Asia Recovery Report 2001

March 2001 http://aric.adb.org

The Asia Recovery Report (ARR) is a semi-annual review of Asia's recovery from the crisis that began in July 1997. The analysis is supported by high-frequency indicators compiled under the ARIC Indicators section of the Asia Recovery Information Center web site.

This issue of the ARR focuses on the five countries most affected by the crisis: Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand. The recovery processes in these five countries together with their strengths and weaknesses are discussed. The special theme of this ARR is foreign direct investment inflows in the wake of the crisis.

Contents

Boxes

Asian Development Bank

Highlights

Recovery in 2000

- The gains in regional equity prices and currency values posted in 1999 were largely wiped out in 2000. However, the real sector of the countries most affected by the crisis (Indonesia, Republic of Korea [henceforth, Korea], Malaysia, Philippines, and Thailand) turned in its best performance since the crisis began in July 1997.
  - Although the tempo of recovery tapered off a little as 2000 progressed, the estimated growth outturn in the affected countries, on average, was 7.1 percent as compared to 6.9 percent in 1999.
  - During 2000, the Philippines exceeded its previous peak level of per capita real GDP, following Korea which did so in 1999. Other countries also partially recovered their lost incomes.
- Efforts to restructure the banking and corporate sectors continued in 2000. While progress was made, much remains to be done.
- The incidence of poverty is beginning to fall in most of the affected countries.

Outlook for 2001

- Since the October 2000 issue of the *Asia Recovery Report*, the downside risks to recovery in the affected countries have increased.
- External risks have heightened because of the faster than expected slowdown in the US and global economies, accompanied by a rapid fall-off in the growth of electronics demand.
  - Exports, which had driven recovery in the affected countries, started to slow sometime after September/October 2000. The slowdown is expected to be quite sharp this year.
  - Lower US dollar interest rates and ongoing economic recovery will tempt international investors back into regional equity markets. Net inflows of private capital are projected for 2001 for the first time since the crisis.
- On the domestic front, while political risks have receded in the Philippines and Thailand, investor confidence has still to be fully restored as policy weaknesses remain.

Continued overleaf

Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AMC	asset management company
ARIC	Asia Recovery Information Center
ARR	Asia Recovery Report
ASEAN	Association of Southeast Asian Nations
BNM	Bank Negara Malaysia
BOT	Bank of Thailand
bp	basis point
CAR	capital adequacy ratio
CDRAC	Corporate Debt Restructuring Advisory Committee
CDRC	Corporate Debt Restructuring Committee
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
GNP	gross national product
IBRA	Indonesian Bank Restructuring Agency
IIF	Institute of International Finance
IMF	International Monetary Fund
IT	information technology
JCI	Jakarta Composite Index
JITF	Jakarta Initiative Task Force
KAMCO	Korea Asset Management Corporation
KLCI	Kuala Lumpur Composite Index
KOSPI	Korean Stock Price Index
M&A	merger and acquisition
MNE	multinational enterprise
MSCI	Morgan Stanley Capital International
NASDAQ	National Association of Securities Dealers Automated Quotation
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PHISIX	Philippine Stock Exchange Composite Index
PRC	People's Republic of China
REMU	Regional Economic Monitoring Unit
ROE	return on equity
SET	Stock Exchange of Thailand
US	United States
WEO	World Economic Outlook
B	baht
P	peso
RM	ringgit
Rp	rupiah
W	won
y-o-y	year-on-year
Note:	"$" refers to US dollars, unless otherwise stated.

The *Asia Recovery Report 2001* was prepared by the Regional Economic Monitoring Unit of the Asian Development Bank and does not necessarily reflect the views of ADB's Board of Governors or the countries they represent.

How to reach us

Asian Development Bank
Regional Economic Monitoring Unit
6 ADB Avenue, Mandaluyong City
0401 Metro Manila, Philippines

Telephone
(63-2) 632-5458/4444

Facsimile
(63-2) 636-2183

E-mail
aric_info@adb.org

- Heightened external risks will impair but not derail recovery in the affected countries.
  - Estimates by the Regional Economic Monitoring Unit (REMU) staff suggest that the adverse impacts of the global economic and electronics industry slowdown will be significant.
  - The consensus view among Asia experts is that incomes in the affected countries will grow by 4 percent, on average, this year compared to 7.1 percent last year. But the situation is expected to improve in 2002 when the affected countries will probably grow by about 5 percent.
- Fears of a new crisis are exaggerated. The quality of recovery is improving, adding resilience to the affected countries, which are now in a much stronger position to absorb shocks.

Country-Specific Recovery Prospects

- Indonesia's recovery is on a firmer foundation, but political problems continue to undermine investor confidence and could lead to policy slippages.
- Countercyclical measures (such as accelerating public spending and lower domestic interest rates) adopted by the Korean Government will cushion the economic slowdown. However, slow progress in corporate restructuring will continue to be a drag on the economy in the medium term.
- In Malaysia, incomplete restructuring of domestic corporations and restrictions on entry of foreign banks continue to undermine foreign investor confidence.
- In the Philippines, near-term anxiety about domestic political conditions has receded, but the Government has yet to present a comprehensive economic program that resolves past problems and puts the economy on a higher growth path. This might not happen until after the congressional elections on 14 May.
- The prospects of a more stable government in Thailand have improved, but there are concerns that some of the new Government's proposals may entail large fiscal costs and work against the efficiency of rural credit markets.

Trends in Foreign Direct Investment Inflows

- Foreign direct investment (FDI) inflows have shown considerable resilience in the wake of the Asian crisis. The presence of foreign firms has also helped to temper the contractionary effects of the crisis.
- An important side effect of the crisis has been the further liberalization of FDI regimes. Three years into the recovery, the future of FDI inflows to the affected countries, with the exception of Indonesia, looks bright.

Tracking Asia's Recovery—A Regional Overview

Introduction

In year 2000, the gains in regional equity prices and currency values posted in 1999 were largely wiped out. But the real sector turned in its best performance since the crisis began. The five countries most affected by the crisis—Indonesia, Republic of Korea (henceforth, Korea), Malaysia, Philippines, and Thailand—grew collectively by an estimated 7.1 percent in 2000, compared to 6.9 percent in 1999. Bank and corporate sector restructuring also made some progress.

Despite a shadow cast over near-term prospects by the slowdown of the US and global economies, and a cooling off in the rapid growth of global electronics demand, regional incomes will expand in 2001, although at a slower pace than in 2000. This should help social recovery. Regional asset markets may fare better in 2001 compared to 2000, net private capital inflows may resume, and monetary policy is likely to remain broadly accommodating.

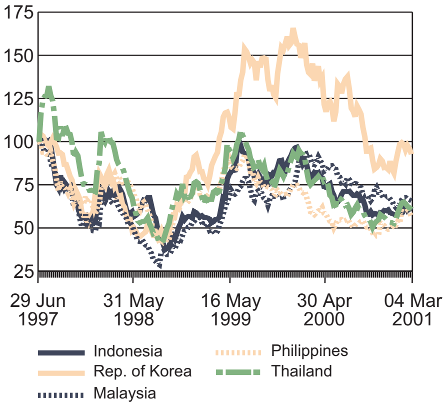
Although fears of a new crisis have been exaggerated, serious challenges remain. Corporate restructuring is slow and a backlog of more difficult cases, often involving multiple creditors and debtors, remains. Real asset markets have been slow to adjust, with liquidations, mergers, and takeovers comparatively few. The agenda of operational restructuring, including how corporations are managed and governed, and conduct their business, lags behind balance sheet restructuring. Financial sector recovery, too, is still only partial. Bank balance sheets, while stronger, remain fragile and credit flows are still stunted. Public debt has risen to a level where scope for deficit spending measures to offset demand shocks has been narrowed. Social recovery has lagged behind broader macroeconomic recovery and means have to be found to distribute the benefits of growth in a more equitable way. Prospects for sustained growth in the medium term—and beyond—will require measurable progress in each of these areas.

Recovery in 2000

Financial and Asset Market Developments

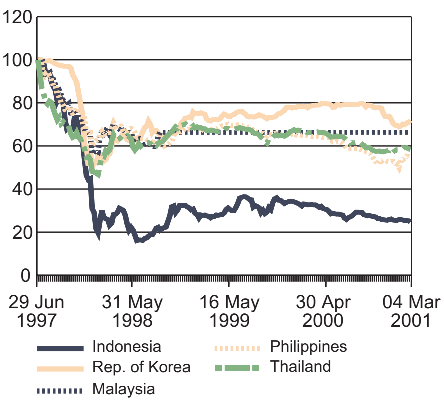
Despite an acceleration of growth, an erosion of equity values in 2000 left some regional equity markets more or less where they were at the

Figure 1: **Composite Stock Price Index*** (last week of 1997June=100)



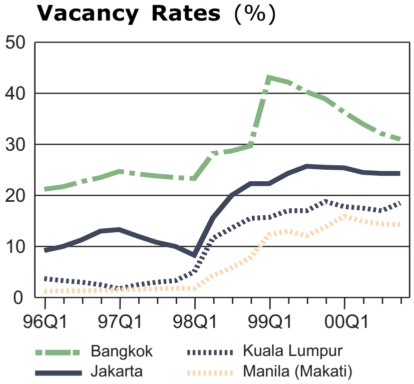
*Weekly averages of JCI (Indonesia), KOSPI 200 (Korea), KLCI (Malaysia), PHISIX (Philippines), and SET Index (Thailand).
Source: ARIC Indicators.

Figure 2: **Exchange Rate Index** (weekly average, last week of 1997June=100, $/local currency)



Source: ARIC Indicators.

Figure 3a: **Office Property Vacancy Rates** (%)



Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

beginning of 1999 in local currency terms. While domestic factors, including, to varying degrees, heightened political risks, fragile fiscal balances, and concerns over the pace of bank and corporate restructuring, played their part in the erosion of equity values, the regional decline was also part of a broader global trend. Increases in US interest rates in late 1999 and early 2000, and a slowdown in the pace of electronics orders, which hit information technology (IT) stocks hard, also took their toll.

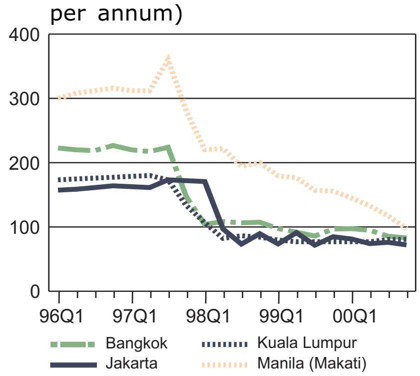
The first few weeks of 2001 have seen a welcome rally in most regional equity markets. Cuts in US dollar interest rates, with the prospect of more to come, the resolution of political uncertainties in some countries, and historically low price-to-earnings ratios have helped support demand for equities. Despite the continued poor performance of the NASDAQ, which is now at its lowest level in more than two years, local markets have sustained their gains. But the relief is still very much partial. Equity values in Indonesia, Malaysia, Philippines, and Thailand are (at end-February 2001) still about 30-40 percent below their June 1997 levels. In Korea, the corresponding gap is 7 percent (Figure 1). In dollar terms, losses measured relative to earlier peaks are larger still.

Through 2000, falling equity values were accompanied by a depreciation of domestic currencies compared to the US dollar—in Indonesia, by 27 percent; Korea, by 10 percent; Philippines, by 20 percent; and Thailand, by 14 percent (Figure 2). While not insignificant, these depreciations were no larger than those seen in some other currencies, such as the euro or Australian dollar. Again, global as well as domestic factors were at work. In particular, rising US dollar interest rates made assets denominated in regional currencies less attractive. International investors also shunned emerging markets across the globe for the safety of home-based, indexed portfolios.

Of course, concerns over the pace of reforms and political uncertainties played their part in the erosion of the value of domestic currencies. Scheduled debt repayments in Indonesia and Thailand also underpinned a strong demand for US dollars. In Korea, a weakening balance of payments position toward the end of the year placed the won under pressure. Meanwhile, rising world oil prices hit the currencies of net fuel importing economies such as the Philippines and Thailand, and continued ethnic unrest in Indonesia has increased selling pressure on the rupiah in recent weeks.

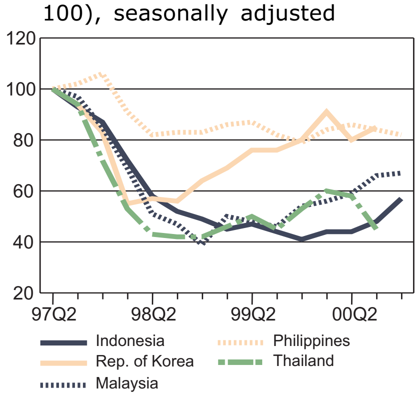
Property markets were badly hit during the crisis. While they have yet to recover, evidence is accumulating that the worst is over. Office vacancy rates remain high and have seesawed from quarter to quarter. Nevertheless, they have generally continued on a downward trend through most of 2000 (Figure 3a). In Malaysia, the office vacancy rate

Figure 3b: **Office Property Rents** ($ per square meter per annum)



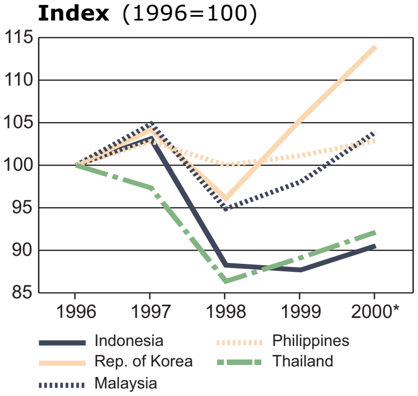
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Figure 4: **Real Gross Domestic Investment Index** (1997Q2=100), seasonally adjusted



Source: ARIC Indicators.

Figure 5: **GDP Per Capita Index** (1996=100)



*GDP for Indonesia, Malaysia, and Philippines are actual values. GDP for Korea and Thailand were based on projections by Consensus Economics. Population estimates were based on national population censuses, except for Indonesia, where the 2000 level was based on the 1999 growth rate.
Sources: ARIC Indicators; Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001; and national statistics offices of Indonesia, Korea, Malaysia, Philippines, and Thailand.

edged up in the last quarter. There were no signs of recovery in office rents in dollar terms (Figure 3b). The luxury residential property market is starting to pick up, but the pattern of recovery is patchy across cities and different segments of the market.

Real Sector Developments

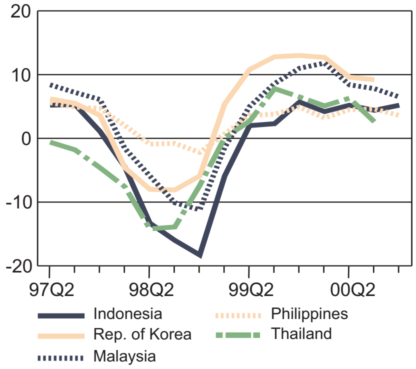
In contrast to the beleaguered asset markets, the real sector performed better in 2000 than in any year since the crisis. Indonesia grew by an estimated 4.8 percent, 0.8 percentage point higher than the Government's own projection. Although the official estimate of growth in 2000 is still not available for Korea, its outcome will likely surprise on the upside. Estimates suggest that year-on-year (y-o-y) growth in 2000 may have reached more than 9 percent. In Malaysia, meanwhile, growth surged to 8.5 percent in 2000, surpassing initial government estimates. For the Philippines, growth in 2000 is now officially estimated at 3.9 percent, quite close to what was expected. However, in Thailand, actual growth is likely to be about 4.5 percent, short of an initial projection of 5 percent.

The supply and demand components of growth are described in Box A. The main discernable feature here is that the structure of growth, both on the demand and supply side, has become more balanced. Even domestic investment, which had for a long time lagged behind, is beginning to pick up in some economies (Figure 4).

There was further recovery of incomes lost during the crisis years. By the end of 1999, per capita incomes in Korea had already surpassed their previous, 1997, peak level. During 2000, the Philippines joined Korea in recouping real incomes. Other countries narrowed the gap. Thanks to solid growth in 2000, Malaysia looks set to fully recover lost income by the end of 2001. However, it may not be until 2003 before Thailand makes up lost ground, and longer still before Indonesia can restore per capita incomes to precrisis levels (Figure 5).

The tempo of recovery is, however, slowing. As 2000 progressed, growth began to taper off, most noticeably in Korea, Malaysia, and Thailand (Figure 6). To some extent, this reflects the low base from which the earlier expansion of output was measured and a reversion to more sustainable rates of growth, particularly in Korea and Malaysia. But economic activity is now being affected by the slowdown in US and global growth that started in the second half of 2000. As Table 1 shows, this has been reflected in a sharp contraction in the rate of growth of exports in all countries.

Figure 6: **Real GDP Growth** (%, y-o-y)



Source: ARIC Indicators.

Table 1: **Exports—Percent Change of Latest* Seasonally Adjusted Monthly Level from Peak**

	All Exports		Electronics Exports	
	Peak	% Change From Peak	Peak	% Change From Peak
Indonesia	Sep 00	-4.3	. . .	. . .
Korea, Rep. of	Aug 00	-12.2	Sep 00	-15.0
Malaysia	Sep 00	-16.6	Aug 00	-12.7
Philippines	Dec 00	-23.3	Dec 00	-11.6
Thailand	Aug 00	-8.2	Nov 00	-3.4

. . . = not available.
*As of January 2001 for Indonesia and Philippines, November 2000 for Korea, December 2000 for Malaysia and Thailand.
Sources: Bloomberg; web sites of Bank of Korea, Bank Negara Malaysia, and Bank of Thailand.

Box A: **Drivers of Asia's Recovery—Sources of Growth**

Figures A-1 to A-10 break down the contribution of the components of demand and supply to overall gross domestic product (GDP) growth. Each bar in the charts is calculated as the product of the percentage change, measured year-on-year (y-o-y), in the expenditure or output category and its base share of GDP. Calculated in this way, the sum of the individual components of growth (from either the demand or supply side) is roughly equal to overall GDP growth.

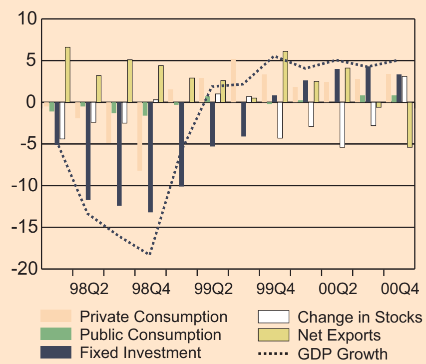
Figures A-1 to A-5 show that it was net exports that tempered the economic contraction and initially led the recovery in most of the affected countries. As recovery progressed, however, domestic demand increasingly became an important source of growth. This was most evident in Korea and Malaysia, where investment and private consumption have been contributing more than 50 percent to growth since late 1999. In Indonesia, too, the combined contribution to growth of private consumption and investment has been expanding since the second half of 2000. But, more important, the fixed component of domestic investment has begun to support growth in Indonesia, Korea, and Malaysia.

While external demand has remained an important source of growth in Thailand, public and private consumption have provided an additional impetus. As in Thailand, net exports continued to be a major contributor to growth in the Philippines. But private consumption has remained the most consistent growth source. Meanwhile, investment has been slowly increasing its contribution to growth since the middle of 2000, but this was more due to changes in stocks than to increased investment spending.

Figures A-6 to A-10 show the contribution to growth by production categories. In the initial stages of recovery, manufacturing led the way in Korea, Malaysia, and Thailand. As recovery advanced, services became another important source of GDP growth.

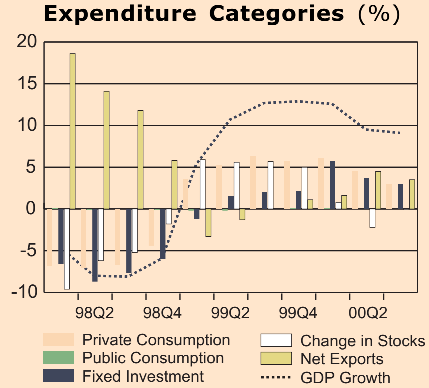
While manufacturing also supported Indonesia's recovery process, its contribution has been less pronounced than in Korea, Malaysia, and Thailand. It is the services sector that has largely propelled Indonesia's economic growth since the middle of 1999. In addition, agriculture has once again contributed positively to growth. In the Philippines, the manufacturing sector has recently begun to contribute to growth, although the services sector remained the dominant source. Agriculture's contribution, on the other hand, faded slightly in 2000.

Figure A-1: **Indonesia Contribution to Growth by Expenditure Categories** (%)



Sources: Statistics Indonesia and Bank Indonesia.

Figure A-2: **Republic of Korea Contribution to Growth by Expenditure Categories** (%)

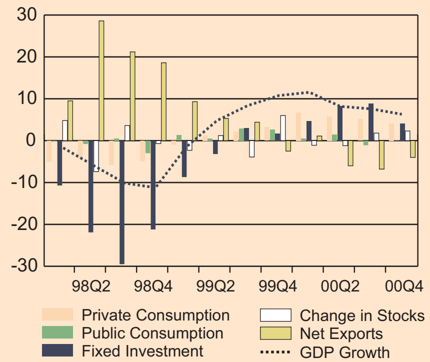


Source: Ministry of Finance and Economy.

Continued next page

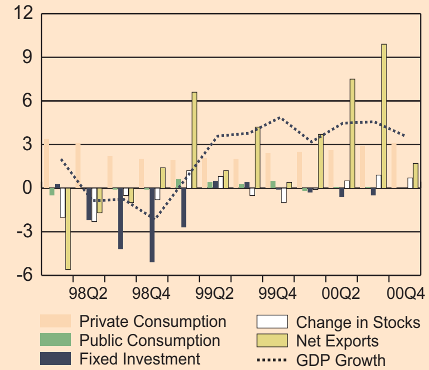
Box A: **Drivers of Asia's Recovery—Sources of Growth** (Cont'd)

Figure A-3: **Malaysia Contribution to Growth by Expenditure Categories** (%)



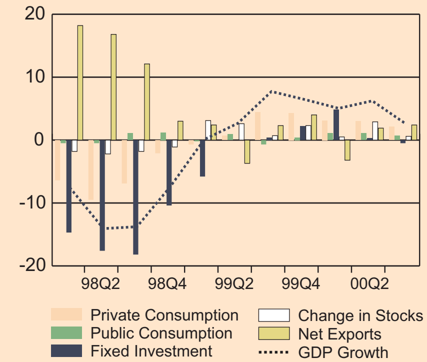
Sources: Bank Negara Malaysia and Department of Statistics.

Figure A-4: **Philippines Contribution to Growth by Expenditure Categories** (%)



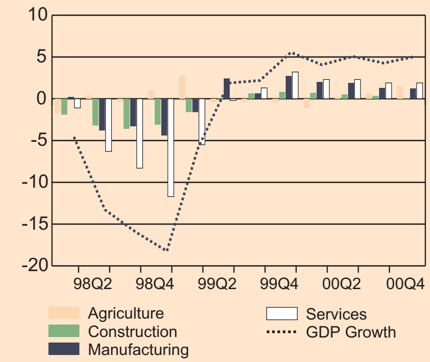
Source: National Statistical Coordination Board.

Figure A-5: **Thailand Contribution to Growth by Expenditure Categories** (%)



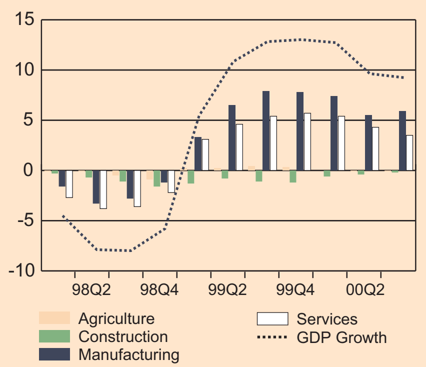
Source: National Economic and Social Development Board.

Figure A-6: **Indonesia Contribution to Growth by Production Categories** (%)



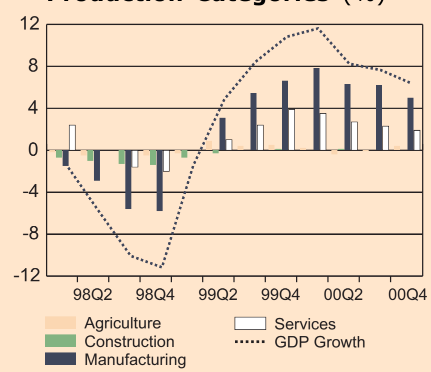
Sources: Statistics Indonesia and Bank Indonesia.

Figure A-7: **Republic of Korea Contribution to Growth by Production Categories** (%)



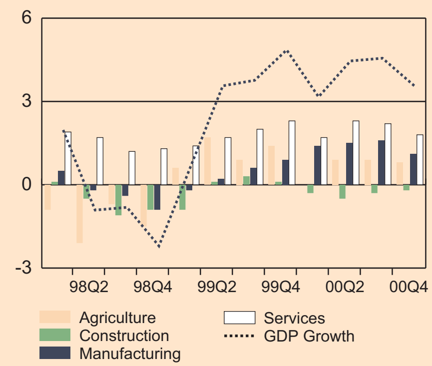
Source: Ministry of Finance and Economy.

Figure A-8: **Malaysia Contribution to Growth by Production Categories** (%)



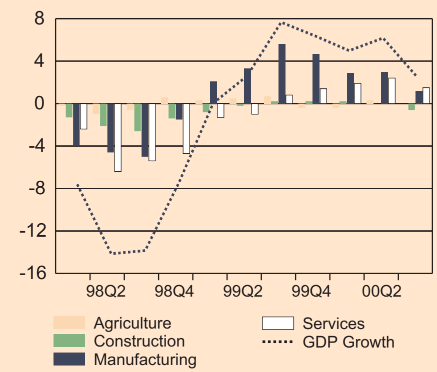
Sources: Bank Negara Malaysia and Department of Statistics.

Figure A-9: **Philippines Contribution to Growth by Production Categories** (%)



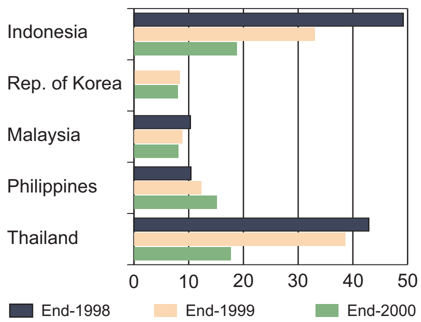
Source: National Statistical Coordination Board.

Figure A-10: **Thailand Contribution to Growth by Production Categories** (%)



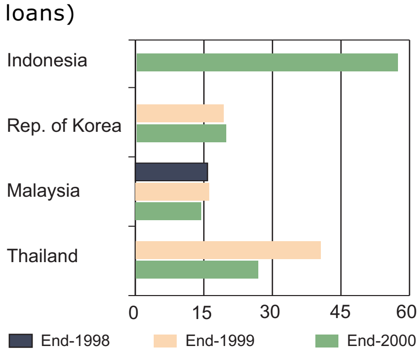
Source: National Economic and Social Development Board.

Figure 7: **NPLs of Commercial Banks*** (% of total commercial bank loans)



*Banking sector for Indonesia. Data on NPLs exclude those transferred to AMCs. The NPL criteria for Korea were changed in December 1999, so no comparable data are available prior to that date. End-2000 data for Korea are as of September. NPLs are on a three-month accrual basis.
Sources: Web sites of Bank Indonesia; the Financial Supervisory Service, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; and Bank of Thailand.

Figure 8: **NPLs Including Transfers to AMCs*** (% of total loans)



*NPLs cover the banking system for Indonesia and Malaysia and the financial system for Korea and Thailand. End-2000 data for Korea are as of September; for Malaysia, as of November for AMCs' NPLs and December for the banking system's NPLs. NPLs are on a three-month accrual basis.
Sources: Web sites of Bank Indonesia and the Indonesian Bank Restructuring Agency; Financial Supervisory Service and Korea Asset Management Corporation; Bank Negara Malaysia and Danaharta; and Bank of Thailand.

Bank and Corporate Restructuring

Work on restructuring the banking and corporate sectors continued in 2000. But much remains to be done.

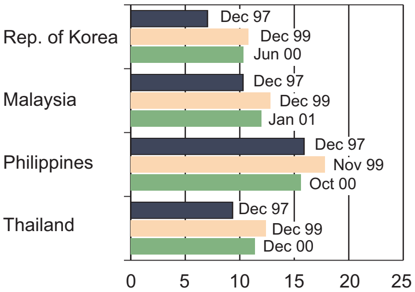
PROGRESS IN BANK RESTRUCTURING. Commercial banks' nonperforming loan (NPL) ratios, on a three-month accrual basis, continued to fall throughout 2000 in all the affected countries, except the Philippines, where the level edged up (Figure 7). By the end of 2000, Thailand's NPL ratio had declined to 17.7 percent, bettering the Government's year-end target of 25 percent. In Indonesia, as of December 2000, the ratio for the banking sector was reported at 18.8 percent, a substantial improvement on the peak levels recorded in early 1999.

