Asia Economic Monitor 2002

April 2002 Update http://aric.adb.org

The *Asia Economic Monitor* (AEM) is a quarterly review of East Asia's growth and recovery, financial and corporate sector reforms, and social developments. It covers the 10 Association of Southeast Asian Nations member countries plus the People's Republic of China and Republic of Korea. The analysis is supported by high-frequency indicators compiled from the ARIC Indicators section of the Asian Development Bank's Asia Recovery Information Center web site (http://aric.adb.org).

Contents

Asian Development Bank

Highlights

- Last year, East Asia experienced its second major external shock in half a decade. A synchronized slowdown in the industrial countries and the collapse of the information technology industry worldwide led to a significant drop in demand for the region's exports.
- Many countries in the region responded with fiscal stimulus measures and interest rate reductions. These measures supported domestic demand and cushioned the external shock somewhat. Yet, the region posted its second slowest growth in decades.
- During the 1997-1998 financial crisis, the countries with open capital accounts were the most affected. By contrast, since last year's shock was primarily one of export demand, countries that were more open to international trade slowed more than others.
- In the aftermath of the 11 September attacks on the US, there was a consensus that East Asia's economic slowdown would deepen, with the rebound occurring some time in the middle of this year. The December 2001 issue of *Asia Economic Monitor* (AEM) reflected this view.
- Global and regional economic developments since then, however, have prompted greater optimism toward the region's immediate economic prospects:
  - As the December 2001 AEM had conjectured, the economic fallout from 11 September has, so far, turned out to be less disruptive than was originally feared.
  - The US economy seems to have bottomed out and appears to be recovering faster than expected.
- For most of the more open and globally integrated East Asian countries, these developments bring good news. Hard on the heels of the better than expected performance of the global economy, signs have started to emerge that last year's economic slowdown in East Asia has perhaps also bottomed out:
  - Exports are showing signs of picking up because of a steady improvement in world electronics demand since November last year.
  - Domestic demand, which cushioned the slowdown somewhat last year, seems to be strengthening in several countries.
  - Reflecting trends in exports and domestic demand, growth slowdown in aggregate gross domestic product as well as manufacturing appears to have stabilized in the last quarter of 2001 in several countries.

Continued overleaf

Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
ADO	Asian Development Outlook (ADB)
AEM	Asia Economic Monitor
AMC	asset management company
ARIC	Asia Recovery Information Center
ASEAN	Association of Southeast Asian Nations
CAR	capital adequacy ratio
EU	European Union
GDP	gross domestic product
IBRA	Indonesian Bank Restructuring Agency
IIF	Institute of International Finance
IMF	International Monetary Fund
IT	information technology
JCI	Jakarta Composite Index
KAMCO	Korea Asset Management Corporation
KLCI	Kuala Lumpur Composite Index
KOSPI	Korean Stock Price Index
Lao PDR	Lao People's Democratic Republic
NASDAQ	National Association of Securities Dealers Automated Quotation
NPL	nonperforming loan
PCOMP	Philippine Stock Exchange Composite Index
PRC	People's Republic of China
REMU	Regional Economic Monitoring Unit (ADB)
SET	Stock Exchange of Thailand
STI	Straits Times Index (Singapore)
TAMC	Thai Asset Management Corporation
WEO	World Economic Outlook
q-o-q	quarter-on-quarter
y-o-y	year-on-year

Note: In this publication, "$" denotes US dollars, unless otherwise specified.

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– Stock markets have rebounded significantly since the fourth quarter of last year. In recent months, rentals and vacancy rates have also firmed up in several Asian cities.

- The main message of this report is that East Asia is moving from last year's sharp and synchronized economic slowdown to a faster-than-expected—but moderate—rebound.
- Despite this year's faster-than-expected rebound, for four of the five crisis-affected countries (except Korea), the five years since the 1997 financial crisis are effectively a lost half decade in terms of improvements in per capita incomes.
- The London-based Consensus Economics Inc.[1] now projects East Asia's average growth to reach 5.2 percent in 2002, an improvement on its forecast of 4.7 percent issued in December. Building on this year's rebound, East Asia's growth will strengthen to more than 6 percent in 2003.
- To ensure sustained rapid growth and resilience against external shocks, East Asian countries need to work toward achieving not only sound macroeconomic fundamentals but also sound structural fundamentals. Key to attaining these objectives is expeditious completion of the remaining agenda of financial and corporate sector reforms and restructuring.
- Reforms at the national level need to be complemented by further strengthening of ongoing initiatives to promote greater monetary and financial cooperation at the regional level.

[1] A private institution that collates forecasts from 200 economic and financial forecasters from more than 70 countries around the world.

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East Asia's Growth and Recovery—A Regional Update

Introduction

Last year, East Asia[1] experienced its second major external shock in half a decade. The deterioration in the global economy during the year subjected the region's economies to a severe stress test. The synchronized slowdown in the industrial countries and the collapse of the information technology (IT) industry worldwide caused a significant drop in the demand for the region's exports. Many countries in the region responded with fiscal stimulus measures and interest rate reductions. These measures supported domestic demand and cushioned the external demand shock somewhat. Yet, the export shock led to a substantial slowdown in economic growth, with the region posting its second slowest growth in decades.

In the aftermath of the 11 September attacks on the US, there was a growing consensus that East Asia's economic slowdown would deepen, dimming the prospects of an early rebound among the region's economies. Reflecting this view, the December 2001 issue of the *Asia Economic Monitor* (AEM) had expected that the rebound in the region might occur around the middle of this year.

Global and regional economic developments since then have prompted greater optimism toward the region's immediate economic prospects. The economic fallout from 11 September has, so far, turned out to be less disruptive than was originally feared. Also data and information released in the last three to four months, especially in the past few weeks, show distinct signs of improvement in the global economic situation. The US economy seems to have bottomed out and appears to be recovering faster than earlier anticipated. A faster-than-expected but milder rebound is also evident in Europe. Meanwhile, recession is persisting in Japan, but there have been some recent positive signs.

For most of the more open and globally integrated East Asian economies, these global developments bring good news: their economies' rebound may perhaps be already underway. Partly reflecting this optimism, many of the region's stock markets have trended up since the fourth quarter

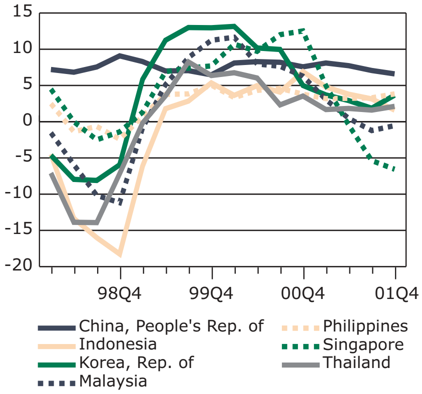
[1]Defined here as the 10 Association of Southeast Asian Nations countries (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China and the Republic of Korea.

of last year. Exports and domestic demand are also starting to pick up. Just like the synchronized economic slowdown of last year, we expect a synchronized rebound in the region this year. But it will not be a mirror image. The rebound this year will be weaker compared to the sharp slowdown in 2001. The major message of this report, therefore, is from a synchronized slowdown last year, the region is headed for a faster-than-expected but moderate rebound this year. National and regional efforts should, therefore, be directed at strengthening the rebound by supporting domestic demand. The pace of economic reforms and restructuring also needs to be accelerated, both to sustain robust growth in domestic demand and to reduce the vulnerability of the region's economies to volatility caused by external shocks, which are difficult to avoid in an increasingly integrated global economy. Ongoing efforts to promote monetary and financial cooperation also need to be further strengthened.

Growth and Recovery in 2001

Real Sector Developments

Figure 1: **Real GDP Growth**
(y-o-y, %)



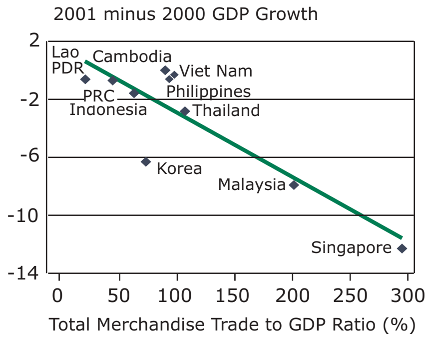
Source: ARIC Indicators.

In 2001, growth slowed across East Asia (Figure 1). The region as a whole grew by 4.3 percent, representing a sharp deceleration from the 7.6 percent growth achieved in 2000. If the People's Republic of China (PRC) is excluded, the deceleration for the region was even sharper: from 7.4 percent to 2.4 percent.

Countries that are more closely linked to the global economy were more adversely affected than those with weaker linkages (Figure 2). Hence, Singapore, the most open economy, saw its gross domestic product (GDP) actually shrink by 2 percent in 2001 compared to growth of 10.3 percent in 2000. Similarly, growth plummeted in Malaysia, Republic of Korea (henceforth, Korea), and Thailand, in that order. The Association of Southeast Asian Nations (ASEAN)-5 (Indonesia, Malaysia, Philippines, Singapore, and Thailand) taken together grew by 1.8 percent, a sizeable drop from 5.9 percent in 2000. Among the ASEAN-5, the growth slowdown was modest only in the Philippines, but this was largely due to the robustness of its agriculture sector, which was largely immune to the external shock.

The external shock had relatively milder effects on the PRC and the smaller ASEAN countries (Brunei Darussalam, Cambodia, Lao People's Democratic Republic [Lao PDR], Myanmar, and Viet Nam). Although growth

Figure 2: **Growth Slowdown and Openness**

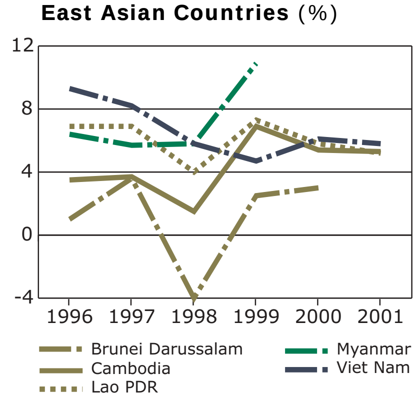


Source: ARIC Indicators.

slowed in the PRC, it remained an impressive 7.3 percent. As for the rest of ASEAN, it is estimated that in 2001 Viet Nam grew by 5.8 percent, Cambodia by 5.3 percent, and Lao PDR by 5.2 percent (Figure 3). Last year's growth for Cambodia, Lao PDR, and Viet Nam was only marginally lower than the corresponding rates in 2000. Official estimates of Myanmar's 2001 growth are not yet available, but the pace of economic activity, although slower than in the previous year, is likely to have remained robust. The relatively smaller share of international trade in GDP explains the resilience of these countries to the external shock. In the case of the PRC, policy responses in the form of fiscal stimulus measures and interest rate reductions also seem to have contributed to the resilience (see Fiscal and Monetary Policies, page 13).

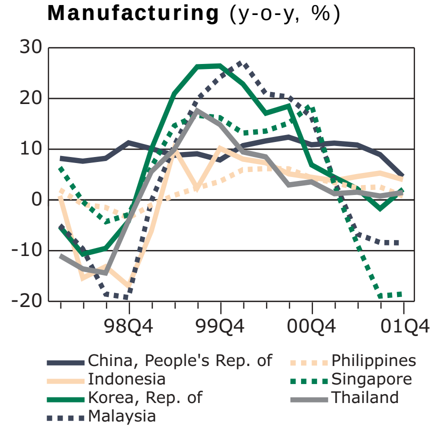
While the regional growth slowdown has cut across most sectors, it was especially evident in manufacturing (Figures 4 and 5). In 2001, Singapore's manufacturing sector shrank by 12 percent, a huge setback from its average growth of more than 14 percent in the previous two years. Similarly, in Malaysia, the manufacturing sector shrank by 5 percent in 2001, compared to an average growth rate of more than 17 percent in the previous two years. Korea's manufacturing grew by only 2 percent, compared to an average growth of more than 18 percent in the previous two years. Even PRC, Philippines, and Viet Nam—countries that experienced only a mild slowdown in GDP growth—saw a deceleration in their manufacturing sectors. Similarly, even though

Figure 3: **GDP Growth—Other East Asian Countries** (%)



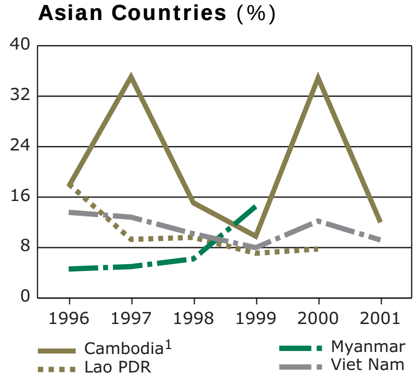
Source: ARIC Indicators.

Figure 4: **Growth of Manufacturing** (y-o-y, %)



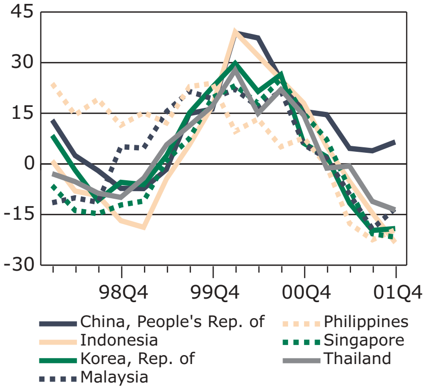
Notes: Data for PRC refer to the industrial sector.
Data for Singapore from 1998-1999 are not consistent with revised annual GDP growth rates, as quarterly data for that period are not yet available.
Source: ARIC Indicators; ADB staff estimates.

Figure 5: **Growth of Manufacturing—Other East Asian Countries** (%)



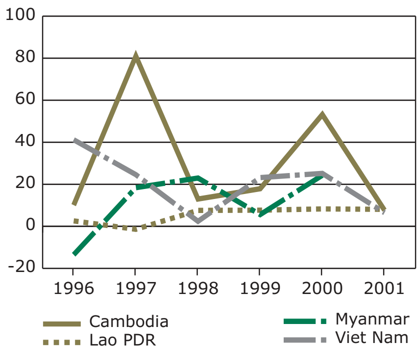
[1]Growth rate for 2001 is for growth of industry.
Source: ARIC Indicators; ADB staff estimates.

Figure 6: **Growth of Merchandise Exports, Dollar Value** (y-o-y, %)



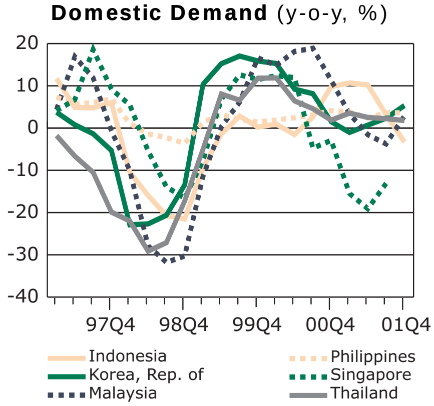
Source: ARIC Indicators.

Figure 7: **Growth of Merchandise Exports, Dollar Value—Other East Asian Countries** (%)



Source: ARIC Indicators; ADB staff estimates.

