

**Back to Basics: Policies and Strategies for Enhanced
Growth and Equity in Post-Crisis East Asia**

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Introduction

Two years after the onset of what has been the most devastating financial crisis since the Depression, there are signs of economic recovery in East Asia. Exchange rates are stabilizing and in some instances, even strengthening (See Figure 1). Growth in most countries in the region remains sluggish; while there has been an upward movement, growth still remains substantially below the pre-crisis trend, and income levels have yet to return to where they were at the onset of the crisis. (See Figure 2). That the crisis would eventually end, I would argue, was inevitable; we know that economies always recover – we just can't say when, or after how long of a recession.

Beyond what we do know about the crisis—that is, beyond the extended period of high unemployment, declining incomes and output, low investment levels, and increased poverty, there remains much that we do not know. What remains uncertain and difficult to measure is the long-term impact on workers and households, impacts that such formal statistics cannot convey. To what extent for example, has the recent crisis scaled back, if not eroded investment, in human capital? How extensive was the malnutrition that will leave life-long scars? How many children had their education interrupted, never to be fully resumed? While in Indonesia, World Bank sponsored programs enabled more than a million children to stay in school during the past two years, and in Thailand, it appears that school enrollments also seem to have withstood the crisis—though the pace at which those statistics had been improving has slowed--we know little about what has happened elsewhere in the region. We worry that there has been extensive erosion of social cohesion, evidenced by the political and social disruptions in Indonesia. Only time will reveal the true economic and social impact of the crisis.

Today, as we stand two years after the onset of the crisis, approaching (in Western calendars) a new millenium, we inevitably ask: What are the prospects for the region? What policies, what actions, will enhance the chances of sustained, equitable, and democratic development? What kind of economy—what kind of society—should the

countries in the region be striving to achieve, and how should they go about doing so? In this talk, I propose to outline a set of answers to these questions.

I will argue that the East Asia Miracle was real, and that it was based on a set of sound fundamentals. Government policies contributed importantly to these successes. At the same time, the crisis has exposed certain weaknesses in these economies. Going forward, the countries must build on the strengths of the past that led to the miracle, but at the same time address those weaknesses. But even if the crisis had not occurred, economic circumstances today are markedly different from what they were two decades ago—and these changed circumstances would necessitate changed economic policies. One of the strengths of the East Asian economies has been how well they adapted to such changing circumstances in the past - for instance, how well they responded to the oil price shocks of two decades ago. I will outline a few of the key categories in which changes will be needed—to promote stronger growth and greater equity.

The Miracle

The crisis that beset the region over the past two years notwithstanding, East Asia remains the best model of development the world has probably ever seen. The Miracle was real and its legacies permanent. Even taking into account the reduced output at the end of the decade, incomes per capita in Korea will be eight times as high as they were just three decades ago. Between 1960 and 1995, eight economies in East Asia grew approximately three times as fast as Latin America and South Asia and five times faster than Sub-Saharan Africa, and outperformed the industrial economies of the oil-rich Middle East-North Africa region. The increases in income were matched by improvements in living standards, reflected in dramatic increases in life expectancy, from 56 years in 1960 to 71 years in 1990.

It was not only that the region grew rapidly and that improvements in living standards - education and health - matched the increases in income, but that the fruits of such growth were shared widely. East Asia reduced the number of people living in

absolute poverty (defined as \$1 a day) by half in the two decades preceding the crisis, from 720 million to 350 million. Moreover, the rate of poverty decline actually *accelerated* over the last ten years of the same period - the total number of people in poverty fell by 27 percent between 1985 and 1995. While 6 out of 10 East Asians lived in absolute poverty in 1975, roughly two in ten did in 1995. This pace of poverty reduction was faster than in any other region of the developing world.

In the aftermath of the crisis, the countries in East Asia were the victims of extensive criticism. It was alleged that they had fundamental weaknesses which made a crisis inevitable. Those of us who knew East Asia better were puzzled by these assertions (typically presented with little or no evidence): If the problems were so severe, how was it that the region outperformed the rest of the world for a third of a century? If these weaknesses made the region so vulnerable, why was it that two of the countries experienced no year of economic downturn and two experienced a single year of economic downturn in three decades - a better record than those in the more developed countries who were so freely doling out such criticism? As this rhetoric gradually diminished, and after scholars had a chance to more carefully examine the record, it became clear that the region was in fact not more susceptible to crisis than other regions, and that some of the alleged factors played little, if any, role in the crisis. In the meantime however, the rhetoric may well have done its damage—at least temporarily-- both in terms of the adverse views of the outside investment community and in terms of the self-confidence of the countries themselves.

Let me be clear: there were weaknesses, several of which I shall discuss shortly, factors which not only made a crisis more likely, but which implied that, once hit by a shock, the downturn may have contributed to the depth of the downturn. But every country has strengths and weaknesses. The question in assessing whether a country is particularly vulnerable entails aggregating the plusses and minuses, to form an overall assessment; and in these terms, the statistical models, by and large, do not suggest that most of the countries in the region were more vulnerable than average.