Despite these achievements, NPL ratios, including those of Korea and Malaysia, remain high. While some debts have been restructured and voluntary servicing of previously impaired loans has recommenced, a substantial part of the NPL reduction can be accounted for by the transfer of problem loans from banks' balance sheets to asset management companies (AMCs). When NPLs still held by AMCs are added to those in the banking system, a truer picture of underlying difficulties emerges (Figure 8). Although aggregate NPLs are falling, many of the problem loans transferred to AMCs are awaiting resolution through disposal or workouts.

A comparatively recent aspect of the NPL problem is the growing reclassification of previously restructured loans as nonperforming. In all the five countries, the operational restructuring of troubled businesses has not kept pace with the restructuring of their financial obligations. Ultimately, an improvement in debt servicing capacity requires a return to operational profitability. Doubts also exist over the classification and valuation of some loan assets, and therefore of the true magnitude of embedded losses in NPL portfolios. For some institutions, these are possibly much larger than has been disclosed.

In all the affected countries, except Indonesia, official estimates of banking sector capital satisfies the current Basle Capital Accord minimum recommended standard of 8 percent (Figure 9). However, care has to be exercised in interpreting these ratios. Capital adequacy ratios (CARs) tend to be a lagging rather than a leading indicator of financial robustness. Also, in some cases, asset values may have been inflated to avoid loan loss recognition and provisioning needs. Besides, it is not clear that a CAR in excess of 8 percent provides adequate

Figure 9: **Capital Adequacy Ratios of Commercial Banks** (%)



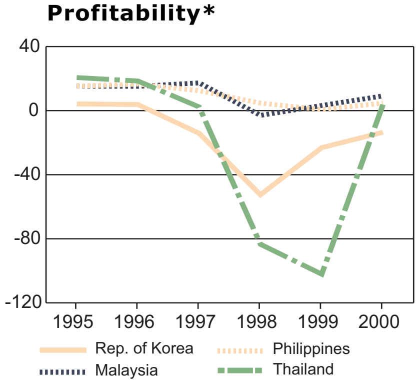
Sources: Web sites of the Financial Supervisory Service, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; and Bank of Thailand.

protection against the risks that banks in emerging markets face. Indeed, proposals contained in the New Basle Capital Accord, published on 16 January 2001, encourage regulators in emerging markets to set minimum capital standards in excess of 8 percent on a bank-by-bank basis, where risk profiles so warrant. Leaving these caveats aside, there was a notable deterioration in reported CARs for Korea, Malaysia, Philippines, and Thailand in 2000. Information is not available on capital adequacy for Indonesia's banking system. But among the seven banks that have been recapitalized with the assistance of the Indonesian Bank Restructuring Agency (IBRA), their CAR was reported to be about 10 percent as of December 2000.

Domestic banks in all the affected countries, except the Philippines, incurred substantial losses during the crisis years, due to loan loss provisions, loan write-offs, and reduced lending. The fact that some banks are gradually returning to profitability suggests that margins must be improving as creditworthy borrowers pay off their debts (Figure 10). Going forward, this should eventually augur well for balance sheet strength.

The process of rehabilitating banks' balance sheets is closely intertwined with the task of restructuring corporate and other debts. During 2000, corporate debt restructuring, under the auspices of centralized and publicly-owned asset management entities, moved forward. Progress in the acquisition and disposal of impaired loan assets has been quickest in Korea and Malaysia (Figure 11). In Indonesia, while more than 80 percent of the banking system's NPLs have been transferred to IBRA, less than 3 percent have been disposed of. Meanwhile, the new administration in Thailand has recently announced its intention to create a centralized AMC that will carve out $28 billion of impaired loans from State and private banks.

Figure 10: **Banking Sector Profitability***

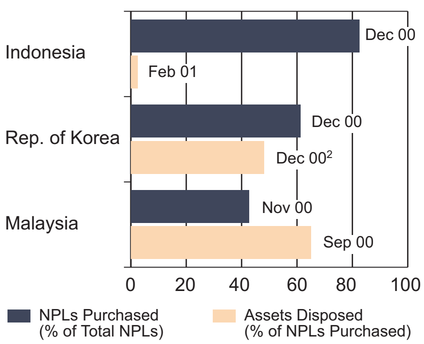


*Average return on equity of commercial banks. Figures for Malaysia, Philippines, and Thailand for 1995-1999 were calculated using data from Bloomberg. For 2000, data used were based on information from Malaysian banks' web sites (referring to the fiscal year); Bangko Sentral ng Pilipinas web site (as of the third quarter); and the Stock Exchange of Thailand web site. Figures for Korea were taken from the Financial Supervisory Service. Sources: Web sites of the Financial Supervisory Service, Bangko Sentral ng Pilipinas, Stock Exchange of Thailand, and selected Malaysian banks; calculations from Bloomberg data.

The recovery of asset values has been greatest in Malaysia and lowest in Indonesia (Figure 12). Although recovery values have also been modest in Korea, assets were acquired by the Korea Asset Management Corporation (KAMCO) at a deep discount. Before expenses, the Korean and Malaysian AMCs made profits from their loan asset disposal activities.

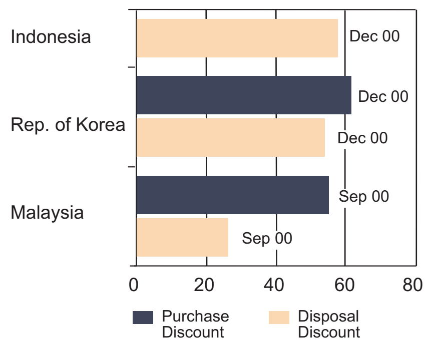
PROGRESS IN CORPORATE RESTRUCTURING. In tandem with asset disposal, measures intended to facilitate corporate restructuring have been moving forward. Nevertheless, problems remain. In Korea, resolving the financial difficulties of *chaebols* remains a pressing concern. In November 2000, the country introduced a corporate restructuring

Figure 11: **NPLs Purchased and Disposed of by AMCs**[1] (%)



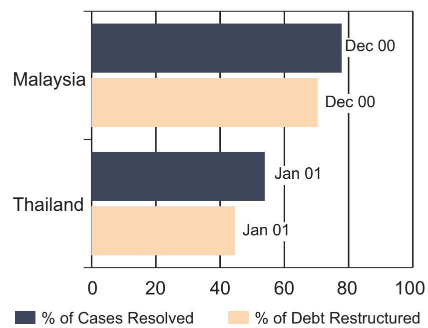
[1] NPLs purchased and disposed of refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia as of the dates indicated.
[2] NPLs acquired as of December 2000 as percent of total NPLs as of September 2000.
Sources: Web sites of Bank Indonesia, IBRA, KAMCO, Bank Negara Malaysia, and Danaharta.

Figure 12: **Discount Rates on NPL Purchases and Disposals by AMCs*** (%)



*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia as of the dates indicated.
Sources: Web sites of IBRA, KAMCO, and Danaharta.

Figure 13: **Government-Supervised Voluntary Workouts***



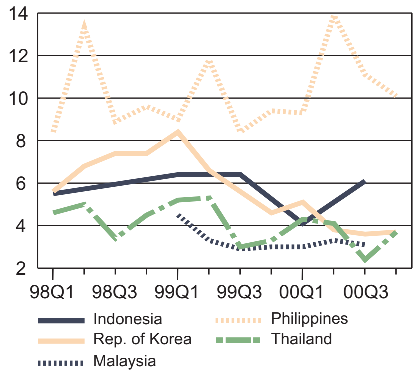
*Data refer to cases registered under CDRC (Malaysia) and CDRAC (Thailand).
Sources: Web sites of CDRC and CDRAC.

vehicle (CRV) system, which aims to improve Korean financial institutions' capital structures by removing from their balance sheets impaired loans owed by ailing firms that are already under workout programs. In December 2000, additional funding was also made available for the second round of corporate and financial restructuring.

However, the restructuring of the top Korean *chaebols* remains a formidable challenge. In November 2000, the Government forced Daewoo Motors (DM) into bankruptcy. But normal operations were unable to continue under receivership. Two of DM's three main plants closed as subcontractors refused to supply parts except for cash. Workers in Daewoo are resisting retrenchment proposals. Some 34 Daewoo executives and accountants have now had charges of fraud leveled against them for inflating the book value of assets. Amid the fallout from Daewoo, the Korean Government has softened its position somewhat on the restructuring of Hyundai Engineering and Construction (HEC).

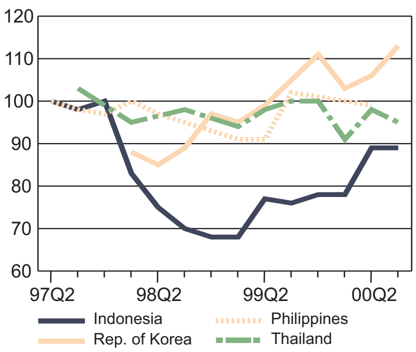
Despite impressive achievements by the Corporate Debt Restructuring Committee (CDRC), restructuring in Malaysia has tended to focus on lengthening the maturity of loans and forgiving interest payments rather than restructuring the operations of debtors. Thailand's Corporate Debt Restructuring Advisory Committee (CDRAC)

Figure 14: **Unemployment Rate** (%), seasonally unadjusted



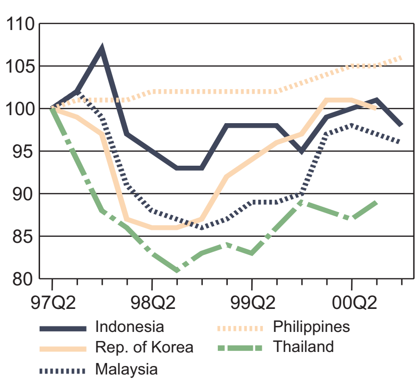
Source: ARIC Indicators.

Figure 15: **Real Wage Rate Index** (1997Q2=100), seasonally unadjusted



Source: ARIC Indicators.

Figure 16: **Per Capita Real Private Consumption Index** (1997Q2=100), seasonally adjusted



Source: ARIC Indicators.

has also made considerable progress in debt workouts (Figure 13), but there is a growing list of cases being referred to the bankruptcy courts. It seems unlikely that Thailand's bankruptcy courts will be able to deal with these expeditiously. In Indonesia, although debt rescheduling by the Jakarta Initiative Task Force (JITF) is still some $2.6 billion short of the April 2001 target agreed upon with the International Monetary Fund (IMF), there has been a significant acceleration in the pace of restructuring over the past six months.

Social Sector Developments

Economic recovery and renewed growth have led to an improvement in job prospects, increases in real wages and private consumption, and have contributed to a measure of social sector recovery.

In Indonesia, Korea, and Thailand, quarterly unemployment rates in 2000 were mostly lower than their respective levels one year earlier (Figure 14). The reduction was particularly sharp in Korea and Thailand as new jobs were created in an expanding economy. However, in the Philippines, despite positive growth, the recorded unemployment rate rose, as new jobs could not keep up with the expansion in labor supply. The underlying rate of population growth in the Philippines is 2.3 percent and the labor force is expanding at about the same rate each year.

Data on real wages are incomplete, but they show that the average real wage rate surpassed its precrisis level in Korea in the third quarter of 1999, reflecting improved labor market conditions (Figure 15). In the Philippines, the real wage index reached its precrisis level in the second half of 1999, but lost ground again in 2000. In Indonesia, although increasing, the real wage remains below its precrisis level. Real wage data are not available for Malaysia.

Real per capita private consumption began recovering in early 1999. In the Philippines it never fell below precrisis levels (Figure 16), while in Indonesia, Korea, and Malaysia it has recovered substantially, with Korea reaching its precrisis peak. However, in Thailand, real per capita private consumption was still about 10 percent below its precrisis level as of the third quarter of 2000.

World Bank data and projections suggest that the incidence of poverty has begun to fall with the renewal of economic growth. Based on a consumption poverty line of $1.5 per day per person, the incidence of poverty in Malaysia is negligible. In the Philippines, the share of the poor in the total population is expected to fall from 27.5 percent in 1997 to about 25.4 percent in 2001. Indonesia has the highest incidence of poverty among the five countries, rising to a peak of 37 percent in 1999. This number is projected to fall to about 32 percent in 2001. In Thailand, it is projected to fall to 12.2 percent in 2001. However, with growth expected to slow in 2001, reductions in the incidence of poverty will come more slowly than anticipated just a few months ago.

Domestic and External Risks to Recovery

Since the last issue of the *Asia Recovery Report* (*ARR*) (October 2000), the downside risks to recovery in the affected countries have increased. In October 2000, the growth outturn in 2001 was projected to be higher than that in 2000 in Indonesia, Philippines, and Thailand; while in Korea and Malaysia, growth was expected to moderate to a more sustainable pace. In the last five months, however, there has been a heightening of downside risks. The US and global economies have slowed more quickly than anticipated, and the electronics sector is quickly losing momentum. Within the region, the picture is mixed. Political uncertainties have come to the fore in some countries but receded in others. Progress on reforms is uneven.

Domestic Risks

In the last few months of 2000, political uncertainties in Indonesia, Philippines, and Thailand had, to varying degrees, a negative impact on market sentiment and investor confidence. In Indonesia and Philippines, corruption allegations against sitting presidents caused jitters in equity and currency markets. Difficulties were further compounded by provincial ethnic conflicts. Pending elections created uncertainty in Thailand, although a coalition with a large majority has now been formed. Political risks have now receded in the Philippines following a peaceful change in administration.

In Indonesia, political uncertainties continue to cloud the horizon, bringing with them a number of serious economic problems. Largely as a consequence of measures taken to stabilize its financial system during the crisis years, the country now faces exceptionally difficult fiscal circumstances. Interest on government debt alone absorbed 54 percent of tax revenue in 2000, and is budgeted to absorb 42.5 percent in 2001. To finance these commitments, the Government hopes to use the proceeds of the sales of impaired assets acquired by IBRA. While these sales are currently on target, more needs to be done to render the process transparent and to address the concerns of potential investors. The implementation of fiscal decentralization plans, in the absence of appropriate fiscal controls, also threatens budgetary stability.

In Indonesia, beyond asset disposal, there are difficult restructuring issues to be broached. Lenient treatment of debtors, many of whom are politically powerful, continues. Recent proposals threaten the independence of Bank Indonesia, while frequent changes of management at IBRA undermine its credibility. On top of this, inflation has edged up to 8.9 percent in the fourth quarter of 2000. Rising interest rates are needed both to combat inflation and support a currency that is being weakened by investor nervousness on reports of continued ethnic violence.

In the Philippines, the new administration faces a legacy of problems, some long-standing, others a consequence of mismanagement by the previous administration. Latest estimates suggest that the budget deficit in 2000 was more than twice its targeted level, resulting in a further increase in public debt. In this difficult context, measures are urgently required to relieve pressures on the poorest segments of the population.

The incoming administration in Thailand is still working out the details of how it will implement and finance the policies and programs on which it was elected. It has already announced the creation of a centralized Thailand Asset Management Company (TAMC) that will carve out $28 billion of impaired loans from the banking system. While this should help strengthen banks' financial positions, it may do little in the short run to get credit flowing as many potential borrowers are still perceived as bad risks. There are also concerns over the broad fiscal implications of proposed measures. Scope for fiscal relaxation is limited given that government debt has already escalated sharply. The suggested subjugation of monetary to fiscal policy and the implied abandonment of inflation targeting could also raise apprehensions about the coherence of the evolving macroeconomic policy framework.

Faltering progress on corporate restructuring in the affected countries will continue to pose risks to the financial sector, undermine confidence of domestic and foreign investors, and threaten the sustainability of recovery. While there has been progress on debt resolution, the most difficult cases, often involving politically powerful and large debtors, have yet to be tackled. In Indonesia and, to a lesser extent, in Thailand, the insolvency framework remains biased against creditors and bankruptcy courts are not proving effective in spurring voluntary debt resolution. The slow pace of needed operational restructuring is another cause for concern. At a micro level, many companies remain too diversified and are burdened by excess capacity. Poor corporate governance practices, an absence of disclosure, and, on occasion, an inhospitable political climate have also deterred nonresidents from providing much needed finance and strategic expertise to restructuring efforts.

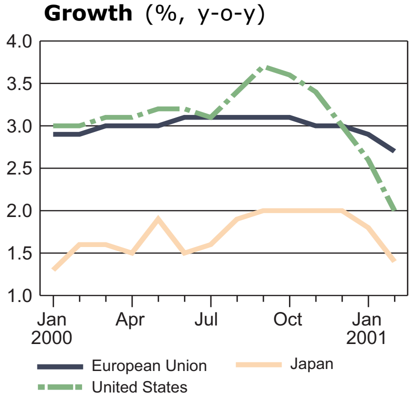
Nevertheless, several reforms were introduced in 2000, including the enactment of a Foreclosure Law and Debt Collection Regime in Thailand. In Korea, corporate restructuring vehicles were introduced. Also, the Securities and Exchange Commission law was amended in the Philippines. The effectiveness of these measures has, however, yet to be tested. More efforts are needed to help create an environment of improved corporate and financial governance that provides adequate protection for minority shareholders and creditors alike.

The confluence of these domestic risks is, in the short term, unlikely to trigger a new crisis. But if problems were to be left untended, the five countries would become more susceptible to shocks, possibly jeopardizing medium-term prospects of stable economic growth and a secure financial system.

External Risks

In the October 2000 issue of the *ARR*, two major external risks were discussed: high oil prices and a possible hard landing for the US economy. The first threat has receded somewhat. While the behavior of the Organization of Petroleum Exporting Countries (OPEC) and tensions in the Middle East have created uncertainties, as 2001 unwinds, a slowing global economy, the arrival of warmer weather in the Northern Hemisphere, and price-induced reductions in demand should put downward pressure on the price of oil. On the other hand, the global and US economies are slowing faster than most expected (Figure 17). The potential impacts on the affected countries of a coincident slowing of the US economy and a sharp downturn in the global electronics market merit careful scrutiny. Previously, dips in electronics growth have been mitigated to some extent by stable growth in the broader global economy.

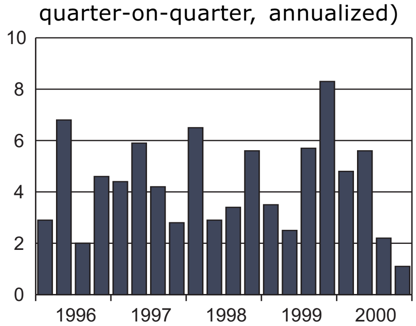
Figure 17: **Consensus Forecasts of 2001 GDP Growth** (%, y-o-y)



Source: Consensus Economics Inc., *Current Economics*, various issues.

To these risks could be added the possible specter of another wave of destabilizing contagion in emerging markets. In late February 2001, Turkey was compelled to float the Turkish lira and remove exchange controls. Its equity market fell 18 percent in one day and $7 billion of foreign exchange reserves were lost. Overnight interest rates increased to more than 4,000 percent. These events followed investor reaction to the news that the International Monetary Fund (IMF) might have to suspend its three-month old assistance package to Turkey. Although Turkey accounts for only 2 percent of emerging market debt, ripples from these events were felt in Russia and as far away as Latin America, where equity markets, currencies, and spreads came under pressure. Although Asian exchange rates and bourses seem to have been largely unaffected by these events, they serve as a timely reminder of the merits of strengthening systems of risk management at national and regional levels. Needless to say, a conjunction of emerging market financial instability and a global growth slowdown would be particularly serious.

Figure 18: **US GDP Growth** (%, quarter-on-quarter, annualized)



Source: Bloomberg.

Slowing Global and US Economies

When the October 2000 issue of the *ARR* was produced, the US economy appeared to be gliding toward a soft landing. Economic data released toward the end of 2000 and in the early part of 2001 suggest, however, that manufacturing activity, consumption spending, and retail sales have been slowing much more quickly than anticipated. GDP grew by an annualized 1.1 percent in the fourth quarter of last year, down from more than 5 percent in the first half (Figure 18). The US Federal Reserve Board (Fed) was sufficiently concerned about these developments to reduce interest rates by 50 basis points (bp) in early January 2001, ahead of its scheduled federal open market committee meeting. Fearing that growth might be close to zero at the beginning of this year, the Fed then cut its federal funds rate by another half percentage point, to 5.5 percent, at its open market committee meeting on 31 January 2001. Not since 1984 have interest rates been cut by 100 bp in a single month.

Some believe that the US economy is already contracting. Since the first quarter of 2000, the NASDAQ has slumped, surrendering value equivalent to 40 percent of US GDP, and is now trading at levels not seen for two years. The implied loss of personal and corporate wealth is substantial. As earlier capital gains had been fueling consumption, and compensating for reduced saving out of personal income, incomes may now have to be diverted from consumption to servicing debts and maintaining wealth. The demand repercussions of this could be substantial.

There seem to be two main threats to the Consensus forecast of 2 percent growth for the US economy in 2001. The first is that investment spending may slow much more quickly than most anticipate. There is accumulating evidence that the cash flow and earnings positions of corporate America are quickly deteriorating. If these trends are maintained, then investment expenditures are likely to be pared back even further, leading to a more protracted and perhaps sharper slowdown than is now expected. A large dip in investment expenditures would also put at risk the productivity gains that are the locomotive of the "New Economy."

The second risk to US growth lies in weakening household, corporate, and, possibly, bank balance sheets. Although equity prices have already fallen, they and other asset prices could drop further and perhaps significantly from their current levels. Making an objective assessment of this risk is difficult since it depends on the extent to which earlier investment decisions have been sensible, expectations of future earnings potential, and whether policy actions can forestall potential dangers. In the short run, demand would also likely suffer if falling US dollar asset prices were to precipitate capital outflows and an accompanying depreciation of the US dollar.

There is a variety of possible ways in which a US slowdown could impact on Asia. The most obvious transmission mechanism would be through trade. But direct investment, financial flows, asset prices, including exchange rates, and the terms of trade may all be affected.

A look at the broad historical record does not provide much insight about how the affected countries are likely to respond to a slowing US economy. Evidence of the past three decades suggests that there has never really been much of a connection between undulations in US economic activity and the pace of growth in most countries of the region. However, there are reasons to think that this relationship may have changed. Today, capital moves more freely across borders than ever before, allowing asset prices to respond quickly to events all over the globe. Moreover, the composition and pattern of trade flows have undergone significant changes in the past decade. An increasing proportion of intra-regional and extra-regional trade is linked through interconnected supply chains and is being driven by capital expenditure on electronics goods in the US.

Can growth elsewhere in the global economy provide additional markets for the affected countries' exports to insulate them from any impacts of a US slowdown? Japan, the second largest trading partner of many regional economies, now looks unlikely to sustain an acceleration of growth. Although investment intentions are strong, industrial production, consumer spending, business confidence, and prices are down and falling. Underlying structural problems are proving difficult to resolve and, reflecting this, a major credit rating agency has just downgraded Japanese government debt. In early March, the Nikkei fell to a 16-year low. The Japanese Government recently revised its estimate of growth in the third quarter of 2000 from 0.2 percent to -0.6 percent, which came after just two quarters of growth. After downgrading its view of the economy twice in the past two months, the Bank of Japan recently cut its mostly symbolic discount rate on loans from 0.5 percent to 0.35 percent and then to 0.25 percent. Programs for quickening the pace of structural reforms are being drawn up. The Government predicts that the economy will grow by 1.2 percent in the fiscal year ending 31 March 2001 and 1.7 percent in fiscal year 2001. Since Japan is also heavily dependent on exports to the US, slowing growth in the US will add to the country's difficulties.

With about 10 percent of its exports destined for the US market, Europe is relatively less reliant on the US economy than Japan and is not as likely to be affected by a slowdown. Nevertheless, economic growth in 2001 in Europe is also likely to edge lower amid weaker global demand. A prospective appreciation of the euro is expected to reduce export growth. The European Central Bank predicts that the growth outturn for 2001 will be just below 3 percent. While Europe is not an unimportant market for the affected countries, it ranks a distant fourth behind the US, Japan, and the other regional economies of East and Southeast Asia. Diversifying and increasing market penetration in Europe is likely to take some time.

Neither can intra-regional trade be expected to insulate the region from a drop in external demand. Although intra-regional trade links have been strengthening in recent years, the bulk of intra-regional exports still consist of the shipment of components among linked production sites. Since this trade ultimately reflects a derived demand for final goods from more developed countries, such as the US, a slowdown in the US economy will hit intra-regional as well as extra-regional trade. The expected strong growth in the People's Republic of China (PRC) and a broadly stable outlook for India in 2001 should, however, provide some modest support for export demand.

While slower growth in the US and global economy will undoubtedly hit export growth, its knock-on impacts on domestic demand are more difficult to unravel. As net export growth slows, domestic demand will be affected through the usual income channels. But lower US interest rates provide scope for a more accommodating monetary policy.

Indeed, interest rates have already come down in Korea, Philippines, and Thailand. In this context, exchange rates could drift lower and provide some support for net exports. But where banks are reluctant to lend and borrowers are cautious about earnings prospects, the full benefits of easier liquidity may fail to materialize.

A second channel through which the trade impacts of a slowing US economy could be offset is through capital flows. Accompanying rising US interest rates was a net outflow of capital from the region in 2000 (see Box B). It is possible that lower US dollar interest rates and recovery in the region could tempt international investors back to the regional equity markets. Indeed, net inflows of private capital are projected for 2001. If capital inflows materialize, they will help support domestic demand through beneficial wealth effects and, if the flows are not sterilized, through the monetary transmission mechanism too. However, these offsets to reduced export demand are by no means certain and, if they occur, are likely to be of small order. (In the section on foreign direct investment starting on page 76, the evolving patterns of FDI inflows and their influence on recovery are examined in detail.)

It is by no means straightforward to infer what these external developments could mean for growth in the affected countries in 2001. However, using the same framework that was developed in the *ARR* October issue, the possible impacts on the region of a range of growth outcomes for Europe, US, and Japan have been estimated. In Box C, these calculations are explained. Depending on the assumptions made, the range of estimated impacts can vary widely. If demand for exports is highly elastic, and global growth is at the bottom end of the range of current estimates, the estimated impacts are not insignificant, ranging from a slowing of 1 percentage point of growth in Indonesia and Korea to more than 2 percentage points in the Philippines. Naturally, the more insulated an economy is from swings in external demand, the less the measured impact will be for any configuration of projected growth rates in the global economy.

There are a number of limitations surrounding the calculations shown in Box C. One immediate concern is that they may not adequately capture the large dependence of some regional economies on electronics. One way to compensate for this would be to inflate demand elasticities to capture the anticipated disproportionate slowing of electronics exports relative to global GDP growth. But a clearer impression of the possible downdraft resulting from the slowing momentum of global electronics demand can be obtained by looking at what happened in similar, previous episodes and tracing the effects on income and demand.

Box B: **Capital Flows to the Five Affected Countries**

Net private capital flows to the five affected countries remained negative in 2000, for the third consecutive year since their sharp fall precipitated the East Asian financial crisis in 1997. The continued outflow of private capital was one cause of the currency depreciations last year. However, prospects are now brighter, with net private capital flows projected to move into positive territory.

Data from the Institute of International Finance (IIF) show that net repayments to commercial banks continued to be the main source of outflows (Table B-1). However, these moderated between 1999 and 2000. The recorded net outflows are also an indication of subdued credit demand and a reluctance of international creditors to lend, as domestic banks and corporations continue to consolidate their balance sheets. In addition, lower domestic interest rates have made domestic credit sources more attractive. Net outflows to commercial banks are projected to ease from $15.3 billion in 2000 to $5.8 billion this year. On the other hand, outflows of nonbank credit have been relatively steady since 1998.

Meanwhile, net equity investment declined in 2000 after a brief surge in 1999. This was mainly due to a reduction of net portfolio inflows in the affected countries. Volatility of equity prices in industrialized countries and the rise in US interest rates led to the protracted weakness of equity prices in the five affected countries.

However, experiences were mixed among individual countries in 2000 (Table B-2). Thailand experienced a sharp reduction in net portfolio inflows while Indonesia and Malaysia recorded smaller, but still significant, net outflows. Only Korea managed an increase in net inflows of portfolio investment, largely during the first part of the year. IIF reports that the reduced demand for electronics exports led to increased pessimism in the earnings capacity of technology stocks, resulting in significant portfolio equity outflows from Korea and Malaysia in the second half of 2000. Meanwhile, the Philippines experienced a $738 million turnaround in portfolio flows—from a net inflow of $254 million in the first 11 months of 1999 to a net outflow of $484 million in the corresponding period in 2000. Apart from external factors, the Philippines—along with Indonesia and Thailand—was buffeted by political uncertainty. Confidence in the Philippine stock market was also shaken by allegations of insider trading.