Figure 8: **Growth Rate of Domestic Demand** (y-o-y, %)



Sources: ARIC Indicators.

Cambodia's GDP growth was unchanged, its industry sector grew at a much slower rate last year (12 percent) compared to 2000 (29 percent).

Most of the regional growth slowdown last year was driven by a sharp falloff in the region's exports. As the global economy slowed, world trade decelerated in 2001 (according to the latest World Bank estimates, the volume of world trade declined by about 1 percent in 2001 compared to growth of 13 percent in 2000), thus reducing the demand for the region's exports. The worldwide collapse of demand for IT products further accentuated the export shock, especially for countries that depend heavily on the US market and electronics exports (such as Korea, Malaysia, Philippines, and Singapore). The dollar value of exports of the five crisis-affected countries (which account for about 60 percent of East Asia's exports) declined by 11 percent in 2001, compared to 19 percent growth in the previous year (Figure 6). In several of these countries, declining exports were also accompanied by a net outflow of private foreign capital (Box 1).

Outside the crisis-affected countries, Singapore saw its exports decline by 11 percent in 2001, compared to 7 percent growth in 2000. Even the PRC, which is much less dependent on electronics exports, saw its export growth fall from 28 percent in 2000 to 7 percent last year. Viet Nam's export growth plummeted from 25 percent in 2000 to 6.5 percent last year, while Cambodia also experienced a major slowdown in its exports (Figure 7). Lao PDR is perhaps the only country in East Asia that did not experience lower export growth last year.

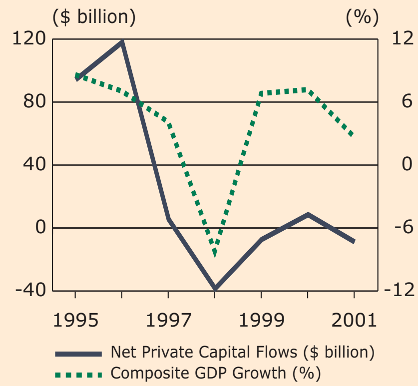
Unlike exports, trends in domestic demand had been varied across the region. Growth in domestic demand has generally trended down in Malaysia, Singapore, and Thailand, whereas it has trended up in Korea and stayed somewhat unchanged in the Philippines. In Indonesia, after remaining resilient in the first and second quarters of 2001, it has decelerated sharply since then (Figure 8). As for the PRC, both domestic consumption and investment remained steady, partly due to the continuation of fiscal stimulus measures for the fourth year in succession since the Asian crisis. The 2001 data on domestic investment and consumption for the newer members of ASEAN are scanty. However, available figures indicate that Viet Nam maintained robust domestic growth but domestic consumption remained subdued.

Since exports declined sharply, whatever growth the region posted last year was attributable to the rise in domestic demand, which, although reduced in many countries, remained positive (Box 2).

Box 1: **Trends in Capital Flows to the Five Crisis-Affected Countries**

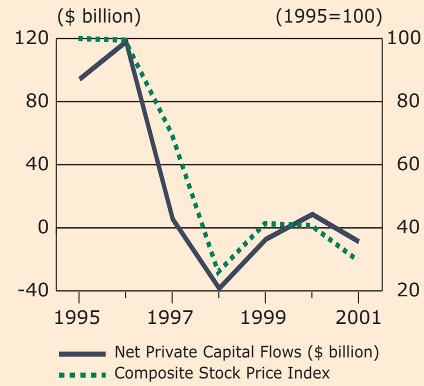
Net private capital flows to the five crisis-affected countries, according to Institute of International Finance (IIF) estimates, declined in 2001, reversing the mild increase seen over the previous two years (Table 1.1). From an inflow of $8.5 billion in 2000, these countries experienced an outflow of $8.8 billion last year. All major components of net capital flows declined, but the sharpest falls were in net portfolio investments and net inflows from nonbank creditors (which comprise bond markets, suppliers' credits, nonresident deposits in domestic banks, and nonresident purchases of Treasury bills). The latter was due to a sharp increase in repayments to nonbank creditors. Net foreign direct investment also fell but by a lower magnitude.

Figure 1.1: **Composite GDP Growth and Net Private Capital Flows—Five Crisis-Affected Countries**



Note: For the composite GDP growth rates of the five crisis-affected countries, growth rates are weighted by GDP levels in dollars.
Source: Bloomberg, Institute of International Finance.

Figure 1.2: **Composite Stock Price Index and Net Private Capital Flows—Five Crisis-Affected Countries**



Note: The composite stock price index is computed as the weighted average of the stock price indexes in dollar terms for the five crisis-affected countries. The 1995 dollar values of the market capitalization of individual stock markets were used as the weights.
Source: Bloomberg, Institute of International Finance.

The large net outflows in nonbank credit were primarily driven by large repayments by Indonesia, Korea, and Thailand. In Indonesia, net outflows were mainly caused by continuing repayments of intercompany loans amid a weak business environment. Meanwhile, in Korea and Thailand, net repayments were a reflection of cheaper domestic borrowing opportunities. The sharp drop in portfolio equity investment in 2001 mostly reflected the poor outlook for corporate earnings on the back of a sharp slowdown in economic activity across the region. Poor growth performance must have also caused the modest decline in net foreign direct investment.

In recent years, net private capital flows to the region have followed a procyclical pattern: increasing during economic upturns and declining during downturns. This is reflected by the positive correlation between net private flows on the one hand, and GDP growth and the stock price index on the other (Figures 1.1 and 1.2). Given this procyclical pattern, the expected rebound in East Asia's growth this year should improve the prospects for private capital inflows. The IIF's latest projection of capital flows to the region indicates such an improvement (Table 1.1). Despite this, net private capital inflows to the five crisis-affected countries are expected to remain negative, although with the ongoing upward revision of growth forecasts for these countries, a higher forecast for capital inflows cannot be ruled out as the year progresses.

Table 1.1: **Net Private Capital Flows to the Five Crisis-Affected Countries** ($ billion)

	1995	1996	1997	1998	1999	2000	2001	2002f
Net Private Flows	**94.18**	**118.00**	**5.53**	**-38.46**	**-7.29**	**8.50**	**-8.84**	**-2.85**
Equity Investment, net	**15.47**	**16.82**	**5.16**	**17.79**	**30.72**	**24.37**	**12.20**	**11.20**
Direct Equity Investment, net	4.43	4.77	6.81	13.23	15.28	12.98	8.40	7.00
Portfolio Investment, net	11.04	12.05	-1.65	4.51	15.44	11.39	3.80	4.20
Private Creditors, net	**78.71**	**101.18**	**0.37**	**-56.26**	**-38.02**	**-15.87**	**-21.04**	**-14.05**
Commercial Banks, credit flows, net	64.70	69.40	-16.98	-49.74	-34.30	-15.14	-13.35	-8.46
Other Private Creditors, net	14.01	31.77	17.35	-6.51	-3.72	-0.73	-7.69	-5.59

f = forecast
Source: Institute of International Finance.

Box 2: **Relative Contribution of Net Exports and Domestic Demand to Growth in the Five Crisis-Affected Countries**

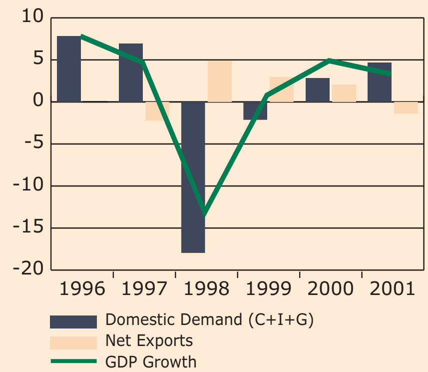
Last year, at 2.7 percent, the five crisis-affected countries taken together posted their slowest growth since 1998, when their combined GDP contracted by 8.2 percent. However, there is a key difference between 1998 and last year in terms of the relative contribution of net exports and domestic demand. In 1998, domestic demand almost collapsed (because of the sharp withdrawal of private capital from the region) and thus made a negative contribution to growth, whereas net exports cushioned the economic contraction (Figures 2.1 to 2.5).

In contrast, last year, domestic demand made a positive contribution to growth in all the five crisis-affected countries, while net exports either made a negative or negligible contribution. In other words, unlike in 1998, although growth in domestic demand slowed in many countries for the most part of last year, it remained positive. If, as in 1998, domestic demand had collapsed last year, the region's growth slowdown would have been much sharper.

Last year's economic shock was predominantly an export demand shock and was much less severe than the external shock of 1997-1998. Unlike in 1998, it did not involve a financial crisis, a collapse of regional currencies, and a sharp withdrawal of foreign capital from the region (although there was a moderate outflow of private capital) (see Box 1). Hence, domestic demand growth, although remaining subdued in many countries, did not collapse as in 1998.

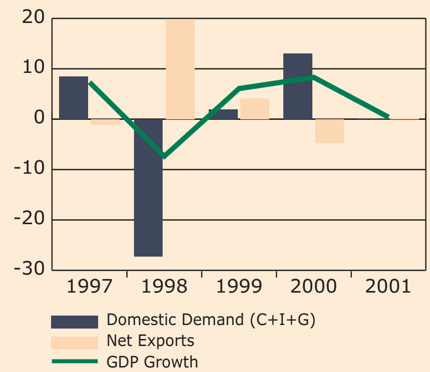
Moreover, the stance of fiscal and monetary policies was different last year compared to 1998. At the height of the Asian financial crisis in 1998, especially in the first half of the year, countries were seeking to stabilize their exchange rates and financial markets through fiscal and monetary tightening. While those policies might have helped countries to stabilize, they also led to a severe contraction in domestic demand. In contrast, in response to last year's export shock, many countries in the region cut interest rates and implemented fiscal stimulus measures. These policies supported the resilience of domestic demand.

Figure 2.1: **Contribution to Growth—Indonesia** (%)



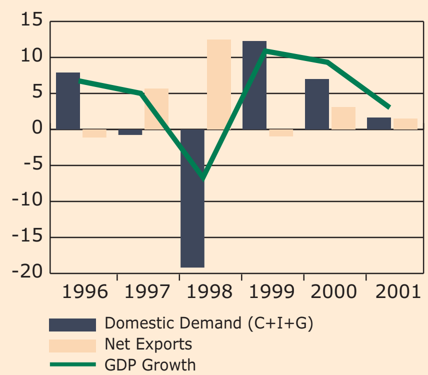
Source: ARIC Indicators.

Figure 2.3: **Contribution to Growth—Malaysia** (%)



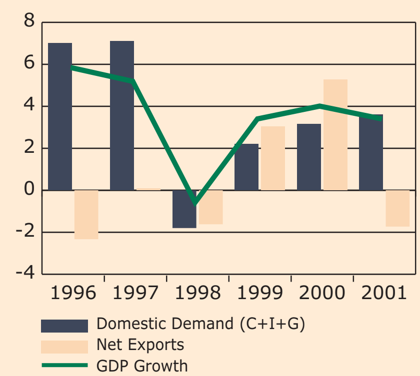
Source: ARIC Indicators.

Figure 2.2: **Contribution to Growth—Korea** (%)



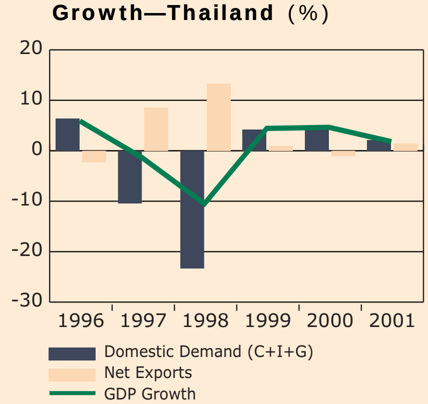
Source: ARIC Indicators.

Figure 2.4: **Contribution to Growth—Philippines** (%)



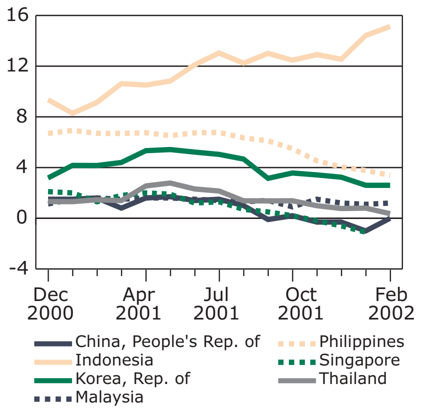
Source: ARIC Indicators.

Figure 2.5: **Contribution to Growth—Thailand** (%)



Source: ARIC Indicators.

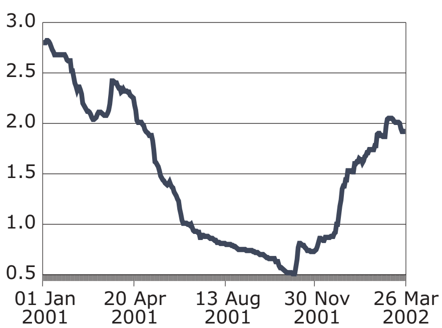
Figure 9: **Inflation Rates** (%)



Sources: ARIC Indicators.

Weakening exports and decelerating growth kept a check on inflation across the region, with the exception of Indonesia (Figure 9). The Philippines registered the sharpest decline in annual inflation, from about 7 percent in December 2000 to 4 percent in December 2001. In the first two months of 2002, the country's inflation has continued falling. At 3.4 percent in February this year, the rate is at its lowest in two years. The PRC and Singapore, which had only moderate inflation of about 2 percent by the end of 2000, are now experiencing mild deflation, whereas Malaysia more or less maintained a rate of about 1.5 percent throughout last year. In Korea and Thailand, inflation edged up somewhat in the beginning of 2001, but has declined since then. Inflation now stands at about 2.5 percent in Korea and at less than 1 percent in Thailand. During 2001, inflation also remained tame among the newer ASEAN members: it was negligible in Cambodia; Viet Nam's annual rate did not reach 1 percent; and although Lao PDR's figure was about 6 percent, this was much lower than the 27 percent experienced in 2000. Indonesia is perhaps the only country in the region that experienced an acceleration in inflation, up from about 9 percent at the beginning of 2001 to more than 14 percent in February 2002.

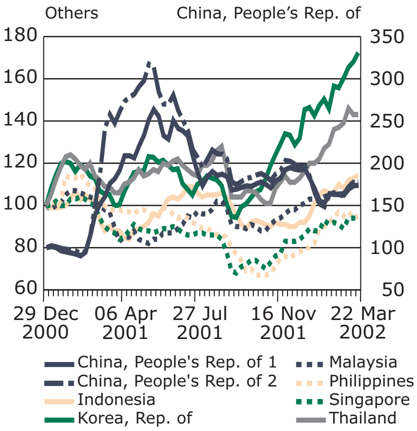
Figure 10: **Computer Chips Spot Price (8Mx8, PC133)**



Source: Bloomberg.

