Canadian Centre For Foreign Policy Development

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SOCIAL IMPACTS OF THE ASIAN CRISIS: THE UNRAVELLING OF THE ASIAN MIRACLE?

Asia Pacific Foundation of Canada

-Roundtable Report-

June 1998

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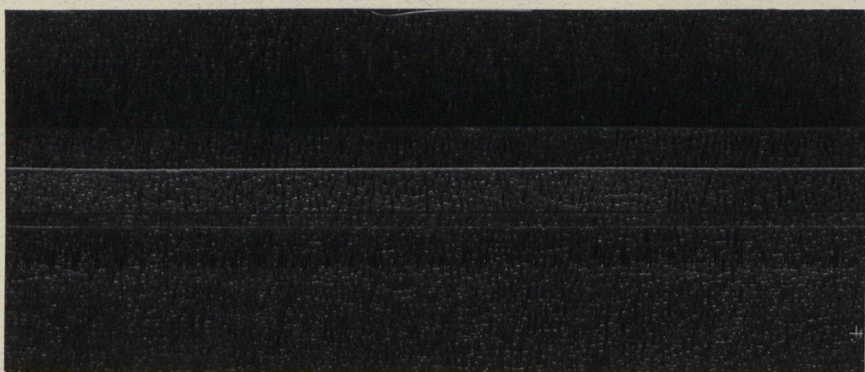

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SOCIAL IMPACTS OF THE ASIAN CRISIS

The Unravelling of The Asian Miracle?

An Asia Pacific Foundation of Canada Roundtable Report

Yuen Pau Woo, Director, Research and Analysis, Asia Pacific Foundation of Canada

ASIA PACIFIC FOUNDATION OF CANADA

The Asia Pacific Foundation of Canada is a national non-profit organization established by an Act of the Parliament of Canada in 1984. Its mandate is to promote stronger ties between Canada and the Asia Pacific region by providing high-quality research and information products and services for policymakers, businesspeople and educators across Canada. It houses the APEC Study Centre in Canada and is the Canadian Secretariat for the Pacific Economic Cooperation Council (PECC), the Pacific Basin Economic Council (PBEC) and the APEC Business Advisory Council (ABAC).

The tag "Economic Miracle" attached by The World Bank to East Asia is usually associated just with the remarkable growth rates that these economies experienced through the 70s and 80s. But the "miracle" was also in how social conditions improved dramatically for the majority of East Asians. As shown in tables 1 and 2 poverty has declined, not only in terms of the number of poor, but also in the severity of poverty. Life expectancy at birth, infant mortality rates, and literacy indicators have also all improved. These achievements are all the more impressive when compared with other developing regions, or even with the experiences of industrial countries during their comparable periods of industrialization.

Will the current economic crisis in Asia, the worst since the oil shock of the 70s, unravel the progress of the past 20 years? Who are the most vulnerable groups in the current crisis and how are they being affected? Is Canada doing enough to address these issues? To examine some of these questions, the Asia Pacific Foundation of Canada brought together a group of scholars, policymakers and NGO representatives in Ottawa on April 21, 1998 in the second of a series of Roundtables, focusing on impacts of the Asian financial crisis.[1]

THREATS TO SOCIAL WELFARE BEFORE THE CRISIS[2]

East Asia's spectacular progress in social welfare was generally developed against a backdrop of political stability (in some cases achieved through authoritarian methods), full employment, high household savings and strong community ties. This benign environment did not encourage governments to plan for downside risks, such as in the present crisis. As a result, even before the crisis, there were growing concerns about the vulnerability of the poor and near-poor, the absence of formal social safety nets to help households manage risks, the erosion of economic gains made by women, and the distribution of the burden of adjustment in view of often repressive labour policies.

Other cracks in Asia's social model were also apparent before the crisis. These include:

- the problem of persistent poverty in such areas as Indochina and Mongolia, and in parts of China, Indonesia and Thailand, despite dramatic reductions in aggregate poverty at the national level;
- the incipient rise in inequality in a number of Asian economies, especially China and Thailand, and to a lesser extent in South Korea and the Philippines;
- the gap between wage increases and productivity growth, as well as the need to modernize worker-management relations in some economies;
- the absence of formal mechanisms to protect many East Asian households from risks associated with job losses, disabilities and aging.

TABLE 1: POVERTY INDICATORS IN EAST ASIA, 1975-95

	Number of people in poverty (millions)			Headcount index (percent)		
ECONOMY	1975	1985	1995	1975	1985	1995
East Asia[a]	716.8	524.2	345.7	57.6	37.3	21.2
East Asia (excluding China)	147.9	125.9	76.4	51.4	35.6	18.2
Malaysia	2.1	1.7	<0.2	17.4	10.8	<1.0
Thailand	3.4	5.1	<0.5	8.1	10.0	<1.0
Indonesia	87.2	52.8	21.9	64.3	32.2	11.4
China	568.9[b]	398.3	269.3	59.5[b]	37.9	22.2

Note: All numbers in this table are based on the international poverty line of US $1 per person, per day at 1985 prices. Economies are ordered according to real GDP per capita (in 1995 purchasing power parity dollars).

a: Includes those economies in the table plus Philippines, Papua New Guinea, Lao PDR, Vietnam and Mongolia.

b: Data are for 1978 and apply to rural China only.