Net FDI also declined in 2000 for the five affected countries. The deceleration in Korea is partly attributable to a large increase in direct investment abroad by local firms. FDI was also limited by the failure to complete the planned sales of Daewoo Motor Company and Hanbo Steel to foreign investors. In the case of Thailand, FDI inflows slackened as attractive opportunities to purchase local assets diminished. The Philippines, meanwhile, experienced a modest gain in the first 11 months of 2000.

Table B-1: **Capital Flows to the Five Affected Countries** ($ Billion)

	1995	1996	1997	1998	1999	2000e	2001f
Net External Financing	98.1	118.6	39.5	-15.2	-4.9	-1.2	-6.8
Net Private Flows	94.2	119.5	4.9	-38.7	-5.2	-3.8	1.9
Equity Investment, Net	15.5	16.8	5.2	16.8	30.1	15.6	13.6
Direct Investment, Net	4.4	4.8	6.8	12.3	14.6	9.5	9.0
Portfolio Investment, Net	11.0	12.0	-1.7	4.5	15.4	6.1	4.6
Private Creditors, Net	78.7	102.7	-0.3	-55.5	-35.3	-19.3	-11.7
Commercial Bank Credit, Net	64.9	69.6	-17.4	-48.8	-29.3	-15.3	-5.8
Nonbank Credit, Net	13.8	33.2	17.2	-6.7	-6.0	-4.1	-5.9
Net Official Flows	3.9	-0.9	34.6	23.5	0.2	2.6	-8.6
International Financial Institutions	-0.5	-1.9	22.7	19.7	-4.6	2.5	-7.9
Bilateral Creditors	4.4	1.0	11.9	3.8	4.9	0.1	-0.8

e = estimate; f = forecast.
Source: IIF, January 2001.

Continued next page

Box B: **Capital Flows to the Five Affected Countries** (Cont'd)

Table B-2: **Capital Flows to Individual Countries** ($ Million)

	1995	1996	1997	1998	1999	Jan-Sep 1999	Jan-Sep 2000
Indonesia							
Net Private Flows	10,252	11,510	-339	-13,848	-15,831	-7,576	-6,956
Net Direct Investment	4,345	6,194	4,677	-356	-2,745	-1,820	-2,806
Net Portfolio Investment[1]	5,907	5,005	-2,632	-1,878	-1,792	-1,827	-1,429
Other Private Flows[2]	. . .	-311	-2,384	-11,612	-5,385	-3,929	-2,721
Official Flows	336	-547	2,880	9,971	5,352	5,255	2,760
Net Capital Flows	10,588	10,963	2,541	-3,875	-4,570	-2,321	-4,196
Republic of Korea[3]							
Net Private Flows	17,793	24,409	-13,884	-13,027	9,354	7,027	11,223
Net Direct Investment	-1,776	-2,345	-1,605	673	5,136	4,142	2,870
Net Portfolio Investment	11,591	15,185	14,295	-1,878	8,676	6,900	11,692
Other Private Flows[2]	7,978	11,569	-26,574	-11,822	-4,458	-4,016	-3,340
Official Flows	-519	-485	15,806	9,660	-6,924	-7,044	336
Net Capital Flows	17,273	23,924	1,922	-3,368	2,430	-18	11,559
Malaysia							
Net Private Flows	5,180	9,180	546	-3,461	-8,381	-6,796	-3,619
Private Long-Term	4,172	5,079	5,136	2,165	1,553	1,326	1,247
Of Which Net Direct Investment	3,327	3,528	3,648	1,860	2,524	. . .	. . .
Private Short-Term	1,008	4,101	-4,590	-5,626	-9,934	-8,123	-4,866
Official Long-Term	2,451	297	1,651	545	1,763	1,651	294
Net Capital Flows	7,631	9,477	2,197	-2,916	-6,618	-5,145	-3,325
Philippines[3]							
Net Direct Investment	. . .	1,338	1,113	1,592	998	791	1,058
Net Portfolio Investment	. . .	2,179	-351	80	347	254	-484
Other Flows (net)[4]	. . .	7,558	5,831	-1,194	-3,028	-1,746	-5,506
Net Capital Flows	. . .	11,075	6,593	478	-1,683	-701	-4,932
Thailand							
Net Private Flows	. . .	. . .	-7,623	-15,483	-13,836	-13,197	-7,785
Net Direct Investment	. . .	. . .	3,298	7,361	5,854	4,018	2,217
Net Portfolio Investment	. . .	. . .	4,386	352	383	230	4
Other Private Flows[2]	. . .	. . .	-15,307	-23,196	-20,073	-17,445	-10,006
Official Flows	. . .	. . .	3,280	5,741	5,929	5,694	1
Net Capital Flows	. . .	. . .	-4,343	-9,742	-7,907	-7,503	-7,784

. . . = not available.

[1] For 1995, Indonesian data on other private flows are included in net portfolio investment.

[2] Other private flows (net) include capital flows arising from medium- and long-term debt, trade credits and short-term debt, and changes in nonresident accounts in the banking system. In Indonesia and Korea, other private flows were obtained as the difference between the category "other investment flows" and the category "official flows," both of which are reported. In Thailand, net capital flows are taken to be equal to the capital and financial account. Other private capital flows were obtained as a residual.

[3] Comparative data for 2000 and 1999 are from January to November for Korea and Philippines.

[4] For the Philippines, net capital flows are taken to be equal to the capital and financial account. The category "other flows" was obtained as a residual. Official flows could not be segregated on a consistent basis up to 1995.

Sources: Bank Indonesia; Bank of Korea web site; Department of Statistics Malaysia web site; International Department, Bank Negara Malaysia; Bangko Sentral ng Pilipinas and its web site; and Bank of Thailand web site.

Box C: **The Impact of a Global Slowing of Trade on Affected Countries**

The calculations reported below are based on the estimation of export impact multipliers for each economy. The multipliers draw on observed consumption, import and export shares, and the geographical pattern of trade of the affected countries. The calculations entail many simplifying assumptions. Among other factors, they assume constant relative prices and terms of trade, and they ignore the secondary transmission of income impacts across regional borders.

Three scenarios are considered. These take high, low, and central growth projections for each global region, drawn from Consensus Economics and other sources. All growth rates are expressed in terms of the *change* on the 2000 outcome. For example, a slowing of growth from 5 percent to 2 percent is a –3 percentage point change.

A range of demand responses to slowing global growth is considered. Evidence suggests that import demands of industrialized economies may be income elastic. It is also possible that exports from small open economies, including those of East Asia, are likely to respond more than proportionately to growth of global trade and income, possibly by as much as a factor of 2. If elasticities were large, the impacts of a global slowing on the crisis economies would be felt more acutely. Impacts are calculated for a range of income elasticities: low (0.5), middle (1), and high (2).

The main results are presented in Table C-1. The calculations suggest that in conditions of low global growth, income elastic demand case growth rates could fall by anything between 1 percentage point in Indonesia and Korea, to about 2 percentage points in the Philippines. The large response in the Philippines is explained by its disproportionate dependence on the US economy. A slowing of 2 percentage points in the Philippines growth rate would take growth below the threshold needed to sustain growth of per capita incomes.

Other scenarios and elasticity assumptions produce less pronounced impacts on country growth. For example, taking the Consensus estimates of the change in growth and applying unitary income elasticities, the estimated slowdown in Philippine growth is reduced to 0.62 of a percentage point. Under these assumptions, the impacts are modest for other countries too.

Note that income elasticities have a multiplicative effect on our calculations. Thus, if demand elasticities were actually 2 and not unitary, the estimated impacts in the Consensus column would all be doubled. Likewise, impacts in the middle column are halved if income elasticities are unity and not 2. It is also worth noting that in the past, Consensus estimates seem to have been a lagging indicator of future growth, so outcomes in 2001 could track lower than the current Consensus view.

Table C-1: **The Estimated Impact of a Global Slowdown on GDP Growth** (percentage points)

	High Growth/Low Elasticity	Low Growth/High Elasticity	Consensus Growth/Unitary Elasticity
Indonesia	-0.08	-1.06	-0.27
Korea, Rep. of	-0.09	-1.01	-0.29
Malaysia	-0.14	-1.56	-0.44
Philippines	-0.21	-2.17	-0.62
Thailand	-0.12	-1.39	-0.39

Notes:
1. All changes are measured by year-on-year swings in GDP growth rates.
2. Low growth scenario (in percentage points): US GDP growth swings by -4.1, Europe by -1, and Japan by -1.5.
3. Central estimate (in percentage points): US growth swings by -2.6, Europe by -0.5, and Japan by -0.4.
4. High growth scenario (in percentage points): US growth swings by -2.1, no growth swings in Europe and Japan.
5. Elasticity estimates: high=2, central=1, low=0.5.

Sources: Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001, and REMU staff estimates.

Global Electronics Slowdown

A particular source of vulnerability for the region's exports is the disproportionate dependence of some economies on electronics. Exports of IT goods alone from the region to the US have grown more than fourfold in the space of a decade. High-tech products account for more than a third of total exports of the five affected countries, ranging from 13 percent in Indonesia to more than one half in Malaysia and Philippines. There is already evidence in recent monthly export numbers that electronic exports, which helped propel East Asia's recovery, are being adversely affected by a decline in US orders. In both Malaysia and Thailand, exports are contracting when measured against their performance in the same month last year. The rapidity with which declines in US capital expenditure on IT products have registered in regional export growth is striking. If, going forward, US capital expenditure contracts sharply, as some fear, there will be more fallout for the region, through reduced orders and adverse movements of terms of trade. While earlier downswings in global electronics cycles have tended to be comparatively short-lived, they have not before coincided with an abrupt slowing of global and US economic growth.

A clue to the possible consequences of a global electronics slowdown for regional electronics export demand can be derived from the experience of 1995 and 1996, the last instance of such a slowdown. During 1995-1996, the rate of growth of worldwide semiconductors sales swung by a massive -49 percentage points, from growth of 40 percent in 1995 to -9 percent the following year. The growth rate of electronics imports (measured in US dollar terms) to the US from Asia swung by about -34 percentage points over the same period. The swing in electronics exports in the affected countries ranged from -36 percentage points for Korea to -19 percentage points for Thailand. In Malaysia, the swing in growth was -24 percentage points. In both Indonesia and the Philippines, export growth actually accelerated over the period as new production platforms were being established at that time, and output and export growth was being measured from an extremely low base.

Looking forward, projections by *Electronic Business* suggest a slowdown in the growth of semiconductor equipment sales in the Americas from nearly 63 percent in 2000 to just 8 percent in 2001, or a change of -53 percentage points, not too dissimilar to what occurred between 1995 and 1996. For the world as a whole, the projected change in the sales growth rate is a staggering -72 percentage points. Semiconductor sales worldwide grew by an estimated 83 percent in 2000. *Electronic Business* projects that growth will slow to just 9.5 percent in 2001. Gyrations of this magnitude in the growth of demand would have significant repercussions for the region's electronics exports. Asia supplies 40 percent of the global electronics markets. Electronics also contributes substantially more to total exports and to GDP in the affected countries than it did before the onset of the crisis. In Box D, estimates of these effects are provided.

These calculations illustrate the diversity of the five economies in their susceptibility to the global electronics cycle. Korea and Malaysia are much more exposed to an electronics downturn than Indonesia, with the Philippines and Thailand lying somewhere between.

Last, an estimate of the combined impact of the projected slowdown of electronics and nonelectronics exports can be obtained by amalgamating the calculations summarized in Boxes C and D. A range of estimates is shown in Table 2. The lower bound estimates of the reduction in growth are obtained by combining the baseline/unit elastic results shown in column 3 of Table C-1 with the results of Table D-1. The upper bound estimates draw on the low global growth, high income elasticity assumptions. In both cases, there is an assumed deceleration of electronics export growth by 20 percentage points. For comparison, the Consensus projections of the change in growth between 2001 and 2000 are shown.

Box D: **The Estimated Impact of Slowing Electronics Demand**

The estimates shown in the table below are obtained from a simplified input-output model. This model assumes that in each economy the electronics sector is an enclave, neither buying inputs nor selling outputs to other industries. External demand for electronics is exogenous (and price inelastic). Electronics activity contributes value-added to the domestic economy, and this, in turn, creates final demand. If the demand for electronics exports contracts, a reduction of income occurs because of the direct contraction of electronics' value-added, and through its induced effects on consumption demand.

While these channels are important, others are missed. If the enclave assumption is inaccurate, inter-industry effects are suppressed. Equally, any impact on demand of balance of payments repercussions or adverse terms of trade movements are not captured. As in all input-output models, adjustments on the supply side are also not accommodated.

In Table D-1, the estimated impact on GDP growth of a 20 percentage point reduction in the growth rate (measured in volume) for each economy's electronics exports is shown.

If the growth of electronics exports were to slow by 20 percentage points between 2000 and 2001 (from say 30 percent growth to 10 percent), the calculations here suggest that GDP growth could slow in Malaysia by almost 2 percentage points. Underpinning this estimate is Malaysia's high dependence on electronics exports and a moderate contribution to value-added. In Korea, which is much less dependent on electronics exports, the estimated reduction of growth for the same shock is 1.2 percentage points. While Korea's share of electronics exports in total exports is about one half of Malaysia's, its electronics industry contributes more value-added per unit of gross output, and so direct income losses and those through induced reductions in domestic demand are commensurately larger.

In the other economies of the region, the impact of a 20 percentage point reduction in electronics export growth is somewhat more muted, though not negligible. In the Philippines, which is highly dependent on electronics exports, effects are contained because of the low value-added content of its electronics industry. Likewise, the limited value-added imparted by Indonesian and Thai industries mitigates impacts in those countries, and the share of their electronics exports in total exports is also smaller.

Note that in these calculations, value-added share parameters are educated guesses rather than direct observations. Input-output data of recent vintage are not available. Increasing the assumed value-added content of electronics increases measured reductions in income growth more than proportionately.

Table D-1: **The Estimated Impact of a Reduction in Electronics Export Growth on GDP Growth** (percentage points)

	Indonesia	Rep. of Korea	Malaysia	Philippines	Thailand
Value-Added Share	0.20	0.50	0.35	0.20	0.25
20 Percentage Point Reduction in Electronics Export Growth	-0.35	-1.24	-1.96	-0.66	-0.41

Table 2: **Overall Impact of Reduced Export Growth on GDP Growth** (percentage points)

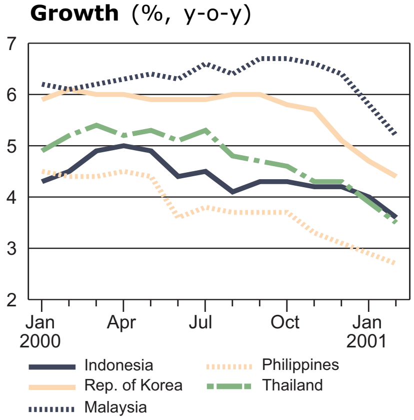
	Estimated Impact of Slower Export Growth	Consensus Change in Projected Growth
Indonesia	-0.6 to -1.3	-1.2
Korea, Rep. of	-1.5 to -2.2	-4.7
Malaysia	-2.4 to -2.9	-3.3
Philippines	-0.9 to -1.6	-1.2
Thailand	-0.7 to -1.6	-0.7

Note: The numbers in this table are obtained by adding the estimated reductions in growth in Table D-1 of Box D, to the estimated reductions in growth in Table C-1 of Box C, weighting the latter by the share of nonelectronics exports in total domestic exports.
Sources: Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001, and REMU staff estimates.

In three out of the five economies, the most recently reported Consensus projection of the change in growth is bracketed by our calculations, while in Korea and Malaysia, Consensus estimates suggest that a sharper deceleration of growth may occur. Taken together, these calculations suggest that the anticipated slowing of global economies and the electronics industry has had a significant impact on expectations of growth prospects in 2001.

Recovery Prospects

Figure 19: **Consensus Forecasts of 2001 GDP Growth** (%, y-o-y)



Source: Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, various issues.

Amid heightened risks, what are the immediate economic prospects for the affected countries? Figure 19 shows the Consensus projections of 2001 growth for the affected countries during the past year or so. Prospects have been successively downgraded especially in the past few months. To the extent that the recent trends suggest that Consensus projections lag rather than lead events, the actual outcome in 2001 may fall short of the most recent projections. On the other hand, if the slowdown in the US proves to be V-shaped rather than U- or L-shaped, then the effects of a recovery in US demand in the second half should be felt quickly and growth would then accelerate going in to 2002.

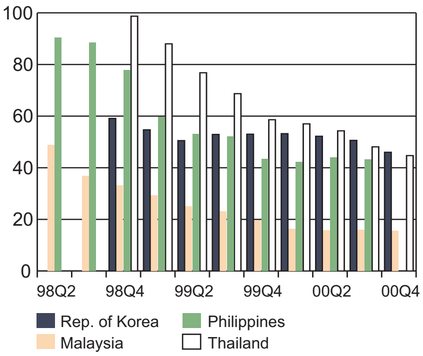
Although growth is already slowing in most economies, fears of a new crisis are exaggerated. A variety of prudential indicators suggest that the region is now much less vulnerable than before. Perceived credit risks are diminishing (Table 3), external debt levels are improving, and foreign exchange reserves provide ample cover for short-term maturing obligations (Figure 20). Real exchange rates also remain highly competitive (Figure 21). While problems are not yet over for domestic

Table 3: **Foreign Currency Long-Term Sovereign Credit Ratings***

		Moody's		Standard & Poor's		Fitch	
Indonesia	Current Outlook	Stable		Negative		Stable	
	Ratings	B3	20-Mar-98	B-	2-Oct-00	B-	16-Mar-98
		B2	9-Jan-98	SD	17-Apr-00	B+	21-Jan-98
		Ba1	21-Dec-97	CCC+	30-Mar-99	BB-	8-Jan-98
				SD	29-Mar-99	BB+	23-Dec-97
				CCC+	15-May-98	BBB-	4-Jun-97
				B-	11-Mar-98		
				B	27-Jan-98		
				BB	9-Jan-98		
				BB+	31-Dec-97		
				BBB-	10-Oct-97		
Rep. of Korea	Current Outlook	Stable		Positive		Stable	
	Ratings	Baa2	16-Dec-99	BBB	11-Nov-99	BBB+	30-Mar-00
		Baa3	12-Feb-99	BBB-	25-Jan-99	BBB	24-Jun-99
		Ba1	21-Dec-97	BB+	18-Feb-98	BBB-	19-Jan-99
		Baa2	10-Dec-97	B+	22-Dec-97	BB+	2-Feb-98
		A3	27-Nov-97	BBB-	11-Dec-97	B-	23-Dec-97
		A1	4-Apr-90	A-	25-Nov-97	BBB-	11-Dec-97
				A+	24-Oct-97	A	26-Nov-97
						A+	18-Nov-97
Malaysia	Current Outlook	Stable		Positive		Positive	
	Ratings	Baa2	17-Oct-00	BBB	10-Nov-99	BBB	7-Dec-99
		Baa3	14-Sep-98	BBB-	15-Sep-98	BBB-	26-Apr-99
		Baa2	23-Jul-98	BBB+	24-Jul-98	BB	9-Sep-98
		A2	21-Dec-97	A-	17-Apr-98	BBB-	13-Aug-98
				A	23-Dec-97		
Philippines	Current Outlook	Negative		Negative			
	Ratings	Ba1	18-May-97	BB+	21-Feb-97	BB+	8-Jul-99
		Ba2	12-May-95	BB-	2-Jul-93		
Thailand	Current Outlook	Stable		Stable		Stable	
	Ratings	Baa3	21-Jun-00	BBB-	8-Jan-98	BBB-	24-Jun-99
		Ba1	21-Dec-97	BBB	24-Oct-97	BB+	14-May-98
		Baa3	1-Dec-97	A-	3-Sep-97		
		Baa2	27-Nov-97	A	29-Dec-94		
		Baa1	2-Oct-97				
		A3	8-Apr-97				

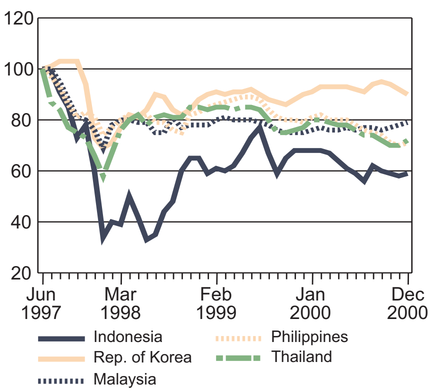
*See Annex for descriptions of ratings.
Sources: Web sites of Moody's, Standard & Poor's, and Fitch.

Figure 20: **Short-Term External Debt*** (% of Gross International Reserves, End of Period)



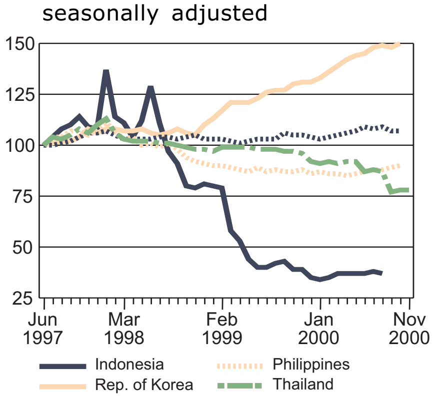
*Data from national sources.
Source: ARIC Indicators.

Figure 21: **Real Effective Exchange Rate Index*** (1997June=100)



*Traded vs. nontraded goods prices.
Source: ARIC Indicators.

Figure 22: **Real Bank Credit Index*** (1997June=100), seasonally adjusted



*Claims on the private sector: deposit money banks.
Source: ARIC Indicators.

banking sectors and firms saddled with debts, there has nevertheless been identifiable improvement over the past 12 months. NPL ratios have declined and some commercial banks are beginning to return to profitability. In Korea and Malaysia, the stock of real bank credit extended to the private sector is growing and exceeds its precrisis level (Figure 22). It has stabilized in Indonesia, turned around in the Philippines, but continues to fall in Thailand.

There are other factors, too, that better place the region to ride out shocks. With the adoption of more flexible exchange rates and the move toward explicit inflation targeting, there is greater clarity and coherence about macroeconomic policies in most economies. Monetary policy rules now recognize that with only one instrument, the authorities can pursue only one objective. In most countries, the authorities have sensibly decided that this should be to contain inflation. The recovery process is also more broad based than before. On the demand side, consumption and investment demands are increasingly supporting growth, and, on the supply side, services activity is expanding alongside manufacturing.

In sum, reduced financial sector vulnerability, strengthened external payments positions, greater coherence in macroeconomic policy frameworks, and somewhat more balanced growth mean that the affected countries are in a stronger position to absorb shocks. Nevertheless, to ensure sustained recovery, it is crucial for them to seriously tackle residual problems in their banking and corporate sectors. If banks remain reluctant to extend credit, and potential investors are encumbered by debts, the investments needed to propel growth into the future will be stunted.

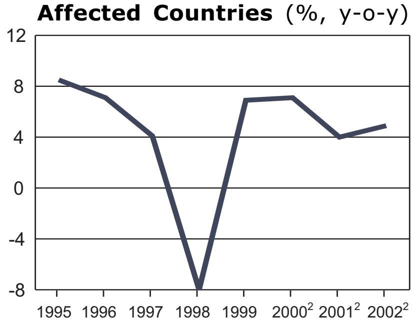
This year, the average growth rate for the affected countries is, according to Consensus estimates, expected to slow to 4 percent from an estimated 7.1 percent in 2000 (Figure 23). In terms of individual countries, Korea and Malaysia are likely to see the biggest drops in their growth, partly because of their high dependency on exports and the US market. But the exceptionally fast growth rates they posted in 2000 were, in any case, difficult to sustain. Consensus Economics (February 2001) projections for 2001 are for a growth rate of 4.4 percent in Korea and 5.2 percent in Malaysia (Table 4). The main challenges for Korea are to accelerate corporate restructuring and to bring the banking sector back to profitability. For Malaysia, one concern is that, with a pegged exchange rate, domestic absorption will have to bear the brunt of an adjustment to slower growth of external demand and a deteriorating current account position.

Table 4: **GDP Growth Projections** (%)

	Indonesia		Rep. of Korea		Malaysia		Philippines		Thailand	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
Official[1]	4.8	4.5-5.5	8.0	5.0-6.0	8.5	7.0	3.9	3.8-4.3	4.0-4.5	3.0-4.5
ADB[2]	—	4.2	9.2	3.9	—	4.9	—	3.1	4.2	3.5
IMF[3]	—	5.0	8.8	6.5	—	6.0	—	3.3	5.0	5.0
World Bank[4]	—	4.0	8.5	6.5	—	6.0	—	3.5	4.5	4.5
Consensus Economics[5]	—	3.6	9.1	4.4	—	5.2	—	2.7	4.2	3.5

[1] Indonesia—Bank Indonesia, *Policy Evaluation in the Year 2000 & Policy Directions for 2001*, 10 January 2001; Rep. of Korea—Ministry of Finance and Economy, *First-Half Economic Achievements of the Kim Dae-jung Administration*, 9 September 2000, and *Korea Economic Update*, 19 January 2001; Malaysia—Ministry of Finance, *GDP by Industrial Origin*, 24 October 2000; Philippines—National Economic and Development Authority, *Press Release,* 26 January 2001; Thailand—Bank of Thailand, *Inflation Report*, January 2001.
[2] Staff estimates, March 2001.
[3] IMF, *World Economic Outlook*, September 2000, and IMF, Public Information Notice No. 01/21, 13 March 2001 (for the Philippines).
[4] World Bank, *East Asia's Recovery: Maintaining Momentum*, 30 November 2000.
[5] Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, February 2001.

Figure 23: **Average[1] GDP Growth Rate of the Five Affected Countries** (%, y-o-y)



[1]Weighted by GDP shares in dollar terms.
[2]Consensus forecasts were used for Korea and Thailand in 2000, and for all countries in 2001 and 2002.
Sources: ARIC Indicators and Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001.

For Indonesia and Thailand, the consensus view is that growth is likely to fall to about 3.5 percent in 2001. In the former, external factors are not biting as hard as the risks from internal constraints. Indonesia is an oil-exporting nation less dependent on manufacturing exports to the US market than other countries of the region. But the threat of accelerating inflation in Indonesia reduces scope for a more accommodating monetary policy to combat slowing growth. A resolution of political uncertainties, and faster progress in asset disposal and bank restructuring are required to restore investor confidence.

In Thailand, political uncertainty has receded. It remains to be seen, however, whether structural reforms will be accelerated under the new administration. Its focus on tackling the problems of rural Thailand is laudable, but this should be carried out in a way that does not jeopardize fiscal balances, nor undermine the efficient functioning of credit and other markets.

The Consensus Economics projection for the Philippines is for 2.7 percent growth in 2001, down from 3.9 percent in 2000. The heavy dependence of the Philippine economy on electronics exports and its tight links to the US economy mean that there could be significant knock-on effects from slowing US growth. The large deficit left by the previous administration and a comparatively high rate of underlying inflation limit the Government's ability to support domestic demand through fiscal or monetary means. If the Government takes firm actions to resolve its fiscal problems, then private investment could recover and GDP could grow by 3 to 3.5 percent.

To sum up, growth in 2001 in the affected countries will be significantly lower than in 2000. In 2002, growth should accelerate provided the

US economy picks up and electronics exports turn the corner. Positive growth rates should mean that broad social and economic recovery continues through this period, although at a slower pace than in 2000.

In the short term, macroeconomic policy should aim to support domestic demand. Amid rising debt levels, accommodation on the monetary front may be easier to accomplish than further deficit spending measures. However, within prudent fiscal limits, there remains scope for ensuring that public expenditure programs are targeted better on the poor and the more vulnerable elements of society. Ultimately, to support growth over the medium term, reform agendas should not be allowed to drift. In particular, measures to ensure a quicker and more efficient resolution of debts are still needed, as are initiatives to spur restructuring of moribund businesses. Implementation of reforms may be more difficult in a context of slower growth, but the costs of inaction are likely to increase in a less hospitable global environment. There is no room for complacency.

Annex: **Description of Long-Term Sovereign Credit Ratings**

Moody's	
Investment Grade Ratings	
Aa1 / Aa2 / Aa3	Bonds judged to be of high quality by all standards. They are rated lower than bonds with the highest ratings (Aaa) because margins of protection for Aa may not be as large, fluctuations of protective elements may be of greater amplitude, or there may be other elements present that make the long-term risk appear somewhat larger than for Aaa securities.
A1 / A2 / A3	Bonds considered as upper-medium-grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present that suggest a susceptibility to impairment sometime in the future.
Baa1 / Baa2 / Baa3	Bonds considered as medium-grade obligations (i.e., neither highly protected nor poorly secured). Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time.
Speculative Grade Ratings	
Ba1 / Ba2 / Ba3	Bonds that have speculative elements; their future cannot be considered as well assured.
B1 / B2 / B3	These bonds lack characteristics of a desirable investment. Assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.