The Crisis

As dramatic as the growth and development of the East Asia miracle was, so too, was the crisis. The economic contraction affected the lives of millions of people, and aggravated social vulnerabilities in numerous ways. The magnitudes of the effects, e.g. on income, output, poverty, and social indicators, varied from country to country, and in many cases, even today we do not have accurate assessments of some of the effects.

At the trough, output in industrial production was approximately 25 percent below what it had been just a year earlier. Figure 3 shows growth rates in 1996, the year before the crisis, 1997, and 1998. The losses in income relative to what they would have been had output continued to expand at its previous pace are truly enormous, to the tune of approximately a trillion dollars, as shown in Figure 4. It appears as though unemployment in Korea and Thailand have increased by three to four-fold, from 2 percent in 1996 to 6.8 percent for Korea and 6.5 percent in Thailand in 1998. In Indonesia, unemployment has increased by a shocking magnitude of seven, from 2.3 percent in 1996 to 17.1 percent in 1998.¹ And even for those who retain jobs, real wages plummeted - by an estimated 25 to 35 percent in Indonesia and 10 percent in Korea..

There has been an attempt in some circles to minimize the magnitude of the downturn. For instance, there is data suggesting that the number in extreme poverty increased relatively little - not surprising, since those in extreme poverty are typically subsistence individuals, relatively unconnected with the market economy. There have been attempts to portray those most hurt as among the better off. But this is wrong: they are poor urban workers - above the poverty level of a dollar a day to be sure, but hardly well off by any standards - who have been thrown into unemployment or, if they retained jobs, saw their wages and incomes fall dramatically.

There have been numerous manifestations of the economic decline, including in some countries threats to educational and health status and increased crime and violence. In Indonesia there has been a radical breakdown in social order as an increasingly fragile social equilibrium was brought under intolerable stress by the collapse in economic confidence and fall in incomes.

Trade, capital flow, and migration linkages among countries hastened the transmission of economic and social effects across the region. While China remained largely insulated, falling regional demand and slowing intra-regional foreign investment aggravated domestic difficulties. China was also wise enough to use standard macro-measures to respond to these difficulties – using public investment addressing the country's long-term needs to meet its short-term macro-economic situation. (Hopefully, the lessons from the contrasting results will be brought to bear in the future)

Erosion of social and organizational capital

Economic declines are costly, but large economic declines are more than proportionately costly. For instance, most firms can weather a slight decline in output; but many firms will go bankrupt in a severe economic downturn, with consequent adverse effects on the economy's social and organizational capital—and its medium term production capabilities. Similarly, some studies suggest that while slight declines may actually strengthen social cohesion, large economic declines lead to the erosion of social capital.

While it is too early to assess the full consequences of this erosion in East Asia, there are examples from other communities afflicted by economic crises that illustrate the point. Economic decline in Latin America during the 1980s contributed to rising violence, in the form of both street violence (especially among young males) and domestic violence (particularly in households affected by falling employment and/or declining incomes). Similarly, studies in poor communities in Ecuador, Hungary, Zambia and the Philippines found that such down turns also contribute to increased workloads for women and children, as mothers worked more and left girls to care for younger children, and government cutbacks in public service led to the substitution of private for public services in areas such as health and education, adversely affecting the poor who lacked the ability to pay. These studies found varied effects on informal community functioning. While moderate pressure could lead to heightened mutual support (increased

¹According to *Global Data Watch*, July 16, 1999 JP Morgan.

use of social capital), severe pressures were more likely to break down community-based coping mechanisms.

The Thai people have shown an enormous ability to cope with the crisis, evidenced by the seeming absence of significant adverse impacts on education and health (especially malnutrition) and it may well be the case that here the positive effects may outweigh the negative. Elsewhere in the region, however, the picture looks less rosy; there is some evidence of increased conflict within the household, the community and society at large. One study suggested that increased economic pressure led to a rise in domestic conflict and so-called loan sharks in Bangkok resorted to violence against people who could not repay their debts. In Teparak, a slum settlement in Khon Kaen, Thailand, a focus group identified a breakdown in community trust in the wake of the crisis. Increased competition for jobs meant that neighbors who once cooperated for communal benefits were now competing for scarce jobs and resources.

Thailand will perhaps be lucky, and not suffer the full consequences of the loss of social capital, partly because of its strong social fabric. Yet, it, like the other countries in the region, need to put into place institutions and policies to reduce the magnitude of the adverse effects on the poor in the event of another crisis. And try as we may, we should be aware that the economic fluctuations which have marked capitalist economies over the past two hundred years will continue. (Indeed, crises have, if anything, become more frequent and deeper over the past two decades, with close to a hundred countries having experienced currency and/or financial crises.)

