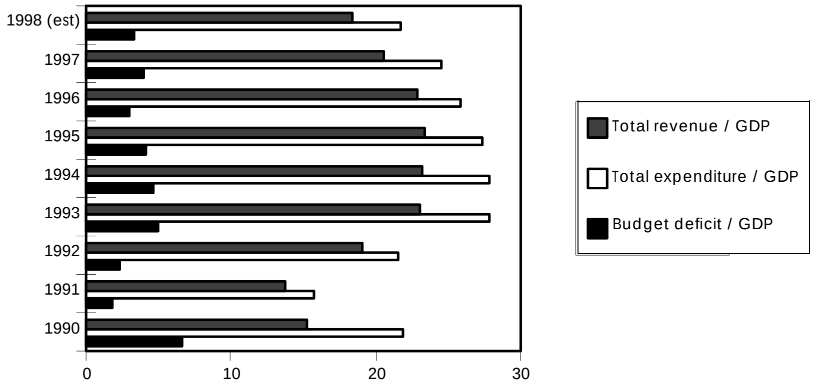
Figure 3.1. Trends in the Inflation Rate



As far as the government budget is concerned, Figure 3.2 (overleaf) shows that total revenue-GDP ratios and total expenditure-GDP ratios have been reduced considerably since 1995, though the budget deficit-GDP ratio has fluctuated around 3 or 4 percent. Because total expenditures in 1998 were cut due to the reduction in total revenues, many public programmes have suffered substantially. For example, the budget expenses distributed to the National Programme on Employment were equal to only 48.1 percent of the 1997 level.

The regional financial crisis exacerbated the slowdown in economic growth. One of the reasons is that strong investment has been a key factor behind Vietnam's high GDP growth rate, with the share of FDI accounting for 27.2 percent of total investment in the period 1991–97. The structure of investment prior to 1997 show-

Figure 3.2. Government Budget (percentage of GDP)



ed that Vietnam greatly depended on external resources. However, the value of FDI approvals started to fall from 1996. In addition, Vietnam suffered a series of natural disasters over the past two years.

The banking system plays a dominant role in the mobilisation of resources. By the end of 1998, Vietnam's banking system consisted of six state-owned commercial banks, the Vietnam National Gem and Gold Corporation, 51 joint-stock commercial banks, two joint-stock finance companies, four joint-venture banks, 24 branches of foreign banks, 55 representative offices of foreign banks, two joint-venture leasing companies, five leasing companies under the state commercial banks, one central credit fund, 21 regional credit funds, 987 local credit funds, and three leasing companies under large corporations (the Vietnam Rubber Corporation, the Vietnam Textile and Garment Corporation, and the Vietnam Post and Telecommunications Corporation). Despite the reforms of recent years, however, the banking system is still weak because there is no stock exchange and the Vietnamese dong is not convertible. In 1998, six joint-stock commercial banks were placed under the special control of the State Bank.

The low efficiency of many SOEs has also created difficulties for the banking system in recovering loans. The number of loss-making SOEs has increased from 17 percent (1995) to 22 percent (1996) and then to 30–35 percent (1997). In a number of banks, overdue debts have reached alarming levels (Table 3.1), reducing the confidence of depositors in the banking system. The SOEs, given their leading role in the economy, continue to use most of the resources in the economy and crowd out the private sector. The low performance of the SOE sector and its trade tax receipts have reduced resources for public spending. The government therefore has had to restrain both current and capital expenditures.

Table 3.1. Overdue Bank Loans (billions of dong)

	1994	1995	1996	1997
Total non-government credit	33,345	42,277	50,751	56,926
Total overdue	3,152	3,337	4,726	7,238
Total overdue / Total non-government credit	(9.5%)	(7.9%)	(9.3%)	(12.7%)

Source: International Monetary Fund (1998) and General Statistical Office

Facing difficult conditions, the government revised the GDP target growth rate for 1998 to only 6–7 percent, instead of the initial planned level of 9–10 percent. The GDP growth rate for 1998 was estimated by the Ministry of Planning and Investment to be 6.3 percent (Table 3.2), which is relatively good compared to the economic performance of other countries in the region, where economic growth rates are expected to be around 0 percent or even to be negative.

Table 3.2. GDP Growth Rate by Sector

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998[1]
GDP	3.6	6.0	4.7	5.1	6.0	8.6	8.1	8.8	9.5	9.3	8.8	6.3
Industry[2]	9.2	5.3	-2.8	2.9	9.0	14.0	13.1	14.0	13.9	14.4	13.6	11.5
Agriculture[3]	-0.5	3.9	6.8	1.6	2.2	7.1	3.8	3.9	5.1	4.4	4.9	3.0
Service	5.3	9.1	7.6	10.8	8.3	7.0	9.2	10.2	10.6	10.0	9.5	6.0

1 = Figures for 1998 are estimates from the Ministry of Planning and Investment. 2 = Including construction.
3 = Including forestry. Source: General Statistical Office

2.1.1. Impact on investment and foreign capital inflows

The share of gross investment in GDP (Table 3.3) increased from 17.6 percent in 1992 to 27.1 percent in 1995, and further to 27.9 percent in 1996, but then decreased to 27.6 percent in 1997. The share of domestic savings in GDP increased from 10.5 percent (1992) to 17.0 percent (1995), but fell to 16.7 percent in 1996 and further to 16.6 percent in 1997.

Table 3.3. Gap between Investment and Savings (percentage of GDP)

	1992	1993	1994	1995	1996	1997
Investment / GDP	17.6	24.9	25.5	27.1	27.9	27.6
Savings / GDP	10.5	10.7	16.1	17.0	16.7	16.6
Percentage gap	7.1	14.2	9.4	10.1	11.2	11.0

Source: General Statistical Office

The relatively large gap between investment and savings is mainly financed by external sources (FDI, overseas development assistance (ODA), and commercial borrowing). In general, gross investment comes from different resources: the state budget, state credits, investment by domestic enterprises (including SOEs and private enterprises) and FDI. In order to implement the Five-Year Plan for 1996–2000 (SRV 1995), Vietnam needs US$41–42 billion of total investment. Domestic accumulation can satisfy over 50 percent of this amount, the rest is expected to be mobilised from abroad, with US$7–8 billion coming from ODA and US$13–14 bil-

lion from FDI. FDI has been a crucial factor in economic reform, contributing substantially to the rapid development of Vietnam's economy. If large inflows of FDI had not taken place in the past few years, the GDP growth rate in 1995 would have been 5.2 rather than 9.5 percent (Vu, n.d.). Investment financed from the state budget for the period 1991–97 has accounted for 21.9 percent of total investment, while that financed with state credits has accounted for 6.2 percent of the total. Investment mobilised by SOEs has accounted for 13.6 percent, and that from the private sector for 31.1 percent. The remainder (27.2 percent) has had to be mobilised from abroad (Table 3.4).

Table 3.4. Sources of Development Investment

	1991	1992	1993	1994	1995	1996	1997	Total
				Billions of dong				
Total	22,720	34,030	51,470	56,130	64,950	73,620	82,800	385,720
From state budget	4,220	10,850	16,860	9,300	13,570	14,160	15,700	84,660
From state credit	2,320	1,160	3,480	4,210	3,060	3,240	6,300	23,770
Mobilised by SOEs	3,300	1,760	3,860	7,000	6,320	11,300	18,800	52,340
Mobilised by the private sector	10,680	15,170	16,250	19,120	20,000	19,780	18,900	119,900
FDI	2,200	5,090	11,020	16,500	22,000	25,140	23,100	105,050
				Percentage share				
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
From state budget	18.6	31.9	32.8	16.6	20.9	19.2	19.0	21.9
From state credit	10.2	3.4	6.8	7.5	4.7	4.4	7.6	6.2
Mobilised by SOEs	14.5	5.2	7.5	12.5	9.7	15.3	22.7	13.6
Mobilised by the private sector	47.0	44.6	31.6	34.1	30.8	26.9	22.8	31.1
FDI	9.7	15.0	21.4	29.4	33.9	34.1	27.9	27.2

Source: Ministry of Planning and Investment

The structure of investment prior to 1997 showed that Vietnam greatly depended on external resources. Since the beginning of 1997, however, FDI flows have declined dramatically, both in term of project licences and capital (330 projects were granted licences in 1997, with a total committed capital of US$4,500 million, compared to 366 licences granted and a capital of US$8,836 million in 1996). This declining trend in FDI approvals has been amplified during 1998. By October 1998, only 204 FDI projects had been given licences, with a total capital of US$1,816 million, much lower than during the same period the previous year. The dynamics of FDI until October 1998 are shown in Table 3.5.

The value of committed FDI has fallen rapidly since early 1997. This is partly because FDI flows to developing countries probably began to decline in 1996, and partly because a large proportion of FDI has come from countries also hit by the regional financial crisis. Developments indicated a much more difficult context for attracting FDI into Vietnam, even before taking into account the direct effect of the Asian crisis and Vietnam's dependence on Asian investment. In fact, from 1988 until May 1998, about 71.5 percent of FDI came from Asian countries, of which about 25 percent was from ASEAN countries.

Table 3.5. Dynamics of FDI (millions of US dollars)

	Number of projects	Committed investment	Disbursed investment	Disbursed / committed investment
1988–90	211	1,783		
1991	152	1,712	312	18.2
1992	195	2,557	459	17.9
1993	275	4,034	1,225	30.4
1994	368	4,801	2,041	42.5
1995	411	7,309	2,744	37.5
1996	366	8,836	2,701	30.6
1997	330	4,500	3,439	76.4
1998 (Jan to Oct)	204	1,816	1,199	66.0
Total	2,512	37,348	14,121	37.8

Source: Ministry of Planning and Investment

The structure of FDI inflows broken down by country is given in Table 3.6. The strong dependence on direct investment from Asia has become more obvious since the regional financial crisis, with not only a dramatic reduction in new projects during recent months, but also a halt in previously approved projects, even when the implementation of such projects had already started. Given the gap between commitments and disbursements, and the fact that about 62 percent of undisbursed commitments have come from Asian countries, disbursed investment in 1999 is expected to decline substantially. Until the end of May 1998, 50 projects with a total capital value of US$3.23 billion had been temporarily halted, and 36 projects with a total capital value of US$2.00 billion are being undertaken only with great difficulty. As a consequence, about 12,000 jobs have been lost from these projects.

Table 3.6. Structure of FDI Inflows by Country (millions of US dollars)

	1988–90		1991–95		1996–98 (May)		Total 1988–98	
	Capital value	Share (percent)	Capital value	Share (percent)	Capital value	Share (percent)	Capital value	Share (percent)
Total	1,583	100.00	16,244	100.00	14,254	100.00	32,081	100.00
Asia-Pacific	780	49.28	11,208	68.99	10,959	76.88	22,946	71.53
ASEAN countries	58	3.69	2,805	17.27	5,088	35.69	7,951	24.78
Other Asian countries	466	29.46	7,688	47.33	5,721	40.13	13,875	43.25
Taiwan	120	7.58	3,113	19.16	1,190	8.35	4,422	13.79
Japan	86	5.43	1,781	10.96	1,405	9.86	3,271	10.20
Hong Kong	240	15.18	1,371	8.44	1,554	10.90	3,165	9.87
China	5	0.31	1,376	8.47	1,531	10.74	2,912	9.08
Europe	691	43.65	3,770	23.21	2,119	14.87	6,581	20.51
France	289	18.28	604	3.72	841	5.90	1,735	5.41
Netherlands	118	7.46	385	2.37	104	0.73	607	1.89
United Kingdom	116	7.30	351	2.16	53	0.37	519	1.62
Germany	9	0.59	23	0.14	140	0.98	173	0.54
America	112	7.07	1,219	7.51	1,176	8.25	2,507	7.82
United States	3	0.16	760	4.68	372	2.61	1,134	3.54
Canada	109	6.90	68	0.42	13	0.09	190	0.59

Source: Ministry of Planning and Investment

According to the Asian Development Bank (ADB), other than 10.5 billion roubles of non-convertible currency debt, the outstanding convertible currency external debt of Vietnam (including the loan component of FDI) was US$11 billion in 1997 and US$13.5 billion in 1998. The accumulation of external debt through FDI inflows amounted to US$5.1 billion at the end 1997. In other words, the accumulative external debt through FDI inflows accounts for 46.4 percent of the total convertible currency external debt. External debt will reach alarming levels in the near future if the external debt-disbursed FDI ratio is not controlled. The external debt-disbursed FDI ratio has tended to increase in recent years (Table 3.7).

Table 3.7. External Debt through FDI Inflows (millions of US dollars)

	Disbursed investment	External debt	Debt / disbursed investment
1991	312.3	114.1	36.5
1992	458.5	87.7	19.1
1993	1,225.0	358.3	29.2
1994	2,041.0	694.9	34.0
1995	2,744.0	1017	37.1
1996	2,701.0	946.1	35.0
1997	3,439.0	1,877.3	54.6
1998 (January – October)	1,199.0	1,001.3	83.5
Total	14,121.0	6,096.7	43.2

Source: Ministry of Planning and Investment

It should be noted that the FDI inflows financed by external debt should contribute to an improvement in the overall efficiency of the economy. Until now, a large proportion of FDI inflows has come into the SOE sector. At present, most participants in joint ventures with foreign investors are SOEs; the number of non-SOEs participating in joint ventures with the foreign investors accounts for only 8 percent of projects and about 2 percent of total committed capital. However, the efficiency of the SOE sector has already deteriorated substantially. The number of loss-making SOEs increased from 17 percent (1995) to 22 percent (1996) and then to 30 percent (1997). The ICOR is used to measure overall investment efficiency. Its value in Vietnam has tended to increase: 2.5 (in 1991), 2.3 (in 1992), 3.3 (in 1993), 3.2 (in 1994), 3.0 (in 1995), 3.3 (in 1996) and 3.5 (in 1997). These figures imply that the efficiency of capital is decreasing.

As shown in the final column of Table 3.7, the ratio between disbursed investment and external debt is increasing quickly. Despite pressure for equal treatment, the state sector continues to hold an advantage over the private sector. The government's industrial policy continues to favour the state sector, with SOEs at an advantage in term of access to land, capital, licences and export quotas. Repeated calls by senior ministers for a level-playing field for the state and private sector are set against the deep-rooted view that state companies should play a leading role in the

economy. Reform of the SOE sector is thus important to improve efficiency. The overall cost of external debt through FDI inflows should not be higher than the total return on those inflows.

The overall level of external debt has not yet reached alarming levels. The debt-GDP ratio was 39.3 percent in 1996 and 37.4 percent in 1997. Because debt stemming from FDI forms part of the national debt and needs to be repaid, the problems mentioned above need to be solved soon; otherwise, the consequences would likely undermine the future development of the economy.

2.1.2. Impact on foreign trade

During the period before 1998, the dynamics of Vietnam's foreign trade showed a positive correlation between export achievements and economic growth (Figure 3.3). Figure 3.3 also shows the high rate of both export and import growth during the period 1992–96, before these slowed during the past two years. Although the slowing trend of export growth in 1997 was explained by a sharp decrease in prices of many exported goods, and narrowed export markets as a result of the regional crisis, the sudden fall of import growth was due to restrictions imposed on imports in 1997. (This situation has continued in 1998, and will be discussed further below.) It should be noted that Vietnam's trade balance has improved during the past two years. The trade deficit was US$2.50 billion in 1997, and has been estimated at US$1.90 billion in 1998, compared with an alarmingly high level of US$3.70 billion in 1996. This improvement is the result of government interventions attempting to narrow the export-import gap by introducing quota and quantitative restrictions on imports, especially on imports of consumer and import substitution goods.

Figure 3.3. Correlation between External Trade and GDP Growth Rates

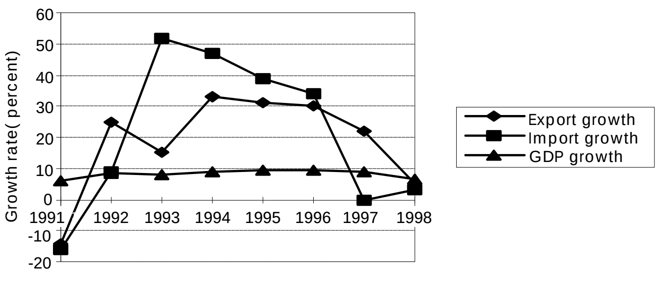


Table 3.8 indicates Vietnam's degree of openness to international trade[2] compared to other developing Asian countries, which allows assessment of the likelihood, as well as the modalities, of further trade expansion in Vietnam's overall economic activity. The table shows that Vietnam has been increasingly participating in world trade, with the ratio of imports and exports to GDP increasing sharply during the period 1990–97. The current degree of openness is as high as that of other developing countries in Asia such as Taiwan and Thailand, and even higher than South Korea and Indonesia. Nevertheless, Corsetti (1998) argues that greater openness makes the country more vulnerable to trade shocks and to restrictive trade policies in other countries.

Table 3.8. Comparison of Openness[2] of Vietnam and Selected Asian Countries

	1990	1991	1992	1993	1994	1995	1996	1997
South Korea	30.04	29.38	29.38	29.04	30.47	33.59	34.36	38.48
Indonesia	26.30	27.18	28.23	25.26	25.94	26.98	26.13	28.22
Malaysia	75.23	86.52	76.64	87.72	92.15	97.42	91.50	95.55
Philippines	30.40	31.09	31.58	35.58	36.98	40.26	44.90	54.20
Thailand	37.76	39.24	38.98	39.69	40.99	44.88	42.19	46.69
Hong Kong	129.93	135.28	140.37	137.18	138.92	151.67	142.28	132.68
Taiwan	44.27	45.14	42.34	43.29	43.16	47.80	46.63	48.07
Vietnam[1]	31.04	33.47	36.79	34.00	40.62	38.38	46.54	49.85

1 = Figures for Vietnam are calculations by the authors. Source: Corsetti *et al.* (1998)

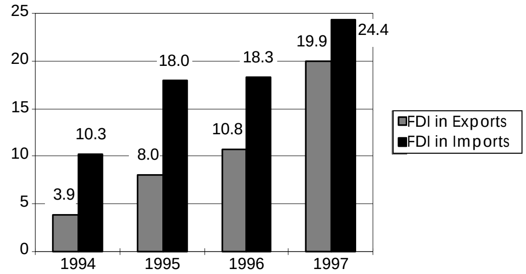
If we take into account the magnitude of exports per capita, however, it turns out that Vietnam's external trade is much smaller than that in other ASEAN countries. Vietnam's exports per capita in 1996, for example, was only US$96, while that of Malaysia was US$3,618 and that of Singapore US$34,700. Vietnam's figure was only one-tenth of Thailand's and one-third of Indonesia's or the Philippines'. Although exports per capita improved in 1997 to US$120, this is far too low to reach the proposed target of US$250 by the year 2000. Reaching this level will require more export promotion measures and policies.

Another characteristic of Vietnam's foreign trade is the increasing participation of FDI projects in foreign trade. As is shown in Figure 3.4, the share of FDI projects in exports is growing, from 4 percent in 1994 to about 20 percent in 1997, and share in imports showed an increase from 10 percent to 24 percent during the same period. This contribution is now facing a challenge in the context of the regional crisis, where many export contracts with foreign partners were cancelled or reduced in 1998. This situation has led exporting enterprises with FDI to scale down their production and to lay off a large number of employees.

Analysis of Vietnam's trade patterns by product is conducted first by looking at changing trends during the period 1990–97, and then by focusing on some problematic issues in terms of product structure and quality.

[2] Defined as half of total exports and imports as a percentage of GDP: ((X+M)/2)/GDP

Figure 3.4. Contribution of FDI in Trade Performance (percentage share)



The dynamics of main exported product structure since 1990 is shown in Table 3.9 overleaf. The share of exported raw materials in total exports shows a decline, but still remains high (from 60.3 percent in 1991 down to 45.1 percent in 1997), while exports of manufactured goods became more important in terms of their contribution in total exports (from 8.1 percent in 1991 up to 25.5 percent in 1997). This indicates considerable improvement of the quality of exported products, enabling Vietnam to increase the value and international competitiveness of its exports. For example, even though the share of high quality rice for export accounted for 40 percent in 1991, it reached a high of 50 percent in 1996. Similarly, exports of high quality marine products accounted for 20 percent in 1991, but reached 50 percent in 1996. Moreover, in recent years some high-tech products made in Vietnam have appeared on the world market, such as electronic goods (exports of which earned US$200 million in 1997), and some agricultural machinery and equipment.

There was also a transformation of the import structure during the period 1991–97 (Table 3.9). Vietnam's imports are concentrated on equipment (up from a share of 22 percent in 1991 to 33 percent in 1996) and intermediate goods (down from 64 to 56 percent in the same period), whereas the share of consumer goods in total imports remains comparatively low, fluctuating from 12 to 16 percent.

However, when analysis focuses on a particular year (1996) and is based on comparison with other countries, some problematic issues emerge:

- Vietnam is still dependent on exports of raw commodities and is therefore vulnerable to adverse commodity price developments, especially of crude oil (with depressed prices since 1997), rice (with price fluctuation, decreasing in 1997 but increasing in 1998 because of the climatic phenomenon El Niño and the impact of the economic crisis on other Southeast Asian countries) and coffee (with prices awaiting the outcome of the Brazilian frost season);
- Despite an increase in the share of manufactured commodities in the past few years, the share of manufactured exports is still low compared to other neigh-

Table 3.9. Vietnam's Main Export and Import Commodities, 1990–97

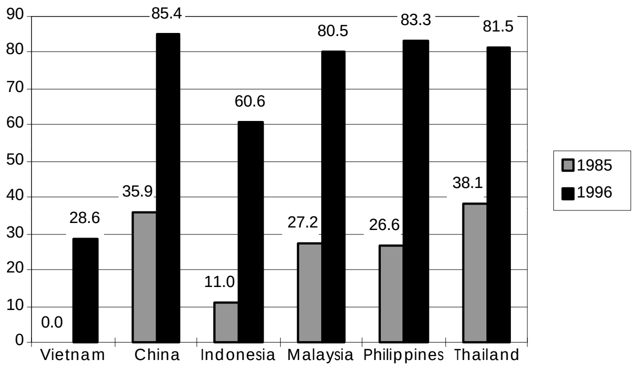
	1990	1991	1992	1993	1994	1995	1996	1997
	Millions of US dollars							
Total exports	2,404.0	2,087.1	2,580.0	2,985.2	4,054.3	5,448.9	7,255.0	8,900.0
Coal	32.7	47.7	62.0	52.0	75.1	88.9	114.3	111.8
Crude oil	468.4	581.0	805.0	861.0	976.0	1,031.8	1,345.0	1,423.7
Rubber	66.4	53.3	67.0	74.7	134.0	157.0	149.9	195.9
Rice	304.6	187.6	300.0	363.0	405.7	546.0	853.0	868.3
Cashew nuts	—	26.0	41.0	44.0	72.5	97.7	95.0	130.0
Coffee	92.5	74.0	92.0	110.6	328.2	595.5	333.8	507.6
Marine products	239.1	285.4	307.0	427.2	551.0	621.4	651.0	760.0
Textiles and garments	214.7	158.0	220.0	335.0	554.0	850.0	1,150.0	1,300
Footwear	—	10.5	16.8	68.0	115.4	296.4	530.0	955.0
Total imports	2,752.4	2,338.1	2,540.7	3,924.0	5,825.8	8,155.4	11,144.0	11,200.0
Electrical machinery	—	29.7	39.7	116.9	104.0	113.8	184.8	—
Steel	—	25.0	85.0	233.0	211.0	365.0	529.2	487.0
Fertilisers	—	236.0	237.0	205.0	247.0	339.0	341.1	419.0
Petroleum products	—	485.0	615.0	687.4	701.0	830.0	1,079.0	1,111.6
Fabrics (for textiles)	—	42.0	13.8	60.0	81.0	199.0	158.0	—
	Percentage share							
Total exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Coal	1.4	2.3	2.4	1.7	1.9	1.6	1.6	1.3
Crude oil	19.5	27.8	31.2	28.8	24.1	18.9	18.5	16.0
Rubber	2.8	2.6	2.6	2.5	3.3	2.9	2.0	2.2
Rice	12.7	9.0	11.6	12.2	10.0	10.0	11.8	9.8
Cashew nuts	—	1.3	1.6	1.5	1.8	1.8	1.3	1.5
Coffee	3.4	3.6	3.6	3.7	8.1	10.9	4.6	5.7
Marine products	10.0	13.7	11.9	14.3	13.6	11.4	9.0	8.6
Textiles and garments	8.9	7.6	8.5	11.2	13.7	15.6	15.9	14.7
Footwear	—	0.5	0.7	2.3	2.9	5.4	7.3	10.8
Total imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Electrical machinery	—	1.3	1.6	3.0	1.8	1.4	1.7	—
Steel	—	1.1	3.4	5.9	3.6	4.5	4.8	4.3
Fertilisers	—	10.1	9.4	5.2	4.2	4.2	3.1	3.7
Petroleum products	—	20.7	24.3	17.5	12.0	10.2	9.7	9.9
Fabrics (for textiles)	—	1.8	0.5	1.5	1.4	2.4	1.4	—

Source: National Commission for ASEAN (1997) and General Statistical Office (1998)

bouring countries (Figure 3.5). These exports are mostly light industry exports under processing contracts, with some doubt about the extent of the local value added, and a high concentration on a limited range of products. This reflects the initial stages of integration into the international market, during which time a major share of exports are raw materials and semi-processed products.