Standard & Poor's	
Investment Grade Ratings	
AAA	The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA+ / AA / AA-	Bonds with this rating differ from highest rated obligations only by a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A+ / A / A-	More susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitments on the obligation is still strong.
BBB+ / BBB / BBB-	Exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
Speculative Grade Ratings	
BB+ / BB / BB-	Bonds that have significant speculative characteristics but are less vulnerable to nonpayment than other speculative issues. It faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
B+ / B / B-	These bonds have significant speculative characteristics and are more vulnerable to nonpayment than obligations rated as BB. The obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment in the obligation.
CCC+/CCC/CCC-	This obligation is currently vulnerable to nonpayment and is dependent on favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation.
SD	The obligor has failed to pay one or more of its financial obligations (rated or unrated) when it came due.

Continued next page

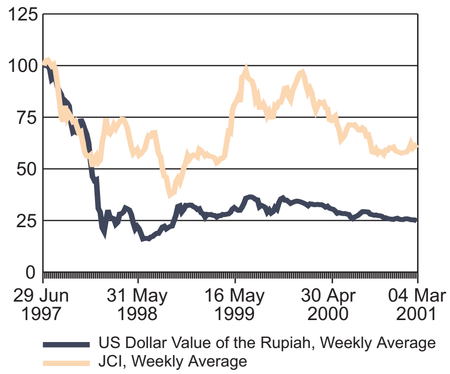
Annex: **Description of Long-Term Sovereign Credit Ratings** (Cont'd)

Fitch	
Investment Grade Ratings	
AAA	Highest credit quality. Denotes the lowest expectation of credit risk. They are assigned only in cases of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
AA+ / AA / AA-	Very high credit quality. Denotes a very low expectation of credit risk. They indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ / A / A-	High credit quality. Denotes a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
BBB+ / BBB / BBB-	Good credit quality. Indicates that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.
Speculative Grade Ratings	
BB+ / BB / BB-	Indicates that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.
B+ / B / B-	Indicates that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.

Indonesia Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes**
(last week of June1997=100)



Source: ARIC Indicators.

The rupiah continues to slide amid weak investor confidence.

Weak investor confidence sparked by concerns over provincial ethnic conflicts, political uncertainties following corruption allegations against the President, and slow financial and corporate restructuring continues to take its toll on the rupiah. Outflows of capital, caused mainly by scheduled debt repayments, have put further pressure on the country's currency, despite a windfall from oil exports. The rupiah lost 27 percent of its dollar value in 2000 and continues to slide in 2001. It breached the psychological barrier of 10,000 rupiah to the dollar recently. By end-February, the dollar value of the rupiah remained 75 percent below its precrisis level of end-June 1997 (Figure 1). In an effort to curb offshore speculation, Bank Indonesia, the central bank, has introduced rules restricting rupiah transactions and the amount of the currency that domestic banks can lend to nonresidents.

The stock market has stabilized and regained some lost ground in 2001.

Higher US interest rates, uncertain regional economic prospects, and alarm over political developments in the country prompted a precipitous fall of the Jakarta Composite Index (JCI) in the first nine months of 2000. The stock market has since stabilized and regained some lost ground in early 2001, as the performance of regional equity markets has improved. Overall during 2000, the JCI fell by 38 percent, compared to a 70 percent gain a year earlier. But it rose by 3 percent in the first two months of 2001. Still, by end-February, the JCI was 40 percent below its precrisis level of end-June 1997 in local currency terms and 85 percent down in US dollar terms.

Vacancy rates fell but property markets remain weak.

Office vacancies in Jakarta fell slightly in the first three quarters of 2000 (Table 1). Leasing activity improved as some IT companies and financial institutions increased their office space requirements. Office rents in local currency as well as dollar terms increased slightly during the third quarter of 2000. In dollar terms, they fell in the fourth quarter of 2000. Several firms have taken on more expatriates, helping to generate more demand in the luxury residential sector. But the political upheaval has scared off tenants from signing longer leases. Overall, with the office vacancy rate close to 25 percent and luxury residential vacancy rate at 43 percent, property prices and rents are not likely to stage a significant recovery soon.

Table 1: **Property Vacancy Rates in Jakarta** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Office Property	15.6	20.0	22.3	22.3	24.3	25.7	25.5	25.4	24.5	24.3	24.3
Retail Property	. . .	. . .	. . .	. . .	16.4	. . .	11.8	. . .	9.3	. . .	6.5

. . . = not available.
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Real Sector

Economic growth gained momentum in 2000.

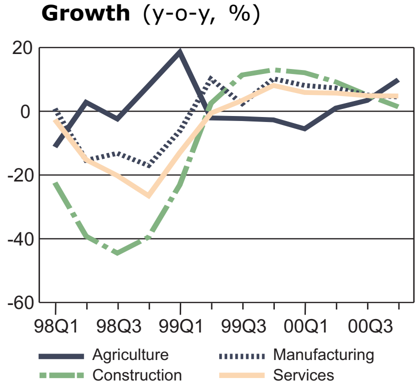
Following stronger growth in 2000, economic recovery has taken firm root. Last quarter growth was particularly robust, at 5.2 percent, lifting the figure for 2000 to an estimated 4.8 percent (Table 2), which exceeds the government target by 0.8 percentage point. However, this is a far cry from the country's historical performance. In per capita terms, Indonesia's real income is still more than 10 percent below its previous peak level.

Table 2: **GDP Growth and Projections** (%)

	1997	1998	1999	2000	2001
Official[1]	4.7	-13.1	0.8	4.8	4.5-5.5
ADB[2]	—	—	—	—	4.2
IMF[3]	—	—	—	—	5.0
World Bank[4]	—	—	—	—	4.0
Consensus Economics[5]	—	—	—	—	3.6

[1] Bank Indonesia, Policy Evaluation in the Year 2000 & Policy Directions for 2001, 10 January 2001.
[2] Staff estimates, March 2001.
[3] IMF, *World Economic Outlook,* September 2000.
[4] World Bank, *East Asia's Recovery: Maintaining Momentum*, 30 November 2000.
[5] Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

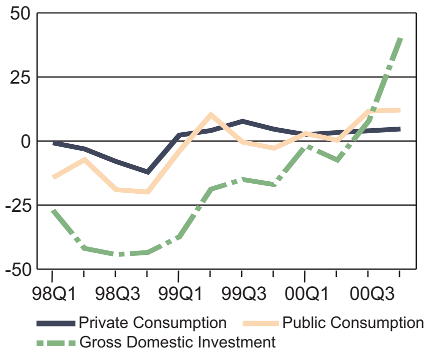
Manufacturing, services, and construction were buoyant, while agriculture turned around.

Fueled by domestic demand and exports, the manufacturing sector continued to show buoyancy in 2000 (Figure 2). Although the sector tapered off in the second half, in response to slowing exports, growth for 2000 nearly doubled that in 1999. One indication of this buoyancy is rising capacity utilization in some production sectors. The same pattern was observed for the services sector as it moved from contraction in 1999 to positive growth at 5.3 percent in 2000. The construction sector, meanwhile, achieved double-digit growth in the first half of 2000, in response to fiscal stimulus, but subsequently slowed, in particular during the fourth quarter. The agricultural sector turned around in the second half of 2000, after five consecutive quarters of dismal performance due to bad weather, credit shortages, and provincial unrest.

Investment is contributing to growth after 10 consecutive quarters of contraction.

After 10 consecutive quarters of negative growth, gross domestic investment finally posted a turnaround from the third quarter of 2000 and is contributing to the country's renewed economic growth (Figure 3). The turnaround in fixed investment came much earlier and remained strong throughout 2000. This has been helped by improvements in the flows of new bank credits and increased self-financing. Private consumption accelerated in the second half of 2000, particularly in the last quarter. This came as the agricultural sector turned the corner and household incomes from wages and salaries, and export revenues improved. Public consumption also surged in the second half, but this may be more a reflection of depressed base periods than fiscal pump-priming.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



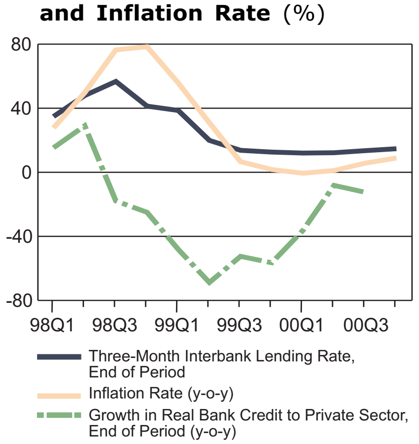
Source: ARIC Indicators.

Fiscal and Monetary Developments

The budget deficit fell below the projected level in 2000, but is expected to widen in 2001.

The central government deficit is estimated to have reached 3.2 percent of GDP for the nine months from April to December 2000. This was below the 4.8 percent of GDP targeted for fiscal year 2000/2001 starting April, but exceeded the 1.5 percent for fiscal year 1999/2000. The lower deficit was partly helped by additional revenues generated by higher oil prices. A new budget for fiscal year 2001, which now coincides with the calendar year, was approved by Parliament in December 2000 and anticipates a deficit of 3.7 percent of GDP. In achieving this target, the Government may be constrained by continued fuel subsidies, which ate up 2.6 percent of GDP in 2000, debt-service obligations, and additional resource requirements to support bank rehabilitation. Softening of oil prices is another risk factor.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth*, and Inflation Rate** (%)



*Growth in real bank credit to private sector for the third quarter of 2000 is as of August.
Source: ARIC Indicators.

Inflation climbed in the second half of 2000 and exceeded the annual target.

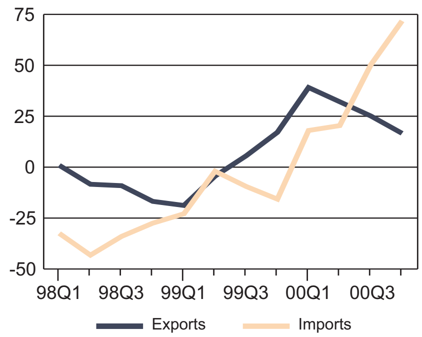
Inflation started to climb from the end of June, reaching nearly 9 percent in the fourth quarter on a year-on-year basis (Figure 4). This is substantially higher than the 5-7 percent targeted by Bank Indonesia. Price increases were partly fueled by improved economic activity as recovery gathers momentum and partly by a weak rupiah. Other factors were the Government's price and income policies (such as fuel price subsidies and minimum wages), which are estimated to have increased inflation by a third.

Monetary policy was tightened to control inflation and support the rupiah.

Bank Indonesia tightened monetary policy from May 2000 to control inflation and support the weak currency. As of end-December 2000, the one-month Bank Indonesia Certificate interest rate stood at 14.5 percent, compared with 11.1 percent in May. Monetary tightening, however, failed to curb the growth of base money, which reached 23.4 percent in 2000, whereas 8.3 percent was targeted. Part of the growth occurred toward the end of the year and was attributable to seasonal factors.

Balance of Payments

Figure 5: **Growth of Merchandise Exports and Imports*** (y-o-y, %)



*In dollar terms.
Source: ARIC Indicators.

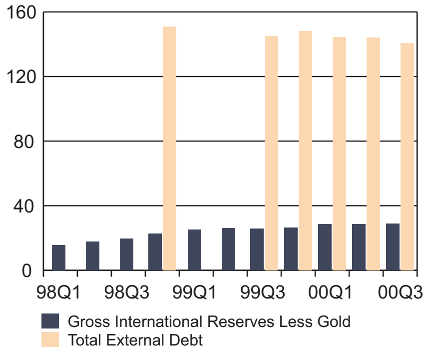
Exports rebounded strongly in 2000.

Merchandise exports (in dollar terms) grew by an estimated 27.3 percent in 2000 (Figure 5). Due to high oil prices, oil exports, which constitute about a fifth of Indonesian merchandise exports, were particularly strong, registering a 50.5 percent increase on a year-on-year basis. Boosted by strong overseas demand for manufactured goods such as electronics products, nonoil exports were also buoyant, growing by 23 percent. Growth of oil and nonoil exports tapered down in the second half as the global economy slowed, especially toward the end of the year.

And imports surged in the second half.

During the first half of 2000, merchandise imports grew at far lower rates than exports. But their growth tripled in the second half, reflecting strong economic recovery. The surge brought import growth for the whole year to 40.7 percent. According to the latest available official data, because of strong imports and lower exports, the trade surplus narrowed to $12.9 billion in the second half of 2000, compared

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

with $15.6 billion in the first half. For the whole of 2000, however, it was still $4.4 billion higher than the 1999 figure. The current account surplus in 2000 rose to $7.7 billion, an increase of $1.9 billion from 1999.

Foreign reserves remained stable in 2000.

Foreign reserves remained stable during the first three quarters of 2000 (Figure 6). The current account surplus and official capital inflows offset external debt repayments. At end-September 2000, foreign reserves stood at $28.9 billion and provided six months' cover for nonoil imports. Data from Bank Indonesia suggest that reserves have increased somewhat in recent months.

Financial and Corporate Sector Developments

The Government's bank recapitalization program was completed in October 2000, but the capital position of the banking sector remains weak.

The Government completed its bank recapitalization program, an important part of the country's bank restructuring program, in October 2000. The completion of the program was marked by the recapitalization of three State banks (Bank Negara Indonesia, Bank Rakyat Indonesia, and Bank Tabungan Negara) and three private banks (Bank Niaga, Bank Bali, and Bank Danamon). However, additional support may be required to raise the CAR of the banking system to the Basle standard of 8 percent, especially if the private sector fails to provide adequate financial resources. The total cost of bank restructuring, including recapitalization, closure, and liquidity support extended by Bank Indonesia, is estimated to have reached Rp670 trillion. This is equivalent to about 55 percent of GDP.

Although large amounts of NPLs have been transferred to IBRA, its asset disposal has been slow.

IBRA achieved its 2000 targets and, by December 2000, had acquired 82.6 percent of the banking sector's NPLs, paring the NPL ratio down to 18.8 percent. These efforts have effectively left the Government owning about 80 percent of the banking system's total assets. But IBRA's asset disposal has been slow. Resistance from powerful debtors, political influence, an ineffective bankruptcy system, and lack of interested buyers are hampering the process. Concerns over institutional weaknesses, insufficient transparency, and political uncertainties have also deterred foreign entities from buying Indonesian banks.

Voluntary corporate restructuring is making some progress.

In 2000, voluntary debt settlements under a government-sponsored framework made some progress. As of early 2001, JITF was handling 111 cases valued at about $19 billion, compared to the 67 cases valued at $13.3 billion in August 2000. By the end of the year, it was reported that JITF had rescheduled about $9.4 billion in corporate debt, nearly twice the $5.2 billion restructured as of August 2000. Under its program with IMF, it needs to restructure $12 billion in debt by April 2001.

Social Sector Developments

Poverty incidence remains high, but is expected to fall slightly in 2001.

The financial crisis inflicted a heavy social cost on Indonesia. Poverty incidence measured by the national poverty line rose from 11.3 percent in 1996 to 20.3 percent in 1998. World Bank estimates based on $1.50 per day per person show that poverty incidence continued to increase to 37 percent in 1999. With recovery now on a more solid foundation and growth regaining strength, it is estimated that poverty incidence based on this criterion will fall to about 32 percent in 2001. However, this level is still high by international and regional standards.

Prospects and Policy Issues

Recovery has taken firm root but the economy remains vulnerable.

The seven consecutive quarters of positive growth since mid-1999 and a stronger than expected performance in the second half of 2000 suggest that recovery has taken firm root in Indonesia. But the economy remains vulnerable amid a slowing global economy, limited scope for monetary easing (because of heightened inflationary pressures and a weak currency) and fiscal expansion (due to a high public debt burden), and a fragile banking sector. Continued religious and ethnic conflicts in some provinces and political uncertainties have caused international credit rating agencies to downgrade the outlook on Indonesia's long-term sovereign credit rating recently. These problems will continue to undermine investor confidence and could also lead to policy slippage. Consensus Economics' latest projection (February 2001) is for GDP growth of 3.6 percent in 2001, but with wide variation, suggesting significant uncertainties.

The threat of inflation may constrain the use of monetary policy to support recovery.

Weak investor confidence will continue to put the rupiah under pressure. Inflationary pressure is also expected to remain strong in 2001, fueled partly by planned increases in energy and food prices, and salaries and wages. Regional autonomy granted under decentralization may induce regional governments to impose additional taxes and levies, which could further fuel inflation. Bank Indonesia is targeting an inflation rate of 4-6 percent for 2001, which excludes the combined impact of the Government's price and incomes policies amounting to an estimated 2-2.5 percent. With various sources of inflationary pressure, it may have limited leeway in easing monetary policy to support recovery, in response to the global slowdown, while achieving the inflation target. Concerns have also been raised over the Government's proposed revision of the Bank Indonesia charter making it easier to remove its Governor and board, as this undermines the independence of the central bank and its capacity to control inflation.

A lot more work is needed on bank and corporate restructuring.

While the bank recapitalization program has been completed, the sector remains weak. More reforms and financial resources are needed to put it back on a strong footing so that it can provide effective financial intermediation. First, most banks need to find more capital to raise their CARs to the Basle Capital Accord minimum standard of 8 percent. The Government will have to issue more bonds to support this process if the private sector fails to provide adequate resources, thus increasing its already high fiscal burden and the public debt level. Second, to safeguard what has been achieved, and the soundness and performance of the banking system in the future, key areas of regulation and governance need to be strengthened, including Bank Indonesia's supervisory capacity; regulatory compliance; corporate governance of banks; and accounting, financial reporting, and disclosure. Third, IBRA has to speed up the disposal of its huge portfolio of acquired assets. Last, the Government has to quickly divest its bank ownership and speed up the privatization of State banks.

Social sector recovery has to be accelerated.

Economic recovery may now be on course, but social recovery is lagging behind. More concerted government efforts are needed to reduce poverty. The social sector may not get the attention it deserves in the face of government administrative reforms. In particular, decentralization will transfer the delivery of health, education, nutrition, and family planning services to the local level. Capacity is low at the local level and this poses a risk to their adequate provision. There are also concerns that regional autonomy and the transfer of revenue collection to regional governments may lead to funds being diverted more to salary and wage increases and less to social development.

Indonesia: Selected ARIC Indicators

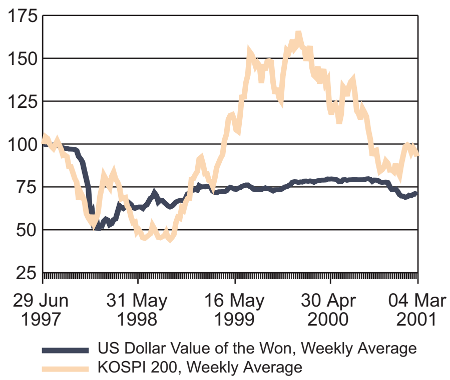
	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Output and Prices																	
GDP Growth (%)	7.8	4.7	-13.1	0.8	4.8	-4.5	-13.3	-16.0	-18.3	-5.9	2.0	2.3	5.7	4.2	5.2	4.4	5.2
Private Consumption Expenditure Growth (%)	9.7	7.8	-6.2	4.6	3.6	-0.7	-3.1	-8.0	-12.1	2.3	4.1	7.7	4.6	2.5	3.3	4.0	4.7
Public Consumption Expenditure Growth (%)	2.7	0.1	-15.4	0.7	6.5	-14.3	-7.3	-19.0	-19.9	-3.9	10.2	-0.4	-2.8	2.9	0.3	11.7	12.1
Gross Domestic Investment Growth (%)	4.9	6.3	-39.0	-23.3	8.9	-27.0	-41.9	-44.3	-43.5	-37.4	-18.8	-15.0	-17.0	-1.8	-7.4	7.9	40.2
Agricultural Sector Growth (%)	3.1	1.0	-1.3	2.7	1.7	-11.2	2.8	-2.4	8.0	18.5	-2.1	-2.3	-2.7	-5.5	1.0	3.4	9.9
Manufacturing Sector Growth (%)	11.7	5.2	-11.4	3.8	6.2	0.8	-15.4	-13.2	-17.0	-6.2	10.1	2.4	10.2	8.1	7.3	5.1	4.5
Construction Sector Growth (%)	12.8	7.4	-36.4	-0.9	6.8	-22.4	-39.2	-44.5	-39.5	-23.1	2.5	11.4	13.0	12.1	9.2	5.1	1.4
Services Sector Growth (%)	6.8	5.6	-16.5	-1.0	5.3	-2.6	-15.2	-20.2	-26.5	-13.0	-0.6	3.4	8.1	5.9	5.7	4.9	4.8
Exports of Goods and Services Growth (%)	7.6	7.8	11.2	-31.6	16.1	57.6	21.8	22.7	-40.4	-43.7	-37.3	-38.2	12.4	15.1	21.2	14.1	14.2
Imports of Goods and Services Growth (%)	6.9	14.7	-5.3	-40.7	18.2	23.4	8.7	4.4	-46.4	-51.6	-43.1	-43.6	-12.8	5.0	3.9	20.1	44.2
Inflation Rate (%)	8.0	6.2	58.5	20.5	3.7	27.7	49.7	76.4	78.4	55.8	30.9	6.6	1.7	-0.6	1.1	5.7	8.9
Unemployment Rate (%)	4.9	4.7	5.5	6.4	6.1	5.5	. . .	. . .	. . .	6.4	. . .	6.4	. . .	4.1	. . .	6.1	. . .
Monetary and Fiscal Accounts																	
Growth of Broad Money, M2 (%)[1]	27.2	25.2	63.5	12.5	. . .	52.6	81.5	67.4	63.5	34.3	9.2	19.1	12.5	10.3	12.6	6.7	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	25.8	41.3	12.6	14.7	34.8	47.9	56.7	41.3	38.6	19.9	13.7	12.6	12.0	12.2	13.5	14.7
Growth in Real Bank Credit to Private Sector (%)[1]	14.5	17.2	-25.0	-56.5	. . .	15.3	29.0	-17.9	-25.0	-48.1	-68.8	-52.5	-56.5	-36.3	-8.2	. . .	. . .
NPL Ratio of the Banking System[1]	. . .	. . .	49.2	. . .	18.8	. . .	. . .	. . .	49.2	. . .	. . .	. . .	. . .	. . .	. . .	26.9	18.8
Average Stock Price Index (JCI)	585.9	607.1	418.3	543.1	508.4	474.7	449.2	392.0	357.4	402.0	566.0	590.4	614.0	620.3	513.9	478.5	420.9
Central Government Fiscal Balance as % of GDP	1.2	-0.7	-2.8	-1.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Central Government Debt as % of GDP[1]	24.3	24.2	68.8	53.3	. . .	29.4	38.2	54.5	68.8	63.8	58.6	55.1	53.3	49.6	49.1	. . .	. . .
Government Expenditure on Education (% of Total)	. . .	. . .	5.0	6.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	. . .	1.4	1.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																	
Growth of Merchandise Exports ($ fob, %)	9.7	7.3	-8.6	-0.4	27.3	0.9	-8.4	-9.1	-16.8	-18.8	-4.4	5.6	17.1	39.1	32.1	25.1	16.6
Growth of Merchandise Imports ($ cif, %)	5.7	-2.9	-34.4	-13.0	40.7	-32.5	-43.2	-34.0	-27.5	-22.9	-2.0	-9.5	-15.7	18.0	20.4	50.3	71.8
Current Account Balance as % of GDP	-3.4	-2.2	4.2	4.1	. . .	4.5	3.1	7.8	2.3	4.8	2.5	5.1	3.9	4.6	. . .	. . .	. . .
Net Foreign Direct Investment ($ Billion)	6.2	4.7	-0.4	-2.7	. . .	. . .	. . .	. . .	. . .	-0.2	-0.9	-0.7	-0.9	-1.5	-0.4	-0.9	. . .
Net Portfolio Investment ($ Billion)	5.0	2.6	1.9	1.8	. . .	-3.5	1.8	0.1	-0.3	-2.0	0.8	-0.6	0.0	0.0	. . .	. . .	. . .
Gross International Reserves Less Gold ($ Billion)[1]	18.3	16.6	22.7	26.4	. . .	15.8	17.9	19.7	22.7	25.2	26.3	26.0	26.4	28.5	28.7	28.9	. . .
Total External Debt as % of GDP[1]	49.8	62.0	154.3	104.2	. . .	. . .	. . .	. . .	154.3	. . .	. . .	107.0	104.2	95.4	92.9	90.0	. . .
Real Effective Exchange Rate (1995=100)[2]	109.5	104.6	52.7	74.5	70.3	42.7	47.5	48.3	72.2	68.2	76.7	76.8	76.4	77.1	69.8	67.5	66.8
Average Exchange Rate (Local Currency to $)	2,342.3	2,909.4	10,013.6	7,854.9	8,404.0	9,433.4	10,460.8	12,252.1	7,908.3	8,730.5	7,977.5	7,501.3	7,210.5	7,391.4	8,243.3	8,740.2	9,241.2

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratio of the banking system, central government debt, total external debt, net foreign direct and portfolio investments, and government expenditure on education and health are from national sources. Data on M2, real bank credit to the private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics.* Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg. Real effective exchange rates are based on REMU staff calculations.

Republic of Korea Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes**
(last week of June1997=100)



Source: ARIC Indicators.

After remaining stable through most of the year, the won has weakened since the last quarter of 2000.

The won remained stable through most of 2000, but depreciated by about 10 percent in the last quarter of the year. Several factors were responsible for the decline, including a strong dollar compared to the yen, euro, and other regional currencies. Also, a narrowing trade balance due to weak export growth and high oil prices in the fourth quarter reduced the availability of foreign exchange and worked against the won. The currency weakened further when the upsurge in debt repayments increased dollar demand. Growing signs of decelerating growth, due to the slowdown in the US economy, and continued concerns about slow corporate restructuring have also had negative impacts. However, the won stabilized in early 2001. As of end-February, its dollar value was 29 percent below the end-June 1997 level (Figure 1).

After losing about half of their value last year, equity prices recovered somewhat in early 2001.

Equity prices declined through 2000. By the end of the year, the Korea Stock Price Index (KOSPI) 200 had lost 51 percent of its value in local currency terms and 56 percent in dollar terms, compared with levels at end-1999. The decline in the KOSDAQ index, which is dominated by technology sector companies, was even sharper, close to 80 percent in local currency terms. In terms of market capitalization, during 2000, the Korean stock market surrendered value equivalent to 54 percent of GDP. This poor performance was in part caused by downturns in global equity markets in response to increases in US interest rates and corrections in IT stocks. However, domestic concerns, in particular, delays in corporate restructuring, also played a part, along with fears that high growth would not be sustainable. In early 2001, Korean equities regained some lost ground. The KOSPI 200 rose by 14 percent and KOSDAQ by 50 percent as of end-February, following interest rate cuts in the US and improvements in regional equity markets. However, the KOSPI 200 was still about 7 percent in local currency terms and 34 percent in dollar terms below its end-June 1997 precrisis level.

House prices declined in the last quarter of 2000.

House prices declined in the last quarter of 2000, fueled by negative investor sentiment in expectation of an economic slowdown and seasonal factors. There were also indications that a slowdown occurred in housing construction in the last quarter and this is expected to continue in 2001. Meanwhile, independent surveys report a slight rise in office vacancies and drop in rental rates in Seoul in the second half of 2000.

Real Sector

GDP growth surprised again on the upside in 2000, but is now tapering off.

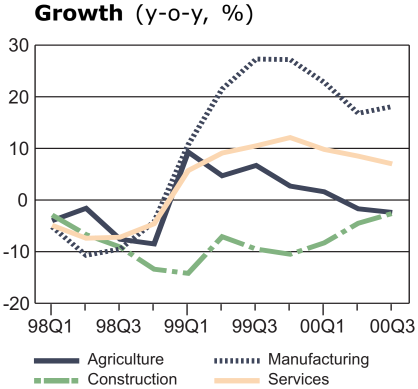
The pace of Korea's recovery surprised again on the upside in 2000, with GDP growth for the whole year likely to have reached more than 9 percent (Table 1). After a blistering start, growth began to slow, particularly in the fourth quarter. This, in part, reflects that growth was measured from a low base in earlier periods. Also taking a heavy toll were declines in exports, following a global slowdown during the second half of 2000.