Source: Ahuja Vinod et al. *Everyone's Miracle? Revisiting Poverty and Inequality in East Asia.* A Directions in Development book. Washington D.C. : World Bank. 1997. Quoted by Tamar Manuelyan Atinç and Michael Walton, *East Asia's Social Model after the Crisis*, (World Bank, 1998, pre-publication version).

SOCIAL IMPACTS OF THE CRISIS: WHAT DO WE KNOW?

Most of the evidence on social impacts of the crisis so far has been anecdotal, which is not surprising given the relatively recent emergence of the problem. Roundtable participants reported various signs of deteriorating social conditions and growing unrest in economies they had visited recently. The indications of mounting social problems are seen in growing unemployment and the need to turn to the informal sector for a living, as well as increased migration of displaced workers.

Large-scale labour migration was mentioned as an important barometer of emerging social impacts. The displacement of workers (from urban to rural areas within a country as well as across borders) translates into a loss of remittances to their home villages and countries, as well as increased social and economic stresses on communities that absorb the newly unemployed.

There is some evidence that the difficulties faced by the agricultural sector in Indonesia (drought, fires and crop failures) have more to do with the effects of El Niño than with the financial crisis. Most participants in the Roundtable felt, however, that the worst of the social impacts from the financial crisis was yet to come. The most seriously affected economies (Indonesia, South Korea and Thailand) have only begun to implement their International Monetary Fund (IMF)-directed structural adjustment programs, which typically include sharp reductions in government spending, high interest rates, elimination of subsidies, and the forced closure of insolvent companies with the attendant layoffs.

TABLE 2: SOCIAL INDICATORS IN EAST ASIA, 1970-95

	Life expectancy at birth (years)		Infant mortality rate (per 1,000 live births)		Primary net enrollment (percent)		Secondary net enrollment (percent)	
ECONOMY	1970	1993	1970	1993	1970	1995	1970	1995
East Asia	59.4	68.2	75.6	33.8	n.a.	n.a.	n.a.	n.a.
Taiwan, China	69.0	74.0	n.a.	6.7	n.a.	>99.0	75.0	87.4
South Korea	60.6	71.3	46.0	10.6	>99.0	>99.0	45.4	93.4
Malaysia	61.6	71.3	45.2	12.6	84.1	88.7	25.5	55.9
Thailand	58.4	68.8	72.6	36.4	78.6	88.2	18.2	34.9
Indonesia	47.9	63.2	118.0	56.0	75.6	>99.0	13.0	55.0
China	61.7	69.2	69.0	30.5	75.9	>99.0	34.7	50.7

n.a.: Not available.

Note: Economies are ordered according to real GDP per capita (in 1995 purchasing power parity dollars).

Source: Ahuja Vinod et al. *Everyone's Miracle? Revisiting Poverty and Inequality in East Asia.* A Directions in Development book. Washington D.C. : World Bank. 1997. Quoted by Tamar Manuelyan Atinç and Michael Walton. *East Asia's Social Model after the Crisis*, (World Bank, 1998, pre-publication version).

If anything, all three countries (plus Malaysia, which is implementing a homemade "virtual" IMF Structural Adjustment Program) are delaying firm closures for as long as they can, in the hope that renewed capital inflows and economic growth will buy time for troubled companies to raise funds, restructure or merge. The much-anticipated layoffs in South Korea, expected to run in the hundreds of thousands, were only beginning in the second quarter of 1998. In Thailand, the National Economic and Social Development Board is projecting that the number of unemployed will more than double from 800,000 at the beginning of 1997 to about 1.8 million by the end of 1998, not including voluntary unemployment. The situation in Indonesia is that of an ongoing political crisis. Even with the resignation of President Suharto there will be a tortuous process of rebuilding political legitimacy and public confidence that can only mean further deterioration of social conditions in the short to medium term.

REVISIONIST HISTORIES OF ASIAN ECONOMIC DEVELOPMENT

Was East Asia's economic miracle a mirage? Were there elements in the "East Asian model" (such as governance structures, outward orientation and a general receptiveness to trade and investment liberalization) that were fundamentally flawed? Did Asia go too far in its "neo-liberal" economic orientation, or not far enough? The Roundtable touched on these questions and a number of participants argued that East Asia's economic model was doomed to fail. Indeed, the current crisis was interpreted by some as a vindication of alternative models of development that do not embrace the "globalization" agenda wholeheartedly. India was mentioned as an example of an economy that had chosen not to liberalize its economy as quickly as the Asian Tigers and had thus escaped the "contagion."