- The quality of many exported products is low as a result of obsolete machinery and equipment (apart from joint venture exporting companies and some newly equipped enterprises). This disadvantage became even worse in the context of the crisis, as foreign partners required stricter conditions for exported products.
- The low share of consumer good imports is misleading because unrecorded and smuggled consumer good imports have been increasing in the past few

Figure 3.5. Share of Manufactured Goods in Total Exports (percentage)



years, and account for a considerable amount of imports, despite recent measures to clamp down on selected imported consumer goods.

- There are questions about the use of imported intermediate goods and equipment. Currently, no official statistics can be found to demonstrate the fact that the major proportion of imported equipment and intermediate goods is used in import-substitution sectors and industries.

The growth of Vietnam's foreign trade by its international markets is shown in Table 3.10 overleaf, which reveals the following characteristics:

- Asia's markets are the most important for Vietnam's external trade, with 72 percent of total exports and 77 percent of total imports in 1996. During the period 1991–96, there was a slight decrease in the share of exports to Asia (from 77 percent in 1991 to 72 percent in 1996), while the share of imports from Asia increased (from 61 percent in 1991 to 77 percent in 1996). This trend has become more apparent during the past two years (1997–98). On the one hand, the regional crisis has left many Asian companies, which are Vietnam's major product importers, in financial difficulty, and they have therefore cancelled many contracts. On the other hand, currency depreciation in Asian countries has made Vietnam's exports less competitive than similar exports from other Asian countries. This led to pressure from Vietnam's partners to reduce prices. It has been estimated that the prices of garment and shoe exports fell by 15–20 percent in 1998.
- The European, North American and Australian markets have gradually begun to play a more important role in Vietnam's external trade. Vietnam's exports to the United States stood at a modest level of US$95 million in 1994, but reached a record of US$204.2 million (or 2.8 percent of total exports) in 1996. Imports from the United States have also increased dramatically, and reached

Table 3.10. Vietnam's Foreign Trade by Trading Partners, 1990–96

	1990	1991	1992	1993	1994	1995	1996
Exports to	Percentage share						
Asia	43.30	76.91	73.73	72.61	72.01	72.39	72.37
Northeast Asia	27.10	51.35	50.11	50.02	49.09	51.13	46.84
Southeast Asia	14.50	25.13	22.32	21.53	22.02	20.41	24.49
South Asia and the Middle East	1.70	0.43	1.30	1.05	0.90	0.85	1.04
Europe	50.50	17.05	14.52	13.70	13.87	18.04	16.19
Western and Northern Europe	7.35	5.86	9.56	8.30	10.82	15.58	14.00
Eastern Europe and the CIS	4.90	0.99	0.90	0.87	0.83	0.98	1.09
Russia	38.25	10.20	4.06	4.54	2.22	1.48	1.10
Americas	0.65	0.25	1.02	1.39	3.45	4.37	4.13
North America	0.17	0.02	0.29	0.34	2.68	3.55	3.68
South and Central America	0.48	0.23	0.72	1.04	0.76	0.82	0.45
Africa	0.17	0.63	0.95	0.38	0.49	0.70	0.36
Australia	0.32	0.25	0.83	1.83	1.23	1.04	1.00
Imports from	Percentage share						
Asia	36.67	60.68	65.44	69.30	67.13	77.47	77.12
Northeast Asia	16.91	24.96	27.56	35.50	37.65	47.56	49.48
Southeast Asia	19.61	43.69	37.52	33.60	29.00	29.15	26.85
South Asia and the Middle East	0.60	1.03	0.35	0.21	0.48	0.75	0.79
Europe	58.29	30.55	16.53	17.61	17.50	13.35	13.98
Western and Northern Europe	10.21	13.33	12.00	12.71	11.47	10.86	11.83
Eastern Europe and the CIS	48.08	17.22	0.59	1.22	1.07	0.71	0.48
Russia	—	—	3.94	3.68	4.96	1.78	1.67
Americas	0.43	0.46	0.98	0.76	1.25	2.08	2.73
North America	0.25	0.31	0.63	0.64	1.24	2.06	2.73
South and Central America	0.18	0.15	0.35	0.11	0.01	0.02	—
Africa	0.09	0.09	0.20	—	0.05	0.28	0.12
Australia	0.39	0.41	0.62	0.77	1.10	1.23	1.19

Source: General Statistical Office (1997, 1998)

US$245.8 million in 1996, compared to US$44 million in 1994. Trade with Australia has seen similar growth, with record levels of US$64.8 million worth of exports to and US$132.8 million of imports from Australia in 1996 (an increase of 8.4 and 11.6 times respectively compared to 1990 levels).

- Vietnam's foreign trade is limited to a number of major partners, especially in Asia. This, together with the aforementioned characteristics, reflects a significant regionalisation of Vietnam's external trade. Table 3.11 gives evidence of this trend, showing that in 1996 the 10 largest importers from Vietnam accounted for 73.2 percent of total Vietnamese exports, while the 10 largest exporters to Vietnam shared 79.7 percent of Vietnam's total imports. Among them, the five leading Asian partners shared 58.9 percent of total exports from and 63.9 percent of total imports to Vietnam in 1996. This has made Vietnam's trade more dependent on its largest trading partners, and susceptible to shocks such as significant changes in trade contracts with these countries.

Table 3.11. Vietnam's Foreign Trade with Ten Largest Trading Partners, 1996

	Export partner	Share of total exports	Import partner	Share of total imports
1	Japan	21.3	Singapore	18.2
2	Singapore	17.8	South Korea	16.0
3	South Korea	7.7	Japan	11.3
4	Taiwan	7.4	Taiwan	11.3
5	China	4.7	Hong Kong	7.1
6	Hong Kong	4.3	Thailand	4.4
7	Germany	3.1	France	3.7
8	United States	2.8	China	3.0
9	Switzerland	2.1	Germany	2.5
10	Netherlands	2.0	United States	2.2
	Total	73.2	Total	79.7

Source: General Statistical Office (1997, 1998)

- Vietnam exports most of its raw commodities to Asian countries, and most of its manufactured products to the European Union. It imports the largest share of intermediate goods, required both for the domestic market and for export manufacturing, from Asian countries. The processing of these intermediate goods is done by machinery imported from a range of developed countries.

- It is projected that trade with other non-Asian countries will continue to expand in the coming years. The reasons for this are that: 1) Vietnam expects to reach a trade agreement with the United States, which will boost bilateral trade; 2) if negotiations on WTO admission are successful, Vietnam's membership would enable it to expand trade with other countries; 3) trade with East European countries has been re-established and gradually expanded during the past few years, and will probably become more important for Vietnam's external trade; and 4) the current Asian crisis has forced Vietnam to look for more non-Asian trade partners to fill the gap of declining trade with Asia during the past two years.

2.2. Responses Taken to Contain the Impact: Recent Policies

2.2.1. Recent policies on investment promotion

The Law on Foreign Direct Investment was approved by the National Assembly on 29 December 1987. It was amended on 30 June 1990, 23 December 1992, and 12 November 1996, to attract FDI inflows into Vietnam. However, the investment environment is still complicated and is characterised by a large number of regulations. As far as the FDI is concerned, a total of 57 regulations were issued between February 1994 and 18 May 1998. As far as domestic investment is concerned, there are about a dozen regulations.

In parallel with the Law on Foreign Direct Investment, the following recent regulations play an important role in attracting FDI inflows into Vietnam:

- Government Decree No. 12/CP (18 February 1997) is the most important decree of the new investment law. It lists the following category of projects requiring the prime minister's approval (referred to as Category A projects)—infrastructure, construction of industrial zones, BOT/BTO/BT projects; projects with investment capital of more than US$40 million in the following sectors: electricity, mining, oil and gas, metallurgy, cement, chemicals, seaports, airports, cultural and tourist areas, real estate; sea and air transport; post and telecommunications; cultural, press, radio and television broadcasting, training, scientific research and health-care; insurance, finance, auditing and inspection; exploitation of rare and natural resources; national defence and security; projects using more than five hectares of urban land or more than 50 hectares of rural land.
- The Law on Foreign Direct Investment and Decree No. 12/CP also give a comprehensive list of target sectors or geographical areas, which serves as a benchmark for preferential treatment. This classification is defined around five categories of projects, four of which are sectoral and one geographical.

  "Specially encouraged" projects include 100-percent export-oriented projects, labour-intensive export-oriented agricultural projects, high technology projects (e.g. biotechnology, electronics, communications and computer-related), environment protection and waste treatment projects, and BOT/BTO/BT projects.

  "Encouraged" projects include a larger list of industries and agricultural products, most of which are either in the intermediate goods (mineral exploitation, chemicals and petrochemicals, cement, as well as materials and inputs for the footwear and textile industries) or in equipment goods (diesel engines, machine tools, precision equipment, etc.), with two exceptions in the pharmaceutical and packaging sectors.

  "Conditional licensing" applies to cases where foreign investment is subject to conditions on the legal form of the investment (e.g. only joint ventures and business cooperation contracts are allowed in telecommunication services, oil and gas, the construction of infrastructure utilities, in industrial and export processing zones, construction, transportation services, cement, steel, industrial explosives, afforestation, tourism, culture and entertainment), on the need to export (at least 80 percent of the production for industries where domestic supply is satisfactory), and on the need to integrate raw material development (dairy products, vegetable oil and cane sugar, wood processing).

  "Forbidden areas" consist of projects for which investment will not be granted (e.g. national security, defence, projects detrimental to Vietnam's culture and to the environment, production of chemicals prohibited by international agreements, etc.). Finally, a list of areas where investment is encouraged includes

both remote and mountainous areas and areas experiencing difficult economic conditions. A project qualifying as an “encouraged project” in one of these designated preferential areas becomes a “specially encouraged” project.

- Prime Ministerial Decisions No. 386/TTg (7 June 1997) and No. 41/1998/QD-TTg (20 February 1998) detail the decentralisation of issuing licenses for FDI projects (referred to as Category C projects). Decision No. 386/TTg, along with Government Official Letter No. 07-KCN (dated 16 June 1997), lists provincial industrial and export zone management committees authorised to issue and amend investment licences for projects with an investment capital of less than US$40 million and which do not fall into the category of projects requiring the prime minister’s approval. Decision No. 41/1998/QD-TTg lists the provincial people’s committees authorised to issue licences for FDI projects with an investment capital of less than US$5 million. To date, 16 provincial people’s committees and 10 industrial and export zone management committees have been authorised to issue licenses for FDI projects. All other projects (referred to as Category B projects) that are not defined in Categories A and C require approval from the Ministry of Planning and Investment.
- Government Decree No. 10/1998/ND-CP (23 October 1998), gives new measures to encourage FDI activities in Vietnam. This decree was drafted to counter the observed decline in approvals and the negative impact of the Asian crisis, and aims to provide easier and better conditions for foreign investors. Some of the new measures in this decree are: removing a large number of restrictions on foreign investments and streamlining registration procedures; exempting and/or reducing profit tax for “specially encouraged” and “encouraged” projects; and exempting some “specially encouraged” and “encouraged” projects from import tax.

2.2.2. Trade policy responses in the context of the regional crisis

This section analyses trade and trade-related policy changes or adjustments of the Vietnamese government during the 1997–98 period. These changes reflect the government’s responses to the deteriorating balance of trade in 1996 and to the impact of the regional crisis on external trade. On the one hand, the government wanted to reduce the trade balance deficit by introducing policies to enhance export production. On the other hand, it introduced more restrictions on imports through administrative measures, with positive effects only in the short term.

For most countries, import and export tariffs are a key mechanism for regulating trade and the economy. In less-developed economies such as Vietnam, export and import taxes are one of the major sources of budget revenue. The share of budget revenues from import and export taxes can be seen in Table 3.12 (overleaf),

which shows that further reductions in the overall tariff have to take into account either the potential for increased volume of trade or the development of other sources of government revenue. The most striking feature of Vietnamese import duties is that they tend to be high and complex—the number of tariff lines and their magnitudes are much higher than those of other countries in the region. During the past two years (1997–98), there have been frequent changes in tariff rates and classification.

Table 3.12. Sources of State Budget Revenue (percentage)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Domestic revenue	96.6	95.0	96.0	96.8	96.8	97.0	97.5	97.5	97.4
Taxes on	76.9	80.8	74.3	77.9	77.4	82.3	82.6	81.4	83.2
State enterprises	33.1	36.0	28.0	27.6	28.3	27.6	27.7	26.8	25.7
Joint venture enterprises	17.1	18.3	20.2	15.9	14.6	15.4	16.5	19.5	20.9
Industry and trade	10.5	8.9	8.7	9.1	8.7	9.9	8.4	8.6	10.2
Agriculture	4.7	6.7	6.2	4.2	2.7	2.9	3.0	2.6	2.3
Imports and exports	11.5	10.4	10.4	19.9	21.8	24.9	24.2	21.1	21.8
Housing and land	0.0	0.0	0.1	0.7	0.5	0.6	0.6	0.5	0.4
Income	0.0	0.6	0.7	0.6	0.7	1.0	2.2	2.3	1.9
Fees and other domestic revenue	19.7	14.2	21.7	18.9	19.4	14.7	14.9	16.1	14.2
Grants from foreign countries	3.4	5.0	4.0	3.2	3.2	3.0	2.5	2.5	2.6

Source: General Department of Taxation

The main change in rates took place in March and September 1997. For the September 1997 changes, a detailed comparison has been made with the original tariff structure established in 1992. The comparison shows that there has been an increase in the complexity of the tariff structure, as well as an upward trend in tariff charges (see below):

Number of products/tariff lines affected in the September 1997 Decree	552
Corresponding number of tariff lines in the March 1992 Decree	438
Unweighted average tariff rate in the September 1997 Decree	11.6%
Unweighted average tariff for corresponding products in the 1992 Decree	7.9%

More tariff lines for the same group of products and an increase of 3.7 percent in the average rate illustrates a worrying trend towards a more complex policy, and one that is more open to arbitrary manipulation at custom points. Looking at the product groups with the largest increase in tariffs between 1992 and 1997, it is obvious that there is a trend towards increased selective protection on consumer goods, upstream activities related to the textile and garment sector (e.g. silk, cotton, fibres or certain fabrics), and some protected intermediate goods (e.g. metal products, cement, glass). The only group of products with a decline in average tariff rates are equipment goods and some processed food products.

This high and complex tariff system, with a lack of clarity and even purpose, is an implicit incentive to unrecorded transactions, corruption and smuggling. Ac-

cording to estimates by the Ministry of Trade, smuggled products that were detected and seized in 1997 were valued at 660 billion dong. The Ministry of Trade and other relevant ministries also admit that the smuggled products which are detected and seized form only a small proportion of the total value of products smuggled into Vietnam. In the past year, the government has required legally imported products to have official stamps affixed to them. Although administrative measures such as tax stamps and increased enforcement efforts may have a temporary effect, they cannot even begin to prevent smuggling. This is because the incentives for smuggling—the opportunity for high profits, created in substantial part by high tariffs—are too strong. High profits from smuggling enable smugglers to quickly introduce counter-measures, such as counterfeit stamps or even actual stamps originally issued for other goods, and, regrettably, bribes to low-paid officials that exceed the new bonuses offered by the government.

The increased complexity and heterogeneity of the tariff structure also creates uncertainty for both domestic and foreign producers, and more so as changes are frequently made. This hinders negotiations on WTO accession, as well as on a bilateral agreement with the United States. Moreover, it appears that these tariff adjustments are short-term answers to local/joint venture pressures or requirements for protection and targeted discrimination, rather than the result of a clearly defined medium-term strategy to encourage the development of industries in which Vietnam has a comparative advantage and in which it could increasingly create formal employment opportunities.

In April 1998, for the first time since becoming a member of ASEAN, Vietnam announced the list and tariff rates of products to be added in 1998 to the CEPT inclusion list (implying rates of less than 5 percent before 2003 and 2006 for fast track and normal schedules). According to this list, there is a small difference in protection (8.2 percent for the unweighted tariff against 10.3 percent for the ordinary tariff) among 1,715 tariff lines. This is considered a significant step to illustrate that Vietnam has been integrating into the international market, and to confirm its commitment to CEPT/AFTA.

In the context of a deteriorating trade balance in 1996 and the increasing impact of the regional crisis on external activities (more pressure on Vietnam's exports and on domestic products as a result of cheaper exports from other Asian crisis countries), the response of the Vietnamese government has been, on the one hand, to promote exports, and on the other, to increase restrictions on imported goods, especially consumer goods and some intermediate goods, to protect domestic production. During the last few years, the government has been using non-tariff barriers as the main measure to manage external difficulties.

The policy of export liberalisation was laid out in the Fourth Plenary Resolution of the Central Committee of the Communist Party of Vietnam (in December 1997) as follows:

> "Specify clearly the small number of goods either banned from export or exported with limited quantity; other goods are allowed to be exported freely with easy and simple procedures. Registered enterprises from all economic sectors that are mainly production enterprises are allowed to export their products directly meeting the conditions specified in law."

To implement this policy, the government has relaxed restrictions on exports in a series of steps over the past 18 months. In 1997, it allowed those organisations with export permits to export any items that did not belong to a small category of restricted goods (prior to this, exporting companies were allowed to export only registered commodities). During 1998, further steps were undertaken to relax export procedures and to promote exports:

- Prime Ministerial Decision No. 11/TTg (23 January 1998) allowed domestic private and joint venture companies to engage in rice exports within a controlled framework of quota allocations;
- Prime Ministerial Decision No. 55/TTg (March 1998) permitted all enterprises from any economic sector to directly export their products without the need for a specific licence. Previously, Vietnamese enterprises were required to obtain export and import permits from the Ministry of Trade in order to sign and implement foreign trade contracts. This decision did not apply to 12 products subject to specific quotas or to other restrictions—such as rice, explosive materials, gems, precious stones and metals, works of art, or antiquities.
- The new Trade Law (January 1998) explicitly authorised the creation of branches by industrial companies, including foreign and joint venture companies. This in principle allows companies to operate representative offices, as is the norm elsewhere (*i.e.* representative offices being able to conduct trade and to sign contracts directly with customers, which was previously not allowed).
- Exporting companies now enjoy tax exemption on imported inputs necessary for their production (Circular No. 106 (23 July 1998) adopted by the Ministry of Finance), and receive a bonus of 1 percent of the export value (from the export bonus fund) for exports worth more than US$100,000 (but less than 150 million dong), as well as bonus for high quality export products at export exhibitions or fairs, etc.

These adjustments are considered to be significant moves towards trade liberalisation, giving more opportunities for all companies to engage in exporting, including private and small and medium-size enterprises (SMEs). In addition, these moves

were expected to alleviate the high transaction costs that used to be imposed on exporting companies under the old system. However, there are questions about the real effect of these new regulations. For example, the authorisation for private companies to engage in rice exports was accompanied by the devolution of power to local authorities to allocate quotas, knowing that these local authorities usually have their own exporting companies. Similarly, the new opportunity for all companies to engage in exports was limited by the requirement that such firms must have "staff with appropriate skills" and a minimum capital of US$200,000, virtually eliminating most private companies.

The other major non-tariff barriers on trade are related to bans and quotas. As noted above, the new Decree No. 57/CP (31 July 1998) has set the list of banned or controlled products for export and import as follows:

- The list of banned export goods—weapons, munitions, explosives, military equipment, antiquities, drugs, toxic chemicals, rough, sawn and piled timber, wood products, fired coal (clinker), prescribed furniture, naturally valuable wild animals and plants;
- The list of banned import goods—weapons, munitions, explosives, military equipment, antiquities, depraved and reactionary cultural products, fire-crackers, toys which may have a negative effect on children's psychology, cigarettes (except a small amount permitted as personal luggage), second-hand consumer goods except those for personal use, right-hand drive automobiles, and used spare parts for automobiles and motorcycles;
- The list of exports subject to quotas—rice and garments exported to the European Union (EU), Canada, Norway and Turkey under bilateral agreements;
- The list of imports requiring special permits—petroleum, fertiliser, motorcycles, vehicles with less than 12 seats, iron, construction-grade steel, cement, refined sugar, paper, wine, and construction-grade glass.

With regard to export quotas set for Vietnam by foreign importing countries—such as export quotas for textiles to the EU, Canada, or Norway—there are questions about how to put in place an efficient mechanism maintain budget revenue and, at the same time, to prevent corruption, as well as to encourage participation by enterprises from any sector. At present, the distribution of export quotas for textiles and garments is still based on an "asking-giving" mechanism. However, this mechanism applies only to enterprises established before 1998; enterprises established since 1998 are not able to export their products if they themselves are not looking for markets.

In fact, many exporting enterprises do not rely excessively on quotas distributed by the government. Instead, they do their best to increase their competitiveness

in international markets. For example, state-owned Garment Company No. 10 is able to export 70 percent of its products to non-quota markets due to the credibility established by the high quality of its products. At present, the proportion of products exported under quotas accounts for only 30–40 percent of the production capacity of most garment SOEs. However, the slow allocation of export quotas by the Ministry of Trade causes many enterprises difficulties. For example, the export quota allocations under the current system may lead to a situation where some export quota allocations are distributed to enterprises that are unable to export, and these enterprises then sell their quotas to other companies.

To improve the system of allocating export quotas, it is necessary to specify clearly the steps for carrying out a pilot study on auctioning export quotas. If auctions of export quotas are implemented publicly and without pressure from the authorities, it may reduce corruption and generate revenue for the government budget. However, it is necessary to build in incentives for those SMEs that are working efficiently and competitively, but which, for various reasons, have not yet been able to participate fully in international trade. Without such incentives for SMEs, the export quotas may all go to the large general corporations, especially in the present circumstances when no law to promote and facilitate competition is in place. If one considers only the purpose of preventing corruption and mobilising revenue for the budget, a reasonable tariff policy may be superior to quota allocations in terms of creating a more level playing field.

