ADB Asia Economic Monitor 2001

December 2001 http://aric.adb.org

The *Asia Economic Monitor* (AEM), which replaces the *Asia Recovery Report,* is a quarterly review of East Asia's growth and recovery, financial and corporate sector reforms, and social developments. Originally focusing on the five countries most affected by the crisis, coverage has now been expanded to include all 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. This issue also features a theme chapter on corporate restructuring in East Asia.

Contents

Asian Development Bank

Highlights

- The global economic slowdown, which began more than a year ago, is turning out to be deeper, longer, and more broad-based than expected.
- The 11 September attacks and subsequent events have introduced an additional element of uncertainty to an already weakening global economy. Although events are still unfolding, it appears that
  - the short-term impacts will be manageable
  - the longer-term impacts are, however, uncertain because they depend mainly on noneconomic factors. With the fall of Kabul and other areas, however, these impacts appear to have diminished somewhat.
- The current economic slowdown in East Asia is expected to deepen and prolong further. Growth might pick up toward the middle of next year, rather than late this year or early next year as anticipated earlier.
- This year, the region is expected to experience the second slowest growth in decades. Next year's rebound in growth is likely to be more subdued than was previously expected and below-trend.
- The London-based Consensus Economics Inc.[1] now projects East Asia's average GDP growth to be 3.9 percent in 2001 and 4.7 percent in 2002. Compared to the forecasts made just before the 11 September attacks, growth is projected to be lower by 0.5 percentage point in 2001 and by 1 percentage point in 2002.
- Recovery in the five crisis-affected countries has been set back somewhat—real per capita incomes in 2002 will be lower than in 1997 in three of the five crisis-affected countries, and the pace of financial and corporate reforms and reduction in poverty is slowing in several of these countries.
- Various prudential indicators, however, suggest that East Asia's vulnerability to a 1997-type capital account crisis has been reduced.
- The past half decade or so represents the most turbulent period in East Asia's recent economic history. Rapid growth up to 1996 was followed by a severe recession in 1998.

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

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
ARR	Asia Recovery Report
ASEAN	Association of Southeast Asian Nations
bp	basis point
CAR	capital adequacy ratio
CDRC	Corporate Debt Restructuring Committee
ECB	European Central Bank
EU	European Union
FDI	foreign direct investment
FY	fiscal year
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
M&As	mergers and acquisitions
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)
ROA	return on assets
ROE	return on equity
SBI	Sertifikat Bank Indonesia
SBV	State Bank of Viet Nam
SESALL	Singapore All Equities Index
SET	Stock Exchange of Thailand
SME	small and medium enterprise
SOCB	state-owned commercial bank
SOE	state-owned enterprise
TAMC	Thai Asset Management Corporation
B	baht
Br$	Brunei dollar
D	dong
MK	kyat
RM	ringgit
Rp	rupiah
S$	Singapore dollar
W	won
Y	yuan
q-o-q	quarter-on-quarter
y-o-y	year-on-year

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

After a faster than expected recovery in 1999 and 2000 has now come a sharp economic slowdown, which has been worsened by the 11 September attacks on the US.

- The lessons to be learned from the volatility and turbulence being experienced by the region is that, in a rapidly globalizing world, countries have to remain vigilant. Globalization enhances the benefits of good policies just as it magnifies the impacts of bad ones.
  - – East Asia cannot remain complacent about the unfinished structural reform agenda and spend its way out of the slowdown.
  - – At the regional level, efforts to enhance monetary and financial cooperation together with trade cooperation must be continued.

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East Asia's Growth and Recovery—A Regional Overview

Introduction

Over much of the last year or so, East Asia[1] has come under stress. Driven mainly by a marked deterioration in the external environment, including a synchronized downturn among industrial countries, a dip in world trade growth, and a fall in the demand for electronics products, most East Asian countries have experienced a sharp economic slowdown beginning in the last quarter of 2000. Against the backdrop of the deteriorating external environment, the September Update of the *Asia Recovery Report* (ARR), which was prepared before the 11 September attacks on the US, had cautioned that with the global economic downturn turning out to be deeper, longer, and more broad-based than expected, East Asia's current slowdown was getting prolonged.

Since the release of the September Update of the ARR, the global economic situation has deteriorated further. The 11 September attacks on the United States and subsequent events have introduced an additional element of uncertainty to already weak global and regional economies. This inaugural issue of the *Asia Economic Monitor* (AEM), which replaces the ARR series, traces the emerging trends in East Asia's economies, examines the implications of the 11 September attacks for them, and assesses their economic prospects.

How the attacks and the subsequent US-led military operations in Afghanistan will impact on East Asia depends very much on what effects these events will have on the US and the global economy at large. There is a growing consensus among economists, policymakers, international financial institutions, and private market analysts that the attacks have pushed the US economy, which was already teetering close to a recession[2], over the brink, further weakening the global economy. However, most expect the US recession to be mild and short-lived and foresee recovery during the first half of next year, although a more prolonged recession cannot be ruled out. These emerging global trends have profound implications for East Asia.

To anticipate the conclusions of this report: (i) with the global economic situation worsening after the 11 September attacks, East Asia's current economic slowdown is likely to be both deeper and more prolonged than

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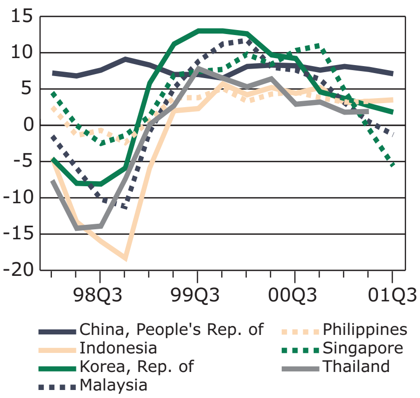
[1]Defined here as the 10 Association of Southeast Asian Nations countries (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam), plus the People's Republic of China and Republic of Korea.

[2]In this report, the term recession refers to two successive quarters of decline in seasonally adjusted GDP—a commonly used definition of a recession. However, using a somewhat different and broader approach, the Business Cycle Dating Committee of the US National Bureau of Economic Research has now judged that recession began earlier in March this year.

anticipated at the time of the release of the September Update of the ARR; (ii) the rebound in the region's economies is likely to be not only postponed but also more subdued as a result; and (iii) the continued economic slowdown will impact on poverty in East Asia, which was otherwise declining at a robust pace on the back of strong growth in 1999 and 2000.

Growth and Recovery in 2001

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



Source: ARIC Indicators.

Real Sector Developments

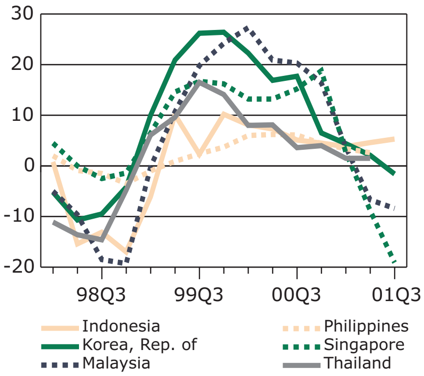
During this year, growth has slowed in most of East Asia (Figure 1). Those countries that are closely linked to the global economy through trade and capital flows have been more adversely affected than those where these linkages are weaker. Similarly, countries with heavier dependence on electronics exports have seen a larger dip in growth.

In the first three quarters of this year, the five crisis-affected countries (Indonesia, Republic of Korea [henceforth, Korea], Malaysia, Philippines, and Thailand) taken together grew by 2.5 percent.[3] This represents a sharp deceleration from the 7.8 percent growth they achieved in the first three quarters of 2000. Outside these five, Singapore saw its gross domestic product (GDP) decline by 0.6 percent in the first three quarters of 2001, compared to 9.5 percent growth in the corresponding period last year. Singapore's growth deceleration was particularly sharp in the third quarter, when GDP contracted by 5.6 percent on a year-on-year (y-o-y) basis. The impact of the global slowdown on the PRC, by contrast, has been limited, partly because of its lower dependence on exports, especially information technology (IT) exports, and partly because of a series of fiscal stimulus measures that have been adopted over the last four years. As a result, it posted strong growth of 7.6 percent in the first three quarters.

For the other ASEAN members (Brunei Darussalam, Cambodia, Lao People's Democratic Republic, Myanmar, and Viet Nam), quarterly or half-yearly data on GDP are not available. Since they are less dependent on external trade and investment, they may have been less affected by the global slowdown than other East Asian countries. Yet, it is unlikely that they have been completely insulated from the regional slowdown as they have significant trade and investment links with the rest of the region.

[3]Third quarter GDP data are not yet available for the Philippines and Thailand. These computations are based on the estimate of third quarter GDP growth for Thailand from Consensus Economics, Inc. For the Philippines, it is assumed that GDP has grown by 3.25 percent in the third quarter, the same rate of growth as in the first half.

Figure 2: **Growth of Manufacturing** (y-o-y, %)

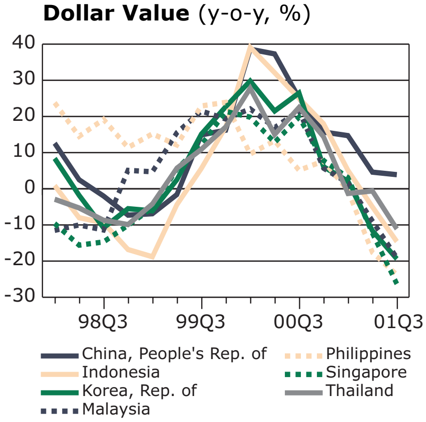


Sources: ARIC Indicators.

While the slowdown has cut across all sectors, it is most evident in manufacturing and particularly in the production and export of electronics (Figure 2). Korea's manufacturing sector grew by only 1.5 percent in the first three quarters of the year, compared to an average growth of more than 18 percent in the previous two years. In Malaysia, the manufacturing sector actually shrank by 4 percent in the first three quarters, whereas the average growth rate was 17.4 percent in the previous two years. Similarly, Singapore's manufacturing shrank by 9 percent in the first three quarters of this year, a huge setback from an average growth of more than 14 percent in the previous two years. Even the Philippines, a country that has experienced only a modest growth deceleration, saw a sharp slowdown in its manufacturing sector.

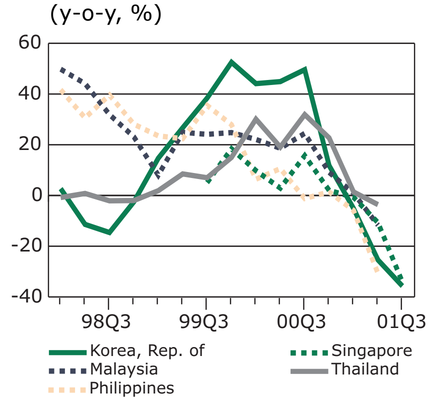
The growth slowdown has been driven by a sharp slowdown in the region's exports, as the world economy slowed and world trade decelerated. The dollar value of exports of the five crisis-affected countries (which account for about 60 percent of East Asia's exports) declined by 8.8 percent in the first three quarters of this year, compared to 23 percent growth in the comparable period a year ago (Figure 3). Outside the crisis-affected countries, Singapore saw its exports decline by 12.7 percent in the first three quarters of this year, compared to 17.4 percent growth in the same period last year. None of these countries, including Singapore, was able to increase exports of semiconductors and other electronic equipment in the first three quarters (Figure 4). For some time, the PRC's exports did hold up against the regional trend of slump, but in more recent months they have been showing distinct signs of slowing (Figure 5).

Figure 3: **Growth of Merchandise Exports, Dollar Value** (y-o-y, %)



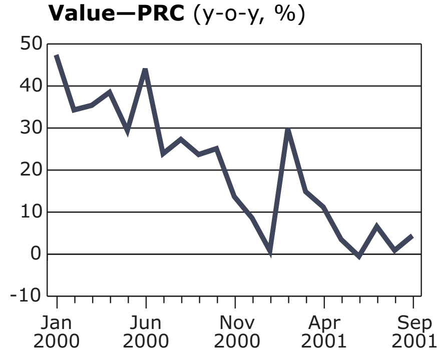
Source: ARIC Indicators.

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



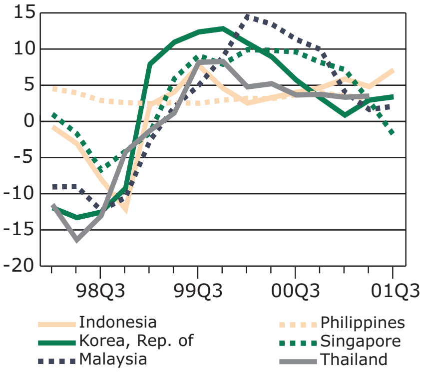
Sources: Bank of Korea; Bank Negara Malaysia; National Statistics Office, Philippines; Bank of Thailand; and Bloomberg.

Figure 5: **Growth of Merchandise Exports, Dollar Value—PRC** (y-o-y, %)



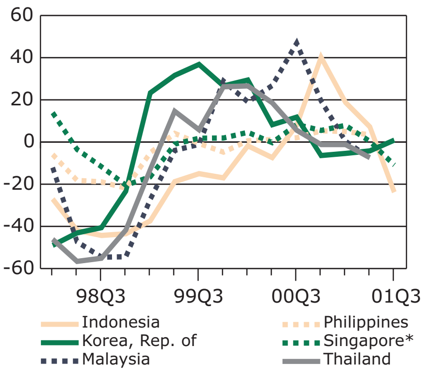
Source: ARIC Indicators.

Figure 6: **Growth of Real Private Consumption Expenditure** (y-o-y, %)



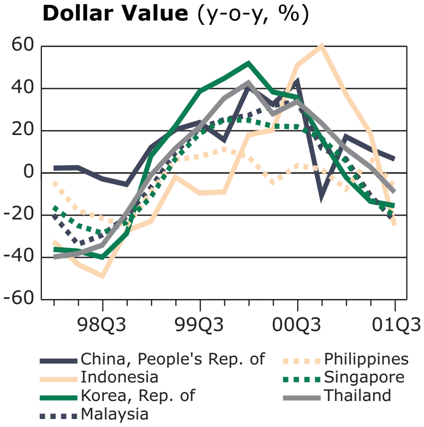
Source: ARIC Indicators.

Figure 7: **Growth of Real Gross Domestic Investment** (y-o-y, %)



*Data for Singapore refer to gross fixed capital formation.
Source: ARIC Indicators.

Figure 8: **Growth of Merchandise Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

To varying degrees, decelerating export demand has been accompanied by softening domestic demand. Slowing growth and the sharp decline in stock prices since the beginning of 2000 have adversely affected both consumer confidence and business investment. Except for the PRC and Indonesia, growth in private consumption remained weak during the year (Figure 6). Similarly, growth in domestic investment remained subdued, with the notable exception of the PRC (Figure 7). In the PRC, domestic demand remained steady, largely due to a strong growth of public sector investment (see the chapter on the PRC).

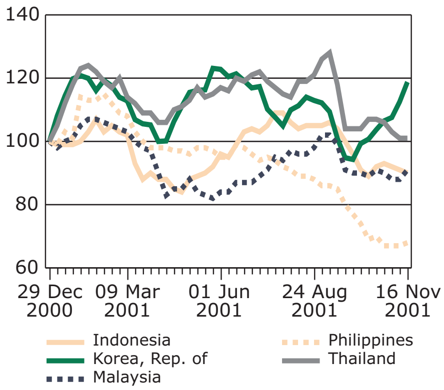
Declining export growth has reduced imports, particularly where import-intensity of exports is high. Further, slower economic growth has reduced the appetite for imports (Figure 8). The dollar value of imports of the five crisis-affected countries contracted by 6.3 percent in the first three quarters of the year, compared to an average growth of 32.6 percent in the same period last year. The combination of sluggish exports and softer imports enabled countries to generally maintain surpluses in their trade balances that had been built up in the previous two years. In the first three quarters of this year, the combined trade balance of the five crisis-affected countries amounted to $40 billion compared with $51 billion for the same period last year.

Asset Market Developments

In 2001, most regional equity markets have not seen much respite from the hammering they received in 2000. In the first two months of this year, regional equity prices regained some of the ground they lost last year. Since then, however, most regional equity prices have declined. Poor performance has reflected global stock market trends, slower economic growth, and lower corporate earnings as well as increased uncertainty since mid-September. (Figures 9a, 9b, 10a, and 10b). Increased capital outflows must have also contributed to the decline in stock prices (Table 1). Equity markets in the region fell sharply immediately following the 11 September attacks and have not rebounded much. Since the 11 September attacks, losses have been substantial, ranging from 5 percent in Singapore to 20 percent in the Philippines. The Philippine Composite index, for instance, is at its lowest in 10 years, having lost more than 35 percent of its value, while the percentage falls in most other regional indexes are in double digits.

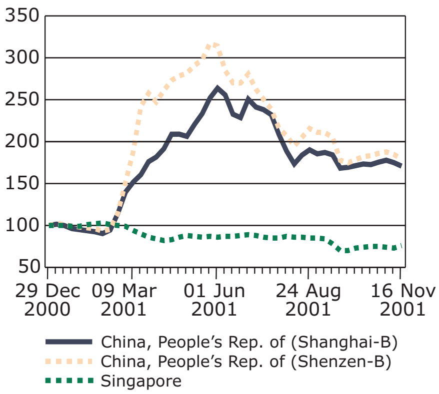
With the exception of the Indonesian rupiah, Brunei dollar, and Singapore dollar, most major regional currencies, after weakening against the US dollar in the first quarter, have remained relatively stable in the second and third quarters (Figures 11a and 11b). So far this year, the rupiah has depreciated by about 9 percent and the Brunei dollar and Singapore dollar

Figure 9a: **Composite Stock Price Indexes—Five Crisis-Affected Countries*** (last week of 2000Dec=100, in local currency)



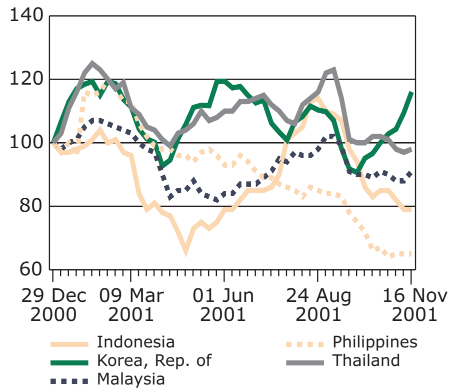
*Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), and SET Index (Thailand).
Source: REMU staff calculations derived from Bloomberg.

Figure 9b: **Composite Stock Price Indexes—Other East Asian Countries*** (last week of 2000Dec=100, in local currency)



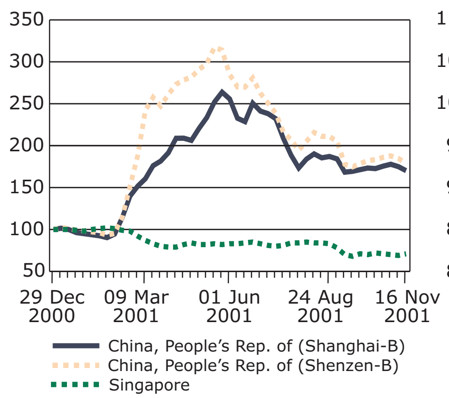
*Weekly averages of Shanghai-B (PRC), Shenzen-B (PRC), and SESALL (Singapore).
Source: REMU staff calculations derived from Bloomberg.

Figure 10a: **Composite Stock Price Indexes—Five Crisis-Affected Countries*** (last week of 2000Dec=100, in dollars)



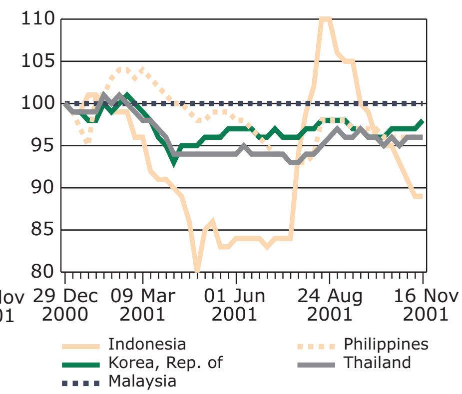
*Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), and SET Index (Thailand). The exchange rate used in the conversion to dollar is from the NY Composite.
Source: REMU staff calculations derived from Bloomberg.

Figure 10b: **Composite Stock Price Indexes—Other East Asian Countries*** (last week of 2000Dec=100, in dollars)



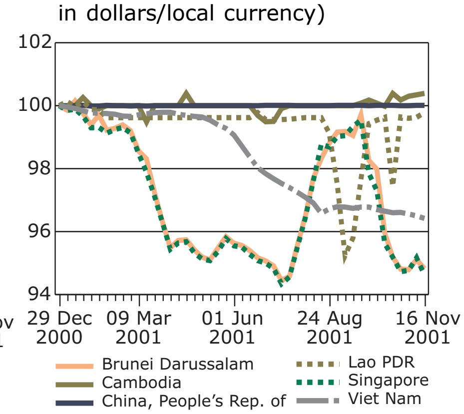
*Weekly averages of Shanghai-B (PRC), Shenzen-B (PRC), and SESALL (Singapore). The exchange rate used in the conversion to dollar is from the NY Composite.
Source: REMU staff calculations derived from Bloomberg.

Figure 11a: **Exchange Rate Indexes—Five Crisis-Affected Countries** (weekly average, last week of 2000Dec=100, in dollars/local currency)



Source: REMU staff calculations derived from Bloomberg.

Figure 11b: **Exchange Rate Indexes—Other East Asian Countries** (weekly average, last week of 2000Dec=100, in dollars/local currency)



Source: REMU staff calculations derived from Bloomberg.

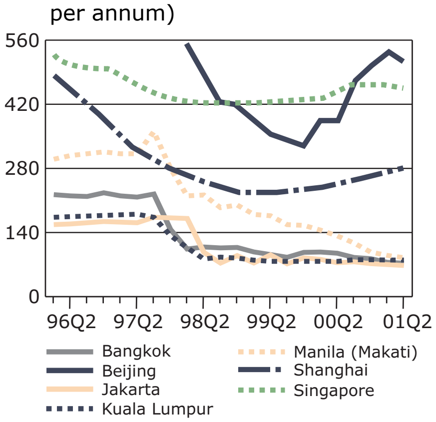
by 5 percent. In the first half of the year, the Malaysian ringgit came under some pressure in the face of sluggish export growth and falling foreign exchange reserves; and there was speculation that the ringgit's peg to the US dollar would be broken. Subsequently, foreign exchange reserves have stabilized and pressure to break the peg has subsided. The PRC's exchange rate has not come under pressure as foreign exchange

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

	1995	1996	1997	1998	1999	2000	2001f	2002f
IIF Estimates								
Net private flows	94.2	118.0	5.6	-37.1	-5.8	7.6	-11.8	-3.1
Equity investment, net	15.5	16.8	5.2	17.8	30.8	24.4	10.6	11.2
Direct investment, net	4.4	4.8	6.8	13.3	15.3	13.0	7.2	8.0
Portfolio investment, net	11.0	12.0	-1.7	4.5	15.4	11.4	3.4	3.2
Private creditors, net	78.7	101.2	0.5	-54.9	-36.5	-16.8	-22.5	-14.3
Commercial bank credit, net	64.7	69.4	-16.9	-48.4	-32.8	-16.1	-14.0	-7.6
Nonbank credit, net	14.0	31.8	17.4	-6.5	-3.7	-0.7	-8.5	-6.7
IMF Estimates								
Net private capital flows	54.9	74.1	-5.9	-31.9	-18.3	-19.8	-28.9	-15.1
Net private direct investment	10.3	11.7	10.2	11.4	8.9	5.1	6.6	6.0
Net private portfolio investment	18.6	27.6	8.8	-9.0	13.1	6.9	-4.5	0.3
Other net private capital flows	26.0	34.7	-25.0	-34.3	-40.3	-31.9	-31.0	-21.5

f=forecast.
Source: Institute of International Finance, *Capital Flows to Emerging Market Economies*, September 2001 and IMF, *World Economic Outlook,* October 2001.

Figure 12: **Office Property Rents** (dollars per square meter per annum)



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

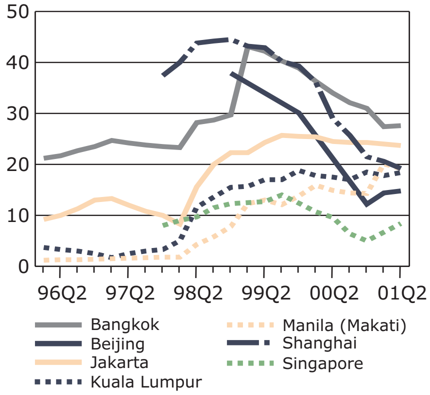
reserves continue to increase, reaching $200 billion by October 2001. However, sporadic weakening of the yen did raise concerns in the People's Bank of China, the country's central bank, about the exchange rate and competitiveness of the country's exports. Compared to end-2000, the Viet Nam dong has depreciated by 4 percent, whereas the Cambodia riel and the Lao kip have remained more or less unchanged.

The worsening economic conditions have taken their toll on property markets around the region. Office rentals in most major cities in East Asia (except Shanghai) continued to decline in the second quarter of the year, the latest period for which data are available (Figure 12). This decline ranged from 2.8 percent in Singapore to 8.5 percent in Manila. The corresponding declines in office rentals in Jakarta and Bangkok were 6.6 percent and 4.1 percent, respectively. Movements in office vacancy rates, have, however, been more varied. They increased in Singapore and Kuala Lumpur, declined in Manila and Shanghai, and remained more or less unchanged in Beijing, Jakarta, and Bangkok (Figure 13).

Fiscal and Monetary Policies

East Asian countries have generally responded to the economic slowdown with modest fiscal stimuli, which have been intensified in the aftermath of the 11 September attacks. Many countries are now incurring fiscal deficits

Figure 13: **Office Property Vacancy Rates** (%)



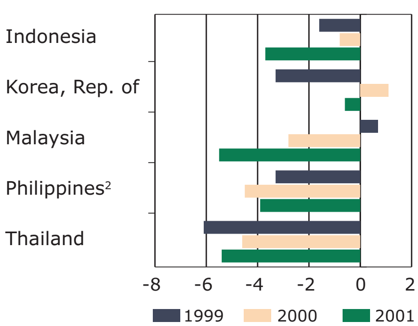
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

as a result (Figure 14). The PRC, Korea, Malaysia, Singapore, and Thailand introduced fiscal stimulus measures in their original budget proposals for 2001 and/or subsequently announced supplementary spending packages, whereas Indonesia and Philippines were constrained by concerns over the already large fiscal deficits.

Monetary policy response has been more mixed than fiscal response. While short-term nominal interest rates have been reduced in Korea, Philippines, Singapore, and Thailand, they have remained more or less unchanged in Malaysia and increased in Indonesia (Figure 15). Interest rate reductions in the region have become more pronounced in the aftermath of the 11 September attacks. In Korea, the rate was cut by 50 basis points (bp) to 4 percent on 19 September; in Malaysia by 50 bp to 5 percent on 20 September; and in the Philippines by 25 bp to 8.75 percent on 4 October. Since December 2000, real interest rates have remained unchanged in most of these countries (Figure 16).

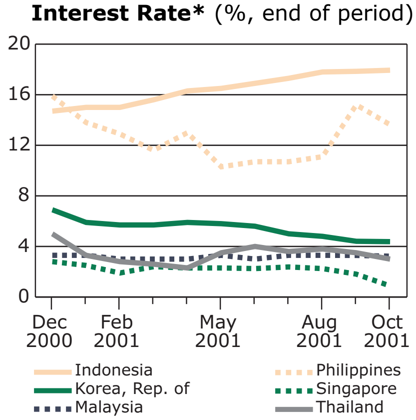
It is too early to judge the macroeconomic effects of these fiscal and monetary policy responses, especially because the latter work with substantial time lags. Given continued strong growth in the PRC, it appears that fiscal stimulus measures have helped to counter, at least partially, the externally induced slowdown in the economy. However, it is not clear whether fiscal expansions have had similar effects on other countries. In any case, modest fiscal expansions would not be expected to have a big impact in many of these economies, which are highly open to foreign trade and exceptionally prudent in their savings habits. Their high marginal propensities to save and import yield a small multiplier effect for a given

Figure 14: **Budget Balance**[1] (% of GDP)



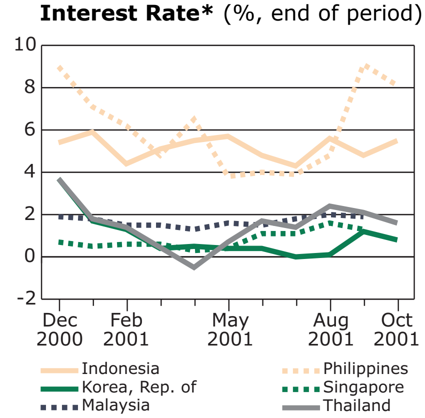
[1]Data refer to the central government budget for Indonesia, public sector budget for Malaysia, Philippines, and Thailand, and consolidated central government budget for Korea.
[2]As percent of GNP.
Source: Institute of International Finance, Country Economic Reports, various issues.