Beyond the measurable impacts, some participants observed a growing frustration and demoralization in Indonesia, South Korea and Thailand. This was likely brought on by the sudden turn of fortunes, which almost overnight set back the economic aspirations of millions, who in the previous two decades had been seduced by what seemed like the immutability of economic growth. Some of the anger was directed at "globalization" and "trade liberalization," and it is not clear what lasting impact this sentiment will have on the trade and investment liberalization efforts in the region, such as in the APEC forum.

There was some discussion on the relatively smoother adjustment process n South Korea compared to Indonesia. One explanation was that Korea ias a well-established labour movement and a democratic process for changes in the leadership. It is also helped by the fact that the incoming President Kim Dae Jung has traditionally had the support of the labour novement — though this support is now starting to erode. Indonesia, on he other hand, has a poorly developed civil society, let alone democratic nechanisms for changes in the leadership. Accordingly, the process of conomic adjustment has a greater sense of popular legitimacy in South Corea than it does in Indonesia.

he IMF has been at the receiving end of much criticism, and while this is familiar (and perhaps even desirable) position for the Fund, the recent riticism has taken on a greater significance because of the persistence of ie crisis and the fact that critics include a growing number of highly-espected mainstream academics, bankers and politicians. Some participants iw the mounting criticism as an opportunity to re-examine the role of the MF and more specifically, Canada's role in the IMF. One topic that has eceived much attention recently is the regulation of short-term capital flows.

Iore broadly, there has been a growing questioning of the "Asian model" f development. Some participants felt that the fundamental problems of is model were not being addressed, including problems of governance, bour repression, and over-dependence on foreign capital and footloose w-wage manufacturing investments.

LESSONS FROM THE PAST

The Asian crisis has invited comparisons with previous episodes of major economic crisis. Latin America and, to a lesser extent, Africa are the most obvious examples from the 70s and 80s. Others pointed to the parallels with the more recent collapse of the Soviet Union. The similarities include the implied failure of a development model, and the need for widespread restructuring of government private-sector relations, corporate practices, and the financial system as a whole.

Based on the work of the Inter-American Development Bank[3], there are a number of possible lessons from Latin America's "lost decade" of the 80s: First, the need for safety nets to be given high priority and to be put in place quickly. Second, the need to protect investment in human capital in affected households, for example through income or consumption transfers, to ensure that families keep children in school. Third, the mobilization of foreign resources for social funds, especially at a time when line departments responsible for social welfare are in disarray.

Social funds should be designed so that they benefit those who are most directly affected by the crisis. At the same time, line departments such as health and education should be protected as far as possible from government spending cutbacks. Finally, governments should consider delaying the removal of general subsidies on goods that are most intensely consumed by the poor and which make up a large portion of poor households' budgets.

Others, however, pointed out that the countries that have fared best in the current crisis are those with the most liberal (albeit well-regulated) trade and investment regimes, such as Hong Kong, Singapore and Taiwan. They suggested that the problems in Indonesia, Thailand and South Korea have more to do with incomplete liberalization and/or poor regulatory practices than with liberalization gone amok.

It was also pointed out that it is a consistent feature of economic crises that external scapegoats be found, whether it is the IMF, foreign currency speculators, conservative economic doctrines, or something as nebulous as "globalization." This kind of reaction has been seen not just in developing economies, but even in the United States which has a tendency to turn protectionist and insular when faced with domestic economic problems.

RESPONDING TO THE CRISIS: POLICY DIRECTIONS

A number of bilateral aid packages have been assembled in response to the social dimensions of the crisis, chiefly directed at Indonesia. A rough comparison of selected aid packages, including assistance from Canada, is shown in Annex A.

The Asian Development Bank has also approved or proposed social-sector program loans for Thailand and Indonesia, similar to World Bank "social funds" that were put in place for Latin America and Africa during the 80s and early 90s. It would seem that the design of the ADB social funds has as much to do with generating support from a broad spectrum of the population for tough economic measures as they have to do with mitigating the effects of economic reform on the existing poor and the "new" poor. It was pointed out that social funds have a tendency to be directed at the most vocal or politically powerful groups. Thailand's self-initiated "social fund," for example, was initially targeted at urban groups who were the most vocal, but likely not the most vulnerable to increased poverty.

Policy responses have to deal with at least three sets of choices: between socio-economic groups, between consumption and investment, and among different ways of protecting consumption. While each economy has to make choices based on its unique position, the types of short-term policy responses that are needed include a) ensuring that food markets work, b) sustaining purchasing power of poor households, c) targeting geographical areas, d) promoting public employment and local infrastructure, and e) providing direct food support, especially where markets are breaking down (such as in Indonesia). In the medium-term, governments should aim to protect social capital such as health and education, increase social services to the poor, improve local financial intermediation, reform labour market policies, and improve monitoring, diagnosis, public information and feedback. Better information includes the need for disaggregated data on gender impacts.