Despite the generally poor growth performance of the region's economies in 2001 as a whole, there were encouraging signs that last year's economic slowdown was bottoming out. First, exports are showing signs of picking up on the back of a steady improvement in the world electronics demand (as indicated by the rise in semiconductor prices in the world market), since November last year (Figure 10). Except for Indonesia, Singapore, and Thailand, export growth, in fact, improved in the last quarter of 2001. This trend has continued during the early part of this year. For example, the Philippines' exports fell by 9 percent in January as compared to a 24 percent decline in December. Second, partly due to last year's fiscal and monetary easing (see Fiscal and Monetary Policies, page 13), domestic demand is showing signs of strengthening in several countries. Except for Indonesia, domestic demand has started picking up even in those countries where it was sluggish in the earlier part of last year. The timing of the upturn in domestic demand varies across countries. Domestic demand picked up in Malaysia from the fourth quarter; in Singapore and Thailand it began in the third quarter; and in Korea as early as the second quarter. Third, reflecting trends in exports and domestic demand, growth slowdown in aggregate GDP as well as manufacturing seems to have stabilized somewhat in the last quarter of 2001 in several countries.

Figure 11a: **Composite Stock Price Indexes*** (last week of 2000Dec=100, in local currency)



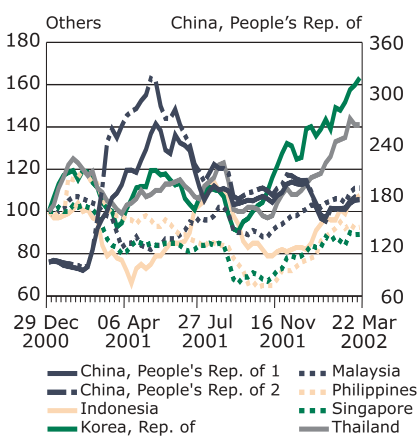
*Weekly averages of Shanghai-B (PRC 1), the Shenzhen-B (PRC 2), JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand).
Source: REMU staff calculations derived from Bloomberg.

Asset Market Developments

Most regional equity markets continued to decline well up to the third quarter of last year. However, since the last quarter of 2001, equity prices in major stock markets have rebounded significantly (Figure 11a and 11b). In local currency terms, these gains have ranged from 23 percent in Malaysia to 73 percent in Korea. The gains in terms of dollar value are similar, ranging from 23 percent in Malaysia and Indonesia to 72 percent in Korea. Because of this rally, equity prices are now higher in most markets than they were in the beginning of 2001, except for the Philippines and Singapore, with Korea performing best in 2001. Several factors have contributed to the recent upturn in regional stock prices. Three deserve special mention: the upswing in the US stock market after falling sharply in the immediate aftermath of 11 September; an earlier-than-expected bottoming out of growth among many regional economies; and the lowering of interest rates in several economies, especially in the second half of last year.

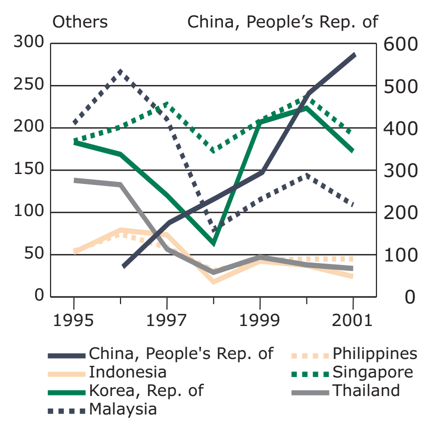
Despite the last quarter upturn in stock prices, most countries experienced a decline in stock market capitalization for the year as a whole, with the notable exception of the PRC. In dollar values, the decline in market capitalization ranged from about 11 percent in Thailand to about 35 percent in Indonesia (Figure 12a). As a proportion of GDP, Indonesia suffered a decline in market capitalization of about 32 percentage points (Figure 12b). The corresponding declines for other

Figure 11b: **Composite Stock Price Indexes*** (last week of 2000Dec=100, in $)



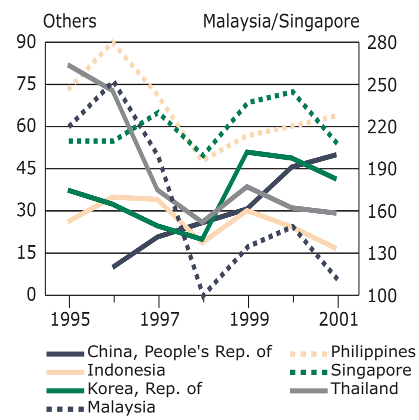
*Weekly averages of Shanghai-B (PRC 1), the Shenzhen-B (PRC 2), JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand). The exchange rate used in the conversion to $ is from the NY Composite.
Source: REMU staff calculations derived from Bloomberg.

Figure 12a: **Market Capitalization, Year-Average** ($ billion)



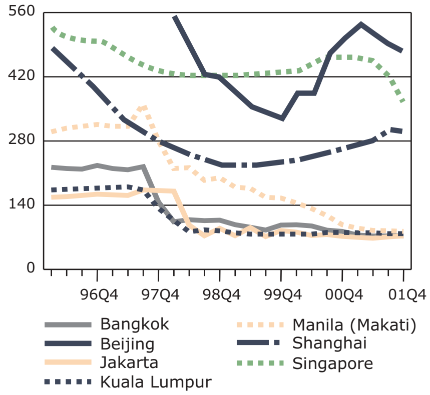
Note: For the PRC, market capitalization is the sum of market capitalization of the Shenzhen and Shanghai markets.
Source: CEIC.

Figure 12b: **Market Capitalization** (% of GDP)



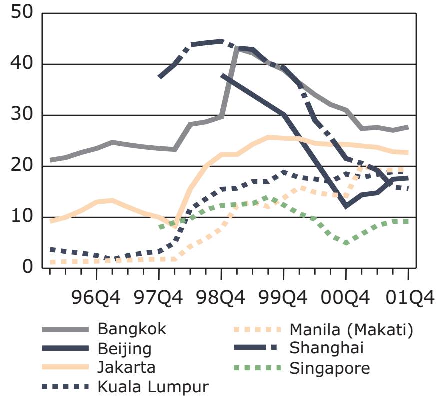
Note: For the PRC, market capitalization is the sum of market capitalization of the Shenzhen and Shanghai markets.
Source: CEIC.

Figure 13: **Office Property Rents** ($ per square meter per annum)



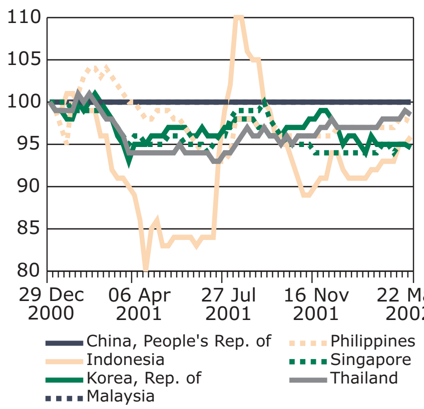
Source: Jones Lang LaSalle, *Asia Pacific Property Digest*, various issues.

Figure 14: **Office Property Vacancy Rates** (%)



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

Figure 15: **Exchange Rate Indexes** (weekly average, last week of 2000Dec=100, $/local currency)

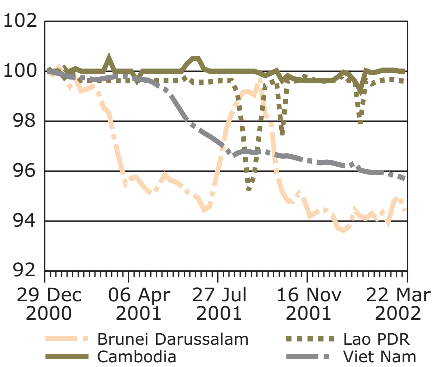


Source: REMU staff calculations derived from Bloomberg.

countries are: 6 percent for Thailand, 15-16 percent for Singapore and Korea, and 24 percent for Malaysia. Only the Philippines saw a mild increase in the ratio of market capitalization to GDP, largely because of a contraction in the dollar value of the country's GDP last year.

Last year's worsening economic conditions also took their toll on several property markets around the region. However, there were significant differences in the performance of the property market across countries. While office rents increased or stabilized in Shanghai, Jakarta, and Kuala Lumpur, they fell in Beijing and Singapore. Similarly, with the exception of Shanghai, Bangkok, and Jakarta, office vacancy rates increased. Over the course of the year, these trends continued well up to the last quarter of 2001, the latest period for which data are available (Figures 13 and 14). The decline in office rentals between end-2000 and end-2001 ranged from 4.3 percent in Bangkok to 16.6 percent in Singapore. During the same period, the increase in office vacancy rates ranged from 0.4 percent in Kuala Lumpur to 5.5 percent in Beijing. However, in more recent months, rentals and vacancy rates are believed to have been firming up somewhat in some of the cities in the region, especially Seoul.

Figure 16: **Exchange Rate Indexes—Other East Asian Countries** (weekly average, last week of 2000Dec=100, $/local currency)



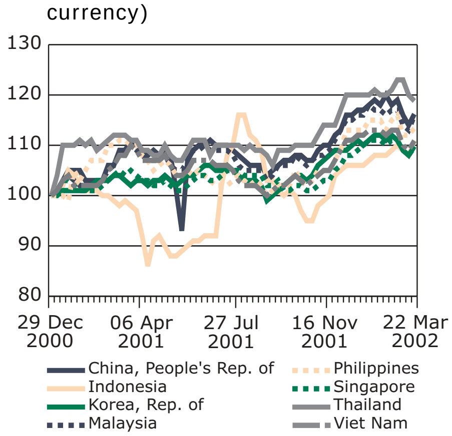
Source: REMU staff calculations derived from Bloomberg.

With the exception of the Indonesian rupiah, the Singapore dollar (and the Brunei dollar, which is pegged to the Singapore dollar), and the Korean won, most of the region's currencies, after weakening against the US dollar in the first quarter of 2001, remained relatively stable (Figures 15 and 16). Between the beginning of 2001 and 22 March 2002, the Indonesian rupiah had depreciated by about 4 percent, the

Singapore dollar by about 5 percent, and the Korean won by about 4 percent.

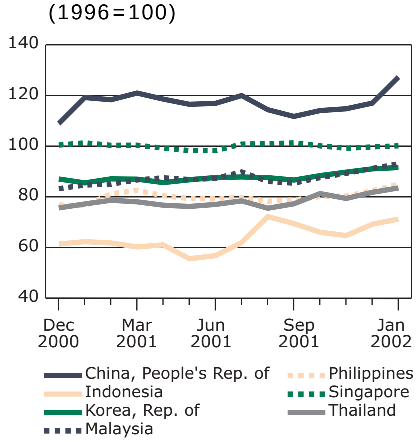
The PRC's exchange rate has not come under pressure, as foreign exchange reserves continue to increase and have crossed the $200 billion mark. Compared to end-2000, the Viet Nam dong has depreciated by about 4 percent, whereas the Cambodia real and the Lao kip have remained more or less unchanged. Pointing at the relative stability of many of the regional currencies against the US dollar in recent years, some analysts have characterized the recent exchange rate regimes in East Asia as a gradual reversion to the de facto dollar peg of precrisis years.

Figure 17: **Exchange Rate Indexes** (weekly average, last week of 2000Dec=100, yen/local currency)



Source: REMU staff calculations derived from Bloomberg.

Figure 18: **Real Effective Exhange Rate Indexes** (1996=100)



Source: ARIC Indicators.

Countries that maintained stable nominal exchange rates against the US dollar have, however, experienced a modest appreciation of their currencies against the Japanese yen (Figure 17). A large part of this appreciation took place after September 2001 when the yen started to depreciate against the US dollar. For example, between September 2001 and 22 March 2002, the appreciation of regional currencies against the yen have ranged from about 7 percent for the Singapore dollar to about 13 percent for the ringgit and peso.

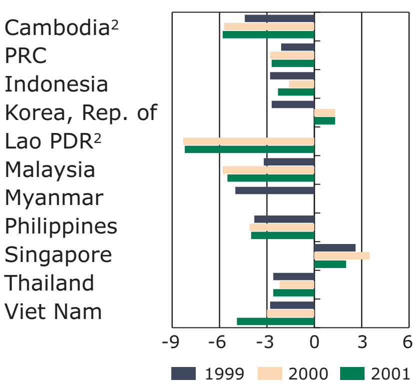
With the notable exception of Singapore (which has had a remarkably stable real effective exchange rate for many years now, even at the height of the Asian crisis—June 1997 to April 1998), the real effective exchange rates of several countries have started appreciating gradually, coinciding with their rise against the yen (Figure 18). The appreciation of real effective exchange rates since September 2001 has ranged from about 2.5 percent for Indonesia to 14 percent for the PRC. Korea (about 5 percent), Malaysia (about 6 percent), Thailand (about 8 percent), and Philippines (about 9 percent) fall in between. For most regional economies, this real appreciation comes after almost three and half years of relative stability in real exchange rates since March-April 1998.

Although real effective exchange rates are still lower than precrisis levels (by 30 percent for Indonesia and by about 15-18 percent for Korea, Malaysia, Philippines, and Thailand), the continued real appreciation of the currencies could erode the export competitiveness of these economies. Moreover, several regional currencies were significantly overvalued on the eve of the 1997 crisis, and those real appreciations contributed to the crisis. Hence, the fact that real effective exchange rates are still below precrisis levels should not be a cause for complacency.

Fiscal and Monetary Policies

To varying degrees, East Asian countries responded to last year's external shock with fiscal stimulus measures and interest rate reductions. The key challenge for many of them was to strike a balance between the gain in output and the deterioration in the external payments position that result from such policy responses. Those countries that had reasonably comfortable external payments positions (running large current account surpluses and holding sizable foreign exchange reserves) were better placed to relax fiscal policy and reduce interest rates, as were countries with comfortable fiscal positions and low inflation.