Figure 15: **Short-Term Nominal Interest Rate*** (%, end of period)



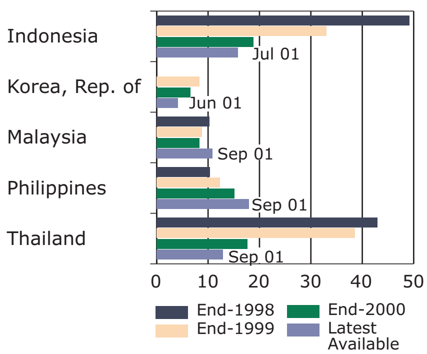
*Three-month interbank lending rate.
Source: ARIC Indicators.

Figure 16: **Short-Term Real Interest Rate*** (%, end of period)



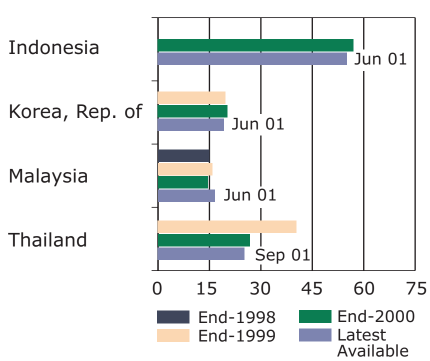
*Three-month interbank lending rate less inflation rate.
Source: ARIC Indicators.

Figure 17: **NPLs of Commercial Banks*** (% of total commercial bank loans)



*Banking sector for Indonesia. Data on NPLs exclude those transferred to AMCs. The NPL criteria for Korea were changed in December 1999, so no comparable data are available prior to that date. NPLs are on a three-month accrual basis.
Source: ARIC Indicators.

Figure 18: **NPLs Including Transfers to AMCs** (% of total loans)



Source: ARIC Indicators.

fiscal stimulus. Equally important, some governments have found it difficult to implement the fiscal stimulus measures that were planned at the beginning of the year. Korea is a case in point.

The Korean Government had planned to run a small fiscal deficit in 2001 compared to a surplus of about 1 percent of GDP in 2000. It also wanted to increase its expenditures by 11.3 percent and frontload two thirds of this expenditure during the first half of the year. However, because government revenues increased faster than expected (especially social security contributions) and actual spending fell far short of planned levels, in the first half of the year the budget was actually in surplus. Such experiences show that countries accustomed to prudent fiscal policies find it difficult to implement expansionary fiscal policies at short notice, just as countries accustomed to lax fiscal policies find it difficult to control fiscal imbalances. Coupled with small multiplier effects, such inertia makes fiscal policy less effective as a short-term stabilization measure in many East Asian economies.

In some countries, the scope for continuation of expansionary fiscal policy is also constrained by the need for fiscal support for recapitalization and restructuring their banking systems and corporate restructuring. Moreover, public sector debt constrains further fiscal stimulus measures where public sector debt is large and increasing relative to GDP. For example, this ratio is running at about 90 percent of GDP in Indonesia, about 70 percent in the Philippines, and over 50 percent in the PRC (when off-budget spending is included) and Thailand.

Financial and Corporate Restructuring

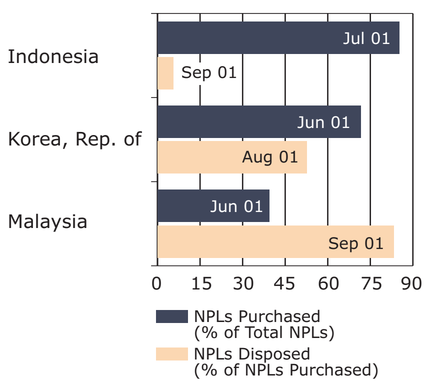
During most of this year, the pace of financial and corporate restructuring in several countries has been slowed by sluggish economic growth and subdued asset markets.

In recent months, the nonperforming loan (NPL) ratios of the banking sector have declined only in Indonesia, Korea, and Thailand. They continued their upward trend in the Philippines and even reversed their declining trend in Malaysia (Figure 17). As previous ARRs have noted, the transfer of problem loans from banks' balance sheets to asset management companies (AMCs) has accounted for a significant part of the improvement in NPL ratios since the financial crisis of 1997. When NPLs still held by AMCs are added to those in the banking system, the picture is even less promising. These aggregate NPL ratios continue to be much higher than those in bank balance sheets alone—about 55 percent in Indonesia, 25 percent in Thailand, and in the 17-19 percent range in Korea and Malaysia (Figure 18). The NPL ratio in the Philippines, which did not set up an AMC after the financial crisis, has been climbing up steadily. At 18 percent, it is comparable to the aggregate NPL ratios in Korea and Malaysia.

The high aggregate NPL ratios reflect both the slow pace of disposal of assets by the AMCs and the reentry of previously resolved loans as NPLs. Indonesia is a striking example of the former. The Indonesian Bank Restructuring Agency (IBRA) has been able to dispose of only about 6 percent of the NPLs it acquired from banks (Figures 19 and 20). In Thailand, where the total NPL ratio has remained at about 25 percent of total loans since the beginning of the year, many loans that were earlier rescheduled have become nonperforming. Moreover, they are increasing as a proportion of total NPLs in the banking system. To deal with these problems, in June the new Government established a centralized AMC, the Thai Asset Management Corporation (TAMC) along with a powerful legal framework for the management and resolution of distressed loans. TAMC will acquire about half of the banking system's NPLs, including all (B1.1 trillion) of the State banks' NPLs and about one quarter (B250 billion) of private banks' NPLs by the end of 2001. Thailand's private banks have set up their own AMC but its performance is difficult to evaluate since asset disposal data are incomplete.

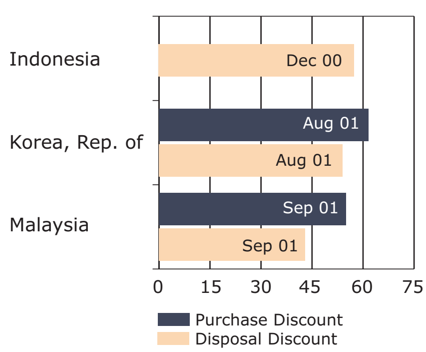
Capital adequacy ratios (CARs) of commercial banks in four of the five crisis-affected countries (Indonesia excluded) have exceeded the 8 percent Basle norm for some time (Figure 21). The Philippine banking system has a CAR of about 16 percent, while Korea, Malaysia, and Thailand maintain CARs in excess of 10 percent. In Indonesia, for the seven banks that have been recapitalized with the assistance of IBRA, the CAR was about

Figure 19: **NPLs Purchased and Disposed of by AMCs*** (%)



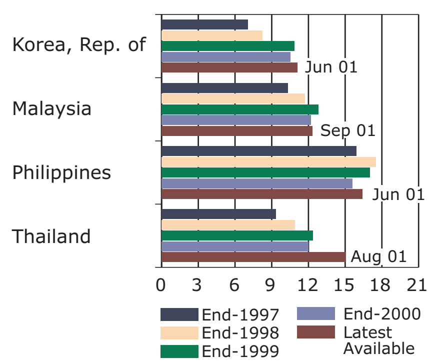
*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia, as of the dates indicated.
Source: ARIC Indicators.

Figure 20: **Discount Rates on NPL Purchases and Disposals by AMCs*** (%)



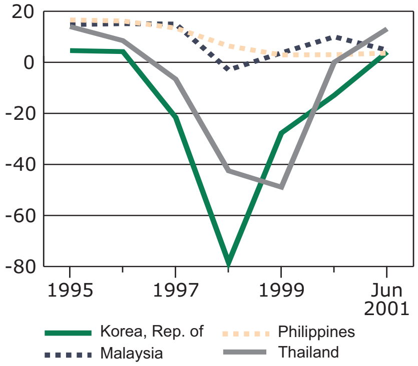
*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia, as of the dates indicated.
Source: ARIC Indicators.

Figure 21: **Capital Adequacy Ratios of Commercial Banks** (%)



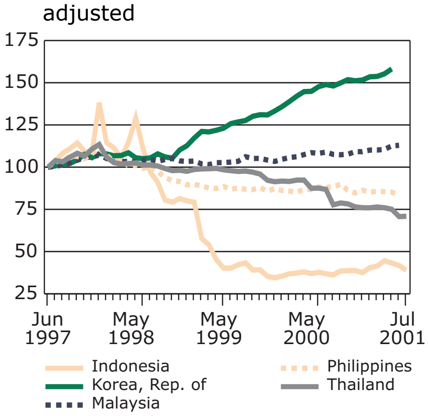
Source: ARIC Indicators.

Figure 22: **Banking Sector Profitability*** (%)



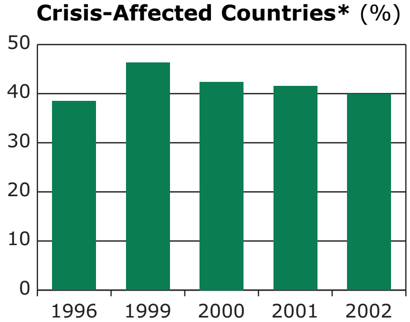
*Data refer to average return on equity of commercial banks except for Malaysia, which refer to listed commercial banks only. Data for Korea is as of March 2001.
Sources: Web sites of the Financial Supervisory Service, Bangko Sentral ng Pilipinas, Stock Exchange of Thailand, and Bloomberg.

Figure 23: **Real Bank Credit*** (1997June=100), seasonally adjusted



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

Figure 24: **Poverty Incidence, $2 per Person per Day—Five Crisis-Affected Countries*** (%)



*Data for 1997 and 1998 are not available.
Source: World Bank, *East Asia Update,* October 2001.

11.8 percent as of September 2001. However, CARs for the other banks are much lower. Indonesia's target is to reach an 8 percent CAR for the banking system as a whole by the end of this year.

With the exception of Malaysia, the profitability of banks, as measured by the average return on equity, has generally improved in 2001 (Figure 22). However, caution should be exercised in interpreting these profitability figures, as they tend to be lagging rather than leading indicators of banking sector health. The sharp recovery of economic activity during the postcrisis years of 1999 and 2000 has contributed to the recent improvement in bank profitability. By the same token, the current economic slowdown will eventually cut into bank profitability, as suggested by the reentry of previously restructured loans as NPLs in bank balance sheets. This makes it even more critical that countries push ahead with fundamental restructuring of their corporate sectors.

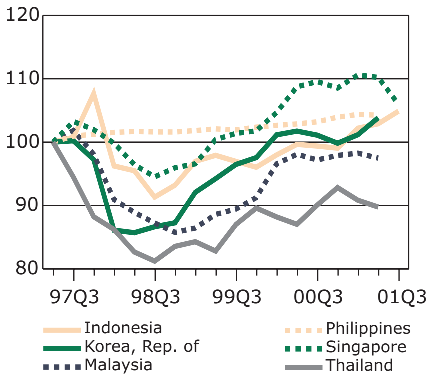
Progress in restructuring the corporate sector has proceeded much more slowly than in the financial sector. While the crisis-affected countries have gone some way toward reducing their excessive debt-equity ratios, rescheduling corporate debt, and lengthening debt maturity, operational restructuring of troubled businesses has lagged behind (for details, see the chapter on Corporate Restructuring). Overall, it is not encouraging to see the continued decline in the stock of real bank credit to the private sector—a composite indicator of the progress in both banking and corporate restructuring—in Indonesia, Philippines, and Thailand, where figures are still substantially below precrisis levels (Figure 23).

Social Sector Developments

On the back of strong growth in 1999 and 2000, many social sector indicators in the crisis-affected countries were recovering, after having slid in the aftermath of the 1997 crisis. By the end of 2000, social indicators such as poverty incidence, job prospects, real wages, and private consumption had partially recovered from their worst levels at the height of the crisis. World Bank estimates suggest that the percentage of population living below the $2 per day poverty line, after increasing in the aftermath of the 1997 crisis, fell in 2000 in the five crisis-affected countries taken together.

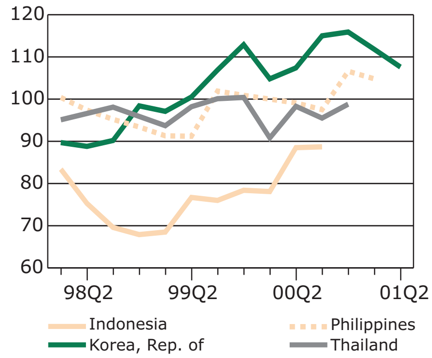
The pace of poverty reduction has probably received a setback from this year's economic slowdown. Latest World Bank estimates support this view. Although there are some differences across countries, in the five crisis-affected countries taken together, the incidence of $2 per day poverty is estimated to have declined only marginally this year compared to last year's relatively sharp fall (Figure 24).

Figure 25: **Per Capita Real Private Consumption Index** (1997Q2=100), seasonally adjusted



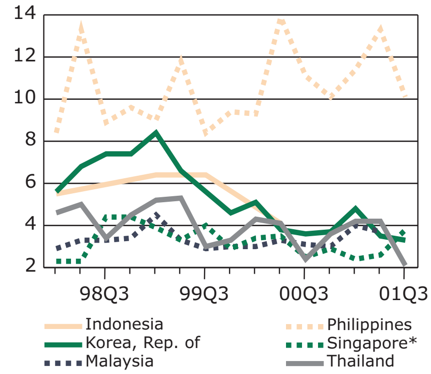
Source: ARIC Indicators.

Figure 26: **Real Wage Index** (1997Q2=100)



Source: ARIC indicators.

Figure 27: **Unemployment Rates—Five Crisis-Affected Countries, Quarterly** (%)



*Data for Singapore are seasonally adjusted.
Source: ARIC Indicators.

Recent trends in other indicators of social recovery are somewhat mixed. Available data for this year suggest that per capita real private consumption is declining in Malaysia and Thailand, almost stagnant in the Philippines, and increasing in Indonesia and Korea (Figure 25). Outside the five crisis-affected countries, the figure is also declining in the recession-hit Singapore. Data on real wages—another indicator of social recovery—are incomplete for 2001. In the two countries for which 2001 data are available—Korea and Philippines—it is falling (Figure 26). In the face of sharply slowing growth, firms in many East Asian countries have been compelled to lay off labor. However, in the absence of data, especially at the national level, it is difficult to assess the magnitude of these layoffs. The unemployment rate, which is known to lag trends in GDP growth, is declining in Korea, Philippines, and Thailand and is below the corresponding levels a year ago. In Singapore, after declining in the first quarter of this year, it has increased in the second quarter and now stands higher than the level a year ago (Figure 27).

Risks to Regional Growth and Recovery

External Risks

Even before 11 September, external risks to the region's growth were on the rise. The US economy was teetering close to a recession with (i) manufacturing output contracting in the previous 12 months; (ii) corporate profits falling; (iii) stock markets sliding; (iv) the unemployment rate increasing; (v) business investment continuing to weaken; and (vi) even consumer confidence, which was resilient until June, starting to weaken.

Emerging trends in Japan and Europe were also not encouraging. Japan was caught between a "liquidity trap" on the one hand and a "public debt trap" on the other. Successive Tankan Surveys had cautioned that the Japanese economy was already in the fourth recession of the past decade. Europe was also being affected by the US slowdown much more than earlier expected.

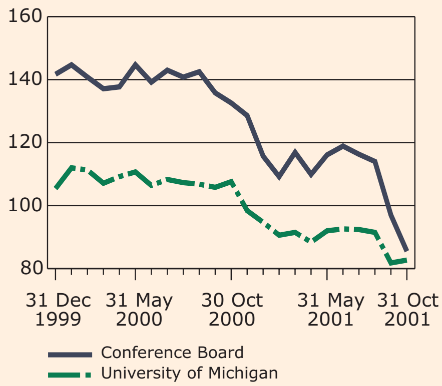
Moreover, as the September Update of the ARR cautioned, unlike previous downturns (which were caused mainly by a contraction in consumer demand after central banks raised interest rates to rein in inflation), this year's global slowdown was caused by a boom-bust cycle in investment, especially in the IT sector, and was mainly structural in nature. Structural downturns tend to be more difficult to reverse as it is harder to purge financial excesses and overcapacity than to deplete inventory and tame overconsumption and inflation. Overall, even before 11 September, the global slowdown was turning out to be deeper, longer, and more synchronized than anticipated. The 11 September attacks on the US, the subsequent US-led military operations in Afghanistan, and the anthrax scares have introduced an additional element of risk and uncertainty to the world economy.

US consumer confidence, which was already weakening before 11 September, seems to have received a further jolt in the wake of the attacks. Available information indicates that the US business sentiment index also declined immediately after 11 September (Box 1). However, US retail sales after plunging immediately after 11 September have picked up strongly in October. Also, the US stock market, after declining sharply immediately after the attacks, has more than recovered its lost ground more recently. These quick rebounds suggest that the short-term impacts of the attacks on the US and the global economy could be moderate. Since the US economy was already on the verge of a recession, even these moderate impacts have pushed it over the brink, beginning in the third quarter of this year when US GDP contracted marginally. However, there is a growing consensus that the US recession is likely to be mild and short-lived.

An important reason for such cautious optimism is that, in the aftermath of the 11 September attacks, the US in particular and other industrial countries in general, have put together a set of appropriate macroeconomic policy responses (Box 2). Because of the aggressive interest rate reductions by the US Federal Reserve Board (FED), the US short-term interest rate (the Federal Funds rate) is now marginally below consumer price inflation. Even the European Central Bank (ECB), which was reluctant to cut interest rates before 11 September, has matched two of the three 50 bp interest rate reductions by the FED after 11 September. It is true that FED's interest

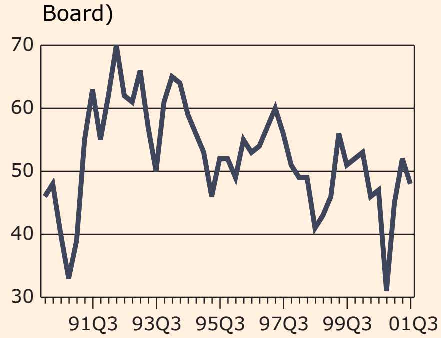
Box 1: **The 11 September Attacks—Impacts on the US**

Figure 1.1: **US Consumer Confidence Index**



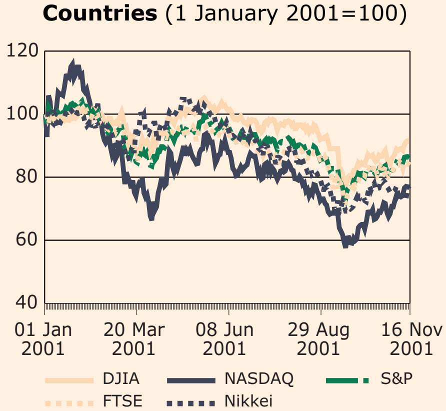
Conference Board numbers released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

Figure 1.2: **US Business Confidence Index** (Conference Board)



Source: Bloomberg.

Figure 1.3: **Stock Market Indexes in Major Industrial Countries** (1 January 2001=100)



Source: Bloomberg.

Conceptually, it is important to distinguish between the short-term and somewhat longer-term effects of the 11 September attacks on the US. The short-term impacts include: (i) the destruction of physical assets in New York and Washington, DC (estimated by some to have been around $40 billion), (ii) the disruption of economic activity in several sectors (notably airlines, hotels, and insurance companies) immediately following the attacks, (iii) the temporary postponement of consumer spending as consumers take a "wait and see" approach because of the additional uncertainty (US retail sales fell by a seasonally adjusted 2.4 percent in September—the biggest monthly drop since January 1992. Among the worst hit were clothing stores [down by 5.9 percent], restaurants and bars [down by 5.1 percent], and car dealers [lower by 4.6 percent]. Also, industrial output fell by 1 percent in September on top of a 0.7 percent decline in August), and (iv) temporary uncertainty in the financial markets and a decline in the stock market (US financial market services were disrupted and stock markets around the world were sharply lower immediately after 11 September, but normalcy was restored soon).

Most of the short-term impacts will be confined largely to the third and fourth quarters of this year, and these are expected to be modest. Since the US economy was already on the verge of a recession, even these moderate impacts were enough to push it into negative growth in the third quarter of this year and probably in the fourth quarter as well. Thus, the key question at this stage is not whether the US is in recession or not, but how long and deep that recession will be. The answer to this depends on the long-term effects of the 11 September attacks.

These will determine the global economic outlook for next year and beyond and could include a prolonged weakness in US consumer confidence and spending, and a further decline in US business confidence and investment.

US consumer confidence, which was already weakening before 11 September, seems to have received a further jolt in the wake of the attacks. Both the US Conference Board's index of consumer confidence and the Michigan consumer sentiment index declined sharply immediately after 11 September (Figure 1.1). To some extent, the September decline was part of the overall downtrend of the last few months. Yet, the 11 September attacks might have accentuated the already declining consumer confidence.

The Conference Board's business sentiment index for the US, which is published quarterly, declined in the third quarter after increasing in the second (Figure 1.2). It is difficult to infer to what extent the decline was due to the 11 September attacks. Also, despite the decline, the index is still higher than its worst level in the last quarter of 2000. Equity values in the US stock market—another proxy for investor sentiment—after dropping significantly in the aftermath of 11 September, have since then recovered. Most industrial country stock markets have followed this trend (Figure 1.3). The recent response of the stock market is in line with past US experience. Stock market weakness following crises generally reverses quickly (this was the case following the Kennedy assassination, the Iranian hostage crisis, and the Gulf war, but the exception was the supply-side driven energy crisis of the early 1970s, which was followed by sustained weakness).

Overall, the 11 September attacks have introduced additional uncertainty to an already weakening US economy. However, it appears that the short-term impacts of the attacks are modest. The longer-term effects are uncertain and difficult to gauge. Yet, the fall of Kabul and other areas in Afghanistan suggests that even these longer-term risks may have diminished somewhat.

rate reductions have not so far helped to revive capital spending in the US. However, it is important to bear in mind that interest rate reductions and monetary easing work with a long and, at times, varying lag. But the historical evidence is that it does work. Much of the impetus from the aggressive interest rate reductions by the FED are, therefore, still to come. US fiscal policy has also taken an expansionary stance since the 11 September attacks, although there is a continuing debate over whether the fiscal stimulus should be mainly in the form of tax cuts or expenditure increases. Moreover, oil prices, after rising sharply following the 11 September attacks, have subsided since then. Fears of an oil shock are receding as a result.

Taking some of these factors into account, the International Monetary Fund (IMF) predicts that the direct economic damage of the 11 September attacks on the US economy this year will be relatively moderate. Accordingly, in a press conference held on 15 November, the IMF made only marginal downward revisions to its forecasts of US and global GDP growth for 2001. It now places US GDP growth for 2001 at 1.1 percent

Box 2: **The 11 September Attacks—Policy Responses by the Industrial Countries***

The macroeconomic policy responses by the industrial countries in the aftermath of the 11 September attacks fall into three broad categories.

Coordinated liquidity provision to stabilize the world financial markets. Immediately after 11 September, central banks of the G7 countries assured that they were ready to provide ample liquidity as well as coordinate their monetary policies to stabilize the world financial system. The FED has injected more than $120 billion of liquidity into the financial markets and announced that it will provide additional funds if required. In addition, soon after the attacks, it established a $90 billion swap line with the ECB, Bank of England, and Canadian Central Bank to ensure that banks in their countries can draw dollars through their own central banks in case of shortages.

Interest rate reductions by the FED and other industrial country central banks. The FED reduced interest rates by 150 bp in three installments of 50 bp each, on 17 September, 2 October, and 6 November. At 2 percent, the FED Funds rate in the US is at a 40-year low and lower than the US inflation rate. Equally important, more interest rate cuts in the near future are not ruled out by the FED. ECB matched the FED's interest rate reductions on 17 September and 6 November by cutting interest rates by 50 bp each time. The Bank of Japan reduced its already low interest rate and brought in measures to increase liquidity. Meanwhile, the Bank of England reduced its benchmark policy interest rate by 100 bp in three installments, the first on 19 September, the second on 4 October, and the third on 7 November. Central banks in other countries have also reduced interest rates by varying degrees since 11 September (for example, Australia, by 25 bp, and New Zealand, 50 bp). Monetary easing works with a long and varying lag, but the historical evidence is that it does work.

Keynesian-type fiscal policy stimulus in the US. US fiscal policy has also become more supportive of aggregate demand and growth since the 11 September attacks. The US Congress has already approved a $40 billion emergency package, equivalent to 0.4 percent of the 2001 GDP, half of it to finance rescue and relief efforts and the other half for unspecified intelligence and military operations. It also has passed another $15 billion rescue package for the US airline industry, which was debilitated by the US Government's temporary ban on flights and is reeling from a precipitous drop in air travel. Moreover, a fiscal stimulus package ranging from $70 billion to $100 billion (about 0.6 percent to 1 percent of the 2001 US GDP)—including cuts in taxes on capital gains and corporations—is under consideration. It is likely that US fiscal policy will continue to remain accommodative next year as well, as the 11 September attacks have reduced political resistance to fiscal expansion even if it meant tapping the Social Security surplus. The scope for fiscal stimulus is, however, limited in Europe (because of the fiscal targets of the Stability and Growth Pact) and Japan (because 10 successive fiscal stimulus packages in the past have swelled the public debt ratio to more than 130 percent of GDP).

*For details, see this web site's page on Aftermath of Attacks on US.

Table 2: **GDP Growth Projections—IMF**

	15 November 2001		Difference from October 2001	
	2001	2002	2001	2002
World Output	**2.4**	**2.4**	**-0.2**	**-1.1**
United States	1.1	0.7	-0.3	-1.5
European Union	1.7	1.4	-0.1	-0.8
Japan	-0.9	-1.3	-0.4	-1.5
Developing Countries	4.0	4.4	-0.4	-0.9

Source: IMF, *IMF Managing Director Horst Kohler's Statement on the Global Economic Situation,* 15 November 2001.

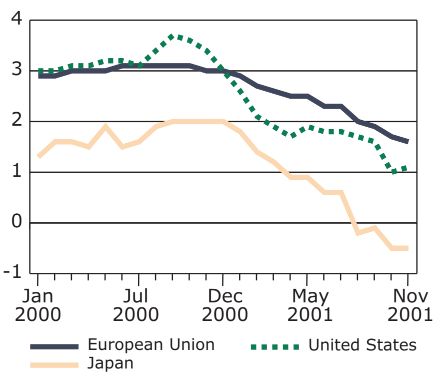
(down from the 1.3 percent forecast made before 11 September) and world GDP growth at 2.4 percent (slightly lower than the 2.6 percent forecast made before 11 September) (Table 2). This figure of 2001 world GDP growth is higher than the rates posted during the previous global recession years of 1975 (1.9 percent), 1982 (1.2 percent), and 1991 (1.4 percent).

Next year's recovery is, however, expected to be more muted than earlier anticipated. The IMF's downward revisions of US and global growth for 2002 are thus larger than those for this year. The IMF now expects US GDP to grow by 0.7 percent in 2002, more than a percentage point lower than its 2.2 percent forecast made before 11 September. It also expects world GDP to grow by 2.4 percent in 2002, down from its 3.5 percent forecast made before the attacks.

Outside the US, Japan is experiencing its fourth recession in a decade and unemployment is at a record level of 5.3 percent. Europe is also slowing faster than most anticipated. The IMF has, therefore, downgraded growth projections for both areas. It expects Japan's GDP to contract by 0.9 percent in 2001, larger than the 0.5 percent contraction projected before the 11 September attacks. The revision for next year is larger: the IMF projects Japan's GDP to contract by 1.3 percent in 2002 as compared to the 0.2 percent growth projection made before the 11 September attacks. As for the European Union, there is only a slight revision to this year's GDP growth, but the prediction for next year's growth is 1.4 percent—0.8 percentage point lower than that made before 11 September.

The most recent forecasts of US and global growth by the World Bank and private sector forecasters are broadly in line with those of the IMF, once the differences in coverage and the methods of weighting individual country growth rates are accounted for. For example, Consensus Economics predicts US GDP growth to be 1.1 percent in 2001 and 0.7 percent in 2002. Consensus Economics' forecasts of GDP growth for other major industrialized countries are of a similar order to the IMF's (Figure 28).

Figure 28: **Consensus Forecasts of 2001 GDP Growth—Industrialized Countries** (y-o-y, %)



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

Domestic Risks

In contrast to external risks, for some time now, domestic risks to East Asia's growth and recovery have been on the decline with the restoration of political stability in Indonesia, Philippines, and Thailand. This is a major plus for East Asia's economic prospects. However, as the September Update of the ARR cautioned, hints of "reform reluctance" or "reform fatigue" and conflicting messages on the direction of economic policy and the reform process have become common in recent months in some of these countries.[4] This does not augur well for the region, especially against the backdrop of sharply slowing growth, increasing outflows of private foreign capital, and the slowing pace of NPL resolution in some countries. A recent report by Ernst and Young cautions that the continued NPL problem in the region is as much a political as an economic or financial issue and political leaders need to take the initiative in pushing through reforms if the NPLs are to be resolved.