Adjustments to the list of banned or controlled products for export and import are adopted by the government based on proposals from the Ministry of Trade. In principle, import and export quotas are applied when tariff measures are not sufficient to overcome the overall imbalance of the economy or the imbalance of domestic demand and supply, or when the goods in question have a negative impact on domestic production. In addition, export quotas are also applied for products whose exports are limited by quotas set by Vietnam’s foreign trade partners.

It is important also to mention those polices and practices related to issuing lists of goods temporarily suspended from export and import. In previous years, the list of goods temporarily suspended from export and import has been announced without adequate warning and without stating reasons. For example, the decision to temporarily suspend motorcycles from import and the allocation of import quotas was carried out without informing the public. Regulations issued in this manner lead to a “feverish” demand for motorcycles, and therefore did not serve the purpose of balancing supply and demand. Moreover, such a sudden prohibition from import should not apply to unfinished foreign trade contracts previously signed with foreign partners; otherwise, such contracts cannot be fulfilled, leading to a loss of confidence in Vietnam’s credibility in international trade circles.

Added to these bans and quotas, a large number of imported products require formal approval by various ministries: the Ministry of Industry for the import of chemicals, the Ministry of Agriculture and Rural Development for veterinary products and animal feed, the Ministry of Health for pharmaceuticals and medical equipment, the Ministry of Aquatic Resources for aquatic products or upstream inputs, the General Department of Post and Telecommunications for transmitters and exchange boards, the State Bank of Vietnam for specialised banking equipment, and the Ministry of Culture and Information for cultural goods.

Since 1997, the exchange rate of the dong against the US dollar has been adjusted four times by the State Bank of Vietnam. On 27 February 1997, the State Bank widened the foreign exchange trading band between commercial banks from ±1 percent to ±5 percent, and on 13 October 1997, widened it further to ±10 percent. On 16 February 1997, the official exchange rate was devalued by 5.6 percent from 11,175 to 11,800 dong to the US dollar. On 7 August 1998, the State Bank of Vietnam decided to devalue the official exchange rate from 11,800 to 12,998 dong to the US dollar, and at the same time narrowed the foreign exchange trading band to ±7 percent.

Foreign exchange is the crucial factor in foreign trade and investment, to the extent that production equipment, production components, technology, spare parts and other inputs must be obtained from abroad. Without access to foreign exchange, in practical terms, an enterprise has no access to international markets for necessary imports.

Although the trade liberalisation measures described above have provided access to international markets for all enterprises from all sectors, the recent tightening of foreign exchange controls has had the opposite effect, reducing access to international markets for Vietnamese enterprises—especially SMEs that have relatively little influence.

At present, foreign exchange controls imposed in Vietnam are composed of the following elements:

- The controls seek to gather foreign exchange into the banks, by requiring individuals and businesses that transfer foreign currencies into Vietnam to promptly convert them into dong or to keep them in a foreign exchange account at an authorised bank. More recently, Decision No. 173/1998/TTg (17 September 1998) requires enterprises to sell 80 percent of their foreign exchange to the banks. Enterprises that fail to sell will have this amount automatically purchased from their foreign currency accounts by the banks. When they need foreign exchange, the enterprises have to repurchase the foreign exchange from the bank, usually at higher rates.

- The controls do not permit enterprises to freely obtain foreign exchange. Instead, to convert dong into foreign exchange, enterprises are required to show that they have a “legitimate purpose” for doing so. According to current foreign exchange regulations, having a “legitimate purpose” means that an enterprise is producing specific items on the government’s import substitution list, or participating in particular infrastructure projects. Such enterprises are permitted to purchase foreign exchange for imports from the banks. Enterprises not included on this list do not have automatic permission to purchase foreign exchange for imports. Even when a “legitimate purpose” is shown, enterprises can only obtain foreign exchange if it is available in the banks.
- The State Bank of Vietnam sets foreign exchange rates, rather than allowing the rate to be set by the market. There are great risks in this approach, especially from an over-valued exchange rate. When the exchange rate for the dong is set too high relative to the market, shortages in foreign exchange will inevitably occur as a natural result of the law of supply and demand. Such shortages will reduce the availability of foreign exchange to banks and enterprises. Moreover, an over-valued exchange rate discourages exports by making them more expensive relative to other countries’ products, and it encourages imports by making them cheaper relative to domestic products. The result is usually a further increase in demand for foreign exchange, a continual worsening in the current account deficit, and the encouragement of a black market. Foreign exchange controls thus often have opposite result from that which they intended—rather than protecting a country’s foreign exchange reserves, exchange controls often cause them to deteriorate.

Some of the foreign exchange controls may not even be in effect. According to the State Bank, enterprises in practice do not sell their foreign exchange to the banks; this is hardly surprising, since the enterprises cannot be sure that they can get the foreign exchange back when they need it, and, even if they are permitted to buy back the foreign exchange, they will probably pay a higher price for it. Indeed, there are indications that foreign exchange is not readily available even to those enterprises that can show a “legitimate purpose,” as indicated by the following report from a recent issue of the *Vietnam Investment Review*:

> “A drastic shortage of hard currency has forced the State Bank of Vietnam to renege on foreign currency repayment guarantees, leaving foreign and state-owned enterprises without enough cash to pay outstanding loans and bills.”

Access to foreign exchange for import is thus limited and uncertain for all enterprises, especially for SMEs.

3. Social Impact of the Crisis and Measures to Mitigate Negative Social Consequences

3.1. Social Impact of the Crisis

A slowdown of growth, stagnation of production and services, an increase in smuggling and contraband—all these elements inevitably have negative social implications, among which unemployment is the most serious.

3.1.1. Unemployment in Vietnam

Unemployment in Vietnam is of great concern to the whole society, and has become more serious since the crisis began. The Vietnamese population has reached 78 million, of which 60 percent are aged under 25, with 43 million people at working age. With an average population growth rate of 3 percent (in some cities 5 percent), the labour force is annually supplemented by 1.2 million people, while the possibility of job creation is less than 2.5 percent. According to an investigation conducted by the Ministry of Labour, Veterans and Social Affairs in 1996, 2.5 million people were jobless in the cities, comprising 5.9 percent of the total labour force, and of the jobless, 75 percent were young people. In 1997, this rate increased to 7.8 percent (and an increasing upward trend has since been recorded). In rural areas, the job situation was worse: 27.6 percent of the work force lacked a job in 1996; the number of fully unemployed is currently more than one million, while partial unemployment is estimated to be over five million. Meanwhile, weaknesses in the investment structure, the slow transformation of the economic structure, especially the sharp decrease of exports and FDI, have reduced employment and the incomes of workers.

At the beginning of April 1998, according to another investigation on unemployment conducted by the Ministry of Labour, Veterans and Social Affairs, in 2,214 investigated enterprises about 60,000 workers (9 percent of the total staff) had no work to do. The proportion of workers who have lost their jobs is estimated to reach 25–30 percent of the total number. It was anticipated that the number of workers without work would increase quickly in 1998.

According to the Ministry of Industry, the present rate of idle workers in enterprises under control of the ministry was 6.1 percent, over 400,000 people, of whom 2 percent have had to leave their enterprises. Jobless workers are concentrated in the industries manufacturing machines and machines serving agriculture (22 percent), electronics and information technology (18 percent), industries exploiting natural resources (15 percent), mechanical and energy-related industries (10 percent), textiles (10 percent), shoes (10 percent), and plastic (8 percent). In joint ventures and enterprises with foreign capital, 8 percent of workers (28,000 people) had been made redundant.

The most recent nationwide survey on the unemployment situation in Vietnam, carried out with a sample method for 105,860 families in 2,856 areas, has shown that the unemployment rate for the working age population in cities was 6.9 percent in 1998, 0.8 percent higher than in 1997. In all large cities, this rate is also much higher than it was in 1997—9.1 percent in Hanoi in 1998, compared to 8.6 percent in 1997; 6.8 percent in Ho Chi Minh City in 1998, compared to 6.1 percent in 1997; 6.4 percent in Danang in 1998; 8.4 percent in Haiphong.

As regards the different regions of the country, the unemployment rate in the Red River Delta has been recorded at 8.3 percent; 7.3 percent along the north-central coast; about 6.5 percent in the northeastern zone, along the south-central coast and in the Mekong River Delta; ; and under 6 percent in the northern mountain and midland zones and in the central highlands.

The direct impact of unemployment has fallen on a large proportion of the population. In Vietnam, 25 percent of the population live in cities and towns, and of these about three million people work in SOEs and state agencies, while others work in companies, private enterprises, cooperatives and in about two million small businesses (*i.e.* individuals, business households, free traders) operating under Government Decree No. 66/HDBT. Seventy-five percent of the rural population who live far from the industrial centres are also economic and social victims of the crisis. One million people are estimated to be facing hunger, 1,715 out of 10,000 villages in Vietnam are reported to be very poor (with less than US$100 income per capita each year).

The most vulnerable group of labourers affected by the crisis are doubtless unskilled or low-skilled workers. According to estimates of the Vietnam General Union of Workers, 56 percent of the total number of workers are unskilled or low-skilled. At this initial stage of transition to the market economy, 22.8 percent of workers have had to change their profession, but only 6.3 percent of them have been re-educated.

3.1.2. Unemployment in the state sector

SOEs form one of the most important sectors in Vietnam's economy. At present, about 1.8 million people work in 5,467 SOEs, of which only 40 percent are profitable. According a recent survey, in many SOEs 8–10 percent of workers have no work to do; in some SOEs this rate has reached as high as 25–30 percent. In 1998, the number of workers without work or with insufficient work has grown much higher (it is estimated to be 25 percent—about 300,000 people). The crisis has particularly affected heavy industries, which so far belong entirely to the state-owned general companies, by a sharp decrease in economic growth, a strong reduction of import demand, and a reduction of import prices of their Asian partners. For exam-

ple, the steel industry can hardly find markets, and also suffers tough competition with steel joint ventures. In Thai Nguyen Steel Company alone, 3,000 out of 13,000 workers lost their jobs in 1998. The coal industry is suffering the same fate: many coal mines have been forced to stop running or to reduce their production because of the crisis. As a consequence, tens of thousands of workers have been obliged to cut short their working hours, and 15,000 "seasonal" workers are at risk of having to leave the mines. The monthly average income of miners has fallen from 1.4 million dong in 1997 to 700,000 dong in September 1998.

3.1.3. Unemployment in the non-state sector

Unemployment in the non-state sector is estimated to be more serious than in the state sector. In Hanoi, for example, 11 percent of the total number of workers were laid off. In Ho Chi Minh City, 10,000 workers in the textile industry were expected to be laid off in 1998. The wages of labourers still in work has continued to decline, in some cases as much as 29 percent.

The non-state sector in Vietnam is characterised by low investment, primitive technology, small-scale production and business, and low skills. The financial crisis has affected mostly the income of labourers in this sector rather than their job security situation.

3.1.4. Unemployment in enterprises with foreign capital

Compared to local businesses, enterprises with foreign capital are thought to have been affected by the financial crisis more seriously. This is because the latter use large amounts of capital from abroad, a huge share of which comes from other ASEAN countries. Hotels, restaurants, and house-leasing sectors have been badly affected by the fall in tourism. In Hanoi, for example, 760 out of 11,706 workers in 96 enterprises with foreign capital currently have no work. In Dongnai province, where a large number of enterprises with foreign capital are concentrated, 5,200 workers in 220 enterprises have had to leave their companies. Many businesses have been forced to introduce a two- or three-day working week.

There is no insurance for unemployment in Vietnam, and the system of social insurance is narrow (covering only about two million employees mostly working in SOEs, companies and cooperatives). Losing a job therefore puts most people in catastrophic circumstances.

The lack of jobs inevitably leads to the redundancies, which in turn leads to conflict between employers and employees. To avoid conflict, some enterprises have been forced to keep their staff in full, and have decided to cut wages. This measure reduces the income of workers, and in the end will lead to discontent and

legal action on the part of employees. Since the beginning of 1998, the Labour Court of Ho Chi Minh City has received 101 petitions from worker collectives and employees suing their employers on different matters concerning income reduction.

3.1.5. Wages and income

The Asian financial crisis has reduced not only the number of employees, but also their income. At present, 3.8 percent of the total number of labourers are receiving real wages that are less than the Labour Code minimum wage of 140,000 dong per month (about US$10). Among them, 53.5 percent are working in agriculture and 42.2 percent in forestry. Of all workers, only 10.3 percent have incomes of over 1.2 million dong, of which two-thirds earn more than 1.5 million dong and are liable to pay income tax.

According to a survey of 150 enterprises with foreign capital conducted by the Institute of Labour Science and Social Affairs and the CIEM, the current average income of Vietnamese labourers working in enterprises with foreign capital is US $115 per month (Vietnamese managers have an average income of US$342).

People working in enterprises with foreign capital have incomes that are several times higher than those of workers in domestic enterprises, but in the 150 survey enterprises, the average length of working time is 51 hours per week; in joint ventures with South Korean and Taiwanese companies, employees have to work for 53–55 hours per week. The government has recently issued a regulation on the minimum level of wages, but has not yet stipulated production norms. Many enterprises therefore deliberately apply norms and requirements that are too high, and are likely not suitable for the Vietnamese. This is a major cause of conflicts.

Because there are no regulations on levels of wages in accordance with each profession, groups of professions or jobs, many enterprises have taken advantage of the crisis to pay low wages to trained Vietnamese labourers. Many other enterprises have taken advantage of the vocational training taking place inside enterprises to recruit employees to work full time, but pay them only apprentice wages. A number of enterprises with foreign capital, and most private enterprises, do not have pay scales, and are either not paying or are paying insufficient overtime wages. The regulation on equal payment to both Vietnamese and foreigners with the same job has not so far been implemented.

The wage scales applied to skilled workers (such as technicians) at present is too low compared with their training as well as the demands of their jobs. There is therefore a “brain-drain” situation in the SOEs, whereby teams of engineers and well-qualified experts have been moving to enterprises with foreign capital and to non-state domestic enterprises.

3.1.6. State of the insurance market

Government Decree 100/CP on the insurance businesses was issued on 18 March 1993, but the insurance market in Vietnam did not began to boom until 1995 or 1996 with the effects of competition. In addition to insurance companies belonging to the Vietnam General Insurance Company (Bao Viet), there are also the State Reinsurance Company (VINARE), the Bao Minh Company, the Bao Long Company, PJICO, Petroleum Insurance, and Human Life Insurance. A form of insurance intermediary joint venture has also been opened, such as INCHINBROK and the International Insurance Company in Vietnam (VIA). Dozens of insurance companies and foreign insurance intermediaries have opened representative offices in Vietnam. Bao Viet is the largest company in the insurance market, controlling 80 percent of the market share. In 1997, total insurance fees were estimated to reach 1,400 billion dong.

Health insurance has been implemented since the issuance of appropriate regulations along with Government Decree 299/H§BT (15 August 1992). To date, almost 10 million people have participated in health insurance, accounting for about 10 percent of the population. Every year the health insurance system mobilises over 500 billion dong, equivalent to one-fifth of the amount that the state budget provides for health services; more than 20 million cases have received medical treatment through insurance.

However, in practice, the emerging insurance market in Vietnam is still narrow, and the financial crisis is undermining its development. Meanwhile, existing insurance regulations contain a range of points which are not suitable for the socio-economic development of the country. For example, health insurance should be considered as administratively belonging to health service sector and not as a business. Besides, the existence of 65 different funds has led to an inability to compensate large losses, especially in cases where the prices of health services have been increasing. In 1997, more than 20 health insurance providers did not have enough funds to cover risks.

According to an inspection conducted by state inspectors in 1996 and the beginning of 1997, the main shortcomings in health insurance were:

- Insurance buyers are not insured equally across the whole country. Some regions have stipulated themselves (without government approval) their own system of health insurance.
- Some regions cannot cover health insurance expenditures because of insufficient funds, while others have excessive turnover but cannot transfer or exchange with neighbouring provinces.

- Some violations in financial management are subjective, but most stem from the fact that funds operate independently from local authorities.

To redress the aforementioned shortcomings, the government on 30 March 1998 approved new health insurance regulations. This new regulation contains the following provisions:

- To improve rights for patients with health insurance cards
- To disburse funds at the same time as medical treatment and health insurance in the ratio of 20:80 (where patients pay 20 percent of the treatment fee), so that funds can be concentrated on assisting serious cases with large big costs, and in particular to take care of people on the social priority list (in these cases, the fund still covers 100 percent of the treatment fees).
- To expand health insurance to village cadres.

3.1.7. Poverty

Poverty is one of the main constraints on the growth of rural industries. According to World Bank, 51 percent of the Vietnamese population is classified as poor. About 25 percent of the people are food-poor in the sense that they cannot meet their daily basic calorie requirement (2,100 calories per capita per day) even if they spend all of their money on the basic food basket. Poverty is much more widespread in rural areas than in urban areas: 90 percent of all the poor are concentrated in rural areas, and 76 percent of the poor are farmers.

The gap between rich and poor is growing: in 1993 the gap between the richest quintile and the poorest qunitile was 6.0, in 1994 it had risen to 6.9.

Under pressure of poverty there is a need to develop rural industries in order to generate employment and income. However, poverty also imposes constraints on rural industrial development due to the low purchasing power of the poor. The poor tend to produce for self-consumption. As a result, this tendency has badly affected the market for goods and services and has constrained rural industrial development. Because of their low level of income, the poor cannot invest in rural industry.

Vietnam is an agricultural country. To date, the rural population comprises 58 million people, about 75 percent of the total population, and the rural work force makes up 70 percent of the total labour force. However, the contribution of Vietnamese agriculture is only 27 percent of GDP. The annual increase of productivity in the agricultural sector on average is only 1.5 percent. Living standards in rural areas are less than a half of those in cities; of the poorest quintile of households, four-fifths live in countryside. As a consequence, most of Vietnamese farmers have no savings for investment.

After 10 years of reform, Vietnam has emerged from the socio-economic crisis which took place at the end of 1980s, and has made a turning point in the process of eliminating hunger, alleviating poverty and improving social welfare. Nevertheless, compared to international standards, Vietnam still belongs to the group of the poorest countries. In 1996, the average quantity of food per capita reached 390 kg, compared to an FAO-suggested food security level of 500 kg. Current per capita income is US$350, half of the world poverty level of US$700.

In rural areas, women's working hours are high—on average about 12.5 hours per day, with the rate for poor women reaching 14–16 hours. Ninety percent of rural women have had no vocational education. In urban areas, only 15–20 percent of female labourers earn a high income; the remainder are low income workers. Since 1992, SOEs have tended to recruit male workers and lay off female workers. In private enterprises, 76 percent of women work without a job contract.

The rapid growth of the population, lack of jobs, low productivity, low living standards, environment pollution, worsening quality of the health and education systems are acknowledged to be the main challenges for Vietnam's economy in general and for its villages in particular. Social consequences in turn have an adverse impact on economic development. Large-scale unemployment in particular can pauperise a significant part of the population. Such pauperisation would be a major reason for rising social unrest, which in turn would block investment and economic growth. This undesirable spiral is a major challenge for all countries affected by the crisis, including Vietnam.

3.1.8. Free Migration

At present, one of the serious problems which all of the Southeast Asian transitional economies (SEATEs) are facing is free migration. The financial crisis is aggravating this and making it a national concern, introducing a range of difficulties to reform of the Vietnamese economy.

According to the latest statistical data from the Ministry of Agriculture and Rural Development, at the end of 1997 Vietnam had almost 172,800 households with 842,000 people freely migrating, mainly from the provinces of Red River Delta and northern mountainous areas to southeastern provinces and the Tay Nguyen Plateau. Of those, about 92,200 households had moved to the Mekong Delta, and about 76,600 households to the Tay Nguyen Plateau.

According to the same statistical data, more than 30 percent of freely migrating households have a per capita income of less than 70,000 dong per month (about US$5), while about 20 percent have an income of 50,000 dong per month, the same as their income before migration.

Large cities are suffering the most serious consequences of this uncontrolled migration. In Ho Chi Minh City, for example, the population has been increasing rapidly during the past few years: in 1976 the city had only 3.3 million people, by 1997 its population had reached already 4.9 million. During the 1990–97 period, the population increased by 100,000 to 120,000 people each year, half of which was the result of inward migration.

In Hanoi, there are 210,000 illegal immigrants, making social problems more complicated. According to the Minister of Labour, Veterans and Social Affairs, every year since 1995 more than 20,000 people from neighbouring provinces have "rushed" into Hanoi to look for jobs. This has had a serious impact on the security situation of the capital. Many people who came in to look for jobs have got involved in illegal activities (it is estimated that 75 percent of criminals are migrants).

This situation is putting great pressure on the infrastructure of large cities, which were already under strain from the pressure of permanent residents (for example: shortage of land for the increasing population, shortage of houses, weak systems of power, water and drainage, increasing unemployment, lack of space in schools, etc.). Since the regional economic crisis, many workers have had to compete with the migrants to keep their jobs, making the employment situation more difficult.

Another example is the situation of migration in Daclak, a mountainous highland province. Despite making every effort to alleviate poverty, this province has to "receive" each year tens of thousands of poor households from other areas, affecting livelihoods and leading to an increase in deforestation. According to a report from the province authorities, 72,322 households with 349,527 people have migrated to Daclak in the last 10 years. The number of free migrants to Daclak at present accounts for 23 percent of the population in the province; only 68.6 percent of people of working age have got jobs (50.7 percent with permanent jobs, and 17.9 percent with temporary work).

Migrants make up 34.8 percent of people working in the self-employed sector; 8.9 percent in private enterprises; 2.1 percent in companies with foreign capital; and 8.2 percent in SOEs. In terms of professions, 1.5 percent of people working in agriculture are migrants; 37.8 percent in industry/construction; 3.8 percent in transportation and post/telecommunications; and 33.4 percent in commercial services, restaurants and hotels. The majority of migrant workers are unskilled.

3.2. Mitigating the Negative Social Consequences of the Crisis

3.2.1. General measures

How should Vietnam escape from the financial crisis and minimise negative social implications? The World Bank has suggested three principal objectives:

- Building the foundation to restore growth and raise incomes by adopting wide-ranging reforms in the financial sector, in corporate governance and competition, and in managing external debt;
- Strengthening social protection for the poor and other vulnerable groups to help cushion the impact of the crisis; and
- Improving the quality and transparency of government institutions, including helping the government address problems of corruption and accountability.

These objectives are thought to be reasonable and suitable for Vietnam.

At present, the Vietnamese government is looking for measures to resume high economic growth. It has reached a consensus that the first thing which needs to be done is to improve the investment and business environment. Since the outbreak of the regional crisis, there has been a range of reform policies, statements and programmes recognising the need for much greater progress on concrete reform, such as the Resolution of the Fourth Party Meeting in December 1997, official calls for accelerated equitisation (privatisation) of SOEs, and caution on state guarantees for enterprise debts.

In 1998, the government issued a range of important regulations related to management. Many are considered to be open and attractive, such as Decree No. 10/1998/ND-CP on measures encouraging foreign investment, Decree No. 07/1998/ND-CP on the promotion of domestic investment, Decree No. 44/1998/ND-CP on the reorganisation of SOEs, and Decree No. 48/1998/ND-CP on securities and securities exchange. The government has ordered ministries and local authorities to remove as much as possible unnecessary administrative procedures for investors. The fight against smuggling is also being strengthened.