Table 1: **GDP Growth and Projections** (%)

	1997	1998	1999	2000	2001
Official[1]	5.0	-6.7	10.7	8.0	5.0-6.0
ADB[2]	—	—	—	9.2	3.9
IMF[3]	—	—	—	8.8	6.5
World Bank[4]	—	—	—	8.5	6.5
Consensus Economics[5]	—	—	—	9.1	4.4

[1] Ministry of Finance and Economy, *First-Half Economic Achievements of the Kim Dae-jung Administration*, 9 September 2000 and *Korea Economic Update,* 19 January 2001.
[2] Staff estimates, March 2001.
[3] IMF, *World Economic Outlook,* September 2000.
[4] World Bank, *East Asia's Recovery: Maintaining Momentum,* 30 November 2000.
[5] Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)

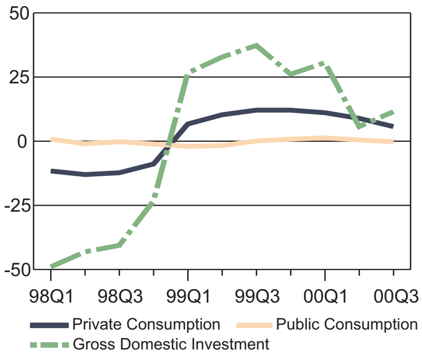


Source: ARIC Indicators.

Manufacturing led the recovery in 2000.

Output growth was mainly driven by the manufacturing sector (Figure 2). The strong performance of this sector, which grew by 19.1 percent in the first three quarters, reflected largely increased production of IT and communication-related equipment, and industrial machinery for overseas markets. The services sector was also buoyant and supported growth. However, the construction sector remained depressed, contracting by 4.8 percent in the first three quarters, while the agriculture sector posted a dismal performance in 2000, due to reductions in cultivated areas and bad weather.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

Investment, private consumption, and exports drove growth.

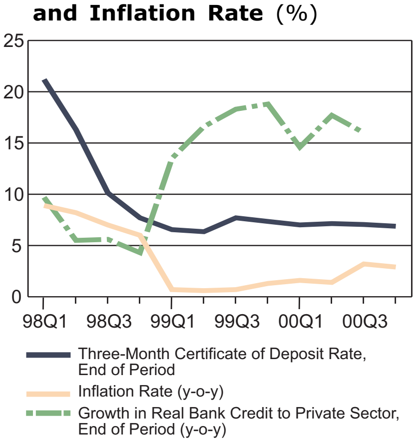
On the expenditure side, investment, private consumption, and exports were the major drivers of growth (Figure 3). Gross domestic investment rose by 14.5 percent in the first three quarters, supported by a 44.7 percent growth of investment in machinery and equipment. Private consumption was particularly strong in the first half, but it tapered off in the second half. The large decline in equity prices, and dislocations stemming from the protracted deadlock on corporate restructuring and closing down of some *chaebol* units took a heavy toll on consumer confidence. Boosted by overseas demand for electronics products, exports continued to rise vigorously until the third quarter. But they dipped significantly in the fourth quarter, due to the global slowdown led by the US economy. Reflecting a tight fiscal stance, public consumption posted only 0.9 percent growth in the first half of 2000 and contracted by 0.2 percent in the third quarter.

Fiscal and Monetary Developments

The Government budget posted a surplus in 2000, but that for 2001 will try to cushion the economic slowdown.

After incurring deficits for three consecutive years, the central Government's budget posted a surplus of W5.6 trillion in 2000, equivalent to 1.1 percent of GDP. Underlying the surplus was a 23.8 percent rise in revenues, boosted by an increase of W17 trillion in tax collection amid strong economic growth. Expenditures also increased, but only by 5.8 percent, in part reflecting slow growth of capital expenditures. Compared with budgeted levels, revenues were 10.5 percent higher and expenditures 8.4 percent lower. Attempting to counter the growth slowdown, the budget for 2001 envisages a deficit of W3.4 trillion, equivalent to about 0.6 percent of GDP. Revenues are expected to grow by 4 percent and expenditures by 11.3 percent.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Despite slowing growth, inflation edged up in the second half of 2000 and continues to rise in early 2001.

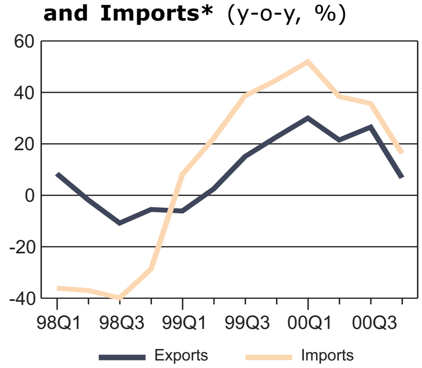
Inflation was low in the first half of 2000, but it edged up in the second half (Figure 4), reaching 3.2 percent in December (y-o-y). The rise was due mainly to oil price hikes, removal of large discounts on some industrial commodities, rising public utility charges, and increases in house rents. Inflation has maintained this upward trend in 2001 despite slowing growth, rising to 4.2 percent (y-o-y) in the first two months.

Monetary policy is also being used to support growth.

The Bank of Korea, the central bank, raised the overnight call rate twice in 2000 to curb inflationary pressures. In response to the economic slowdown, however, it lowered the overnight rate by 25 bp in February 2001. While inflation remains a threat, the central bank expects demand-side pressures to subside as growth slows further. The Bank of Korea has set the core inflation target for 2001 at 2-4 percent.

Balance of Payments

Figure 5: **Growth of Merchandise Exports and Imports*** (y-o-y, %)



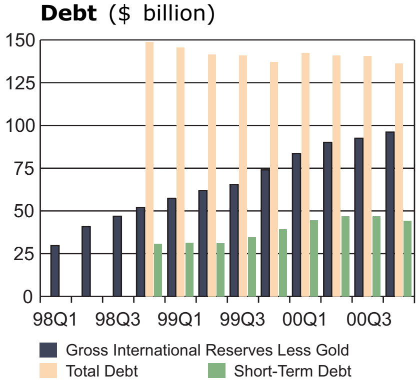
*In dollar terms.
Source: ARIC Indicators.

The trade and current account surpluses halved in 2000.

Merchandise exports (in dollar terms) were buoyant in the first three quarters of 2000. But export growth fell sharply in the fourth quarter (Figure 5), as the global slowdown reduced electronics demand from overseas. The insolvency of Daewoo Motor Company reduced automobile exports and contributed to the dip in export growth. Merchandise imports were strong for most of 2000, spurred by high growth. Rising oil prices, which caused the oil import bill to bloat, was another contributory factor. But import growth eased to 5 percent in December, reflecting weakening business and consumer confidence as signs of slow growth emerged. In 2000, Korea posted a trade surplus of about $12.1 billion and a current account surplus of about $11 billion, both about half of what was recorded in 1999. Preliminary estimates show that in the first two months of 2001, exports grew by about 6 percent on a year-on-year basis. Imports, meanwhile, contracted by 1 percent in January and grew by 6 percent in February.

Debt repayments led to net capital outflows in the last few months of 2000.

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

After 11 consecutive months of net capital inflows, the capital account moved into deficit in September through November 2000. Amounting to $3.6 billion, the net outflows were caused mainly by external debt repayment and, in September, withdrawal of portfolio capital. For most of 2000, however, the capital account was in surplus. In the first 11 months, net portfolio investment inflows reached $11.7 billion and net FDI $2.9 billion.

The external payments position continues to remain comfortable.

Korea's total external debt, both in terms of absolute levels and as a percentage of GDP, continues to fall (Figure 6). Total external debt stood at $133.4 billion as of end-January 2001, which is equivalent to 29.3 percent of GDP, the lowest level since the crisis started in 1997. The share of short-term debt in total external debt started to decline in the second half of 2000, and by January 2001 reached 31.7 percent. Short-term debt was equivalent to 46 percent of international reserves, compared to 53 percent a year earlier. Korea's international reserve level, amounting to $96 billion at end-2000, is the second largest level among Organisation for Economic Co-operation and Development (OECD) countries and provides more than seven months' import cover.

Financial and Corporate Sector Developments

NPL ratios continue to fall.

Financial restructuring in Korea is making further progress. Despite the more stringent rules on loan classification adopted in 1999, NPL ratios of the financial system and commercial banks continued to decline, standing at 9.7 and 7.9 percent, respectively, at the end of the third quarter of 2000. However, NPL ratios of nonbank financial institutions remained high. Efforts to improve financial institutions' balance sheets have continued. By December 2000, KAMCO had acquired NPLs of about W95 trillion, amounting to 61 percent of total NPLs in the financial system. Asset disposal through a variety of methods including loan sales, issuance of asset backed securities, and sales of collateral has likewise proceeded, reaching W45 trillion by December 2000, amounting to 48 percent of KAMCO's total acquired assets.

But commercial bank profitability remains negative.

Despite progress in bank restructuring, the average ROE for commercial banks has remained negative since 1997. But the magnitude of loss is declining. After dropping to -52.2 percent in 1998, the average ROE improved to -13.5 percent for the 12-month period ending in September 2000. The disparity between nationwide and regional commercial banks in terms of profitability is quite large: ROE was -50.7 percent for regional banks and -11.9 percent for national banks. In 2000, the number of loss-making national banks was reduced to five from six a year earlier. But all six regional commercial banks remained loss-makers.

Social Sector Developments

Although improving, the unemployment rate remains higher than precrisis levels.

After showing improvement until mid-2000, the unemployment rate inched up toward the end of the year, hitting 4.1 percent in December and 4.6 percent in January 2001, due mainly to a slowdown in manufacturing employment. Although lower than the figures registered in the same period of the previous year, these rates were substantially higher than precrisis levels. Measured against a benchmark of $7.94 per day per person (the national poverty line), poverty incidence is expected to fall to 12.5 percent in 2001 from a peak of 23.2 percent in 1998. This, though, still exceeds the 11.4 percent recorded in 1997.

Prospects and Policy Issues

Growth in 2001 is likely to be much lower than in 2000.

The Korean economy is expected to experience a significant slowdown in 2001, with the Government projecting GDP growth of 5-6 percent. The Consensus Economics projection (February 2001) for growth ranges from 2.8 to 6 percent, with a mean estimate at 4.4 percent. This expected deceleration arises from the country's dependence on exports, especially of electronics goods, growth of which is expected to slow dramatically in 2001. Financial risks also remain significant, as banking sector profitability is still negative, while corporate restructuring is becoming increasingly difficult.

Accomodative monetary and fiscal policy could partially cushion the adverse impacts of the global slowdown.

With global interest rates falling, there may be room for further monetary easing. As the Government's books are now in the black, there is also scope for fiscal expansion. The Government has already initiated some measures, with recent interest rate reductions and an increase of fiscal expenditure by 11 percent in the 2001 budget. Given the country's comfortable external payments position and slowing growth, more accommodative fiscal and monetary policies are unlikely to cause macroeconomic and financial instability.

Corporate restructuring remains a formidable challenge.

While there has been progress in corporate restructuring in 2000, such as the introduction of CRVs and measures to speed up bankruptcy proceedings, the process remains slow. Large *chaebols* continue to be highly indebted and vulnerable to shocks. Consolidated financial statements released in mid-2000 suggest that the average debt-equity ratio for the 30 largest *chaebols* still exceeds the targeted level of 200 percent. The restructuring of major *chaebols*, such as Hyundai and Daewoo, remains incomplete and faces difficulties due to strong resistance from trade unions. Moreover, final resolution of the debt of HEC is not yet in sight. There are growing concerns that the Government has continued to provide financial assistance to ailing *chaebol* affiliates and this could stall restructuring efforts. Continued problems in the corporate sector will not only undermine investor confidence, but will also jeopardize the financial sector reform process.

Financial sector restructuring needs to be consolidated.

Korea's banking sector has progressed the fastest in the country's financial restructuring. However, movement in the nonbank financial sector, which accounts for about 20 percent of the total assets of the financial sector, has been much slower. With high NPL ratios in this sector, increased attention will need to be directed toward nonbank financial institutions, particularly, investment trusts, and insurance and securities companies, as banking sector reform, including recapitalization of banks, continues. The introduction of mark-to-market valuation of portfolios of investment trust companies (ITCs) is a positive step since this makes it easier to spot vulnerabilities. More reforms to upgrade disclosure, accounting, auditing, and supervisory standards for ITCs will have to be undertaken. With regard to insurance companies, there is a need for stricter enforcement of the 1998 solvency requirements and eventually they should be subjected to more stringent risk-based solvency standards. Also, the Government will have to refine its techniques for market oversight on a continuing basis to minimize systemic risks from securities companies.

Labor market rigidity is hampering corporate restructuring.

Perceived labor problems are hampering corporate restructuring because foreign investors are reluctant to infuse fresh capital into ailing but viable Korean companies. For instance, Ford's planned acquisition of Daewoo Motor Company had to be put off because labor problems were expected to arise in the wake of planned layoffs. Building an efficient corporate sector that is flexible enough to adjust to the changing business environment and market conditions requires a flexible labor market. The Government has taken steps to improve labor market flexibility, including the enactment of the revised Labor Standard Act in February 1998 and legislation that allows the establishment of labor leasing business. Despite these moves, the conditions for laying off workers are still stringent, especially when compared to other OECD countries. A further relaxation of these regulations will help to enhance labor market flexibility.

Republic of Korea: Selected ARIC Indicators

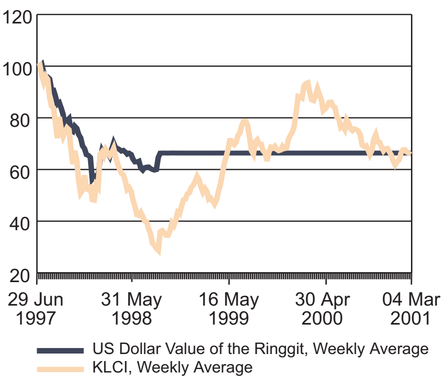
	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Output and Prices																	
GDP Growth (%)	6.8	5.0	-6.7	10.7	. . .	-4.6	-8.0	-8.1	-5.9	5.4	10.8	12.8	13.0	12.7	9.6	9.2	. . .
Private Consumption Expenditure Growth (%)	7.1	3.5	-11.4	10.3	. . .	-11.6	-13.0	-12.3	-8.9	6.7	10.3	12.1	12.1	11.1	8.9	5.7	. . .
Public Consumption Expenditure Growth (%)	8.2	1.5	-0.4	-0.6	. . .	0.8	-1.0	-0.2	-1.1	-2.0	-1.7	0.1	0.8	1.3	0.5	-0.2	. . .
Gross Domestic Investment Growth (%)	8.7	-7.5	-38.4	30.4	. . .	-49.0	-43.1	-40.6	-23.3	26.6	32.8	37.3	26.1	30.6	5.7	11.5	. . .
Agricultural Sector Growth (%)	3.3	4.6	-6.6	4.7	. . .	-4.0	-1.6	-7.6	-8.5	9.3	4.7	6.7	2.7	1.6	-1.7	-2.4	. . .
Manufacturing Sector Growth (%)	6.8	6.6	-7.4	21.8	. . .	-5.2	-10.7	-9.5	-4.2	10.7	21.5	27.3	27.2	22.8	16.8	18.1	. . .
Construction Sector Growth (%)	6.9	1.4	-8.6	-10.1	. . .	-2.9	-6.7	-9.1	-13.4	-14.2	-7.1	-9.5	-10.5	-8.3	-4.5	-2.6	. . .
Services Sector Growth (%)	6.2	-9.1	-6.0	9.4	. . .	-4.9	-7.4	-7.2	-4.6	5.7	9.1	10.5	12.1	9.8	8.5	7.0	. . .
Exports of Goods and Services Growth (%)	11.2	21.4	13.2	16.3	. . .	25.8	13.6	8.5	7.6	9.2	14.6	20.0	21.0	26.1	23.1	23.6	. . .
Imports of Goods and Services Growth (%)	14.2	3.2	-22.4	28.9	. . .	-27.3	-25.7	-26.1	-10.1	27.3	28.3	32.3	28.0	32.1	19.8	23.4	. . .
Inflation Rate (%)	4.9	4.4	7.5	0.8	2.3	8.9	8.2	7.0	6.0	0.7	0.6	0.7	1.3	1.6	1.4	3.2	2.9
Unemployment Rate (%)	2.0	2.6	6.8	6.3	4.1	5.6	6.8	7.4	7.4	8.4	6.6	5.6	4.6	5.1	3.8	3.6	3.7
Monetary and Fiscal Accounts																	
Growth of Broad Money, M2 (%)[1]	15.8	14.1	27.0	27.4	25.5	12.1	16.3	24.8	27.0	36.3	26.4	24.1	27.4	26.0	37.7	28.3	25.5
Three-Month Certificate of Deposit Rate (%)[1]	13.3	25.0	7.7	7.4	6.9	21.2	16.3	10.1	7.7	6.6	6.4	7.7	7.4	7.0	7.1	7.1	6.9
Growth in Real Bank Credit to Private Sector (%)[1]	14.4	14.4	4.3	18.8	. . .	9.7	5.5	5.6	4.3	13.5	16.6	18.3	18.8	14.6	17.7	16.0	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	. . .	11.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	11.3	10.8	10.7	9.7	. . .
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	. . .	8.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	8.3	8.0	8.7	7.9	. . .
Average Stock Price Index (KOSPI 200)	90.6	67.8	47.1	94.7	92.1	58.3	43.0	36.5	50.6	68.4	90.1	113.1	107.3	114.3	96.9	89.8	67.2
Central Government Fiscal Balance as % of GDP	0.1	-1.3	-3.8	-4.6	. . .	4.1	-2.4	-4.2	-8.7	-0.2	-4.9	0.1	-7.1	1.5	3.0	. . .	. . .
Central Government Debt as % of GDP[1]	. . .	11.1	16.1	18.5	. . .	. . .	. . .	. . .	16.1	17.9	. . .	18.2	18.5	18.7	19.0	19.2	. . .
Government Expenditure on Education (% of Total)	. . .	. . .	23.1	19.2	20.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	. . .	1.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																	
Growth of Merchandise Exports ($ fob, %)	4.3	4.8	-2.8	8.6	20.1	8.4	-1.8	-10.8	-5.5	-6.1	2.5	15.1	22.7	30.0	21.5	26.5	6.8
Growth of Merchandise Imports ($ cif, %)	12.3	-2.2	-34.2	28.4	34.0	-36.1	-37.0	-39.9	-28.7	8.1	22.2	38.7	44.8	51.9	38.4	35.7	16.3
Current Account Balance as % of GDP	-4.4	-1.7	12.6	6.0	. . .	16.0	14.2	11.9	9.5	6.7	6.3	6.5	4.8	1.4	2.3	3.0	. . .
Net Foreign Direct Investment ($ Billion)	-2.3	-1.6	0.7	5.1	. . .	0.0	0.6	0.7	-0.5	0.1	1.2	2.1	1.7	0.2	1.8	0.3	. . .
Net Portfolio Investment ($ Billion)	15.2	14.3	1.9	8.7	. . .	3.8	0.6	-3.9	-2.4	0.9	4.0	-1.2	4.9	7.1	1.6	2.4	. . .
Gross International Reserves Less Gold ($ Billion)[1]	34.0	20.4	52.0	74.0	96.1	29.7	40.8	46.9	52.0	57.4	61.9	65.4	74.0	83.6	90.1	92.5	96.1
Total External Debt as % of GDP[1,3]	30.3	33.3	46.4	33.6	30.0	. . .	. . .	. . .	46.4	42.4	38.9	36.7	33.6	33.5	32.1	30.9	30.0
Short-Term Debt as % of Gross International Reserves[1]	. . .	312.3	59.1	53.0	46.0	. . .	. . .	. . .	59.1	54.7	50.5	52.9	53.0	53.2	52.2	50.6	46.0
Short-Term Debt as % of Total Debt[1]	. . .	. . .	20.6	28.6	32.4	. . .	. . .	. . .	20.6	21.6	22.1	24.5	28.6	31.3	33.3	33.3	32.4
Real Effective Exchange Rate (1995=100)[2]	104.5	100.3	83.1	90.8	94.1	73.8	83.7	88.8	86.1	91.7	92.6	89.7	89.2	93.7	94.2	94.9	93.5
Average Exchange Rate (Local Currency to $)	804.5	951.3	1,401.4	1,188.2	1,131.5	1,605.7	1,394.6	1,326.1	1,279.3	1,196.3	1,188.9	1,195.0	1,172.5	1,127.0	1,116.4	1,115.0	1,167.6

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
[3] The denominator for the December 2000 figure is the sum of quarterly nominal GDP in dollar terms from fourth quarter of 1999 to third quarter of 2000.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the financial and commercial banking system, central government debt, total and short-term external debts, net foreign direct and portfolio investments, and government expenditure on education and health are from national sources. Data on M2, real bank credit to the private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics.* Data on certificate of deposit rate, average stock price index, and average exchange rate are from Bloomberg. Real effective exchange rates are based on REMU staff calculations.

Malaysia Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes** (last week of June1997=100)



Source: ARIC Indicators.

The KLCI declined in 2000 and remains flat this year.

The Kuala Lumpur Composite Index (KLCI) has performed poorly since the second quarter of 2000, in line with weaknesses in other regional equity markets (Figure 1). Despite low domestic interest rates; easier liquidity, helped in part by strong balance-of-payments surpluses; and a powerful recovery in the real sector, the KLCI's decline continued for most of 2000, and remains flat this year. In an attempt to shore up the market, the Government announced the scrapping of the 10 percent tax on profits repatriated after one year, effective 1 February 2001. As of end-February 2001, the KLCI was 34 percent in local currency terms and 56 percent in dollar terms below its end-June 1997 precrisis level.

The property market still faces difficulty.

The property market in Malaysia still faces difficulties. Office vacancy rates in the central business district of Kuala Lumpur trended downwards during the first three quarters of 2000, but the level rose again in the last quarter, to 18.5 percent (Table 1). The picture is similar in the retail property market, where the vacancy rate rose to 13.4 percent in the last quarter of 2000 from 13.2 percent half a year earlier. In the residential property market, capital values appeared to have stabilized in 2000, but were still down on a year-on-year basis.

Table 1: **Property Vacancy Rates in Kuala Lumpur** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Office Property	11.6	13.6	15.5	15.7	17.0	17.0	18.8	17.8	17.5	17.0	18.5
Retail Property	. . .	. . .	. . .	. . .	12.8	. . .	15.2	. . .	13.2	. . .	13.4

. . . = not available.
Source: Jones Lang LaSalle, *Asia Pacific Property Digest*, various issues.

Real Sector

GDP growth is beginning to come off its highs.

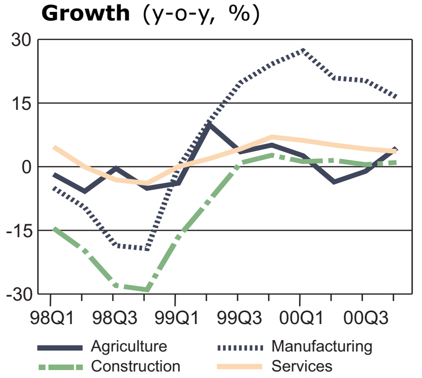
Real GDP grew by 10 percent in the first half of 2000, with second quarter growth moderating to 8.4 percent from 11.8 percent in the first quarter. In the third quarter, growth slowed to 7.8 percent and slid further still to 6.5 percent in the fourth. This brings the growth rate for the year to 8.5 percent. Although this is a healthy and perhaps more sustainable level, the Malaysian economy is beginning to slow (Table 2).

Table 2: **GDP Growth and Projections** (%)

	1997	1998	1999	2000	2001
Official[1]	7.3	-7.4	5.8	8.5	7.0
ADB[2]	—	—	—	—	4.9
IMF[3]	—	—	—	—	6.0
World Bank[4]	—	—	—	—	6.0
Consensus Economics[5]	—	—	—	—	5.2

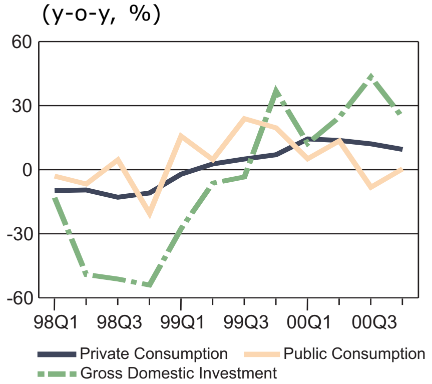
[1] *Ministry of Finance*, 24 October 2000.
[2] Staff estimates, March 2001.
[3] IMF, *World Economic Outlook*, September 2000.
[4] World Bank, *East Asia's Recovery: Maintaining Momentum*, 30 November 2000.
[5] Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, February 2001.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

The recovery is becoming increasingly broad based.

Malaysia's manufacturing sector continued to power ahead, but recovery is also becoming increasingly broad based. All major sectors of the economy posted positive growth (Figure 2). Even the mining and construction sectors, which until recently lagged behind, contributed, although marginally. Moreover, while exports, aided by a competitive exchange rate and strong demand for electronics, drove growth on the demand side for most of 2000, local investment and private consumption continued to support domestic demand. Earlier concerns about an undervalued ringgit compared to other regional currencies have been mitigated to some degree by the appreciation of the US dollar.

Private consumption remained strong but is now tapering off.

In 1999, private consumption lagged broader GDP growth, with public expenditure providing the main support for total consumption. In the first quarter of 2000, there was a reversal, with public consumption posting 5.1 percent growth while private consumption grew at 14.4 percent (Figure 3). Since then, private consumption has begun to taper off, falling to 13.7 percent in the second quarter, 12 percent in the third, and 9.5 percent in the fourth. Public consumption, which rebounded in the second quarter to post a 13.5 percent increase, tailed off sharply in the third quarter, contracting by 8.2 percent.

Investment emerged as a major contributor to growth.

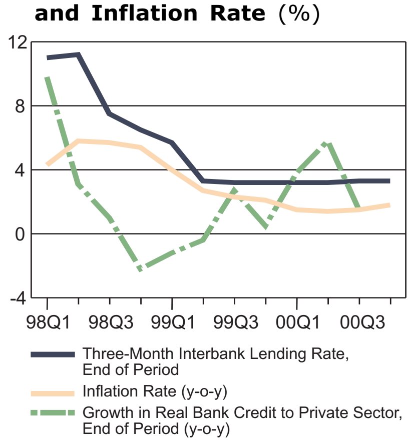
Investment demand grew in the first half of 2000, before experiencing a sharp upturn in the third quarter. Domestic investment expanded in the second quarter by 24.6 percent (y-o-y) and shot up by 43.4 percent in the next. Much of this expansion is likely to have been due to investment by public sector and State-related enterprises. Investment in the fourth quarter fell back to 24.4 percent, which is still a very healthy rate and more sustainable. FDI continued to be low relative to precrisis levels (see section on foreign direct investment starting on page 76). In many private sector companies, there is probably still some excess capacity, though capacity utilization rates are increasing.

Manufacturing output continued to soar, but a slowdown looms.

In the third quarter of 2000, manufacturing production grew by 20.3 percent (y-o-y), but slowed slightly to 16.4 percent in the fourth quarter. Spearheading this growth were the electronics and electrical sectors for overseas markets. However, exports started to tail off in the last quarter, and this trend is likely to continue in 2001, driven by a downswing in the global electronics cycle.

Fiscal and Monetary Developments

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

The fiscal deficit in 2000 is expected to be lower than programmed.

The Government remains committed to an expansionary fiscal stance to support the recovery of private demand. The target deficit for 2000 was 4.5 percent of GDP. Although the Government posted a surplus in the first quarter of 2000, there was a deficit in the second and third quarters, leaving the overall figure for the first three quarters in deficit. Nevertheless, with strong growth, the actual deficit may prove to be substantially lower than that originally programmed. The revised 2000 budget put the fiscal deficit at about 3 percent of gross national product (GNP).

Monetary policy remains broadly accommodating.

Interest rates fell steadily in 1999 to reach historic lows. Since then, they have shown little movement (Figure 4). In a benign inflationary environment, Bank Negara Malaysia (BNM) followed a broadly accommodating monetary policy and maintained stable liquidity. In the second quarter of 2000, commercial banks' base lending rates remained at historic lows. Low interbank interest rates were a reflection of this policy. With inflation still under control, and interest rates falling worldwide, domestic interest rates are likely to remain low into 2001.

There are early signs of renewed credit growth.

Recent monthly data suggest that banking system loans are on the rise to accommodate increased residential property and manufacturing sector demand. In December 2000, the money supply (M3) recorded its largest monthly increase for the year reflecting a broad-based expansion in loans. After declining further during the first quarter, the loan-to-deposit ratio is now beginning to track up. Nevertheless, banks are still using cash to buy government securities as they seek to further strengthen their balance sheets.

Inflation remains tame.

Despite a vigorous expansion in economic activity, consumer price inflation remained subdued in 2000, with an annual inflation rate of 1.5 percent, compared to 2.7 percent in 1999. Stable food, and transport and communications service prices contributed to this decline. Producer price inflation also moderated. But there are indications that inflation could begin to edge up as transport prices and fuel subsidies are revised in the face of high oil prices.