Regional Economic Outlook

With the worsening of the global economic situation in the aftermath of the 11 September attacks, the economic slowdown in East Asia is likely to deepen further, while being more prolonged (For details of the transmission mechanisms of these effects of the worsening global situation following the 11 September attacks, see Box 3). Growth is now expected to pick up toward the middle of next year rather than late this year or early next year, as earlier anticipated in the September Update of the ARR. Next year's rebound is also likely to be more subdued than was previously predicted. Growth rates for most countries of the region have thus been revised down for both this year and the next. Consensus Economics has now revised the average 2001 GDP growth for East Asia down to 3.9 percent, 0.5 percentage point lower than its September forecast (Figures 29a, 29b, and 29c and Table 3). This would be the region's second slowest yearly growth in two decades, after the 1.4 percent GDP contraction in 1998 at the height of the Asian crisis.

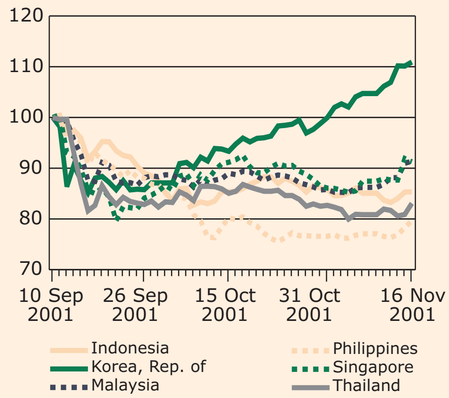
The current slowdown is being caused by an external demand shock that is being felt all around the region. Hence, with the exception of the PRC and the smaller ASEAN countries, the region is experiencing a synchronized slowdown, although countries with high dependence on exports, the US market, and global electronics demand are slowing faster than others. This is in contrast to the 1997 crisis years, when countries with open capital accounts and weak financial sectors suffered the most, while those

[4] See the September Update of the ARR for details.

Box 3: **The 11 September Attacks—Mechanisms of Transmission to East Asia**

As the world economic outlook deteriorates in the aftermath of the 11 September attacks, the impacts on the domestic economies of the East Asian economies will be felt in several ways. The channels through which the deteriorating external environment following the attacks transmit to East Asia are many and complicated. The most important of these channels are financial markets, capital flows, trade in goods and services, commodity prices, and certain sectoral linkages—especially tourism and airlines. It is also possible that the resulting environment of increased risk and uncertainty will impinge upon Asia in ways that are still difficult to pin down.

Figure 3.1: **Major East Asian Stock Indexes**

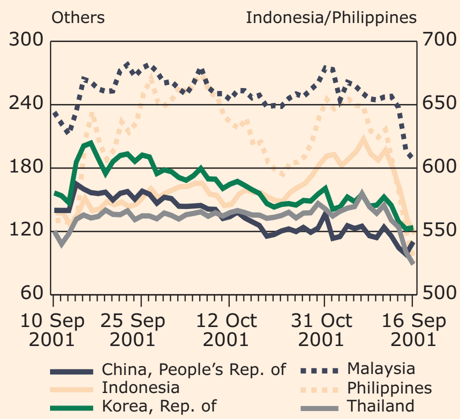


Source: Bloomberg.

Financial Market Channel

The most immediate, and already apparent, channel operates through financial market linkages. Equity markets in East Asia fell sharply immediately following the 11 September attacks. Although US, European, and Japanese bourses have more than recovered since then, major East Asian markets (except Korea) have not (Figure 3.1). Since the 11 September attacks, their losses have been substantial, ranging from 6 percent in Singapore to 20 percent in the Philippines.

Figure 3.2: **Bond Spreads over US Treasuries** (basis points)



Source: Bloomberg.

Capital Flows Channel

Even before 11 September, the weakening global economy was causing a decline in capital flows to the region. The 11 September attacks have worsened investor sentiment to the region. In the immediate aftermath of the attacks, bond market spreads increased in all East Asian countries (Figure 3.2). However, they have more than recovered lost ground and are now lower than the preattack levels. A related but longer-term impact involves the flow of foreign direct investment (FDI) to the region. Japan, US, and to a lesser extent the European Union (EU), are major investors in the region, and slowing growth in these source countries could reduce its supply of FDI.

Trade and Terms of Trade Channels

Even before 11 September, world trade had been projected to slow significantly this year. The IMF's October *World Economic Outlook* projected that growth in the volume of world trade in goods and services would slow to 4 percent in 2001 from 12.4 percent in 2000. The 11 September attacks will provide a further blow to world trade. The World Trade Organization (WTO) now projects that the volume of world trade will grow by less than 2 percent in 2001, down from its 7 percent forecast of May. The World Bank, meanwhile, places the growth of world trade in 2001 at 1 percent and in 2002 at 4 percent. Most countries in the region rely heavily on world trade, especially the US market for their exports. In 2000, for instance, the US share in total exports ranged from about 15 percent for Indonesia to about one third for the Philippines. Any further slowing of US imports will bite into already depressed export sales from the region. Exports to other industrialized countries will also be affected as they slow close on the heels of the US.

Apart from trade volumes, terms of trade are also likely to be affected by a contraction in global demand for goods and services. Although manufactures tend to dominate the external trade of most regional economies, the high share of electronic exports in total exports and the sharp contraction in their prices suggests that the manufactures' terms of trade will weaken further from their already depressed levels. The external environment would also impinge upon prices of commodities, thus altering the terms of trade of regional countries. Immediately after 11 September, prices of most non-oil commodities fell, but many of these prices have now fully recovered to the pre-attack level except cotton and coffee (Figures 3.3a and 3.3b).

Services Sector Linkages

Tourism and airlines are two service sectors that are likely to be most affected following the 11 September attacks. The effect on the tourism sector is, however, likely to be highly varied across countries, depending on the share of tourism in the economy, which ranges from around 1.9 percent of GDP in Myanmar to more than 7 percent in Thailand (Table 3.1)

Moreover, a reduction in tourist arrivals will affect associated industries such as hotels and restaurants, and

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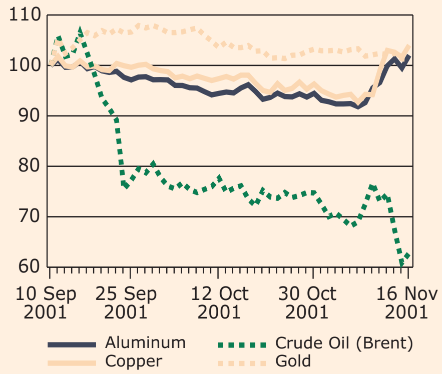
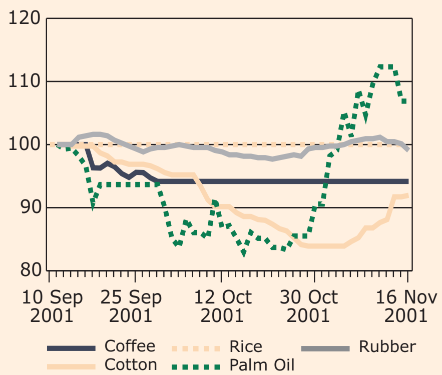
Box 3: **The 11 September Attacks—Transmission Mechanisms to East Asia** (Cont'd)

Figure 3.3a: **Oil/Metals Commodity Price Indexes**



Source: Bloomberg.

Figure 3.3b: **Agriculture Commodity Price Indexes**



Source: Bloomberg.

the cumulative impacts could be much higher. Tourism also generates significant foreign exchange receipts. In Thailand, for instance, net travel receipts are equal to about 50 percent of its current account surplus, while the figure is 31 percent in Malaysia, 22 percent in Indonesia, and 14 percent in the Philippines. The potential for a significant drop-off in foreign exchange receipts is thus a particular concern for crisis-affected countries, given the current environment of uncertainty and associated vulnerability.

Another visible and much publicized indirect impact is the troubled state of the world's airlines. The spate of recent collapses in Europe and Australia and reported difficulties in the US have been alarming, although many of these carriers were in severe trouble even before the 11 September attacks. It appears, however, that the sudden fall in passenger volumes and increased insurance costs following the attacks may have simply pushed them over the edge. According to the International Civil Aviation Organization, Asian airlines, on the other hand, do not appear to have been as badly affected. In most cases, any increase in insurance costs has been passed on to consumers in the form of a small surcharge, although the governments of Korea and Singapore have offered subsidies to varying extents.

In a fundamental sense, the current uncertain and risky environment following 11 September imposes a type of "security tax" on countries around the globe. In particular, the trade and tourism sectors seem to bear the major brunt of the tax. Hence, the more open the economy to trade and factor flows, the larger is this tax. Although the tax may be short-lived, its impacts can be significant. The tax manifests itself in various forms, including increases in insurance costs and even longer queues at airports and ports, as a result of heightened perceived risks. Higher insurance costs make the various forms of transport costs more expensive, which in turn impinges upon the movement of goods and people across borders. Thus, the cost of conducting trade, travel, and all types of business has increased, with sectors and industries that are engaged in trade and tourism, either directly or indirectly, feeling the greatest impact.

Table 3.1: **US Travelers and Asia's Exposure to Tourism**

Country	US Visitors as % of Total in 2000	Tourism as % of GDP in 2001
Cambodia	10.2	3.6
China, People's Rep. of	8.8	2.7
Indonesia	3.6	3.4
Korea, Rep. of	8.6	2.2
Lao PDR	4.5	4.9
Malaysia	1.8	4.0
Myanmar	5.5	1.9
Philippines	24.0	4.2
Singapore	5.0	4.6
Thailand	5.4	7.3
Viet Nam	9.7	3.6

Source: Pacific Asia Travel Association and World Travel & Tourism Council.

Figure 29a: **Weighted Average GDP Growth Rates*—East Asia** (y-o-y, %)

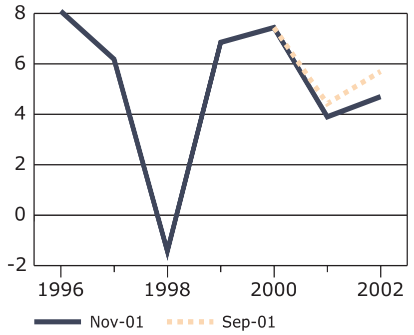


Figure 29b: **Weighted Average GDP Growth Rates*—East Asia excluding PRC** (y-o-y, %)

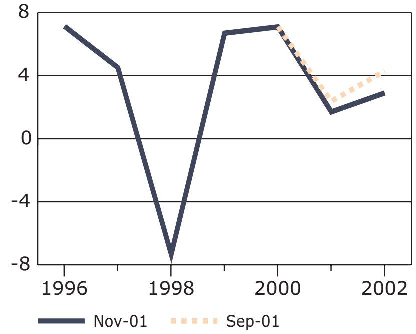
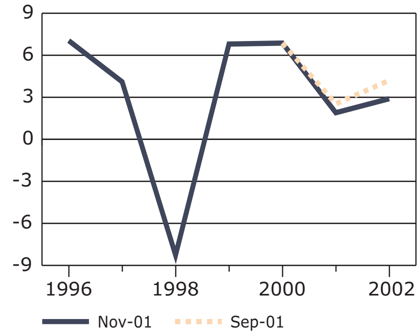


Figure 29c: **Weighted Average GDP Growth Rates*—Five Crisis-Affected Counries** (y-o-y, %)



*GDP growth rates weighted by GDP levels in dollars.
Sources: 1995-2000 data from official sources; 2001-2002 forecasts from Consensus Economics Inc. *Asia Pacific Consensus Forecasts* (September 2001 and November 2001 issues) for all countries except for Cambodia and Lao PDR, which are from official sources; GDP weights are from Asian Development Bank, *Asian Development Outlook.*

with relatively closed capital accounts or robust financial sectors generally escaped the contagion. The current downward revisions to 2001 growth (from the September 2001 forecasts) are particularly sharp for Singapore (2 percentage points), Korea (0.9 percentage point), Thailand (0.8 percentage point), and Malaysia (0.7 percentage point) (Table 3).

Table 3: **Annual GDP Growth Rates—East Asia** (%)

						November 2001 Forecasts				Difference from September 2001 Forecasts	
	1996	1997	1998	1999	2000	2001		2002		2001	2002
						Mean	Low/High	Mean	Low/High		
East Asia	8.1	6.2	-1.4	6.9	7.4	3.9	. . .	4.7	. . .	-0.5	-1.0
East Asia excluding PRC	7.1	4.5	-7.3	6.7	7.1	1.7	. . .	2.9	. . .	-0.7	-1.4
Five Crisis-Affected	7.0	4.1	-8.3	6.8	6.9	1.9	. . .	2.9	. . .	-0.6	-1.3
Cambodia	7.0	3.7	1.8	5.0	5.0	6.1	. . .	6.3	. . .	0.0	0.0
China, People's Rep. of	9.6	8.8	7.8	7.1	8.0	7.4	6.9/7.6	7.4	6.8/8.1	-0.2	-0.5
Indonesia	7.8	4.7	-13.1	0.8	4.8	2.9	1.5/3.6	2.9	1.2/4.1	-0.1	-1.0
Korea, Rep. of	6.8	5.0	-6.7	10.9	8.8	2.0	0.8/2.6	3.2	-1.0/4.7	-0.9	-1.5
Lao PDR	6.9	6.9	4.0	7.3	5.7	5.7	. . .	6.5	. . .	0.0	0.0
Malaysia	10.0	7.3	-7.4	6.1	8.3	0.0	-1.3/1.1	2.9	0.7/4.7	-0.7	-1.6
Philippines	5.8	5.2	-0.6	3.4	4.0	2.4	. . .	2.8	. . .	-0.1	-0.6
Singapore	7.6	8.5	0.1	5.9	9.9	-2.6	-3.2/-2.0	1.7	-2.0/4.5	-2.0	-3.0
Thailand	5.9	-1.4	-10.8	4.2	4.4	1.1	-0.2/1.8	2.3	1.0/3.3	-0.8	-1.1
Viet Nam	9.3	8.2	5.8	4.8	6.7	6.1	. . .	5.9	. . .	0.2	-0.2

. . . = not available.
Sources: 1997-2000 from official sources; 2001-2002 data from Consensus Economics, Inc., *Asia Pacific Consensus Forecasts* (September 2001 and November 2001 issues) for all countries except for Cambodia and Lao PDR, which are government forecasts.
Note: *Asian Development Outlook* weights (1995/1996 dollar GDP levels) were used to calculate composite growth.

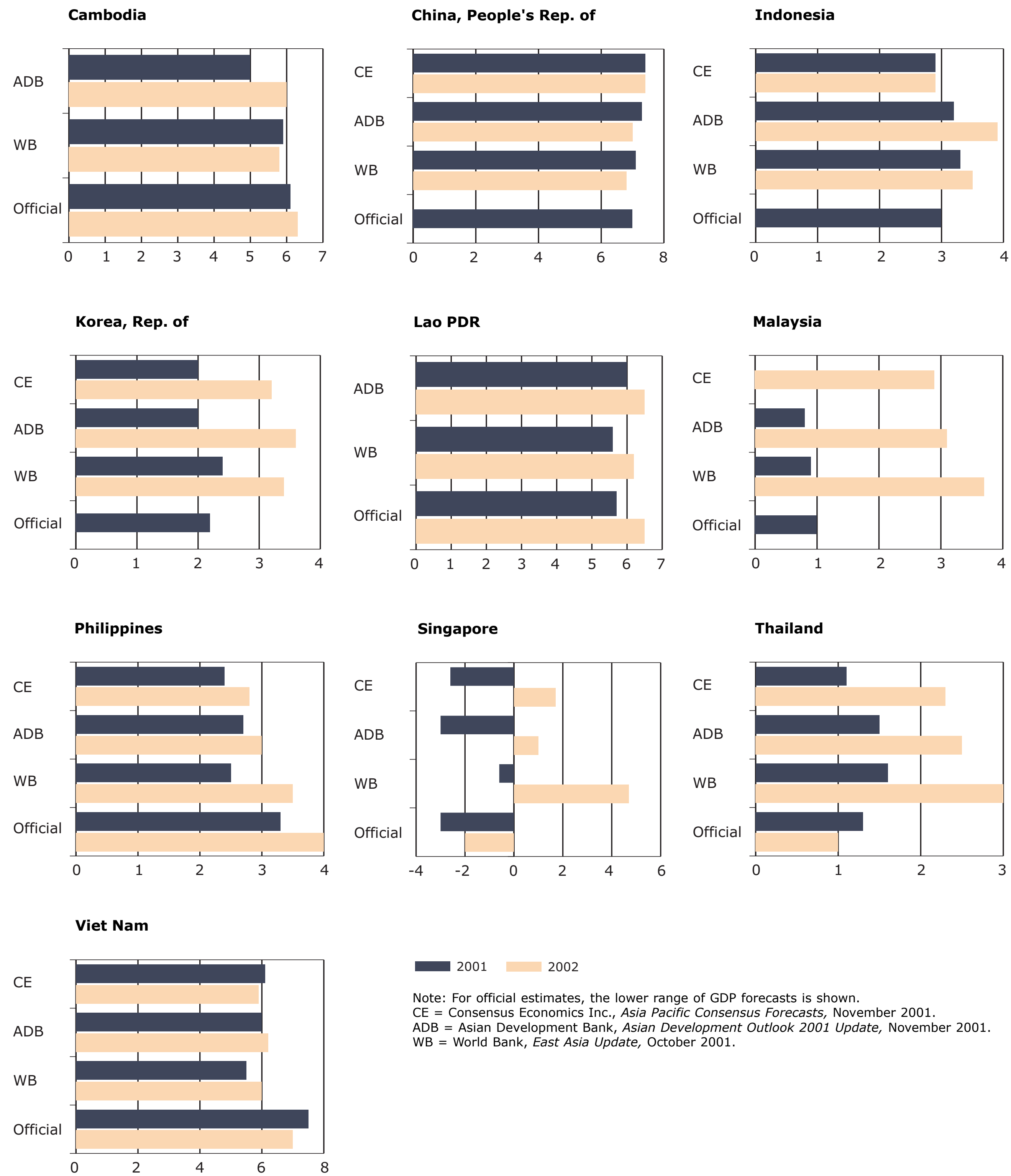
Among the East Asian countries, growth this year is expected to be robust only in the PRC (7.4 percent), Cambodia (6.1 percent), Viet Nam (6.1 percent), and Lao PDR (5.7 percent). GDP is expected to contract in Singapore by 2.6 percent, to remain stagnant in Malaysia, and to grow by less than 3 percent in Indonesia, Korea, Philippines, and Thailand. The five crisis-affected countries taken together are expected to grow by 1.9 percent this year. This compares poorly with their average growth rate of about 7 percent in the previous two years.

The recent downward revision of growth forecasts for 2002 is even larger than those for this year, suggesting that next year's rebound is also likely to be more subdued than was expected only about two months ago. Consensus Economics' projection is for GDP growth in 2002 of 4.7 percent for East Asia, a full percentage point lower than that of September. For the five crisis-affected countries, the corresponding revision is somewhat larger—from 4.2 percent to 2.9 percent. Downward revisions in the 2002 growth projection are particularly large for Singapore (3 percentage points); Malaysia (1.6 percentage points); Korea (1.5 percentage points); Thailand (1.1 percentage points); Indonesia (1 percentage point); and Philippines (0.6 percentage point). Even the growth projection for the PRC has now been lowered by 0.5 percentage point. Recent assessments of the region's growth prospects by the World Bank and the Asian Development Bank carried out after the 11 September attacks are broadly similar to these Consensus Economics forecasts (Figure 30). In view of the fluid international situation, risks still weigh on the downside for the region's economic prospects for next year.

Both the continued slower growth this year and subdued rebound next year represent a setback to the region's recovery from the 1997 crisis. Because of the sharp slowdown of growth, real per capita incomes in 2002 are expected to be lower than in 1997 in three out of the five crisis-affected countries—Indonesia, Malaysia, and Thailand (Figure 31). Meanwhile, it will just about hover around the 1997 level in the Philippines. The March ARR had noted that Malaysia looked poised to recover its lost income by the end of 2001. That assessment now needs revision. The country is unlikely to regain its 1997 real per capita income level even by 2002.

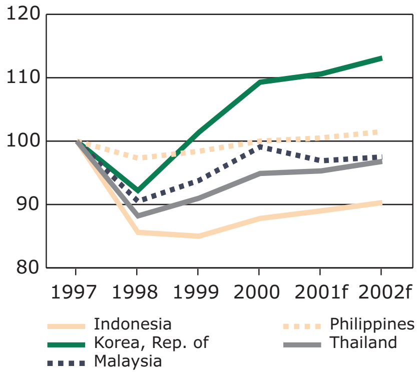
Lower growth this year and the next will also impact adversely on the pace of poverty reduction among these countries. Recent World Bank estimates support this assessment. Also, as discussed earlier, the pace of financial and corporate sector reforms has slowed in some countries this year because of the sluggish growth and subdued asset markets, providing yet another setback to the region.

Figure 30: **Comparative 2001 and 2002 GDP Growth Forecasts for East Asian Countries** (%)



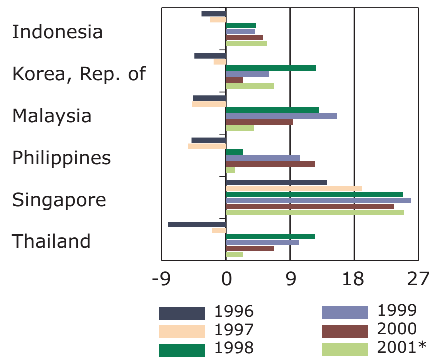
Note: For official estimates, the lower range of GDP forecasts is shown.
CE = Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* November 2001.
ADB = Asian Development Bank, *Asian Development Outlook 2001 Update,* November 2001.
WB = World Bank, *East Asia Update,* October 2001.

Figure 31: **GDP Per Capita Index*** (1997=100)



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., *Asia Pacific Consensus Forecasts,* November 2001.
Source: Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries,* ADB Statistical Database System; International Monetary Fund, *IMF Staff Report;* various national sources.

Figure 32: **Current Account Balance** (% of GDP)

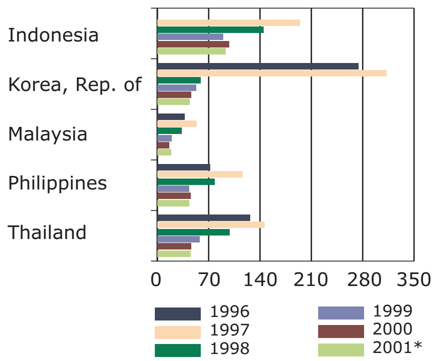


*2001 data until 2Q2001, except Indonesia (data are until 1Q2001) and Singapore (data are until 3Q2001).
Source: ARIC web site and Ministry of Trade and Industry (Singapore).

Coming so soon after the 1997 crisis, both the sharper-than-expected slowdown this year and the slower-than-expected rebound next year raise concerns about the robustness of the region's recovery from the crisis. There have even been fears that the region may experience a second round of the Asian crisis. However, it is encouraging that, although regional economies are experiencing severe difficulties, circumstances differ somewhat from those of the 1997 crisis.

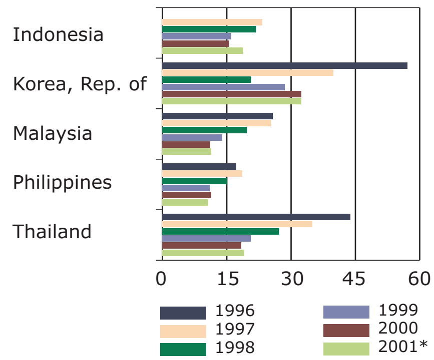
Judged by several prudential indicators, today the region is more resilient to a 1997-type crisis. Almost all East Asian countries, including the five crisis-affected countries, now run current account surpluses (Figure 32). Foreign exchange reserves have improved significantly and more than cover the entire short-term external debt (Figure 33). The short-term to total debt ratios and total external debt to GDP ratios are now lower than those seen at the height of the 1997 crisis (Figures 34 and 35). 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 capital adequacy ratios and profitability of banks are slowly recovering. It is also important to remember that the 1997 crisis was primarily a capital account crisis that was exacerbated by pegged, but unsustainable, exchange rates. Since then, many East Asian countries have moved toward more flexible exchange rate regimes. This should enable them to adjust to external shocks more smoothly. Several countries have also adopted the policy of inflation targeting.

Figure 33: **Short-Term External Debt** (% of Gross International Reserves)



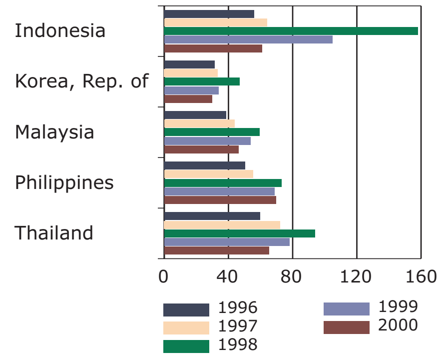
*Data as of June 2001.
Sources: ARIC Indicators except data for Indonesia which are taken from Nomura International and Bisnis Indonesia.

Figure 34: **Short-Term External Debt** (% of Total External Debt)



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

Figure 35: **Total External Debt** (% of GDP)



Source: Various national sources.

Medium and Longer Term Perspectives

The years since the onset of the Asian crisis represent the most turbulent half decade in East Asia's recent economic history. Rapid growth up to the 1997 crisis was followed by a severe recession in 1998. Since then, the faster than expected recovery of 1999 and 2000 has now been followed by a sharp economic slowdown, which has been worsened by the 11 September attacks on the US.

The turbulence and volatility hitting the region suggest that, in a rapidly integrating global economy, countries have to remain vigilant, as problems in one part of the world feed through to other parts at a rapid pace. In such an environment, there simply is no room for policy drift.

Going forward, it is perhaps not possible to make countries in a globalized world completely immune to shocks and economic cycles. But that does not mean that they cannot minimize the adverse effects of bad times such as the one facing the region now. To do that, countries need to undertake appropriate policy measures to improve their resilience to shocks. Globalization enhances the benefits of good policies just as it magnifies the impacts of bad ones.

Although the recent fiscal stimulus measures may provide modest short-term relief to some of the region's economies, past experiences of developing countries around the world suggest that countries should not rely entirely on spending their way out of an externally induced economic slowdown. Such strategies ultimately increase public debt and their vulnerability to future shocks, unless accompanied by measures to improve long-term growth potential.

It would, therefore, be in the best interests of the region's economies to complement the recent fiscal stimulus measures and interest rate reductions by pushing ahead with the remaining agenda of structural reforms in the financial and corporate sectors. Over the short term, that would enable them to strategically position themselves to take advantage of the improvements in the external environment that would follow the global recovery sooner or later. Over the longer term, it would also improve their growth potential and resilience to future shocks.

Efforts to push ahead with the remaining agenda of reforms and restructuring at the national level need to be complemented by measures to promote greater monetary and financial cooperation at the regional level. By strengthening regional policy dialogues, enhanced monetary and financial cooperation could also increase the benefits to the region of the PRC's membership to the WTO and the proposed free trade agreement with the ASEAN countries (Box 4). In fact, monetary and trade cooperation could proceed in a mutually beneficial manner.

The regional self-help efforts at greater information exchange, economic surveillance, and resource sharing that have been initiated by the ASEAN and ASEAN+3 countries in the aftermath of the 1997 crisis are encouraging (Box 5). The current slowdown, which has set back the region's recovery process from the 1997 crisis, provides another compelling reason why these initiatives at building a more robust regional financial architecture should be given further impetus.

Box 4: **The PRC—WTO and AFTA**

The accession of the PRC to the WTO will bring wide-ranging adjustments to output and international trade. Despite the spectacular strides that have been taken by the PRC over the past two decades it remains a comparatively poor and labor-intensive economy. There is still a large pool of "reserve labor" that can be absorbed into more productive activities in the industrial sector. The PRC's export mix reflects its cost advantage in labor-intensive activities. Its exports are concentrated in sectors such as footwear, toys, textiles, and clothing and to a lesser extent in consumer electronics. These account for more than 50 percent of exports to industrial countries. Its imports have been mostly capital and knowledge-intensive goods.

With improved access to the industrial economies that results from WTO membership, it is the labor-intensive activities that may be expected to make the most gains in terms of market share. With the scheduled end to the Multi-Fibre Agreement in 2005 and the lifting of quotas, the PRC is likely to increase its exports of textiles and clothing.

The overall export structure of the ASEAN 5 countries is quite different from that of the PRC. ASEAN 5's exports are concentrated more in electronics goods and office machinery. This is likely to limit competition between the PRC's and ASEAN 5's exports in third country markets. There would be limited trade diversion effects as a result. The situation is somewhat different for other ASEAN countries such as Cambodia, Lao PDR, and Viet Nam which export more labor-intensive products, and hence will face stiffer competition from the PRC's exports in the third markets.