Figure 19: **Fiscal Balance**[1]
(% of GDP)

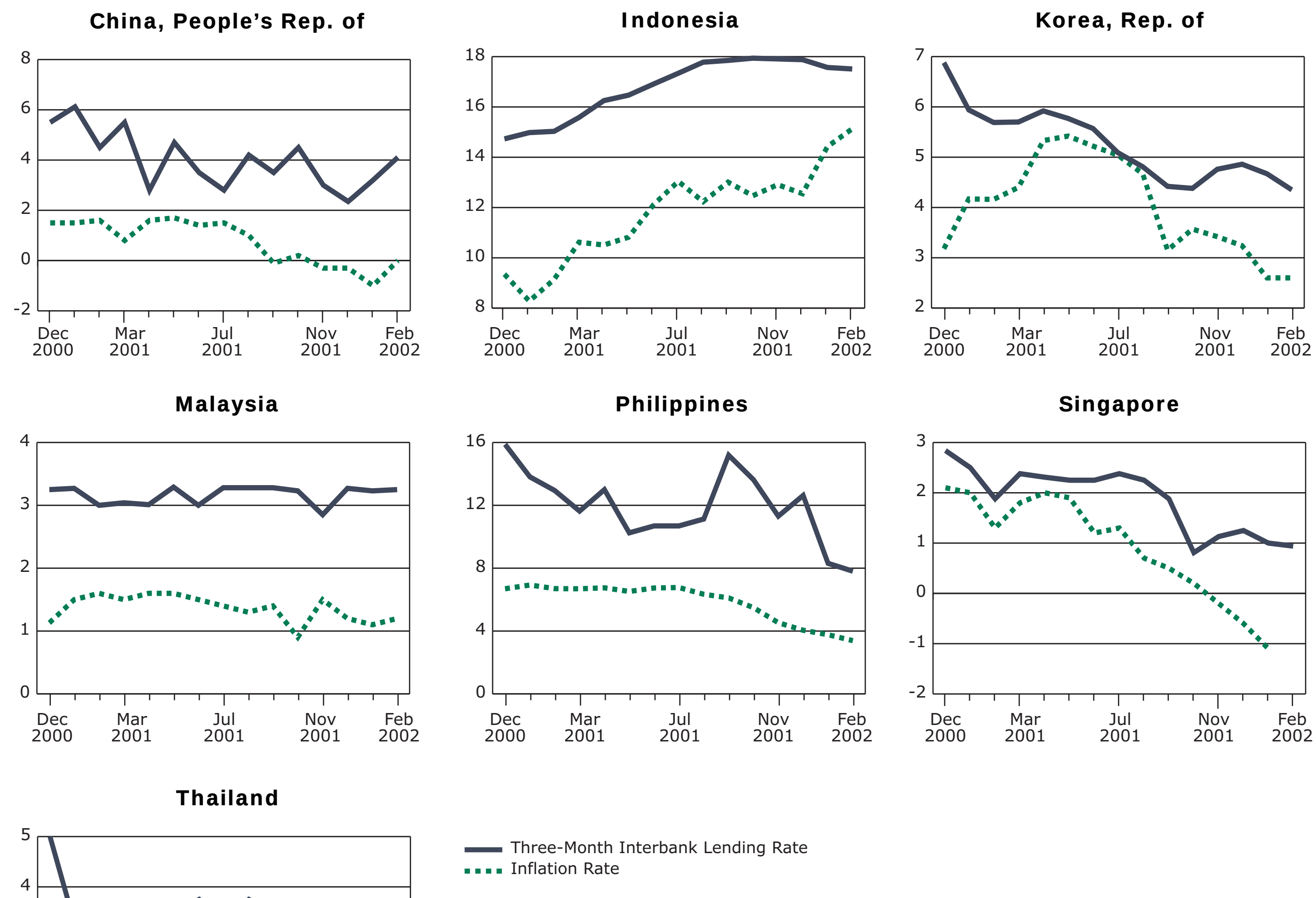


[1]Data refer to central government for Cambodia, PRC, Indonesia, Korea, Myanmar, Singapore, and Viet Nam; national government for Thailand; general government for Lao PDR; federal government for Malaysia; and consolidated public sector for the Philippines.
[2]Data are on a fiscal year basis (October-September) and refer to overall balance excluding grants.
Source: Ministry of Trade and Industry (Singapore); Bank of Thailand (Thailand); National Statistics Coordination Board and Bangko Sentral ng Pilipinas (Philippines); Bank of Korea; ADB staff estimates; IMF; *Lao PDR: First Review Under Poverty Reduction and Growth Facility; Cambodia: Article IV.*

Korea's fiscal response was to introduce a significant stimulus in its budget for 2001. Originally, the Government had planned to run a small fiscal deficit in 2001 compared to a surplus of about 1.3 percent of GDP in 2000 (Figure 19). Toward that end, the Korean Government intended to increase its expenditures by about 11 percent and frontload two thirds of its expenditure during the first half of the year. However, because government revenues increased faster than originally expected and actual spending fell short of planned levels, in the first half of the year, the fiscal stimulus ran into problems. In response, in June 2001, the Government introduced a supplementary budget that incurred additional expenditures (worth about W5 trillion) on improving educational facilities, national health insurance, and employment creation schemes. Despite all these efforts, actual government expenditures fell far short of budgeted figures, while total revenues surpassed original targets. As a result, the budget actually ended with a fiscal surplus equivalent to 1.4 percent of GDP. However, excluding social security fund, the consolidated fiscal balance posted a deficit of 1.5 percent of GDP as compared to a deficit of 1.2 percent in 2000. Unlike fiscal policy, monetary policy was more decisive. The Central Bank cut interest rates significantly. As a result, the three-month interbank lending rate fell from 6.9 percent in December 2000 to 4.4 percent in February 2002 (Figure 20). The interest rate reductions were helped along by the gradual decline in inflation from more than 5 percent in the second quarter of last year to less than 3 percent in February 2002.

With an increase in the bank deposit rate in June 2001, Thailand appeared to be reversing its earlier accommodative monetary policy stance. However, it turned out later that the June 2001 interest hike was just a one-off event, and the country has cut interest rates since then. As a result, the three-month interbank lending rate in Thailand has gradually

Figure 20: **Interest and Inflation Rates** (%, end of period)



Source: ARIC Indicators.

fallen from 5 percent in December 2000 to 2.3 percent. On the fiscal front, tax cuts and special schemes aimed at spurring activity in the rural economy, small and medium enterprises (SMEs), and the tourism sector were the key components of the stimulus package. A special discretionary spending program of B58 billion ($1.3 billion), the bulk of which is earmarked for the agricultural and tourism sectors, has been introduced. In addition, a revolving Village Fund of B77 billion ($1.8 billion) was established with the Government Savings Bank for onlending to residents in each of Thailand's 70,000 villages.

Not all of these fiscal stimulus measures are reflected in the 2001 calendar year fiscal balances reported in Figure 19, as many of these expenditure programs are included in the budget for the fiscal year 2001-2002 (October 2001 to September 2002). Hence, this will be reflected in the fiscal deficit for 2002. At about 58 percent of GDP in 2001, Thailand's public debt level is only marginally lower than that of the Philippines. More recently, however, the Government has taken encouraging steps towards fiscal consolidation, such as setting a ceiling on public debt and a target of balanced budget within the next five years.

The Philippines responded strongly with substantial interest rate reductions. The three-month interbank lending rate was halved from 15.9 percent in December 2001 to about 7.8 percent in February 2002. As in the case of Korea, the interest rate reductions were helped by the gradual decline in inflation. The Philippines was, however, constrained in providing major fiscal stimulus measures, as the national government's fiscal deficit was already 4.1 percent of GDP in 2000. Moreover, for some time, the country's public debt has hovered around 70 percent of GDP. There was a consensus that the country needed to gradually reduce the fiscal deficit, consolidate the fiscal position, and restore lost fiscal credibility. Hence, fiscal restraint rather than fiscal expansion has underpinned the policy agenda of the Philippine Government.

The PRC's policy response was somewhat akin to that of the Philippines: interest rates were cut during the year, but the magnitude of the fiscal deficit in 2001 was more or less the same as in the previous year. As the PRC's already low inflation has further trended down during the course of the year, the three-month interbank lending rate has fallen from 5.5 percent in December 2000 to 4.1 percent in February 2002 (although there have been significant monthly fluctuations during the period). With regard to fiscal policy, the national Government started running fiscal deficits (of about 2.5 to 3 percent of GDP) after the 1997 Asian financial crisis. In 2001, that fiscal stance was maintained. However, unlike Korea or Malaysia, the PRC has not responded by significantly increasing the size of the fiscal deficit. Given that the PRC's economic slowdown last year was mild, such a stance was perhaps more appropriate. Moreover, there is the concern that once the quasi-fiscal expenditures, which are not included in the official budget, are taken into account, the PRC's public sector deficit could be as high as 8 percent of GDP and the public debt stock could be about 50 percent of GDP.

Malaysia went in for a substantial fiscal expansion, but did not cut interest rates. To start with, inflation and interest rates in Malaysia were low compared to the Philippines and Thailand. With inflation remaining low and stable at about 1-1.5 percent during most of last year, Malaysia maintained its short-term interest rate at about 3 percent. However, the country had larger scope for fiscal expansion, as its stock of public debt was low by international standards at about 35 percent of GDP. The depth of Malaysia's economic slowdown last year also warranted substantial fiscal stimulus, something that the country recognized. The original budget for 2001 was supplemented by two additional spending packages mainly on public works and infrastructure development. Hence, in 2001, for a second year in succession, Malaysia ran a fiscal deficit of more than 5 percent of GDP.

Inflation and interest rates in Singapore were lower than in Malaysia during 2001. The already low inflation (of about 2 percent in December 2000) has gradually yielded to mild deflation. In line with this trend, the three-month interbank lending rate has gradually declined from 2.8 percent in December 2000 to less than 1 percent in February 2002. Singapore's fiscal stimulus measures consisted largely of tax rebates and reductions rather than expenditure increases. These measures consisted of rebates on corporate and personal income, and property taxes, as well as on rentals on public properties used for commercial and industrial purposes.

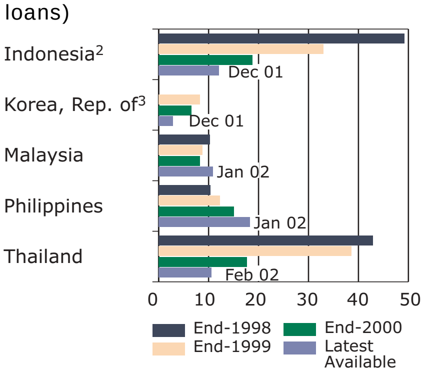
Indonesia was in a delicate position when faced with formulating an appropriate fiscal-monetary policy response to last year's external shock. For one thing, unlike in other countries, inflation has not only been high but also rising for most of the last year or so. This constrained policymakers from reducing interest rates. In fact, given the uptick in inflation (from about 9 percent in December 2000 to more than 15 percent by February 2002), short-term interest rates had to increase (from about 15 percent in December 2000 to 18 percent in February 2002). As for the fiscal situation, although the country's fiscal deficits were not large in recent years, Indonesia already had the highest public debt to GDP ratio in the region (at about 90 percent of GDP in 2000). In addition, shortfall in revenues and lower disbursements from external official creditors due to delays in receiving disbursements were common in recent years. The scope for fiscal expansion to counter the external shock was, therefore, limited in Indonesia. In fact, the Government had to take several austerity measures in 2001. These included hiking domestic energy prices, increasing the tax on interest income from bank deposits, increasing sales tax on luxury goods (including beverages, electronic products, cars, and large houses and apartments), introducing a value added tax on agricultural products, and scaling back public spending. Despite these revenue mobilization and expenditure containment measures, the central Government fiscal deficit for 2001 turned out to be slightly larger than in the previous year.

Among the newer ASEAN members, given the stability of prices last year, Viet Nam kept interest rates more or less stable, but incurred a larger fiscal deficit in 2001 (4.9 percent of GDP) compared to 2000 (3 percent of GDP). The fiscal and monetary stance in Lao PDR, meanwhile, seems to have remained more or less unchanged during 2001, with interest rates and the fiscal deficit stable. Against the backdrop of stable prices for much of last year, Cambodia maintained a fiscal deficit of about 6 percent of GDP, more or less the same level as in the previous year. In Myanmar, interest rates were stable, and the fiscal deficit is believed to have remained at about 5 percent of GDP.

Financial and Corporate Restructuring

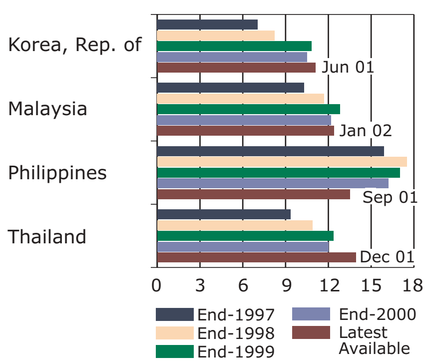
With some notable exceptions, the banking sectors of the five crisis-affected countries posted encouraging results. The ratio of nonperforming loans (NPLs) in bank balance sheets continued to decline (with the exception of Malaysia and the Philippines), banks' capital adequacy ratios stayed above the Basle norm of 8 percent, and bank profitability, although still below precrisis levels in Malaysia and the Philippines, is increasing (Figures 21 through 23).

Figure 21: **NPLs[1] of Commercial Banks** (% of total commercial bank loans)



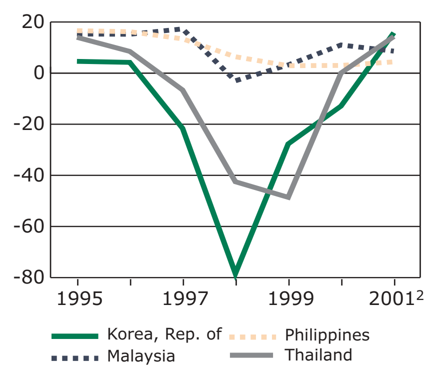
[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis in Malaysia, three months or more in Korea and Thailand.
[2]Refer to NPLs in banking sector.
[3]NPL criteria were changed in December 1999, so no comparable data are available prior to that date.
Source: ARIC Indicators.

Figure 22: **Capital Adequacy Ratios of Commercial Banks** (%)



Source: ARIC Indicators.

Figure 23: **Banking Sector Profitability[1]** (%)



[1]Data refer to average return on equity of commercial banks except for Malaysia, which refer to listed commercial banks only.
[2]Except for Thailand, data are annualized estimates based on partial year information.
Sources: Web sites of the Financial Supervisory Service, Bangko Sentral ng Pilipinas, Stock Exchange of Thailand, and Bloomberg.

In recent years, the ratio of NPLs in bank balance sheets has fallen substantially in Indonesia (from as high as 50 percent in 1998 to about 12 percent in December 2001) and Thailand (from about 43 percent in 1998 to about 10 percent in February 2002). Korean banks, which had much lower NPL ratios to begin with, have reduced their NPLs to about 3 percent of their total loans in December 2001. In Malaysia, however, the decline in the NPL ratio was reversed last year, due largely to the sharp economic slowdown and its adverse effects on corporate borrowers from banks. As a result, the NPL ratio, although declining somewhat in recent months, has climbed back close to its 1998 level of more than 10 percent. The Philippines has been the sole exception in showing a steady rise in its banking sector NPL ratio, from about 10 percent in 1998 to more than 18 percent. Among the five crisis-affected countries, the NPL ratios now range from 2.9 percent (Korea) to 18.3 percent (Philippines).

Compared to 1998, capital adequacy ratios (CARs) of the banking system have improved in most of the crisis-affected countries, except in the Philippines where it is now about 2.5 percentage points lower than in 1998. Despite this decline, at 13.5 percent, the Philippine banking system has a CAR that is still much higher than the Basle norm. Among the five crisis-affected countries, CARs now range from 11 percent (Korea) to 13.9 percent (Thailand).