While I have focused on the impacts on social capital—largely because they are all too often ignored—the impacts on organizational and informational capital that result from the shutting down of firms and the closure of banks (at least if done in ways that are not attentive to the issue) are no less important, especially for economic performance in the intermediate run. Economic policies—from those that affect the overall level of economic activity, to those that affect interest rates, as well as bankruptcy law and how it is implemented, and financial sector regulations, and how they are implemented—can have significant effects on the extent of destruction of the economies organizational and information capital. There are important non-linearities and irreversibilities that have to

be taken into account: while most firms can survive a small downturn, few can survive a prolonged and deep depression or an extended period of very high interest rates, and it is far easier to destroy firms and financial institutions (and the associated informational and organizational capital) than to recreate them.

Lessons from the Crisis

Since crises will occur, and economic downturns are not only costly in the short run, but inevitably risk eroding social capital, what is a government to do? Three broad lessons emerge from the crisis:

- Take strong actions to minimize the magnitude of the downturn, recognizing that there are asymmetric risks—the risks of a large downturn are particularly severe, and may not be easily or quickly undone.
- In the event of a downturn, make sure that social expenditures aimed at the poor are maintained, and even strengthened. Thailand's record in this regard is to be commended.
- Design institutions which reduce the vulnerability (increase the resiliency) of the economy, and protect the poor.

Let me dwell for a moment on these institutional changes, because they represent a core part of the reforms that will enable the countries in East Asia to have sustained growth in the coming decades. While a complete discussion would entail a long list of reforms, it seems to me that six in particular deserve attention.

- Weak financial institutions can be a major source of instability, every bit as important as bad macro-economic policies. The countries made a mistake in pursuing financial market liberalization while they should have been concentrating on creating appropriate regulatory structure, strengthening regulations in some areas while stripping them away in others. The dangers (and inefficiencies) of relying excessively on capital adequacy standards - and the weaknesses in the risk adjustments and accounting frameworks that have been standards in the past - are increasingly being recognized. Banks will need to move towards more comprehensive and robust regulatory structures, including a portfolio of approaches. Such regulations will include implementing exposure limits on foreign-denominated liabilities and assessing the exposure of the firms to which they lend. Restrictions on real estate lending and other forms of risky lending should almost surely be imposed. Speed limits (rates at which a banks portfolio can increase) also need to be considered.

- Short term capital flows are a major source of instability, with those engaging in these transactions bearing only a portion of the social risks which they impose on others. It is therefore important for governments to take actions to discourage those flows unrelated to trade, and especially to work to stabilize those flows. There are mechanisms by which this can be done (as Chile has well demonstrated.) It is perhaps worth noting that Malaysia's intervention to stem the outflow of capital does not seem to have produced the dire consequences that its ardent critics seems to have predicted, and perhaps wished for. (Indeed, at least in the short run, foreign direct investment was not adversely affected, and in some months, seemed to have even increased.)
- Excessive reliance on debt does increase the vulnerability of firms. Unless corporate governance reforms, such as legal protections for minority shareholders, increased transparency and better accounting practices, are put into place, it will be difficult for firms to raise substantial amounts of capital in equity markets. Hence they will have to rely on debt. At the same time, we should be aware that relatively few countries have instituted legal protections that are sufficiently strong that they can support diverse shareownership. Accordingly, the countries may face a trade-off: They can reduce reliance on debt finance, by relying more on retained earnings. While this will reduce vulnerability it will also reduce growth.
- Good bankruptcy laws could have mitigated some of the worst aspects of the downturn. Elsewhere, I have called for a "super-chapter 11" type of provision, which would provide for an expedited corporate reorganization in the face of massive macro-economic disturbances such as those confronting East Asia over the past two and half years. Such a provision within the bankruptcy code would recognize that under extreme macro-economic circumstances, the borrower should not bear all or even most of the blame for the inability to repay its debts: well managed firms employing prudential financial policies simply cannot withstand extreme unanticipated events, exorbitant interest rates, massive devaluations, and economic collapse. Thus, such a provision should be more debtor friendly than conventional

bankruptcy codes, and there should be a strong presumption for firm continuity. The social cost of bankruptcy, the destruction of organizational and informational capital, is especially high at such times, and the macro-economic costs of the delays that so often characterize conventional bankruptcy procedures entail, under the circumstances, enormous macro-economic costs. Such a provision also recognizes the fundamental symmetry of loan contracts: for every loan there is a borrower and a lender; and a bad loan can be as much a result of failure of the lender to engage in due diligence as it is of the borrower. Lenders need to be forewarned that if they fail to engage in due diligence, if they push lending excessively beyond the ability of the borrowing country to repay, they are at risk. To be sure, such a provision may slow down the rush of capital into a country in boom times, but that is all to the good. Such a provision provides a decentralized partial alternative to a government or internationally sanctioned standstill, and is the standard market mechanism for "bailing in" creditors. Thai's Central Bankruptcy Court opened on June 18, and I am hopeful that the new bankruptcy law will be facilitate the resolution of outstanding cases, and reduce Thailand's vulnerability in the event of a future crisis. But other countries have yet to put in place an effective bankruptcy law, and even countries with seemingly good laws have encountered significant problems in implementation.