While the PRC will compete in export markets against these ASEAN countries, the opening up of the massive internal market in the PRC will also present opportunities for trade creation for ASEAN. Although ASEAN's share in the PRC's imports is small (8 percent), it has significant potential to grow in the future. Further, ASEAN's location gives it an advantage in exploiting opportunities to export to such a large domestic market. Even if market shares do not increase, the PRC's import growth as a WTO member should accelerate further and trade creation should be substantial for many ASEAN economies, far outweighing any trade diversion. Once an increase in trade shares is factored in for ASEAN, trade creation effects dominate even more.

There will also be benefits to other countries in East Asia from more rapid growth and opening of the PRC, particularly the newly industrialized economies (NIEs), which can export textiles, petrochemicals, electronics, and other manufactures to the PRC. Some calculations show that the NIEs will benefit even more than ASEAN from the PRC's accession to WTO, primarily because their exports are more complementary.

Trade between the PRC and ASEAN could be further enhanced by plans to form a free trade zone within the next 10 years, announced on 2 November 2001 at an ASEAN summit meeting in Brunei Darussalam. The potential gains to both parties from such an agreement could be substantial, as it would form the world's largest free trade area of nearly two billion people and a combined GDP of $2 trillion. Five areas of cooperation have been identified—agriculture, information technology, human resources, direct investment, and development of the Mekong River basin. It could add as much as 1 percent to the combined GDP of ASEAN and about 0.3 percent to the PRC's GDP, according to Wang Yi, a Chinese deputy foreign minister.

There are, however, challenges and potential roadblocks to bringing the agreement to fruition. The free trade zone will have to be carefully negotiated and timed so as to minimize the adverse effects on ASEAN countries that could result from direct competition from PRC exports. There is also the risk that ASEAN members will give in to political pressure to defend their own producers at the expense of longer-term gains. Such an agreement is further complicated by the fact that ASEAN is working toward its own free trade area (the ASEAN Free Trade Area [AFTA]) in which barriers to trade on a wide range of goods are to be removed by 2003. Some resistance to free trade within ASEAN itself has cropped up with some countries wanting to protect local manufacturers.

Box 5: **Regional Monetary and Financial Cooperation in East Asia**

In the immediate aftermath of the Asian crisis, several proposals were advanced for promoting monetary and financial cooperation in the region. Initially, these proposals attracted some skepticism. But gradually the situation has changed and there is now a growing groundswell of support for expansion of such cooperation.

Information Exchange and Surveillance Processes

Manila Framework Group. The Manila Framework Group was established in November 1997 for the overriding purpose of regional surveillance and self-help when the proposal for the Asian Monetary Fund was turned down. This Group meets semi-annually and brings together deputies from the finance ministries and central banks of 14 countries, both within and outside the Asian and Pacific region. In these meetings, the deputies discuss the emerging economic situation in the region and exchange their assessment of key policy challenges. The Asian Development Bank (ADB), IMF, and World Bank present surveillance reports to the deputies.

The ASEAN Surveillance Process. In October 1998, the ASEAN Finance Ministers signed a Terms of Understanding that established the ASEAN Surveillance Process. Based on the principles of peer review and mutual interest among ASEAN member countries, the purpose is to strengthen the capacity of policymaking within the ASEAN group. In addition to the usual monitoring of exchange rates and macroeconomic aggregates, the ASEAN Surveillance Process monitors sectoral and social policies, and includes provisions for capacity building, institutional strengthening, and sharing of information. The ASEAN Finance Ministers meet twice a year for policy coordination under the ASEAN Surveillance Process.

The ASEAN+3 Surveillance Process. The ASEAN+3 group was formalized in November 1999 and the first peer review meeting under the ASEAN+3 Surveillance Process was held in May 2000 on the sidelines of ADB's Annual Meeting. It is similar to the ASEAN Surveillance Process, but includes—in addition to the ASEAN countries—PRC, Japan, and Korea.

Mechanisms for Resource Provision

The Asian Monetary Fund/Regional Financing Facility. The notion of regional monetary cooperation in Asia was introduced initially by Japan in September 1997. A $100 billion fund was proposed, half of which was to be provided by Japan and the remainder by the PRC; Hong Kong, China; Singapore; and Taipei,China. It was argued that this would provide sufficient liquidity that could be quickly mobilized to forestall speculative attacks on the region's currencies. Despite the strong support of several countries, the idea was turned down at the Fifth Asia Pacific Economic Cooperation (APEC) Meeting in Manila. It was argued that a regional fund would duplicate the IMF's activities and lead to moral hazard problems. However, the regional monetary fund or an equivalent structure continues to feature prominently in regional consultative meetings, the press, and academia.

The Chiang Mai Initiative (CMI) of the ASEAN+3 Finance Ministers. At their May 2001 meeting held in Chiang Mai, on the sidelines of the ADB Annual Meeting, the ASEAN+3 Finance Ministers came up with the CMI. In addition to reiterating the need for strengthened policy dialogues and regional cooperation activities, the CMI called for:

(i) An expanded ASEAN Swap Arrangement that would include all ASEAN countries, and a network of bilateral swap and repurchase agreement facilities among ASEAN countries, PRC, Japan, and Korea.
(ii) Use of the ASEAN+3 framework to promote the exchange of consistent and timely data and information on capital flows.
(iii) Establishment of a regional financing arrangement to supplement existing international facilities.
(iv) Establishment of an appropriate mechanism (early warning system) that could enhance the ability to provide sufficient and timely financial stability in the East Asian region.

Since then, there has been encouraging progress in these areas. In November 2000, the ASEAN Swap Arrangement was expanded to cover all ASEAN members and the total amount was also expanded from $200 million to $1 billion. Also, three bilateral swaps involving Japan and ASEAN countries have been signed and several more (including a two-way swap between the PRC and Japan) are at an advanced stage of negotiation.

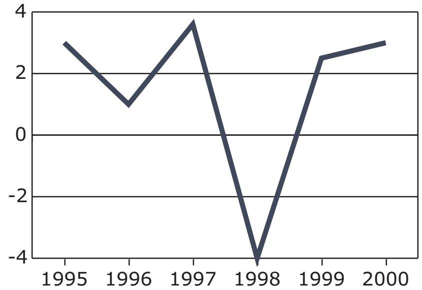
Beyond the Chiang Mai Initiative

Efforts are also under way to go beyond the CMI and harmonize macroeconomic and exchange rate policies. For example, an ASEAN Task Force on "ASEAN Currency and Exchange Rate Mechanism" was established in March 2001 and its deliberations are continuing. Additional impetus to this work is being provided under the "Kobe Research Project," which is an initiative of the Asia-Europe finance ministers to provide greater regional monetary cooperation in East Asia.

Under the "Kobe Research Project," a number of studies are being undertaken by institutions/individuals in Asia and Europe to explore ways and means of improving monetary and financial cooperation in the region. As part of a regional technical assistance project, ADB is conducting a study on "Monetary and Financial Cooperation in East Asia." The study will address issues in three key areas of regional financial and monetary cooperation: (i) information exchange, surveillance systems, and institutional arrangements; (ii) mechanisms for resource provision, including multilateralization of the CMI swap agreements and regional financing facilities; and (iii) regional exchange rate arrangements and coordination mechanisms. The ultimate objective of the study is to develop a road map of policy options to carry forward the ongoing monetary and financial cooperation efforts of ASEAN+3 countries. ADB is also supporting the ASEAN and ASEAN+3 surveillance process through capacity building for economic surveillance at both the national and regional levels.

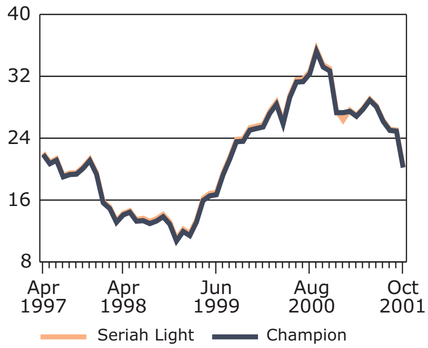
Brunei Darussalam

Figure 1: **Real GDP Growth** (%)



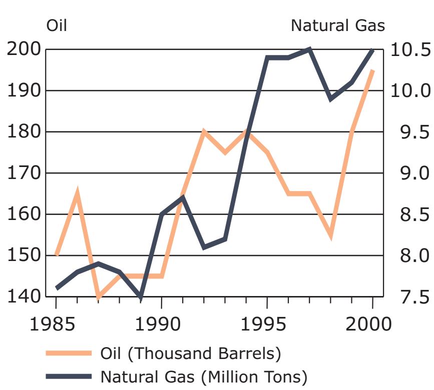
Source: National Development Committee, *Eight National Development Plan 2001-2005*.

Figure 2: **Brunei Contract Crude Oil Prices** ($/barrel)



Source: Bloomberg.

Figure 3: **Oil and Natural Gas Production per Day**



Source: Bloomberg.

Growth momentum may be tempered in 2001.

The Eight National Development Plan, which was released in October, is targeting annual average GDP growth of 5 to 6 percent per year in 2001-2005. But growth for 2001 is likely to fall short of both this target and the 3.0 percent figure realized last year (Figure 1). This is to be expected given the weakening global economy and the softening of world prices of oil and liquefied natural gas (LNG), the sultanate's major exports. The monthly average contract price of Brunei's crude oil fell to $20/barrel in October from its peak of $35/barrel a year ago (Figure 2). World prices of LNG, the country's other export pillar, have seen a similar decline. In line with the falling oil prices, the country reduced average oil production for the first six months of 2001 to 174 thousand barrels/day, which is 6 percent lower compared to the same period last year when oil and gas production reached record levels (Figure 3). With the hydrocarbon sector accounting for 37 percent of Brunei's GDP, lower oil and gas prices and production are likely to have a negative impact on output. In addition, weak export demand from Japan, Thailand, and US are also expected to further dampen GDP growth this year, as these three economies accounted for 68 percent of the sultanate's total exports in 2000.

The budget surplus is threatened.

Last year, fiscal prudence together with high oil prices enabled the Government to post a $1.2 billion surplus. This was a welcome change from the chronic deficits that have plagued the economy in recent years. This year, however, with plans to widen the tax base yet to be implemented and oil and gas prices falling sharply, the Government may find it difficult to maintain this surplus. Measures being considered to keep the budget balanced include reducing or adjusting privileges given to civil service workers and requiring payment for utilization of some government services. Taxes to be levied on foreign workers, numbering about 60,000 last year, are also being considered. On the other hand, plans to reduce tariffs on vehicles from around 200 percent to 15-20 percent next year will have a negative impact on government revenues.

The weak private sector and high unemployment are still a concern.

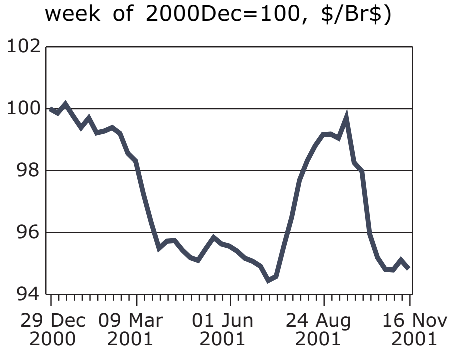
The slump continues in the private sector, which has yet to recover from the Asian financial crisis and the 1998 collapse of a large domestic construction company, which at that time was the country's largest private employer. With falling oil prices squeezing government revenues, government spending will be limited and this could mean continued weakness for the private sector. Businesses are seeking a hike in government spending to keep the economy moving and themselves afloat. The Government, however, has reiterated that it is not keen on handing out construction contracts to stimulate the economy. Given all of these factors, it is not surprising that unemployment remains a problem, estimated by official sources at somewhere between 5 and 6 percent. The problem is believed to be more acute for new graduates, 25 percent of whom have not found jobs.

Initiatives to boost private sector growth and employment are being undertaken.

The Government has embarked on various measures to address the economy's twin problems of continued private sector weakness and high unemployment. In February, it launched a Br$2.2 million government-paid apprenticeship training program in domestic firms for university graduates and higher diploma holders. Response to the program, however, has been poor, with only 340 out of the estimated 7,000 newly unemployed applying for the program. A second government program involves a micro-credit financing scheme, carried out in coordination with nine banks. Under this, university graduates may borrow up to Br$30,000 in order to start their own business, especially those in primary resources, construction, service, and info-tech communications sectors. The response to this program has also not been enthusiastic. Of the Br$30 million the fund has to offer, only Br$4 million has been disbursed. Another government initiative involves the passage of new regulations on investment, which seek to provide clear and definite guidelines for granting pioneer status to industries and give tax relief to foreign and local investors. Through these new incentives, the Government hopes to increase job creation and hasten commercial and industrial development.

Weakness in Singapore undermines Brunei's currency.

Figure 4: **Exchange Rate Index** (weekly average, last week of 2000Dec=100, $/Br$)



Source: ARIC Indicators.

The Brunei dollar, which is exchanged at par with Singapore's currency, has been weakening against the US dollar throughout most of 2001 (Figure 4). After a brief strengthening in August to early September, its value has dropped sharply since the 11 September attacks on the US. The US dollar value of Brunei's currency is now 4.7 percent below its 10 September level. The current economic downturn in Singapore will undermine both the Singapore and Brunei dollar. Thus, weakness is likely to persist in those currencies, resulting in higher domestic prices in Brunei, since the sultanate imports most of its food, building materials, clothing, and other daily necessities from abroad. On the other hand, the strong US dollar will have a positive impact on the country's export sector, enabling it to earn more Brunei dollars for its oil and gas exports, which account for more than 80 percent of total exports.

Economic diversification is a continuing thrust of the Government.

Services is one sector that the Government is pinning its hopes on to achieve its goal of economic diversification. The tourism industry, in particular, is being developed as a source of foreign exchange and private sector employment, so the Government is spending $2.9 million to actively promote this year as "Visit Brunei 2001." Brunei has, likewise, signed an open skies agreement with five countries in order to abolish restrictions on flights, foreign investment, and airline marketing services among them. These initiatives are timely since hotels in the country have long been suffering from low occupancy rates (currently around 20-30 percent) since the Asian crisis. Unfortunately, tourist arrivals in the country may have been negatively affected by the attacks in the US. Travel agents have already reported a drop in bookings and reservations to the country since 11 September.

The banking and financial institutions sector is another service subsector that the Government is keen on developing. This sector contributes about 80 percent to the non-oil and gas tax revenue. According to the Government, regulations governing International Insurance and Takaful Order (Islamic Insurance) are the only remaining legislation yet to be implemented in order for Brunei to become a full fledged international offshore banking center. The other three major areas of legislation, for which laws have already been enacted, relate to the banking, securities, and trust industries. All in all, 10 new laws were passed to make the country's business climate more attractive to foreign investors and lenders. In addition, the creation of a domestic capital market is also being considered. In this regard, the Government has plans to issue bonds (denominated in Brunei and US dollars) of different maturities in order to establish a yield curve for the country. But these plans for repackaging Brunei as an international financial center may meet stiff competition from already established rival centers in the region such as Hong Kong, China; Singapore and Tokyo. The country, however, may have found a niche with respect to providing Islamic financial facilities and services. The Islamic Development Bank Infrastructure is the first international financial group to set up an office in the sultanate, while the Islamic Mutual Fund is the first mutual fund company to open in the Brunei International Financial Centre.

More reforms are needed to promote foreign investment.

The Government still has to undertake various reforms to promote foreign investment and economic diversification, while further laws are needed to complement recently passed ones. For example, the inability of private individuals to sue the Government is seen by some as a hindrance to the entry of foreign investors in the country. The absence of timely and reliable economic and financial data is another problem, since it prevents informed analyses of the country's performance. Remedying these will be important to attracting foreign investors and competing with other offshore international financial centers that have more transparent government policies in place.

Cambodia

Growth should increase in 2001 with a pickup in agriculture.

The year 2000 was marred by unusually prolonged and severe flooding, but more recent indications are that damage to agricultural production was not as severe as initially feared. This outcome, combined with strong growth in garment exports and buoyant earnings, resulted in GDP growth of 5 percent in 2000. Recent forecasts suggest that growth might be higher in 2001, despite the global economic slowdown, which has recently been exacerbated by the 11 September attacks (Table 1).

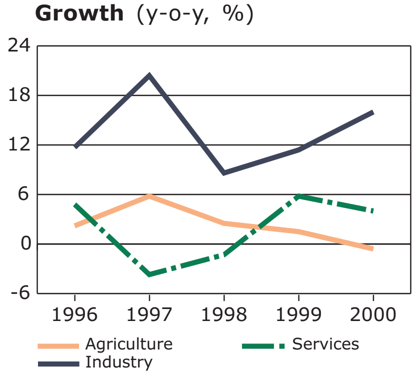
With agriculture generating nearly half of national income, the sector's performance will be critical to achieving strong growth. Weather conditions permitting, the agricultural sector should rebound and contribute to growth. Exports of garments and tourism earnings have been strong recently, and these are also expected to play a part. Thus, the Government predicts that growth in 2001 will exceed 6 percent, assuming continued political stability and international donor support.

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

	1997	1998	1999	2000	2001	2002
Official[1]	3.7	1.8	5.0	5.0	6.1	6.3
ADB[2]	—	—	—	—	5.0	6.0
IMF[3]	—	—	—	—	6.0	6.0
World Bank[4]	—	—	—	—	5.9	5.8

[1]Ministry of Finance, *Strengthening Macroeconomic Stability and Ensuring Sustainable, Broad Based Development,* June 2001.
[2]ADB, *Asian Development Outlook 2001*, April 2001.
[3]IMF, *Third Review Under the Poverty Reduction and Growth Facility,* August 2001.
[4]World Bank, *East Asia Update*, October 2001.

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



Source: ADB, *Asian Development Outlook 2001,* April 2001.

The industrial sector remained robust.

Agriculture contracted in 2000 due to the floods, which affected more than 20 percent of rice-producing lands (Figure 1). The output of forestry also fell—as a result of new limits imposed on felling timber. A silver lining to the flooding is that it helped boost fisheries production to some degree. Both manufacturing and construction made a strong contribution to industrial growth. Manufacturing growth in 2000 was again supported by the textiles and garment industry, whose output expanded following improved access to US and European markets. Preliminary estimates for 2001 suggest that manufacturing is again growing strongly.

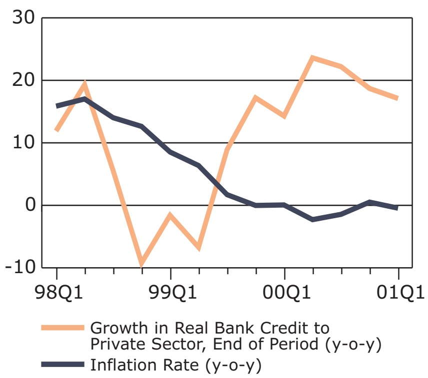
But the recovery in domestic private sector demand has been slow.

There was a modest pickup in public and private investment in 2000. Foreign investors remain hesitant about economic prospects, however, and FDI has not grown as much as expected following the return of political stability. FDI flows continued to hover below 5 percent of GDP in 2000. The Government is currently reviewing the tax and other incentives provided to investors (domestic and foreign) with a view to removing distortions as well as protecting revenues.

Needed fiscal consolidation is occurring, but problems remain.

Cambodia's overall fiscal deficit as a percent of GDP declined from 5.7 percent in 1998 to 4.2 percent in 1999, but increased again to 5.4 percent in 2000. The Government expects the deficit to be no higher than 6 percent for 2001. Most of the deficit was financed through foreign sources. The value-added tax introduced in 1999 was expanded further in 2000, and the elimination of ad hoc exemptions has increased customs collection and contributed to the country's revenue efforts. The 2001 budget aims to increase revenue to 12 percent of GDP, up from 11.5 percent in 2000. Despite these improvements, revenue mobilization remains difficult. Although defense and security spending continue to be a significant drain on scarce public resources, they are trending downwards.

Figure 2: **Real Bank Credit Growth and Inflation Rate** (%)

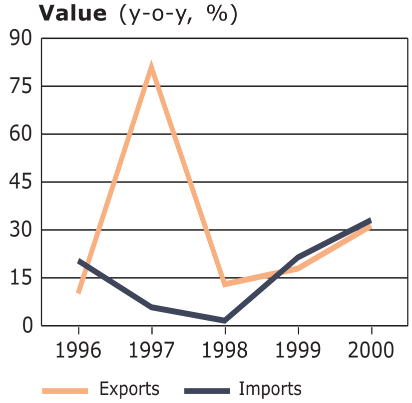


Source: ARIC Indicators.

Monetary easing increased domestic liquidity, but without putting undue pressure on domestic prices.

The Cambodian economy is characterized by a high degree of dollarization. Currency substitution reflects a lack of confidence in the local currency and constrains monetary policy. Inflation is more directly affected by the rate of depreciation of the riel than by monetary expansion. So with the riel broadly remaining stable, inflationary pressure has been muted in 2000 and 2001 (Figure 2). Given the difficulty in appraising the creditworthiness of borrowers and an uncertain domestic outlook, commercial banks continue to favor acquisition of foreign assets rather than domestic lending.

Figure 3: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)

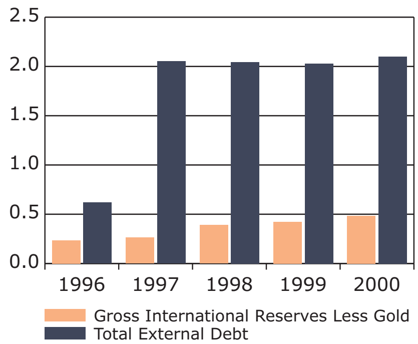


Source: ADB, *Asian Development Outlook 2001,* April 2001.

Exports picked up.

The total merchandise exports (in US dollar terms) grew by more than 30 percent in 2000 (Figure 3). Garment exports contributed strongly to this growth. Import demand grew at a slightly faster pace, at more than 33 percent. As such, the trade deficit increased slightly. The current account deficit for 2000 reached 4.6 percent of GDP, from 1.7 percent in 1999. Meanwhile, tourist arrivals continued to increase strongly and rose by 34 percent in 2000. Large official transfers helped to finance substantially the current account deficit in 2000. Capital inflows also increased in 2000 and were sufficient to finance the residual deficit. Cambodia's external reserve position remains healthy and reached $501.7 million as of end-December 2000, and improved further to

Figure 4: **International Reserves and External Debt** ($ billion)



Source: IMF, *Third Review Under the Poverty Reduction and Growth Facility,* August 2001.

$556 million by end-September 2001 (Figure 4). This is sufficient to finance four months of imports.

Private sector investment is crucial in achieving growth.

Private sector investment is constrained by limited infrastructure, restricted access to credit, and a weak regulatory framework. Reforms in these areas are needed to enhance the economy's growth potential.

The external sector looks favorable.

Following the signing of an agreement giving Cambodia preferential access to markets in the European Union until 2002, garment exports to Europe are expected to increase. This comes on top of a 5 percent increase in garment quotas to the US in 2000. However, most quotas are still not binding, reflecting relatively small volumes, and there is some flexibility in transferring unused portions of quotas across categories of garment exports. This flexibility, together with quota-protected trading relations, suggests that a sharper or faster-than-expected US growth slowdown is likely to have only a muted impact on the demand for Cambodia's garment exports. Tourist arrivals are likely to continue on their upward trend. This will boost services income, but financing the external deficit will continue to depend on aid inflows.

Poverty remains a problem.

With a GDP per capita of only $286 (2000 estimate), more than one third of the population remains poor. The Government has pledged to improve living conditions and recently released its Interim Poverty Reduction Strategy Paper, which serves as an input to the Second Five-Year Socioeconomic Development Plan (2001-2005) now being formulated. This paper recognizes that poverty alleviation hinges heavily on the realization of the country's growth potential.

The longer-term outlook is favorable, but challenges remain.

A stable political environment as well as physical and human resources improvement are required to sustain Cambodia's reform efforts so that real GDP growth rates of 6-7 percent are achievable over the medium term. However, difficult challenges remain. Improvements in forestry management have been encouraging, but more needs to be done, particularly in curtailing illegal logging. Progress in combating law and order problems is also going to be critical, while demobilization of the military is needed to contain public expenditure. Positive results from reforms, including labor standards, will help maintain an essential pipeline of international assistance, and improve Cambodia's access to important international markets, such as textiles and garments.

Cambodia: Selected ARIC Indicators

	1996	1997	1998	1999	2000	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																
GDP Growth (%)	. . .	3.7	1.8	5.0	5.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Agricultural Sector Growth (%)	. . .	5.8	2.5	1.5	-0.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Services Sector Growth (%)	. . .	-3.7	-1.3	5.8	4.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Industry Sector Growth (%)	. . .	20.4	8.6	11.4	16.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Inflation Rate (%)	7.2	8.0	14.8	4.0	-0.8	8.5	6.4	1.7	-0.02	0.1	-2.3	-1.4	0.5	-0.5	. . .	. . .
Unemployment Rate (%)	0.9	0.7	5.3	0.6	2.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts																
Growth of Broad Money, M2 (%)[1]	40.4	16.6	15.7	17.3	26.9	22.8	21.7	30.1	17.3	31.8	39.1	27.5	26.9	9.6	8.4	. . .
Growth in Real Bank Credit to Private Sector (%)[1]	34.6	34.2	-9.2	17.2	18.7	-1.6	-6.7	8.9	17.2	14.3	23.6	22.2	18.7	17.1	. . .	. . .
Loans to Deposit Ratio	0.7	1.0	1.0	0.8	0.7	0.6	0.7	0.8	0.8	0.7	0.7	0.7	0.7	0.6	. . .	. . .
Central Government Fiscal Balance as % of GDP	-2.8	-0.4	-2.7	-1.5	-1.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Education (% of Total)	10.7	10.7	11.3	15.0	16.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	5.4	5.6	4.7	6.9	10.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rate																
Growth Rate of Merchandise Exports ($ fob, %)	10.1	81.0	13.0	17.9	31.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Growth Rate of Merchandise Imports ($ cif, %)	20.4	5.8	1.6	21.4	33.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Gross International Reserves less Gold ($ Billion)[1]	0.3	0.3	0.3	0.4	0.5	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.6
Ratio of M2 to GIR[1]	1.3	1.0	1.0	1.0	0.9	1.0	1.0	1.0	1.0	0.9	1.0	0.9	0.9	0.9	0.9	. . .
Current Account Balance as % of GDP	-3.5	0.7	-0.3	-1.7	-4.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Foreign Direct Investment ($ Billion)[1]	0.3	0.2	0.1	0.1	0.1	0.05	0.03	0.03	0.03	0.02	0.03	0.03	0.04	. . .	. . .	. . .
Total External Debt ($ Billion)[1]	0.6	2.1	2.0	2.0	2.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Total External Debt as % of GDP	19.4	66.0	72.7	67.5	65.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Real Effective Exchange Rate (1995=100)[2]	105.5	109.9	99.9	108.7	107.0	104.5	109.5	111.1	109.6	107.0	106.0	106.5	108.4	104.7	. . .	. . .
Average Nominal Exchange Rate (Riel per $)	. . .	2,624.7	3,761.0	3,813.7	3,828.1	3,793.9	3,788.6	3,830.9	3,839.4	3,809.0	3,816.5	3,859.7	3,829.4	3,833.9	3,833.9	3,834.2

. . . = not available.
[1]End of period.
[2]Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output, fiscal balance, current account balance, and merchandise exports and imports are from Asian Development Bank, *Asian Development Oulook 2001;* M2, gross international reserves, ratio of M2 to reserves, loan deposit ratio, and inflation rate are from International Monetary Fund, *International Financial Statistics,* September 2001; nominal exchange rates are from Bloomberg; government expenditure on health and education, and unemployment rates are from Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2001;* total external debt are from International Monetary Fund, *Third Review on Poverty Reduction and Growth Facility,* August 2001. Real effective exchange rates are based on REMU staff calculations.

People's Republic of China

Real Sector

GDP growth remained robust in the first three quarters of 2001.

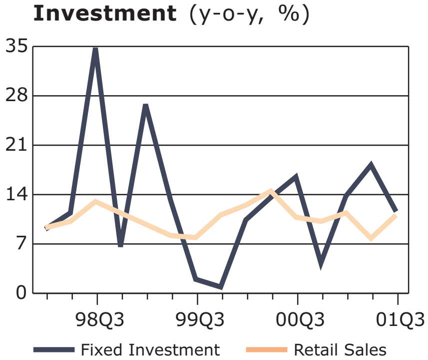
Despite the global slowdown, the PRC maintained its robust economic growth in the first three quarters of 2001. Real GDP grew by 7.6 percent (y-o-y), driven by strong domestic demand. But there was a slight slowdown in growth from 8.1 percent in the first quarter to 7 percent in the third, due to weakening exports. However, given the PRC's more diversified export markets and less dependency on IT, its growth is not as vulnerable as many of its neighboring countries to the global economic downturn. The official growth forecast for 2001 is 7 percent (Table 1).

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

	1997	1998	1999	2000	2001	2002
Official[1]	8.8	7.8	7.1	8.0	7.0	—
ADB[2]	—	—	—	—	7.3	7.0
IMF[3]	—	—	—	—	7.5	7.1
World Bank[4]	—	—	—	—	7.1	6.8
Consensus Economics[5]	—	—	—	—	7.4	7.4

[1]National Bureau of Statistics.
[2]ADB, *Asian Development Outlook 2001 Update*, November 2001.
[3]IMF, *World Economic Outlook*, October 2001.
[4]World Bank, *East Asia Update*, October 2001.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, November 2001.