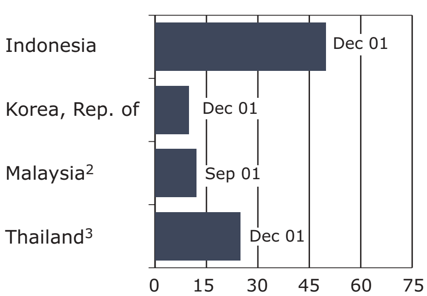
Banking sector profitability, as measured by the average return on equity, has also shown improvements in many of these countries. At the height of the Asian financial crisis, the banking sector’s average return on equity plunged to as low as –80 percent in Korea and –50 percent in Thailand. Recent years have witnessed a sharp recovery in bank profitability in these countries. The average return on equity is now in the range of 4.4 percent in the Philippines to 15.8 percent in Korea, with Thailand (14.3 percent) and Malaysia (8.6 percent) in between.

Caution should, however, be exercised in interpreting the improvements in bank balance sheets. First, more often than not, banking sector profitability tends to be a lagging rather than leading indicator of banking sector health. The sharp recovery of economic activity during 1999 and 2000 contributed to the recent improvement in bank profitability. By the same token, last year’s economic slowdown will eventually be reflected in poor banking sector profitability. A case in point is the increasing instances of reentry of previously restructured loans as NPLs in bank balance sheets in some of these countries. Second, it is not clear that a CAR in excess of the 8 percent Basle norm provides adequate protection against the volatility and risks that banks in emerging markets face. Indeed, proposals contained in the New Basle Accord, established in 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. Third, the sharp decline in banking sector NPLs in the region, notably in Indonesia and Thailand, reflects the transfer of problem loans from banks' balance sheets to publicly funded asset management companies (AMCs). When NPLs held by the AMCs are added to those still in the banking system, the picture is less promising. These aggregate NPL ratios are as high as 50 percent in Indonesia and 25 percent in Thailand (Figure 24).

The high aggregate NPL ratios reflect the fact that the AMCs have been able to dispose of only a small proportion of the NPLs transferred to them by banks. For example, by December 2001, as much as 88 percent of the banks' problem loans had been transferred to the Indonesian Bank Restructuring Agency (IBRA) (Figure 25). However, IBRA has been able to dispose of only about 7 percent of these NPLs, retaining most of the banking sector's NPLs that it purchased. Similarly, in Thailand, by end-2001, about half of the banking sector's NPLs (equivalent to B700 billion) have been transferred to the centralized Thai Asset Management Company (TAMC). Out of these amounts, TAMC has resolved about one-fifth.

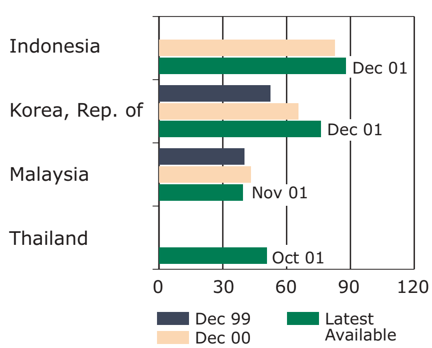
Only in Korea and Malaysia have AMCs been able to dispose of a significant portion of the NPLs they acquired from banks. In Korea, by December 2001, about 76 percent of the banking sector's NPLs had been transferred to the Korea Asset Management Corporation (KAMCO), which had disposed of about 58 percent of these NPLs in January 2002 (Figure 26). In comparison to other countries, Malaysia transferred a

Figure 24: **NPLs Including Transfers to AMCs[1], Net of Disposals** (%)



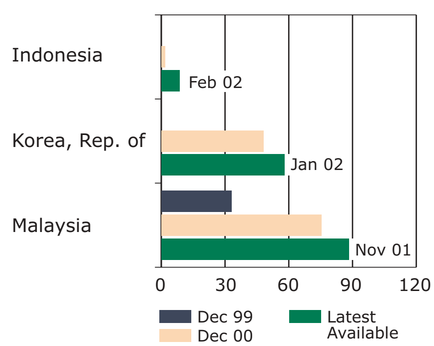
[1]NPLs are on a three-month accrual basis in Malaysia, three months or more in Korea and Thailand. These also refer to NPLs in the financial system, except Indonesia, which is for the banking system.
[2]Loans purchased by Danaharta are valued in Total Loan Rights Acquired.
[3]Data include transfers to private AMCs and assume no NPL disposals.
Sources: Bank Indonesia, IBRA, Financial Supervisory Service, KAMCO, Bank Negara, Danaharta, Bangko Sentral ng Pilipinas, Bank of Thailand.

Figure 25: **NPLs Purchased by AMCs*** (% of total NPLs)



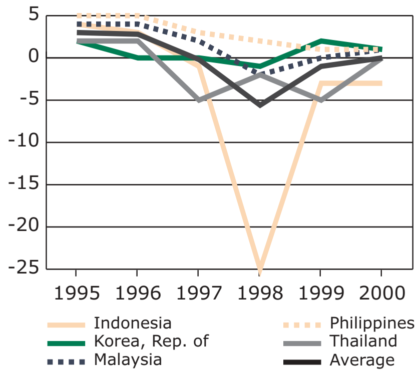
*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia, as of the dates indicated.
Source: ARIC Indicators.

Figure 26: **NPLs Disposed of by AMCs*** (% of NPLs purchased)



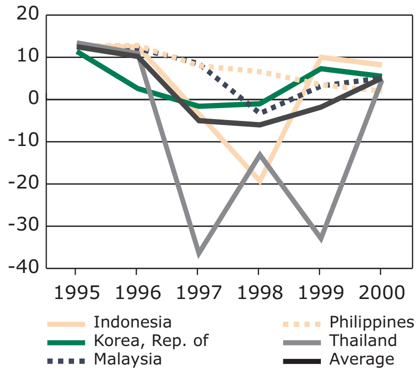
*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia, as of the dates indicated.
Source: ARIC Indicators.

Figure 27: **Corporate Return on Assets** (%, weighted average)



Note: Data cover corporations whose stocks are included in the composite indexes of their respective markets. For Korea, only the companies comprising the KOSPI 200 (Korea Stock Price Index) are included.
Source: REMU staff calculations derived from Bloomberg.

Figure 28: **Corporate Return on Equity** (%, weighted average)



Note: Data cover corporations whose stocks are included in the composite indexes of their respective markets. For Korea, only the companies comprising the KOSPI 200 (Korea Stock Price Index) are included. ROE=Net Profit(Loss)/Total Stockholder's Equity. In the case of ROE, companies with negative reported equity values are excluded.
Source: REMU staff calculations derived from Bloomberg.

smaller share of banking sector NPLs (about 40 percent) to its AMC, Danaharta, which has disposed of about 88 percent of these. Hence, at about 12 percent, the aggregate NPL ratio in Malaysia is quite close to the NPL ratio in banks' balance sheets alone. Since the Philippines has not set up an AMC, its aggregate NPL ratio of about 18 percent is higher than that of Korea and Malaysia, but lower than that of Indonesia and Thailand.

One of the reasons for the high aggregate NPL ratios is the slow progress in the operational restructuring of the corporate sectors among the crisis-affected countries.[2] No doubt, in recent years, countries have made some progress in financial restructuring of their corporate sectors through debt rescheduling, debt-equity swaps, debt forgiveness, and indexation of interest payments to earnings, etc. However, progress in operational restructuring of the corporate sectors—improvements in efficiency and management, streamlining of business lines, mergers and acquisitions, closing down of nonviable business units, reductions in staff and wages, etc.—has been slow. In many cases, corporate restructuring has not involved changes in management. Moreover, banks and AMCs are not only reluctant to take measures such as selling off nonperforming assets or converting debt into equity, they are also lax in forcing corporations to close nonviable businesses, sell overvalued assets, and undertake other forms of operational restructuring.

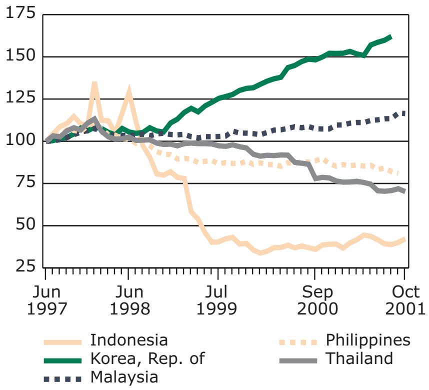
A good indicator of the progress in operational restructuring is the trend in corporate profitability measured as return on assets or equity (Figures 27 and 28). With the exception of Korea, corporate profitability in the crisis-affected countries, although improving, has remained below precrisis levels. Last year's region-wide economic slowdown must have made a further dent in corporate profitability.

Trends in the stock of real bank credit to the private sector—a composite proxy indicator of the progress in both banking and corporate restructuring—are not encouraging either. Except for Korea and Malaysia, they are continuing to decline and remain significantly below precrisis levels (Figure 29).

Experience from other countries suggests that AMCs are best used for financial rather than operational restructuring. One reason is the lack of skills at commercial banks and AMCs, but political factors

[2]For a detailed discussion of the progress in corporate restructuring among the five crisis-affected countries and the challenges ahead, see the theme chapter of AEM, December 2001.

Figure 29: **Real Bank Credit*—Five Crisis-Affected Countries** (1997June=100), seasonally adjusted



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

also have limited the ability of publicly-owned agencies to force through difficult corporate restructuring. For instance, governments are reluctant to fire excess workers and close nonviable businesses. More generally, they have practiced various forms of regulatory forbearance against banks and other financial institutions to soften the impacts of corporate restructuring. At times, this has led to the propping up of large distressed companies, often those controlled by the politically well connected. In addition, governments had to continue to balance the interests of various constituencies, such as demands for wage increases from workers, with the viability of the corporate sectors.

Outside the five crisis-affected countries, several countries in the region are making efforts at restructuring their financial and corporate sectors. These reform programs are at different stages.

The PRC has continued to carry forward its banking sector reforms initiated in the aftermath of the 1997 Asian financial crisis. Official estimates place combined NPLs of the four State banks at 25.4 percent of their total assets at the end of last year. This constitutes a decline from 29.2 percent at the end of 2000. However, these figures do not include the NPLs still held by the four AMCs that were set up in 1999. If these are included, the NPL ratio at the end of last year would be higher at about 32 percent. However, it is important to note that these official estimates of NPLs in the PRC are not based on internationally comparable norms. Many observers believe that if these are applied, the extent of NPLs in the PRC's banking system would be much higher than the official estimates. Capital adequacy figures for the banking system are not reported in the PRC, but unofficial estimates suggest that many banks would have negative net equity if assets were to be classified according to international standards.

Recognizing some of these problems, at the beginning of 2002, the PRC Government adopted a new loan classification system for all domestic banks. The system, which is in line with international practice, had already been tried by a few banks for the past three years on a pilot basis. In conjunction, guidelines on loan-loss provision have also been introduced. The Government expects NPLs to be higher under this system, but intends to reduce the NPL ratio of the banking system by 2-3 percentage points annually over the next few years. Achievement of this NPL reduction target would depend on success in reforming and restructuring PRC's State enterprises, to which the State banks have large exposure.

In Viet Nam, State Banks have a sizable portfolio of NPLs, owed mostly by unprofitable State enterprises. Official estimates place these NPLs for the four large State banks at about 10 percent of the total portfolio of banks, whereas if international loan classification norms are applied, NPLs are believed to be higher at about 30 percent. In March 2001, the Government adopted an overall reform program for the State banks and developed restructuring plans for the State enterprises. The State enterprise reform program provides for restructuring of about 1,800 SMEs through liquidation and mergers. Due to difficulties in resolving inter-enterprise debt, valuation of enterprise assets, and handling labor redundancy, progress in State enterprise reform program was slow in 2001. Even if the Government achieves greater success in its reform program, the remaining task in the area of enterprise reform and restructuring will be huge. The current reform program does not cover the larger and more capital-intensive enterprises that account for about 90 percent of the total State enterprise debt owed to the banks.

The banking sector in Lao PDR is also saddled with sizable NPLs, although their exact magnitudes are difficult to pin down given the limited availability of data. Some estimates place the NPL ratio in Lao PDR's banking sector in the range of 30 to 40 percent. The Government is concerned about the fragility of the banking system and is making efforts to tackle the problem of NPLs with banks. The country has introduced a new loan classification system that is more in line with international practice as well as credit appraisal procedures. Beginning this year, full provisioning by the banks for NPLs incurred after 2000 has been made mandatory.

Available data indicate that, at about 12 percent, Cambodia's NPL ratio in the banking system, which is predominantly privately owned, is much more manageable than in many other countries in the region. Nevertheless, Cambodia is undertaking several measures to strengthen its banking sector. Following up on the promulgation of a new law on Banking and Financial Institutions in 1999, the National Bank of Cambodia, the central bank of the country, placed 11 insolvent banks up for liquidation in December 2000. Meanwhile, the banking supervision capacity of the National Bank of Cambodia is being strengthened through training and on-site inspection. A new law on Negotiable Instruments and Payments Transactions has been recently drafted and is scheduled to be submitted for approval by the Legislature by May 2002. With assistance from the Asian Development Bank (ADB), a blueprint for financial sector development for 2001-2010 was prepared.

Prospects for East Asia's Growth and Recovery

External Economic Environment

When the December 2001 AEM was released, the external environment confronting East Asia was deteriorating rapidly. Using a variety of economic indicators, in November the Business Cycle Dating Committee of the US National Bureau of Economic Research, which is the official arbiter of American recessions, declared that the US had been in recession since March 2001. US GDP was estimated to have declined for two successive quarters in the second half of 2001—another indication that the country was in recession beginning in the third quarter of last year. Although there was a growing consensus at that time that the US recession would be mild and short-lived, the possibility that it would turn out to be deeper and more prolonged was not ruled out. Moreover, the 11 September attacks and the subsequent US-led military operations in Afghanistan introduced additional uncertainties to an already fragile US and world economy.

However, global economic developments since December 2001 have turned out to be more favorable. First, as the December AEM had conjectured, the impacts from 11 September and subsequent events have, so far, turned out to be less disruptive to East Asian economies than was originally feared. In fact, stock markets rebounded quickly and exceeded pre-attack levels, while bond spreads, after rising initially, fell quite quickly below pre-attack levels. Although "security taxes" in the form of higher insurance premiums and transport costs have increased, these are unlikely to have a major effect on trade. Perhaps the most important effect of 11 September has been the slowdown in tourism incomes for the Philippines and Thailand, but the magnitude of this effect suggests that it is manageable. Second, and perhaps more important, the US economic downturn has turned out to be even shorter and milder than was thought in December. In fact, data released for the last quarter of 2001 show that, applying the commonly-used definition of recession as two successive quarters of GDP contraction, the US economy did not even fall into recession. It perhaps was only a case of an economic slowdown. A number of macroeconomic indicators from the US, data on which have become available in recent months, suggest that the US is set to achieve a faster than expected, although moderate, recovery this year (See Box 3).