Some participants pointed out that the crisis has created new opportunities in various regional fora such as APEC to discuss social issues like labour-management relations that were previously considered too sensitive. It was suggested that Canada take advantage of this new openness to advance social issues on the APEC agenda. Already, the Human Resources Development Working Group of APEC has launched projects looking at the impact of the crisis on labour markets and on best practices in the workplace.

Other participants reported a growing intolerance of NGO activities in some of the affected economies. Grassroots organizations which publicized the plight of the poor were increasingly subject to government intimidation. Despite the rhetoric of greater openness and transparency, many NGOs are skeptical of governments' willingness to tolerate criticism and alternative viewpoints.

As a possible policy response, some participants suggested that Canada provide support for alternative viewpoints and solutions put forward by individuals and organizations in the affected economies. This group would include academics, journalists and the NGO community. It was pointed out that Canada had supported alternative thinkers in Chile during the Pinochet era, with seemingly favourable results.

Prior to the crisis in Indonesia, the Canadian International Development Agency (CIDA) had been working on a transition strategy for its bilateral development assistance program, with a view to bringing to an end Official Development Assistance (ODA) over a period of about 10 years. CIDA's current programming for Indonesia focuses on human rights, cooperatives, the environment and private sector development. Depending on how sharp the reversal in economic welfare in Indonesia turns out to be, there may be a need to rethink the transition strategy. Some participants felt that Indonesia had the makings of a potentially massive food crisis, made worse by the fact that much of the bad news on food shortages is being withheld by local authorities. It was also pointed out that many international development agencies working in Indonesia and Thailand are ill-equipped to deal with the looming humanitarian crisis. Like CIDA, many agencies were preoccupied with transition strategies and are no longer staffed by people with expertise in crisis management or humanitarian relief issues.

CAN WE TALK?

A number of participants at the Roundtable suggested that the crisis has created a new willingness among Asian member economies of APEC to discuss issues that were previously considered too politically sensitive. A stronger version of this thesis would go as far as to exhort Western governments, including Canada, to take advantage of the relative weakness in Asia to press for tangible progress in sensitive issues such as human rights. But does the new-found openness in Asia reflect a genuine change in the attitudes of political elites or are we looking at a short-lived experiment in wishful thinking? Do Western governments really have greater leverage today to exert their influence on sensitive issues in Asia? Should they exercise this leverage?

The commitment of Asian governments to undertake fundamental reforms of an economic nature, let alone social reform, has yet to be proven. The IMF package for Indonesia, for example, has had to be renegotiated a

THE MEDIUM-TERM OUTLOOK

number of times because of the unwillingness or inability of the Indonesian government to implement measures they had previously agreed to. For better or worse, the IMF has the best chance of imposing its policies on Asian governments because of its obvious financial leverage. It is not clear that APEC, which operates on the principle of an equal partnership and consensus decision-making, can bring about real changes merely through dialogue. On the other hand, some participants felt that APEC may be exactly the sort of forum which will allow for difficult issues to be discussed and advanced in a non-threatening and voluntary manner. Whatever the role of Western governments or international fora, changes in the attitude of Asian governments will be influenced more by domestic political considerations than by shifting international power balances. Any foreign-led activist agenda for social change that disregards domestic factors is not likely to go very far.

A number of participants expressed confidence in Asia's medium-to-long term prospects, which were underpinned by high savings rates, a well-educated workforce and, as a result of the currency realignments, improved competitiveness. If the economic reforms are carried out, Asia could emerge even stronger in two or three years. According to this view, the risk to Asia's recovery rests largely with the international economic environment, especially in the US, Japan and China. The US economy continues to show strong growth, but some analysts fear that the deteriorating current-account situation as well as a possible sharp correction in North American financial markets could derail the US expansion. Japan has shown only sporadic growth for about six years and may in fact experience a contraction of its economy in 1998. Instead of providing much-needed demand for Asian exports, it may turn out to be a drag on the international economy and as a result forestall an early recovery in the region. Some participants observed that Japan's sluggish performance in the 1990s was the root cause of the Asian crisis, and that the government's continued inability to address fundamental economic problems was a growing cause for concern.

While China has so far been largely unscathed by the Asian crisis because of its relatively closed capital markets, it is facing massive economic challenges related to the restructuring of State-owned enterprises and the insolvency of State banks. The official forecast for GDP growth in 1998 is a modest 8%. The risk of slower growth is rising unemployment which will threaten social peace and open the door to a devaluation of the yuan. Participants were reminded that China's role as a "pillar of stability" for the region is not guaranteed, and that a sharp economic downturn could have even more severe consequences for Asia than the present crisis.