Urgent action is needed to avoid the growing risk of government failure through excessive lending and investment in the SOE sector. SOEs that were not genuinely profitable on average over the past five years are unlikely to be profitable in the future. The intention to rescue large loss-making SOEs by pouring more capital into them from the state budget in order to rescue their workers is thus not justified in the long run. Instead, it is necessary to reform such SOEs through more resolute methods such as equitisation or diversification.

With regard to transparency and reliable information, particularly in the banking and corporate sectors, Vietnam remains one of the most information-starved economies in the world. Without reliable information on the real state of the business sector and on the related quality of banking sector loans, a serious risk of over-investment remains, which will lead eventually to financial crisis and instability. Greater transparency and access to reliable information would also limit the scope for corruption. One of the most urgent priorities is therefore to fill this gap.

3.2.2. Measures to reduce unemployment

As far as measures to reduce and prevent unemployment are concerned, the following approaches should be taken:

- Developing the rural market. This is crucial to create jobs for labourers. This approach will lead to good results if it can link agricultural production with the domestic consumer market as well with the international market. It requires the following concrete measures:
- Favouring and accelerating the development of different economic sectors in rural areas, thereby creating employment for rural labourers and changing the economic structure;
- Expanding rural industries, especially traditional rural industries, with the help of a national fund for job creation and other target programmes;
- Opening easy access to export for all kinds of enterprises; and encouraging them to export by providing fiscal incentives and low-interest credit;
- Improving the skills of workers by investing in the development of a system of vocational schools, and by encouraging creation of private vocational schools;
- Improving and widening the system of job centres as a “bridge” between labourers and businesses;
- Setting up an unemployment insurance system; and
- Investing in social security and pension reform, and health-care policies that provide wider access to low-income groups, which will strengthen future growth while ensuring that the benefits continue to be shared broadly.

3.2.3. Solving the wages problem

It is necessary to improve the quality of human resources to meet increasing demand in industries using foreign capital, in order to make the “human resources” capital in the country more attractive to foreign investors.

The government should set up a more flexible salary regime, one that will ensure minimum wages but will not restrict the maximum level of wages, in order to encourage employees' productivity and motivation.

3.2.4. Proposals on the development of the insurance market

A law on the insurance industry to replace existing governmental regulations is urgently needed. This law should cover every aspect of insurance business activities, especially issues which are not covered by Decision No. 100, such as regulations on insurance contracts; transference of insurance contracts between companies in cases of take-over or bankruptcy; changes in the ownership structure in insurance companies; forms of joint venture companies and shared companies; problems relating to life insurance; property insurance; civil responsibilities of foreign investors; foreign partner business cooperation contracts, and so on.

Diversification of the insurance business is, in the authors' opinion, the right direction for the development of the insurance market in Vietnam, which should include increasing the participation of different economic sectors; expanding insurance services to such sectors as airports, marine shipping, petroleum; establishing investment companies and investment funds to use the "idle" capital of insurance businesses; establishing insurance associations, and so on.

3.2.5. Measures to alleviate poverty

To protect and assist the poor, Vietnam has adopted a large-scale programme entitled "Famine Elimination and Poverty Alleviation," and the government has established a Bank for the Poor. Encouraging investment in remote and mountainous areas, stimulating farmers to expand their cultivated land, and seeking ways for rural industrialisation, are main priorities.

Protecting the poor during this uncertain period is of great concern. In the short term, public spending is the most effective way to ensure adequate social assistance. Measures should include:

- The introduction and expansion of credit schemes in urban and rural areas to give the poor easy access to state credit. Credit activity in Vietnam has shown that with a small amount of money borrowed from the bank, many poor farmers have managed to set up their own business and earn a living, and 99 percent of borrowers have repaid their loans.
- The concentration of public spending on rural infrastructure and marginal urban areas to create business opportunities for the poor or enhance their ability to consume produced goods.

3.2.6. Proposals to solve the problem of uncontrolled migration

One of the most important solutions to the problem of free migration is to improve the livelihood of the people by carrying out a national programme to develop agriculture in rural and mountainous areas. This programme would be a combination of all former programmes and projects on investment in mountainous and minority areas. Farms, state-run afforestation yards, military units and state-owned commercial units should support ethnic minorities by transferring technology, supplying materials, and investing capital to them on favourable terms.

At the same time, the government should issue policies to encourage highland and ethnic groups to develop the market economy by lending them capital at preferential interest rates or without interest to plant fruit trees and commercial timber. Goods produced should be bought by state agencies at an agreed and stable price. To encourage economic development, the government should give highland and ethnic groups some tax exemptions and concessions.

Another means of government support would be to train local cadres, scientists and technicians and train people in mountain villages to conduct household business, as well as raise awareness about producing profitable agricultural products. It will also be necessary to enforce preferential policies on salaries and allowances to attract teams of scientists and technicians from the plains and urban areas up to mountainous areas, and to allow large cities to enforce policies encouraging businesses to move to the outskirts of towns and to new industrial zones.

4. Lessons for Future Policy-Making

From the internal weaknesses of Vietnam's economy, and based on the responses of the government to the crisis considered above, the following lessons for future policy-making can be drawn:

- State sector reform is essential if economic growth is to be assured. The government should redefine the role of SOEs in the economy. As shown from its success in agricultural performance, Vietnam could not have become an exporter of rice if the role of state farms had not been changed. Unless the "leading role" of SOEs is defined clearly, SOE reform is likely to make little progress. A leading role does not necessarily mean dominance. If unprofitable and non-viable SOEs cannot be closed down, the equitisation process cannot be accelerated and the efficiency of SOEs cannot be improved. If poverty reduction is on the government agenda, the role of private SMEs should be increased. A level playing field should be created for both the private and state sectors, otherwise competition and monopoly regulations make little sense.

- Further reform of the banking system is required. Reforms need to be made to the institutional structure in areas such as the regulatory and supervisory framework, transparency and the disclosure of information, accounting systems, market infrastructure, and risk management. Political pressure from some interest groups should be reduced to avoid insider trading and excessively risky lending to speculators. Capacity in project evaluation should be increased with modern equipment and trained/re-trained cadres.
- Protection measures should not conflict with the global and regional integration process. Administrative measures should be replaced by appropriate market forces. Trade liberalisation can create opportunities to improve the competitiveness of all sectors. However, competitiveness can be improved only in the absence of market distortion. The pre-conditions for successful liberalisation should be based on a sound macro-economic framework consistent with the correct choice of exchange rate regime and a strong and well-regulated domestic financial sector.
- The role of information should be given more emphasis. The excuse of confidential information should not be abused to argue for unnecessary regulations and decisions.

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Chapter Four
Thailand Country Paper

Nattapong Thongpakde & Srawooth Paitoonpong[1]

1. Introduction

Thailand was the first of the victims of the Asian financial crisis, and an alleged carrier of a new epidemic called "Tomyam Koong Disease."[2] Until the crash, Thailand had experienced rapid economic growth from the mid-1980s to the early 1990s, with average growth rates of 7.6 percent. The Thai economy rebounded strongly from the worldwide recession in the second half of the 1980s, with recovery beginning as early as the end of 1986 and continuing at least until 1995. Since July 1997, Thailand has been experiencing a severe economic meltdown. Without doubt, the crisis of Thailand is worth studying with respect to its causes and impact, with a view to providing lessons for future policy-making.

The primary objectives of the present study are to review the origin or causes of the Thai crisis, to examine its domestic socio-economic impact and its potential impact on the Southeast Asian transitional economies (SEATEs)—Cambodia, the Lao PDR and Vietnam—and to delineate policy implications. The paper is divided into four sections. The first gives a brief introduction to the objectives and outline of the study. The second deals with the causes of the crisis and its domestic impact. The third examines the potential impact on the SEATEs and prospects for the Thai economy. The final section provides concluding remarks, lessons learned and some policy recommendations.

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[2] *Tomyam koong* is a world famous Thai hot and sour soup, which here refers to Thailand being the source of contagion of the Asian financial crisis.

2. Review of the Thai Crisis

2.1. Causes of the Crisis

The crisis was not the result of a single, time-specific event: it was the result of a process related to weak policies, weak institutions and weak management. In other words, the crisis was caused by many factors, including volatile international financial markets, weak corporate governance and domestic policy failures. An ILO report adds to this list of determining factors "crony capitalism"—political interference in the market via corruption, relatives and cronies of the government, plus excessive and misallocated investment and a consequent lower rate of return to capital (Lee 1998a). Another school of thought divides causes into immediate and root causes of the crisis, involving education, human capital, etc. Indeed, professional opinion is seriously divided. This section will limit its discussion to the immediate causes, with an emphasis on domestic economic factors.

2.1.1. Foreign exchange liberalisation within a fixed exchange rate system

Thailand's high economic growth was the result of export growth and the massive inflow of foreign loans due to foreign exchange liberalisation, with the establishment of the Bangkok International Banking Facility (BIBF) in 1993 and the Stock Exchange Commission (SEC) Act of 1992.

Foreign exchange liberalisation is a relaxation of cumbersome rules and regulations governing the foreign exchange system of a country which thwart smooth international transactions. Since liberalisation, there have been only a few restrictions governing foreign transactions, such as the prohibition of a Thai national or Thai juristic person[3] to invest in securities abroad. Liberalisation unquestionably has greatly facilitated international transactions, including foreign borrowing.

The BIBF was established in 1993 to facilitate international lending and borrowing. The aim was to establish Thailand as the financial centre of the region. Under this scheme, Thai banks and representatives of foreign banks are allowed to act as intermediaries for foreign international currency transactions. Activities related to the BIBF may be classified into three types: out-out, out-in and in-out. Out-out activities involve lending abroad by borrowing abroad. Out-in activities are those related to lending in the domestic market by borrowing abroad. In-out activities include lending abroad by borrowing from the domestic market. As expected, the out-in scheme has been the most successful of the three. Initially, the minimum amount of lending was $500,000. This subsequently rose to $2 million. The out-in scheme enabled small and medium-sized investors to gain access to cheap funds abroad.

[3] A legal term for a company registered in Thailand.

With a view towards financial liberalisation, the main objective of the SEC Act of 1992 was to develop the Thai capital market. It allowed limited companies and public companies to issue debt instruments abroad as private placement without permission from the Security Exchange Commission. Since the issuing of debt instruments can be done only by large companies, the act therefore gave large companies access to low-interest foreign funds.

With the basket system of foreign exchange, the Thai baht in effect was fixed to the US dollar, and as the exchange rate of the US dollar was quite stable this eliminated exchange rate risk. In addition, domestic investors as well as speculators took the advantage of the high interest rate differentials. As a result, the three schemes greatly promoted massive foreign borrowing through the BIBF and the issue of long-term debt instruments, which were mainly European Convertible Debentures. The loans were often used to finance investment in various sectors, especially property development and speculative activities. Evidence of the sharp rise in investment may be found in the drastic increase in the proportion of private investment spending in GDP, and in the high proportion of imported capital goods to total imports from 1993 to 1996.

The government at that time also unintentionally stimulated foreign borrowing by drastically expanding expenditure. Although the budget was in surplus, government spending continued to increase. During the 1993–95 period, government spending increased at an average rate of 17 percent. With the sharp increase in private and public spending, the Bank of Thailand (BOT) maintained high interest rates to keep inflation under control. High interest rates, stable exchange rates and economic prosperity induced more foreign borrowing.

The massive foreign borrowing and investment unfortunately caused the subsequent severe economic downturn. The massive borrowing led to an enormous increase in the foreign debt burden. Outstanding foreign debts increased from US$43.6 billion in 1992 to US$90.5 billion at the end of 1996. Foreign debts continued to increase in the first, second and third quarters of 1997, but then decreased during the fourth quarter of 1997 and the first and second quarters of 1998 to US $88.2 billion (Table 4.1 overleaf).

2.1.2. Weakened financial institutions due to high non-performing loans

Some foreign loans, moreover, were not used productively, and there was over-investment in many sectors, such as real estate and basic industries, causing massive excess supply. The excess supply of housing in and around Bangkok was expected to exceed 300,000 units, and the occupancy rate of office space in Bangkok dropped to only about 60 percent at the end of 1998. Due to excess supply, some investors are unable to repay both foreign and local debts. Non-performing loans

Table 4.1. External Debt, 1992–98 (billions of US dollars)

	1992	1993	1994	1995	1996	1997[p]	1997Q2[p]	1997Q3[p]	1997Q4[p]	1998Q1[p]	1998 May[p]
Total debt stocks (end of period)											
Public sector	13.07	14.17	15.71	16.40	16.81	17.17	17.35	17.02	17.17	17.70	17.42
Long-term	12.52	14.17	15.53	16.32	16.75	17.15	17.33	17.00	17.15	17.68	17.40
Short-term[1]	0.55	-	0.18	0.09	0.05	0.02	0.02	0.02	0.02	0.02	0.02
Private sector	30.59	37.96	49.15	66.17	73.73	67.32	75.60	71.76	67.32	63.17	61.81
Long-term	12.26	15.30	20.15	25.16	36.17	37.41	39.07	39.30	37.41	37.02	36.89
Short-term[1]	18.33	22.66	29.00	41.01	37.56	29.91	36.54	32.46	29.91	26.15	24.92
Commercial Bank	6.30	5.30	9.87	14.44	10.68	8.16	11.76	9.89	8.16	8.92	9.03
Long-term	0.80	1.30	3.45	4.44	2.31	2.55	3.28	3.07	2.55	2.84	3.84
Short-term[1]	5.50	4.00	6.42	9.99	8.37	5.62	8.49	6.82	5.62	6.09	5.19
BIBF[2]	-	7.74	18.11	27.50	31.19	30.08	32.57	31.17	30.08	27.82	26.54
Long-term	-	1.34	2.97	3.80	10.70	10.32	11.40	11.41	10.32	9.82	8.47
Short-term[1]	-	6.40	15.14	23.70	20.49	19.76	21.17	19.76	19.76	18.00	18.07
Non-bank	24.29	24.92	21.18	24.23	31.86	29.08	31.27	30.71	29.08	26.43	26.24
Long-term	11.46	12.66	13.73	16.91	23.16	24.55	24.39	24.82	24.55	24.36	24.58
Short-term[1]	12.83	12.26	7.44	7.31	8.70	4.53	6.88	5.89	4.53	2.06	1.66
Monetary authorities	-	-	-	-	-	7.29	-	4.48	7.29	9.30	8.99
Use of IMF credit	-	-	-	-	-	2.43	-	1.62	2.43	2.70	2.67
Others	-	-	-	-	-	4.87	-	2.86	4.87	6.60	6.32
Total	43.66	52.13	64.86	82.57	90.54	91.78	92.96	93.26	91.78	90.16	88.22
Long-term	24.78	27.47	35.68	41.47	52.92	61.85	56.40	60.78	61.85	63.99	63.28
Short-term[1]	18.88	22.66	29.18	41.10	37.61	29.93	36.56	32.48	29.93	26.17	24.94
Debt service ratio	10.5	10.7	11.3	11.4	12.3	15.8	16.6	15.3	16.7	20.3	n.a.
Public sector	3.7	3.7	3.4	2.8	2.5	2.6	2.0	3.3	2.2	3.1	n.a.
Private sector	6.8	7.0	7.9	8.6	9.8	13.2	14.6	12.0	14.5	17.2	n.a.

P = Projection. 1 = Short-term external debt is defined as debt that has an original maturity of one year or less. 2 = BIBF's debt has been adjusted to original maturity basis since January 1996, consistent with other external debt items. Source: BOT

proliferated as a result, creating problems for financial institutions. However, the problems were overshadowed by the illusion of the strong and unending economic prosperity at the time.

Table 4.2 indicates a significant increase in the proportion of non-performing loans to the total loans of commercial banks from June to December 1997. Although total loans increased slightly during this period, the proportion of non-performing loans to total loans drastically increased from 8.4 percent to 20.1 percent. The problem of bad debt in financial institutions is partly attributable to the supervision of the BOT. Unlike most central banks, the BOT also supervises financial institutions. In addition, in cases of troubled financial institutions, the BOT plays a supervisory role in the rehabilitation of those institutions. Since the BOT is independent from the Ministry of Finance and from politics, it has almost absolute power to oversee activities related to financial institutions, and there is no other economic agent involved in these activities. Some information about financial institutions is classified as secret and cannot be disclosed to the public. Due to this system, the efficiency of the supervisory role of the BOT has eroded over time.

Table 4.2. Loans and Non-Performing Loans of Commercial Banks (US$ billion)

	Total loans[1]		Non-performing loans		Growth Jun–Dec	Non-performing loans as percentage of loans	
	Jun 1997	Dec 1997	Jun 1997	Dec 1997	(percent)	Jun 1997	Dec 1997
Bangkok Bank	971,362	1,074,396	79,035	180,572	128.5	8.1	16.8
Krung Thai Bank	618,415	687,910	63,729	148,412	132.9	10.3	21.6
Thai Farmers Bank	563,272	609,494	41,434	105,379	154.3	7.4	17.3
First Bangkok City Bank	237,299	287,915	11,472	130,834	1040.5	4.8	45.4
Siam City Bank	198,378	233,634	14,233	70,401	394.6	7.2	30.1
Siam Commercial Bank	468,250	568,160	27,836	66,403	138.6	5.9	11.7
Bangkok Metropolitan Bank	170,879	187,614	28,460	62,688	120.3	16.7	33.4
Bank of Ayudhaya	369,947	406,568	22,276	55,147	147.6	6.0	13.6
Thai Military Bank	286,649	303,263	26,652	46,908	76.0	9.3	15.5
Bangkok Bank of Commerce	150,531	148,799	27,225	45,417	66.8	18.1	30.5
Laem Thong Bank	35,009	42,244	3,502	23,621	574.5	10.0	55.9
Bank of Asia	112,871	134,289	8,900	16,886	89.7	7.9	12.6
Thai Dhanu Bank	105,725	115,814	5,563	16,534	197.2	5.3	14.3
Union Bank of Bangkok	54,616	57,560	6,515	14,279	119.2	11.9	24.8
Nakornthon Bank	55,469	60,027	2,980	6,357	113.3	5.4	10.6
Total	4,398,672	4,917,687	369,812	989,838	167.7	8.4	20.1

1 = Prior to deduction of provision for possible loan losses. Source: Lewis (1998)

On 3 March 1997, the BOT ordered 10 financial companies which faced non-performing loans and insolvency problems to recapitalise within 45 days or face intervention from the Financial Institutes Development Fund (FIDF) if they were not able to recapitalise. On 27 June, the BOT made a decision to close down temporarily 16 insolvent financial companies, and subsequently closed a further 42 companies on 5 August.

2.1.3. Weak corporate governance

The question of how independent and transparent the management of the BOT and other regulators in the financial sector, such as the Stock Exchange of Thailand (SET) and the SEC, was brought to public attention following the disclosure of the Bangkok Bank of Commerce (BBC) problem. The BBC case has been described as the largest banking fraud in Thailand's history and one of the biggest in the world, and it cost the country more than 200 billion baht in bail-out funds. The problem arose when more than 75 billion baht was borrowed by politicians and/or companies controlled by them, of which only about 5 percent has been repaid.

The similar situation also appeared in a number of financial companies, where large sums of money were moved on the signatures of top executives alone. Executives from one company were under investigation by the BOT for allegedly having approved loans without sufficient collateral. Executives from another were under investigation in relation to approximately 2 billion baht in money transfers to its leasing unit with little or no supporting documentation to legitimise such payments. Similarly, three top executives from a third company have been charged by the BOT for approving loans exceeding 2.1 billion baht to two companies (located at the same address) which had a combined capitalisation of 310 million baht, and thus a combined negative net worth of 1.4 billion baht. In fact, such fraudulent transactions appear consistently, not only in the financial sector, and the ones who benefit from such transactions are those who have close relationships with politicians, government officials and company executives.

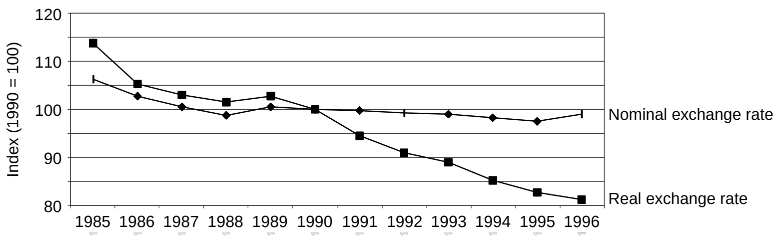
Viverito (1998) suggests that a lack of local accounting supervision brought on by a shortage of quality auditors, restrictions against foreign auditors, and ineffective controls, has contributed to the economic crisis in Thailand. The absence of corporate controls, the mingling of funds among listed and closely held companies of the same family, the use of multiple sets of accounting books, and highly paid rubber stamp directors are common characteristics of Thailand's private companies, and one of reasons that brought the Thai economy to the brink of collapse. For example, the profits of one electronics company had been overstated by at least US$164 million during a three-year period, and at least US$160 million had been transferred to other companies controlled by the founder without board approval. This generated a huge debt of US$450 million owed by the company.

2.1.4. Appreciation of the baht and an export slowdown

Economic prosperity came to an abrupt end in 1996. The US dollar, after reaching its lowest level of about 79 Japanese yen to the dollar at the end of 1995, rebounded strongly to a peak of about 127 yen to the dollar in mid-1996. As the Thai baht was pegged against a dollar-dominated basket system, it also appreciated against other

currencies. Figure 4.1 shows changes in the nominal and real exchange rates of the baht and the US dollar from 1985 to 1996. The nominal exchange rate (NER) of the baht appreciated from 27.16 baht to the dollar in 1985 to its highest level of 24.92 baht to the dollar in 1995, but then depreciated slightly to 25.34 baht to the dollar in 1996. The real exchange rate (RER) has also been continually and significantly appreciating since 1985, mainly due to a continuous and higher increase in price levels in Thailand than in its major trading partners. This in turn damaged Thailand's competitiveness and led to a slowdown of exports, especially in labour-intensive products, since the price of Thai exports, in terms of dollars, was no longer competitive.

Figure 4.1. Changes in Nominal and Real Exchange Rates (1985–96)



The problem was compounded by the inventory cycle in the United States, and the inventory cycle of electronics worldwide. Export growth dropped sharply from about 23 percent in 1995 to 0.5 percent in 1996. In fact, most regional countries also experienced an export growth slowdown. The export growth of Malaysia and Singapore, in particular, exhibited a similar pattern to that of Thailand. Since exports contribute about 20 percent of GDP, a drop in export growth obviously had a strong adverse impact on economic growth, and GDP dropped from 8.6 percent in 1995 to about 6.7 percent in 1996.

2.1.5. High current account deficit

Table 4.3 overleaf indicates a significant increase in the current account deficit during the 1987–96 period. The current account deficit increased from 0.7 percent of GDP in 1987 to 8.5 percent of GDP in 1990, and continued to be high, in a range between 5 and 8 percent, until 1996. In theory, rapid economic growth and the high current account deficit indicated an imbalance between aggregate demand and aggregate supply. The excessive expansion of demand due to the surge of investment financed by foreign borrowing is acceptable only if the investment projects pay off, especially in terms of foreign currency earnings. However, as mentioned above, most of the foreign borrowing had been used in a range of unproductive activities,

and this caused the economy to become more vulnerable to internal and external shocks. Moreover, since exports had stagnated and an over-supply situation had developed in various sectors, confidence in the Thai economy and in value of the baht eroded. Following the economic slowdown, the Thai economy has declined further, and hidden problems have begun to emerge which have greatly aggravated the severity of the downturn.