- Competition policy is essential, not only to promote economic efficiency, but to break the government-business nexus that often contributes to bad economic decisions and to avoid the too-big-to-fail problems which give rise to moral hazard and economic inefficiency more generally.
- Safety nets are important to protect those adversely affected by macro-economic shocks. Yet we must recognize that even in developed countries, at least formal safety nets for the self-employed (including farmers) – parts of the country that loom large in most developing countries – are weak. Thailand, and some of the other countries in East Asia are lucky that there are informal safety nets (e.g. family support) that have seemed to work quite well, and it is important that new formal safety nets not simply replace the informal ones, thereby gaining little in risk reduction, but at the same time, weakening society's social capital. Still, we should be

aware of the strains that were imposed, as those, for instance, in the Northeast, not only lost remittances from relatives in Bangkok, but had to support them as family members remigrated. The impact of the economic downturn was thus felt by many more than just those who lost their jobs or saw their wages fall. Moreover, many of the poor survived by eating into their meager savings—by one estimate, 20% of their consumption was so financed; it is not clear how long this could have continued, again reemphasizing the importance of government policies to sustain the economy at full employment, minimizing the magnitude of downturns and restoring the economy as quickly as possible once a downturn has set in.

The wrong lessons

Before leaving the discussion of the lessons of the crisis, I need to say a word about the *wrong* lessons that are being drawn as the countries recover from the crisis. First, some point to the stabilization of the exchange rate as evidence that the crisis is over. From the perspective of international investors and speculators, that may well be the case, but that should not be the perspective for the countries in the region. For the region, the crisis should not be declared over until growth has been restored and incomes have recovered. While the Mexico crisis was declared over sometime in mid-1995, real wages have yet to reach pre-crisis levels and the financial institutions remain weak.

Secondly, some argue that the recovery proves that the policies adopted in response to the crisis were correct - an egregious example of the *post hoc ergo proper hoc* fallacy. As I said earlier, crises almost always end. The relevant question about the appropriateness of the policies is: could the downturn have been shorter and shallower? And when the recovery occurs, to what do we attribute the recovery? There is a growing recognition that Mexico's quick recovery had more to do with exports - its major trading partner, the United States, was experiencing a boom and NAFTA had opened new trade and investment opportunities - than with any bail-out package, restoration of strength to its financial institutions (which as I have already noted, remained strong) or inflows of short-term capital. (To be sure, the counterfactual is always problematic: would trade

have soared without the bail-out? Or would it have increased even more if the exchange rate had not been implicitly supported by the bail-out.)

The seeming quick recovery presents puzzles for both the diagnosis and the prescription. Does one really believe that the deep fundamental problems that were described as at the root of the problems in Korea were resolved in the space of a year and a half (issues like corruption, the influence of the Chaebol, and a fundamentally unsound financial system) If true, it bodes well for countries around the world: reforms can be instituted almost overnight, bringing a country from a state of abysmal institutions to a viable state of strength. But I suspect that the criticisms were vastly overstated, and while the reforms were movements in the right directions, the source of recovery lies elsewhere. We need to ask questions such as, to what extent was Korea's quick recovery due to the fact that it did not close down its major financial institutions and restructured them instead (in contrast to Indonesia, where shutting down some private banks led to a run on other banks, with a resultant credit contraction contributing to the magnitude of the downturn, and the gaps in financial institutions making recovery all the more difficult)? To what extent is Korea's strong recovery due to the fact that it has maintained a low exchange rate, preventing an appreciation of the currency by buying huge amounts of foreign exchange which it has added to its reserves? These are complicated issues, and I do not have time to provide here a definitive treatment. I only wish to caution against hasty judgments. But I cannot but comment, looking around at the patterns and pace of recovery not only in this crisis, but elsewhere, that there are enormous costs associated with the destruction of information and organization capital, of the kind that results from extensive closure of financial institutions and firms in ways that are not attentive to these issues.

Policies and Strategies for the Longer-Term

The East Asian Miracle was built on a set of sound public policies. Governments promoted high levels of savings, investment in human capital, good macro-management, efficient allocation of investment, competition, closing the knowledge/technology gaps between their countries and more advanced industrial countries, and limited price distortions; without these policies there would have been no basis for growth. Policies

that assisted the financial sector in capturing non-financial savings and increase household and corporate savings were central. Despite allegations of weak financial institutions and poor corporate government, the countries in the region managed to invest the huge flow of savings remarkably well; incremental capital output ratios remained remarkably stable (in contrast to other countries where high investment rates quickly led to large increases in incremental capital output ratios.) Acquisition of technology through openness to direct foreign investment and licensing was also crucial to rapid productivity growth. Export oriented policies not only encouraged firms to adopt more advanced technologies and improve their quality, but also subjected firms to enormous competitive pressures. Public investment complemented private investment. Limited inequality—and widespread educational opportunity-- played a role in promoting social cohesion. These and other policies should remain the basis of future development strategies aimed at rebuilding of East Asia's battered economies.