Balance of Payments

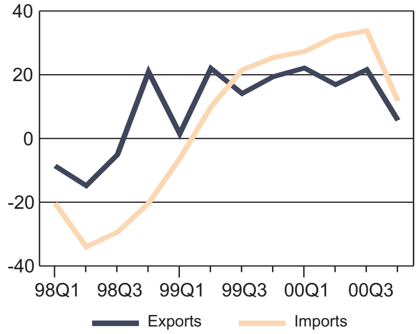
The trade account remained in surplus.

Malaysia posted its 14th consecutive trade surplus in the fourth quarter of 2000. After a slight narrowing of the surplus in the second quarter due to strong import growth, increased exports lifted it again to 5.2 percent of GDP in the third quarter (Figure 5). Exports, particularly from manufacturing, continued to perform well in the third quarter with strong demand for electronics and electrical goods. This trend is projected to soften sharply this year, however, while manufacturing exports will also taper off.

Foreign exchange reserves tapered off slightly but are still at a healthy level.

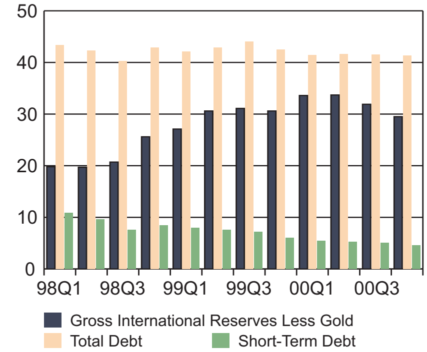
Malaysia's large trade surpluses in all four quarters of 2000 helped to maintain foreign exchange reserves at healthy levels. As of mid-February

Figure 5: **Growth of Merchandise Exports and Imports*** (y-o-y, %)



*In dollar terms.
Source: ARIC Indicators.

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

2001, BNM reported that they stood at $29.2 billion, sufficient to finance 4.3 months of retained imports and are 6.3 times the short-term external debt. A slight tapering off in the levels of foreign reserves is reflected in similar reductions in external debt, but some reserves have been expended in defending the pegged exchange rate (Figure 6).

Financial and Corporate Sector Developments

Banking system capital strength has been maintained.

The merger program initiated by BNM to consolidate the banking institutions by 31 December 2000 resulted in 50 of the 54 domestic banking institutions being merged into 10 banking groups. In March 2001, another banking institution completed a merger. Consolidation is taking place against the backdrop of a significant improvement in banking system balance sheets. As of end-January 2001, capital injection by Danamodal in the banking system declined to RM3.7 billion compared with the initial injection of RM7.1 billion. The core capital adequacy (CCA) and risk-weighted capital ratios (RWCR) confirm an increase in the capital strength of the Malaysian banking system over the past two years. The CCA reported in February 2001 was

10.4 percent, well above the 8 percent Basle norm, while the RWCR also continues to be healthy, at 12.1 percent in February 2001.

Nonperforming loan ratios are falling.

As of end-November 2000, Danaharta had already carved out a large portion (RM37 billion) of the NPL portfolio from the Malaysian banking system. Banks, however, have still been left to work out a significant portion of problem loans, many of which are comparatively small. The net NPL ratio, measured on a three-month accrual basis, is lower than in 1999, with the latest data for December 2000 showing a figure of 9.6 percent.

Danaharta's operations continue at a steady pace.

Danaharta's mandate is to rehabilitate and restructure viable loans. Recovery rates on assets have been high by international standards. As of end-December 2000, a total of RM35.8 billion of loans or assets have been restructured or disposed of with an average recovery rate of 66 percent.

CDRC has resolved more than half of the referred cases.

As of end-December 2000, CDRC had received and accepted applications amounting to RM39.4 billion. Of these, 42 applications with a value of RM27.3 billion had been resolved, representing almost 70 percent of the debt accepted by CDRC. Only 12 cases involving debts totaling RM12.1 billion remain outstanding. The pace of restructuring under CDRC has been relatively slow due to the involvement of a large number of creditors and the need to obtain a consensus from all the parties involved. The lackluster performance of the capital market in recent months has further exacerbated the situation, resulting in the deferral of debt restructuring schemes that involve raising of equity. Another concern is that to the extent that unrestructured enterprises are once again being permitted to borrow aggressively, some difficulties may be deferred rather than resolved.

Prospects and Policy Issues

Malaysia's growth in 2001 will be lower than in 2000.

The latest Consensus Economics (February 2001) projections suggest that the Malaysian economy is likely to grow by 5.2 percent in 2001, a significant decline from the 8.5 percent of 2000. Some institutions, however, project a higher growth rate for 2001. The main factor behind the slowdown is a likely sharp decline in export growth, particularly of electronics exports, on which Malaysia is heavily reliant. In this respect, the slowdown in US growth will hit demand hard. The economic slowdown is likely to occur despite continued strength in private consumption and investment demand, and any further loosening of monetary policy following reductions in US interest rates.

The ringgit peg will remain for now.

Against a background of subdued inflation and currency depreciation elsewhere in the region, a revaluation of the ringgit looks unlikely any time soon. With the expected slowdown in exports in 2001, particularly of electronic and electrical goods, pressure may build for a devaluation of the currency to increase competitiveness. Although a change to the value of the peg continues to appear unlikely for the time being, a trigger could come in the form of a drop-off in exports large enough to push the trade account into deficit.

Opening the banking sector more could encourage greater efficiency and contribute to the return of FDI.

FDI has been slow to return to Malaysia. Although the Government has instituted measures recently to encourage the return of FDI, more changes will be required. Among others, greater foreign participation needs to be introduced into the banking sector to contribute to greater efficiency of the sector. Further entry of foreign banks will be considered only in the third phase of the recently launched Financial Sector Master Plan. If this policy change is to be effective, however, it will have to be accompanied by an easing of restrictions on the lending activities of foreign banks. The second phase of the plan does provide for greater deregulation of the domestic market, however, and this is expected to create a more level playing field for foreign and domestic financial institutions.

Malaysia: Selected ARIC Indicators

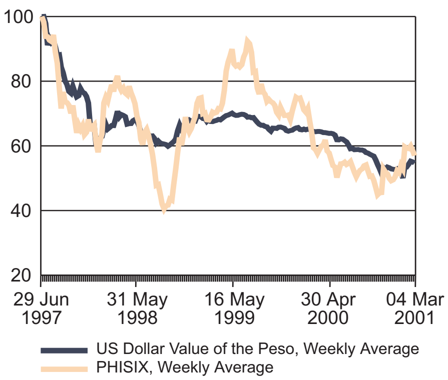
	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Output and Prices																	
GDP Growth (%)	10.0	7.3	-7.4	5.8	8.5	-1.6	-5.9	-10.1	-11.2	-1.4	5.0	8.6	11.0	11.8	8.4	7.8	6.5
Private Consumption Expenditure Growth (%)	6.9	4.3	-10.8	3.1	12.4	-9.8	-9.5	-12.9	-10.9	-2.1	2.7	5.0	7.0	14.4	13.7	12.1	9.5
Public Consumption Expenditure Growth (%)	0.7	7.3	-8.0	16.3	1.7	-3.0	-6.7	4.6	-20.4	15.7	4.7	23.9	19.6	5.1	13.5	-8.2	0.4
Gross Domestic Investment Growth (%)	4.7	11.1	-43.0	-5.1	25.9	-13.1	-49.1	-51.2	-54.0	-27.6	-6.3	-3.4	36.8	12.3	24.6	43.4	24.4
Agricultural Sector Growth (%)	4.5	0.4	-3.0	3.8	0.4	-1.8	-5.8	-0.4	-5.1	-3.9	9.9	3.5	5.1	2.6	-3.6	-1.1	4.4
Manufacturing Sector Growth (%)	18.2	10.1	-13.4	13.5	21.0	-5.0	-9.6	-18.6	-19.3	-0.2	10.7	19.8	24.2	27.3	20.9	20.3	16.4
Construction Sector Growth (%)	16.2	10.6	-23.0	-5.6	1.1	-14.5	-19.8	-28.0	-29.0	-16.6	-7.9	0.9	2.7	1.2	1.5	0.5	1.0
Services Sector Growth (%)	8.9	9.9	-0.7	3.3	4.7	4.7	0.0	-3.1	-3.9	0.0	1.9	4.2	7.0	6.2	5.1	4.2	3.6
Exports of Goods and Services Growth (%)	9.2	6.2	-0.2	13.4	16.3	-1.1	1.3	-2.9	1.9	1.9	13.0	19.5	18.4	19.9	15.1	19.9	11.0
Imports of Goods and Services Growth (%)	4.9	5.7	-18.7	10.8	23.6	-10.3	-25.0	-23.5	-17.7	-7.9	8.8	18.1	25.6	22.1	24.6	31.1	16.8
Inflation Rate (%)	3.5	2.7	5.3	2.7	1.5	4.3	5.8	5.7	5.4	4.0	2.7	2.3	2.1	1.5	1.4	1.5	1.8
Unemployment Rate (%)	2.5	2.6	3.2	3.4	. . .	. . .	. . .	. . .	. . .	4.5	3.3	2.9	3.0	3.0	3.3	3.1	. . .
Monetary and Fiscal Accounts																	
Growth of Broad Money, M2 (%)[1]	24.3	17.4	-1.4	16.9	12.0	10.0	6.8	2.8	-1.4	3.6	13.2	17.1	16.9	18.5	11.9	7.3	12.0
Three-Month Interbank Lending Rate (%)[1]	. . .	. . .	6.5	3.2	3.3	11.0	11.2	7.5	6.5	5.7	3.3	3.2	3.2	3.2	3.2	3.3	3.3
Growth in Real Bank Credit to Private Sector (%)[1]	16.9	19.9	-2.2	0.5	. . .	9.8	3.1	1.0	-2.2	-1.2	-0.4	2.7	0.5	3.8	5.8	1.5	. . .
NPL Ratio of the Banking System[1]	. . .	. . .	13.6	11.0	9.6	. . .	. . .	12.8	13.6	14.2	12.4	12.0	11.0	10.7	10.4	10.1	9.6
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	10.3	8.8	8.1	. . .	. . .	10.5	10.3	11.1	9.4	9.6	8.8	8.9	8.6	8.5	8.1
Average Stock Price Index (KLCI)	1,134.1	978.9	517.7	692.0	842.4	657.7	565.3	381.1	466.7	556.0	706.9	763.2	741.8	950.1	892.8	792.0	734.8
Central Government Fiscal Balance as % of GDP	0.7	2.4	-1.8	-3.2	. . .	5.9	-0.5	2.1	-14.6	1.8	0.2	-7.3	-6.5	1.2	-1.9	-5.2	. . .
Central Government Debt as % of GDP[1]	35.3	31.9	36.2	37.3	. . .	30.5	31.3	30.7	36.2	36.8	38.3	37.8	37.3	36.7	37.4	37.2	. . .
Government Expenditure on Education (% of Total)	21.4	21.3	21.4	22.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	5.9	6.2	6.5	6.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																	
Growth of Merchandise Exports ($ fob, %)	0.4	-2.5	-2.9	14.3	16.1	-8.6	-14.8	-5.1	20.9	1.5	22.0	14.1	19.4	22.1	16.9	21.6	5.7
Growth of Merchandise Imports ($ cif, %)	1.4	1.8	-21.5	12.5	25.7	-20.3	-34.0	-29.4	-20.3	-6.3	9.9	21.5	25.4	27.3	32.0	33.8	11.8
Current Account Balance as % of GDP	-4.6	-4.7	13.0	15.5	. . .	6.4	11.4	17.3	16.6	13.7	16.6	18.1	13.6	13.4	9.3	8.8	. . .
Private Long-Term Capital ($ Billion)[2]	5.1	5.1	2.2	1.6	. . .	1.1	0.7	-0.2	0.6	0.3	1.0	0.0	0.2	0.7	. . .	. . .	. . .
Private Short-Term Capital ($ Billion)[2]	4.1	-4.6	-5.6	-9.9	. . .	-2.3	-1.2	-1.1	-0.6	-1.8	-0.7	-4.2	-3.3	0.9	. . .	. . .	. . .
Gross International Reserves Less Gold ($ Billion)[1]	27.0	20.8	25.6	30.6	29.5	19.8	19.7	20.7	25.6	27.1	30.6	31.1	30.6	33.6	33.7	31.9	29.5
Total External Debt as % of GDP[1]	38.3	43.4	59.2	53.8	46.2	46.7	50.3	52.9	59.2	57.9	58.0	57.6	53.8	50.3	49.0	47.4	46.2
Short-Term Debt as % of Gross International Reserves[1]	. . .	53.5	33.1	19.7	15.6	54.9	48.9	36.9	33.1	29.3	25.0	23.2	19.7	16.3	15.8	15.9	15.6
Short-Term Debt as % of Total Debt[1]	. . .	. . .	19.7	14.1	11.2	25.1	22.7	19.0	19.7	18.9	17.8	16.4	14.1	13.2	12.8	12.2	11.2
Real Effective Exchange Rate (1995=100)[3]	106.5	105.5	86.8	87.6	86.2	84.8	88.9	86.5	87.1	89.4	89.7	87.2	84.2	85.8	85.7	85.8	87.4
Average Exchange Rate (Local Currency to $)	2.5	2.8	3.9	3.8	3.8	4.0	3.8	4.1	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Quarterly figures were converted to dollars from ringgit using the quarterly average exchange rate.
[3] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the banking and commercial banking system, central government debt, total and short-term external debts, private long-term and short-term capital, and government expenditure on education and health are from national sources. Data on M2, real bank credit to the private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics.* Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg. Real effective exchange rates are based on REMU staff calculations.

Philippines Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes** (last week of June1997=100)



Source: ARIC Indicators.

The peso hit record lows, but it has stabilized after the resolution of the political crisis.

External and domestic factors combined to pull down the peso during most of 2000. Until early October 2000, its steady depreciation was partly a reflection of a strong US dollar vis-à-vis some major global and regional currencies. However, the peso's record lows registered in October 2000 and again in January 2001 (Figure 1) were due to heightened political risks arising from corruption allegations against the former President and the subsequent impeachment trial. The significance of political risks can be further seen in the peso's sharp appreciation—by 6 currency units in just one day—after it had become clear that a peaceful transition of political power was imminent. The peso has since stabilized and, as of end-February 2001, its dollar value was 45 percent below its June 1997 level.

Equity prices fell in 2000 but have recovered slightly in 2001.

Political uncertainty weighed heavily on the stock market, as the Philippine Stock Exchange Composite Index (PHISIX) hit a 25-month low in October 2000. During the year, the PHISIX fell by about 30 percent in local currency terms and 44 percent in dollar terms. External factors, particularly the hike in US interest rates, also contributed to the year-long slide in equity prices. Investor confidence was partly restored when the new administration took over, reflected in a one-day gain of about 17 percent in the composite index on 22 January 2001. Another factor in the recovery was an improvement in the region's equity markets following US interest rate cuts in early 2001. As of end-February, the PHISIX was 43 percent below its end June-1997 level in peso terms and 69 percent off in dollar terms.

Office vacancies declined slightly, but rentals continue to fall.

After peaking in the first quarter of 2000, office vacancies in Makati, the country's prime business district, dropped slightly in the latter part of the year (Table 1). No increase in office area was recorded in the second half of 2000, although it is expected that 250,000 square meters of new office space will be available in 2001. This increase in supply may lower rental rates. In fact, aggressive premarketing and lower asking prices by older real estate projects have already lowered rental rates in local currency by 5.6 percent in the third quarter of 2000. By the last quarter, rental rates further declined by 10 percent.

Table 1: **Property Vacancy Rates in Prime Business District in Manila (Makati)** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Office Property	4.3	5.8	7.8	12.3	13.0	12.1	13.8	15.9	14.9	14.4	14.3
Retail Property	. . .	. . .	. . .	9.3	11.0	12.9	12.6	. . .	13.0	. . .	11.2

. . . = not available.
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Real Sector

Political instability took its toll on growth in the last quarter, but the 2000 figure is close to the Government's revised target.

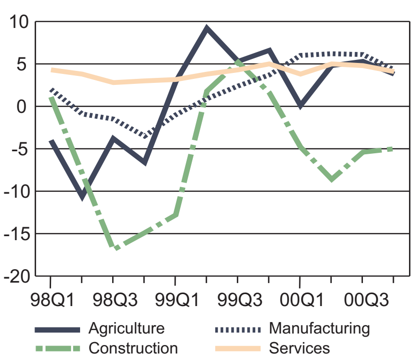
Domestic political instability, an interest rate hike, high oil prices, and the global slowdown led to a fall in GDP growth to 3.6 percent in the last quarter of 2000, from about 4.5 percent in the previous two quarters. For 2000 as a whole, growth is estimated to have reached 3.9 percent, which is 0.6 percentage point higher than that in 1999 and close to the Government's revised target (Table 2). The 2000 GDP growth rate was also the highest since 1997.

Table 2: **GDP Growth and Projections** (%)

	1997	1998	1999	2000	2001
Official[1]	5.2	-0.6	3.3	3.9	3.8-4.3
ADB[2]	—	—	—	—	3.1
IMF[3]	—	—	—	—	3.3
World Bank[4]	—	—	—	—	3.5
Consensus Economics[5]	—	—	—	—	2.7

[1] National Economic and Development Authority Press Release, 26 January 2001.
[2] Staff estimates, March 2001.
[3] IMF, Public Information Notice No. 01/21, 13 March 2001.
[4] World Bank, *East Asia's Recovery: Maintaining Momentum,* 30 November 2000.
[5] Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

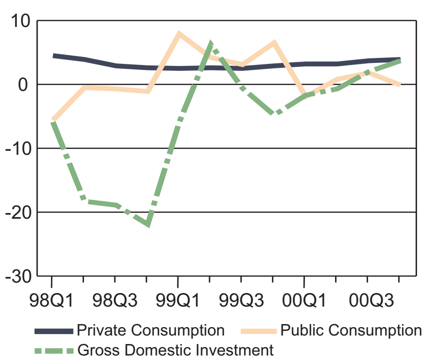
Sectoral growth became more balanced in 2000, but most sectors experienced a slowdown in the last quarter.

Economic growth in 2000 was more sectorally balanced than in 1999 (Figure 2). The momentum gained by agriculture, which staged a strong recovery in 1999, extended into 2000 when it grew by 3.4 percent, exceeding its historical trend. The manufacturing sector grew by more than 6 percent in the first three quarters, on the back of rapid expansion of the electronics sector, which was buoyed by strong overseas demand and a gradual move by local firms into the design process. But the sector's growth tapered off to 4.3 percent in the last quarter. The services sector continued its steady growth in 2000, although it also slowed in the last quarter. The surge in the transport, communications, and storage sector—reflected in the increased use of cellular telephones—underpinned a 4.4 percent expansion of the services sector.

Sectors that were hardest hit by the crisis continue to falter.

Despite improved economic conditions, the three sectors hardest hit by the 1997 crisis—construction, financial services, and real estate—continue to falter. The contraction in construction intensified in 2000 as the Government's contribution to this sector declined by 8.7 percent compared to an increase of 14.9 percent in 1999. This was a direct result of the Government's inability to continue with its pump-priming activities due to the worsening fiscal situation. Meanwhile, private construction maintained its downtrend, which, in turn, contributed to near-zero growth in the real estate sector. Value-added in the financial sector also barely increased. Sluggish domestic demand and the ongoing restructuring process translated into limited credit growth and low profits for the banking sector.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

Net exports and private consumption drove growth, while fixed investment continues to languish.

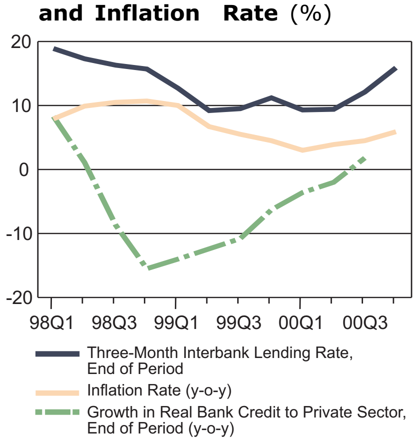
Net exports were a principal contributor to growth in the first three quarters of 2000, thanks largely to a favorable exchange rate and the strong US economy. But their importance diminished in the latter part of the year as imports increased significantly and private consumption accelerated in the fourth quarter (Figure 3). For 2000 as a whole, exports of goods and services grew by a robust 16.4 percent, and private consumption increased by 3.5 percent. On the whole, domestic demand remained sluggish as gross domestic capital formation barely increased. Fixed investment contracted in 2000, reflecting the fragile state of business confidence.

Fiscal and Monetary Developments

The fiscal deficit widened in 2000.

Major shortfalls in revenue generation and a slight expenditure overrun led to a wider fiscal deficit of 4.1 percent of GDP last year, compared to 3.7 percent in 1999. The estimated deficit of P136.1 billion in 2000 was more than double the target of P62.5 billion. A failure to meet privatization targets was the primary cause of the revenue shortfall. Meanwhile, despite the 2 percent excess of actual over programmed expenditures, there was a reduction in capital outlays of 5 percent. This was reflected in the decline of public construction spending. The wider fiscal deficit resulted in an increase in public debt. As of September 2000, the national government debt was 63.1 percent of GDP, compared to the 1999 end-year figure of 57.6 percent. The new administration has announced that while it will not present the 2001 budget until after the May elections, it plans to limit the deficit to below 4 percent of GNP this year and will balance the budget over a five to six year period.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Inflation accelerated towards the end of 2000 and continues to rise in 2001.

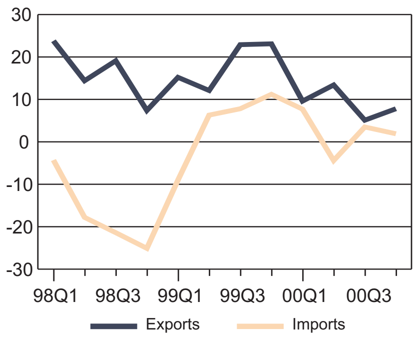
The inflation rate increased throughout 2000, accelerating particularly in the latter half of the year (Figure 4), under pressure from rising fuel prices and the weakening peso. Still, because of the cushion provided by the relatively low figures in the first half of 2000, inflation averaged only 4.3 percent last year, substantially below the original government target of 6-7 percent. Inflation has maintained its upward momentum into 2001, increasing to an average of about 6.8 percent (y-o-y) in the first two months of this year.

Monetary policy was tight for most of 2000, but has started to ease since the end of the year.

Subdued inflation enabled the monetary authorities to reduce interest rates in early 2000 (Figure 4). But monetary policy was tightened subsequently for most of the year in response to the peso depreciation, the rise in US interest rates, and emerging inflationary pressure. As a result, in the last quarter of 2000, short-term interest rates were higher by almost 500 bp than in the corresponding period of the previous year. Since December 2000, however, monetary policy has started to ease, with the central bank cutting interest rates to invigorate the economy. The easing of the overnight borrowing rate by half a percentage point to 10.5 percent on 12 March 2001 brought the total cuts in the key rate to 4.5 percentage points over the last three months. Lower US interest rates, resolution of the political crisis, and the consequent broad stability of the peso provided room for monetary easing. There was a turnaround in real credit growth in the last two quarters of 2000, after two years of decline. However, banks, burdened with high NPLs, remain reluctant lenders, and demand for credit from the private and corporate sector is weak.

Balance of Payments

Figure 5: **Growth of Merchandise Exports and Imports*** (y-o-y, %)



*In dollar terms.
Source: ARIC Indicators.

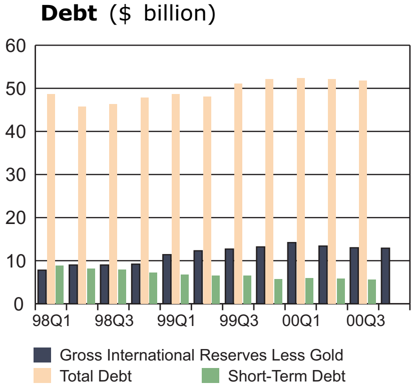
Despite an export slowdown, the trade and current account surpluses increased.

Export growth in nominal dollar terms decelerated sharply to 8.7 percent in 2000 from 18.6 percent in 1999. The slowdown was particularly marked in the second half of the year when the global electronics market began to weaken (Figure 5). On the other hand, tepid investment demand and a depreciated exchange rate translated into slow import growth. As a result, the trade surplus increased from $4.3 billion in 1999 to $6.7 billion in 2000. Following the trend in the trade balance, the current account surplus improved slightly.

But the capital account weakened considerably.

From January to November 2000, net capital outflows amounted to $4.9 billion, a huge jump from the net outflow of $701 million for the corresponding period in 1999.[1] This can be partly attributed to the $738 million turnaround in portfolio investment in the first 11 months of 2000, as higher US interest rates and the political uncertainty took their toll. Also contributing to the capital flight was the outflow arising from trade credits and loan repayments. FDI increased, although it remained low compared with neighboring countries. January-November 2000 figures indicate a net inflow of $1.06 billion, as opposed to only $791 million in the same period of 1999. However, data suggest that most FDI inflows were associated with mergers and acquisitions (M&As) rather than new ventures.

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

And the overall balance of payments declined.

Even with the surplus in the current account, net capital outflows led to a balance of payments deficit of $918 million from January to November 2000. This is a sharp reversal from the surplus of $3.3 billion in the first 11 months of 1999. The central bank's gross international reserves (excluding gold) fell slightly as a result, from $13.2 billion at end-1999 to $12.9 billion at end-2000 (Figure 6). However, the level of external debt in September 2000, which was $52.2 billion, was the same as in December 1999. The level of short-term debt edged down from $5.7 billion to $5.6 billion in the same period.

[1]This discussion is based on the old balance of payments definition.

Financial and Corporate Sector Developments

NPL ratios rose slightly and the CAR fell.

The NPL ratio of commercial banks rose steadily through November 2000, reaching 16.3 percent, before edging down to 15.1 percent in December. While this is lower than the figures seen in Thailand and Indonesia, the November ratio is the Philippines' highest since the outbreak of the financial crisis in 1997. Initially, the rise was attributed to technicalities, such as the reclassification of certain loans after the merger of two large banks and the fall in interbank loans, which caused total gross loans—the denominator—to decline. However, with the resumption of growth in commercial bank credit, an increasing NPL ratio should be a source of concern. Meanwhile, the CAR of banks fell to 15.6 percent in October 2000 after reaching 17 percent earlier in the year. However, the ratio is still well above the international norm of 8 percent.

Social Sector Developments

The unemployment situation worsened in 2000.

Despite the economy's positive growth, the unemployment situation worsened in 2000. Unemployment rates for the four quarters of 2000 were 9.3, 13.9, 11.1, and 10.1 percent, respectively, all higher than their corresponding levels in 1999. While a detailed breakdown of unemployment by income group is not available, an annual poverty indicators survey by the National Statistics Office in 1999 suggests that the incidence of job losses was higher for families belonging to the bottom 40 percent income strata than for the top 60 percent group.

Prospects and Policy Issues

GDP growth is projected to fall in 2001.

GDP growth in 2001 is likely to fall below last year's outcome, in line with a general slowdown in global and regional economic activity. Of particular relevance to the Philippines is the slowing US growth, due to its high dependency on the US economy. Consequently, export growth is expected to taper off. Anxieties about domestic political conditions have receded, but the Government has yet to present a comprehensive economic program that resolves past problems and puts the economy on a higher growth path. This might not happen until after the elections in May. Moreover, another *El Niño* weather disturbance is predicted this year and this would adversely affect the agricultural sector. Fiscal problems are also causes for serious concern. The latest Consensus Economics forecast of 2.7 percent (February 2001) reflects all these issues. On the other hand, if investors perceive that the Government has taken firm action to resolve its fiscal problems, then private investment will recover and GDP could grow between 3 and 3.5 percent, as most multilateral agencies predict. However, this would still be lower than the government target of 3.8-4.3 percent (Table 2).

And inflation will be higher in the first half of 2001, but should slow in the second half.

The inflationary momentum that built up in the last quarter of 2000 will likely carry into the first half of 2001. The bulk of the peso depreciation and hikes in fuel prices occurred in the second half of 2000. Expenditures in the forthcoming elections in May will also add to inflationary pressures. Since the risk of higher oil prices has receded and the exchange rate will be more stable during 2001, inflation should slow toward the end of the year. The Consensus Economics forecast puts the inflation rate for 2001 at 6.7 percent, which is consistent with government targets.

Restoring fiscal credibility should be given high priority, but the onus of reducing the fiscal deficit should largely fall on revenue mobilization.