Table 4.3. Macro-Economic Indicators, 1987–97

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Economic growth (percentage)	9.5	13.3	12.2	11.6	8.4	7.8	8.3	8.8	8.6	5.5	-0.4
Inflation (percentage)	2.5	3.8	5.4	6	5.7	4.1	3.4	5.2	5.7	5.9	5.6
Current account / GDP (percentage)	-0.7	-2.7	-3.5	-8.5	-7.7	-5.7	-5.1	-5.6	-7.9	-7.9	-2.2
Exchange rate (baht to US dollar)	25.72	25.29	25.7	25.59	25.52	25.4	25.32	25.15	24.92	25.34	31.37
Export growth (percentage)[1]	28.5	34.6	27.9	14.2	23.0	13.7	13.5	21.6	23.6	0.4	27.9
Interest rate (percentage)	9.5	9.5	9.5	12.3	13.7	8.9	8.6	8.5	11.6	9.1	11.5

1 = Value of exports calculated in terms of baht. Source: *International Financial Statistics*, 1997; *World Economic Outlook*, 1998; BOT´s *Key Economic Indicators*, various issues.

2.1.6. Currency attacks and the depletion of foreign exchange reserves

The above discussion indicates the vulnerability of the Thai economy. The huge outstanding foreign debt accumulated from 1993 to 1996, high current account deficits for two consecutive years, an excess supply in property and other sectors, leading to high and increasing non-performing loans from financial institutions, the unusually strong baht, and the slowdown of exports, all made the baht unstable. As a result of these problems, the baht was under attack by international hedge funds for almost two years, and the BOT adopted a strategy of defending it by keeping interest rates high. The inter-bank rate began to rise, and the money market become less liquid. As a result of the unstable baht and other economic problems, capital outflows made credit tighter and interest rates surged. The high interest rates and tight credit market caused a further slowdown in private investment and consumption spending.

The severe attacks on the baht occurred in February and May 1997, as speculators gambled on the fact that the BOT would not able to endure in its precarious situation. To defend the baht, the BOT had to use foreign reserves to counter the attacks, by buying in the both spot and forward markets. In May alone, foreign reserves fell by as much as US$4 billion. The forward commitment of a long position on the baht taken by the BOT totaled an astonishing high of US$23.4 billion. In addition to the conventional scheme to defend the baht, the BOT also adopted a two-tier foreign exchange market system, and the foreign exchange market was separated into onshore and offshore markets in May 1997. Under this scheme, fi-

nancial institutions in Thailand were instructed not to conduct baht transactions in the offshore market in order to limit the supply of baht to currency speculators. As a result, the speculators were unable to find baht to cover their short positions, and were forced to settle with the BOT. Apparently, the scheme worked, at least in the short term, because the gap between the offshore and onshore rates was substantial at the beginning of the scheme. The gap has since become narrower, especially following the floatation of the baht, casting doubt on the effectiveness of the scheme, and BOT finally abolished it in early 1998.

Following the attack in May, the financial situation worsened. The money market has become tight, reflected by the surge of inter-bank interest rates, which peaked at almost 30 percent. Capital outflows rose and foreign reserves continued to dwindle. At the end of May, the minimum lending rate (MLR) and minimum overdraft rate (MOR) rose sharply as liquidity was drained from the system. The situation deteriorated as high interest rates slowed the economy, non-performing loans rose, and rumours about financial difficulties spread. Panic ensued, resulting in deposit runs at many financial institutions and producing a liquidity crunch in those companies. The problems in the financial sector finally began to spread to the production sector, due to tight liquidity and high interest rates. Speculation about the devaluation of the baht became stronger, causing capital outflows which, in turn, caused a drain on liquidity in the financial markets.

Finally, the BOT on 2 July 1997 decided to abandon the old exchange rate regime of the basket system and adopted a new managed float regime. Under this new regime, the value of the baht is determined by supply and demand. The former process, whereby the mid-rate was quoted by the Exchange Equalisation Fund each morning, has been cancelled. The new regime uses the reference rate, which is the average closing rate of the baht traded by 15 commercial banks on the previous day, and the baht is expected to move according to market conditions. The exchange rate is closely monitored by the authorities, who have said that they will intervene when necessary to stabilise the rate within an unspecified range.

The severity of the economic downturn and problems accumulated during the economic expansion reveal that the Thai economy and policy-makers were not ready for the globalisation of capital mobilisation. There were weaknesses in various institutions, including the financial system and the supervision of the financial system, policy-making processes and in the business community. For the Thai economy to have sustainable prosperity, these weaknesses must be seriously dealt with and structural adjustment in various sectors, the financial sector in particular, are needed. In the end, the Thai government was forced to request assistance from the International Monetary Fund (IMF) to alleviate the economic crisis.

2.2. Impact of the Crisis

2.2.1. Exchange rate instability and an increase in the debt burden

Unfortunately, as in most countries whose currencies were floated, the baht has been volatile. As expected, the baht has depreciated because it had been considered overvalued. Since the change in the exchange rate regime, the baht depreciated considerably, from about 26 baht to the US dollar prior to floatation to about 30 to 32 baht to the dollar in the first two months afterwards. It then dropped to about 35 to 37 baht to the dollar at the beginning of October, and continued to depreciate, hitting its lowest point in January 1998 of 56 baht to the dollar (a depreciation of more than 100 percent). The baht has since appreciated, becoming stable in the range of 39 to 41 baht to the dollar from the middle of March 1998, and further increasing to 36 to 37 baht to the dollar at the beginning of November 1998.

Although the floatation of the baht was considered a first and necessary step to revive the ailing economy, it will have far reaching effects on the Thai economy in the short term. Since foreign debts were as high as US$92.96 billion at the end of the second quarter of 1997, the depreciation of the baht led to an immense burden for Thai debtors. Many corporations will go bankrupt as a result.

2.2.2. Financial sector

As mentioned above, many finance companies and commercial banks have experienced the problem of insolvency because an increasing share of their loans became non-performing, undermining profitability. They have also faced liquidity problems since they have to pay back foreign loans. Due to the economic situation, foreign lenders are unwilling to roll over the short-term debt. Furthermore, in the middle of 1997, there was a run on deposits in finance companies and some small commercial banks because of the lack of confidence. These institutes had to borrow from the BOT through the FIDF, which acts as the lender of last resort. The excessive debt burden and under-capitalisation of financial institutes caused the BOT to intervene in their operations.

On 27 June 1997, the BOT temporarily closed down 16 financial companies, and then closed down a further 42 financial companies on 5 August 1997. Since the economic situation had not improved during that period, the BOT decided to permanently close 56 of these 58 financial companies in December 1997. This closure reduced liquidity in the financial system. Because of high non-performing loans, the existing finance companies and commercial banks needed to increase their capital to a satisfactory ratio. Furthermore, the BOT initiated a new standard on the provision of financial institutes' loans, so these commercial banks were required to increase their reserves. There is no incentive for financial institutes to provide loans

to business, with the exception of longstanding customers who have a good record, since they have to raise the provision and capital if the loans turn bad.

Taken together, these factors caused a credit crunch and high interest rates. The credit crunch arose as banks were reluctant to lend to corporations whose balance sheets had deteriorated as a result of the depreciation of the baht, which in turn led to a contraction of the economy, since support to domestic private companies by local financial institutions had been withdrawn. In addition, the credit crunch could also be viewed as a result of the set of conditions stipulated by the IMF, along with its rescue package, for the purpose of financial reform. The tighter regulations and supervision of financial institutions were needed in order to restore confidence in and the stability of the financial system, but made it more difficult for investors to secure bank loans. Without doubt, the credit crunch directly led to in a fall in investment.

High interest rates were also an obstacle to investment. Although high interest rates could be viewed as a mechanism to screen out bad borrowers, they discourage investment. Inter-bank rates stayed in a range of 9–11 percent in 1995–96, surged to 15–16 percent in 1997, and continued to increase to approximately 20 percent in the first four months of 1998 (Table 4.4 overleaf). The MOR and MLR also moved in a similar fashion, where the MOR increased from 13.25–13.50 percent in June 1997 to 15.75–16.25 percent in April 1998, while the MLR increased from 12.75 percent to 15.25–15.50 percent during the same period.

Vichyanondh (1998) suggests that the primary reason for the escalation of interest rates is that money supply was increasingly drained from the system. The difference between the balance of payments (BOP) and the government cash surplus (GCS), which represents the net amount of money injected into the system, fell significantly from 53.3 billion baht in 1995 to 11.4 billion baht in 1996, and to -308.3 billion baht in 1997, mostly attributed to the worsening BOP. The drastic deterioration of the BOP was mainly due to speculation on baht devaluation and the repayment of external debts in 1996–97. However, in 1998, the improvement of the BOP, a further decrease in manufacturing production and private investment have not resulted in a reduction of interest rates. In contrast, interest rates have moved up slightly, which in turn indicates that the credit crunch in 1998 was not caused by illiquidity, but rather was due to the IMF requirements mentioned above.

Although the government recently attempted to relax its monetary policy and reduce interest rates in order to stimulate the economy, the commercial banks are still unwilling to lend due to the problem of non-performing loans.

Table 4.4. Macro-Economic Data, 1995–98

		Private investment index	Production (growth of 12-month average)	BOP billions of baht)	GCS (billions of baht)	BOP-GCS (billions of baht)	Inter-bank interest rate (percent)	MOR (percent)	MLR (percent)
1995	Jan	115.6	8.8	-12.1	9.6	-21.7	12.43	11.75	11.75
	Feb	119.1	10.0	14.0	4.2	9.8	13.20	12.25-12.75	12.25
	Mar	121.4	10.3	-11.9	-1.4	-10.5	14.26	13.00-13.25	13.00
	Apr	122.9	10.8	32.9	9.5	23.4	13.08	13.50-13.75	13.50
	May	123.0	11.6	37.3	20.6	16.7	10.84	13.50-13.75	13.50
	Jun	125.0	11.8	43.3	30.7	12.6	9.50	13.50-13.75	13.50
	Jul	128.3	12.1	-8.6	22.5	-31.1	6.97	13.50-13.75	13.50
	Aug	124.2	12.1	21.8	-4.9	26.7	9.46	13.50-13.75	13.50-13.75
	Sep	124.1	12.2	28.6	17.3	11.3	11.30	13.50-13.75	13.50-13.75
	Oct	118.6	12.0	0.3	14.9	-14.6	8.65	13.75-14.00	13.50-13.75
	Nov	120.0	11.7	12.6	4.3	8.3	11.56	14.00	13.75
	Dec	118.9	11.9	21.3	-1.1	22.4	10.29	14.00-25	13.75
1996	Jan	118.0	11.7	24.8	15.4	9.4	7.06	14.00	13.75
	Feb	115.6	11.8	15.3	1.2	14.1	8.26	13.75-14.00	13.75
	Mar	113.4	10.8	9.9	-0.6	10.5	6.58	13.75-14.00	13.75
	Apr	111.4	10.3	-2.0	14.9	-16.9	6.12	13.75-14.00	13.75
	May	107.6	9.6	7.7	6.0	1.7	6.82	13.75-14.00	13.25-13.75
	Jun	104.0	8.9	20.5	36.0	-15.5	9.78	13.75-14.00	13.25-13.75
	Jul	101.3	8.3	-17.1	5.6	-22.7	10.54	13.25-13.75	13.25-13.50
	Aug	100.1	7.8	2.6	1.2	1.4	10.77	13.25-13.75	13.25-13.50
	Sep	100.9	7.7	8.4	6.4	2.0	12.94	13.25-13.75	13.25-13.50
	Oct	101.7	8.0	10.0	4.7	5.3	10.11	13.25-13.75	13.25-13.50
	Nov	98.8	7.6	-6.2	-17.2	11.0	10.70	13.25-13.75	13.25-13.50
	Dec	98.5	7.2	-19.2	-30.3	11.1	12.12	13.25-13.50	13.00-13.25
1997	Jan	96.3	7.4	24.7	2.9	21.8	10.65	13.25-13.50	13.00-13.25
	Feb	93.2	6.5	-26.6	-5.0	-21.6	14.94	13.25-13.50	13.00-13.25
	Mar	92.0	6.9	-0.7	0.6	-1.3	8.34	13.25-13.50	13.00-13.25
	Apr	91.1	6.7	-15.5	7.6	-23.1	8.75	13.25-13.50	12.75-13.00
	May	88.4	6.7	-112.3	-4.7	-107.6	12.13	13.25-13.50	12.75
	Jun	88.3	6.8	-24.6	29.5	-54.1	15.10	13.25-13.50	12.75
	Jul	88.2	6.7	-51.5	-18.7	-32.8	18.66	14.25-14.50	13.75
	Aug	83.5	5.6	-146.1	-21.9	-124.2	15.43	14.25-14.50	13.75
	Sep	80.2	4.3	133.0	21.5	111.5	23.87	14.75-15.00	14.25
	Oct	74.9	2.3	58.3	-17.4	75.7	18.72	15.25-15.50	14.75
	Nov	73.4	0.6	-185.0	11.9	-196.9	19.99	15.25-15.50	14.75
	Dec	69.7	-0.8	46.9	2.6	44.3	21.73	15.75-16.00	15.25
1998	Jan	61.0	-2.4	-19.5	3.5	-23.0	21.51	15.75-16.00	15.25
	Feb	55.8	-3.9	-26.7	0.4	-27.1	19.83	15.75-16.25	15.25-15.50
	Mar	49.5	-6.7	70.7	3.1	67.6	20.57	15.75-16.25	15.25-15.50
	Apr	40.5	-8.6	71.2	5.0	66.2	19.11	15.75-16.25	15.25-15.50
	May	n.a.	n.a.	-73.2	n.a.	n.a.	n.a.	n.a.	n.a.

Source: BOT

2.2.3. Savings and investments

The persistently high interest rates and economic downturn have forced most entrepreneurs either to abolish or to postpone investment projects. There are two signs of a decline in investment spending: a slowdown in the investment index, and a decline in both the number of projects which have applied for investment promotion

from the Board of Investment and the number of projects actually implemented. The number of applications for investment promotion from the Board of Investment decreased from 1,193 projects in 1996 to 993 projects in 1997 (Table 4.5 overleaf). The number is expected to further decline in 1998, as only 735 applications were made from January to October 1998. In addition, the number of projects actually implemented also fell, from 609 projects in 1996 to 480 projects in 1997. However, their number increased to 619 projects in the period from January to October 1998.

The process whereby investment varies directly with GDP is known as the acceleration principle. Theoretically, the accelerator works with a multiplier causing economic fluctuations. In case the of the current economic downturn, the theory fits rather well, as investment spending is declining with the downturn. However, in this case, the decline in investment is partly the result of the tight money market and high interest rates, not the economic downturn *per se*. Consequently, the downturn is more severe than normal.

The economic situation has deteriorated rapidly mainly due to liquidity problem. The BOT ultimately decided to relax monetary policy. The required reserve ratio was reduced from 7 to 6 percent, and the deposit rate of financial companies was tied to banks' deposit rates, such that the rate offered by financial companies cannot exceed the average rate offered by large banks by more than 3 percent.

A reduction of capacity utilisation was also leading to a fall in investment. According to a World Bank survey in 1998, capacity utilisation on average fell in five selected industries—garments, textiles, electronics, food processing and auto parts—from 1996 to the first half of 1997 and again in the second half of 1997. Half of the firms reported cutting back their capacity in the second half of 1997, and 40 percent anticipated a further contraction in their rate of production in 1998.

While a number of firms had cut back their capacity utilisation, 15 percent of firms reported expansion. However, it should also be noted that 70 percent of these are exporters and 60 percent are large firms. In addition, their overall increase in capacity utilisation was small (60 percent of firms reported increases of 10 percent or less). Moreover, more than 20 percent of firms had abandoned plans which were laid before July 1997 to expand their capacity.

The withdrawal of foreign money was also expected to affect savings and investment. However, this was likely to be reflected more in a decrease in investment rather than in savings, which in turn reversed the trend of the current account deficit during the past couple of years.

2.2.4. Effects on exports and imports

One positive result has emerged from the crisis, which is that exports of agricultural products grew since the prices of most agricultural products rose sharply, responding to the rise in exchange rates and increased demand with impact of the El Niño weather phenomenon on other countries. The volume and value of exports of such products was expected to increase.

However, considering exports aside from agriculture, the benefits from the devaluation of baht have not had as much effect on export volumes as expected. This is mainly due to the simultaneous collapse of other Asian currencies and also the shortage of working capital as a result of the credit crunch. Consequently, the total benefit from the depreciation is obviously lower than the depreciation of the baht in 1984, when most exports were agricultural and labour-intensive products. Exports for the first three months following the baht floatation support this conclusion. In July and August, exports increased about 25 percent in baht terms and 8 percent in US dollar terms. In September, exports unexpectedly grew 54 percent in baht terms and 12 percent in dollar terms. This positive trend continued throughout 1997, with total exports in 1997 significantly increasing by 27.9 percent in baht terms and 10.1 percent in dollar terms. Orders have been received by many exporting companies showing signs of a strong recovery; however, credit shortages may hinder the recovery. Many small and medium exporters, though in possession of orders, will be unable to fulfill their obligations due to a lack of credit and liquidity.

Exports in US dollar terms in the first quarter of 1998 compared to those in the first quarter of 1997 fell by 1.6 percent, even though exports in baht terms significantly increased by 79.4 percent. This in turn reflected a slight increase in the volume of exports benefiting from the drastic devaluation of the baht. Although the exchange rate became more stable in the second quarter of 1998, exports worsened, since exports in dollar terms fell by 6.7 percent. This can be viewed as a result of intensifying competition among crisis-facing countries, fewer exporting markets and the credit crunch.

Moreover, other countries in Asia were also affected by the depreciation of their currencies against the US dollar. During the period from 1 July 1997 to 13 July 1998, the Japanese yen and Taiwanese dollar depreciated by approximately 23 percent, while the Singaporean dollar and the Malaysian ringgit depreciated by 21 and 68 percent respectively. Indonesia was most severely affected by the crisis—the relative value of rupiah to the dollar on 13 July 1998 was five times less than it was on 1 July 1997. Since exports from Thailand to East Asian and Southeast Asian countries in 1996 accounted for almost 50 percent of total Thai exports, such a collapse of Asian currencies would significantly affect exports, not least because it would affect prospects of increasing exports to these countries.

Thailand’s total imports significantly decreased from US$72.32 billion in 1996

to US$61.34 billion in 1997. In other words, the crisis as well as the depreciation of the baht adversely affected imports, since the growth rate of imports in 1997 fell by 15.2 percent. Imports continued to decrease in the first and the second quarters of 1998, with growth rates of -37.3 and -38.1 percent respectively compared to those in the same period of the previous year.

2.2.5. Severe decline in economic growth and high inflation

As mentioned above, Thailand had experienced rapid economic growth from the mid-1980s to the early 1990s, and this trend continued until 1995, with growth averaging 8 percent per year. However, the growth rate dropped to 5.5 percent in 1996. One of many factors behind this decline in economic growth was a slowdown of exports. Although the economic crisis in 1997 resulted in a further decline in economic growth, this can be viewed as a result of the aggregate demand contraction and conditions set up by IMF.

A decline in the private investment index during 1996–98 reflects a drastic fall in investment in Thailand (see Table 4.4 above). The private investment index stood at 118.0 in January 1996, but then continued falling, hitting a low of 40.5 in April 1998. The same trend can be seen in the growth rate of manufacturing production. Although this growth rate was quite high in 1995 and the first half of 1996, it then started to fall. The decline rate of manufacturing production by 8.6 percent in April 1998 indicates a severe contraction of production in the manufacturing sector.

Abiding by the IMF conditions in the early stage of the crisis caused a further contraction of the economy. The Thai government had to adopt strict monetary and fiscal policies in order to meet IMF conditions on the government budget surplus. A number of measures had been applied since the crisis, such as reducing the government budget and maintaining high interest rates. This, in turn, seriously hurt real sectors of the economy, as many businesses and industries were hit by the credit crunch and thus went bankrupt.

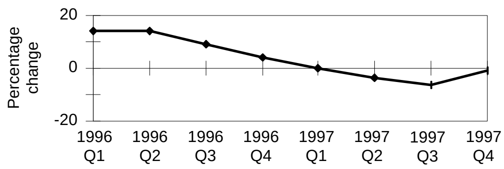
The growth rate of Thai economy in 1997 was -0.4 percent. Moreover, according to the sixth letter of intent proposed to IMF, the Thai economy was expected to further deteriorate in 1998. The real GDP growth rate at constant prices was expected to be in a range of -7 to -8 percent. The current account balance in 1998 was expected to be positive at US$13.5 billion—11.5 percent of GDP. This surplus was expected to result from a reduction in imports in US dollar terms of 25 to 30 percent rather than from an increase in exports. Such a high current account balance, which reflects weak domestic demand, carries over into higher projected reserves of approximately US$28 billion by the end of the year.

The depreciation of the baht could also increase import prices of finished goods, intermediate products and raw materials, including crude oil and petroleum products. Inflation is also expected to surge. To alleviate the situation, the Department of Commerce has launched a number of measures to counter inflation. The government also slowed the increase in the price of public utilities, such as electricity, telecommunications, and water, for about six months. Rising oil prices, due to the depreciation of the baht, were partly neutralised by the declining trend in world oil prices. Nevertheless, the increase in prices of imported goods, intermediate products and raw materials, crude oil and petroleum products, in particular, will eventually be transmitted to a rise in consumer prices when stocks of these goods have been depleted. Although the recent inflation rate is much higher than those in the last decade, it has not been as high as anticipated, since there are many deflationary factors such as the economic slowdown, budget cuts, a reduction in consumption and a slowdown in investment. The inflation rate for 1997 was 5.6 percent, slightly down from the previous year. In addition, according to the esti-mate in the IMF's sixth letter of intent, the inflation rate for 1998 is expected to be 8 percent.

2.2.6. Government revenue and expenditure

Government revenues were also affected by the crisis. As shown in Figure 4.2, government revenues began to deteriorate in the first quarter of 1997 and then significantly decreased in the third quarter. Although an improvement of government revenues could be seen in the fourth quarter, this was probably the result of the policy of increasing value-added tax (VAT) and gasoline and diesel excise taxes rather than because of a recovery of the economy.

Figure 4.2. Changes in Government Revenue, 1996–97



One can view government expenditure as a main factor in stabilising or stimulating the economy, and the reduction of government revenue thus also affects government expenditure in a number of crucial areas, such as expenditure for projects on human development (health and education), technological development, and those aimed at increasing domestic aggregate demand. Such a reduction in government expenditures therefore affected both real economic and social sectors.

The budget cuts resulting from the tight fiscal policy also affected government expenditure. Since it is difficult to reduce administrative expenditures, such as salaries, government investment in a number of projects mentioned above, including investments in physical and institutional infrastructure, had to be cancelled or postponed. This in turn affected the future prospects of economic growth.

2.3. Social Impacts

The social impact of the crisis covers a wide range of problems, including employment, education, health, crime and social security, drug abuse and trafficking, as well as the institution of the family. This section will highlight selected social problems resulting from the crisis, with an emphasis on unemployment.

2.3.1. Unemployment

One of the major social impacts of the crisis in Thailand is high and widespread unemployment. Unemployment reflects social suffering through the loss of income, means of obtaining basic needs and quality of life, as well as social status. A person's employment not only indicates his or her utilisation of time for productive purposes but also for social purposes. It also determines, or is closely related to, a person's social behaviour. This section reviews the unemployment situation before and after the crash, under the presumption that the crisis is a major cause of unemployment and other employment problems.

By and large, the credit crunch forced most manufacturers to reduce production, and this led to a fall in output. This in turn affected employment, as many economic sectors had to lay off workers or reduce their working hours at high and low ends of the market.