Another risk factor is Indonesia. Continued political unrest in the country will have both direct and indirect effects on neighbouring economies. These range from a fall-off in bilateral trade and investment (especially with Singapore and Malaysia) to a general loss of confidence among international investors in Southeast Asia, with a possible prolongation of the "contagion" effect.

In assessing the medium-term economic outlook, some participants pointed out that it was important to consider "rogue factors" that had impacted the economic environment over the past 24 months. These include El Niño-induced drought, forest-fires and "haze" (impacting agricultural production in Indonesia and tourism in neighbouring economies), as well as low semiconductor prices in 1996-7, followed by low oil prices more recently.

The medium-term outlook for social welfare in the most severely affected Asian economies is not promising, even though it would take a prolonged and extremely deep economic recession to undo most of the improvement in social indicators that Asian countries have experienced in the past two decades. However, policymakers should not be resigned to worsening poverty during the current period of economic adjustment. With appropriate

PRO-POOR POLICIES

The important role of meso-policies in ameliorating the negative impact on vulnerable groups was brought up at the Roundtable. Whereas macro-policies influence primary incomes of the poor, meso-policies — in particular with respect to taxation and public expenditure — may compensate for or accentuate the effects of macro-policy, through their influence on secondary incomes. Well-designed meso-policies can, to some extent, protect the poor from adverse effects on their primary incomes during economic recessions. For example, if taxation on goods typically consumed by lower-income groups (e.g. staples, beer, tobacco) is increased, the secondary incomes of these groups will be worsened. Meso-policy choices with respect to public expenditure can be even more important in protecting the poor. These choices include the overall level of public expenditure with respect to GDP (and the corresponding tax ratio); the proportion of total government expenditure going to social sectors, for example health and education; and the priority that is given to social-sector expenditures, such as primary health care, which are directed at lower income groups.[4]

support from the international community, governments have at their disposal policy choices that protect the poor and which maintain investment in social capital such as health and education. Canada can play a role in supporting this kind of policy emphasis.

Put differently, the incidence of poverty will be affected by, among other things, whether there is a worsening of income distribution in affected economies. The World Bank's projections show that even with zero growth for the next three years, the incidence of poverty in Indonesia, Thailand, Philippines and Malaysia would rise only slightly, to levels prevailing in the mid-1990s, if there is no change in inequality. However, if inequality worsens, the rise in poverty could be much higher. For example, a 10% worsening in inequality would cause poverty incidence to more than double, from less than 7% in 1997 to almost 15% in 2000.[5]

A scenario of worsening income inequality, especially in Indonesia, is not difficult to envisage, and the resultant increase in poverty would undo much of the social progress of the last two decades. Such an abrupt reversal in economic welfare would undermine even further the legitimacy of political and economic institutions that have played an important part of East Asia's economic success. The stakes are very high indeed.

END NOTES:

1 The Asia Pacific Foundation of Canada would like to thank the Canadian Centre for Foreign Policy Development for financial support and the International Development Research Centre for the use of its premises. The Roundtable was conducted under Chatham House rules and comments are not attributed to individuals.

2 This section draws heavily from Tamar Manuelyan Atinç and Michael Walton, *East Asia's Social Model after the Crisis* (Washington: The World Bank, 1998, pre-publication version).

3 Lustig, Nora, *Latin American Crises and Social Costs: What Lessons for Asia?* Paper presented at Conference on "East Asia: The Unfinished Agenda," cosponsored by the World Bank and the Asian Development Bank, Manila, March 10-12, 1998.

4 Stewart, Frances, *Adjustment and Poverty: Options and Choices* (London: Routledge, 1995).

5 Atinç, Tamar Manuelyan and Michael Walton, *East Asia's Social Model after the Crisis*. (Washington: The World Bank, 1998, pre-publication version).

ANNEX A: SELECTED ASSISTANCE PACKAGES ANNOUNCED IN RESPONSE TO THE ASIAN CRISIS

CANADA

- Adopted a "generous and flexible approach" to open employment authorization applications by students from Thailand, South Korea, Malaysia and Indonesia under existing "Temporarily Destitute Students" provisions.
- Canadian assumption of the Indonesian bilateral commitment to the IMF program in Thailand of US $500 million.
- C $1 million to Thailand - $500,000 to support the work of the Thailand Development Research Institute and $500,000 to support Thailand's restructuring activities.
- C $281 million to Indonesia - $250 million in agricultural export credits to be managed by the Canadian Wheat Board; $20 million in export credits for essential goods to be managed by the EDC; $9 million in CIDA donations of food, medicine etc.; $1 million food aid to Irian Jaya; $50,000 additional contribution to East Timor food program.
- US $1 billion pledged to augment the IMF package for South Korea.