Restoring fiscal credibility should be given high priority. This requires a well-designed medium-term program through which the fiscal deficit could be gradually reduced. Given that government expenditures in the Philippines are modest in comparison to those in other countries in the region, the onus of reducing the fiscal deficit should fall largely on improved revenue mobilization. Improvements in tax administration, elimination of leaks and loopholes, and stricter enforcement of tax laws should go a long way toward increasing the revenue base. Proceeds from the privatization of the National Power Corporation and National Food Authority could also provide additional fiscal resources, although only temporarily.

The broader context shows the necessity of improved public sector governance at all levels.

In terms of several indicators of governance, such as the rule of law, the efficiency of the judicial system, and the risk of contract repudiation and of expropriation, the Philippines compares poorly with many countries. Many governance problems are rooted in corruption. Improvements will require a concerted effort, increased public awareness, as well as an improved institutional and legal framework for anticorruption. The new Government has indicated that it will tackle the country's governance problems forcefully and has initiated measures to reengineer government administration.

Actions are required to rejuvenate private investment.

Three years after the onset of the financial crisis, private investment spending has yet to show signs of recovery in the Philippines. It would be difficult to blame external factors (e.g., oil price increases) and the lingering effects of the crisis because Indonesia, Korea, Malaysia, and Thailand experienced much higher investment growth rates than the Philippines in 2000. While the installation of the new Government should provide a strong boost to investor confidence, long-standing issues have to be resolved. One is the need to upgrade infrastructure, an area where the Philippines is acknowledged to lag behind most of its neighbors.

Philippines: Selected ARIC Indicators

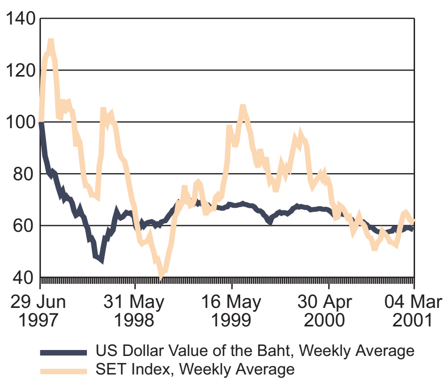
	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Output and Prices																	
GDP Growth (%)	5.8	5.2	-0.6	3.3	3.9	2.0	-0.9	-0.8	-2.2	0.7	3.6	3.8	4.9	3.2	4.5	4.6	3.6
Private Consumption Expenditure Growth (%)	4.6	5.0	3.4	2.6	3.5	4.5	3.9	2.9	2.6	2.5	2.6	2.5	2.9	3.2	3.2	3.7	3.9
Public Consumption Expenditure Growth (%)	4.1	4.6	-1.9	5.3	0.2	-5.6	-0.5	-0.7	-1.1	7.9	4.2	3.1	6.5	-1.9	0.8	1.8	-0.1
Gross Domestic Investment Growth (%)	12.5	11.7	-16.3	-1.7	0.8	-5.9	-18.3	-18.9	-21.9	-5.9	6.2	-0.6	-4.8	-1.7	-0.7	2.0	3.7
Agricultural Sector Growth (%)	4.6	3.2	-6.3	6.0	3.4	-4.0	-10.6	-3.8	-6.6	2.9	9.2	5.3	6.6	0.1	4.8	5.3	3.8
Manufacturing Sector Growth (%)	5.6	4.2	-1.1	1.6	5.6	2.0	-0.9	-1.5	-3.5	-1.0	0.9	2.4	3.7	6.0	6.2	6.1	4.3
Construction Sector Growth (%)	10.9	16.2	-9.6	-1.6	-6.0	1.1	-7.9	-16.9	-14.9	-12.8	1.8	5.2	1.6	-4.8	-8.6	-5.4	-5.0
Services Sector Growth (%)	6.4	5.4	3.5	4.1	4.4	4.3	3.8	2.8	3.0	3.2	3.8	4.3	5.0	3.8	5.0	4.8	4.1
Exports of Goods and Services Growth (%)	15.4	17.2	-21.0	3.6	16.4	-4.5	-19.4	-21.4	-34.8	-8.4	3.3	11.5	8.9	10.7	13.7	18.3	22.4
Imports of Goods and Services Growth (%)	16.7	13.5	-14.7	-2.7	2.2	5.8	-12.5	-15.7	-32.8	-16.8	0.1	1.5	6.6	1.4	-3.8	-2.1	15.5
Inflation Rate (%)	9.0	5.9	9.8	6.6	4.3	7.9	9.9	10.5	10.7	10.0	6.7	5.5	4.5	3.0	3.9	4.5	5.9
Unemployment Rate (%)	7.4	7.9	9.6	9.4	10.1	8.4	13.3	8.9	9.6	9.0	11.8	8.4	9.4	9.3	13.9	11.1	10.1
Monetary and Fiscal Accounts																	
Growth of Broad Money, M2 (%)[1]	22.1	25.0	8.1	16.8	. . .	17.2	19.2	14.6	8.1	10.5	9.1	10.4	16.8	14.2	13.0	9.9	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	31.4	15.7	11.2	15.9	18.9	17.3	16.3	15.7	12.7	9.2	9.5	11.2	9.3	9.4	12.1	15.9
Growth in Real Bank Credit to Private Sector (%)[1]	38.8	20.2	-15.5	-6.3	. . .	8.3	1.1	-8.7	-15.5	-14.0	-12.4	-10.8	-6.3	-3.6	-2.0	1.8	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	11.0	. . .	. . .		9.7	11.6	11.0	13.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	10.4	12.3	15.1	7.4	8.9	11.0	10.4	13.2	13.1	13.4	12.3	14.1	14.7	15.7	15.1
Average Stock Price Index (PHISIX)	3,054.2	2,595.2	1,799.0	2,168.7	1,585.8	2,029.2	2,044.0	1,431.3	1,691.7	2,003.4	2,381.5	2,285.4	2,004.6	1,882.3	1,574.6	1,487.1	1,399.1
Central Government Fiscal Balance as % of GDP	0.3	0.1	-1.9	-3.7	-4.1	-1.9	-1.9	-0.3	-3.2	-4.9	-2.6	-4.7	-2.8	-3.0	-3.2	-4.3	-5.6
Central Government Debt as % of GDP[1]	53.2	55.8	53.1	57.6	. . .	. . .	. . .	. . .	53.1	. . .	. . .	. . .	57.6	61.7	62.2	63.1	. . .
Government Expenditure on Education (% of Total)	17.9	19.3	19.9	19.1	18.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	2.7	2.9	2.5	2.5	2.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																	
Growth of Merchandise Exports ($ fob, %)	17.7	24.3	15.7	18.6	8.7	23.8	14.4	19.1	7.4	15.2	12.1	22.9	23.1	9.6	13.4	5.1	7.8
Growth of Merchandise Imports ($ cif, %)	20.8	12.7	-17.5	3.7	2.1	-4.3	-17.8	-21.4	-25.1	-9.0	6.3	7.8	11.2	7.7	-4.4	3.5	1.9
Current Account Balance as % of GDP	-4.8	-5.3	2.4	10.3	. . .	-0.2	1.1	3.1	4.9	8.8	7.0	13.8	11.5	8.3	10.9	14.5	. . .
Net Foreign Direct Investment ($ Billion)[2]	1.3	1.1	1.6	0.9	. . .	0.2	0.2	0.2	1.0	0.4	0.1	0.1	0.1	0.5	0.3	0.3	. . .
Net Portfolio Investment ($ Billion)[2]	2.2	-0.4	0.1	0.3	. . .	-0.4	0.3	-0.7	-0.1	1.8	1.2	0.5	1.3	-0.5	-0.2	0.0	. . .
Gross International Reserves Less Gold ($ Billion)[1]	10.0	7.3	9.2	13.2	12.9	7.8	9.0	9.0	9.2	11.4	12.3	12.7	13.2	14.2	13.4	13.0	12.9
Total External Debt as % of GDP[1]	50.5	55.0	72.9	68.2	. . .	63.5	64.5	69.8	72.9	71.5	68.1	69.0	68.2	67.8	67.3	67.4	. . .
Short-Term Debt as % of Gross International Reserves[1]	. . .	116.1	77.9	43.4	. . .	113.1	90.4	88.5	77.9	59.6	53.1	52.1	43.4	42.3	44.0	43.2	. . .
Short-Term Debt as % of Total Debt[1]	. . .	. . .	15.0	11.0	. . .	18.2	17.8	17.2	15.0	14.0	13.6	13.0	11.0	11.5	11.3	10.8	. . .
Real Effective Exchange Rate (1995=100)[3]	110.4	111.0	94.0	100.8	91.0	91.5	97.2	92.6	94.7	102.2	105.1	100.5	95.2	96.4	94.2	89.2	84.4
Average Exchange Rate (Local Currency to $)	26.2	29.5	40.9	39.1	44.3	40.7	39.4	42.9	40.6	38.7	38.0	39.3	40.4	40.7	41.9	45.1	49.4

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Based on old balance of payments definitions.
[3] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the financial and commercial banking system, central government debt, total and short-term external debts, net foreign direct and portfolio investments, and government expenditure on education and health are from national sources. Data on M2, real bank credit to the private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics.* Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg. Real effective exchange rates are based on REMU staff calculations.

Thailand Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes** (last week of June1997=100)



Source: ARIC Indicators.

The baht declined in 2000 but has rallied a little this year.

The baht declined by 14 percent in 2000, but enjoyed a modest postelection rally in the early part of this year. Nevertheless, it is still about 13 percent cheaper in dollar terms than at the start of 2000 (Figure 1). The baht's present level reflects uncertainties about the economic prospects in 2001 of not only Thailand but the region as a whole. Other factors have been at work, too. Historically low nominal baht interest rates have induced residents to swap baht for foreign currency deposits. Capital outflows have also been triggered by payments of debts rescheduled during the crisis years.

The stock market is also regaining some lost ground.

The Thai equity market surrendered nearly half of its value during 2000. Concerns, in particular, about the pace of bank and corporate sector restructuring, and banks' continuing losses weighed heavily on the market. Domestic banks account for about 25 percent of the composite Stock Exchange of Thailand (SET) index. However, during early 2001, the market has perked up, gaining more than 20 percent within the first two months. The prospect that a centralized AMC will remove a significant portion of banks' NPLs has buoyed market sentiment.

Commercial real estate is faring better than the residential market.

Bangkok's high end office property market is showing renewed signs of life. The vacancy rate for grade A office space fell to 31 percent in the last quarter of 2000, from 39 percent one year earlier (Table 1). However, the residential property market remains sluggish, following the collapse of prices during the crisis, and there is little sign of a return to precrisis levels.

Table 1: **Office Property Vacancy Rates in Bangkok** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Office Property	28.2	28.7	29.7	43.1	42.2	40.3	38.9	36.3	34.0	32.1	31.0

Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Real Sector

Economic growth is slowing.

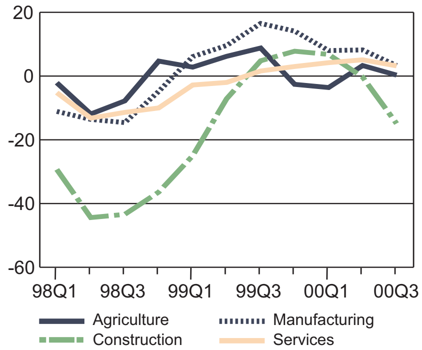
The Thai economy grew by 5.7 percent year-on-year in the first half of 2000, before the figure shrank in the third quarter to 2.6 percent. Although data are not yet available, it is unlikely that early 2001 has seen a reversal of this trend. The National Economic and Social Development Board predicts that the full year growth for 2000 will be 4.5 percent, lower than the 5 percent it projected in September (Table 2).

Table 2: **GDP Growth and Projections** (%)

	1997	1998	1999	2000	2001
Official[1]	-1.7	-10.3	4.2	4.0-4.5	3.0-4.5
ADB[2]	—	—	—	4.2	3.5
IMF[3]	—	—	—	5.0	5.0
World Bank[4]	—	—	—	4.5	4.5
Consensus Economics[5]	—	—	—	4.2	3.5

[1] Bank of Thailand, *Inflation Report,* January 2001.
[2] Staff estimates, March 2001.
[3] IMF, *World Economic Outlook,* September 2000.
[4] World Bank, *East Asia's Recovery: Maintaining Momentum,* 30 November 2000.
[5] Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

The manufacturing and services sectors drove growth in 2000.

Manufacturing continued to support output growth in 2000, but slowed considerably compared with 1999, particularly in the second half of the year, due to weak domestic demand and reduced exports (Figure 2). Within manufacturing, growth was largely confined to export-oriented sectors such as electronics, with domestic market production much less healthy. Industrial capacity utilization also remained low at an average of just under 56 percent. But the services sector was buoyant and contributed to growth in 2000, although this also experienced a slowdown in the third quarter, reflecting weakened private consumption.

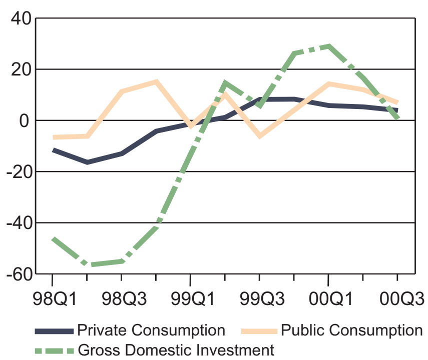
The construction sector turned in a dismal performance while agriculture experienced mixed fortunes.

The agricultural sector turned in a mixed performance in 2000, surging by 3.3 percent in the second quarter after a negative growth of 3.6 percent in the first. Subsequently, however, growth tapered down to 0.3 percent in the third quarter, as a result of low agricultural prices and floods. It could revive in 2001 as the sector recovers from the floods and high oil prices. More pessimistic is the outlook for construction activity, which shrank in the second and third quarters of 2000 after posting three consecutive quarters of positive growth. Real investment in structures remained depressed and, with oversupply in most segments of the property sector, there is little prospect of a quick return to growth. Earlier fiscal measures intended to boost construction would now appear to have run their course.

Growth of domestic demand is also weakening.

After a rebound in the first half of 2000, domestic demand growth weakened through the second half. Private consumption growth (y-o-y) slowed from more than 5 percent in the first two quarters to 3.9 percent in the third (Figure 3). A shaky job market and declines in farm income contributed to bearish consumer sentiment. The rate of growth of recurrent public expenditure also slipped as infusions from the Miyazawa Fund stopped.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

Investment demand grew nearly 23 percent in the first half of 2000, but increased only marginally in the third quarter. Following a similar pattern, total fixed investment expanded in the first half by 23 percent (y-o-y) and then dipped to 0.6 percent in the third, despite falling interest rates and ample liquidity. Much of the slowdown is likely to have been due to a reduction in public construction investment. Excess capacity, debt overhang, and a general reluctance by banks to lend have combined to curb the appetite for investment.

Fiscal and Monetary Developments

The fiscal deficit continued to support recovery.

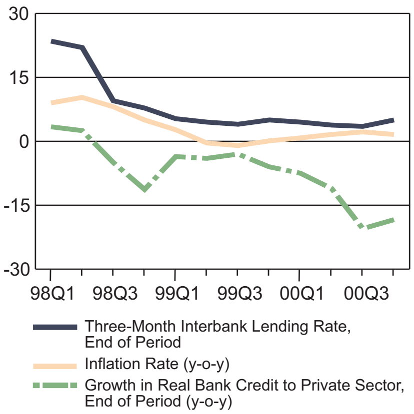
In reaction to the economic recovery and an end to the external assistance provided under the Miyazawa Fund and other sources, the Government began to scale back its deficit spending measures in 2000. Nevertheless, fiscal policy continued to support economic growth. For the fiscal year ending September 2001 the central Government budgeted a deficit of B110 billion. As a percentage of GDP, the 2000/2001 deficit is likely to be lower than the 3.3 percent recorded in 1999/2000.

But central government debt has climbed.

As of October 2000, total public debt was B2.8 trillion, equivalent to a little more than 55 percent of GDP. Central government debt alone accounted for about half of this. Levels were only 15 and 6 percent of

GDP for total debt and government debt, respectively, in 1997. With real interest rates exceeding the underlying growth rate, the present levels of Thailand's public debt may soon limit fiscal options.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth*, and Inflation Rate** (%)



*Growth in real bank credit to private sector for the fourth quarter of 2000 is as of November.
Source: ARIC Indicators.

Inflation remains subdued.

Despite the baht's weakness and higher oil prices, inflation has remained tame. The consumer price index rose (y-o-y) by only 1.6 percent in the fourth quarter of 2000, compared to 2.2 percent in the preceding quarter (Figure 4). Core inflation (which excludes raw food and energy components) averaged just 0.7 percent in 2000, which was within the target set by the Bank of Thailand (BOT). Recently, BOT's Monetary Policy Board narrowed its core inflation target to 1.5-2.5 percent for 2001.

Baht interest rates are at a historic low.

Low inflation rates have permitted BOT to bring interest rates down. The 14-day repurchase interest rate now stands at 1.5 percent and commercial deposit rates in Thailand are barely positive. Recently, BOT issued bonds of 15-year maturity that attract a yield of just 5.6 percent.

Bank credit to the private sector continued to contract.

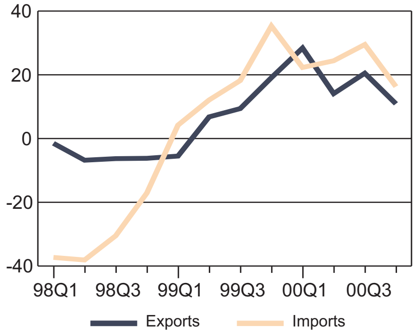
The stock of real private sector bank credit contracted during 2000. This shrinkage reflected banks' reluctance to lend and the removal of some NPLs from banks. The depressed loan market has created substantial excess liquidity in the system. Although the stock of broad money is now trending up, it is still lower than at the end of 1997.

Balance of Payments

The trade account posted a deficit in January 2001 after 30 months of surplus.

Export growth, which spearheaded Thailand's recovery for the 30 months to January 2001, is now showing signs of losing its vigor (Figure 5). Following a broader regional trend, Thailand's trade data for January 2001 show a deficit of $400 million, the first since August 1997. Exports fell to $4.8 billion (nearly 12 percent down compared with January last year). The main factors in this sharp slowdown were drops in exports of electronics and computer parts to the United States

Figure 5: **Growth of Merchandise Exports and Imports*** (y-o-y, %)



*In dollar terms.
Source: ARIC Indicators.

(electronics exports form 30 percent of total exports, about one fifth of which go to the United States). Meanwhile, imports surged to $5.2 billion in January 2001, a 26.2 percent increase compared to January last year.

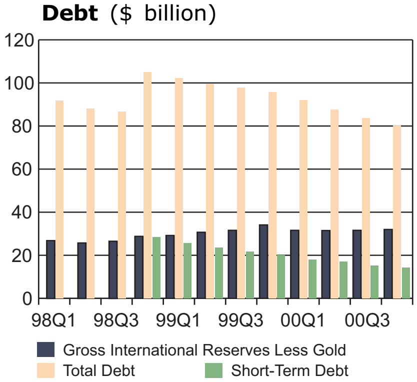
The current account surplus narrowed in 2000.

The rapid growth of imports in 2000 led to a narrowing of the current account surplus, which shrank to $8.4 billion from $12.5 billion in 1999. Rising revenue from tourism and services helped to offset import growth.

Capital outflows were substantial.

Thailand's capital account registered a deficit during 2000. However, this edged down from $3.8 billion in the first quarter to $2.7 billion and $1.3 billion in the second and third quarters, respectively. To a degree, the deficit reflected the repayment of loans, some of which had been earlier rescheduled. The Government also began to repay its IMF loans toward the end of the year. Low domestic interest rates and preelection uncertainty may also have encouraged a movement of funds offshore. Official international reserves, which stood at $32 billion as of end-2000 and $32.8 billion as of end-January 2001, provide adequate cover for imports and debt of short-term maturity (Figure 6).

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

Total external debt declined and its profile improved.

The private sector's repayment of short-term foreign loans led to an improvement in the maturity structure of the country's external debt. The ratio of short-term debt to total debt fell to 17.8 percent at end-December 2000, compared to 20.9 percent and 27.1 percent at the end of 1999 and 1998, respectively. A decline in private short-term debt has largely been responsible for the reduced overall debt burden. Outstanding external debt as of December 2000 was $80.2 billion, down from $95.6 billion at the end of 1999.

Financial and Corporate Sector Developments

Financial conditions are improving.

As of December 2000, NPLs in the commercial banking system stood at 18 percent of total outstanding loans (B0.9 trillion). NPLs dropped sharply during 2000 and the end of year figure exceeded targets. But much of the improvement can be explained by the transfer of impaired assets of Krung Thai Bank (B500 billion) and other specialized financial institutions to AMCs and extensions of the maturity of rescheduled loans. Still, NPLs in private banks (18 percent of total loans in December 2000) remain at a lower level than in the State-owned banking sector (22 percent of total loans).

Most private banks have also made significant progress toward meeting regulatory capital adequacy and provisioning standards. Since 1998, domestic commercial banks have raised a total of B902 billion to strengthen their capital and meet provisioning requirements, while private banks have raised some B440 billion. The Government has pumped in about B454 billion in new capital into State banks. The CAR for the commercial banking system stood at 11.4 percent at the end of 2000, 2.9 percent above the central bank's 8.5 percent minimum requirement.

But there was an increase in "reentry" NPLs.

While the flow of new NPLs compared to total stock is showing an encouraging downward trend, there is a growth of "reentry" NPLs, i.e., loans that were earlier rescheduled but have become nonperforming anew. As the total stock of NPLs has fallen, there has also been a sharp decline in the proportion of debt being restructured. Despite the fact that the most difficult loans remain, there have been few write-offs. These developments suggest that there is little immediate prospect of further significant reductions in NPLs under current arrangements.

The bond market is becoming a more important source of corporate financing.

With banks reluctant to lend, the domestic bond market has become a more important source of corporate finance in the early part of 2000. For the year as a whole, private bond issuance registered a total of B143.4 billion. But following the Securities and Exchange Commission's requirement that debentures issued after April 2000 must be rated, the rate of issuance has declined substantially.

Corporate restructuring has been slow.

Corporate restructuring, broadly defined, has been slow to get off the ground. While there has been measurable progress in the amount of debt restructured, rising from B0.6 trillion in mid-1999 to B1.95 trillion in December 2000, restructuring has largely been financial rather than operational. Most cases have entailed an extension of maturity, lowering of interest payments, and debt-to-equity conversions. The restructuring of operations and mergers have been rare.

Social Sector Developments

Poverty reduction is still a big challenge.

The socioeconomic impacts of the crisis are likely to be felt for some time. In Thailand, the poor were disproportionately affected, largely through price increases, which lowered their real incomes. It is estimated that the total real income of poor rural households, mainly landless farmers and farm workers, declined by close to 20 percent during the crisis period to 1999. While recent data are hard to come by, the incidence of poverty in rural areas was estimated to be 21.5 percent as recently as 1999. Much of this poverty was located in the northeastern region of the country.

Other quality of life indicators are also showing some improvement.

Life expectancy at birth is increasing in Thailand and mortality rates are lower. Nevertheless, about one third of the Thai population is still without any health insurance coverage. Also, two out of three of those covered, namely holders of low-income health cards, cannot access the benefits they are entitled to. Health care management and financing reforms began under the previous administration and Thailand's new Government has been elected in part because of its pledge to provide health care for a uniform fee of B30 (less than $1) per visit.

Prospects and Policy Issues

The economy is set to slow in 2001.

Economic growth projections for 2001 are being revised downwards. The latest Consensus Economics projection for Thailand (February 2001) is for growth of 3.5 percent, while official projections see a range of 3.0 to 4.5 percent. Export growth, in particular, is expected to slow in 2001, with domestic demand remaining weak. The balance of risks in the global and regional economies is predominantly on the downside.

Although fiscal policy could provide some stimulus to demand, deficit spending measures will be constrained by high levels of debt. Also, while nominal interest rates are likely to fall further, they may do little to stimulate demand against a backdrop of serious debt overhang.

Rural support programs should balance efficiency and equity.

The new administration was elected on an ambitious platform intended to accelerate economic and social recovery in Thailand. Complete details of the various policies and programs (see Box E) are yet to be announced, but their fiscal implications will need to be closely monitored. While the emphasis on the recovery of the rural economy is particularly welcome, interventions should balance efficiency with equity considerations.

NPLs are to be centralized in an AMC.

One initiative that has been broadly welcomed by markets is the decision to set up a centralized AMC, which will be mandated with the removal of NPLs from banks' balance sheets. It is hoped that improving the capital positions of banks will lead to enhanced flows of credit in the economy. The ultimate success of the AMC in achieving this and letting markets adjust will depend very much on its mandate, financing arrangements, structure, and operating principles. AMCs have sometimes proven to be costly failures, succeeding only in funneling money from taxpayers to the owners of sick banks. In comparatively tranquil circumstances, Thailand has an opportunity to benefit from experiences and best practices elsewhere.

Box E: **The New Government's Proposed Policies and Programs**

Although Thailand has made considerable headway in recovering from the crisis and restoring financial stability, the country's per capita incomes have not caught up to 1996 levels. The incidence of poverty has also increased. But Thailand's new administration has been elected on an ambitious platform, aimed at catalyzing fast and irreversible economic recovery, and spreading the benefits of growth to the agrarian and rural poor.

The Government has outlined a number of programs intended to meet these objectives. Prominent among these are measures to accelerate the recovery of Thailand's beleaguered rural and agricultural sector. Broader social support initiatives, including universal health care at low cost, have also been announced. On the financial front, the new administration has committed to quickly resolving debt difficulties that have hamstrung businesses and banks alike. Also, to support demand and growth, tax breaks have been promised, while earlier plans to increase value-added tax are to be shelved.

Immediate relief for Thailand's farmers is to come in the form of a three-year debt moratorium. Rural communities will also benefit from the provision of a village revolving fund. The idea is that by lifting the debt-servicing burden on farmers and providing fresh sources of credit, agricultural and rural regeneration will be assisted. In the better times ahead, the servicing of debts can then recommence.

On a positive note, these measures should, at least in the short run, succeed in boosting rural incomes. However, neither seems to be particularly well targeted, suggesting that the benefits may not be closely matched to need. The long-run benefits of the initiatives are also questionable. Given that underlying difficulties faced by Thailand's farmers and rural communities are structural rather than cyclical in origin, a debt moratorium and a revolving credit fund may offer only a temporary respite. They do not address underlying structural impediments to productivity growth. A particularly serious risk is that, in an already weak credit culture, a debt moratorium will tempt reckless behavior, jeopardizing future resource mobilization and allocation in rural and agrarian areas. In the process, the fabric of rural credit markets and credit institutions could be seriously weakened.

The new administration's proposal to remove NPL assets from State and private commercial banks and place them with a centralized AMC have been broadly welcomed by markets. Many countries have resorted to such AMCs to deal with bad loans and banking crises—in 1997, both Korea and Malaysia created AMCs to carve out problem loans from their banking and nonbank financial sectors. Thailand is in the fortunate position of establishing its centralized AMC in comparatively tranquil circumstances, thus it has a window of opportunity to absorb important lessons from other countries. This is crucial, because AMCs have frequently failed to meet their stated objectives.

Whether or not AMCs succeed seems to depend on the initial conditions that they face, their resources and powers, the types of assets they acquire, and the way in which they are structured. Successful AMC operations have most often been associated with arrangements that guarantee their operational independence, provide for the outsourcing of management to private sector professionals, entail the use of performance contracts and competitive processes, and require the application of transparent and market-based asset valuation models. They should not be a vehicle for bailing out delinquent bankers. To minimize the burden on the taxpayer, incentives should be structured so that they maximize their return on capital.

An AMC's mandate also seems to have a decisive influence on its effectiveness. In the past, AMCs have done better where there is an emphasis on quick disposal rather than warehousing or restructuring of assets. Quick disposal is easiest to perform with readily liquifiable assets, such as real estate or those secured by real estate. AMCs that have attempted to restructure manufacturing assets or loans that have been extended on the basis of political connections have fared much less well. Where there are legal impediments to asset transfers, foreclosure, and bankruptcy, AMCs may also need special powers to operate effectively.

Initial estimates suggest that the Thailand Asset Management Corporation (TAMC) will acquire about 1.3 trillion baht of impaired loans from banks and other AMCs. NPLs will be transferred to the TAMC at their net book value in exchange for 10-year notes, guaranteed by the Financial Institutions Development Fund (FIDF). These notes will bear interest equal to the weighted average deposit rate of the banking system.

Taken together, the new administration's proposals could constitute a significant burden on the budget. If Thailand's growth rate slows, as is widely anticipated, further stresses could be placed on the deficit and underlying debt. Given that government debt has more than doubled in the past four years, care is needed to ensure that these and other election pledges do not result in a sharp deterioration of Thailand's fiscal position, nor, indeed, jeopardize the country's potential for sustainable, pro-poor growth.