These basics, the fundamentals that underlay the region's success over the past quarter of a century, provide the foundations for the restoration of growth in the region. But they are not enough. As I said earlier, countries have to adapt to changing circumstances; while these policies almost surely remain necessary for success in the coming decade, there is a question about whether they are sufficient. The crisis itself has had an effect on the countries. It is, for instance, not obvious that firms will be willing to undertake the heavy indebtedness that they did in the past to finance rapid growth. In the following paragraphs, I want to describe several elements that not only represent a strengthening of these basics, but reach beyond to create the foundations of democratic, sustainable, and equitable development.

The Foundations of a Market Economy

We are increasingly recognizing how difficult it is to make a market economy work. One needs much more than just private property. One needs a whole array of institutions, legal and financial; competition law, bankruptcy law, contract law, regulatory frameworks, and a judiciary capable of fairly and effectively enforcing the laws. In the early stages of their development, the economies in East Asia managed reasonably well with an underdeveloped set of foundations. But as the economies have

grown, it is unlikely that this can continue (and this would have been true even without the crisis.) Firms, for instance, are likely to be discouraged from investing in countries which lack the necessary legal and financial institutional infrastructure. And as we have already noted, the absence of this infrastructure makes economies more vulnerable; it may, for instance, force a greater reliance on debt, or a slower rate of growth. (As another example, China's remarkable growth over the past two decades has been based on job and enterprise creation by townships and villages, the so-called TVE's. As I asked in a speech I delivered in Beijing on Saturday, the question is, in the coming decades, will they be able to continue to provide the impetus for growth, or will China need to turn to alternative forms and structures of ownership.)

Let me say a word about institutional development. Legal structures and institutions cannot be grafted wholesale from one country onto another. Nor can they be imposed from the outside. They need to be adapted to the circumstances of the country, and they have to reflect the sense of values. These are not matters simply to be left to technocrats. An example may help illustrate my point. In the aftermath of World War II, the U.S. occupying forces imposed a competition law upon Japan that was modeled after that of the U.S. It did not take root, and, at least among many economists, there is a belief that anti-competitive practices remained a source of serious concern.

Moreover, just as societies change, so too will these institutions and legal structures. For instance, over the last several years, the United States has been engaged in an intense debate over reforming its bankruptcy law, trying to get the balance right between encouraging creditors to engage in due diligence in making loans and discouraging lenders from engaging in deceptive practices, and encouraging borrowers to repay their loans. In countries where a credit culture has yet to be established—where borrowers systematically do not repay loans—stronger credit protection is necessary; in circumstances where the inability to repay has little to do with the malfeasance of the borrower, more debtor friendly laws seem appropriate.

Effective Public Governance

The success of East Asia was in no small measure due to effective (and market-friendly) interventions by the government. We also now have a wealth of evidence that ineffective and corrupt states impede growth and discourage investment. We know many of the elements of policy which contribute to strong public governance, such as public commitment from senior leaders, are important, but there are also concrete reforms that are essential if this agenda is to move forward. I do not have time here to outline the full agenda, but there are two elements of it that I do want to stress. I have become convinced that for most countries at least, an essential part of strengthened public governance is increased participation, both directly in political processes, and indirectly through the activities of non-governmental organizations.

Secondly, meaningful participation requires an informed citizenry. This means that governments must be open and transparent, that they must recognize citizens' basic right to know - the government works for the people of the country, and they, the people, have every right to full knowledge of what it is doing and why it is doing it, with some very narrowly carved exceptions. Behind secrecy, corruption flourishes and democratic processes are undermined. The provisions of the 1997 Constitution in Thailand reflecting this basic right to know must be fleshed out and aggressively implemented. There will be those who will put forth all manner of argument undermining this basic right to know, such as that certain information may roil the market. As I argued in my Oxford Amnesty speech this year, we should be suspicious of such arguments; if anything, more information is likely to lead to more, not less, stability.

The international financial institutions have a special obligation in this regard, since they have no direct accountability (only an indirect accountability through government ministries and central banks—many of which themselves today have attained a high degree of independence) either to the citizens of the countries who founded and support them or to the citizens of the countries that they are supposed to serve.

Increased productivity

The countries in East Asia focused heavily on exports. In some of the areas that they traditionally exported they will in coming years be faced with increasing competition from other countries pursuing export oriented growth strategies. Some of these countries will have low wages, and while their productivity may also be lower, the lower wages may give these countries a competitive advantage. Either wages will have to be decreased (or increase at a slower rate), or these countries will have to restore their competitive edge, e.g. by moving up the “technology ladder.” This they can do, but it will require *strengthening knowledge institutions and investing more in secondary and tertiary education*. As I noted earlier, much of the earlier success of the region was due to its efforts at closing the knowledge gap, the gap in technology that separated them from the more developed countries. The region has made heavy investments in primary and secondary education, and some countries have made heavy investments in universities and research institutions, but other countries have lagged behind. Unless those countries make the requisite investment, they will not be able to move up the next rung in the ladder of development. Moreover to close the knowledge and technology gap, the countries in the region will have to remain open to the outside.

There are other aspects of economic policy which will play a role in longer term productivity—and which may at the same time contribute to increasing overall living standards. Thailand’s development has been heavily concentrated in the capital city, which (as I shall comment on below) not only places heavy stresses on that city, but also on the broader social fabric. All too often migration leads to the splitting up of families. More rural based development may assist the more efficient allocation of resources, at the same time that it addresses these broader social issues.