AUSTRALIA

- US $600 million in credit insurance funds to Australian exporters for sale of products (in particular wheat, barley, cotton and beef) to Indonesia.
- US $1 billion to Thailand and South Korea to help them overcome their financial crises.
- US $300 million to Indonesia to assist with its financial crisis.

CHINA

- US $3 million to Indonesia for emergency food and medicine.
- US $200 million (over 2 years) in trade credits for Indonesia.
- Offers to expand counter-trade, especially in agricultural products, with Indonesia.

EUROPEAN UNION

- US $25 million to help Asian countries pay for expertise to restructure their financial institutions.

JAPAN

- US $30 million to Indonesia for food and medicine
- Increase of US $10.8 million (up from US$ 23 million) contribution to special Japanese fund at the World Bank to provide technical assistance for financial sector reform in Asia.
- US $1 billion loan to Indonesia's central bank to help cash-strapped importers.

SINGAPORE

- US $3 billion to finance Indonesian exports to Singapore - amount could increase to US $5 billion. This represents Singapore's original commitment to the IMF agreement with Indonesia.

UNITED STATES

- US $70 million to Indonesia - $25 million in food aid; $25 million for purchase of basic foodstuffs; unspecified amount to assist Indonesian students studying at US universities.
- US $520 million to Indonesia — represents continuing programs funded by the US Department of Agriculture and the US Agency for International Development. US $400 million of this could be used to help Indonesian textile manufacturers purchase cotton and other materials from the US should normal commercial credits be unavailable; US $45 million for technical assistance in financial sector reform; US $75 million in trade guarantees.

Source: Press Releases from DFAIT and CIDA; *Asian Wall Street Journal*; *The Wall Street Journal*; *Business Times*, Singapore; Dow Jones; Central News Agency, Taiwan.

* As of April 1998. The initiatives described here do not necessarily represent assistance that is separate from existing bilateral commitments under the auspices of the IMF.

ANNEX B: OTTAWA ROUNDTABLE ON SOCIAL IMPACTS OF THE ASIAN CRISIS — PARTICIPANTS

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Canada Asia

Commentary

It is nearly a year since the financial whirlwind that brought havoc to East Asian economies first touched down in Thailand. Now is the time to take stock of the opportunities that repair of the economic storm damage may offer Canadian business and also of the role Canadian policymakers can play in assisting both Asian recovery and the Canadian private sector's participation.

Asia's economic landscape has changed – is still changing — though perhaps not as much as the rhetoric by politicians and economists may have us believe. The countries that stand out as having weathered the turmoil the best are Thailand and South Korea. Both have stabilized their foreign financial sectors with the help of injections of capital through packages led by the International Monetary Fund (IMF). Both have been able to reschedule or at least roll over their most pressing foreign debts. Both have begun implementing financial reforms mandated by the IMF. Both have seen their currencies recover from their low points of early this year. Yet the relative attractions of the countries to Canadian business at this time are quite different.

Canada's business relationship with South Korea and Thailand has traditionally been through trade rather than investment. Exports to South Korea in 1997 were $2.9 billion, while cumulative Canadian direct investment to the end of 1996 was just $177 million. Exports to Thailand in 1997 were $444 million: cumulative direct investment in 1996 was $271 million. However, in today's new environment, the best avenue for Canadian involvement appears to be through direct investment rather than increased exports. Of the two countries, South Korea looks a better, though still risky, bet as Bangkok has not yet moved as far as Seoul in opening to foreign investors.

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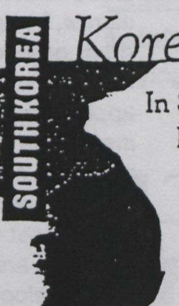

Korea flings open the door to FDI

In South Korea both international support and internal reform have been extensive. Because of this, the opportunities opening up are more obvious and may involve less anguish than in Thailand — though there are many reasons to believe that internal and external shocks over the next year will make Korea's recovery less than smooth. There is a high probability of crises accompanying the restructuring of debt-laden banks, massive corporate bankruptcies, violent protests by unemployed workers and backsliding by the government on its reform promises as the urgency of crisis eases and political compromises come into play. There is also the unpredictable impact of unrelated developments in Indonesia, Japan or Hong Kong which, given the fragile state of foreign investor confidence in all of Asia, are likely to cause fluctuations in the value of the won and hinder the raising of new capital.

But, for companies willing to accept the risks of currency instability and political scares, South Korea could be attractive. The accompanying panel shows that the door to foreign investors has been opened wide. But, who should enter?