Figure 1: **Growth of Real Retail Sales and Total Fixed Investment** (y-o-y, %)



Source: National Bureau of Statistics.

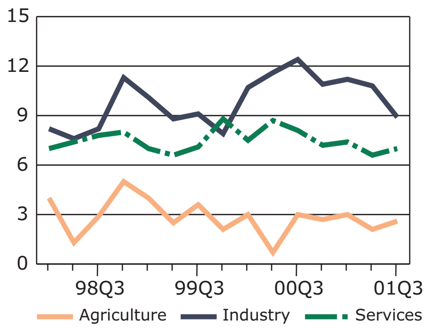
Consumption and investment have been driving growth.

Strong consumption and investment supported domestic demand as both benefited from four consecutive years of fiscal stimulus and accommodative monetary policy. In the first three quarters, retail sales grew by 10.1 percent (y-o-y) in real terms (Figure 1). Urban consumption continued to grow faster than that in rural areas, boosted in part by salary increases for civil servants. Fixed asset investment rose by 14.6 percent (y-o-y) in real terms during the same period, on the back of continued heavy government spending. State sector investment grew twice as fast as investments by the non-State sector, including collectives and privately owned businesses.

Industrial production remains strong.

On the supply side, growth was led by the industrial sector. Supported by the strength of the domestic economy, industrial value added grew

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



Source: ARIC Indicators.

by 10.3 percent (y-o-y) in the first nine months of the year (Figure 2). The performance of foreign-funded enterprises was even stronger, with their value added increasing by 12.3 percent (y-o-y), compared with 9.1 percent for State-owned enterprises. The sector's growth, however, dipped in the third quarter, to 8.9 percent, indicating that it is being hurt by the global slowdown. In fact, growth of manufacturing export deliveries (in value terms) declined for four consecutive months from April 2001, although this decline stopped in August. Meanwhile, the agriculture sector grew by only 2.5 percent in the first three quarters. With more than 20 of the 31 provinces and municipals being affected by serious droughts, yields of summer crops fell by 4.6 percent compared to the same period last year.

Fiscal and Monetary Developments

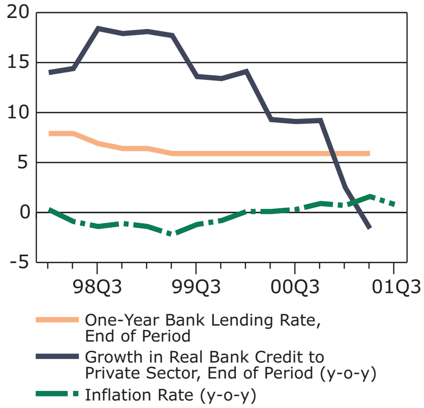
Fiscal policy continues to support growth.

The fiscal stance remained expansionary in 2001 in the face of the global economic slowdown. In the past three years, the Government has implemented three fiscal stimulus packages, backed by bond issuance, to contain the adverse effects of the Asian financial crisis (Y100 billion in 1998, Y110 billion in 1999, and Y150 billion in 2000). In 2001, Y150 billion worth of bonds are expected to be issued to finance continued investment in infrastructure and environmental projects, particularly in the western region. The Government has indicated that another Y150 billion will be injected into the economy next year as a pump-priming measure to offset the slowdown in the global economy and keep the growth rate above 7 percent.

The fiscal deficit in 2001 is likely to be lower than the programmed level.

The programmed fiscal deficit for 2001 is 2.7 percent of GDP, slightly lower than the 2.8 percent in 2000. This reflects efforts to contain government current expenditures, strengthen tax administration, and curb smuggling. Better-than-expected revenue collection in the first half suggests that the actual fiscal deficit in 2001 is likely to be lower than programmed. In the nine months to September, tax revenue increased by 22.3 percent compared to 21 percent during the same period in 2000. The main contributors to this were the value-added and consumption taxes, both of which rose by more than 20 percent. Meanwhile, enterprise income taxes increased by 41.4 percent.

Figure 3: **Interest Rate, Real Bank Credit Growth*, and Inflation Rate** (%)



*Data for 01Q2 as of April 2001.
Source: ARIC Indicators.

Monetary policy remains accommodative.

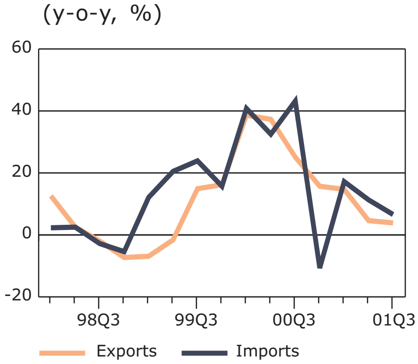
In an effort to stimulate domestic demand, monetary policy has remained accommodative. After seven consecutive cuts beginning in May 1996, the People's Bank of China (PBC), the country's central bank, has left the domestic one-year bank deposit rate unchanged at 2.25 percent and the prime lending rate of financial institutions at 5.85 percent since June 1999 (Figure 3). By end-September 2001, the outstanding broad money (M2) was up 13.6 percent over the same period of last year, while the aggregate loan balance of all financial institutions was also 13.5 percent higher. The fourth quarter meeting of the Monetary Policy Committee of the PBC recently concluded that renminbi lending and deposit interest rates, and the exchange rate should be kept stable.

Inflation started to edge up, but will stay low.

On the back of strong domestic demand and increases in prices of government-controlled goods and services, inflation has started to edge up. The consumer price index increased by 1 percent in the first nine months of 2001, compared to only 0.2 percent during the same period in 2000. While food and clothing prices continued to decline, housing and service prices rose. Overall, inflation will remain low in the short term because of excess capacity in many sectors. According to recent surveys by the State Economic and Trade Commission, 500 out of 603 commodities were in excess supply.

Balance of Payments

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

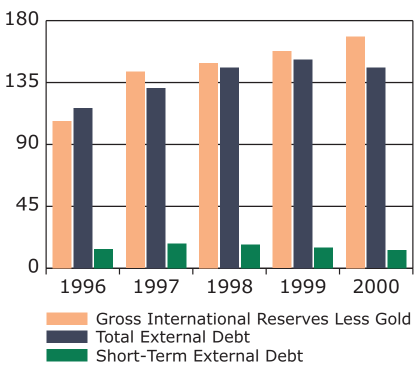
Export growth continues to fall sharply.

Because of the global slowdown, exports grew by only 7.2 percent (y-o-y) in the first nine months of 2001, compared to 33.1 percent in the same period last year (Figure 4). The decline began in the second half of 2000, reaching a low in June 2001, when exports registered negative growth of 0.5 percent. Although they bounced back into positive territory in July (6.6 percent), August (0.9 percent), and September (4.4 percent), the growth rate remained much lower than its recent trend. Imports, too, were well below last year's first three quarter average of 38.7 percent, growing by only 11.2 percent in that period this year. Starting in January, the Government eased tariffs on more than 3,000 dutiable items, leading to a reduction of the average tariff rate from 16.4 percent to 15.3 percent. The cuts, which helped keep import growth in double digits, are part of the Government's commitment to reduce the general tariff level to about 10 percent by 2005, in line with bilateral agreements reached in the WTO accession negotiations.

The trade account balance narrowed.

As a consequence of the export slowdown, the trade surplus in the nine months to September narrowed to $14 billion—$5.2 billion less than in the same period last year. The decline, equivalent to 0.6 percent of GDP, was caused mainly by an increasing trade deficit with Asian and European countries. Although net exports to the United States also fell in the first three quarters of 2001, the decline was limited due to the small share of IT products in the PRC's total trade with the US.

Figure 5: **International Reserves and External Debt** ($ billion)



Source: Bloomberg and International Monetary Fund, *International Financial Statistics,* March 2001.

Foreign direct investment surged.

Strong economic growth and the expected entry to WTO made the PRC a highly favored destination for foreign investment. Contracted and actual foreign investments grew strongly in the first three quarters of 2001. Actual FDI reached $32.2 billion, up by 20.7 percent over that recorded during the same period last year.

Foreign reserves continue to increase.

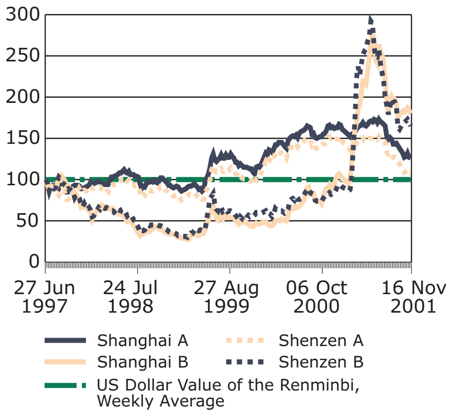
The trade surplus and FDI flows led to a further swelling of foreign exchange reserves, which reached $200 billion at the end of October 2001. Total external debt stood at $145.7 billion as of the end of 2000, of which, short-term debt amounted to 13.1 billion (Figure 5).

Asset Markets

The exchange rate remains stable.

Strong economic performance and large international reserves have helped to keep the dollar value of the domestic currency stable. Foreign exchange regulations will soon be revised to make them consistent with WTO principles, which require that the same rules in buying and selling foreign exchange be applied to domestic and foreign financial institutions.

Figure 6: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ADB calculations derived from Bloomberg.

There have been corrections in stock prices in recent months.

After the opening of the B-share markets to domestic investors in February this year, price indexes of the B-shares in the Shanghai and Shenzhen stock exchanges surged by about 200 percent in less than four months (Figure 6). Since the beginning of June, however, there have been significant corrections in B-share prices. By the end of October, the price index of B-shares had declined by 33 percent in Shanghai and 39 percent in Shenzhen from their peaks in early June. The corrections partly reflect the speculative nature of the earlier B-share market boom. A-share prices have also been in retreat in recent months. From mid-June to mid-October, Shanghai and Shenzhen A-shares lost around 25 percent of their values. The retreat was in part caused by the Government's announcement in June requiring domestic listed firms to sell State-owned shares. The Government has now suspended the State-share sale program. Both Shanghai's and Shenzhen's indexes shot up by nearly 10 percent on 23 October after the suspension was publicized.

Office vacancies are stable and office rentals continue to rise.

After a significant decline last year, office vacancy rates were relatively stable in the first two quarters of 2001. In Beijing, the average vacancy rate in the Grade A office market was 14.8 percent as of end-June (Table 2), 2.6 percentage points higher than at the end of 2000. Office rents continued to rise in the first quarter but softened a little in the second. In Shanghai (central Puxi), the office vacancy rate declined slightly and office rents continued to rise in the first six months. In both Beijing and Shanghai, multinational companies that were expanding their offices largely dominated leasing activity. IT companies became less active with many delaying or canceling their expansion plans.

Table 2: **Office Property Vacancy Rates** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2
Beijing	33.0	35.5	37.9	37.6	37.9	34.4	30.1	21.2	12.2	8.1	12.2	14.4	14.8
Shanghai, Central Puxi	43.8	44.2	44.5	43.2	42.9	40.2	39.3	36.1	29.0	25.7	21.5	20.6	19.2

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

Financial and Corporate Sector Developments

Interest rate deregulation is under way.

Interest rate deregulation was initiated in September 2000. As the first step, financial institutions were given freedom to set interest rates for loans and deposits in foreign currencies. According to the plan announced by PBC, the next step is to liberalize domestic currency lending rates. Freeing up rates for deposits in domestic currency will be the last step of the reforms.

Stock market listing to be allowed for foreign-funded companies.

In line with the PRC’s accession to WTO, the Government announced a new policy to allow foreign-funded companies (FFCs) to seek listing in the A- or B-share markets. A FFC can apply for listing if it has more than five shareholders and its foreign shareholders will retain at least a 25 percent stake in the company after listing. This measure will enable foreign investors to gain access to the domestic capital market and will greatly improve their financial strength. The new policy shows the Government’s commitment to integrating domestic financial activities with the global economy and will put pressure on poorly performing domestic companies by introducing more competition.

Social Sector Developments

New Poverty Reduction Strategy announced.

Despite remarkable achievements, the PRC’s fight against poverty is far from over. The Government announced a new Ten-Year (2000-2010) Poverty Reduction Strategy in June 2001. A system focused at the county level will be used to channel assistance to the remaining 30 million rural residents with annual incomes under the official poverty line of Y625 per capita. The system will cover between 300 and 700 key counties. Poor villages in non-key counties will also be eligible for national poverty funding. Key county status will be based on income, social conditions, geography, and other physical conditions. Priority will be given to remote and mountainous areas, those populated by minorities, and places where poverty is severe.

Prospects and Policy Issues

The Government’s growth target for 2001 will be exceeded.

Although growth is expected to be slower in the second half than in the first, full year growth for 2001 is likely to surpass the Government target of 7 percent. But exports will remain weak due to the slump in the global economy. And there are concerns that the current external weakness could have a bigger impact on the PRC economy than the 1997-1998 financial crisis. However, strong domestic demand will offset the negative impact of the adverse external environment. Investment will continue to be supported by public investment programs and FDI inflows, while measures to stimulate household spending such as further salary hikes for civil servants and increases in the minimum income level will help to maintain the momentum of consumption growth. The latest Consensus Economics (November 2001) projection is for GDP growth of 7.4 percent in 2001, exceeding the official target, and 7.4 percent in 2002.

Winning the bid to host the 2008 Olympic Games will give the PRC economy new momentum.

Hosting the 2008 Olympic Games will help to boost the PRC economy over the next couple of years. The process of transforming Beijing in preparation for the Games will generate sizable investment opportunities and a large number of jobs, as well as attract greater foreign investment. It is estimated that hosting the Olympics will contribute 0.3-0.4 percentage points annually to the country's economic growth during the next seven years.

WTO accession will pose serious challenges to domestic banks.

Despite recent reform efforts, the country's banking sector remains ineffective in channeling resources to their most efficient use. Commercial banks are still largely owned by the State, and they have a weaker capital base, poorer asset quality, lower operational efficiency, and are less competitive compared to many of their foreign counterparts. The Government has made substantial commitments in opening the banking sector during WTO entry negotiations. Two years after joining WTO, foreign banks will be allowed to provide renminbi business to all of their customers and, five years after entry, will receive the same treatment as their local counterparts. Although in the long term, WTO membership will help to improve the efficiency of local banks, in the short to medium term, they will be put under great pressure, as profitability is squeezed and customers are lost, along with market shares and managerial talents. This could put the stability of the domestic banking system at risk.

Banking sector reforms must be accelerated to meet these challenges.

To face these challenges, banking sector reforms must be accelerated. One area is to strengthen the domestic banks' capital base by tackling the problem of NPLs. Official estimates put NPLs of the four State-owned commercial banks at about 25 percent of their total loan portfolios. This excludes the 10 percent of NPLs already transferred to the four AMCs established in 1999. Another priority area is to accelerate the pace of commercialization of State-owned banks. As a first step, domestic banks should establish an effective corporate governance structure. The Governor of the PBC has announced that, in the next few years, a number of State-owned banks will be listed in the stock exchange. To do so, the banks must operate under market rules and improve disclosure and transparency. Domestic banks should also boost their risk management, develop new business practices, improve their banking services, and introduce better human resource management systems.

People's Republic of China: Selected ARIC Indicators

	1996	1997	1998	1999	2000	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																
GDP Growth (%)	9.6	8.8	7.8	7.1	8.2	8.3	7.5	7.2	6.8	8.1	8.3	8.2	7.4	8.1	7.8	7.0
Agricultural Sector Growth (%)	5.1	3.5	3.5	2.8	1.5	4.0	2.5	4.0	1.8	3.0	0.7	3.0	2.7	3.0	2.1	2.6
Industrial Sector Growth (%)	12.1	10.5	8.9	8.1	9.7	10.1	8.8	9.1	7.9	10.7	11.6	11.8	7.1	11.2	10.8	8.9
Inflation Rate (%)	8.3	2.9	-0.8	-1.4	0.3	-1.4	-2.2	-1.2	-0.8	0.1	0.1	0.3	0.9	0.7	1.6	0.8
Unemployment Rate (%)	3.0	3.1	3.1	3.1	3.1	...	...	...	...	...	...	...	...	...	...	...
Monetary and Fiscal Accounts																
Growth of Broad Money, M2 (%)[1]	25.3	20.7	13.8	14.7	12.3	16.3	17.7	15.3	14.7	13.0	13.7	13.4	12.3	13.2	16.8	13.6
Three-Month Interbank Lending Rate (%)[1]	...	...	1.1	...	0.6	...	0.6	0.7	0.8	0.6	0.5	0.4	1.0	0.7	0.5	0.2
Growth in Real Bank Credit to Private Sector (%)[1]	16.6	20.5	17.5	12.7	9.8	18.1	17.7	13.6	13.4	14.1	9.3	9.1	9.2	2.5	-1.6	...
Ratio of Loans to Deposit	1.0	1.0	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	...	...
Average Stock Price Index (Shanghai A)	797.7	1,228.9	1,334.7	1,450.0	1,988.6	1,215.9	1,340.1	1,700.3	1,543.7	1,721.1	1,969.8	2,116.5	2,147.0	2,134.0	2,272.0	2,045.6
Average Stock Price Index (Shanghai B)	...	...	41.3	36.4	56.2	25.4	35.4	45.9	39.0	38.7	47.7	64.8	73.8	107.8	199.8	172.6
Average Stock Price Index (Shenzen A)	236.6	409.3	412.2	434.2	620.6	368.6	400.7	506.9	460.5	533.1	616.4	661.4	671.6	653.1	682.6	612.0
Average Stock Price Index (Shenzen B)	...	...	76.3	73.8	105.3	48.2	73.3	92.7	80.8	86.4	99.4	117.1	118.3	195.2	377.6	285.4
Central Government Fiscal Balance as % of GDP	-0.8	-0.8	-1.2	-2.1	-2.8	...	...	...	...	...	...	...	...	...	...	...
Central Government Debt as % of GDP	2.9	3.3	4.2	4.5	4.7	...	...	...	...	...	...	...	...	...	...	...
External Account, Debt, and Exchange Rates																
Growth of Merchandise Exports ($ fob, %)	1.6	21.0	0.5	6.2	27.7	-6.9	-1.6	14.9	16.2	38.6	37.3	25.1	15.7	14.7	4.6	3.9
Growth of Merchandise Imports ($ cif, %)	5.2	2.3	-1.2	18.1	35.8	12.1	20.5	23.9	15.7	40.8	32.5	43.2	-10.7	17.2	11.3	6.6
Current Account Balance as % of GDP	0.9	4.1	3.3	2.1	1.9	...	...	...	...	...	...	...	...	...	...	...
Net Foreign Direct Investment ($ billion)	...	45.3	45.5	40.3	40.8	7.3	11.2	10.6	11.1	7.1	10.0	9.5	14.1	8.0	20.8	...
Net Portfolio Investment ($ billion)	1.7	6.9	-3.7	-11.2	-4.0	...	...	...	...	...	...	...	...	...	...	...
Gross International Reserves Less Gold ($ billion)[1]	107.0	142.8	149.2	157.7	168.3	150.5	150.6	154.7	157.7	159.8	161.3	162.6	168.3	178.9	183.9	...
Ratio of M2 to GIR	8.6	7.8	8.5	9.3	9.8	8.7	8.9	9.0	9.3	9.4	9.6	9.8	9.8	9.5	...	...
Total External Debt as % of GDP[1]	14.2	14.5	15.2	15.3	13.5	...	...	...	...	...	...	...	...	...	...	...
Real Effective Exchange Rate (1995=100)[2]	112.2	121.3	131.5	124.2	122.3	131.2	126.6	122.1	116.7	127.0	121.1	120.0	121.1	134.1	131.7	129.5
Average Exchange Rate (Local Currency to $)	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3

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

Indonesia

Real Sector

The economy posted surprisingly strong growth in the first three quarters of 2001.

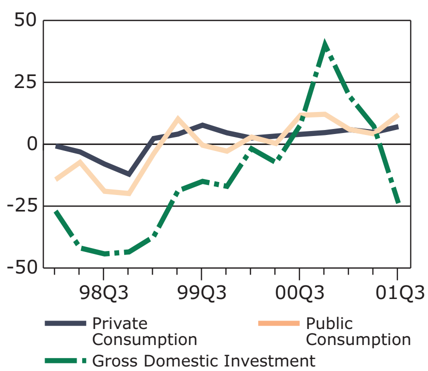
Despite a turbulent external environment, institutional weakness, and domestic political instability, the Indonesian economy posted respectable growth of 3.3 percent (y-o-y) in the first nine months of 2001, led by strong private spending. But the synchronized weakness in industrial countries dampened what could have been a stronger performance. Despite this, Indonesia's real income is still 8 percent below its precrisis peak. The Government forecasts growth for 2001 at 3-4 percent (y-o-y) (Table 1).

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

	1997	1998	1999	2000	2001	2002
Official[1]	4.7	-13.1	0.8	4.8	3.0-4.0	—
ADB[2]	—	—	—	—	3.2	3.9
IMF[3]	—	—	—	—	3.0	4.3
World Bank[4]	—	—	—	—	3.3	3.5
Consensus Economics[5]	—	—	—	—	2.9	2.9

[1]Bank Indonesia, *The Development of Economy, Monetary, Banking and Payment System in the Third Quarter 2001, and Future Policy Direction*, 9 October 2001.
[2]ADB, *Asian Development Outlook Update*, November 2001.
[3]IMF, *World Economic Outlook*, October 2001.
[4]World Bank, *East Asia Update Regional Brief,* 17 October 2001.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, November 2001.

Figure 1: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

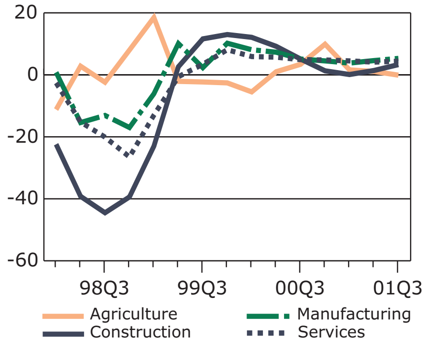
Private spending and investment continue to drive growth.

Private spending lifted growth in the first nine months of 2001, as durable goods spending, including motor vehicles, remained relatively strong (Figure 1). Gross fixed capital formation, however, slid in the third quarter after posting a respectable growth in the first half of 2001. The investment rate, having risen further to 25 percent in the second quarter of 2001 from 23 percent in the last quarter of 2000, fell to 21 percent in the third quarter, as the growth in bank credit was offset by sluggishness in FDI.

On the supply side, growth was led by manufacturing and services.

Fueled by domestic demand, the manufacturing sector grew by 4.6 percent (y-o-y) in the first nine months of 2001, a deceleration from the 6.8 percent (y-o-y) achieved in the same period last year

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



Source: ARIC Indicators.

(Figure 2). Manufacturing sector resilience was reflected in a sustained higher level of capacity utilization of 70-75 percent. This in turn was supported by imports, which grew, in dollar terms, by 27 percent (y-o-y) in the first half of 2001. The commercial sector (i.e., trade, hotels, and restaurants), another major component of Indonesia's GDP, continued to expand in the first nine months of 2001—by 5.5 percent (y-o-y), as did transportation and communication (by 6.7 percent [y-o-y] in the first nine months of 2001). However, recent data show signs of slowing growth in the last quarter of 2001. After posting strong growth of 6.3 percent (y-o-y) in the second half of 2000, the agricultural sector slowed to 0.9 percent (y-o-y) in the first nine months of 2001 as a result of softening commodity prices. The sector is expected to remain slow in the fourth quarter. The industrial production index is also expected to slide in the last quarter of this year.

Fiscal and Monetary Developments

The actual size of the 2001 budget is likely to be smaller than programmed…

On the fiscal front, the total budget has fallen as a share of GDP, because the revenue shortfall has been accompanied by a cutback in fiscal spending. Political instability in the leadup to the special general assembly session in July also affected the budget.

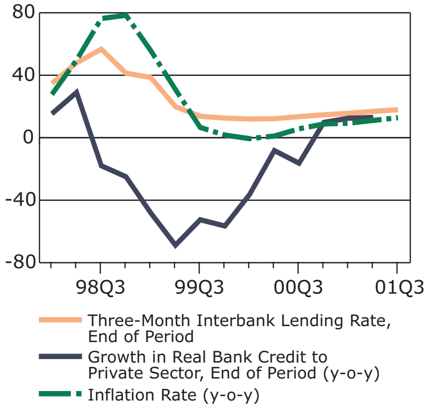
…because a revenue shortfall…

On the revenue side, the targeted non-oil tax revenues were achieved in the first half of 2001. But oil and gas revenues fell in the face of softening oil prices and a decline in output due to security disruptions in the fields. As of end-June 2001, IBRA managed to meet only about one third of its targeted revenue for 2001. Further, the targeted proceeds from the privatization plan (at Rp6.5 trillion in 2001) will likely be difficult to meet as the plan has stalled and revenue has not been generated. Divestment of Bank Central Asia will also likely be slow given political opposition and weak market conditions.

…was accompanied by lower spending.

Allocations for rice subsidies, public health, and education were increased to help reduce the impact of higher fuel prices on low-income households. Interest payments on government debt also rose due to higher interest rates. However, the Government hiked domestic energy prices in June to reduce the level of subsidy and scaled back development spending in an effort to keep the deficit target intact.

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Full-2001 inflation is likely to exceed targets…

At the latest letter of intent between the Indonesian Government and IMF (signed on 27 August 2001), the inflation target for 2001 was set at 9-11 percent. After accelerating sharply in the first seven months of 2001 (Figure 3), inflation remained high in September and October at 13 percent. The high level was caused by improved economic activity, a sharp depreciation of the rupiah, and adjustments in the Government's price and income policies, which all added several percentage points. Through December, when major religious festivals take place, price pressures are expected to continue. Taking all of this into account, Consensus Economics (November 2001) expects inflation in 2001 to reach 11 percent (y-o-y).

…and nominal interest rates will remain high for the remainder of 2001.

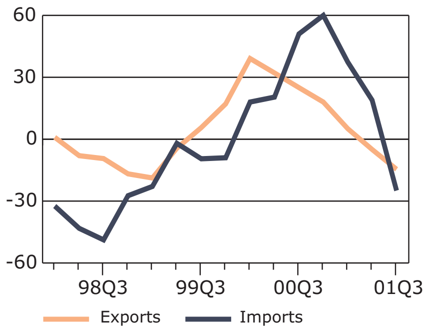
To fight inflation and a weakening rupiah, Bank Indonesia has raised the benchmark interest rate (one-month Sertifikat Bank Indonesia [SBI]) by more than 300 bps this year. As of mid-August 2001, the one-month SBI was 17.6 percent, compared with 14.5 percent by end-December 2000. Bank Indonesia intends to absorb liquidity in excess of the level dictated by the IMF's performance indicator while still being cautious not to hinder economic recovery. With a weak rupiah and the need to rein in inflation, monetary policy is poised to maintain the existing policy bias. Relatively strong growth, persistent weaknesses in the banking system, and few indications that inflation is softening provide other reasons for Bank Indonesia not to adjust its policy stance.

Balance of Payments

Exports have been the victim of a global economic slowdown.

Although Indonesia is less exposed to the global downturn in the electronics cycle (electronics exports form only 7 percent of GDP), the country is not completely shielded. Non-oil exports declined as demand from the US and Asia (together they absorb more than half of Indonesian exports) softened due to the economic slowdown. Oil and gas exports, which jumped by almost 50 percent (y-o-y) in 2000, were flat in the first half of 2001. The pickup in the volume of crude exports was offset by the easing price of Minas crude and falling LNG exports following the four-month shutdown of Pertamina Exxon-Mobil gas production in Aceh.

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



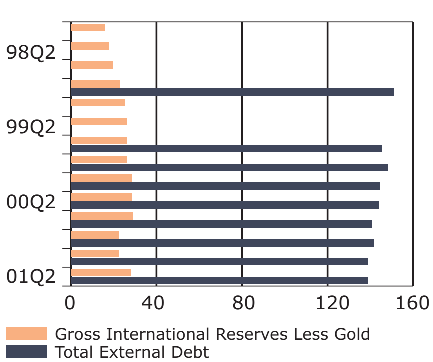
Source: ARIC Indicators.

Total merchandise exports (in dollar terms) contracted by 0.1 percent (y-o-y) in the first half of 2001, a big drop from the 21.5 percent (y-o-y) growth seen in the second half of 2000, owing to a decline in non-oil exports and stagnating oil and gas exports (Figure 4). In the third quarter of 2001, merchandise exports fell by 15 percent (y-o-y). This brings the monthly average value of exports to $4.9 billion in 2001, against $5.12 billion in 2000. In combination with weaker demand from Europe and Japan, the 11 September attacks on the US have added another element of uncertainty to Indonesia's export prospects. Meanwhile, intra-Asian trade, which was initially expected to cushion Indonesia from a global slowdown, has not been able to take up the slack, since it is also linked with the global electronics cycle. For 2001 as a whole, Consensus Economics (November 2001) forecasts total exports for 2001 to contract by 5.7 percent (y-o-y), against 28 percent (y-o-y) growth in 2000.