Improved living standards

The objective of development involves more than the increase in per capita GDP; that we strive for broader increases in living standards, for democratic, equitable, and sustainable development. These broader aspirations are especially relevant for the

countries of East Asia, for the enormous increases in incomes over the past third of a century has brought the vast majority of their citizens out of the dire poverty in which so many had lived for so long. And East Asia has even had a large measure of success in these broader goals. As I noted earlier, literacy is nearly universal for both girls and boys, life expectancy has increased, and the declining poverty rates have shown that the fruits of development are widely shared. There have even been long strides towards the creation of democratic institutions, and the greater participation of civil society bodes well for the political sustainability of reforms. While environmental sustainability is increasingly doubtful (especially in the urban areas), there is a growing recognition of this problem, and that at least is a necessary precursor to the challenge being effectively met. But, as we enter the twenty-first century, many are beginning to go beyond these questions, to ask what kind of *society* do the countries in the region wish to create. The economy and the polity are both reflections of, and an essential ingredient in, deep structures in society; they both affect, and are affected by, commonly accepted views of the relationship between individuals and their society. These are broad themes, and I have time here only to touch on three important manifestations.

Creating livable—and workable-- cities

One of the most important parts of the environment is the one in and surrounding cities. East Asia is becoming increasingly urban. More broadly, we used to think of that one of the features distinguishing less from more developed countries was the greater importance of the rural sector. In fact, by 2030 a majority of those in the developing world will live in cities. In the nineteenth century, during the period of rapid industrialization and urbanization in Western countries, cities became nasty and brutish places, where environmental degradation – from bad air, to dirty water, to unsanitary living conditions – was so bad that lifespans actually deteriorated and other health indicators (such as height) also became worse. This need not be the case in the coming decades in East Asia, but there is a real danger that it may if appropriate actions are not undertaken, and undertaken fairly quickly.

Urban congestion has occurred to such an extent that the very efficiency of the cities - the economies of scale and scope which give rise to the agglomeration economies that underlies the growth of cities - is threatened. Dealing with these challenges requires a four pronged strategy:

- First, infrastructure must keep pace with the growth of the cities. Much of this infrastructure can be privately financed and provided, if only the right regulatory structure is put into place.
- Secondly, careful attention has to be placed on land use patterns. Inevitably some form of zoning/regulation has to be implemented. The externalities associated with land use patterns are great, and free market development will accordingly tend to be far from efficient. Such land use control must extend well beyond the center city, because if there is not, what will result is the kind of urban sprawl which has been a blemish on the landscape in so many parts of the world.
- One of the most important determinants of land use patterns is the nature of the transportation grid. There is increasing recognition that, at least in large, dense cities, greater reliance must be placed on public transportation. (The extensive reliance on the automobile in many advanced industrial countries is not a natural evolution of competitive economic forces, but the result of collusion among the automobile industry to suppress public transportation. Demonstrative of this is the case of Los Angeles, where the rail-based public transport system was actually destroyed.) Even if one ignored the broader social consequences of the reliance on the private automobile, one can make a compelling case for curtailing its use, focusing simply on congestion, pollution, and accident externalities.
- And finally, careful attention needs to be devoted to the allocation of land for public use, e.g. public parks. This is an important ingredient in making cities livable and in enhancing standards of living in urban centers. More than that, such communal spaces can be an important part of a strategy for helping create social capital – a necessary ingredient for the long run success of any society and economy.

- *Strengthening the social safety net, including adapting to demographic changes*

Among the most important challenges confronting the countries of East Asia over the coming decades will be adapting to the changing demographic structures. This has several dimensions. Families will be smaller, and this will have profound impacts on social interactions. Many parents will not have children to support them in their old age, and the State (as well as individuals themselves) will have to assume greater responsibility. The changing patterns of dependency ratios may, at the same time, create economic tensions in the long run. The pace of these changes has not been fully realized. In France, it took 140 years for the proportion of the population over the age of 60 to double – from 9 to 18 percent. By contrast, in Korea, people over the age of 60 will double their share in the population in only 30 years – between 1990 and 2020 – and in China, this proportion of the aged population will rise from 9 percent to 16 percent during the same period.

A key part of the response to these demographic shifts will be creation of a safety net, particularly targeted at the aged. Such a social safety net must be attentive to the concerns of many in the region, that it preserve the individual's and the community's sense of responsibility at the same time that it reflects widespread views concerning social justice. Singapore and Malaysia have demonstrated how to combine social justice with individual responsibility in ways that promote both economic security, growth and efficiency through provident funds. Elsewhere, I have argued that integrated social insurance programs (combining, for instance, retirement and unemployment) can provide greater risk mitigation with better incentives than could separate programs. I believe that such a broadened social safety net should be considered seriously as part of the post-crisis reforms.