To understand the impact of the crisis on the employment situation, a few observations should be made regarding Thailand's employment statistics. First, Thailand's employment is highly seasonal. As shown below (Table 4.6), employment varies according to the agricultural seasons, which can be simply divided into the dry or slack season (around February) and the wet or peak season (around August). Thus, comparison of employment data across a year should make reference to the time of survey (e.g. it is not correct to say that employment fell from 33.2 million in 1997 to 29.4 million in 1998 because of the crisis, as the decline was in fact due mainly to seasonal reasons). Second, the unemployment rate of Thailand is generally low for three major reasons: 1) there is no unemployment insurance system which would encourage workers to report their unemployment; 2) there is no registration system for the unemployed, and the measurement of unemployment is thus based on sample surveys which have limited coverage and definition of em-

Table 4.6. Seasonal Change in Employment 1993–98 (millions of people)

	Round one (February)	Round three (August)	Percentage Change
1993	29.21	32.15	10.07
1994	28.23	32.10	13.71
1995	29.06	32.58	12.11
1996	30.10	32.23	7.08
1997	30.27	33.16	9.55
1998	29.41	31.74	7.92

Source: NSO, *Report of the Labour Force Survey* (various years)

ployment status; and 3) partly because of the first reason given above, and the nature of the Thai economy and society, those facing unemployment, particularly the low income class, simply cannot afford not to work and therefore have to find employment in the agricultural or informal sectors. In addition, the impact of the crisis on employment does not always show up in the form of unemployment or layoffs. Reductions of wages and salaries or working hours have also been commonly practised during the crisis.

Changes in unemployment during the crisis can be observed from the data in Table 4.7. For the dry season, the total number of unemployed people more than doubled from 700,000 in February 1997 to 1.48 million in February 1998. The size of the labour force waiting for the farming season also increased from 1.04 million in 1997 to 1.25 million in 1998. The size of the labour force (excluding those waiting for the farming season) in February 1998 contracted from 30.96 million to 30.89 million. In the wet season, the number of unemployed people increased almost fourfold, from 290,000 in August 1997 to 1.13 million in August 1998.

Table 4.7. Labour Force by Work Status, 1996–98 (millions of people)

	1996			1997		1998		
	Round 1 (Feb)	Round 2 (May)	Round 3 (Aug)	Round 1 (Feb)	Round 3 (Aug)	Round 1 (Feb)	Round 2 (May)	Round 3 (Aug)
Population	59.75	59.90	60.05	60.35	60.65	60.95	61.10	61.25
Labour force	31.90	32.50	32.75	32.00	33.56	32.14	32.17	32.94
Current labour force	30.74	31.04	32.59	30.96	33.45	30.89	30.17	32.88
Employed	30.10	30.38	32.23	30.27	33.16	29.41	28.55	31.75
At work	28.09	28.57	31.76	28.31	32.71	26.96	25.77	31.07
Not at work	2.01	1.81	0.47	1.96	0.45	2.45	2.79	0.68
Unemployed	0.64	0.66	0.35	0.70	0.29	1.48	1.61	1.13
Looking for work	0.12	0.16	0.11	0.18	0.10	0.40	0.49	0.52
Not looking for work	0.52	0.50	0.24	0.52	0.20	1.08	1.12	0.62
Waiting for the farming season	1.16	1.47	0.16	1.04	0.11	1.25	2.00	0.06
Not in labour force (aged over 13)	13.74	13.25	13.12	14.33	13.24	14.89	14.98	14.33
Doing housework	4.01	3.83	3.54	4.20	3.45	4.34	4.27	3.58
Studying	5.47	5.30	5.52	5.81	5.58	6.09	6.05	6.17
Too young or old to work	3.38	3.40	3.38	3.45	3.52	3.66	3.84	3.65
Other	0.89	0.73	0.68	0.87	0.69	0.80	0.81	0.93
Aged less than 13	14.11	14.14	14.18	14.01	13.85	13.92	13.95	13.98

Source: NSO, *Report of the Labour Force Survey* (various years)

Additional information (Table 4.8) indicates that approximately 80 percent of the people unemployed were in rural areas, with 874,000 in rural areas compared to 260,000 in urban areas. However, the unemployment rate, the ratio of the unemployed to the labour force in the same area, is higher in urban than in rural areas, 3.84 compared to 3.34 percent in 1998.

Table 4.8. Urban and Rural Employment, 1996–98 (millions of people)

	August 1997			August 1998		
	Urban	Rural	Total	Urban	Rural	Total
Labour force	6.77	26.69	33.35	6.76	26.12	32.88
Employed	6.70	26.47	33.16	6.50	25.25	31.75
Unemployed	0.07	0.22	0.29	0.26	0.87	1.13
Waiting for the farming season	0.00	0.10	0.10	0.00	0.06	0.06

Source: NSO, *Report of the Labour Force Survey* (1997 and 1998 Round 3)

The crisis also seems to have caused a structural change in employment. The NSO data shown in Table 4.9 indicate obvious declines in the construction sector, where employment fell from 2.98 million in February 1997 to 2.04 million in February 1998, and from 2.02 million in August 1997 to 1.31 million in August 1998. The obvious gain in employment was found in the service sector and in commerce and transport (dry season only). Surprisingly, in both the dry and wet seasons, employment in the agricultural sector was found to have decreased rather than increased. This suggests that the agricultural sector did not absorb as many workers as might have been expected during the crisis. The data in Table 4.7 support this argument, indicating that the size of the labour force waiting for the farming season was unusually high in early 1998—1.25 million people, compared to 1.04 million in February 1997. On the other hand, the increased employment in services and commerce suggests that the informal sector has worked as a safety net during the time of the crisis.

Table 4.9. Employment by Industry, 1996–98 (millions of people)

Industry	1996			1997		1998		
	Round 1 (Feb)	Round 2 (May)	Round 3 (Aug)	Round 1 (Feb)	Round 3 (Aug)	Round 1 (Feb)	Round 2 (May)	Round 3 (Aug)
Total	30.10	30.38	32.23	30.27	33.16	29.41	28.55	31.75
Agriculture	12.15	12.77	16.13	11.94	16.69	11.64	11.13	15.37
Non-agriculture	17.95	17.61	16.11	18.33	16.47	17.77	17.43	16.37
Mining and quarrying	0.06	0.06	0.05	0.06	0.05	0.06	0.04	0.04
Manufacturing	4.97	4.75	4.33	5.00	4.29	4.92	4.78	4.27
Construction and repair	3.13	2.69	2.17	2.98	2.02	2.04	1.92	1.31
Electricity, gas, water, etc.	0.16	0.19	0.14	0.17	0.18	0.19	0.23	0.19
Commerce	4.45	4.62	4.34	4.60	4.60	4.74	4.86	4.89
Transport, communications	1.04	1.05	0.95	1.10	0.98	1.07	0.96	0.99
Services	4.10	4.22	4.09	4.40	4.34	4.73	4.62	4.69
Other	0.05	0.04	0.02	0.01	0.01	0.01	0.02	0.00

Source: NSO, *Report of the Labour Force Survey* (various years)

If we assume that employment in the formal sectors can be represented by the number of "employers" and "employees," and employment in the informal sector

by the number of "self-employed" and "unpaid family workers," it would be expected that there would be a decline in the number or proportion of the employers/employees category and a corresponding increase in number or proportion of those under the self-employed/unpaid family workers category. However, the data in Table 4.10 do not support this conjecture. The proportion of the "self-employed" and "unpaid family workers" in rural areas increased from 56.9 percent in February 1997 to 58.6 percent in February 1998, whereas in urban areas the proportion decreased from 29.4 to 28.6 percent. The proportion of "employers" and "employees," on the other hand, decreased slightly from 36.8 percent in February 1997 to 34.4 percent in February 1998 in rural areas, and from 56.3 to 55.1 percent in urban areas. It should be noted, however, that the "employers/employees" category does not include government employees, since increases in the number of government employees are arbitrary and depend on government unemployment alleviation programmes that hired a large number of jobless workers.

Table 4.10. Employed People by Work Status, 1997–98 (millions of people)

	1997	Percentage	1998	Percentage	Percentage Change
Rural areas	23.74	100.0	22.85	100.0	-3.74
Employers	0.51	2.1	0.50	2.2	-1.76
Government employees	1.49	6.3	1.60	7.0	7.49
Private employees	8.23	34.7	7.35	32.2	-10.66
Self-employed workers	8.03	33.8	8.24	36.0	2.57
Unpaid family workers	5.49	23.1	5.17	22.6	-5.84
Urban areas	6.52	100.0	6.56	100.0	0.54
Employers	0.26	4.0	.29	4.4	8.57
Government employees	0.93	14.2	1.07	16.3	15.20
Private employees	3.41	52.3	3.33	50.7	-2.43
Self-employed workers	1.27	19.5	1.25	19.0	-2.20
Unpaid family workers	0.65	9.9	0.63	9.6	-2.64

Source: NSO, *Report of the Labour Force Survey* (1997 and 1998, round one)

2.3.2. Layoffs, under-employment and wage employment contraction

The unemployment figure alone does not describe the full impact of the crisis, as there are a considerable number of workers whose employment was affected by the crisis in forms of layoffs or reduced working hours or wage rates. Moreover, those who were laid off did not necessarily become unemployed. Since there are no unemployment benefits available and no substantial social insurance to cope with unemployment, some of those laid off had to earn a living in the informal sector or return to their hometown for social security.

Between February 1997 and February 1998, the number of people working less than 35 hours per week increased by almost two million from 2.43 million people (7.6 per cent of the labour force in 1997) to 4.41 million (13.7 percent) in 1998. Of this increase, about 1.2 million people were "private employees." The three sec-

tors with the highest rates of under-employment in early 1998 were agriculture (1.86 million people), manufacturing (1.1 million) and commerce (0.7 million). However, the largest increase in under-employment was found in the manufacturing sector (Table 4.11). The increase was relatively more significant in urban areas—the number of people underemployed in urban areas increased from 100,000 in 1997 to 650,000 in 1998, while in rural areas the number rose from 450,000 to 820,000 during the same period. Among the under-employed in urban areas, almost half of the men and three-quarters of the woman were in the industrial sector. Under-employment of a large number of industrial workers has emerged as a new phenomenon following the crisis (Siamwalla & Sopchokchai 1998).

Table 4.11. Underemployment by Industry, 1995–98 (thousands of people)

Industry	Working less than 35 hours per week				Change		
	1995	1996	1997	1998	1996	1997	1998
Total	2,309.2	2,473.8	2,432.2	4,411.9	164.6	-41.6	1,979.7
Agriculture	1,374.6	1,615.9	1,590.5	1,861.5	241.3	-25.4	271.1
Mining and quarrying	1.9	3.7	0.9	5.2	1.8	-2.7	4.3
Manufacturing	244.8	202.8	199.6	1,082.9	-42.1	-3.2	883.4
Construction and repair	102.2	104.7	88.1	198.0	2.4	-16.5	109.9
Electricity, gas, water, etc.	3.9	2.2	3.6	10.6	-1.7	1.4	7.0
Commerce	294.6	286.9	285.6	706.5	-7.7	-1.4	420.9
Transport, communication	64.1	67.8	59.0	113.0	3.7	-8.8	54.0
Services and other	223.0	189.8	205.0	434.0	-33.4	15.2	229.1

Source: Working Sub-Committee on Estimates of the Labour Force, Employment and Underemployment (second meeting report, 1998)

Although manufacturing employment had decreased slightly from the previous year (as shown in Table 4.9 above), a significant decrease in manufacturing employment after February 1998 was expected as illiquidity and insolvency problems became more serious. The Ministry of Labour and Social Welfare estimated that almost 300,000 people were laid off, more than half while their establishment was still in operation, and the rest because the establishment had closed down.

According to the Ministry of Labour and Social Welfare, about 4,900 establishments went out of business in 1997, laying off approximately 409,000 workers, while from January to August 1998, about 2,600 establishments closed down and laid off about 223,000 workers. The majority of lost jobs were in manufacturing factories, including the automotive industry, construction and the finance sector. It should be noted that number of jobs lost is likely to be underestimated, since it takes account only of establishments that have gone out of business, and does not include laid-off workers from downsized businesses. At the same time, it should also be noted that while some businesses were closing down, new businesses were hiring new workers. Looking at only the number of laid-off workers could exaggerate the unemployment situation.

From a different angle, the impact of the crisis on employment was shown in a drastic reduction in wage employment in the private sector, particularly during

1997–98. As shown in Table 4.12, in the dry season (February), the number of private employees fell in 1998 by 960,000, down to 10.68 million from 11.64 million in 1997. In the wet season, the number decreased by 1.03 million to 9.04 million in 1998 from 10.1 million in 1997.

Table 4.12. Changes in Wage Employment, 1994–98 (thousands of people)

	1994	1995	1996	1997	1998
February (first found survey)					
Private employees	10,130.2	10,732.1	11,681.0	11,638.6	10,678.7
Public employees	2,376.0	2,417.6	2,310.6	2,415.7	2,668.0
August (third round survey)					
Private employees	8,823.1	9,189.2	9,850.6	10,063.3	9,036.0
Public employees	2,334.5	2,424.1	2,300.6	2,426.2	2,693.2

Source: NSO, *Report of the Labour Force Survey* (various years)

2.3.3. Returned labour from abroad and new entrants to the labour market

Since the crisis has affected not only Thailand but most of the countries in Asia, there was an increase in the large number of labourers returning from abroad (e.g. from Taiwan and Brunei), and this exacerbated unemployment. Although the government adopted a number of policies to support labourers working abroad in order to alleviate unemployment, the targets have not yet been met. The return of workers from abroad could be expected to further exacerbate the unemployment situation.

The unemployment situation also has been and will be affected by the influx of new entrants to the labour market. The Thailand Development Research Institute (Thongpakde 1998) indicated that the number of graduates from all levels of education entering the labour market from 1997 to 2001 averages 525,800 people per year. Although more than half of the new entrants are university graduates, demand for this group accounts for only 20 percent of supply. This over-supply suggests that more labour will be unemployed. Moreover, considering supply and demand of labour during the period 1997–2001, TDRI maintains that there will be an excess demand for labour with primary and less than primary education, accounting for more than 219,000 people. In contrast, the excess supply of labour with secondary and university education accounts for more than 260,000 people. If the excess supply of labour is not able to adjust itself to work in the agricultural sector, where there is excess demand, unemployment among educated labour will become more serious. Although there is an excess demand for labour with primary and lower than primary education, this has been substituted by foreign labour, which recently accounted for more than 700,000 people. The policy to send these labourers back to their countries is therefore necessary, otherwise unemployment among uneducated labour will become more severe. Whether this policy will have an impact on the SEATEs is discussed below.

2.3.4. Migration

It is evident that a large-scale reverse migration is taking place, which is leading to an increasing number of unemployed people in rural areas. This in turn raises concerns about whether the rural Thai economy, especially the farming sector, is able to accommodate all of the returned migrants after years of neglect. The poor quality of public services (e.g. health and education), the already fragile state of natural resources and the environment, and the expected prolonged severe drought in rural areas, can together be viewed as obstacles to the expansion of the rural economy.

Before the crisis, most of the families living in rural areas consisted of elderly people and children, while younger people and parents of the children had moved away to work in Bangkok, other cities and overseas. Although the return of migrants would benefit society in the sense of reuniting families, this in turn increased the burden on women and the elderly to feed all members of the family, sometimes by using their savings. This happened especially when there were no other occupations, such as handicrafts and small-scale livestock, to accommodate the returnees. As shown above, even though there has been a trend of returning urban-rural migration, employment in the agricultural sector has not increased.

2.3.5. Declining social services

Another major concern centres on the social impact caused by a fall in government expenditure which in turn was occasioned by a fall in government revenue. Although there is increasing demand for public services, especially for health and education, budget constraints have forced the government to curtail some social programmes. In cutting expenditure, the government acted under the advice of the IMF. Following criteria set by the IMF, a number of programmes, such as low-priority programmes in the Eighth National Economic and Social Development Programme, non-urgent construction projects, and programmes which are no longer appropriate because of changing economic conditions, were liable to be cut. In contrast, programmes aimed at improving competitiveness, lessening the social impact of the crisis, and improving provincial economies, were not supposed to be affected by the budget cuts.

Although there was an attempt to follow these criteria, it was not consistent. The sharpest cuts were in transport and communications, but there were also severe cuts in the environment and social services (Siamwalla & Sopchokchai 1998).

More than 18 percent of the first budget submitted, totalling 182,000 million baht, was cut from the 1998 budget, which was revised several times to accommodate the IMF conditions. These budget cuts have directly affected a number of programmes related to social development organised by the Ministries of Education, Public Health, Labour and Social Welfare, and Interior.

The 1998 budget for the Ministry of Education, for example, shows a 10.7 percent reduction from the original budget bill with a cut of more than 17,730 million baht, leaving almost 148,580 million baht available for all the departments of the ministry. Because more than 80 percent of the budget was distributed to the National Primary Education Commission, the Department of General Education and the Department of Vocational Education, only about 25,690 million baht was available to the other nine departments in the ministry, including the Department of Non-Formal Education and the Teacher Civil Service Commission.

This decline in the budget raises concerns about human resources development of the country, as it is evident that the number of students dropping out of schools and universities has significantly increased since the crisis started. Such an increase can be viewed as a result of the loss of or reduction in income of parents, forcing their children to drop out of the education system to look for work. A survey by the Ministry of Education indicates that more than 45,000 students have been affected because their parents lost their jobs (UNDP 1998). Although the government has provided 1,000 million baht in loans for drop-out students, only 10 percent of this amount has been disbursed.

The crisis has affected not only students, but also both public and private schools, which face problems of falling budgets and increasing costs. Private schools across the country recorded 923 million baht in overdue tuition for the second semester of the 1997 academic year, and public schools saw decreasing budgets available for stationery, tuition fees and food.

The impact of the budget cuts on government scholarships should also be taken into consideration, since this is an important means to develop human resources in the government sector. The total number of scholarships provided by the Civil Service Commission in 1998 was higher than those provided in 1997, partly because of the introduction of a government programme aimed at increasing manpower in the government sector. This project provides 500 scholarships per year from 1998 to 2002. However, with the budget constraints, even though expenditure on scholarships was untouched and protected from the cuts, the value of the scholarships became insufficient due to the depreciation of the baht. The budget constraints also affected ongoing scholarships in the form of a 10-percent reduction in allowances, and a reduction in other expenses, such as funds for computers, learning materials, trips or seminars.

The Ministry of Public Health's budget also suffered a 14.6 percent cut compared to the 1997 budget. Although more than 75 percent of the 1998 budget, accounting for almost 45,250 million baht, was earmarked for the Office of the Permanent Secretary, only 13,260 million baht (22 percent of the 1998 budget) went to the Department of Medical Services, the Department of Communicable Disease

Control, the Department of Mental Health and the Department of Health. The insufficiency of public health services has now become severe, with public hospitals facing problems of overcrowding with less funds available, higher costs for imported medical supplies, and an increasing number of patients who can no longer afford private hospitals and clinics.

2.3.6. Other social problems

Apart from the social impacts mentioned above, other social problems, such as drug abuse, crime and prostitution, were also expected to increase due to the crisis. Since laying off a large number of workers has an immediate impact in terms of the loss of income, the shrinking economy also makes it more difficult for laid-off workers to find new jobs, and the drastic rise in the cost of living severely hurt this group. These factors may pressure or induce the unemployed to engage in crime. More and more criminal acts have been reported in the newspapers, with a notable rise in drug-dealing, robbery and car thefts. Furthermore, such tension may also worsen the problem of drug abuse, as some people may turn to drugs themselves.

Prostitution has long been a problem in Thailand. Although a survey by TDRI in 1998 suggested there had been a decrease in the total number of brothels and massage parlours operating in Chiang Mai as a result of the crisis, the total number of private or self-employed prostitutes was expected to increase.

Another group of people affected by the crisis were those in need of social welfare. Although expenditure on social welfare was protected from the IMF budget cuts, the amount of such expenditure fell in real terms as a result of the significant increase in the cost of living. Moreover, the increasing number of unemployed people and the reduced income of a large number of workers worsened the problem, since the demand for social welfare increased significantly while the supply remained unchanged.

3. Potential Impact on the SEATEs

3.1. Impact on Trade

The crisis caused a contraction in the Thai economy, which in turn reduced Thailand's demand for imports. One can observe that the current account surplus resulted mainly from declining imports rather than an increase in exports. Thailand is a market for the SEATEs' exports. In order to investigate the impact of the crisis on trade, this section examines changes in imports from the SEATEs before and after the crisis. The impact of the reduction of Thailand's imports on each SEATE country depends on how important Thailand is as a trading partner, *i.e.* on the magnitude of trade and on how sluggish the growth of imports has been.

With regard to the magnitude of imports, among the three countries the value of imports to Thailand from Cambodia was the highest during 1993–95, as shown in Table 4.13. However, the value of imports fell to only US$47 million in 1996 and US$70 million in 1997. The value of imports from the Lao PDR was second until 1997, when imports from Vietnam rose to almost three times their value in 1996 and surpassed those of the Lao PDR.

Table 4.13. Thailand's Trade with the SEATEs, 1993–97 (millions of US dollars)

	1993	1994	1995	1996	1997	1997				1998	
						Q1	Q2	Q3	Q4	Q1	Q2
Exports to											
Cambodia	179	260	334	363	307	94	83	63	73	72	78
Lao PDR	175	291	354	363	377	95	100	96	88	85	83
Vietnam	116	254	468	579	543	143	119	129	147	155	160
Exports to the SEATEs	470	805	1,156	1,304	1,226	332	302	288	309	312	320
Exports from Thailand	36,962	45,233	56,444	55,718	57,590	14,129	14,026	14,575	14,773	13,735	13,080
Imports from											
Cambodia	96	126	160	48	70	36	23	15	4	6	8
Lao PDR	63	69	70	68	55	20	21	12	7	9	8
Vietnam	85	39	43	66	183	34	36	53	54	55	49
Import from SEATEs	244	235	273	182	308	90	80	80	65	70	65
Imports to Thailand	46,075	54,435	70,784	72,319	61,338	17,484	17,206	15,167	12,914	10,951	10,649

Source: BOT

Although the value of imports from the Lao PDR to Thailand was small, due to the size of the Lao economy, Thailand was the second largest destination of Lao exports, after Vietnam, with a 20-percent share in 1996. Thailand was also the second largest market for Cambodia's exports. The export markets of Vietnam have been more diversified than those of the Lao PDR and Cambodia, and Thailand was not in the top 15 of Vietnam's largest export destinations. From this aspect, the Lao PDR and Cambodia would likely be affected by the Thai crisis more than Vietnam.

The data from Table 4.13 show that the growth rate of imports from the SEATEs to Thailand fluctuated a great deal from 1994 to 1997, especially in the case of Cambodia, whose growth rate in 1994 was 31 percent over the previous year, but in 1996 -70 percent from the previous year. Imports from Vietnam experienced an upward trend even in 1997 and the first half of 1998, the period after the crisis. The Lao PDR has been most severely affected by the crisis. Thailand's imports from the Lao PDR fell by 19 percent in 1997, and further deteriorated in the first and the second quarters of 1998 by 55 and 60 percent respectively. In contrast, imports from Cambodia and Vietnam grew by 47 and 178 percent respectively in 1997, even though Thailand's imports from Cambodia started to contract in the fourth quarter of 1997.