Softening imports were cushioned by buoyant domestic demand.

Weaker exports dragged down imports of capital goods and raw materials (more than 80 percent of total imports) in the first half of 2001. However, a sustained increase in domestic demand for consumer goods imports somewhat cushioned the fall. Imports averaged around $2.45 billion per month in the third quarter, compared with $2.93 billion per month in the first half of 2001 and $2.8 billion in 2000. According to Consensus Economics forecasts, the 2001 trade surplus will be compressed to about $20 billion, from $25 billion the previous year.

Figure 5: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

Foreign exchange reserves remained stable.

Despite increased capital outflows in 2001 (see capital flows discussion in Regional Overview) foreign exchange reserves remained stable. As of end-August 2001, foreign exchange reserves fell to $28.6 billion, compared with $29.4 billion at end-December 2000, as a weak capital account offset the surplus in the current account (Figure 5). Foreign exchange reserves are now equivalent to 9.5 months of cover for total imports—up from 8.1 months recorded in the ARR May 2001 report. The short-term debt to foreign exchange ratio also fell to an estimated 70 percent—down from 160 percent in 1998.

Assets Markets

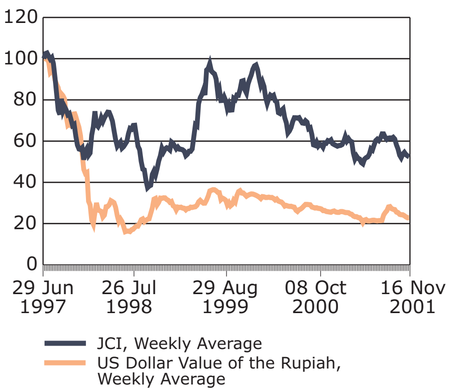
The rupiah has yo-yoed through 2001...

Having maintained a level of about Rp11,000/$1 between February and July this year, the rupiah rebounded to around Rp8,600/$1 in August following a smooth political transition. However, the events of 11 September brought renewed weakness to the currency. Since then, the rupiah has traded at about Rp10,000/$1. Several key factors will determine the future direction of the exchange rate. These include domestic sentiment, currency movements in other Asian countries, and the prospect of a successful negotiation in the third round of the Paris Club, which will lengthen the maturity of government debt and reduce the country's financial risks.

...and so has the Jakarta Composite Index.

Lingering risks, persistent financial distress of the financial sector, and weak regional economic condition have continued to affect the Jakarta Stock Exchange (Figure 6). The stock market, battered by political uncertainty in the first half of 2001, received a small boost from the smooth political transition. But it has been hit again by the 11 September events. The Jakarta Composite Index (JCI) rose from this year's low of 348 in late April to 443 on 10 September, before sliding back to 378 (16 November 2001). In another development, nearly half of the listed companies were moved from the main board to a development board for companies undergoing restructuring.

Figure 6: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: ARIC Indicators.

Office vacancy rates inched down further.

As in other Asian countries, the property market remained soft in the first half of 2001 as a result of weak demand for commercial and retail space. Nevertheless, the office vacancy rate edged down further to 23.7 percent in the second quarter of 2001 from 24 percent in the previous quarter (Table 2). Likewise, the retail property vacancy rate moved down to 5.3 percent in the same quarter from 6.5 percent previously. With a slower economy expected in the second half of this year, property prices are not likely to stage a significant recovery soon.

Table 2: **Property Vacancy Rates in Jakarta** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2
Office Property	15.6	20	22.1	22.3	24.3	25.7	25.5	25.4	24.5	24.3	24.3	24.0	23.7
Retail Property	. . .	. . .	. . .	. . .	16.4	. . .	11.8	. . .	9.3	. . .	6.5	. . .	5.3

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

The fixed income market is still dominated by SBIs.

The plan to phase in the Government's six-month and 12-month Treasury bills in April 2001 did not materialize. It now appears that the phasing in of those bonds will not be effective until at least January 2002. This leaves the SBI continuing to dominate the fixed income markets. As of end-July 2001, SBI outstanding amounted to Rp79.7 trillion, compared with Rp87.5 trillion in January 2001 and Rp60 trillion in December 2000. The need to stabilize the rupiah and to fight inflation led Bank Indonesia to auction more SBIs to absorb excess liquidity.

Sovereign bond spreads have narrowed.

Thanks to a smooth political transition, the spread on Indonesia's bonds narrowed to 581 bp in mid-October 2001 from 795 bp in June—the month when the second memorandum to former President Wahid was issued by the parliament. The recent upgrade in ratings outlook to positive from stable has contributed to the narrowing of spreads. The signing of a fresh pact of economic reforms between Indonesia and the IMF that clears the way for reviving a multibillion loan program and keeping a major debt rescheduling deal on track is a further positive development. The 11 September attacks had a temporary impact on bond spreads. However, as of 16 November, spreads were already 550 or 15 bp lower than the 10 September close.

Financial and Corporate Sector Developments

IBRA's progress has been slow.

IBRA's pace is slow, with an assets recovery rate of only about 10 percent or less. Divestment of two telecom companies, BCA and Bank Niaga, has been delayed for some time; and it remains unclear whether the process can be completed by end-2001. Foreign investors' appetite for Indonesian assets has been low owing to concerns over insufficient transparency and political uncertainties. Other impediments to IBRA's performance include resistance from powerful debtors, political influence peddling, an ineffective bankruptcy system, and a lack of interested buyers. In the first half of 2001, IBRA managed to book only Rp11.2 trillion in cash revenue, about one third of its target for 2001.

Banks have begun to flex their muscles...

Total loans being channeled through the banking system totaled Rp287 trillion in June 2001, as against Rp265 trillion in January 2001. At the same time, SBI holdings—which are a safer investment alternative—were down to Rp79.7 trillion in June 2001 from Rp87 trillion in January 2001. A reduction in the amount of fixed income securities and an increase in loans are indications that the banks have become more active as financial intermediaries.

...but asset quality of the banking system remains low.

Despite the continuation of the credit restructuring process, write-offs, and disbursement of fresh loans, improvement in NPLs has been marginal. The low quality of assets of many Indonesian banks is reflected in the NPL level, which was 15.8 percent in July 2001, down slightly from the December 2000 rate of 18.8 percent. On the one hand, this is a reflection of the slow pace of corporate restructuring and, on the other, weak financial markets.

Social Sector Developments

Slower 2001 growth limits progress in poverty reduction.

In 2001, faced with slower growth, it is likely that the pace of poverty reduction in Indonesia will slow. Estimates by the World Bank based on $1 per day show that the poverty head count will fall to 7.3 percent in 2001 from 8 percent in 2000. This level is slightly lower than the average 2001 figure for East Asia-Pacific (excluding the PRC) of 7.5 percent, but higher than the average figure for the five crisis-affected countries of 6.4 percent.

Prospects and Policy Issues

Growth in 2001 may surprise the markets on the upside.

Market consensus is now predicting 2001 growth of 2.9 percent (y-o-y) (Consensus Economics, November 2001), slightly below the Government's lower estimate in the 3-4 percent range (y-o-y). To realize a full-year growth of 2.9 percent (y-o-y), the economy needs to grow by another 2.5 percent (y-o-y) in the second half of 2001. On a year-on-year comparison, especially given the current global weakness, this expectation may look realistic. However, 2.5 percent (y-o-y) growth in the second half actually implies an economy that is contracting by 2 percent on an annualized, seasonally-adjusted, quarter-on-quarter basis. This runs counter to the progress seen in the third quarter of 2001. Against this trajectory, the overall 2001 outturn may well surprise the markets on the upside. For 2002, Consensus Economics also forecasts a growth to 2.9 percent.

The road ahead toward economic recovery is bumpy...

Although there have been several positive economic and political developments, the country still faces many deep-rooted and complex problems requiring comprehensive and consistent reforms. An unstable political context has made it difficult to design a comprehensive solution. On many occasions, politics has clogged the economic pipelines, hampering the productive use of resources. Thus, the recovery process, which could otherwise be even faster, is largely a function of political and institutional weakness.

...as there are many holes in the road...

On the legal front there are conflicts over the new labor law, amendment of the central bank's law, and Bank Indonesia's liquidity support. The effort to bring to justice past corruption cases and a weak legal system complicate the picture. On the institutional front, Indonesia is confronted with equally complicated problems. The new regional autonomy and fiscal decentralization laws, as well as the reorganization of the public sector, have created tension in the relationship between the central and the local governments. These issues have also injected regulatory uncertainties and increased business transaction costs. Interlinked as they are, they have weighed down on the capacity to push forward viable economic policy initiatives.

...thus, policy priorities should be firm and transparent.

Credible policy initiatives have been few since the onset of the political crisis. With the new Cabinet lineup and a more stable political situation, there are hopes that economic policy will be pursued in a more coherent and consistent way. Economic reform and corporate restructuring programs need to go in tandem with legal reforms. Also, in view of the debt overhang and the need to rein in inflationary pressures, the near-term policy priority must focus on monetary policy and corporate restructuring. With regard to the latter, speeding up the long-delayed corporate restructuring and asset sales is imperative.

Indonesia: Selected ARIC Indicators

	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																				
GDP Growth (%)	7.8	4.7	-13.1	0.8	4.8	-4.5	-13.3	-16.0	-18.3	-5.9	2.0	2.3	5.7	4.2	5.2	4.4	5.2	3.1	3.3	3.5
Private Consumption Expenditure Growth (%)	9.7	7.8	-6.2	4.6	3.6	-0.7	-3.1	-8.0	-12.1	2.3	4.1	7.7	4.6	2.5	3.3	4.0	4.7	5.9	4.8	7.1
Public Consumption Expenditure Growth (%)	2.7	0.1	-15.4	0.7	6.5	-14.3	-7.3	-19.0	-19.9	-3.9	10.2	-0.4	-2.8	2.9	0.3	11.7	12.1	6.0	4.2	11.9
Gross Domestic Investment Growth (%)	4.9	6.3	-39.0	-23.3	8.9	-27.0	-41.9	-44.3	-43.5	-37.4	-18.8	-15.0	-17.0	-1.8	-7.4	7.9	40.2	18.8	7.2	-23.8
Agricultural Sector Growth (%)	3.1	1.0	-1.3	2.7	1.7	-11.2	2.8	-2.4	8.0	18.5	-2.1	-2.3	-2.6	-5.5	1.0	3.4	9.9	1.6	1.1	-0.1
Manufacturing Sector Growth (%)	11.6	5.3	-11.4	3.8	6.2	0.8	-15.4	-13.1	-17.0	-6.1	10.1	2.3	10.2	8.1	7.3	5.1	4.5	3.8	4.6	5.3
Construction Sector Growth (%)	12.8	7.4	-36.4	-0.8	6.7	-22.4	-39.2	-44.5	-39.4	-23.0	2.6	11.6	13.0	12.1	9.2	5.1	1.3	0.1	1.4	3.3
Services Sector Growth (%)	6.8	5.6	-16.5	-1.0	5.3	-2.6	-15.2	-20.1	-26.5	-13.0	-0.6	3.4	8.1	5.9	5.7	4.9	4.8	4.5	4.1	4.4
Exports of Goods and Services Growth (%)	7.6	7.8	11.2	-31.6	16.1	57.6	21.8	22.7	-40.4	-43.7	-37.3	-38.2	12.4	15.1	21.2	14.1	14.2	18.4	17.4	6.6
Imports of Goods and Services Growth (%)	6.9	14.7	-5.3	-40.7	18.2	23.4	8.7	4.4	-46.4	-51.6	-43.1	-43.6	-12.8	5.0	3.9	20.1	44.2	46.6	29.0	. . .
Inflation Rate (%)	8.0	6.2	58.5	20.5	3.7	27.7	49.7	76.3	78.4	55.8	30.9	6.6	1.7	-0.6	1.1	5.7	8.8	9.3	11.1	12.8
Unemployment Rate (%)	4.9	4.7	5.5	6.4	6.1	5.5	. . .	. . .	. . .	6.4	. . .	6.4	. . .	4.1	. . .	6.1	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts																				
Growth of Broad Money, M2 (%)[1]	27.2	27.2	25.2	63.5	12.5	25.2	52.6	81.5	67.4	63.5	34.3	9.2	19.1	12.5	10.3	12.6	7.3	15.9	16.8	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	25.8	41.3	12.6	14.7	34.8	47.9	56.7	41.3	38.6	19.9	13.7	12.6	12.0	12.2	13.5	14.7	15.6	16.9	17.9
Growth in Real Bank Credit to Private Sector (%)[1]	14.5	17.2	-25.0	-56.5	9.8	15.3	29.0	-17.9	-25.0	-48.1	-68.8	-52.5	-56.5	-36.3	-8.2	-16.3	9.8	12.5	13.0	. . .
NPL Ratio of the Banking System[1]	. . .	. . .	49.2	33.0	18.8	. . .	. . .	. . .	49.2	. . .	. . .	. . .	33.0	. . .	30.0	26.9	18.8	18.1	16.6	. . .
Average Stock Price Index	585.9	607.1	418.3	543.1	508.4	474.7	449.2	392.0	357.4	402.0	566.0	590.4	614.0	620.3	513.9	478.5	420.9	414.2	386.1	435.3
Central Government Fiscal Balance as % of GDP	1.2	-0.7	-2.8	-1.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Central Government Debt as % of GDP	24.3	24.2	68.8	53.3	48.6	29.4	38.2	54.5	68.8	63.8	58.6	55.1	53.3	49.6	49.2	48.8	48.6	. . .	. . .	. . .
Government Expenditure on Education (% of Total)	. . .	. . .	5.0	6.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	. . .	1.4	1.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																				
Growth of Merchandise Exports ($ fob, %)	9.7	7.3	-8.6	-0.4	27.7	0.9	-8.0	-9.4	-16.8	-18.8	-4.4	5.6	17.1	39.1	32.1	25.0	18.0	5.1	-5.0	-14.6
Growth of Merchandise Imports ($ cif, %)	5.7	4.1	-38.8	-11.2	38.3	-32.4	-43.2	-48.8	-27.4	-22.9	-2.0	-9.5	-9.0	18.0	20.4	51.0	60.0	37.4	18.9	-24.9
Current Account Balance as % of GDP	-3.4	-2.2	4.2	4.1	5.2	4.5	3.1	7.8	2.3	4.8	2.5	5.1	3.9	4.6	3.5	5.9	6.8	5.8	. . .	. . .
Net Foreign Direct Investment ($ Billion)	6.2	4.7	-0.4	-2.7	-4.6	. . .	. . .	. . .	. . .	-0.2	-0.9	-0.7	-0.9	-1.5	-0.4	-0.9	-1.7	-1.2	. . .	. . .
Net Portfolio Investment ($ Billion)	5.3	5.0	-13.5	-7.2	-5.4	-6.6	-1.4	-3.5	-2.0	-2.6	-1.2	-2.0	-1.42	-0.48	-2.4	-1.8	-0.8	-1.6	. . .	. . .
Gross International Reserves Less Gold ($ Billion)[1]	18.3	16.6	22.7	26.4	22.5	15.8	17.9	19.7	22.7	25.2	26.3	26.0	26.4	28.5	28.7	28.9	22.5	22.4	27.9	. . .
Total External Debt as % of GDP[1]	49.8	62.0	154.3	104.2	92.0	. . .	. . .	. . .	154.3	. . .	. . .	107.0	104.2	95.4	92.9	90.0	92.0	93.3	97.1	. . .
Real Effective Exchange Rate (1995=100)[2]	109.5	104.6	52.7	74.5	70.3	42.7	47.5	48.3	72.2	68.2	76.7	76.8	76.4	77.1	69.8	67.5	66.8	67.3	69.7	74.3
Average Exchange Rate (Local Currency to $)	2,342.3	2,909.4	10,013.6	7,854.9	8,404.0	9,433.4	10,460.8	12,252.1	7,908.3	8,730.5	7,977.5	7,501.3	7,210.5	7,391.4	8,243.3	8,740.2	9,241.2	9,778.8	11,226.1	9,717.2

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

Republic of Korea

Real Sector

The economic slowdown continues.

The slowdown in economic activity seen in the last half of 2000 continued into 2001. After registering 8.8 percent in 2000, GDP growth declined to 2.7 percent (y-o-y) in the first nine months of 2001. Resilient private consumption (contributing 1.3 percentage points of the first nine months' figure) cushioned the steep decline in exports. The fallout from the 11 September attacks on the US will hit Korea's growth further in the fourth quarter of 2001. This, presumably, has been reflected in the Korea Development Institute's revised forecast for 2001 GDP, which has been lowered to 2.2 percent (y-o-y), almost halving the 4 percent forecast it made in July (Table 1).

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

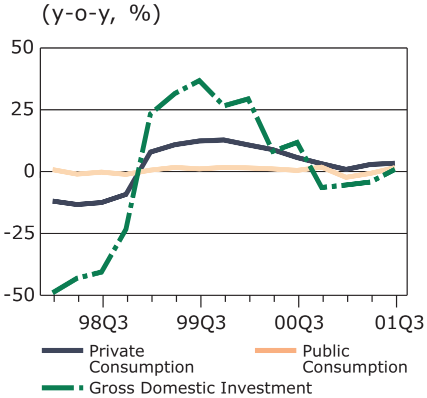
	1997	1998	1999	2000	2001	2002
Official[1]	5.0	-6.7	10.9	8.8	2.2	—
ADB[2]	—	—	—	—	2.0	3.6
IMF[3]	—	—	—	—	2.5	4.5
World Bank[4]	—	—	—	—	2.4	3.4
Consensus Economics[5]	—	—	—	—	2.0	3.2

[1]Korea Development Institute, October 2001.
[2]ADB, *Asian Development Outlook Update,* November 2001.
[3]IMF, *World Economic Outlook,* October 2001.
[4]World Bank, *East Asia Update Regional Brief,* 17 October 2001.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, November 2001.

Investment is expected to contract sharply in 2001.

Gross fixed investment is now forecast to contract by 4.6 percent (y-o-y) in 2001, against a previous Consensus Economics estimate (made three months ago) of 2.5 percent (y-o-y). A deteriorating earnings environment (particularly for those companies dependent on exports), relatively weaker private spending, and the still harsh credit environment are dissuading firms from undertaking new investment in plant and equipment. Although public works spending will be maintained in order to slow the rise in the unemployment rate, this will not be enough to offset the slowdown in investment demand from the private sector.

Figure 1: **Growth of GDP Expenditure Components** (y-o-y, %)

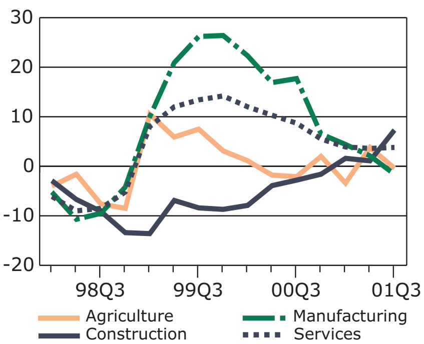


Source: ARIC Indicators.

Consumer spending, which softened in the first half, picked up in the third quarter.

Over the past one and a half years, private consumption growth has slowed (Figure 1). On the one hand, slow consumption growth was due to a deceleration in real wage growth as corporate profits have slowed. On the other hand, continued financial problems at some large firms may have put a cap on consumer sentiment. The wholesale and retail sales growth that slowed to 6 percent (y-o-y) in August (from an average growth of 7.2 percent in the second quarter of 2001), picked up to 7.9 in September. Moreover, domestic car sales, which fell to 2 percent (y-o-y) in the first half of 2001 compared with full-2000 growth of 16 percent (y-o-y), grew by 13 percent in September. Nevertheless, despite the slow growth, consumption spending has still cushioned the slowdown, which has been more dramatic in other sectors.

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



Source: ARIC Indicators.

The slump in semiconductors production has dragged down the manufacturing sector.

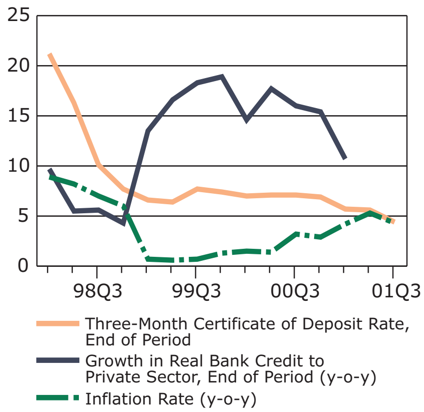
The manufacturing sector has suffered a pronounced slowdown. In the first nine months of 2001, it grew by a mere 1.5 percent (y-o-y), against 15.4 percent (y-o-y) in 2000 (Figure 2). Industrial production spiked to 5.1 percent (y-o-y) in September after experiencing three consecutive months of decline led by semiconductor production. Semiconductors play a major role in the Korean economy and represent a significant portion of total exports. Nevertheless, industrial production excluding the semiconductor sector remained broadly positive. The automotive subsector, for example, has been strong and offset some of the weakness in electronics/semiconductors.

Fiscal and Monetary Developments

Fiscal policy supported growth in the third quarter of 2001.

The slowdown in the last quarter of 2000 prompted the Government to revise down its 2001 revenue projection and to shift to a deficit from a 2000 surplus (of 1 percent of GDP) to buttress the slowing economy. But the plan did not materialize as stronger than expected revenue growth coupled with increased social security contributions and underspending combined to yield a budget surplus in the first half of 2001. As a result, public consumption made a small net negative contribution to growth. However, this situation was reversed in the the third quarter of the year. In June 2001 the Cabinet approved a supplementary budget worth W5.1 trillion. The main components of the extra budget were subsidies to be disbursed by central Government to local governments to boost regional economic growth and improve educational facilities (70 percent), a national health insurance scheme (23 percent), and disaster relief and employment measures for young adults (6 percent). Increased spending in the third quarter had supported growth. The attacks on the US prompted the Government to expand fiscal measures further by bolstering the domestic capital markets and the economy. State pension funds were directed to accelerate planned share purchases involving W2.2 trillion. The consolidated government budget revised in September calls for a deficit of 1.4 percent of GDP compared with the original target of 0.6 percent of GDP.

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Inflation has peaked and pressure is now easing…

Average CPI inflation rose by 4.6 percent year-to-date in October owing to price increases for fuel, medical care services, and food. At a disaggregated level, core inflation also exceeded the target range of 2-4 percent. But continued weakness in economic activity has led to an easing in inflationary pressures (Figure 3). Softer oil prices and a relatively stable won also helped to stabilize prices. For the year as a whole, Consensus Economics forecasts an inflation rate of 4.3 percent.

…but monetary policy still walks the tightrope.

Monetary policy has been delicate in the first eight months of 2001. The Bank of Korea has had to carefully weigh the tradeoff between cutting interest rates further to jumpstart the economy and fueling inflation with a more accommodating monetary policy. Given the liquidity crisis at key Korean companies, the Bank of Korea will have little choice but to maintain a broadly accommodating monetary policy until next year. It had already reduced its target rate by 50 bps to 4.5 percent in August, but the 11 September attacks on the US prompted a further rate cut to 4 percent.

The Bank of Korea has also lowered the lending rate on the aggregate credit ceiling loan by 50 bps to 2.5 percent, as well as reduced the lending rate on liquidity adjustment loans by 50 bps to 3.75 percent.

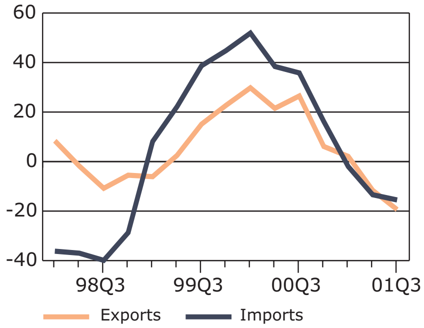
Market interest rates (three-year government bond yield), already in a downward trend since April 2001, also declined further—to 4.5 percent at end-September from 5.9 percent in June.

Balance of Payments

Exports weakened but the trade surplus widened.

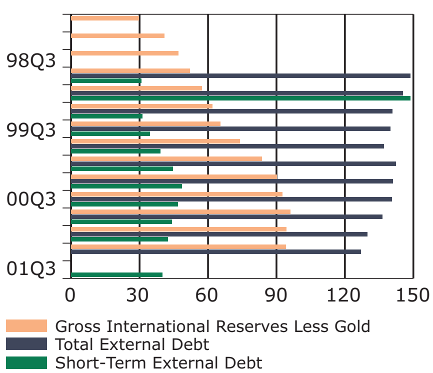
In the first nine months of 2001, exports fell by 10 percent (y-o-y), led by a sharp decline in shipments of electronics and semiconductors

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Values** (y-o-y, %)



Source: ARIC Indicators.

Figure 5: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

(about 40 percent of total exports) (Figure 4). Shipments of electronics, for example, were 9 percent lower in the first half of 2001 than a year earlier. Imports, however, fell more sharply than exports, contracting by 10.4 percent (y-o-y) in the first nine months of 2001. Capital goods and oil imports fell by 13 percent (y-o-y) and 2 percent (y-o-y), respectively. As a result, the merchandise trade surplus widened to $7.6 billion in the first nine months of 2001, against $5 billion a year earlier. In combination with falling net invisible payments and easing growth in transport costs, the current account surplus narrowed to $7.8 billion in the first nine months, against $8.2 billion a year earlier. Going forward, developments in the US and Japan, the two largest markets for Korea's exports, will have a critical bearing on Korea's external position. Consensus Economics now forecasts Korea's current account surplus at 2.3 percent of GDP, broadly similar to the 2000 level.

Foreign exchange reserves remain healthy.

As of October 2001, foreign exchange reserves (excluding gold) were $100.4 billion, compared with $96.1 billion by end-December 2000 (Figure 5). This is roughly eight months of import cover. A large current account surplus was offset by the reduction in external debt as Daewoo's domestic creditors bought back some $55 billion of Daewoo's debt from its foreign creditors at 60 percent discount. The ratio of short-term debt to foreign reserves as of August 2001 was 40 percent compared with 52.9 percent a year earlier.

In August 2001, Korea completed repayment of a $19.5 billion IMF loan, almost three years ahead of schedule.

Asset Markets

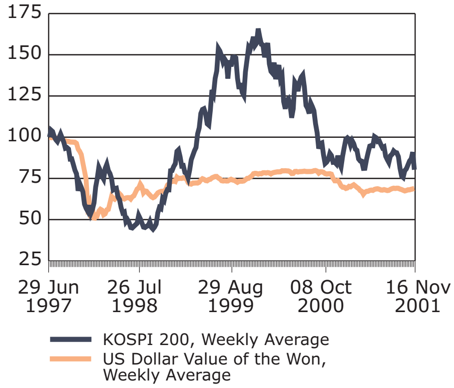
The won slipped in the first half of 2001.

As of 16 November 2001, the won had gained back some of its value (almost 2 percent) after losing 3 percent in the first half of 2001 (Figure 6). With a large trade surplus and healthy foreign exchange position, the value of the yen is probably the most important factor determining the level of the won for the remainder of 2001.

Stock markets have been weak...

Following a 51 percent drop in 2000, KOSPI rose 21 percent through November 2001 to 611 (16 November 2001). But this is still about 40 percent below its postcrisis high of 1059 in early 2001. The

Figure 6: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

market's momentum has also been weak, as the uncertain domestic and regional economic condition, rising inflation in the first half of 2001, and a less favorable earnings outlook in the third quarter have dampened domestic investors' appetites. With foreign inflows slowing over the past six months, there are few significant push factors to lift the market.

...but fixed income securities have performed relatively well.

Since June 2001, the performance of corporate bonds has been quite favorable. Yields on three-year AA-corporate bonds have increased as liquidity has fled to bonds from equities. At the same time, slower monetary growth amid lower appetite for risks has also sustained government bond yields. It remains to be seen whether the increased issuance of public bonds over the year to finance restructuring will put pressure on government bond yields.

Spread performance looks better poised given the healthy balance-of-payments position. Having risen to 210 bp on 20 March 2001, the sovereign yankee bond spread fell to 124 bp on 16 November 2001.

The property sector remains stable.

According to an independent report, the vacancy rate in Seoul generally looks stable. However, the housing and office markets could soften further if the slowdown in the US and Japanese economies continues for long.

Financial and Corporate Sector Developments

Substantial progress has been made in corporate and bank restructuring...

Among the crisis countries, Korea has made the most progress in financial restructuring, with debt-equity ratios having fallen by about half since 1997 as a result of government policy changes. The business landscape has changed dramatically, following the bankruptcy of the Daewoo motor company and the breakup of Hyundai Group. Further, the move to merge Korea's two largest banks, Kookmin and H&BC, scheduled for November is almost complete.

...although much more remains to be done.