Last year's experience showed that Europe's economic prospects are fairly well synchronized with the performance of the US economy. An

Box 3: **Faster than Expected, but Moderate US Recovery**

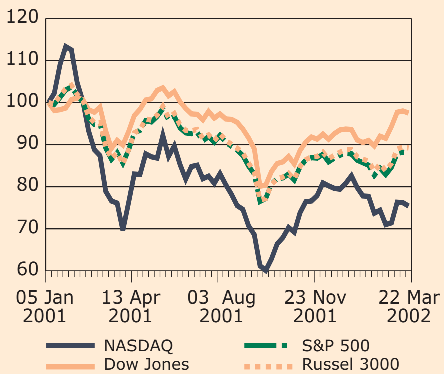
Most of the data and numbers released in the US over the past few weeks suggest an economic rebound that came faster than was expected in the fourth quarter of last year, especially in the immediate aftermath of the 11 September attacks on the US. However, weaknesses persist in one key aspect of the US rebound: fixed investment and business confidence. On balance, these indicators suggest that a moderate recovery has already started in the US, although some question its sustainability, pointing out the confluence of imbalances—record debt levels, minimal savings, excess capacity, and massive current account deficit (see Risks to Regional Growth and Recovery, page 31).

US financial markets have remained bullish in recent months. Major US stock price indexes, after falling sharply immediately after 11 September, have generally trended up since then (Figure 3.1). The increases in the stock prices since their worst levels in September 2001 range from 19 percent in the S&P 500 to 29 percent in the NASDAQ.

On the production side, growth in industrial production, having decelerated during the first nine months of last year, has turned around since October (Figure 3.2). Similar trends are also noticeable in housing starts, which is an indicator of residential construction activity. Moreover, some forward-looking indicators also suggest that the recent economic activity could remain strong in the future. The Purchasing Managers Indexes (which proxy the planned orders for goods by the purchasing managers of a sample of companies), both for the manufacturing and non-manufacturing sectors, have entered an expansionary phase since October (Figure 3.3).

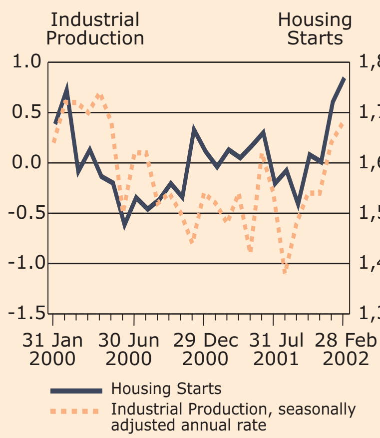
On the aggregate demand side, US consumer spending showed remarkable resilience during last year's economic slowdown. Immediately after 11 September, consumer confidence indexes fell, but have recovered somewhat since October-November 2001 (Figure 3.4). March witnessed the biggest surge in consumer confidence in 25 years. Similarly, retail sales have also shown encouraging trends in recent months, after being affected temporarily by the 11 September events (Figure 3.5). The recent rally in stock

Figure 3.1: **US Stock Market Indexes** (weekly average, week ending 5 Jan 2001=100)



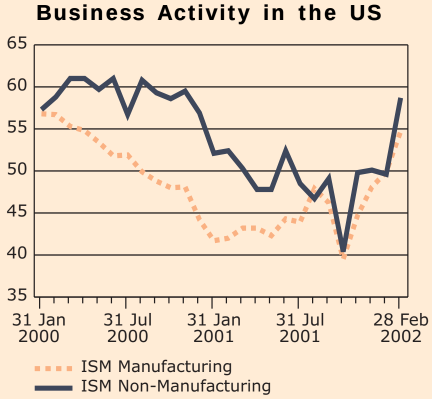
Source: REMU staff calculations derived from Bloomberg.

Figure 3.2: **US Industrial Growth** (%) **and Housing Starts** (thousands of units)



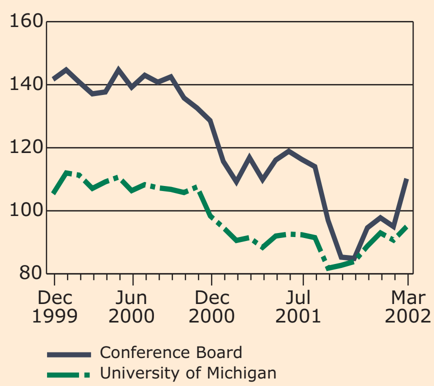
Source: Bloomberg.

Figure 3.3: **Surveys of Business Activity in the US**



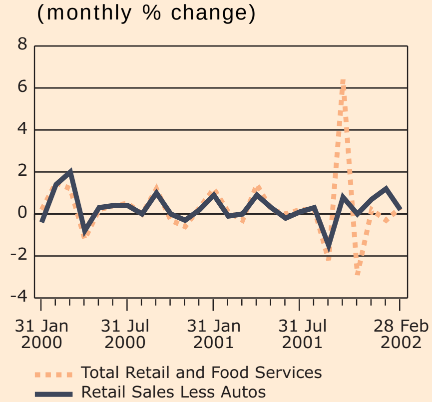
Source: Bloomberg.

Figure 3.4: **US Consumer Confidence Index**



Note: Conference Board numbers are released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

Figure 3.5: **US Retail Sales** (monthly % change)

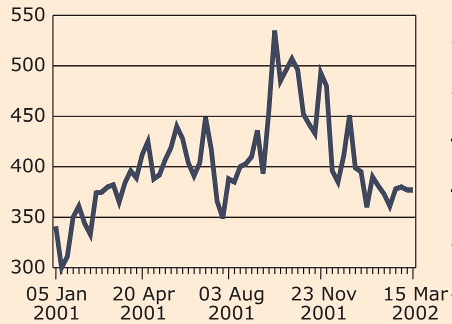


Source: Bloomberg.

Continued next page

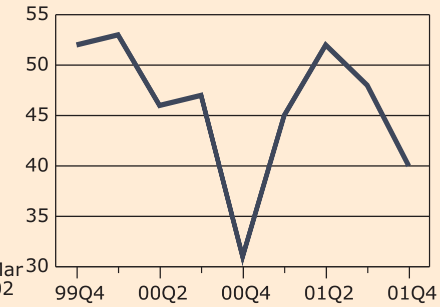
Box 3: **Faster than Expected, but Moderate US Recovery** (Cont'd)

Figure 3.6: **US Initial Jobless Claims, Weekly** (US dollars)



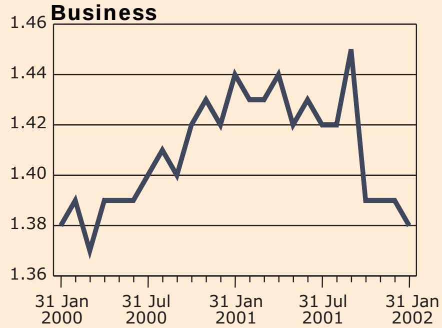
Source: Bloomberg.

Figure 3.7: **US Business Confidence Index** (Conference Board)



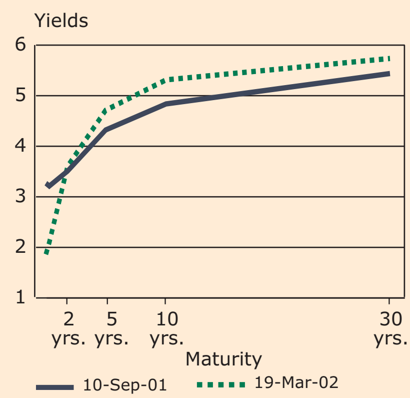
Source: Bloomberg.

Figure 3.8: **Inventories to Sales Ratio in US—Total Business**



Source: Bloomberg.

Figure 3.9: **US Treasury Bond Yield Curves** (% per annum)



Source: Bloomberg.

prices should support consumer spending, as should the decline in initial jobless claims (Figure 3.6). The fall in the unemployment rate in January and February this year, having increased for five consecutive months, should also augur well for US consumer spending.

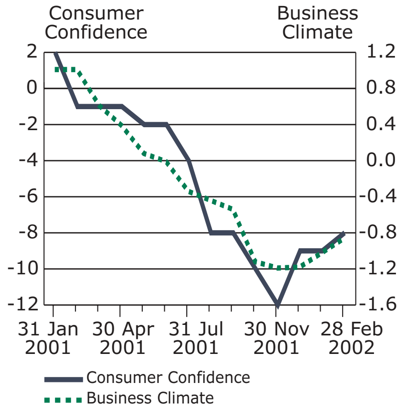
Unlike in the case of consumer confidence, the US business confidence index, data on which are available only until the last quarter of 2001, does not indicate a turnaround in business investment (Figure 3.7). However, business inventory demand—a component of investment demand that plays a key role in timing the turning points of a business cycle—should support an early economic rebound. Along with weak business fixed investment, the drawing down of inventories was a major factor holding down GDP growth last year. The US Federal Reserve Board's (FED) estimates suggest that about 1.25 percentage points of the slowdown in US GDP growth last year were attributable to the decline in nonfarm inventory investment. However, because sales were also weakening, the inventory-to-sales ratio remained high and even increased in much of manufacturing. Now that sales have picked up but inventories are low, the inventory-to-sales ratio has fallen sharply in the beginning of this year (Figure 3.8). Businesses are now restocking and this will provide an important fillip to the first quarter rebound in the US.

The fiscal stimulus measures that were introduced last year as well as those that are planned for this year should provide a modest stimulus to US aggregate demand. Because of the fiscal stimulus (including the tax rebates), the fiscal surplus in 2001 was $127 billion (1.25 percent of GDP)—well below both the record $281 billion surplus recorded in 2000 and the $281 billion surplus that the Government had budgeted for 2001.

The US bond market is also indicating that economic recovery is around the corner. The yield curve for US Government bonds (a schedule that relates bond yields with the corresponding maturities) has steepened modestly over the last six months (Figure 3.9). The steepening of the yield curve, (which means that the yield differential between bonds of short and longer term maturities is increasing) is an indication that the bond market expects recovery to be around the corner and that the FED will raise interest rates soon to smoothen the recovery in economic activity.

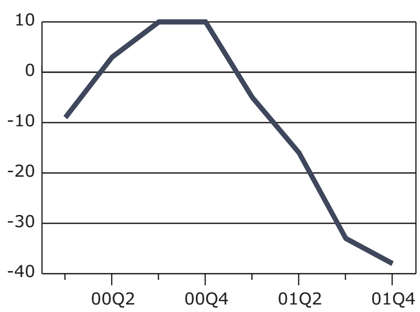
early US recovery should, therefore, provide a lift to Europe. In 2001, close on the heels of the US slowdown, growth in the 12-nation European Union (EU) decelerated to 1.5 percent from the 3.3 percent achieved in 2000. In fact, in the last quarter of 2001, EU GDP declined

Figure 30: **European Union Consumer Confidence and Business Climate Indicators**



Business Climate Indicator: A high level indicates that, overall, the survey points to a healthy cyclical situation. Its movement is linked to the industrial production of the Euro area.
Consumer Confidence Indicator: Represents the arithmetic average of the answers (balances) to the four questions on the financial situation of households and general economic situation (past and future) together with that on the advisability of making major purchases.
Source: Bloomberg.

Figure 31: **Business Conditions Indicator in Japan** (Tankan Survey)



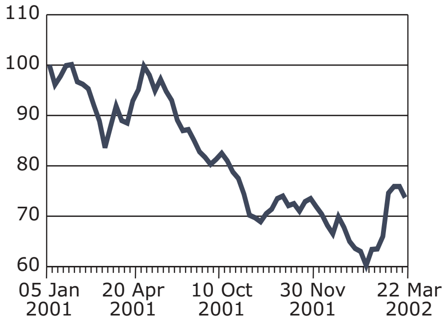
Source: Bloomberg.

by 0.2 percent on a quarter-on-quarter (q-o-q) basis (or by 0.6 percent on an annualized basis), its first quarterly fall since 1993. Despite this last quarter drop, there are increasing signs that, with the US recovering, the EU will not be far behind. Consumer confidence and business climate indicators in the EU have improved somewhat in recent months (Figure 30). Also, the Reuters-NTC Research index—a composite index of buying intentions of purchasing managers in Europe—topped 50 in February this year, indicating economic expansion for the first time since August last year.

Emerging economic trends in Japan, the world's second largest economy, are, however, less encouraging. With GDP contracting in the last three quarters, the overall decline in 2001 was 0.8 percent. The unemployment rate is at a record high level. For the 11th consecutive year, property prices fell—by about 6 percent in 2001—the fastest annual decline for almost a decade. GDP is expected to contract this year as well, making it the first time in the postwar period that the Japanese economy has contracted for two consecutive years. As of the end of last year, the Tankan Survey of business conditions continued to point toward depressed economic prospects (Figure 31). However, there are some tentative signs that the economy may soon bottom out. First, business inventories are at their lowest levels since 1990, following last year's sharp reduction of the sort that typically presages a pickup in factory production. Second, the stock market has witnessed a sharp rally in recent weeks; the Nikkei stock market index gained more than 20 percent in just about a month (Figure 32). Third, because of the recent monetary easing by the Bank of Japan, the country's monetary base is surging at a more than 25 percent annualized rate. This pace of monetary expansion is four times the historical average and the fastest rate since 1974. Fourth, a faster than expected US rebound would extend a helping hand to Japan's exports. A positive assessment is also reflected in the Japanese Government's latest monthly report on the economy. For the first time in the last 21 months, in its March report on the economy, the Japanese Government said that the economy was showing signs of bottoming out in some areas. This is an improvement over its February assessment that the economy was continuing to deteriorate.

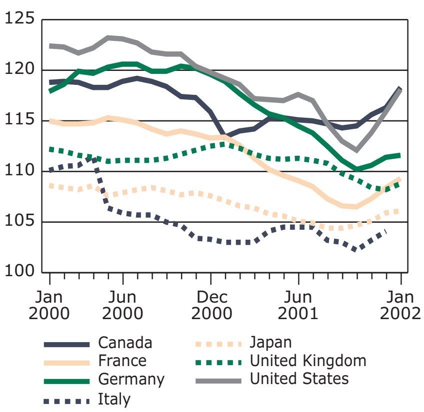
Reflecting improved economic prospects for the industrial countries, the composite leading indicators for most members of the Organisation for Economic Co-operation and Development (OECD) have trended up since October last year (Figure 33). Forecasts of GDP growth for the industrial countries in general and US economy in particular have been revised up in recent months by most forecasters.

Figure 32: **Nikkei 225** (weekly average, week ending 5 January 2001=100)



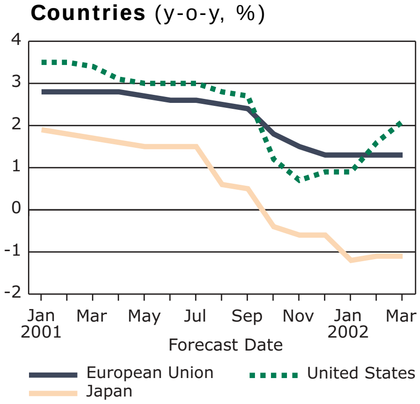
Source: REMU staff calculations derived from Bloomberg.

Figure 33: **OECD Leading Indicators**



Source: OECD.