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Korean companies are short of cash but rich in assets

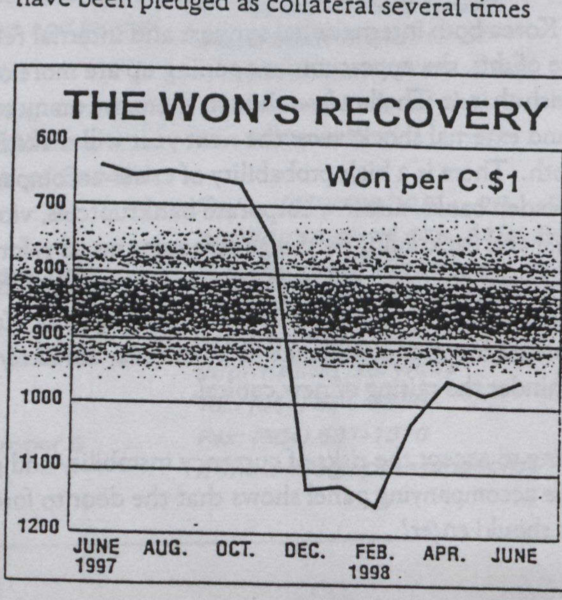
South Korea's urgent need is for new capital and strong management. It has a technologically up to-date industrial base, efficient infrastructure and a large, skilled workforce. But, the quest by its business groups for output growth, at the expense of productivity improvements and financial return, made it vulnerable to the break in lender confidence which came in November. Without rapid sales growth, there was insufficient cash flow in many companies to service outstanding loans. However, the material assets underlying those loans are, in most cases, sound — although usually heavily leveraged. The reforms implemented or underway are intended to attract foreign direct investment (FDI) into those assets for both the capital and the management expertise foreign owners can bring.

The service sector offers the best match for Canadian skills

For Canadian companies which already have a good understanding of the Korean market and Korean business practices, the reforms have issued an invitation to find a liquidity-strapped business in need of the added strength a foreign partner can offer. There are sound manufacturing assets available in areas of Canadian expertise like food processing and biotechnology products. However, the best opportunities are probably in more service-oriented sectors such as environmental services, information technology areas like value-added network services, specialized computer software and systems integration, management consulting, provision of low-cost housing and in the troubled but newly liberalized area of financial services.

Investors should beware of the many pitfalls facing foreign buyers of Korean assets

But a warning. New investors should not delude themselves that their progress will be smooth. While they may be saviours of the enterprises in which they invest, they may also find themselves accepted only as a necessity. There is widespread resentment at the need to cede control of Korean companies to foreign investors. New offshore owners may find this reflected in difficulty in dealing with senior employees. Working with Korean partners always presents challenges for Canadians because of the very different management styles of each country. Also, any potential investor must tread with care — and have good legal advice — when negotiating to buy Korean assets: one of the weaknesses of the Korean financial system is that a maze of loan cross-guarantees often means the same assets have been pledged as collateral several times



FDI REFORMS SO FAR

Major reforms already undertaken in South Korea to make foreign investment easier and more attractive include:

- Foreigners can now purchase up to 55% equity in a company on the Korean stock exchange. The ceiling will be removed entirely by the end of 1998. Purchase of up to 33% equity without the consent of the existing board, is now also permitted in most companies.
- All but 18 of 1,148 business areas are now open to direct foreign investment. Excluded or still restricted are certain defence-related or cultural industries (for instance, foreign ownership of cable TV program producers will be limited to 30%). In 24 sectors where some restrictions still apply, lengthy prior approval of investments has been replaced with a system of simple notification, with automatic approval unless an objection has been raised within a set time. Restrictions on further business areas like real-estate leasing, land development and petroleum retailing, will be removed in July and August.
- Restrictions on foreign ownership of land will be removed by mid-year.
- Many controls on corporate foreign exchange transactions will be removed on July 1 with further liberalization from April 1, 1999.

over. For this reason, now is not the time for companies not already familiar with the business culture to look for an investment in South Korea.

Though passive so far, Canada could play a special role in Korean reforms . . .

At a policymaking level, Canada has so far been surprisingly uninvolved in recent developments in Korea. It provided financial support along with other G-7 countries by offering up to US $1 billion in stand-by loans as part of the December 1997 financial support package. However, South Korea is a country with which Ottawa has been seeking a special partnership, cemented by an exchange of visits by Prime Minister Chrétien and former President Kim Young Sam and by a formal agreement to develop Canada's role in Korea's services and advanced technology sectors. The massive restructuring facing the Koreans provides both a need and an opportunity for Canada to move ahead in these areas — to the mutual benefit of Korea and to Canadian business. A meeting of the Special Partnership Working Group — the first since the crisis began — in Seoul on June 22 - 24 provides a timely setting to advance the relationship.