Democratic Participation

Accomplishing many of the changes that I have discussed in this talk will not be easy. There are vested interests that will resist them. Others will see them as generating uncertain risks. Key to success in promoting more rapid growth with equity will be extending democratic participation in society, e.g. by promoting non-governmental organizations and civil society more generally. Research done at the World Bank has

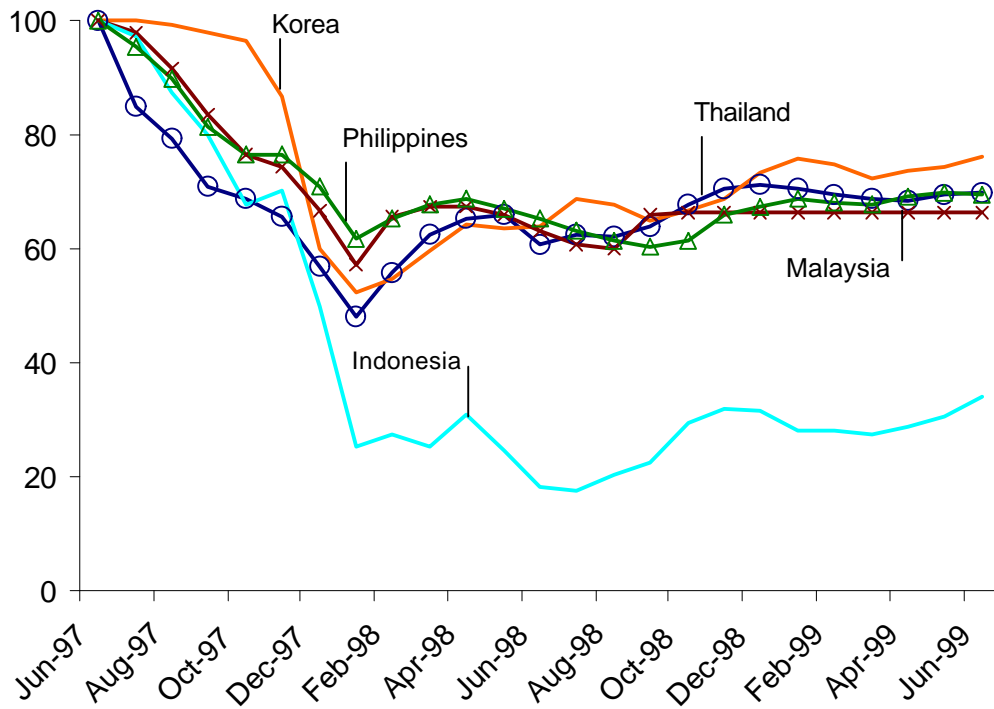
shown that participation facilitates success of our development projects. I have seen vividly how NGO's have succeeded in promoting development in country after country, in not only increasing the incomes of the poor, but in enhancing their sense of security, and giving them voice—a sense of empowerment the lack of which is one of the worst aspects of poverty. The changes within the region in this direction in recent years bode well for its future.

Conclusion

I have argued that we should not view the crisis as over at least until incomes have been restored to their pre-crisis levels—and this may take a while yet. Yet it is appropriate that we begin to go beyond the crisis, to think of strategies that will lead to a restoration of growth. There are, I think, four lessons that emerge from the arguments presented here:

- The countries of the region should not accept blanket blame and condemnation; they should be proud of the three decades of world class growth and poverty reduction.
- But neither should they ignore the structural issues, some of which were long present, which may have contributed to its vulnerability and/or weakened its competitiveness, making it difficult for it to sustain increases in per capita income.
- Thailand—and the other countries in the region—should not step back from openness to the outside world, in its many dimensions, especially to ideas and knowledge, investment capital, and competition; but that does not mean that it has to subject itself blindly to the vagaries of short term capital flows;
- And most importantly, Thailand should recognize that participation and popular voice are its strong suit in the region, and must be sustained and deepened, as they are key to its stability, to its social cohesion, and to reducing the inequities that built up in the pre-crisis period, and were exacerbated by the crisis itself.

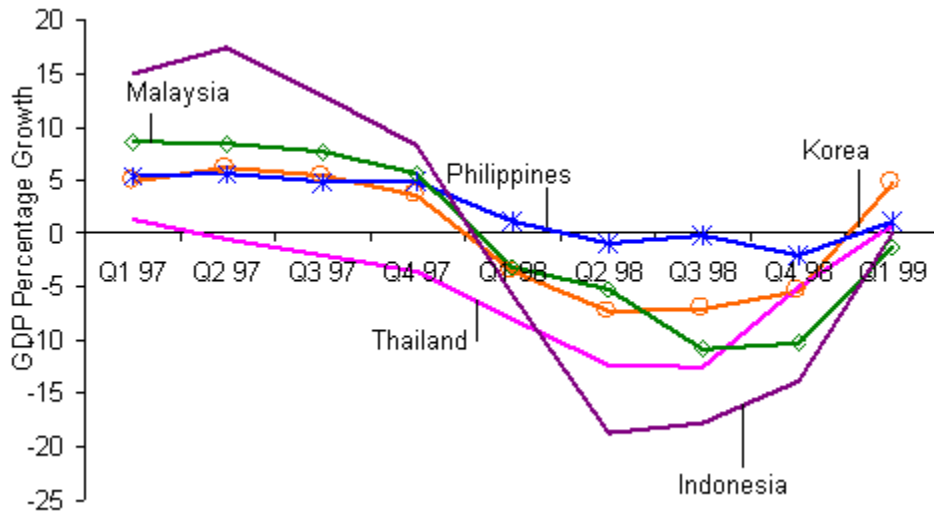
Figure 1: Exchange Rates in East Asia



The figure depicts the percentage change in exchange rates relative to the average June 1996 national currency/\$U.S. rate.