Figure 34: **Consensus Forecasts of 2002 GDP Growth—Industrialized Countries** (y-o-y, %)



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

Consensus Economics (a private institution that collates forecasts from economic and financial forecasters for more than 70 countries around the world) now (11 March survey) places its mean forecast (from 31 forecasters) of US GDP growth for 2002 at 2.1 percent (Figure 34). This is about 0.9 percentage points higher than the mean forecast made in October 2001. The upward revisions have been particularly large since January this year. The current forecast is half a percentage point higher than the February forecast and 1.2 percentage points higher than the January forecast. Within 2002, the year-on-year (y-o-y) quarterly GDP growth rates are forecast to accelerate from 0.9 percent in the first quarter to about 3.4 percent by the last quarter, a rate that is expected to be maintained throughout 2003. Consensus Economics' mean forecast of US GDP growth in 2002 is higher than the World Bank's forecast of 1.3 percent made in March 2002 (World Bank, *Global Development Finance,* March 2002), but is lower than the US Federal Reserve Board's March forecast of 2.5-3 percent.

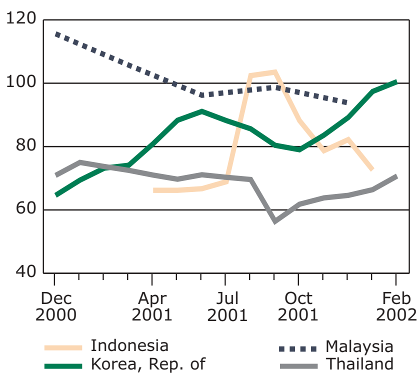
At 1.1 percent, the mean forecast of 2002 GDP contraction (from about 20 forecasters) in Japan is unchanged from February. This is an improvement from the continuous downward revisions issued from July 2001 to January 2002. The quarterly time profile of Japan's GDP contraction in 2002 indicates that from a y-o-y GDP contraction of 2.4 percent in the first quarter of this year, Japan's GDP is expected to stabilize in the last quarter, culminating in about –1.1 percent GDP growth in 2002. Consensus Economics' mean forecast for this year's GDP contraction is slightly lower than the World Bank's latest forecast of a 1.5 percent contraction.

The mean forecast of 2002 GDP growth for EU is 1.3 percent, more or less the same rate forecast since December 2000. As in the case of Japan, the forecast is stabilizing, reversing the downward revisions that took place in the aftermath of 11 September. The 1.3 percent growth forecast for 2002 is marginally lower than the 1.5 percent growth EU achieved last year. But it is comparable to the 1.2 percent forecast made by the World Bank in March this year, and appears to be lower than the forecast made by both the European Commission and the European Central Bank in March.

Overall, Consensus Economics predicts an average GDP growth of 1.4 percent in 2002 for about 70 countries (developed and emerging market economies) it covers. The latest (mid-March this year) World Bank projection is for world GDP growth of 1.3 percent, similar to last year's growth of 1.2 percent, but significantly lower than the actual figure of 3.9 percent in 2000. The World Bank also forecasts the volume of world trade to grow by 1.8 percent in 2002. This is an improvement over last year's 0.8 percent decline, but pales in comparison to the 13.1 percent growth in 2000. Both the Consensus Economics and World Bank estimates of average world GDP growth use the current dollar GDPs of countries as the weights. In comparison, the International Monetary Fund (IMF) uses purchasing power parity (PPP) GDPs. Since the IMF methodology implies larger weights for developing countries (which on average grow faster than developed countries), its estimates of world GDP growth are generally higher than those of the World Bank (and Consensus Economics). In its December 2001 *World Economic Outlook* (WEO), the IMF projected world GDP growth of 2.4 percent (based on a GDP growth forecast of 1 percent for the US, 1.7 percent for the EU, and –0.4 percent for Japan). In an interview on 14 March, the IMF's Managing Director said that the overall picture was one of recovery and he expected the US to improve in its economic activity in the first half of this year and to gain strength in the second half. In view of the changes in the global economy in recent months, he indicated that the IMF's December forecast of world GDP growth would be revised upwards in the forthcoming WEO, which will be presented to the spring meeting of the IMF.

Regional Economic Outlook

Figure 35: **Consumer Confidence Indexes—East Asian Countries**

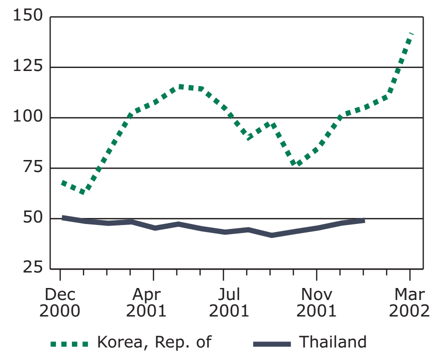


Note: Indonesia—Composite index measured by two components, the Current Economic Condition Index and the Consumer Expectation Index (Bank of Indonesia); Korea—Indicates the current consumers' expenditure, a level over 100 means that consumers think the current economic situation and level of living are better than six months ago (National Statistics Office); Malaysia—Quarterly Consumer Sentiment Index (MEIR); Thailand—Consumer Confidence Index: Economics (Thailand Chamber of Commerce).
Source: Bloomberg and CEIC.

The faster-than-expected recovery in the US, and with it the global economy, augurs well for East Asia's economic outlook. As earlier noted, on the back of improvements in the US economy in recent months, not only have many of the region's economies bottomed out, but a moderate rebound is underway in many of them. Forward-looking macroeconomic indicators are not readily available for many of East Asia's economies. Available indicators do, however, signal a turnaround in the region. Survey-based consumer confidence indexes show that consumer confidence has, since October last year, improved in Korea and Thailand (Figure 35). Similarly, the business confidence index has improved significantly in Korea since November and trended up in Thailand since October while business expectations indexes trended up in Singapore since October (Figures 36 and 37). Latest reports from the Philippines also indicate improving business confidence in the first quarter of this year. Composite leading indicators for Malaysia and the Philippines—two countries for which we have such indicators—have trended up in recent months (Figure 38).

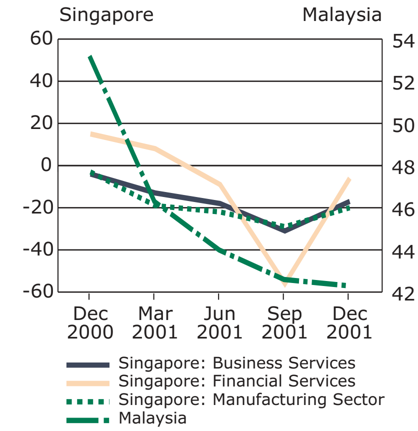
Reflecting the overall improvements in the region's economic prospects, in recent months Consensus Economics has continuously revised its

Figure 36: **Business Confidence Indexes—Korea and Thailand** (%)



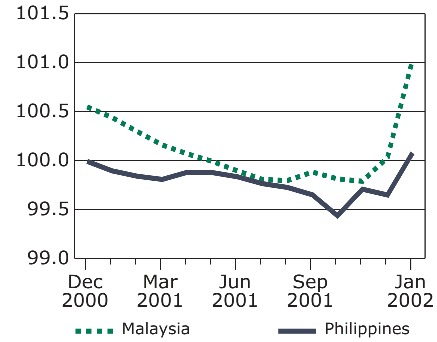
Note: Thailand—Business Sentiment Index, Whole Kingdom (Bank of Thailand); Korea—Composite Business Conditions, Forecast for All Industries (Federation of Korean Industries).
Source: CEIC.

Figure 37: **Business Condition / Expectations Indexes—Malaysia and Singapore**



Note: Malaysia—Business Condition Index (MEIR); Singapore—Business Expectations Indexes (Ministry of Trade and Industry). For Singapore, a plus sign indicates a positive balance or net upward trend and a minus sign denotes a negative balance or net downward trend.
Source: CEIC.

Figure 38: **Composite Leading Indicators—Malaysia and Philippines**



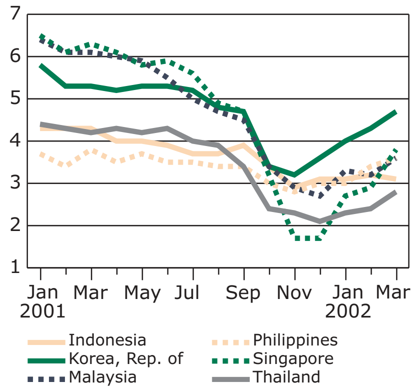
Source: REMU staff calculations.

Table 1: **Annual GDP Growth Rates** (%)

							March 2002 Forecasts				Difference[1]
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**		**2003**		**2002**
							Mean	**Low / High**	**Mean**	**Low / High**	
Brunei Darussalam	1.0	3.6	-4.0	2.5	3.0	. . .	. . .	. . .	. . .	. . .	. . .
Cambodia	3.5	3.7	1.5	6.9	5.4	5.3	4.5	. . .	. . .	. . .	-1.8
PRC	9.6	8.8	7.8	7.1	8.0	7.3	7.2	6.8/7.6	7.6	7.0/8.1	-0.2
Indonesia	7.8	4.7	-13.1	0.8	4.9	3.3	3.1	2.0/3.9	4.1	3.5/5.2	0.2
Korea	6.8	5.0	-6.7	10.9	9.3	3.0	4.7	3.1/6.0	5.8	5.0/7.8	1.5
Lao PDR	6.9	6.9	4.0	7.3	5.8	5.2	5.0	. . .	. . .	. . .	-1.5
Malaysia	10.0	7.3	-7.4	6.1	8.3	0.4	3.6	2.5/5.3	5.3	4.0/6.5	0.7
Myanmar	6.4	5.7	5.8	10.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Philippines	5.8	5.2	-0.6	3.4	4.0	3.4	3.6	. . .	4.0	. . .	0.8
Singapore	7.6	8.5	-0.1	6.9	10.3	-2.0	3.8	3.0/5.0	5.8	4.6/7.0	2.1
Thailand	5.9	-1.4	-10.5	4.4	4.6	1.8	2.8	1.8/3.6	3.9	3.1/4.0	0.5
Viet Nam	9.3	8.2	5.8	4.7	6.1	5.8	5.7	. . .	6.7	. . .	-0.2
East Asia[2]	8.1	6.2	-1.4	6.9	7.6	4.3	5.2	. . .	6.1	. . .	0.5
East Asia[2] exc. PRC	7.1	4.5	-7.3	6.8	7.4	2.4	3.9	. . .	5.1	. . .	1.0
ASEAN[2]	7.4	4.1	-7.8	3.7	5.9	1.9	3.3	. . .	4.5	. . .	0.6
Five Crisis-Affected	7.0	4.1	-8.2	6.8	7.2	2.7	3.9	. . .	5.0	. . .	1.0

. . . = not available
[1]Difference from December 2001 AEM estimates/forecasts.
[2]Exclude Brunei Darussalam and Myanmar. For 2003, weights were normalized to also exclude Cambodia and Lao PDR, since 2003 forecasts are not available for these countries.
Sources: Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2001*; official sources; IMF, *World Economic Outlook* (October and December 2001); *Cambodia: Article IV; Lao PDR: First Review Under Poverty Reduction and Growth Facility;* Consensus Economics Inc., *Consensus Forecasts* and *Asia Pacific Consensus Forecasts* (March 2002).

Figure 39: **Consensus Forecasts of 2002 GDP Growth** (y-o-y, %)



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

2002 growth forecast for East Asian countries (Figure 39). The March 2002 Consensus Economics Survey forecasts a moderate rebound in East Asia's growth this year. This is in comparison to the somewhat subdued growth forecasts made only a few months ago.

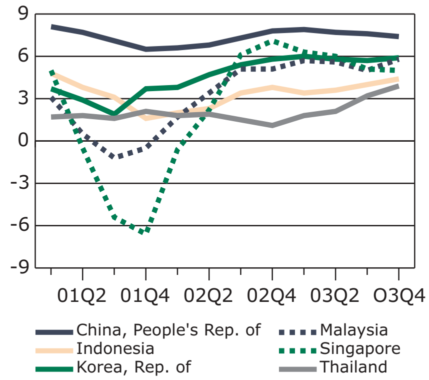
Based on the March 2002 Consensus Economics survey, East Asia's average GDP growth forecast for 2002 works out to be 5.2 percent (Table 1). This is about 0.5 percentage points higher than the corresponding figure given in the December 2001 *Asia Economic Monitor*. For the region excluding the PRC, the corresponding upward revision is larger—about 1 percentage point. Similarly, the upward revision in the growth forecast for the five crisis-affected countries is about 1 percentage point, and for ASEAN about 0.6 percentage point.

The current upward revisions to 2002 growth forecasts are larger for the more open economies in the region, especially those with larger dependence on electronics exports and the US market, than for others. This is to be expected as this year's economic rebound is likely to be driven largely by an improved external environment just as last year's slowdown was caused by the export shock following the global slowdown. Hence, the largest upward revision in the 2002 growth forecast is for Singapore (2.1 percentage points), followed by Korea (1.5 percentage points), Philippines (0.8 percentage point), Malaysia (0.7 percentage point), Thailand (0.5 percentage point), and Indonesia (0.2 percentage point). Growth this year is expected to be higher than last year almost across the region. Malaysia and Singapore will be making the biggest gains.

Among the East Asian countries, growth this year is expected to be robust in the PRC (7.2 percent), Viet Nam (5.7 percent), and Lao PDR (5 percent); slowest in Indonesia (3.1 percent) and Thailand (2.8 percent). Korea is expected to grow by 4.7 percent, Cambodia by 4.5 percent, Singapore by 3.8 percent, and Malaysia and the Philippines by 3.6 percent each.

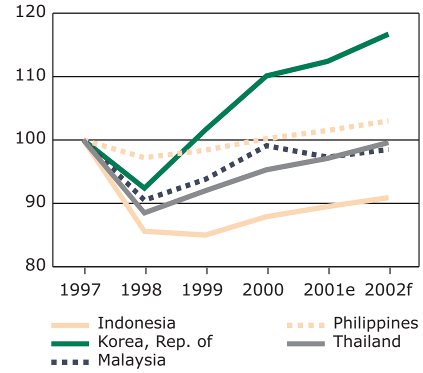
This year's moderate rebound in the region's growth is expected to strengthen in 2003. Average GDP growth in 2003 is forecast to improve to over 6 percent for East Asia as a whole, and about 5 percent for East Asia excluding the PRC as well as the five crisis-affected countries. Once again, the magnitude of this improvement (in next year's growth over this year's) is the largest for Singapore (2 percentage points), followed by Malaysia (1.7 percentage points), Korea and Thailand (1.1 percentage points), Indonesia and Viet Nam (1 percentage point), and the PRC and the Philippines (0.4 percentage point).

Figure 40: **Quarterly GDP Growth—Actual 2001 and Consensus Forecasts 2002 and 2003** (y-o-y, %)



Sources: ARIC Indicators; Consensus Economics Inc., *Asia-Pacific Consensus Forecasts,* March 2002.

Figure 41: **GDP Per Capita Index*** (1997=100)



e=estimate; f=forecast
*Except for census years, population data are estimates. 2002 population was calculated using growth rates in 2001. GDP forecasts are from Consensus Economics Inc.
Sources: Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2001*; Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* March 2002; various national sources.