. . . and Ottawa could use anti-US feeling to its advantage

Of particular interest is regulation of the financial sector. On April 1, the Korean Government established a unified financial supervisory agency to take over the functions of four different organizations. It will be crucial to the Korean economic recovery for this agency to exercise strong and effective prudential supervision of Korean banking. Canada has a strong and well-regulated banking industry and is in a good position to provide assistance to the Koreans. While the US has traditionally had a major presence in Korean banking, there is much resentment that the conditions the IMF imposed on Korea match closely the liberalization goals Washington had been pursuing with Seoul for years. Free of this political baggage, Canada and Canadian companies are well-placed to offer expertise in assisting the Korean financial reform. They should not be shy in playing the "we are not Americans" card.

Thailand stalls for time

Thailand is a different story. While that country has been praised for its agreement to reform and liberalize important segments of its economy, little has yet been done outside the financial sector. Even there, reforms are hedged with restrictions and are proving difficult to put into practice. One problem is the strong cultural and political opposition to measures that involve opening up to greater foreign ownership. While these mirror similar popular sentiments in Korea, the installation of Kim Dae Jung as South Korea's president in February brought into power an administration which, in general, is independent of the business

REFORMS SO FAR

Major reforms already undertaken in Thailand to make foreign investment easier and more attractive include:

- Regulations have been eased to allow majority foreign shareholdings in local financial institutions for 10 years. After that, new share issues must be offered to local investors to reduce progressively the foreign holding to 49%. However, the Finance Ministry may allow foreign institutions to take a permanent 100% stake in four failed banks now under government control.
- A new bankruptcy law, in effect since April 10, allows for debt restructuring under a court-approved recovery plan. This replaced the old law which provided only for the liquidation of insolvent companies. The new law gives protection to investors providing new capital, as an enticement to foreign investors. This will be further strengthened by a new law relating to confiscation of assets of insolvent companies, expected to be in operation by November.
- Restrictions on foreign exchange transactions, introduced last year, have been removed.
- The government is committed to the IMF to announce details of how it plans to substantially privatize Thai Airways International and state-owned power and petroleum retail corporations in 1998, plus petroleum production and telecommunications corporations in 1999. These are expected to attract substantial foreign investment.

elite and is secure in its tenure for five years. It is, at least initially, free from obligations to big business, allowing it to propose radical reforms — although action is yet to come on putting its commitments into practice.

Chuan government is susceptible to business-pressures to limit liberalization

In contrast, the Thai government of Chuan Leekpai, which came to power in November, appear stable, but is far from secure. It is a six-party coalition which must face an election likely some ti within the next year. In addition, the government is made up of politicians who have long been part of the governing elite. While Chuan and a few of his senior colleagues are considered to be personally untainted by the endemic corruption in Thai politics, they are still part of the coalitio of business and political interests which brought the Thai economy to its knees and are thus vulnerable to pressures from major business groups. Reform, especially opening up the economy increased competition through greater foreign ownership, will come grudgingly.

A huge property glut hangs over Thai efforts to resolve banking crisis

Some progress has been made. However, plans to amend restrictions on foreign ownership of lan and real estate appear to have stalled, along with those to open much of the services sector to foreign investment. Popular sentiment is against foreign ownership of property. At present, only foreign-controlled projects promoted by the Board of Investment are allowed to own land, along with a ceiling of 40% foreign ownership of condominium projects. Government policy seems to b to stall for time in the belief that the economy will recover sufficiently so that some of its most painful moves — especially selling off a huge portfolio of finished and partly-built property financ by defunct finance companies — can be delayed until prices recover. Otherwise, solvent banks w see their capital wiped out by having to write down the value of property backing their loan portfolios to fire-sale levels. This is a huge dilemma. The government is holding about C $32.5 billion of assets, much of it property, of 56 insolvent finance companies on which it is estimated to be facing losses of up to C $19 billion if sold today. The problem of valuing property collateral for outstanding loans was also one of the unresolved issues on which takeover talks between Bank of Nova Scotia and Nakornthon Bank, one of the smaller Thai banks, founded earlier this year.

In these circumstances, it would be wise for Canadian companies, especially those not already familiar with Thailand, to move cautiously when looking at the apparent bargain assets now available in Thailand in areas like agro-business or auto-parts manufacturing, and to avoid any property purchases. The long-term potential is good — Bank of Nova Scotia, which has been involved in the Thai financial market for more than a decade, is expected to take up a full bankin licence in Thailand in July. But, for other companies, delay may be wise.

Canada won friends by taking over Indonesia's pledge to Thai bailout package

While Canadian business has generally held back from new commitment to the Thai economy during its crisis, Canadian policymakers have shown considerable creativity. In April, Finance Minister Paul Martin announced that Canada was taking over from Indonesia its commitment of US$500 million to the IMF-led Thai financial support package. While obviously welcomed by Bangkok, the move also earned considerable goodwill from Indonesian officials who were no longer in any position to meet a commitment made before Indonesia found itself a recipient rather than a donor. The Canadian loan ensured the annual Canada-Thailand Bilateral Economic Committee meeting in Bangkok on May 28-29 was a friendly affair.