Despite the reduction in the number of top conglomerates to 16 from 30, the exposure level of financial institutions to *chaebols* remains relatively high. The ratio of exposure fell to about 37 percent (end-2000) from 53 percent (end-1997). By end-February 2001, the Government announced that it had completed a large chunk of its restructuring program. But concern about the pace of reform remains. The current economic structure continues to present the Government with the dilemma of choosing between intensifying reform and preserving the status quo for fear of undermining economic stability, especially at times when the economy is slowing.

Headline NPL ratios continue to fall.

NPL ratios at commercial banks fell further to 4.1 percent in June 2001 from 6.6 percent in December 2000. But if transfers to AMCs are included, NPLs were 19.3 percent by June 2001, down slightly from 20.3 percent in December 2000.

Social Sector Developments

The unemployment rate fell but it is still higher than the precrisis level.

After inching up to 4.8 percent in the first quarter of 2001, the unemployment rate improved to 3.1 percent in October 2001 against 3.4 percent a year earlier. This is despite slower GDP growth in the first half of 2001. The improvement in unemployment is perhaps explained by a pickup in agricultural sector growth in the second quarter and a sustained increase in activity in the construction sector in the first half of 2001. However, the rate is still higher than the precrisis level of 2.6 percent registered in December 1997.

Prospects and Policy Issues

Slower growth is likely but the risk of financial meltdown looks remote.

The latest Consensus Economics forecasts Korea’s GDP to grow at 2 percent (y-o-y) in 2001. This is much lower than the estimates made at the beginning of this calendar year. But there are several sources of relief amid the downturn. The balance-of-payments remain healthy, while short-term external debt does not pose a threat to the economy. Both of these factors should shield Korea from additional financial distress.

Adjustment of the monetary stance must be carried out with caution.

Given the tradeoff between inflation and the need to reinvigorate the slowing economy, it is important to constantly assess how low interest rates can go. Under normal circumstances, lower interest rates would have a stimulating effect, as companies facing reduced value of money will increase their capital spending. Likewise, individuals will spend more. But anecdotal evidence tends to suggest that the actual direction of the effect of monetary policy action is being muted by consumers' expectation about future economic prospects as those living on pension and interest income tighten their purse strings in anticipation of harder times ahead. Similarly, firms anticipating a continual slowing of the economy are less willing to undertake new investment in plant and equipment.

Corporate restructuring should remain the policy priority.

Korea's restructuring program, although it has proceeded in fits and starts, has built up the best track record among the crisis economies. The process may have slowed recently, but if the merger of the two largest banks succeeds, it could set off a virtuous circle of consolidation within the financial and manufacturing sectors. The consolidation of the financial sector is imperative given present market sentiment. This would further allow a more commercial allocation of credit and address inefficiencies in the allocation of resources that for so long was dictated by the Government.

Republic of Korea: Selected ARIC Indicators

	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																				
GDP Growth (%)	6.8	5.0	-6.7	10.9	8.8	-4.6	-8.0	-8.1	-5.9	5.8	11.2	13.0	13.0	12.6	9.7	9.2	4.6	3.7	2.7	1.8
Private Consumption Expenditure Growth (%)	7.1	3.5	-11.7	11.0	7.1	-11.9	-13.3	-12.5	-9.2	7.9	10.9	12.4	12.8	10.8	8.9	5.7	3.2	0.9	2.9	3.4
Public Consumption Expenditure Growth (%)	8.2	1.5	-0.4	1.3	1.3	0.8	-1.0	-0.2	-1.1	0.6	1.7	1.1	1.7	1.5	1.1	0.5	1.8	-2.3	-0.7	1.6
Gross Domestic Investment Growth (%)	8.7	-7.5	-38.4	29.5	8.0	-49.0	-43.1	-40.6	-23.3	23.3	31.6	36.8	26.6	29.4	8.2	11.8	-6.4	-5.4	-4.2	0.9
Agricultural Sector Growth (%)	3.3	4.6	-6.6	5.4	0.1	-4.0	-1.6	-7.6	-8.5	10.5	5.9	7.5	3.1	1.1	-1.8	-2.1	2.0	-3.4	3.8	-0.4
Manufacturing Sector Growth (%)	6.8	6.6	-7.4	21.0	15.4	-5.2	-10.7	-9.5	-4.2	10.0	20.9	26.2	26.4	22.3	16.9	17.7	6.5	4.4	2.1	-1.6
Construction Sector Growth (%)	6.9	1.4	-8.6	-9.1	-3.7	-2.9	-6.7	-9.1	-13.4	-13.6	-6.9	-8.4	-8.7	-7.9	-3.9	-2.8	-1.6	1.6	1.1	7.3
Services Sector Growth (%)	7.8	5.4	-7.2	11.9	9.0	-6.1	-9.0	-8.5	-5.2	8.0	12.0	13.4	14.2	12.0	10.3	8.7	5.5	3.9	3.6	3.8
Exports of Goods and Services Growth (%)	11.2	21.4	14.1	15.8	21.6	26.7	14.4	9.3	8.6	9.1	14.4	20.0	19.5	27.1	21.4	22.5	16.4	8.4	1.0	-4.3
Imports of Goods and Services Growth (%)	14.2	3.2	-22.1	28.8	20.0	-27.0	-25.4	-25.8	-9.7	27.1	28.1	32.2	28.0	31.6	20.6	22.4	8.2	-0.7	-7.2	-6.0
Inflation Rate (%)	4.9	4.4	7.5	0.8	2.3	8.9	8.2	7.0	6.0	0.7	0.6	0.7	1.3	1.5	1.4	3.2	2.9	4.2	5.3	4.3
Unemployment Rate (%)	2.0	2.6	6.8	6.3	4.1	5.6	6.8	7.4	7.4	8.4	6.6	5.6	4.6	5.1	3.8	3.6	3.7	4.8	3.5	3.3
Monetary and Fiscal Accounts																				
Growth of Broad Money, M2 (%)[1]	15.6	15.8	14.1	27.0	27.4	14.1	12.1	16.3	24.8	27.0	36.3	26.4	24.1	27.4	26.0	37.7	28.3	25.4	24.0	20.1
Three-Month Certificate of Deposit Rate (%)[1]	. . .	25.0	7.7	7.4	6.9	21.2	16.3	10.1	7.7	6.6	6.4	7.7	7.4	7.0	7.1	7.1	6.9	5.7	5.6	4.4
Growth in Real Bank Credit to Private Sector (%)[1]	14.4	14.4	4.3	18.9	15.4	9.7	5.5	5.6	4.3	13.5	16.6	18.3	18.9	14.6	17.7	16.0	15.4	10.7	. . .	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	. . .	11.3	8.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	11.3	10.8	10.7	9.7	8.1	7.2	6.4	. . .
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	. . .	8.3	6.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	8.3	8.0	8.7	7.9	6.6	5.4	4.1	. . .
Average Stock Price Index	90.6	67.8	47.1	94.7	92.1	58.3	43.0	36.5	50.6	68.4	90.1	113.1	107.3	114.3	96.9	89.8	67.2	72.0	71.9	66.9
Central Government Fiscal Balance as % of GDP	0.1	-1.3	-3.8	-4.6	. . .	4.1	-2.4	-4.2	-8.7	-0.2	-4.9	0.1	-7.1	1.5	3.0	-3.0	. . .	. . .	. . .	. . .
Central Government Debt as % of GDP[1]	. . .	11.1	16.1	18.6	19.5	. . .	. . .	. . .	16.1	17.9	. . .	18.3	18.6	18.8	19.0	19.3	19.5	19.6	. . .	. . .
Government Expenditure on Education (% of Total)	. . .	. . .	23.1	19.2	20.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	. . .	1.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																				
Growth of Merchandise Exports ($ fob, %)	3.7	5.0	-2.8	8.6	19.9	8.4	-1.8	-10.8	-5.5	-6.1	2.5	15.1	22.7	29.8	21.5	26.5	6.1	2.1	-11.6	-19.4
Growth of Merchandise Imports ($ cif, %)	11.3	-3.8	-35.5	28.4	34.0	-36.2	-37.0	-39.9	-28.7	8.1	22.2	38.7	44.8	51.9	38.4	35.8	16.2	-2.0	-13.4	-15.5
Current Account Balance as % of GDP	-4.4	-1.7	12.6	6.0	2.5	16.0	14.2	11.9	9.5	6.7	6.3	6.5	4.8	1.3	2.4	3.4	2.7	3.1	3.6	. . .
Net Direct Investment, ($ Billion)	-2.3	-1.6	0.7	5.1	3.5	-0.03	0.6	0.7	-0.5	0.1	1.2	2.1	1.7	0.2	2.2	-0.2	1.3	0.4	0.4	-0.7
Net Portfolio Investment, ($ Billion)	15.2	14.3	-1.9	8.7	12.0	3.8	0.6	-3.9	-2.4	0.9	4.0	-1.2	4.9	7.1	1.9	2.1	1.0	0.9	2.7	0.2
Gross International Reserves Less Gold ($ Billion)[1]	34.0	20.4	52.0	74.0	96.1	29.7	40.8	46.9	52.0	57.4	61.9	65.4	74.0	83.6	90.1	92.5	96.1	94.4	94.2	100.0
Total External Debt as % of GDP[1,3]	30.3	33.3	46.4	33.7	30.0	36.0	40.5	44.8	46.4	42.4	38.8	36.5	33.7	33.6	32.1	31.0	29.8	28.9	29.0	38.9
Short-Term Debt as % of Gross International Reserves[1]	274.2	312.1	59.1	53.0	46.0	180.3	82.9	65.4	59.1	54.7	50.5	52.9	53.0	53.2	53.9	50.6	46.0	44.9	43.7	39.1
Short-Term Debt as % of Total Debt[1]	57.1	39.9	20.6	28.6	32.4	34.7	21.8	20.2	20.6	21.6	22.2	24.7	28.6	31.3	34.4	33.3	32.4	32.6	32.4	31.9
Real Effective Exchange Rate (1995=100)[2]	104.5	100.3	83.1	90.8	94.1	73.8	83.7	88.8	86.1	91.7	92.6	89.7	89.2	93.7	94.2	94.9	93.5	90.4	91.6	91.3
Average Exchange Rate (Local Currency to $)	804.5	951.3	1,401.4	1,188.2	1,131.5	1,605.7	1,394.6	1,326.1	1,279.3	1,196.3	1,188.9	1,195.0	1,172.5	1,127.0	1,116.4	1,115.0	1,167.6	1,271.6	1,305.8	1,291.4

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

Lao PDR

GDP growth to stabilize in 2001.

After a slowdown in 1998, precipitated by the regional crisis and growing macroeconomic imbalances, GDP growth picked up in 1999. Official figures place output growth at 7.3 percent, although more conservative estimates suggest that the economy grew at something closer to 5.2 percent, which is still an improvement on 1998 (Table 1). A narrower fiscal deficit, strong agriculture growth, and higher garment exports underpinned the expansion in output. For 2000, official sources report an estimated GDP growth of 5.7 percent, implying that there was a deceleration of output growth. The Economic Intelligence Unit (EIU) estimates GDP growth in FY1999/2000 to be 4.5 percent compared to 5.4 percent in FY1998/99. (FY is from October to September.)

The official forecast for 2001, as well as those of multilateral agencies, suggests that growth in 2001 will be similar to 2000. Official sources project GDP growth to remain at 5.7 percent in 2001 and to accelerate slightly to 6.5 percent in 2002. Meanwhile, EIU forecasts 5-5.5 percent growth in FY2000/01 and FY2001/02. Slightly higher public investment is expected this year, while the start of the Nam Theun 2 hydroelectric project is likely to boost private investment in 2002. Unlike in many other developing Asian countries, it appears that the 11 September attacks and associated uncertainties are unlikely to significantly alter Lao PDR's growth prospects. Some impact is likely, however, given the increasing importance of tourism and close integration with the Thai economy.

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

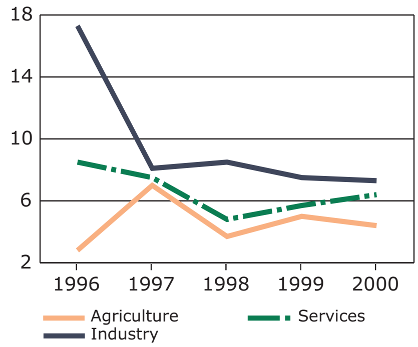
	1996	1997	1998	1999	2000	2001	2002
Official[1]	6.9	6.9	4.0	7.3	5.7	5.7	6.5
ADB[2]	—	—	—	—	—	6.0	6.5
World Bank[3]	—	—	—	—	—	5.6	6.2
EIU[4]	—	—	—	—	—	5.5-6.0	5.5-6.0

[1]IMF *Article IV* 2001, 26 April 2001.
[2]ADB, *Asian Development Outlook 2001,* April 2001.
[3]World Bank, *East Asia Update,* October 2001.
[4]In fiscal year October-September, *EIU Country Report,* May 2001.

All major sectors posted lower growth.

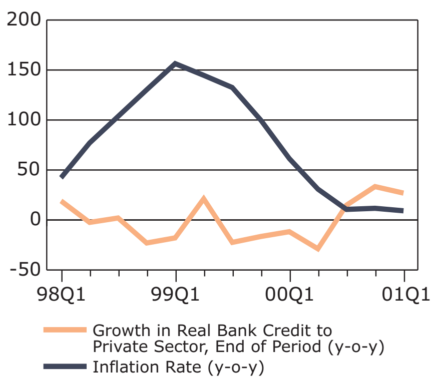
Official estimates show lower growth in the agricultural and industry sectors from 1999 to 2000 (Figure 1). The slowing of agricultural growth for the calendar year 2000 was more pronounced after severe floods in September. Higher fuel prices, the slower-than-expected growth of

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



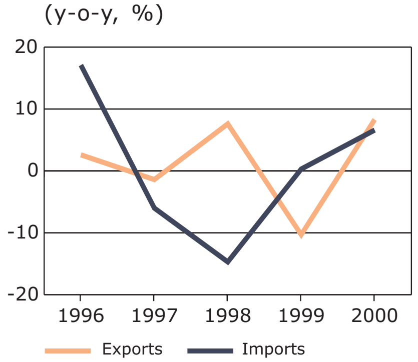
Source: ARIC Indicators.

Figure 2: **Real Bank Credit Growth and Inflation Rate** (%)



Source: ARIC Indicators.

Figure 3: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

the Thai economy, and a decline in the investment rate contributed to more sluggish industrial growth. But the services sector received a boost from increased tourist arrivals in 1999 and 2000.

Fiscal conditions improved.

The fiscal deficit—measured without official grants—narrowed to 10 percent of GDP in FY1998/99 from 14 percent in FY1997/98. In FY1999/2000, the deficit declined further to 8.2 percent. Revenues increased at a faster rate than expenditures between FY1998/99 and FY1999/2000—74 percent as compared to 47 percent. An adjustment of the exchange rate applied to the valuation of import duties accounted for much of the increase in tax revenues. Meanwhile, expenditures were streamlined and fiscal discipline was maintained. The rise in the share of current expenditures, from 30 percent in FY1998/99 to 39 percent in FY1999/2000, is also an encouraging sign, although it could increase much further.

Lower inflation contributed to the more favorable macroeconomic environment.

The average inflation rate for 2000 is estimated at 25 percent, substantially lower than the 128 percent seen in 1999 (Figure 2). Inflation in 2001 is anticipated to decline, perhaps to less than 10 percent. The Government's inflation forecast suggests an average of only 10 percent in 2001. The improvement has largely been a result of tightened fiscal and monetary policy. Slower monetary growth arose mainly from lower growth of credit to State enterprises.

But the macroeconomic situation remains vulnerable.

Despite an improvement in macroeconomic balances, the economy remains vulnerable on a number of fronts. Its financial system is shallow; effective monetary policy is difficult in a context of a high degree of dollarization; the State-owned banks, which hold 71 percent of total banking sector assets, are technically insolvent; and, notwithstanding some recent improvement in revenue mobilization, fiscal balances remain fragile.

The trade deficit widened despite a rebound in exports.

The trade deficit widened in 1999 after a decline in exports and a modest recovery of imports (Figure 3). The current account also increased as a percent of GDP, from -10 percent in 1998 to -11.2 percent in 1999. There was also a larger deficit on the capital account in 1999. Exports rebounded sharply in 2000, growing by 8.3 percent. But imports also grew strongly at 6.6 percent in 2000, leading to another slight widening of the trade deficit.

International reserves strengthened.

The deterioration of the balance-of-payments position translated into a decline in international reserves, from 2.2 months of imports in 1998 to two months in 1999. However, the situation is likely to have improved in 2000. Estimates indicate an international reserves position equivalent to 2.4 months of imports by the end of 2000.

The reform agenda needs to be revitalized.

The reform process that began with the introduction of the New Economic Mechanism in 1986 stalled when the financial crisis erupted in 1997. It is essential that the reform agenda be put back on track to provide a platform for sustainable growth. Economic restructuring should focus on reducing dependence on the agriculture sector and official development assistance for output growth, and expanding the role of the private sector in development. The most serious difficulties with the trade regime have emanated from quantitative restrictions on certain imports. More openness and greater transparency are required. And if there is to be greater private sector involvement, the regulatory environment will have to be more transparent and stable.

Lao PDR: Selected ARIC Indicators

	1996	1997	1998	1999	2000	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																
Real GDP Growth (%)	6.9	6.9	4.0	7.3	5.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Agricultural Sector Growth (%)	2.8	7.0	3.7	5.0	4.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Services Sector Growth (%)	8.5	7.5	4.8	5.7	6.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Industry Sector Growth (%)	17.3	8.1	8.5	7.5	7.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Inflation Rate (%)	13.0	27.5	91.0	128.4	25.1	156.4	144.7	132.5	99.9	61.4	30.9	10.6	11.7	9.2	. . .	. . .
Unemployment Rate (%)	3.1	3.9	5.6	6.8	7.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts																
Growth of Broad Money, M2 (%)[1]	26.7	65.8	113.3	78.4	46.0	133.9	211.4	95.4	78.4	58.3	7.9	49.7	46.0	31.0	. . .	. . .
Growth in Real Bank Credit to Private Sector	11.5	25.5	-23.0	-16.5	33.4	-17.9	21.2	-22.4	-16.5	-11.7	-28.8	14.8	33.4	26.9	. . .	. . .
Loans to Deposit Ratio	0.8	0.6	0.6	0.5	0.5	0.6	0.6	0.5	0.5	0.6	0.6	0.6	. . .	. . .	. . .	. . .
Central Government Fiscal Balance as % of GDP[2]	-5.6	-6.5	-9.6	-4.0	-5.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Education (% of Total)	. . .	7.2	6.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	2.0	3.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rate																
Growth Rate of Merchandise Exports ($ fob, %)	2.6	-1.4	7.6	-10.3	8.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Growth Rate of Merchandise Imports ($ cif, %)	17.1	-6.0	-14.7	0.3	6.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Gross International Reserves less Gold ($ Billion)[1]	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	. . .	. . .
Ratio of M2 to GIR[1]	1.5	1.4	1.8	2.0	2.0	1.8	1.8	1.9	2.0	2.3	2.3	1.9	2.0	2.2	. . .	. . .
Total External Debt ($ Billion)[1]	0.9	1.0	1.1	1.2	1.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Total External Debt as % of GDP	48.3	100.8	89.7	39.7	28.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Ratio of Short-Term Debt to Reserves[1]	0.2	0.1	0.0	0.1	0.1	. . .	0.2	. . .	0.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Short-Term External Debt as % of Total[1]	3.5	1.0	0.1	0.7	0.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Current Account Balance as % of GDP	-16.4	-16.1	-10.0	-11.2	-5.8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Real Effective Exchage Rate (1995 =100)[3]	95.5	91.5	57.8	65.7	70.5	74.3	61.0	60.1	67.5	70.7	72.4	71.1	67.9	68.2	69.4	. . .
Average Nominal Exchange Rate (Kip per $)	920.0	972.6	1,877.2	5,042.3	7,563.5	4,072.9	4,267.1	5,095.5	7,777.4	7,538.9	7,581.9	7,575.7	7,567.4	7,591.7	7,599.8	7,677.5

. . . = not available.
[1]End of period.
[2] Fiscal year ending September.
[3]Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on GDP are from International Monetary Fund (IMF), *IMF Interim Poverty Reduction Strategy Paper*, March 2001; sectoral GDP, fiscal balance, current account balance, and merchandise exports and imports are from Asian Development Bank (ADB), *Asian Development Outlook 2001*; M2, gross international reserves, ratio of M2 to reserves, loan to deposit ratio, and inflation rate are from IMF, *International Financial Statistics*, September 2001; unemployment rates are from ADB, *Country Economic Review 2001*; nominal exchange rates are from Bloomberg; total and short-term external debt are from Joint IMF-World Bank-OECD-BIS Statistics on External Debt. Real effective exchange rate is based on REMU staff calculations.

Malaysia

Real Sector

GDP growth turned negative in the third quarter of 2001.

GDP growth slowed sharply in the second quarter of 2001 to 0.5 percent, down from 3.1 percent in the first, and fell to -1.3 percent in the third quarter. To some extent, the slowdown, which began at the start of 2000, is a correction to the strong rebound over the previous year following the financial crisis of 1997/98. The growth figures for 2001, however, imply a sharper and more prolonged slowdown than initially expected, particularly in light of recent global uncertainties following the 11 September attacks on the US (Table 1).

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

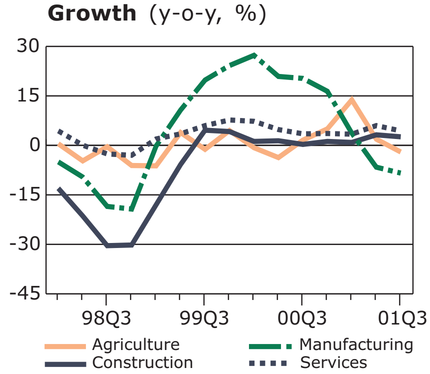
	1997	1998	1999	2000	2001	2002
Official[1]	7.3	-7.4	6.1	8.3	1.0-2.0	—
ADB[2]	—	—	—	—	0.8	3.1
IMF[3]	—	—	—	—	1.0	4.8
World Bank[4]	—	—	—	—	0.9	3.7
Consensus Economics[5]	—	—	—	—	0.0	2.9

[1]Ministry of Finance, 2002 Budget Speech, October 2001.
[2]ADB, *Asian Development Outlook Update,* November 2001.
[3]IMF, *World Economic Outlook*, October 2001.
[4]World Bank, *East Asia Update Regional Brief,* 17 October 2001.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* November 2001.

Manufacturing and agriculture dropped sharply.

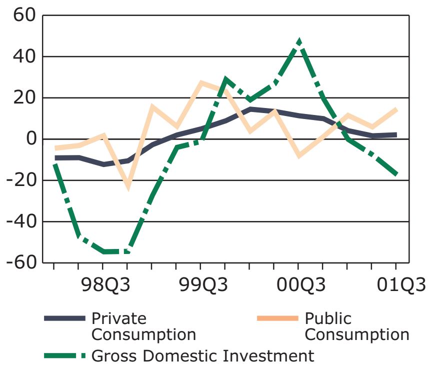
Sharp drops in manufacturing and agricultural production underlie the overall growth slowdown. Manufacturing production fell by 6.6 percent in the second quarter of 2001, after recording modest growth of 3.7 percent in the first quarter (Figure 1). It fell further by 8.4 percent in the third quarter. This contrasts with average growth in excess of 20 percent in 2000. The manufacturing sector was adversely affected by the downturn in the global electronics cycle, which turned out to be more pronounced than anticipated. The electronics sector alone contracted by 25.2 percent in the second quarter, following a decline of 1.2 percent in the first. Agricultural output, meanwhile, grew by only 1.9 percent in the second quarter of 2001, down sharply from the 13.8 percent recorded in the first quarter. It fell by 2 percent in the third quarter, highlighting the severity of the decline in this sector. Although the construction and services sectors appeared to be benefiting from low interest rates and the Government's fiscal stimulus program in the second quarter, they too experienced slower growth in the third.

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



Source: ARIC Indicators.

Figure 2: **Growth of GDP Expenditure Components**
(y-o-y, %)



Source: ARIC Indicators.

Construction grew by 3.2 percent in the second quarter of 2001, an improvement on the first quarter's figure of 0.9 percent, but tapered off to 2.6 percent in the third quarter. Services expanded by 6 percent in the second quarter of 2001, up from 3.4 percent in the first, but also fell to 4.4 percent in the third quarter.

Domestic investment fell sharply while there was a modest improvement in private consumption.

Domestic investment turned negative for the first time since mid-1999, falling by 4.1 percent in the first half of 2001 (Figure 2). It fell even more sharply in the third quarter, dropping by 17.2 percent. Double-digit growth in private consumption in 2000 also retreated in 2001, with 4.1 percent growth in the first quarter and only 1.6 percent in the second. There was a modest improvement in the third quarter, however, with private consumption increasing by 2.1 percent. While public consumption grew sharply in the first quarter of 2001 to reach 11.5 percent, it tapered off in the second quarter to 5.9 percent. It shot up sharply again in the third quarter, reaching 14.6 percent.

Fiscal and Monetary Developments

A new government spending package is intended to offset the impact of the global slowdown.

The Government posted a surplus of RM1.8 billion in the first half of 2001. Before the September 11 attacks, it had announced that it would be spending an additional RM3 billion in 2001 to provide a stimulus to the slowing economy. But the attacks and the expected further slowing of the global economy prompted the announcement of another large spending package in September 2001. The Government now plans to spend a total of RM4.3 billion ($1.1 billion), mainly on public works projects. While it is still unclear how much of the package will be spent this year, the Ministry of Finance has revised its 2001 budget deficit estimate to RM22.4 billion (6.5 percent of GDP) compared with an earlier forecast of RM16.1 billion (4.7 percent of GDP).

Monetary policy remains broadly accommodating.

Interest rates fell steadily in 1999 to reach historic lows. Since then, they have shown little movement until recently, when Bank Negara Malaysia (BNM) followed the US FED in its response to the 11 September attacks and reduced the three-month intervention rate by half a percentage point, bringing it down to 5 percent. Effective 15 October, lending rates for SMEs were also reduced by 0.5 percentage points to provide the impetus for investment growth. Maximum lending rates charged to SMEs now stand at 5 percent. In a benign inflationary environment, BNM has continued to follow a broadly accommodating monetary policy and liquidity conditions remain supportive.

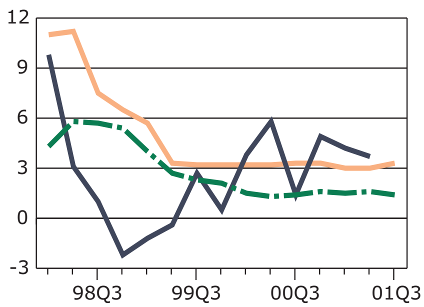
There are early signs of renewed credit growth.

Recent monthly data suggest that banking system loans are now on the rise. Total loans increased by 5.8 percent in August from levels a year ago. The residential property and manufacturing sectors are driving new loan demand. While real bank credit extended to the private sector remained positive, the rate of increase slowed to 3.6 percent in the second quarter from 4.2 percent in the first. The money supply (M3) continued to grow in the early months of 2001, after recording its largest monthly increase for the year in December 2000, reflecting a broad-based expansion in loans. The loan-to-deposit ratio, having fallen for some time, is now beginning to track up. Nevertheless, banks are still using cash to buy government securities as they seek to further strengthen their balance sheets.

Inflation remains tame.

Subdued inflation in 2000 has continued into 2001, amid a slowing economy. Consumer price inflation ranging from 1.4-1.6 percent in the first three quarters of 2001 mirrors the annual rate of 1.5 percent in 2000 (Figure 3). Slow growth and low inflation abroad suggest that domestic inflation is likely to remain subdued for the remainder of 2001.

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth*, and Inflation Rate** (%)



Three-Month Interbank Lending Rate, End of Period
Growth in Real Bank Credit to Private Sector, End of Period (y-o-y)
Inflation Rate (y-o-y)

Source: ARIC Indicators.

Balance of Payments

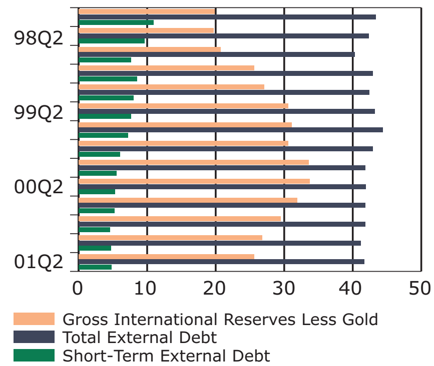
The trade account remained in surplus.

Malaysia's trade account continues to remain in surplus, despite a sharp decline in exports, reaching $10.8 billion in the first nine months of 2001. Gross exports contracted for the first time since the financial crisis, falling by 8.8 percent in the second quarter of 2001, but imports fell by 10.5 percent in the same quarter (Figure 4). The downturn was even more severe in the third quarter, with exports and imports contracting by 19 and 23 percent, respectively. The continuing downsizing in the global electronics cycle explains most of the sharp falls in exports and imports.

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)

Source: ARIC Indicators.