The quarterly time profile of GDP growth forecast for this year and the next suggests that for most countries in the region, the turnaround is expected to take place in the first quarter of this year (Figure 40). The exception is Korea and Malaysia, where it started in the fourth quarter of last year.

Despite the faster than expected rebound this year, real per capita incomes will be lower than their 1997 levels in Indonesia (by about 10 percent), hover around the 1997 level in Malaysia and Thailand, and be only marginally higher in the Philippines (about 4 percent) (Figure 41). Among the crisis-affected countries, only Korea has made significant gains in per capita GDP since the 1997 crisis. For the other four countries, the five years since the 1997 crisis are effectively a lost half decade in terms of improvements in per capita incomes.

Risks to Regional Growth and Recovery

While the current forecast of a moderate rebound in the region's growth this year as well as its strengthening next year is a strong possibility, it is subject to certain risks and uncertainties. On the external front, two sets of risks could upset the current assessment: (i) a weaker rebound in the US than is suggested by the available indicators, and

(ii) a possible extension of the US-led military operations against terrorism to the Middle East. The latest assessment of the US Federal Reserve chairman is that "risks are equally balanced between weaknesses and inflation." On the regional or domestic front, notable progress has been made in recent years in strengthening the domestic financial and corporate sectors, but vulnerabilities that could be sources of shocks to the system still persist.

External Risks

Consensus Economics' 2.1 percent mean GDP growth forecast for the US this year is likely, but the possibility of its growth turning out to be lower than this cannot be completely ruled out. Of the 31 forecasters surveyed by Consensus Economics for the US, 10 forecast US GDP growth in 2002 to be between 2.5 percent and 3 percent, another 10 forecast it to be between 2 percent and 2.4 percent, and yet another 10 forecast it to be between 1.4 percent and 1.9 percent, with one forecaster predicting it to be only 0.6 percent. Although this distribution around the mean forecast of 2.1 percent is not skewed one way or another, the fact that one third of the forecasters predict growth to be less than 2 percent indicates that downside risks to the mean forecast cannot be completely ruled out.

Three types of downside risks to US growth forecast deserve special mention. First, indicators of a turnaround in fixed investment in the US are far less prominent than the corresponding indicators of consumer expenditure. As last year's economic slowdown was driven primarily by the collapse of fixed investment, including the bursting of the technology bubble, the weak signals of a recovery in fixed investment constitute a key risk. The recent World Bank report underscores the importance of this risk in forecasting a somewhat low (only 1.2 percent) 2002 GDP growth for the US.

Second, US consumer expenditure remained resilient throughout last year, and recent improvements in consumer confidence indexes augur well for a faster-than-expected rebound. Yet, many point out that the record levels of debt (of both household and the corporate sectors) and minimal savings of the household sector cast doubts on the staying power of US consumers.

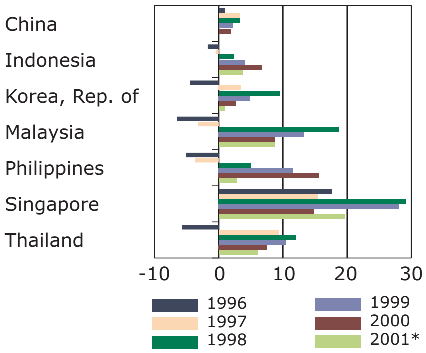
Third, there is the concern that the stock markets may have been overly optimistic in their expectations for corporate profit growth in the coming quarters. If actual earnings fail to materialize in the course of the year, there is the risk of a market correction. Further adding to this risk is the concern over "creative accounting" in the aftermath of the Enron Corporation collapse in the US. First quarter earnings are expected to be low as companies write off losses partly to meet new accounting standards. The IMF's inaugural issue of the *Global Financial Stability Report* released in mid-March this year highlights these market-related risks to the US recovery.

Considering all these risks, some analysts have cautioned that, notwithstanding the positive economic news emanating from the US in recent months, the US, and with it the world economy, could experience a double-dip growth pattern—a weak, temporary recovery from last year's downturn followed by a second downturn later on. The optimistic news of the past few weeks could then be a "false dawn."

Meanwhile, any spillover of the ongoing US-led military operations against terrorism to the Middle East could push up the crude oil price, which has already increased by 24 percent this year. Although the general view in the Organization of Petroleum Exporting Countries (OPEC) is that a surge in the price of oil, as in 1974, 1979, or 1999-2000, is only a remote possibility, political uncertainties following any military operations could suddenly upset this sanguine outlook. If that happens, recession could return not only to the US but to the rest of the world too. Since several East Asian countries depend heavily on oil imports, the regional effect of a sharp oil price hike would be substantial.

Domestic Risks

Figure 42: **Current Account Balance** (% of GDP)



*2001 data are until 3Q2001, except for Philippines and Singapore, which are for the full year.
Source: ARIC Indicators.

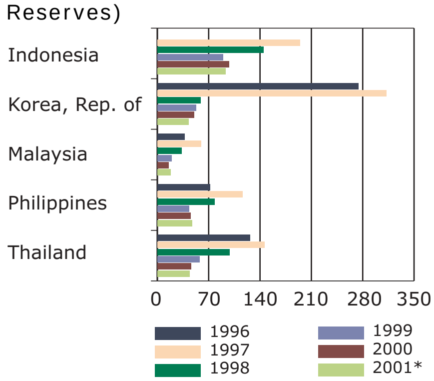
As the December 2001 AEM noted, domestic risks to East Asia's growth and recovery have been receding with the restoration of political stability in Indonesia, Philippines, and Thailand. On the economic front also, despite last year's slowdown, prudential indicators have improved in recent years in most East Asian nations. For example, almost all East Asian countries, including the five crisis-affected countries, continue to run current account surpluses, although at lower levels than in 2000 (Figure 42). Foreign exchange reserves have improved significantly and more than cover the entire short-term external debt (Figure 43). The short-term to total debt ratios and total external debt to GDP ratios are lower than those at the height of the 1997 crisis (Figures 44 and 45). For most of these countries, the ratio of money supply to foreign exchange reserves—another indicator of the vulnerability of a country to a currency crisis—has improved and CARs and profitability of banks are slowly recovering. Reflecting many of these improvements, international credit rating agencies have upgraded their assessments for some countries (e.g., Korea, Malaysia, and Philippines) (Table 2). All these indicate that domestic risks to the region's growth and recovery

Table 2: **Foreign Currency LT Sovereign Credit Ratings**[1]

	Item	PRC		Indonesia		Korea		Malaysia		Philippines		Singapore		Thailand		Viet Nam	
Moody's	Current Outlook	Stable	14-Aug-01	Stable	7-Feb-02	*Stable*	*28-Mar-02*	*Positive*	*4-Mar-02*	*Stable*	*3-Feb-02*	Stable	27-Jun-01	Stable	22-Jun-00	Stable	23-Apr-01
	Ratings	A3	10-Sep-93	B3	20-Mar-98	*A3*	*28-Mar-02*	Baa2	17-Oct-00	Ba1	18-May-97	Aa1	18-Jan-96	Baa3	22-Jun-00	B1	9-Jul-98
		Baa1	8-Nov-89	B2	9-Jan-98	Baa2	16-Dec-99	Baa3	14-Sep-98	Ba2	12-May-95	Aa2	24-May-94	Ba1	21-Dec-97	Ba3	17-Apr-97
		A3	18-May-88	Ba1	21-Dec-97	Baa3	12-Feb-99	Baa2	23-Jul-98	Ba3	1-Jul-93	Aa3	20-Sep-89	Baa3	27-Nov-97		
				Baa3	14-Mar-94	Ba1	21-Dec-97	A2	21-Dec-97					Baa1	1-Oct-97		
						Baa2	10-Dec-97	A1	15-Mar-95					A3	8-Apr-97		
						A3	27-Nov-97							A2	1-Aug-89		
						A1	4-Apr-90										
						A2	18-Nov-86										
Standard & Poor's	Current Outlook	Stable	20-Jul-99	Negative	2-Nov-01	*Stable*	*13-Nov-01*	*Positive*	*4-Mar-02*	Negative	19-Oct-00	Stable	16-Mar-01	Stable	5-May-99		
	Ratings	BBB	20-Jul-99	CCC	2-Nov-01	*BBB+*	*13-Nov-01*	BBB	11-Nov-99	BB+	21-Feb-97	AAA	6-Mar-95	BBB-	8-Jan-98		
		BBB+	14-May-97	CCC+	21-May-01	BBB	11-Nov-99	BBB-	15-Sep-98	BB-	2-Jul-93	AA+	6-Sep-91	BBB	24-Oct-97		
		BBB	20-Feb-92	B-	2-Oct-00	BBB-	25-Jan-99	BBB+	24-Jul-98			AA	24-May-89	A-	3-Sep-97		
				SD	17-Apr-00	BB+	18-Feb-98	A-	17-Apr-97					A	29-Dec-94		
				CCC+	31-Mar-99	B+	22-Dec-97	A	23-Dec-97					A-	26-Jun-89		
				SD	30-Mar-99	BBB-	11-Dec-97	A+	29-Dec-94								
				CCC+	15-May-98	A-	25-Nov-97										
				B-	11-Mar-98	A+	24-Oct-97										
				B	27-Jan-98	AA-	3-May-95										
				BB	9-Jan-98	A+	1-Oct-88										
				BB+	31-Dec-97												
				BBB-	10-Oct-97												
				BBB	18-Apr-95												
Fitch IBCA	Current Outlook	Stable	6-Dec-01	**Stable**	**30-Nov-01**	Stable	13-Jun-01	Stable	5-Mar-02	Stable	15-Mar-02	Stable	17-Jan-02	Stable	24-Jun-99		
	Ratings	A-	11-Dec-97	B-	16-Mar-98	BBB+	30-Mar-00	BBB	7-Dec-99	BB+	8-Jul-99	AA+	18-Nov-98	BBB-	14-May-98		
				B+	21-Jan-98	BBB	24-Jun-99	BBB-	26-Apr-99					BB+			
				BB-	8-Jan-98	BBB-	19-Jan-99	BB	9-Sep-98								
				BB+	22-Dec-97	BB+	2-Feb-98	BBB-	13-Aug-98								
				BBB-	4-Jun-97	B-	23-Dec-97										

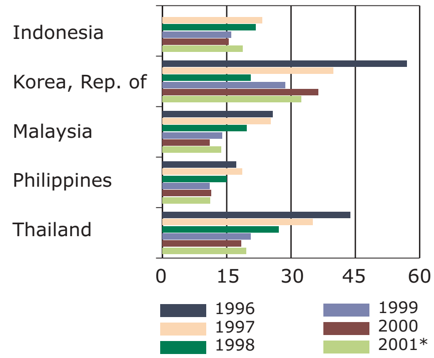
Notes: A positive/negative outlook suggests that a long/intermediate-term movement (i.e., an upgrade/downgrade) is likely. A stable outlook means that the rating is not currently subject to change.
Those in italics refer to an improvement over a previous rating or outlook and those in bold refer to a deterioration since the last report.
[1]Refer to Annex in Regional Overview of the *Asia Recovery Report,* March 2001, for a description of ratings.
Sources: Web sites of Moody's, Standard and Poor's, and Fitch.

Figure 43: **Short-Term External Debt** (% of Gross International Reserves)



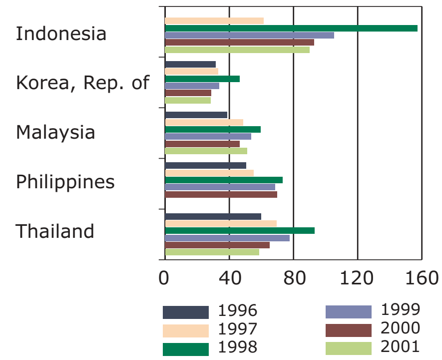
*Data for Indonesia are as of June 2001; for Philippines as of September 2001.
Sources: ARIC Indicators, except data for Indonesia, which are taken from Nomura International and Bisnis Indonesia.

Figure 44: **Short-Term External Debt** (% of Total External Debt)



*Data for Indonesia are as of June 2001; for Philippines as of September 2001.
Sources: ARIC Indicators, except data for Indonesia, which are taken from Nomura International and Bisnis Indonesia.

Figure 45: **Total External Debt** (% of GDP)



Source: ARIC Indicators.

have generally subsided. Yet, domestic economic vulnerabilities in a globalized world could arise almost without notice, and a key policy challenge for the region is to minimize these. Weather-related risks such as the El Niño weather pattern cannot also be ruled out.

East Asia's Policy Challenges

The immediate policy challenge for the region is to support this year's economic rebound with appropriate demand management policies. Another key challenge is to increase the resilience of the region's economies to the external shocks and volatility that are difficult to avoid in an increasingly globalized world economy.

Countries could strengthen this year's rebound by supporting domestic demand, further cutting interest rates, and easing fiscal policy. Given that inflation continues to remain either low and/or declining in the region (except for Indonesia and Lao PDR), there is scope for further reduction in interest rates. However, the scope for fiscal expansion varies a great deal across countries. Among the five crisis-affected countries, Korea and Malaysia, by virtue of their relatively low levels of public debt, may be best placed for further fiscal expansion (although the recent sharp increase in the stock market and the firming up of property prices in Korea may limit the scope somewhat). In contrast, Indonesia and the Philippines are severely constrained to bolster domestic demand through fiscal expansion. Although Thailand is in a stronger position than Indonesia and the Philippines, it also has to contend with its rapidly rising public debt. Outside the crisis-affected countries, Singapore's fiscal situation does not constrain further expansion. In the PRC, although the reported public debt levels are low, once quasi-fiscal operations that are not included in the budget are taken into account, the country's public sector financial position is much less comfortable.

There are, however, practical limits to using fiscal policy for demand management. While it may now be easy to expand the budget through additional spending on public programs, it is generally difficult to restrain those expenditures when the economy has recovered and fiscal policy needs tightening. This is because once public programs are introduced, it is difficult to unwind them. Pressure groups and domestic lobbies spring up to resist the termination or even downsizing of such programs. Historically, therefore, fiscal deficits that originated in severe downturns tended to last well beyond the recovery in most OECD countries. Because of such fiscal inertia, in practice, monetary easing through interest rate reductions is more suited for countercyclical demand management than fiscal expansion.

Going beyond the imperatives of strengthening domestic demand through fiscal and monetary policies, there is the need to push ahead with the remaining agenda of structural reforms in the financial and corporate sectors. This is required both to support demand and to reduce the vulnerabilities of countries to external shocks and volatility. One of the key lessons of the 1997 Asian financial crisis is that sound macroeconomic fundamentals must be accompanied by sound structural fundamentals to ensure sustained rapid growth and resilience against external shocks and volatility. These efforts need to be complemented by further measures to promote greater monetary and financial cooperation at the regional level.[3]

[3]For details of East Asia's remaining agenda for financial and corporate sector reforms, see the theme chapter of the December 2001 AEM. Ongoing efforts to promote monetary and financial cooperation were discussed in Box 5 of that issue.