Diversification of export products lessened the impact of the crisis. Vietnam's major export products to Thailand include crude oil, frozen seafood, gems, animal

hides, chemicals and electronic goods. Trade in electronic products indicates links between Thai and Vietnamese electronics firms that produce for the international market rather than for domestic demand. In addition, the magnitude of trade between Vietnam and Thailand before 1997 was small compared to the size of the economy (the value of imports from Vietnam was less than those from the Lao PDR to Thailand in 1996). Thus, there is potential for trade expansion between these two countries, and the growth rates of imports in 1997 and 1998 were positive. Wood, wood products and electricity are the only major exports from the Lao PDR. Wood and wood products depend on the growth rates of production in Thailand's real estate and furniture sectors, which were severely affected by the crisis. Demand for electricity in Thailand also slowed significantly, and there was excess reserve in the generation system. The slowdown in exports from Cambodia resulted from both the unstable security and political situation there, which disrupted the trade flow between these two countries, and the contraction of the Thai economy.

It should be mentioned that the slowdown of imports to Thailand from the rest of the world is greater than that from the SEATEs, *i.e.* the economic crisis has had less effect on imports from the SEATEs compared to those from the rest of the world. Thailand's major imports from the rest of the world are machinery and parts and raw materials for production. These items are used for exports and for production in capital-intensive industries, such as petrochemicals, steel, automobiles and cement. Since export growth has been slow, especially for labour-intensive products, while domestic demand for import-substituting capital-intensive industries has declined substantially, the demand for imports for these industries also declined significantly.

The trade growth of the SEATEs has not only been affected by the crisis situation in Thailand, but also by the domestic environment of each country. The liberalisation policies in the SEATEs have increased trade and investment flows enormously, especially in Vietnam after the abolition of the US trade embargo. On the other hand, political instability and insecurity in Cambodia caused a fluctuation in trade, both for exports and imports, during the period of this study. Consequently, even if the situation in Thailand improves, internal factors in each country are still the major constraints on how far trade can be enhanced.

The above discussion focuses on the impact of the crisis on imports from and the economic growth of the SEATEs. There is another aspect of its impact on trade to the Lao PDR, which is an impact on inflation. The Lao PDR imports 80 percent of its total import value from Thailand. Higher inflation in Thailand can therefore be transmitted to the Lao PDR via higher import prices, and the depreciation of the baht does not offset inflation, since most transactions and border trade are conducted in baht.

There is also some concern that Vietnam will lose competitiveness to Thailand due to the depreciation of the baht. However, the baht exchange rate at 36 baht to the dollar is about the same as the depreciation rate of the Vietnamese dong. Furthermore, the major export markets of Vietnam are Japan, Germany, Singapore and France, while the major markets for Thailand are the Association of Southeast Asian Nations (ASEAN), Japan and the United States. Japan appears to be a major market in which Thailand competes with Vietnam. However, the export products of Thailand to Japan are semi-high-technology intensive, while those from Vietnam are processed products and labour-intensive. Thus, arguments that the crisis intensified competition between these two countries are not conclusive.

3.2. Impact on Investment

Foreign direct investment (FDI) has long been regarded as a major factor in the development process in developing countries. Countries may benefit from technology transfer, export generation, employment generation and industrial links as a result of FDI. A number of developing countries, including the SEATEs, have therefore pursued policies to attract FDI. For transitional economies, FDI is also an important factor promoting integration with the world trade system, since these countries still lack entrepreneurs and international market channels following long periods under centrally planned economies.

Thailand is one of the major investors in all three SEATEs. The value of Thailand's investment in the Lao PDR from 1988 to March 1998 was US$2.66 billion, the highest among foreign investors in the country (Table 4.14). Thai entrepreneurs invested in various sectors, such as hotels, electricity, garments, banking, telecommunications and wood products. Although the number of Thai investment projects in the Lao PDR significantly increased during 1991–94, investments started to rise

Table 4.14. Thai FDI in the Lao PDR, 1988–98 (millions of US dollars)

	Number of projects	Project value[1]	Total investment[2]
1988	4	0.69	0.89
1989	21	11.08	61.42
1990	10	4.22	5.17
1991	23	92.93	112.78
1992	35	34.95	39.27
1993	55	56.55	88.39
1994	46	1,571.98	2,528.57
1995	19	161.53	760.50
1996	18	646.57	1,034.77
1997	13	5.68	7.27
1998 (Jan-Jun)	11	n.a.	81.62[3]
Total	255	2,586.20[4]	4,720.64

1 = Value of FDI for the whole project, including the share of other countries' investments; 2 = Including the share of Lao investors; 3 = The Laos Railway Transportation project accounts for US$75 million of this; 4 = Until 1997; Source: Board of Investment

at a slower pace after 1995. There were 55 Thai investment projects in 1993, but the number dropped to 13 projects in 1997.

Thailand is the eighth and the tenth largest foreign investor in Vietnam and Cambodia respectively. Until 1997, there were 109 Thai investment projects in Vietnam with total value of US$1.04 billion, while Thailand's investments in Cambodia were worth US$44.6 million during the same period.

Table 4.15. Thai FDI in Vietnam, 1988–97 (millions of US dollars)[1]

	Number of projects	Registered capital	Legal capital
1988	37	371.8	288.4
1989	68	582.5	311.5
1990	108	839.0	407.5
1991	151	1,322.3	663.6
1992	197	2,165.0	1,418.0
1993	269	2,900.0	1,468.5
1994	343	3,765.6	1,729.9
1995	370	6,530.8	2,986.6
1996	325	8,497.3	2,940.8
1997	340	4,462.5	2,148.8
Total	2,208	31,436.8	14,363.6

1 = Excluding VIETSOVPETRO projects and licensed projects in export-processing zones. Source: *Vietnam Statistical Yearbook* 1997

There are three reasons motivating FDI: one is to utilise host countries' resource endowment; a second is to produce for domestic demand; and a third is to use the host country as an export base, taking advantage of strategic factors such as location or low-wage labour. As mentioned above, Thailand has invested in a range of activities in the SEATEs, covering the agriculture, manufacturing and service sectors. Most projects are aimed at using host country resources to serve regional demand, or utilising domestic demand, rather than producing for export. The rate of natural resource deterioration in Thailand has increased over time, and utilisation of natural resources in the SEATEs has been one of the major motivations behind Thai FDI in the SEATEs.

The economic crisis has discouraged outward investment from Thailand. Over-capacitiy in some industries, such as cement and automobiles, reduced the incentive to invest in the SEATEs. Over-capacity in Thailand not only results in no expansion of capacity in Thailand, but also affected investment expansion in the SEATEs. The credit crunch, which arose when banks were reluctant to lend to corporations whose balance sheets had deteriorated as a result of the depreciation of the baht and the consequent drastic increase in their foreign debt, also restricted investment, not only abroad but also in Thailand. Moreover, the unwillingness of foreign creditors to lend to banks worsened the problem. Since banks have become much less willing to lend to their customers, it is unlikely that Thai investment can soon expand either domestically or internationally.

Although the economic crisis directly resulted in a decline in investment in Thailand, and thus an expected decrease in Thailand's investment in the SEATEs, internal factors of the host country have also had a strong effect on a decline of Thai investment. Slow economic growth and excess supply, such as in the case of the hotel and real estate sectors in the SEATEs, made investments in these countries less attractive.

In addition, a number of rules and regulations in the SEATEs can also be viewed as obstacles to FDI, even before the crisis. For example, the under-utilisation of the Mekong Bridge from Nong Khai to Vientiane, where regulations do not permit the entry of cars from Thailand and visa entry requirements limit the time available for travel in the region, have obstructed the movement of people. Consequently, the elimination of rules and regulations that obstruct the flow of border trade and the movement of people will be likely to attract more FDI, and thus benefit the SEATEs. The data available indicate that the value of FDI had been declining even before the crisis, reflecting other factors such as the absorptive capacity of the host countries and obstacles posed by regulations.

3.3. Impact on Tourism

One of the factors worsening the current account deficit was the foreign exchange outflow due to the large number of outward-bound Thai tourists, who are notorious big spenders. The depreciation of the baht, coupled with the slowdown of economic growth, made travel abroad more expensive. It would thus be anticipated that the number of outward Thai tourists would decline, and available data confirms this hypothesis. In 1996, the number of outward Thai travellers was 1.82 million. This dropped by 10.2 percent to 1.64 million in 1997, and further decreased by 25.86 percent from January to July 1998 compared with the same period in 1997 (Table 4.16).

Table 4.16. Outward-Bound Thai Tourists, 1996–98 (thousands of people)

Destination	1996	1997	1997 (Jan–Jul)	1998 (Jan–Jul)
Laos	141.08	153.23	76.12[1]	105.81[1]
Cambodia	14.83	14.14	9.92	6.69
Vietnam	16.46	16.72	10.22	8.60
Myanmar	25.77	26.57	15.19[1]	12.73[1]
Singapore	268.56	211.11	132.75	95.52
Hong Kong	273.45	201.37	132.84	62.90
Europe	174.24	155.66	95.71	45.65
United States	65.36	53.94	33.45	17.20
Other	843.92	804.86	660.13	560.53
Total	1,823.68	1,637.60	1,075.01	796.98

1 = January to June 1998. Source: Tourism Authority of Thailand Immigration Bureau

Likewise, it would be expected that the Vietnamese, Cambodian and Lao tourist industries would be adversely affected by the depreciation of the baht. However, Table 4.16 shows that the number of Thai tourists travelling to these countries did not decline as much as the number travelling to other areas, such as Singapore, Hong Kong, Europe and the United States. In 1997, the number of Thai tourists travelling to Vietnam increased by 1.57 percent from 1996, from 16,458 to 16,716, while the number travelling to Cambodia and the Lao PDR dropped by 4.70 and 6.04 percent respectively. From January to July 1998, a reverse trend is noticeable in the case of Vietnam and the Lao PDR, such that the number of Thai tourists travelling to Vietnam decreased by 15.82 percent, while the number travelling to the Lao PDR increased by 1.68 percent. In addition, the number travelling to Cambodia fell at a rate of 32.51 percent during the same period. This decline was also due to political instability and security problems in Cambodia.

Although the number of Thai tourists travelling to the Lao PDR using visa entry has tended to fluctuate at low rates, the number using border passes increased by 17.83 percent in 1997, and further increased by 61.62 percent from January to July 1998. The total number of tourists to the Lao PDR rose by 8.60 percent in 1997 and 39 percent in the first half of 1998.

The crisis does not appear to have had a strong negative impact on tourism in the SEATEs. The depreciation of the baht, however, benefited Thailand's tourist industry, as the number of tourists arriving in Thailand has increased by 3.46, 1.42 and 6.44 percent in 1996, 1997 and January–September 1998. This in turn may benefit Vietnam, Cambodia and the Lao PDR from spill-over, since it is possible that those tourists may continue their journey to these countries. However, no data is available to prove this hypothesis. Nevertheless, cooperation in tourism between the SEATEs and Thailand will provide mutual benefit for the region.

3.4. Impact on Employment: Migrant Workers from the SEATEs

The potential impact of the Thai economic crisis on employment among SEATE workers can be divided into a direct impact, where the crisis directly affects the employment of SEATE workers, and an indirect impact, where the crisis indirectly affects the economies of the SEATEs in general, and in turn induces changes in the SEATEs' labour market. This section limits its discussion to the first issue, particularly with regard to the employment of SEATE workers in Thailand.

Thailand is a major destination for migrant workers from the SEATEs and other neighbouring countries. Given the serious employment problems encountered by Thailand during the crisis, an impact on the SEATE migrant workers was to some extent expected. The natural tendency for Thailand, as for other countries in this position, was to repatriate foreign workers, especially undocumented workers,

to save jobs for the local population, in view of strong political pressure in the wake of rising domestic unemployment.

3.4.1. SEATE migrant workers in Thailand

To begin, we need to know the extent of the presence of SEATE workers in Thailand. In fact, the number of migrant workers from the SEATEs is not that high compared to those from Myanmar or Bangladesh.

Migrant workers in Thailand can be divided into two major groups—legal immigrants, and illegal immigrants or undocumented migrant workers. According to Yongyuth and Chalongphop (1998:16), the total number of legal aliens in Thailand reached 316,174 in 1996, a sizeable increase from 180,022 in 1994. The increase was due to an increase in the number of temporary work permits issued, which resulted from government resolutions in mid-1996 to amnesty illegal migrant workers. However, the majority of the legal migrant workers come from non-SEATE countries, such as Japan, Hong Kong, Taiwan and Western countries.

The number of illegal migrant workers was estimated at 943,745 in 1997, compared to 750,000 in previous year (Yongyuth & Chalongphop 1998:17). The movement of undocumented unskilled workers across the border from South and Southeast Asia has grown since the Second World War. Push factors for this include civil wars in neighbouring countries, which have made Thailand an asylum for refugees. Pull factors include Thailand's increasing affluence. Yongyuth and Chalongphop indicate that the major reasons for the increasing number of illegal migrants in Thailand are: 1) an enormous wage differential between Thailand and its neighbours, 10 times compared to Myanmar and five times to the Lao PDR or Cambodia (moreover, it is estimated that these migrant workers sent at least US$1 billion back home each year, while the Thai employers saved at least US$3 billion on their wage bills); 2) the lack of job opportunities in the migrants' own countries, in addition to unfavourable living conditions; 3) informally organised networks of private placement agencies, with cooperation from officials and business people, which helped to facilitate or speed up the influx of illegal migrants; 4) the long, porous border, making enforcement difficult; and 5) bribery, corruption and the inefficiency of immigration law enforcement, encouraging employers to opt for cheap migrant workers.

How many of the illegal migrants come from the SEATEs? Because of its underground nature, there is no clear data available on illegal migrants. According to the National Security Council, there were 525,000 illegal migrants in Thailand in September 1994, of whom nearly two-thirds were from Myanmar. By the end of 1994, the number of Myanmar migrants increased by at least 10 percent. The number of illegal migrant workers was estimated at 943,745 in 1997, compared to

750,000 in 1996. The number of undocumented migrants is given in Table 4.17. Out of the 943,745, only 293,652 (about 39 percent) registered when the government allowed them to do so in 1995. Although it is not known how many of the unregistered migrant workers are from the SEATEs, official data indicates that out of 269,948 registered migrant workers, only 10,874 are from the Lao PDR, 23,439 from Cambodia, and none from Vietnam. At the risk of over-simplifying, if the same proportion of registered migrant workers is applied, the number of unregistered migrant workers from the Lao PDR could be around 26,952, and that from Cambodia around 58,620. As a result of this simple estimate, the total number of undocumented migrant workers is around 37,826 from the Lao PDR and 82,020 from Cambodia.

Table 4.17. Number of Undocumented Migrant Workers, 1997

Area	Total		Registered		Unregistered	
	Number	Percentage	Number	Percentage	Number	Percentage
Border	256,146	27.1	79,195	29.3	176,951	26.3
Coastal	313,896	33.3	117,549	43.5	196,347	29.1
Other						
Bangkok	223,288	23.7	38,412	14.2	184,876	27.4
Non-Bangkok	150,415	15.9	34,792	12.9	115,623	17.2
Total	943,745	100.0	269,948	100.0	673,797	100.0
Percentage	(100.0)		(28.6)		(71.4)	

Source: Department of Employment, Ministry of Labour and Social Welfare, 1997

3.4.2. Unemployment and policies to replace migrant workers

In response to the crisis, and under IMF conditions, the Thai government in December 1997 adopted a resolution to establish an "unemployment alleviation action plan" consisting of seven policy measures, among which was "Immigrant Workers Replacement" (Department of Employment 1998). This measure was aimed at reducing the number of undocumented migrant workers in factories by 300,000 to provide employment for local workers.

The measure, however, was not implemented without resistance from local employers, who were used to cheap and undemanding workers. They argued that local workers were not willing to take up jobs involving arduous and dangerous work with low pay, such as rice-milling and fishing. In response to pressure from the employers, the government appointed a working committee to study the problem and to recommend appropriate measures. At present, a relaxation is underway to allow workers from the Lao PDR, Cambodia and Myanmar to work in specified border provinces and in the marine fishing and rice-milling sectors.

In May 1998, the Department of Employment reported that 179,649 illegal migrant workers had been repatriated. However, only 78,592 of their jobs were taken by Thai workers (Department of Employment 1998).

3.4.3. *Impact of the Thai crisis on SEATE migrants*

A rough assessment suggests that the crisis affected SEATE migrants in Thailand only a little and for a short period of time when the policy to replace foreign workers was first implemented. The measure has since been relaxed after pressure from local employers, who have argued that for certain types of work (the so-called 3Ds—dangerous, dirty and demanding) it is difficult to find Thai workers. Depending on how long the crisis lasts, and how long Thai labourers can stand the tightened job market, there will still be demand for foreign workers. The following observations can therefore be made.

The number of migrant workers liable to be affected is about 37,826 from the Lao PDR and 82,020 from Cambodia, a total of 119,846. However, out of this number, it is likely that not all of them will be affected.

For the time being, it may be more difficult for them not only to work openly but also to find employment. It is clear that certain industries in Thailand, particularly construction, are in deep trouble, and thus there will be no demand from these sectors. At present, only work in the marine fishing and rice-milling industries in given provinces is permitted. According to an ILO estimate, about one-third of the work for migrant workers has disappeared (Wickramasekara 1998).

Although the labour market for the SEATE migrants is different from that for local workers, if the crisis continues there will be more pressure to replace foreign workers.

3.5. *Human Resource Development Cooperation with the SEATEs*

Thailand’s economic crisis not only left the country in a bad financial position, but also revealed many other problems reflecting structural weaknesses. Thailand’s confidence as the fifth tiger of Asia has probably gone, and its active role in development cooperation in the Greater Mekong Sub-region is open to question. In the context of SEATEs, this section reviews and discusses the potential role of Thailand in providing technical assistance to Cambodia, the Lao PDR and Vietnam, with an emphasis on human resource development.

3.5.1. *Background*

Thailand’s development cooperation programme dates back to 1954, when the government organised education and training programmes for fellows or trainees from developing countries who received fellowships from international organisations or donor countries. However, the cooperation was rather limited with neighbouring countries. The events of the mid-1970s, when communist and socialist regimes assumed power in mainland Southeast Asia, reduced Thailand’s role in cooperation

with these countries. With the end of Cold War, Thai cooperation resumed. The formal resumption occurred in 1988, when Thailand's prime minister announced a policy of turning the battlefields of Indochina into a marketplace.

Thailand's development cooperation at present is the responsibility of four major government agencies: the Ministry of Foreign Affairs, the National Security Council, the Department of Technical and Economic Cooperation (DTEC), and the Committee for the Coordination of Economic Cooperation with Neighbouring Countries (CCEC). Within DTEC, the Division of External Cooperation, established in March 1992, is responsible for the administration and coordination of technical and economic cooperation provided by the Thai government to other countries. The CCEC, on the other hand is responsible for the coordination of economic cooperation between Thailand and neighbouring countries in the Greater Mekong Sub-region, particularly those that fall under the framework of the Asian Development Bank's Greater Mekong Sub-regional Economic Cooperation Programme (ADB-GMS), the Mekong River Commission (MRC), the Forum for the Comprehensive Development of Indochina (FCDI), the Working Group on Economic Cooperation in Indochina and Myanmar (WGEC-CLM or AEM-MITI), the ASEAN-Mekong Basin Development Cooperation, and the Quadripartite Economic Cooperation (QEC).

Generally, there are three broad types of development cooperation—bilateral, trilateral and multilateral. Bilateral cooperation is cooperation between Thailand and another country, with funding from Thailand and possibly some counter-funding from the partner country. Trilateral cooperation involves three parties—Thailand, donor countries/organisations and recipient developing countries. Multilateral cooperation is where Thailand cooperates with international organisations to provide assistance to developing countries. Operationally, however, the Thai International Cooperation Programme (TICP), especially cooperation under the responsibility of the DTEC, is divided into the following five classifications:

1) Bilateral programme;
2) Annual International Training Courses (AITC) or the Thai International Training Programme (TITP);
3) Technical Cooperation among Developing Countries (TCDC);
4) Third Countries Training Programme (TCTP); and
5) Multilateral cooperation programme.

The bilateral programme consists of two types of programmes: 1) country programmes and individual requests; and 2) Sino-Thai cooperation. The first focuses on human resource development in the fields of education, health and agriculture by

assisting other developing countries in identifying and designing special courses which could serve their specific needs. The second was created in 1978, when the People's Republic of China and Thailand began scientific and technical cooperation on the basis of UNDP/TCDC arrangements in exchanging experts.

The AITC provide a wide range of development courses on agriculture, rural and community development, industry, energy, health-care and telecommunications. Fellowships to support participation are also available.

The TCDC was an adoption of UNDP/TCDC modalities under the Buenos Aires Plan of Action. Responsibility for the costs involved is shared between both countries which exchange participants—the participating country is responsible for international costs, while the host country absorbs all local costs.

The TCTP organises training programmes or study tours in Thailand for participants from other countries who are sponsored by international organisations or donor countries. The DTEC is responsible for the coordination and programme arrangements, as well as the administrative costs.

The multilateral cooperation programme can be arranged in a number of ways. The first is under the TCTP. The second is based on cost-sharing between the Thai government and donor countries or international organisations to provide assistance to recipient developing countries. Such assistance includes group training courses, sub-regional cooperation programmes, partnership programmes, and technical cooperation among developing countries.

3.5.2. Assistance to the SEATEs

In 1997, Thai development assistance to the SEATEs was worth almost 283 million baht—56.7 million baht for Cambodia, 177.7 million baht for the Lao PDR, and 48.5 million baht for Vietnam (Table 4.18)—compared to 205 million baht in 1995, reflecting an increase of about 19 percent per year. (In 1995, Thailand's development assistance was 20.2 million baht for Cambodia, 157.0 million for the Lao PDR, and 27.9 for Vietnam (Paitoonpong *et al.* 1996:20).) About 63 percent of this assistance went to the Lao PDR, whereas 20 and 17 percent went to Cambodia and Vietnam respectively. Approximately 90 percent of development assistance in 1997

Table 4.18. Value of Thai Development Assistance, 1997 (millions of baht)

Recipient country	Bilateral	AITC	TCDC	ILP	TCTP	Total (percentage)
Cambodia	48.41	6.97	0.38	0.43	0.53	56.72 (20.0)
Lao PDR	168.71	6.35	0.05	1.50	1.06	177.67 (62.8)
Vietnam	37.51	5.43	0.05	4.80	0.73	48.51 (17.1)
Total	254.63	18.75	0.48	6.73	2.32	282.89 (100.0)
(Percentage)	(90.0)	(6.6)	(0.2)	(2.4)	(0.8)	(100.0)

AITC = Annual International Training Courses; TCDC = Technical Cooperation among Developing Countries; ILP = Institutional Linkage Programme; TCTP = Third Country Training Programme. Source: DTEC (1997)

was under the bilateral programme, mostly in the form of assistance on request. Group training was second in demand from the SEATEs (accounting for 8.5 percent), whereas TCDC accounted for little (1.2 percent).

In 1997, the majority of the assistance (67.3 million baht—70 percent) was for equipment and construction, while assistance for human resource development fell to 18 million baht (19 percent) compared to 114 million in 1995 (Table 4.19).

Table 4.19. Composition of Development Assistance, 1997 (millions of baht)

Recipient country	Training	Experts	Equipment	Other	Total
Cambodia	3.10	0.28	32.57	n.a.	35.95
Lao PDR	7.73	2.34	20.16	2.96	33.19
Vietnam	0.72	3.57	14.60	1.17	26.57
Total	11.55	6.19	67.33	4.13	95.71
(Percentage)	(18.9)	(6.5)	(70.3)	(4.3)	(100.0)

Source: DTEC (1997)

3.5.3. Potential impact on the SEATEs

The potential impact of the crisis on Thailand's technical assistance to the SEATEs depends almost entirely on the government budget allocated to the agencies responsible—the Ministry of Foreign Affairs, the National Security Council, the DTEC, and the CCEC. In this regard, DTEC's budget deserves attention, as it is the major organisation responsible for coordinating technical assistance to the SEATEs.