Source: Klingebiel, D. 1999. *The Use of Asset Management Companies in the Resolution of Banking Crises, Cross Country Experiences*. World Bank.

Thailand: Selected ARIC Indicators

	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4
Output and Prices																	
GDP Growth (%)	5.9	-1.7	-10.3	4.2	. . .	-7.6	-14.2	-13.9	-7.4	0.1	2.7	7.8	6.5	5.1	6.3	2.6	. . .
Private Consumption Expenditure Growth (%)	5.9	-1.2	-11.5	4.0	. . .	-11.5	-16.4	-13.0	-4.2	-1.3	1.2	8.2	8.3	5.8	5.3	3.9	. . .
Public Consumption Expenditure Growth (%)	9.5	-0.3	3.6	0.9	. . .	-6.6	-6.2	11.3	15.1	-2.1	10.0	-6.1	4.1	14.3	12.0	6.9	. . .
Gross Domestic Investment Growth (%)	6.8	-22.7	-50.3	7.2	. . .	-46.1	-56.6	-55.1	-41.7	-13.0	14.6	5.8	26.2	29.0	16.5	0.6	. . .
Agricultural Sector Growth (%)	4.0	-0.4	-3.2	2.7	. . .	-2.1	-11.9	-7.8	4.7	2.8	6.2	8.8	-2.6	-3.6	3.3	0.3	. . .
Manufacturing Sector Growth (%)	6.5	1.4	-11.1	11.5	. . .	-11.1	-13.6	-14.6	-4.8	6.1	9.6	16.5	14.1	8.0	8.2	3.3	. . .
Construction Sector Growth (%)	6.9	-26.4	-39.0	-5.4	. . .	-29.3	-44.4	-43.4	-36.4	-25.0	-7.1	4.8	7.8	6.8	-0.3	-14.9	. . .
Services Sector Growth (%)	5.3	-1.2	-10.0	-0.1	. . .	-5.2	-13.2	-11.4	-10.0	-2.8	-2.0	1.6	3.0	4.2	5.1	3.2	. . .
Exports of Goods and Services Growth (%)	-5.5	8.3	6.5	9.9	. . .	14.8	8.7	5.5	-1.3	-0.6	4.6	14.0	21.4	21.4	16.0	18.9	. . .
Imports of Goods and Services Growth (%)	-0.5	-11.4	-21.7	10.6	. . .	-26.5	-27.8	-21.3	-9.3	-7.8	15.7	13.8	19.6	44.3	16.0	20.8	. . .
Inflation Rate (%)	5.8	5.6	8.1	0.3	1.5	9.0	10.3	8.1	5.0	2.7	-0.4	-1.0	0.1	0.8	1.6	2.2	1.6
Unemployment Rate (%)	1.1	0.9	4.4	4.2	3.6	4.6	5.0	3.4	4.5	5.2	5.3	3.0	3.3	4.3	4.1	2.4	3.7
Monetary and Fiscal Accounts																	
Growth of Broad Money, M2 (%)[1]	12.6	16.5	9.7	5.4	. . .	15.7	13.8	12.7	9.7	8.6	6.2	3.4	5.4	4.1	3.8	4.5	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	26.0	7.8	5.0	5.0	23.5	22.0	9.5	7.8	5.3	4.5	4.0	5.0	4.5	3.8	3.5	5.0
Growth in Real Bank Credit to Private Sector (%)[1]	9.4	13.6	-11.3	-6.0	. . .	3.4	2.5	-5.0	-11.3	-3.6	-4.0	-3.0	-6.0	-7.5	-11.1	-20.5	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	45.0	38.9	17.9	. . .	32.7	39.7	45.0	47.0	47.4	44.7	38.9	37.3	32.0	22.9	17.9
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	42.9	38.6	17.7	. . .	31.0	37.9	42.9	46.2	46.5	43.9	38.6	36.9	31.8	22.4	17.7
Average Stock Price Index (SET)	1,167.9	597.8	353.9	421.1	342.5	473.1	361.5	246.0	335.0	357.1	461.8	450.5	415.0	432.7	358.2	304.0	275.0
Central Government Fiscal Balance as % of GDP	0.9	-0.3	-2.8	-3.3	. . .	0.0	0.6	-8.5	-3.4	0.0	-4.2	-4.2	-4.9	-1.6	. . .	. . .	. . .
Central Government Debt as % of GDP[1]	. . .	6.3	14.6	21.4	. . .	5.4	9.0	10.2	14.6	18.6	19.8	20.9	21.4	21.1	21.9	23.4	. . .
Government Expenditure on Education (% of Total)	22.2	23.9	25.2	25.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	6.9	7.3	7.8	7.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																	
Growth of Merchandise Exports ($ fob, %)	-1.3	3.4	-5.7	7.5	18.0	-1.5	-6.8	-6.3	-6.2	-5.5	6.8	9.4	19.1	28.4	14.1	20.5	10.9
Growth of Merchandise Imports ($ cif, %)	2.2	-15.2	-30.1	17.5	22.7	-37.3	-38.1	-30.5	-17.1	4.2	12.1	18.2	35.3	22.3	24.4	29.5	16.3
Current Account Balance as % of GDP	-8.1	-1.9	12.5	10.2	. . .	16.3	10.1	12.6	12.0	12.6	7.5	10.1	10.3	7.1	5.1	8.1	. . .
Net Foreign Direct Investment ($ Billion)	. . .	3.3	7.4	5.9	. . .	2.2	2.5	1.4	1.2	1.0	1.9	1.2	1.8	0.8	0.7	. . .	. . .
Net Portfolio Investment ($ Billion)	. . .	4.4	0.4	0.4	. . .	0.4	-0.1	-0.3	0.3	-0.1	0.3	-0.2	0.1	0.0	0.4	-0.4	. . .
Gross International Reserves Less Gold ($ Billion)[1]	37.7	26.2	28.8	34.1	32.0	26.9	25.8	26.6	28.8	29.2	30.7	31.6	34.1	31.6	31.5	31.6	32.0
Total External Debt as % of GDP[1]	59.6	70.1	93.3	78.2	. . .	67.0	73.7	78.2	93.3	86.5	83.0	79.7	78.2	74.9	70.5	68.7	. . .
Short-Term Debt as % of Gross International Reserves[1]	. . .	146.3	98.7	58.6	44.7	. . .	. . .	. . .	98.7	88.0	76.8	68.7	58.6	57.0	54.3	48.1	44.7
Short-Term Debt as % of Total Debt[1]	. . .	. . .	27.1	20.9	17.8	. . .	. . .	. . .	27.1	25.1	23.7	22.2	20.9	19.6	19.5	18.1	17.8
Real Effective Exchange Rate (1995=100)[2]	109.2	102.4	90.0	93.5	86.9	77.3	92.5	93.5	96.8	97.3	97.5	91.9	87.4	92.0	89.3	84.9	81.4
Average Exchange Rate (Local Currency to $)	25.3	31.4	41.4	37.8	40.2	47.1	40.3	41.1	37.0	37.1	37.2	38.3	38.8	37.7	38.7	41.0	43.4

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the financial and commercial banking system, central government debt, total and short-term external debts, net foreign direct and portfolio investments, and government expenditure on education and health are from national sources. Data on M2, real bank credit to the private sector, central government fiscal balance, currenct account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics.* Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg. Real effective exchange rates are based on REMU staff calculations.

FDI Inflows to the Crisis-Affected Countries

Introduction

Foreign direct investment was a key factor in the rapid economic growth and structural transformation of East Asian countries in the lead-up to the crisis, enabling them to maintain investment levels well above their domestic saving capacity. FDI played an even more important role in their industrial transformation through transfer of technology, management practices, and marketing know-how, while improving the overall quality of investment.

The crisis revealed structural weaknesses in the financial and corporate sectors of the affected countries, sparking fears that FDI flows to them would decline permanently, thus delaying the recovery and undermining the long-term growth potential of these countries. How far these fears have been realized is an issue examined in this section. It documents the trends in FDI flows to the affected countries in recent years, the emerging policy environment toward FDI, the challenges that remain, and the role played by FDI in adjusting to the crisis, and finally pulls together key conclusions.

Postcrisis Trends

The crisis can be said to have generated positive as well as negative impacts on FDI. On the negative side, domestic demand contraction caused by output collapse and lowered immediate growth prospects discouraged domestic market-oriented foreign investment. Policy uncertainty, particularly during the initial adjustment phase, hampered all types of foreign investment.

But there are at least two ways in which the crisis could have had an indirect positive impact on FDI. First, large currency depreciations reduced domestic production costs and asset values, making foreign investment more profitable. Since depreciation of host country currencies makes foreign firms wealthier in terms of their purchasing power, investment can increase. Second, revisions to FDI laws that were included among crisis management and corporate restructuring packages in affected countries (in Korea and Thailand, in particular) opened up new opportunities for cross-border M&As.

During the precrisis period the level of FDI inflows to the affected countries increased sharply from a total of $1.7 billion in 1980-1984 to almost $20 billion in 1996 (Table 1). The share of the affected countries in global FDI inflows also increased from 3.4 percent to 5.2 percent over the same period. In 1998, when the crisis kicked in, the level of FDI inflows fell from $19.2 billion in 1997 to $16.7 billion in 1998, before increasing again in 1999 to $17.4 billion.

The FDI figures for the five affected countries taken in aggregate mask significant intercountry variation in fortunes. Within this broader picture, each country has its own story to tell.

Table 1: **Foreign Direct Investment Inflows: East Asia in a Global Context, 1980-1999***

	1980-1984	1985-1989	1990-1994	1995	1996	1997	1998	1999
(a) Level ($ billion)								
World	49.3	128.5	200.5	328.9	377.5	473.1	680.1	865.5
Developing Countries	11.9	22.3	61.1	106.2	145.0	178.8	179.5	207.6
East Asia	4.4	10.3	34.5	63.4	81.3	82.1	75.8	83.5
PRC	0.5	2.5	16.1	35.8	40.2	44.2	43.8	40.4
Hong Kong, China	0.7	1.6	4.5	3.3	10.5	11.4	14.8	23.1
Singapore	1.4	2.4	5.2	7.2	9.0	8.1	5.5	7.0
Taipei,China	0.2	0.8	1.2	1.6	1.9	2.2	0.2	2.9
Five Affected Countries	1.7	3.0	9.4	13.9	19.7	19.2	16.7	17.4
Indonesia	0.2	0.4	1.7	4.3	6.2	4.7	-0.4	-3.2
Korea, Rep. of	0.1	0.7	0.8	1.8	2.3	3.1	5.2	10.3
Malaysia	1.1	0.8	4.2	4.2	7.3	6.5	2.7	3.5
Philippines	0.0	0.4	0.8	1.5	1.5	1.2	1.8	0.7
Thailand	0.3	0.7	1.9	2.1	2.4	3.7	7.4	6.1
(b) As a Percentage of Gross Fixed Capital Formation								
World	4.0	4.1	5.1	5.4	5.9	7.5	11.1	11.4
Developing Countries	3.8	3.9	6.9	7.3	9.1	10.8	11.5	12.1
East Asia	2.4	4.0	7.8	8.1	9.1	9.9	11.5	14.5
PRC	0.6	2.2	8.8	12.7	14.3	14.6	12.9	13.2
Hong Kong, China	7.1	12.1	5.6	4.2	3.2	2.7	2.0	3.2
Singapore	18.9	29.3	28.1	25.4	25.6	22.1	17.6	18.5
Taipei,China	1.2	3.6	2.5	2.5	3.0	3.4	0.4	0.7
Indonesia	0.9	1.8	3.8	6.7	8.8	6.8	-0.8	-1.2
Korea, Rep. of	0.3	1.5	0.7	1.1	1.3	1.8	5.5	7.4
Malaysia	11.5	9.3	15.7	12.1	17.0	15.1	13.9	16.2
Philippines	0.4	6.2	6.5	9.0	7.8	6.2	12.8	13.1
Thailand	2.6	4.5	4.5	2.9	3.1	7.8	25.1	26.7

*FDI is defined as the sum of equity capital, reinvested earnings, and intra-company loans by foreign firms or their affiliates.
Source: UNCTAD, *World Investment Report* (various years), and IMF, *International Financial Statistics* (CD-ROM).

In Korea the crisis-driven slowdown in FDI inflows lasted only for about two quarters. From then on, they started to increase significantly as investors responded to new FDI liberalization initiatives and participated in M&A activities. Total flows in 1999 were significantly higher than levels recorded in 1996. Although the FDI postcrisis increase was aided by a decline in net outward investment by Korean companies (reflecting their domestic financial troubles), the overall rise in inflow was not much different from that of gross inward flows. While the influx of FDI has taken place across all production sectors, emphasis has fallen on the financial sector, where most of the foreign M&A activity took place under the banking sector restructuring program.

Table B-2 on page 20 provides more recent data covering the first nine months of 2000. Although these data are not strictly comparable (they are derived from individual country sources and are net of overseas investment by domestic firms), they do provide indicative information on trends. In 2000, it appears that FDI began to taper off, coming off the peak recorded in 1999.

In Thailand, the pickup in FDI inflows started about the second quarter of 1998. Compared to 1997, the amount of inflows doubled in 1998, after which a decline set in. Net direct investment data in Table B-2 for the first nine months of 2000 confirm this downward trend. This decline may be a reflection of investor weariness resulting from the slowdown in both the rate of asset disposals and the reform momentum.

In sharp contrast to Thailand and Korea, FDI flows to Indonesia have been negative since 1998, and the outflow is on the increase. The outflow in the first nine months of 2000 has already exceeded the total outflow in 1999 (Table B-2). The volatile political and security situations in the country are undoubtedly to blame.

The amount of FDI flows into the Philippines has remained relatively small and changed a little throughout (although it fell in 1999). Despite a small pickup in 1999, FDI inflows to Malaysia have been falling since 1996. This trend appears to have continued into 2000 (Table B-2). There may be a number of reasons for this.

First, unlike in Korea and Thailand, M&A activity has not been an important component of foreign capital inflows during this period. Despite the severity of the downturn, corporate distress was far less widespread in Malaysia than elsewhere, and there were simply fewer bargain assets. Malaysia did not promote acquisitions/takeovers by foreign companies as part of its corporate and bank restructuring process.

Second, compared to Korea and Thailand (in particular, the former), Malaysia's foreign investment regime has remained more liberal and for a longer time, and in some sectors the presence of multinational enterprises (MNEs) had already reached high levels before the onset of the crisis. Thus the postcrisis increase in FDI in the former countries compared to Malaysia may also reflect "catching-up" by foreign firms following the new FDI liberalization initiatives.

Third, in the immediate precrisis years, intra-regional inflows (particularly those from Korea and Taipei,China) accounted for more than a third of total FDI flows to Malaysia and these have dwindled following the onset of the crisis. In other words, supply factors may also account for part of the slowdown. These factors suggest that the FDI slowdown in Malaysia does not reflect a reversal in attitudes of foreign investors toward Malaysia as an investment site, but rather a temporary adjustment period. It is likely that FDI flows will increase again in the future when these factors no longer operate.

There has been some shift in the shares of individual countries in terms of total FDI to the East Asian region (Table 2). The PRC continues to attract about half of total FDI flowing to the region. There has been a compositional shift, which began before the crisis and continued into the recovery, that has favored Hong Kong, China, in particular.

Table 2: **Country Composition of FDI Inflows to East Asia, 1990-1999** (%)

	1990-1994	1995	1996	1997	1998	1999
East Asia	100.0	100.0	100.0	100.0	100.0	100.0
PRC	44.2	58.0	49.4	51.9	54.1	44.5
Hong Kong, China	12.4	5.3	12.9	13.4	18.3	25.4
Singapore	14.2	11.7	11.1	9.5	6.8	7.7
Taipei,China	3.2	2.5	2.3	2.6	0.2	3.2
Five Affected Countries	26.2	22.4	24.2	22.4	20.5	19.2
Indonesia	4.7	7.0	7.6	5.5	-0.5	-3.5
Korea, Rep. of	2.3	2.9	2.8	3.6	6.4	11.3
Malaysia	11.5	6.8	9.0	7.6	3.3	3.9
Philippines	2.3	2.4	1.8	1.4	2.2	0.8
Thailand	5.4	3.3	3.0	4.3	9.1	6.7

Source: UNCTAD, *World Investment Report* (various years), and IMF, *International Financial Statistics* (CD-ROM).

Taken together, the share of the affected countries in total East Asian FDI has fallen only slightly. This better than expected outcome can be explained in terms of rapid increases in FDI associated with M&A activity in Korea and Thailand in particular, a faster than expected growth recovery in the region, and further liberalization of FDI policy regimes following the crisis.

FDI Policies in East Asia

Prior to the crisis, Korea (like neighboring Japan and Taipei,China) had adopted a relatively cautious approach toward FDI. Although there were some notable measures relaxing restrictions on FDI in the 1990s, Korea's overall stance remained lukewarm. In contrast, the affected countries in Southeast Asia began encouraging FDI as far back as the late 1970s in a much more aggressive manner as part of their outward-oriented development effort. By the time the crisis hit, all of these countries had quite liberal FDI regimes.

The crisis triggered significant changes in policy toward FDI in all of the affected countries.

- Korea underwent the most dramatic change, relaxing considerably its conservative approach toward FDI. In November 1998, as part of the reform program agreed with IMF, the Government enacted the Foreign Investment Promotion Act, with a view to creating a much more investor-friendly policy environment. The main changes included streamlining foreign investment procedures, expanding investment incentives, full-fledged liberalization of cross-border M&As, and allowing foreign ownership of land.
- In Thailand, foreign investment liberalization was an important part of the IMF-led reform package. Key initiatives included further liberalization of brokerage services; the wholesale and retail trade; nonsilk textiles; hotels; and garment, footwear, and beverage production. The Government amended the Condominium Act in late 1998, allowing foreigners to purchase 100 percent of buildings of 2 acres or less.
- Indonesia too committed to various FDI-related policy changes as part of the IMF reform program. Measures implemented include significantly narrowing the list of sectors that are closed to foreign investment (in July 1998) and lifting restrictions on foreign investment in wholesale trade. A proposal to reorganize the Investment Board

into a new institution under the Coordinating Minister for Economic Affairs, focusing on investment promotion rather than regulation activities, has been derailed by political turmoil.

- Malaysia has continued to promote FDI aggressively, despite its radical policy shift in September 1998. Capital controls were confined to short-term capital flows and aimed at making it harder for short-term portfolio investors to speculate, and for offshore hedge funds to drive down the currency. No new direct controls were imposed on import and export trade, and profit remittances and repatriation of capital by foreign investors remained free. Immediately following the imposition of capital controls, BNM experimented with new regulatory procedures in this area. But these were swiftly removed in response to protests from firms. Moreover, measures were introduced to further encourage FDI participation in the economy. These included allowing 100 percent foreign ownership of manufacturing regardless of the degree of export orientation; increasing the foreign ownership share limit in telecommunication projects, stockbroking, and insurance companies; and relaxing curbs on foreign investment in landed property.
- In the Philippines, the crisis has not resulted in any significant shift in the country's policy toward FDI. However, the emphasis on the promotion of export-oriented foreign investment, which started in earnest in the late 1980s, seems to have received further impetus from the crisis.

The Role of FDI in Adjustment to the Crisis

FDI has assisted in the adjustment to the crisis in at least two ways. The first relates to the existing *stock* of FDI when the crisis hit, and is associated with the performance of foreign-owned firms relative to domestically owned firms. The second relates to new *flows* of FDI in the aftermath of the crisis, and is based on M&A activity associated with the corporate and bank restructuring process.

In Korea, Malaysia, Philippines, and Thailand the share of FDI in total fixed capital formation was higher in 1998 and 1999, compared to precrisis levels (Table 1). Thus, FDI has been more resilient to the crisis than domestic private investment. Depending on the policy, FDI can act as an effective cushion against the overall collapse in investment during a crisis.

There is anecdotal evidence suggesting that MNEs in general increased their exports, in absolute terms and as a share of total sales, following the crisis. There is firm evidence that relates to US affiliates operating in the affected countries. The share of exports from US affiliates in total exports of the affected countries increased from 3.2 percent in 1995 to 5.2 percent in 1998 (Table 3). Further, as local sales declined sharply following the onset of the crisis (by 30 percent in the affected countries between 1997 and 1998), the affiliates of US MNEs were quick to redirect their sales from host country to external markets to minimize the impact on their overall performance. Consequently, the ratio of exports to total sales of these affiliates shot up in all of the affected countries.

Table 3: **Exports of Majority-Owned Affiliates of US MNEs in Affected Countries, 1995-1998**

	1995	1996	1997	1998
	As a Percentage of Total Host Country Exports			
Five Affected Countries	3.2	3.9	4.3	5.2
Indonesia	0.5	0.5	0.5	0.5
Korea, Rep. of	0.5	0.6	0.5	0.5
Malaysia	6.6	8.3	10.7	14.8
Philippines	9.1	9.4	9.3	9.1
Thailand	5.2	6.1	6.3	8.8
	As a Percentage of Total Sales by MNEs			
Five Affected Countries	45.8	50.4	53.3	67.4
Indonesia	17.0	19.3	17.3	32.2
Korea, Rep. of	15.9	16.3	15.8	19.1
Malaysia	59.1	66.8	68.6	85.4
Philippines	40.6	44.2	47.1	54.2
Thailand	59.6	61.0	60.9	72.8

Source: Lipsey, Robert E. (2001), *Foreign Investment in Three Financial Crises*, NBER Working Papers 8084, Cambridge, MA: National Bureau of Economic Research.

With strong export performance, total employment in US affiliates in the affected countries declined at a much slower rate compared to total national employment in these countries. Similarly, the decline in fixed capital formation (expenditure on plant and equipment) by affiliates in 1998 in the affected countries was far smaller than the massive contractions recorded in national fixed capital formation estimates. This suggests that despite the crisis, US firms have taken a relatively optimistic view of long-run prospects for the region. All in all, these findings support the hypothesis that foreign-owned firms have behaved differently from domestically-owned ones in their response to the Asian crisis and that this behavior has aided the affected countries' adjustment process. It appears that FDI presence has added to the agility of the affected countries.

M&A activity has been driving the corporate and bank restructuring process in the affected countries, contributing to a more sustained recovery. All affected countries have benefited from increased M&A activity, although to varying degrees (Table 4).

Table 4: **Mergers and Acquisitions by Foreign Firms in Affected Countries, 1998 to 2000, Announced Value** ($ million)

	1998	1999	2000
Indonesia	35.98	545.69	1,441.51
Korea, Rep. of	1,864.65	3,914.24	3,723.57
Malaysia	1,334.46	867.38	250.23
Philippines	1,478.64	293.03	1,126.69
Thailand	829.24	1,014.58	314.27

Source: Bloomberg.

- Korea has received by far the largest inflow of capital associated with M&As, in line with comprehensive liberalization of policies governing such inflows.
- Thailand received large inflows associated with M&As in 1998 and 1999, but these have tailed off sharply in 2000. The drop-off might be related to the slowdown in the pace of debt restructuring, but perhaps the more attractive assets have already been sold.
- Continued political uncertainty has limited flows to Indonesia, despite the large number of potentially attractive opportunities. Inflows did shoot up in 2000, however, and this may reflect recent optimism associated with improved debt restructuring.
- Inflows associated with M&A activity have been relatively low in Malaysia, and are falling. This is not surprising given that Malaysia has not been encouraging such activity, preferring instead for the restructuring process to be internally driven.
- Even though the Philippines was the least affected by the crisis, it has been an active site for M&As. Unlike in other affected countries where corporate distress has been the driving factor, most of its M&As have been linked with consolidating market positions and refocusing or streamlining operations.

The Future of FDI and Related Issues

With an eye to attracting future FDI, some regional and multilateral initiatives have been undertaken in the Association of Southeast Asian

Nations (ASEAN) region. These initiatives are likely to receive added emphasis in the postcrisis era. The idea of forming an ASEAN Investment Area (AIA) first formally surfaced at the 1995 Bangkok Summit and the framework agreement was subsequently signed in October 1998. With the AIA, there will be joint extra-regional promotional efforts, and perhaps some moves to harmonize certain aspects of the FDI regulatory regime within the region. But it is difficult to envisage much more than this. For example, attempts to develop common FDI policy regimes (including not just regulatory but also fiscal provisions) would almost certainly flounder, as would the concept of offering preferential treatment to investors from other member countries. In short, while initiatives such as this can play a complementary role, the success of countries in the region in attracting FDI will continue to depend on the efficacy of unilateral action.

What unilateral policy measures should these countries introduce in order to increase their attractiveness to FDI? They would vary by country, and depend primarily on the existing incentive climate and stage of development.

Among the five affected countries, Korea has undergone the most significant FDI liberalization as part of its overall crisis management package. This policy initiative, coupled with reforms in other areas such as *chaebol* restructuring, revamping of bankruptcy procedures, and banking reforms, seem to have set the stage for rapid expansion in FDI participation in the Korean economy. However, with the rapid recovery from the crisis, resistance of trade unions and other domestic lobby groups against these policies has begun to intensify. Whether the recent pick-up in FDI inflows will eventually become a major force in the economic transformation of Korea depends on the ability of policymakers to resist such pressures.

Despite its unorthodox crisis management policy, Malaysia is likely to soon regain its precrisis position as the most attractive location for FDI among ASEAN countries after Singapore. The constraint in the medium to long run is likely to be the erosion of its comparative advantage in labor intensive assembly activities in the face of tightening labor market conditions. A major challenge lies in developing the domestic human capital base in order to facilitate an upward shift in MNE activities along the value ladder. Over the past decade or so, Malaysia has increasingly relied on migrant workers in order to preserve its comparative advantage in labor intensive production. But, this policy choice could be counterproductive in the long run as it may prevent the structural adjustment required for economic maturity.

In Thailand, crisis-induced FDI liberalization has significantly improved the climate for FDI. However, the twin problems of incomplete banking sector reform and private sector debt overhang could continue to threaten the future attractiveness of the country for domestic market-oriented FDI. In the area of export-oriented FDI, Thailand still has considerable opportunities in labor intensive product sectors compared to Malaysia. But unlike in Malaysia, domestic infrastructure bottlenecks continue to constrain FDI to some degree.

In Indonesia, the entry of FDI into export-oriented manufacturing began just before the crisis. With excess domestic supply of labor and tightening labor markets in neighboring FDI-receiving countries (Malaysia and Singapore, in particular), there is considerable scope for further expansion of these activities. However, there is little that policymakers can do to promote FDI, given the continued policy uncertainty and social unrest. In particular, FDI of "Chinese origin" (especially from Hong Kong, China; Singapore; and Taipei,China) has been a major casualty of the political situation in Indonesia.

In the Philippines, policy reforms from the early 1990s have made considerable leeway in improving the incentive structure for foreign investors. However, the poor state of domestic infrastructure, policy uncertainty, and lack of transparency in investment approval regimes are major stumbling blocks to greater global integration of domestic industry through FDI.

Conclusions

FDI inflows have shown considerable resilience in the wake of the crisis. In countries such as Korea and Thailand, FDI inflows have actually shot up recently, with M&A activity driving most of the increase, contributing to the restructuring process. At the other extreme, Indonesia is still experiencing outflows of all types of capital, and this is unlikely to change until political stability returns. The slowdown in FDI inflows to Malaysia has not relented despite a return to strong growth, but there are reasons for this, and fears that this may be a permanent change appear unwarranted. In the Philippines, FDI inflows have remained relatively small and changed a little throughout. In short, the crisis has not introduced a major discontinuity into the FDI story in the affected countries, apart from a modest decline in inflows in its immediate aftermath, and sharp declines in inflows to Indonesia due mostly to noneconomic factors.

Foreign firms also appear to have played an important role in weathering the crisis. Relative to domestic firms, they displayed greater capacity to switch sales from depressed domestic markets to international markets, allowing them to limit the amount of layoffs and reductions in fixed capital formation, which tempered the contractionary effects of the crisis.

An important side effect of the crisis in all affected countries has been the further liberalization of FDI regimes, which has been encouraging. The commitment of these countries to FDI has not been compromised by the crisis; indeed it has been strengthened as a result. There has been some nationalistic opposition to the increase in foreign ownership during the early postcrisis years, as financial institutions and firms recapitalize their operations through injections of foreign equity. But with the possible exception of Indonesia, where nationalistic opposition to rising foreign ownership could resurface, the principal policy issue now is not whether to promote FDI but how to build on the present proactive strategy toward FDI. Although further liberalization of FDI regimes is required, recent policy changes introduced in all affected countries are encouraging. In light of this, and three years into the recovery, the future of FDI flows to the affected countries looks bright.

Publication Stock No. 030101