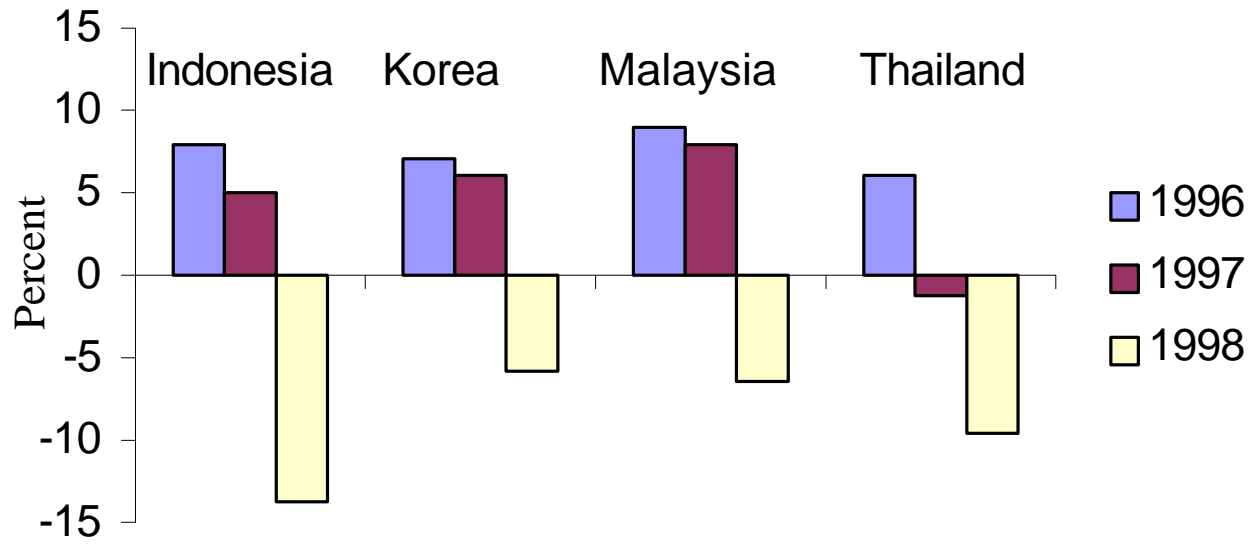
Source: World Bank.

Figure 2: East Asia Percentage GDP Growth



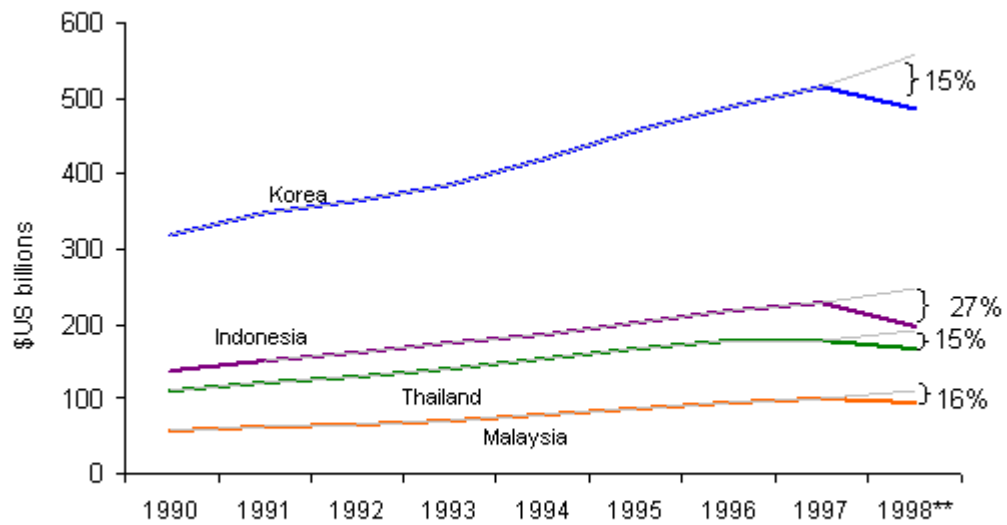
Source: World Bank.

Figure 3: GDP Growth in East Asian Economies, 1996-98



Source: Statistical Information and Management Analysis database.

Figure 4: East Asian GDP Growth Relative to Precrisis Trends



* Dotted line represents projected GDP growth based on average 1990-96 growth trends.

Source: Statistical Information and Management Analysis database