According to the 1998 budget, which was revised a number of times to accommodate IMF conditions, more than 18 percent of the initial proposed budget was cut. The 1999 budget for DTEC was eventually reduced to 133 million baht, compared to about 300 million baht allocated in the 1998 fiscal year. This heavy cut will certainly affect technical assistance to recipient countries, including the SEATEs. In an informal consultation with DTEC authorities, we learned that the government's policy in connection with sub-regional technical assistance is to pursue commitments to ongoing projects but to refrain from giving new assistance. The policy will be reconsidered in 2000, depending on the crisis situation.

3.6. Prospects for the Thai Economy

To foresee Thailand's prospects, one should monitor what the country has done to address the problems, and other measures which are in the process of implementation. It is also necessary to explore the external environment that is likely to contribute, positively or negatively, towards recovery in the Thai economy.

3.6.1. Government measures in response to the crisis

Numerous government measures have been employed since the start of the crisis. Weak macro-economic conditions led to attacks on the baht in early 1997. The exchange rate system was accordingly changed from a basket of currencies system to a managed float scheme. In the meantime, financial institutions were in trouble due to an excessive foreign debt burden, mounting bad debts and the economic slowdown. Together, the currency and financial crises led to severe economic meltdown. When it seemed that the government was unlikely to control the crisis alone, the IMF was called in in August 1997. A rescue package was formulated under the standby credit arrangement scheme. Under this scheme, the IMF lent US$17.2 billion to Thailand. The policy measures adopted were the result of consultation and negotiation between the Thai government and the IMF. These policy measures and targets are described in letters of intent. In this section, we discuss major policy measures on macro-economic management, financial system restructuring and structural reform. However, as well as economic policy measures, the government introduced various measures to alleviate the social impact of the crisis, though these are not discussed in this paper (Thongpakde *et al.* 1998:28–47).

When the IMF was called in, it planned to administer the standard IMF dose of medicine. The main objectives of its rescue plan were to stabilise the currency and to eliminate excess demand. Hence, tight monetary policy and fiscal discipline were imposed on the country as macro-economic policies—cuts in government expenditure, an increase in taxes to reduce consumption, both public and private, and high interest rates to reduce investment and to stabilise the exchange rate. Improvement in the current account and stability of the baht were the main policy objectives during this period.

The contractionary policies of the first four IMF letters of intent resulted in a more intense slowdown in the Thai economy than expected. In addition, the contagion effect in the rest of Asia, which discouraged Thai export demand, further shrank aggregate demand in the economy. Domestic output fell sharply, unemployment rose, and many businesses collapsed. In response, due to the severe economic recession, macro-economic policies shifted from contractionary to expansionary in the fifth letter of intent. Fiscal policy was eased from a budget surplus to a deficit of 3 percent of GDP. The expanded government spending was aimed at stimulating domestic demand as well as alleviating the social impact of the crisis. Monetary policy was also reversed, from tightening to relaxation. More liquidity was injected into the market, providing credit for important sectors such as exports and manufacturing. As a result, interest rates have been declining since October 1998. In addition, the government has put more emphasis on improving broader agricultural production, industrial restructuring and the opening up of Thailand’s economy.

From the sixth recent letter of intent, the Thai government has extended its role in boosting the economy, with a increase in the permissible budget deficit from 3 to 5 percent of GDP, and more expenditure planned for community and social services. Monetary policy has been further eased, and the government has also put more pressure on commercial banks to lower lending rates. As a result, interest rates are tending to move downward.

Financial liberalisation without adequate regulation and supervision allowed local financial institutions and corporations to misuse low-cost foreign borrowing. Mismatching capital usage and unhedged foreign borrowing positions, on account of the stable baht under the basket of exchange rates scheme, left local borrowers vulnerable to sudden currency fluctuations. Over-lending to unproductive sectors, skyrocketing debts due to depreciation of the baht, excess capacity in various sectors, and a slowdown in economic growth, were the major factors driving local financial institutions into trouble due to the jump in non-performing loans. As a consequence, loss of public confidence in the financial system has been widespread. At the time, the FIDF was the only instrument of the central bank to deal with the liquidity problems of financial institutions, as a lender of last resort.

The basic idea of the financial liberalisation policy is to restructure and rehabilitate the entire financial system. The government has produced a number of measures, which aim to:

- Restore and maintain solvency in and the credibility of the financial system;
- Strengthen the capital position of financial institutions;
- Impose international standards on the financial institution system;
- Intervene in finance institutions which have failed to raise capital, and consolidate them;
- Enable financial institutions to perform effectively their role in supporting economic growth; and
- Provide incentives to facilitate corporate recovery.

Government measures to restructure the ailing financial system are listed below:

a) Closure of failed financial institutions

The first stage of the financial crisis developed from the currency crisis which started in early 1997. Loss of public confidence in the local financial system caused runs on some financial companies. As a consequence, the government decided to suspend those troubled companies. To restore confidence, it also required all financial institutions to recapitalise. Finally, financial institutions that failed to raise capital were permanently shut down. Together with the closure of some financial

companies, the government announced that all depositors and creditors would be guaranteed, to protect against exposure of the financial system. In addition, the government established new organisations such as the Financial Restructuring Agency (FRA) and asset management companies (AMCs) to manage and liquidate assets seized from the closed financial companies.

b) Intervening in troubled companies
Non-performing loans had continued to rise, with problems worsening over time. The closure of troubled financial companies was proved to be ineffective. The government instead applied an intervention and consolidation method. Failed financial institutions were ordered to write down their shareholders' equity to cover the losses in bad debts, and existing management was replaced. The FIDF stepped in and converted debt into equity in an effort to recapitalise them, effectively nationalising them.

c) Capital support facilities for solvent institutions
This package was based on the idea that the shareholders must be responsible for the losses incurred from existing bad debt, through losses in their equity. The government would then support new investors in the ailing banks, providing new liquidity and absorbing the rest of the losses through two-tier capital support facilities (CSFs). It is prepared to ease the Basle standards through regulatory changes in the capital adequacy ratio between tier-1 and tier-2 capital.

d) Additional measures

- Loan classification and provisioning rules were tightened to meet international standards.
- The government liberalised the foreign shareholding limit in financial institutions to encourage foreign investment. Foreign investors were allowed to hold an unlimited share of financial institutions for up to 10 years. After the tenth year, they will be able to hold a majority stake but will not be able to acquire newly issued shares.
- Financial institutions were encouraged to set up private AMCs. The private AMCs are able to manage the distress loans that have been separated from the banks and financial companies. This will enable the financial institutions to resolve non-performing loans more quickly.
- A Financial Restructuring Advisory Committee (FRAC) was established to oversee financial rehabilitation, as well as corporate debt restructuring.
- A Corporate Debt Restructuring Advisory Committee (CDRAC) was established by the BOT to facilitate and oversee corporate debt restructuring. The incentive package supporting restructuring, comprising a series of tax incentives is now complete.

- Institutional frameworks for the supervision of financial institutions have been reviewed and reformed to avoid past mistakes. The BOT is in the process of strengthening its supervisory capacity with help from a steering committee of international bankers and the World Bank.
- A deposit insurance scheme will be established to replace the current general guarantee. The Thai Bankers' Association plans to establish a private credit bureau, with guidance from the BOT. The preliminary strategy calls for two phases of development: a negative list (non-performing loans, reorganisations, foreclosures, etc.), and then an expansion to all firms.

Liberalisation to increase competition and efficiency is one of the main targets for the IMF rescue package. The government approved the Master Plan for State Enterprise Reform on 1 September 1998, with the first batch of reforms relating to state water, transportation, telecommunications and energy agencies.

Amendment of legislation related to foreclosures and bankruptcy reform (the Civil Procedure Act and Civil and Commercial Code), and to foreign ownership (the Alien Business Law, Land Code, Condominium Act) has been carried out. These laws support debt restructuring, speeding up the process of foreclosure on collateral, and increased foreign investment. They also increase capacity in the judicial system for the resolution of commercial disputes. A bankruptcy court also will be established.

3.6.2. Assessment for economic outlook

Increased fiscal stimulation, with a planned budget deficit of 5 percent of GDP in fiscal year 1999, should boost consumption and investment to some extent. However, it is not expected to have a significant impact on driving up local demand. This is due to the fact that: 1) government expenditure accounts for only 20 percent of GDP; and 2) more than half of expenditure will go towards general governmental services and community and social services (20 and 42 percent respectively).

The supportive monetary policy will further lower interest rates, but low interest rates may not boost credit growth substantially, in view of mounting non-performing loans and the massive need for recapitalisation. Non-performing loans currently are not estimated to have reached their peak, which is believed to be at 50 percent. Banks are now over-sensitive to the problem of non-performing loans.

The CSFs announced in mid-August 1998 have yet to produce fruitful results. Most banks, especially large ones, are hesitant to apply for capital injections from the CSF programme. Their main concern is that existing shareholder's funds would probably be wiped out, or substantially reduced, before new capital from private

investors or from the government is injected into the institution. This results from one of the conditions imposed by the government, that any financial institutions applying have to adopt, up-front, the year-end 2000 loan classification and provisioning rules. This means the financial institutions have to set aside full provisioning and up-front write-off, which results in the existing shareholders absorbing all the loan losses.

The establishment of private AMCs will be beneficial to the financial institutions, such that the setting up of non-performing loan recovery units will alleviate the bank's stock problem. Additionally, it is expected that private AMCs will be in an advantageous position to attract new capital from specific investors specialised in the management of distress loans. However, some concerns should be pointed out. Transfer or sale of non-performing loans to private AMCs should be in line with the market, which means at a discount to the face value of the loan. To offset the discounts, the financial institutions should write down their equities by the same amount. This will discourage them from setting up private AMCs.

In sum, both the CSFs and the establishment of private AMCs may not result in loan growth. Hence, if the credit crunch persists, it will hurt the production sector and domestic demand. The latest data showed banking loans growth to have dropped over time (Figure 4.3 overleaf). This means that the financial institutions remain cautious about extending loans, due to the rising non-performing loans and the huge recapitalisation required.

Corporate debt restructuring moves slowly. Among 200 large cases monitored by the CDRAC, only 0.7 percent of total non-performing loans (worth 16.7 billion baht—US$463.9 million) were completely restructured as of 30 September 1998. Corporate debt of 437.7 billion baht (US$12.2 billion) has yet to be restructured, with more than half in the manufacturing sector. It is hoped that debt restructuring will stimulate production activities. However, the results so far are far from satisfactory (Table 4.20 overleaf).

On the structural reform side, the process will take quite a long time, and will not have a significant impact on economic recovery in the near future. Many expected that the rapid passage of legislative reform involving foreclosures and bankruptcy could bring economic activities back to life, but the outcome of the reform is still uncertain.

From Asian crisis to crisis in Russia and Latin America, and from short-term shock to long-term recession, it is unlikely for a small country such as Thailand to be able to recover without international assistance. It could be argued that the major developed countries, such as the United States, Japan, the United Kingdom and Germany responded well to this crisis, though too slowly. However, a response is better late than never. For Thailand, getting back to a normal growth path requires

Figure 4.3. Growth of Bank Loans and Deposits, 1996–98

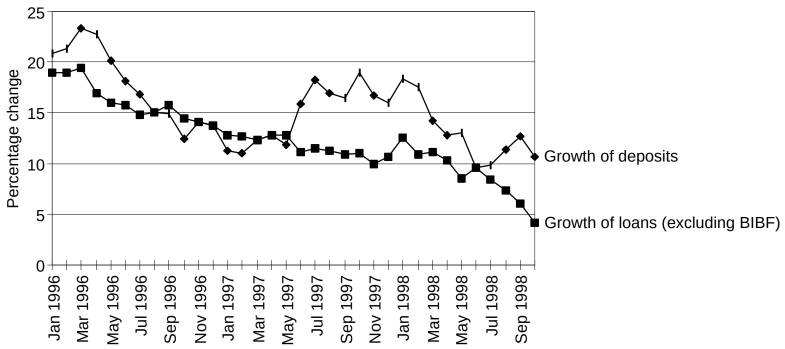


Table 4.20. Progress in Restructuring 200 Firms (billions of baht)[1]

	In progress (debt being negotiated)		Restructuring complete	
	June	September	June	September
Manufacturing	131	228	2	6
Construction	6	14	-	1
Real Estate	29	61	0	1
Export	6	8	-	-
Other	45	133	1	8
Total	217	438	4	17

1 = 200 firms selected by CDRAC with total debt worth 300 billion baht. Source: BOT (estimate)

both regional and international cooperation. Recently, several international conferences have been arranged to search for solutions to prevent the world economy falling into depression. These include meetings of the G7 countries, G22 countries, the IMF, World Bank and the Asia-Pacific Economic Cooperation (APEC). These meetings have resulted in interest rate cuts in major industrialised countries, more financial contributions to the IMF, economic support from Japan, and most important the setting up of an Asian fund via the Miyazawa Plan. This fund, worth of US$30 billion, has been set up through the initiation of Ki'ichi Miyazawa, Japan's finance minister, to assist Asian countries. Thailand is currently preparing to request financial aid from this scheme to increase its foreign reserves and restructure its economy.

The contagion effect had a severe impact on the world economy beyond all expectation. We are told that the current recession is the worst since the 1930s, but so far it has not generated austerity in other parts of the world on that scale. The share of developed countries' GDP is around half of that of the entire world, so a sluggish economy in the United States and Europe, while Japan is still in a slump, and at the same time with the rest of Asia still in deep trouble, will undoubtedly bring the world economy to recession.

As the Asian crisis persists, as well as crises in Russia and Latin America, major economic institutions have revised downward their growth projections for 1999. World GDP growth was on average 4 percent in 1996 and 1997, but JP Morgan has revised growth for 1998 and 1999 to around 1.5 and 1.7 percent respectively. The IMF, in its latest *World Economic Outlook* (September 1998), revised projections down to 2.0 and 2.5 percent in 1998 and 1999. However, most institutions still perceive next year to be slightly better than 1998. The implications are that a prospective Asian recovery is therefore possible. Nevertheless, the magnitude of the Asian recovery depends on the growth of demand for imports from developed countries as well. Thailand also is not exempt from this.

It is necessary to consider in more detail Thailand's major trading partners:

- The United States is the largest economy in the world and has a crucial role for Thai economic recovery, as it contributes to around 22 percent of Thai exports (Table 4.21). From current projections, US economic growth will decline slowly from 3.5 percent in 1998 to 2.0 percent in 1999.
- The continued slowdown in Japan's economy, which has been going on for the past eight years, partly contributed to the worsening of the current crisis. Japan exports around 40 percent of its merchandise exports and around 37 percent of its service exports to the Asian region. It is therefore an important player whose economic direction contributes enormously to the rest of the region. Japan has been urged by fellow developed countries to play a more active role in the region, first by putting its own house in order by cleaning up its financial system, and second by providing a market for Asian exports, in order to pull the Asian economy out of the current recession. To do so, Japan has launched a series of measures to clean up its financial system and boost local consumption. Furthermore, a fund has been set up to give financial aid to other Asian countries. However, with its sluggish economy, it is unlikely that tha Japanese economy will pick up soon enough to pull other countries in Asia out of recession.
- The euro became a new common currency for the Euro-11 on 1 January 1999. The European Union (EU) members, particularly, the Euro-11 will likely be

Table 4.21. Thai Export Markets, 1997–98

	1997		1998[1]	
	Growth	Percentage share	Growth	Percentage share
United States	12.7	19.6	9.9	22.3
ASEAN	3.5	18.8	-23.3	17.7
European Union	3.7	16.1	7.7	17.6
Japan	-7.9	14.9	-17.3	13.6
Others	3.4	30.6	-9.6	28.7
Total	3.3	100.0	-5.6	100.0

1 = January–September 1998. Source: BOT

restrictive in their monetary and fiscal policies in 1999. The current crisis in Asia affects the EU only marginally. However, the contagion that spread to Russia and other emerging countries in Eastern Europe could adversely affect Europe, first through its financial institutions and then through a reduction in demand for its exports. The EU ranks third as a destination for Thai exports—thus close monitoring is required.

- ASEAN ranks second as a destination for Thai exports. With the same problems as Thailand, it is not expected that other ASEAN countries will recover from their own deep recession in the near future, and will therefore not contribute considerably to Thai exports.

In all, the world economic situation will not be of great help in getting Thailand back to normal, though hopefully it will not worsen the current situation.

Various forecasts predict that Thailand will be slightly better off in 1999 (Table 4.22). The Siam Commercial Bank Research Institute is the most optimistic forecaster, while other institutes offer different forecasts. However, the common issue mentioned is that exports will not be a major economic drive due to sluggish global trade and the reduced competitiveness of Thai products. Government spending will play an important role in boosting domestic consumption. The debt restructuring process and financial restructuring are the main factors for recovery next year.

Table 4.22. Comparison of Economic Forecasts for Thailand, 1998–99

				1998		
	IMF	TDRI	IDE	SCB	SG	Merril
Real GDP growth (percent)	-7.0 – -8.0	-5.5	-7.7	-7.4	-8.3	-9.6
Inflation (percent)	8.0	9.4	8.2	8.1	8.0	8.3
				1999		
	IMF	TDRI	IDE	SCB	SG	Merril
Real GDP growth (percent)	1.0	1.0	-0.2	5.2	1.3	-2.4
Inflation (percent)	2.5 – 3.0	4.0	3.6	0.0	2.5	4.4

Sources: IMF = International Monetary Fund; TDRI = Thailand Development Resource Institute; IDE = Institute of Developing Economies (Japan External Trade Organisation); SCB = Siam Commercial Bank Research Institute; SG = SG Securities Research Ltd; Merrill = Merrill Lynch, Pierce, Fenner & Smith Inc.

In sum, prospects for the Thai economy to get back on track remain mixed. A number of measures to revive the financial system have proved fruitless. Increased government spending could have a minimal impact on stimulating economic activities. A 5-percent of GDP budget deficit amounts to around 250 billion baht per year, while banks were lending at rates of around 50–60 billion baht per month prior to the crisis. Therefore, the credit crunch problem has to be tackled to get the financial system back in order. This will generate the necessary demand in consumption and investment.

A return in foreign capital inflows and stopping outflows are certainly a big help and constitute a positive sign. However, apart from the baht improving due to the depreciation of US dollar and capital inflows, and despite the drop in local interest rates, there have been almost no signs of consistent improvement in other key indicators. Growth of the manufacturing production index and the private investment index have remained negative throughout the past 20 months, with no significant signs of improvement. The current account may be in surplus, but export growth has been plunging in dollar terms.

Another factor hindering the Thai economy is the declining price of agricultural products. This will worsen local consumption to some extent.

Given the slow growth in the world economy, especially in Thailand's major trading partners, the collapse of intra-Asian trade, the strengthening of the baht, and slow improvement in export competitiveness, Thai exports will not immediately recover next year. Accordingly, economic recovery will depend on how fast local demand can be boosted. In this case, local consumption and investment will play a dominant role, particularly on the government side. Exports will not benefit from appreciation of the baht, and restructuring to increase competitiveness will take a long time.

As the external environment is not quite positive to Thai exports, and since there are a lot of constraints lying ahead, the prospects for the Thai economy are difficult to predict. For any potential economic recovery to be viable and sustainable, the current credit crunch problem has to be solved quickly in order to get the financial system back in order.

4. Concluding Remarks

One should bear in mind that the process of recovery cannot be accomplished in the short term, because the crisis problems have been accumulating for a long time. Excessive foreign debt exposure, excess capacity, over-spending and a high current account deficit, highly leveraged companies, an over-valued baht in the fixed exchange rate regime, a weak financial system and a bubble economy were the main causes of the current crisis. Thus, a large number of measures are required to recover from the current deep recession. The effectiveness and efficiency of policy implementation are important factors contributing to beginning the recovery. This is no easy task for a coalition government comprising a number of political parties with different views. Moreover, the IMF is not the sole doctor for the current syndrome. Some fine-tuning between the government and the IMF over the policy measures may be necessary.

We shall conclude this study by mentioning a few lessons learned:

4.1. What Should Have Been Done before Liberalisation?

- Domestic financial systems should have been liberalised before opening up to foreign capital. Thailand, however, failed to do this. Interest rate ceilings, limited competition, government-directed lending and insider relationships between banks and borrowers, or patronage systems, have all served to channel credit inefficiently without regard for rates of return. Foreign money was employed in the same way, leading to excessive and unproductive investment.
- Strict bank regulation and supervision are necessary for financial liberalisation to prevent a reversal in capital flows. This includes placing ceilings on banks' foreign currency exposure.
- Flexibility is required in the exchange rate system. Free capital movement and a pegged exchange rate are a dangerous combination. A fixed exchange rate encouraged too much foreign currency borrowing when foreign interest rates were lower than local rates. In addition, it did not encourage local borrowers to hedge their foreign borrowing, leading to vulnerability to currency fluctuation.
- Access to reliable information is needed. If lenders had had better information about the reserves of Thai banks, they would have pulled back sooner or lent less. In that case, the eventual problems would have been less severe.

The result of these four mistakes was high foreign debt, excess capacity, rising numbers of non-performing loans, and instability in the financial system. The government ultimately shut down 56 finance companies, while 18 finance companies and commercial banks were nationalised.

4.2. Dealing with Financial Institutions' Problems

- The closure of weak financial institutions could not prevent a loss of public confidence. As a consequence, this measure forced the government to bear a huge financial burden.
- Strengthening the capital base and stricter loan provision rules alone cannot restore confidence in the financial system. On the contrary, these measures crippled the financial system. Following their implementation, the massive amounts of capital required and rising non-performing loans had a negative impact on credit extension. A tight credit policy further impeded corporate revival, resulting in more loan problems, and further deepening the recession.

- In the end, the public has to bear the burden of the financial damage via the budgetary system. The philosophy that financial institutions cannot go under has proved responsible for huge losses.

4.3. Other Issues

- The Thai experience points to the need for restructuring, such as sound macro-economic management, structural adjustment, a social safety net to cope with the sudden external shock, and reform of the public administration.
- In terms of foreign capital, FDI is better than portfolio investments and loans. Free capital movement, especially in the short term, is difficult to control, and thus it causes instability. Foreign financial institutions can make mistake in appraising projects, so it is impossible to be sure that they will provide loans to good and productive projects.
- When financial regulation, supervision, monitoring and rehabilitation functions are located within the same organisation, there is a need for a proper check and balance system to overview the whole working process.
- During the crisis, flexibility in management of policy measures was important, due to the dynamics of the problems. For instance, strict to tight monetary and fiscal policies in the initial stage of the crisis were appropriate, since they raised investors' confidence. However, when the economy had contracted excessively, a prompt adjustment to an expansionary policy was necessary. Some would argue that due to the IMF's conditions, this adjustment was too slow in the case of Thailand.
- Good governance in both public and private sectors is important. Corruption in the public sector in developing countries is well recognised as something that increases the transaction costs of business and causes mismanagement of policy measures. The crisis in Thailand shows that irregularities in business practices are common, and this leads to a lack of confidence from foreign investors. For example, some financial institutions provided loans without proper project appraisal but based instead on personal benefit. Accounting systems provided inadequate, or sometime false, information on the status of companies. Some financial institutions were engaged in stock price manipulation. Therefore, transparency, accountability, and reliable information disclosure are crucial to establish good corporate governance in order to get out of the crisis.

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