Figure 5: **International Reserves and External Debt** ($ billion)



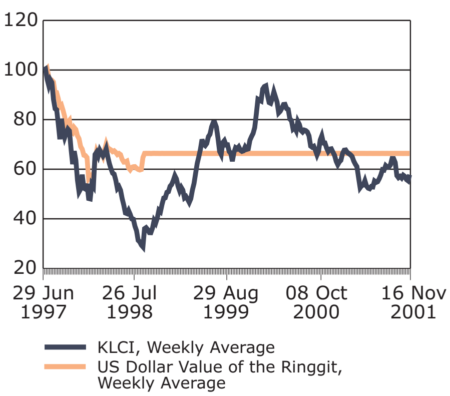
Source: ARIC Indicators.

The foreign exchange reserves position remains healthy.

The level of Malaysia's foreign exchange reserves remains healthy in 2001 (Figure 5). As of end-August 2001, BNM reported that official reserves were at $27.7 billion, sufficient to finance 4.1 months of retained imports. The current level of reserves also provides ample cover (a multiple of 5.8) for short-term external debt.

Asset Markets

Figure 6: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: ARIC Indicators.

The KLCI has seen a modest recovery since mid-2001.

The Kuala Lumpur Composite Index (KLCI) lost 11 percent of its value in the first half 2001, continuing a trend that began in early 2000 (Figure 6). This was, however, much in line with weaknesses in other regional equity markets at the time. Although the KLCI displayed a modest recovery in the third quarter of 2001, this was interrupted by the September 11 attacks. As of mid-November, the KLCI remained 8.6 percent below its value at the start of the year, effectively wiping out the 16 percent gained during the third quarter before the attacks on the US.

The property market still faces difficulty.

The property market in Malaysia is still adjusting. Office vacancy rates in the central business district of Kuala Lumpur trended downwards

Table 2: **Property Vacancy Rates in Kuala Lumpur** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2
Office Property	11.6	13.6	15.5	15.7	17.0	17.0	18.8	17.8	17.5	17.0	18.5	17.8	18.4
Retail Property	. . .	. . .	. . .	. . .	12.8	. . .	15.2	. . .	13.2	. . .	13.4	. . .	12.5

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

during the first nine months of 2000, but the level bounced back to 18.5 percent in the last quarter (Table 2). This has tapered off again in the first quarter of 2001 to 17.8 percent but has blipped to 18.4 percent in the second quarter. The picture is similar in the retail property market, where the vacancy rate rose to 13.4 percent in the last quarter of 2000 from 13.2 percent half a year earlier, but dropped to 12.5 percent in the first half of 2001. In the residential property market, capital values appeared to have stabilized in 2000, but were still down on a year-on-year basis.

Financial and Corporate Sector Developments

Banking system capital strength has been maintained.

The merger program initiated by BNM to consolidate banking institutions by 31 December 2000 resulted in 50 of the 54 domestic banking institutions being consolidated into 10 banking groups. In March 2001, another bank completed its merger exercise. Consolidation is taking place against the backdrop of a significant improvement in banking system balance sheets. As of end-September 2001, capital injection by Danamodal in the banking system declined to RM3.7 billion compared with the initial injection of RM7.1 billion. The core capital adequacy (CCA) and risk-weighted capital ratios (RWCR) confirm an increase in the capital strength of the Malaysian banking system over the past two years. The CCA as of end-September 2001 was 10.6 percent, well above the 8 percent Basel norm, while the RWCR also continued to be healthy, at 12.5 percent.

Nonperforming loan ratios are rising.

As of end-June 2001, Danaharta had already carved out a large portion (RM39.8 billion) of the NPL portfolio from the Malaysian banking system. Banks, however, have still been left to work out a significant portion of problem loans, many of which are comparatively small. As of September 2001, banking system NPLs increased to 11.8 percent of total loans, from 9.7 percent in end-December 2000. Commercial banks' NPLs have also been on the rise, increasing from 8.3 percent at end-2000 to 10.8 percent in September 2001.

Danaharta's operations continue at a steady pace.

As of end-June 2001, Danaharta, whose mandate is to rehabilitate and restructure viable loans, was managing loans valued at RM48 billion, of which RM39.8 billion were acquired from the banking sector, representing 40.5 percent of the banking system's NPLs. More than 85 percent of the loans in Danaharta's portfolio had been disposed of by the end of the second quarter of 2001. Recovery rates on assets have been high by international standards, averaging about 57 percent.

CDRC has resolved the majority of referred cases.

As of end-September 2001, CDRC had received and accepted applications amounting to RM56.4 billion (including nonbanking and offshore institutions). Of these, 36 applications with a value of RM28.2 billion had been resolved.

Prospects and Policy Issues

Malaysia's GDP in 2001 is projected to be stagnant.

The latest Consensus Economics (November 2001) projections suggest that Malaysia's GDP is likely to remain stagnant in 2001. This is a significant setback from the 8.3 percent achieved in 2000 and considerably lower than the April 2001 Consensus forecast of 4.8 percent. Even though the Government is still forecasting positive growth of 1-2 percent for the year, press reports suggest that it is bracing for the possibility of a recession. Given the highly open and trade dependent nature of the Malaysian economy, the timing of a rebound would undoubtedly depend on global growth, and particularly the electronics cycle. Consensus Economics now projects growth in 2002 to be 3.4 percent. With few signs of inflation and interest rates falling worldwide, domestic interest rates are likely to remain low into 2002.

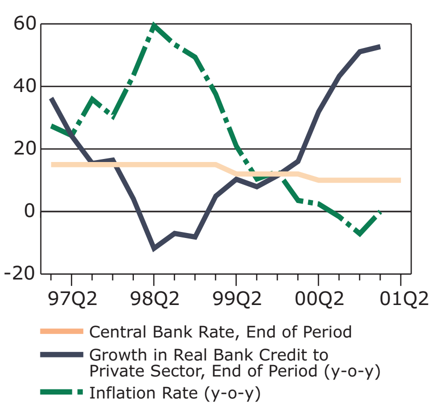
Malaysia: Selected ARIC Indicators

	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																				
GDP Growth (%)	10.0	7.3	-7.4	6.1	8.3	-1.5	-5.9	-10.2	-11.2	-0.9	5.1	8.8	11.2	11.7	8.0	7.6	6.3	3.1	0.5	-1.3
Private Consumption Expenditure Growth (%)	6.9	4.3	-10.2	3.3	12.2	-9.1	-9.0	-12.3	-10.5	-2.7	2.0	5.0	8.9	14.5	13.4	11.3	9.9	4.1	1.6	2.1
Public Consumption Expenditure Growth (%)	0.7	5.7	-8.9	18.5	1.7	-4.4	-3.1	1.7	-22.6	15.5	6.2	27.2	23.1	3.9	13.2	-8.0	1.3	11.5	5.9	14.6
Gross Domestic Investment Growth (%)	4.7	12.2	-43.5	-5.1	27.8	-12.1	-47.3	-54.6	-54.4	-27.2	-4.0	-1.1	28.9	19.0	26.8	46.9	19.5	-0.1	-7.6	-17.2
Agricultural Sector Growth (%)	4.5	0.7	-2.8	0.4	0.6	0.5	-4.7	-0.4	-6.1	-6.2	3.9	-1.2	4.5	-0.7	-3.7	1.6	5.0	13.8	1.9	-2.0
Manufacturing Sector Growth (%)	18.2	10.1	-13.4	13.5	21.0	-5.0	-9.6	-18.5	-19.3	-0.2	10.7	19.8	24.2	27.3	20.9	20.3	16.4	3.7	-6.6	-8.4
Construction Sector Growth (%)	16.2	10.6	-24.0	-4.4	1.0	-13.0	-21.4	-30.4	-30.2	-18.0	-5.8	4.6	4.2	1.2	1.4	0.3	1.2	0.9	3.2	2.6
Services Sector Growth (%)	8.9	9.9	-0.4	4.8	4.8	4.4	0.06	-2.6	-3.0	1.95	3.5	6.0	7.7	7.3	4.8	3.5	3.6	3.4	6.0	4.4
Exports of Goods and Services Growth (%)	9.2	5.0	0.9	13.4	16.1	-0.9	-1.5	2.3	3.7	2.3	12.8	18.8	18.9	21.0	16.8	19.9	8.3	6.1	-6.8	-18.1
Imports of Goods and Services Growth (%)	4.9	5.8	-18.8	10.8	24.2	-9.5	-24.9	-22.5	-17.1	-8.1	9.2	18.1	25.5	25.7	27.7	32.0	12.8	6.8	-9.1	-21.3
Inflation Rate (%)	3.5	2.7	5.3	2.7	1.4	4.3	5.8	5.7	5.4	4.0	2.7	2.3	2.1	1.5	1.3	1.4	1.6	1.5	1.6	1.4
Unemployment Rate (%)	2.5	2.6	3.2	3.4	3.1	2.9	3.3	3.3	3.4	4.5	3.3	2.9	3.0	3.0	3.3	3.1	3.0	4.0	3.7	. . .
Monetary and Fiscal Accounts																				
Growth of Broad Money, M2 (%)[1]	20.9	24.3	17.4	-1.4	16.9	17.4	10.0	6.8	2.8	-1.4	3.6	13.2	17.1	16.9	18.5	11.9	7.2	9.9	7.3	6.4
Three-Month Interbank Lending Rate (%)[1]	. . .	. . .	6.5	3.2	3.3	11.0	11.2	7.5	6.5	5.7	3.3	3.2	3.2	3.2	3.2	3.3	3.3	3.0	3.0	3.3
Growth in Real Bank Credit to Private Sector (%)[1]	16.9	19.9	-2.2	0.5	4.9	9.8	3.1	1.0	-2.2	-1.2	-0.4	2.7	0.5	3.8	5.8	1.4	4.9	4.2	3.7	. . .
NPL Ratio of the Financial System[1]	3.7	4.1	13.6	11.0	9.6	7.0	8.9	12.8	13.6	14.2	12.4	12.0	11.0	10.7	10.4	10.1	9.6	10.6	11.4	11.8
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	10.3	8.8	8.1	. . .	. . .	10.5	10.3	11.1	9.4	9.6	8.8	8.9	8.6	8.5	8.1	9.3	10.3	10.8
Average Stock Price Index	1,134.1	978.9	517.7	692.0	842.4	657.7	565.3	381.1	466.7	556.0	706.9	763.2	741.8	950.1	892.8	792.0	734.8	694.7	579.2	646.7
Central Government Fiscal Balance as % of GDP	0.7	2.4	-1.8	-3.2	-4.8	5.9	-0.5	2.1	-14.7	1.8	0.2	-7.3	-6.4	1.2	1.9	-5.2	-16.7	-2.0	2.2	. . .
Central Government Debt as % of GDP[1]	35.3	31.9	36.4	37.3	36.9	30.5	31.4	30.8	36.4	36.9	38.5	37.9	37.3	36.5	37.2	37.0	36.9	37.7	. . .	. . .
Government Expenditure on Education (% of Total)	21.4	21.3	21.5	22.1	23.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	5.9	6.2	6.5	6.4	6.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																				
Growth of Merchandise Exports ($ fob, %)	8.8	0.8	-7.1	15.4	16.1	-11.5	-10.0	-11.4	5.1	4.7	15.5	21.5	19.3	22.1	16.9	21.6	5.7	1.6	-8.9	-19.3
Growth of Merchandise Imports ($ cif, %)	0.9	0.8	-26.3	12.1	25.7	-19.9	-33.8	-29.4	-20.6	-6.8	9.6	21.2	25.3	27.3	32.0	33.8	11.7	6.7	-10.5	-22.8
Current Account Balance as % of GDP	-4.8	-5.2	13.5	15.9	9.4	6.4	11.4	17.4	18.7	15.9	16.7	18.0	13.3	12.9	7.8	8.3	8.7	10.0	8.2	. . .
Private Long-term Capital ($ Billion)[2]	5.1	5.1	2.2	1.6	1.9	1.1	0.7	-0.2	-0.6	0.3	1.0	0.05	0.2	0.5	0.5	0.3	0.6	. . .	. . .	. . .
Private Short-term Capital ($ Billion)[2]	4.1	-4.6	-5.2	-9.9	-9.2	-2.3	-1.2	-1.1	-0.6	-1.8	-0.7	-4.2	-3.3	0.4	-1.6	-2.9	-5.1	. . .	. . .	. . .
Gross International Reserves Less Gold ($ Billion)[1]	27.0	20.8	25.6	30.6	29.5	19.8	19.7	20.7	25.6	27.1	30.6	31.1	30.6	33.6	33.7	31.9	29.5	26.8	25.6	. . .
Total External Debt as % of GDP[1]	38.3	43.4	59.4	54.3	46.6	46.7	50.4	53.1	59.4	58.7	58.7	58.2	54.3	50.6	49.0	47.6	46.6	45.8	46.6	. . .
Short-Term Debt as % of Gross International Reserves[1]	37.0	53.5	33.1	19.7	15.7	54.9	48.9	36.9	33.1	29.4	25.0	23.2	19.7	16.2	15.8	16.3	15.7	17.5	18.6	. . .
Short-Term Debt as % of Total Debt[1]	22.8	28.8	19.7	14.0	11.1	25.1	22.7	19.0	19.7	18.8	17.7	16.3	14.0	13.1	12.7	12.4	11.1	11.4	11.4	11.8
Real Effective Exchange Rate (1995=100)[3]	106.5	105.5	86.8	87.6	86.2	84.8	88.9	86.5	87.1	89.4	89.7	87.2	84.2	85.8	85.7	85.8	87.4	91.0	93.4	92.7
Average Exchange Rate (Local Currency to $)	2.5	2.8	3.9	3.8	3.8	4.0	3.8	4.1	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8

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

Myanmar

Figure 1: **Central Bank Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Growth slowed in 2001 and a pickup is not expected until 2002/03.

Official estimates suggest that after posting robust economic growth of 10.9 percent in FY1999/2000 (the fiscal year ends in March), growth dropped to 6.2 percent for 2000/01. Although no breakdown on output has been made available, there are indications that the manufacturing sector grew rapidly as production of key goods such as cotton fabric, cement, paper, and milled sugar increased. Growth in the agricultural sector also prompted expansion of agro-based industries.

Output growth is expected to slow further in FY2001/02 in the face of weak external and domestic demand, which constrains growth in industrial output and the agricultural sector. The latter, particularly rice, has been adversely impacted by heavy rains that hit the country in the middle of the dry season harvest although the production of other crops remains favorable. Industrial growth may also be limited by weak domestic demand and slowing external demand as a result of the global slowdown. There may be a pickup in growth in 2002 as authorities continue to provide subsidies and incentives to support agricultural output and incomes. The services sector, particularly retail, is also expected to grow as the civil service wage increases kick in.

The budget deficit widened.

The budget deficit for FY1999/2000 reached MK109.7 billion, up from MK91.9 billion in FY1998/99. In the past, authorities have attempted to reduce the deficit by compressing both current and capital expenditure. However, despite spending cuts, poor revenue effort has kept the public sector deficit at an uncomfortably high level of 5 percent of GDP. It is estimated that the deficit widened further in FY2000/01 as a result of a pay increase for civil servants in April 2000. Perennial deficits are financed through expansion of central bank credit and by issuance of government bonds.

Inflation was negative in 2000.

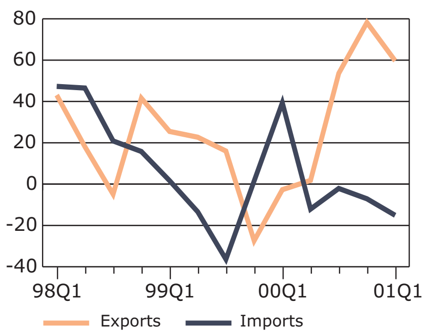
Official estimates put inflation at about –0.1 percent in 2000 (Figure 1). From July 2000 to February 2001, inflation was in negative territory, registering –0.02 percent in the first quarter of 2001. Food prices are heavily weighted in the index. Their stability, resulting from improved agriculture performance and the implementation of "tax-free markets," which reduce marketing and distribution costs, are said to explain the rapid decline in inflation. Likewise, large expenditure cuts reduced the deficit and inflationary finance. However, declining prices and slowing inflation may be short-lived. In March 2001, prices began rising again and inflation reached 3.8 percent in March and 5 percent in April 2001. It is expected that inflation may average 9.6 percent in 2001, driven by such factors as the rising civil service wages, continued monetization of the deficit, the fall in the value of the kyat, and rising import prices.

Real interest rates became positive.

After a significant reduction in the rate of inflation, real interest rates turned positive beginning in the first quarter of 2000, after several years in negative territory. Even though inflation picked up somewhat beginning March 2001, real interest rates are still positive. These may support domestic resource mobilization and improve the domestic savings rate, which has averaged only about 12 percent of GDP since 1988.

The current account balance improved slightly.

Figure 2: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

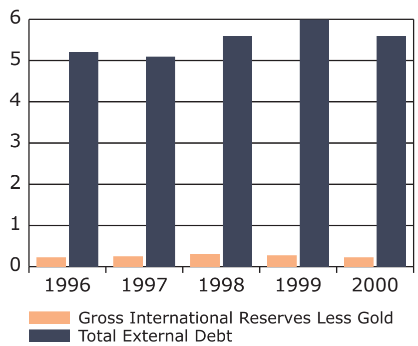
Faster export growth and slowing imports (Figure 2) reduced the trade deficit in 2000. Export growth was supported by a strong performance from commodity exports, such as rice, pulses, fish, and timber. Recent data indicate that exports of rice grew by 227.9 percent in FY2000/01. However, this was from a very low base. There are no recent data on exports of garments, but there has been a modest increase in investments in the garments industry from other ASEAN member countries and this may indicate that garments also contributed strongly to exports. The rise in the free market exchange rate and the slowdown in domestic investment, which resulted in a drop in capital imports, were factors explaining lower imports.

Export growth in 2001 may pick up due to the expected rise in prices of the country's key exports. Exports of gas from the Yadana and Yetagun gasfields are also expected to provide a boost. Imports may be constrained by the weakness of the kyat and import controls that are in place. Thus, the trade and current account deficit may narrow further in 2001.

FDI approvals increased.

FDI approvals for the 11 months of FY2000/01 amounted to $146.8 million. The amount is higher by 171.4 percent compared to the approvals in April-February 1999/2000. However, stiffening sanctions limited actual investments in the first half of 2001 to $44.5 million—down by almost 40 percent from levels for the same period in 2000. The bulk of investments was made in the manufacturing sector. There have also been new investments in sugar milling and garments coming from Asian countries. Prospects for improved FDI flows in the second half of 2001 are grim as the global growth slowdown bites.

Figure 3: **International Reserves and Total External Debt** ($ billion)



Source: The Economist Intelligence Unit (EIU), Country Report, August 2001.

International reserves continued to fall.

Myanmar's foreign exchange reserves declined further in 2000. As of the end of the year, the country's gross international reserves (excluding gold) amounted to about $230 million. The drop has continued into 2001, with data for the first quarter of 2001 showing that reserves had fallen to $200.9 million, equivalent to about one month of imports. Combined with a current account deficit, and limited foreign investments and access to external loans and foreign aid, this places the country in a fragile balance of payments position. As a result, there has been a drop in the free market exchange rate, which now stands at about MK750/$1.

External debt stands at $5.6 billion.

Myanmar's external debt for 2000 was $5.6 billion, slightly lower than the $6 billion posted in 1999 (Figure 3). Lack of access to concessional bilateral and multilateral loans has meant that the country has had to rely more on commercial credits, principally from the PRC. As a result, repayment priorities have shifted toward commercial rather than multilateral loans. Myanmar suspended servicing its debt to ADB and the World Bank in 1998. Bilateral debts, however, have been repaid, and there are no debts to the IMF.

Although there are no recent data on government expenditure for social sector provisions such as health and education, past spending on these has averaged about 0.5 percent of GDP. Spending cuts to reduce the budget deficit have strained social sector provisions in the country and have resulted in low educational attainments and inadequate healthcare. The recent grant received from the European Union, however, may help to improve health services in the country.

Reforms are needed to sustain growth.

The economy of Myanmar had grown by 7 percent annually in the period 1996-2000. For growth to be sustained, reforms must be put in place. Agricultural as well as tax and expenditure policies, and the management of the exchange rate are all creating distortions and inefficiencies that are holding back Myanmar's considerable economic potential. Market-based policies would create a better incentive structure and improve efficiency. Liberalization of the agricultural sector, public sector reforms, removal of trade restrictions, unification of the exchange rate, and a more transparent decision-making process would do much to promote growth over the medium term. If these measures were to be accompanied by a decline in political risks, Myanmar could prove highly attractive to foreign investors.

Myanmar: Selected ARIC Indicators

	1996	1997	1998	1999	2000	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																
Real GDP Growth (%)	6.4	5.7	5.8	10.9	6.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Agricultural Sector Growth (%)	5.0	3.7	4.5	11.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Services Sector Growth (%)	6.5	6.7	7.0	9.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Industry Sector Growth (%)	10.7	8.9	6.1	13.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Inflation Rate (%)	16.3	29.7	51.5	18.4	-0.1	37.6	20.9	10.4	12.8	3.5	2.4	-1.6	-7.1	0.0	. . .	. . .
Unemployment Rate (%)	6.3	6.7	7.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts																
Growth of Broad Money, M2 (%)[1]	38.9	28.8	34.2	29.7	42.4	27.6	26.5	29.4	29.7	31.4	37.1	38.8	42.4	. . .	. . .	. . .
Growth in Real Bank Credit to Private Sector (%)[1]	24.7	16.4	-8.1	11.5	51.1	4.9	10.3	7.9	11.5	16.0	31.9	43.3	51.1	. . .	. . .	. . .
Ratio of Loans to Deposit	0.8	0.9	0.9	0.8	0.8	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8	. . .	. . .	. . .
Central Government Fiscal Balance as % of GDP	-2.5	-0.2	0.3	-0.9	0.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Education (% of Total)	13.4	10.2	11.1	8.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	4.0	3.6	2.4	2.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																
Growth of Merchandise Exports ($ fob, %)	-12.3	16.1	23.0	5.6	24.7	25.5	22.7	16.0	-27.4	-2.7	1.8	53.6	78.2	59.7	. . .	. . .
Growth of Merchandise Imports ($ cif, %)	1.8	50.0	30.9	-13.7	3.1	1.7	-13.4	-36.4	1.5	39.4	-12.1	-2.1	-7.1	-15.1	. . .	. . .
Current Account Balance as % of GDP	-0.3	-0.4	-0.2	-0.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Foreign Direct Investment ($ Billion)[1]	0.3	0.4	0.3	0.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Gross International Reserves Less Gold ($ Billion)[1]	0.2	0.2	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	. . .	. . .
Total External Debt ($ Billion)[1]	5.2	5.1	5.6	6.0	5.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Real Effective Exchange Rate (1995=100)[2]	121.1	157.2	233.7	267.3	. . .	264.8	265.4	269.3	269.8	258.2	255.3	249.1	. . .	. . .	. . .	. . .
Average Exchange Rate (Local Currency to $)	5.8	5.9	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.4	6.6	6.7	6.7

. . . = not available.
[1]End of period.
[2]Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output, fiscal balance, current account balance, and foreign direct investment are from Asian Development Bank, *Asian Development Outlook 2001.* Merchandise exports and imports, M2, gross international reserves, real bank credit to the private sector, loan to deposit ratio, and inflation rate are from International Monetary Fund, *International Financial Statistics,* September 2001. Nominal exchange rates are from Bloomberg. Government expenditure on health and education are from International Monetary Fund, *IFM Staff Report.* Total external debt is from *EIU Country Report,* August 2001. Real effective exchange rates are based on REMU staff calculations.

Philippines

Real Sector

GDP continued to slow in the first half of 2001.

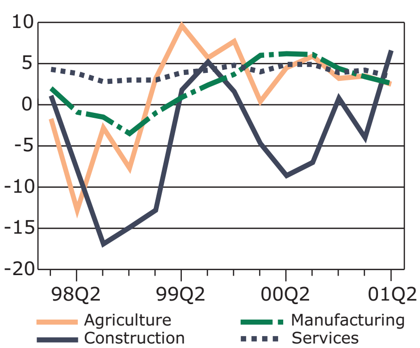
The economic deceleration that began in the last quarter of 2000 continued in the first half of 2001, with GDP growth falling to 3.3 percent, compared to 3.8 percent in the first half last year. While second quarter growth of 3.3 percent beat most expectations—including official forecasts—momentum will probably not be sustained as the economy continues to be buffeted by adverse factors. The global economic downturn, which was already deeper and broader than expected before 11 September, has been worsened further by the uncertainty resulting from the attacks on the US. Added to this are the burgeoning fiscal deficit, capital outflows, higher inflation, and weak private investment. Despite the gloomy outlook, the Government has persevered with its 3.3 percent growth target for the whole year (Table 1).

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

	1997	1998	1999	2000	2001	2002
Official[1]	5.2	-0.6	3.4	4.0	3.3	4.0-4.5
ADB[2]	—	—	—	—	2.7	3.0
IMF[3]	—	—	—	—	2.5	3.5
World Bank[4]	—	—	—	—	2.5	3.5
Consensus Economics[5]	—	—	—	—	2.4	2.8

[1]National Statistical Coordination Board, *National Accounts of the Philippines,* and National Economic Development Authority projections as of 04 October 2001.
[2]ADB, *Asian Development Outlook Update,* November 2001.
[3]IMF, *World Economic Outlook,* October 2001.
[4]World Bank, *East Asia Update Regional Brief*, 17 October 2001.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, November 2001.

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



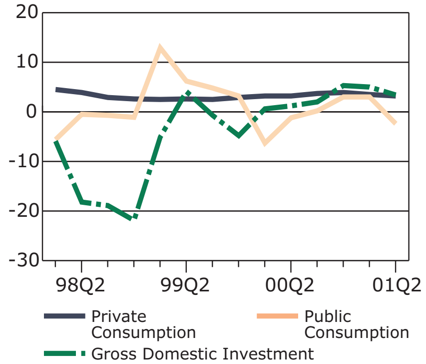
Source: ARIC Indicators.

Output growth in the first half was underpinned by factors that may not be sustained.

Strong agriculture growth of 3.5 percent lifted the economy in the first quarter of 2001 (Figure 1). After this sector reverted to its long-run trend of 2.5 percent in the second quarter, the slack was picked up by the turnaround in the construction sector. The latter expanded by 6.6 percent in the second quarter after five quarters of near-zero growth or decline. The rebound, however, is hardly encouraging since it was due to a surge in public construction, which in turn was attributable mostly to one large government project. Meanwhile, the export crunch filtered into manufacturing sector activity, pulling down growth to 3 percent in the first half from 6.1 percent a year ago. The service sector likewise experienced lower growth because of the subdued economic climate. Meanwhile, the production sectors hardest hit by the financial crisis—private sector construction, finance, and real estate—continue to be mired in a slump. Since all major sectors are on a downtrend and the stimulus provided by public construction is only temporary, prospects in the second half are rather bleak.

Private sector investment continues to be sluggish.

Figure 2: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

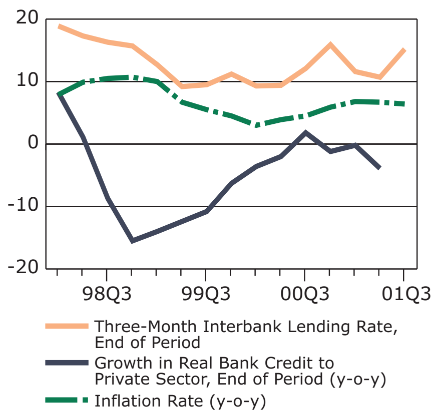
Despite the resolution of the political crisis in the first half of 2001 and a fall in interest rates, private sector investment has not returned to precrisis levels and remains sluggish. Investment in durable equipment barely grew in the first half of the year after increasing by 4.7 percent in the corresponding period in 2000. Private construction contracted slightly, a reversal from its 6.2 percent growth in the first half of 2000. Only the sharp increase in public construction allowed total fixed investment to post higher growth, from 0.2 to 1.2 percent. Meanwhile, personal consumption expenditures grew at a marginally faster pace, from 3.2 percent in the first half of 2000 to 3.4 percent this year (Figure 2). The steady performance of the agriculture sector, which accounts for about 40 percent of employment, can partly explain the resilience of personal consumption. But as expected, the deficit in net exports widened in the first half of 2001 compared to its level in the corresponding period last year, due to the decline in external demand.

Fiscal and Monetary Developments

The budget deficit remains a priority issue.

In the first nine months of 2001, the national Government's deficit was 1.6 percent higher than its programmed level as revenues continued to fall below target. Cutbacks in expenditures from programmed levels prevented further fiscal slippage, but with limited sources of growth, this course of action cannot be maintained. The Government, however, has earmarked improved revenue performance as one of its major goals, which would ensure the sustainability of efforts to lessen the deficit. The programmed deficit for 2001 is P145 billion, which is 4.2 percent of the target GDP.

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Inflation stabilized after peaking at the start of the year.

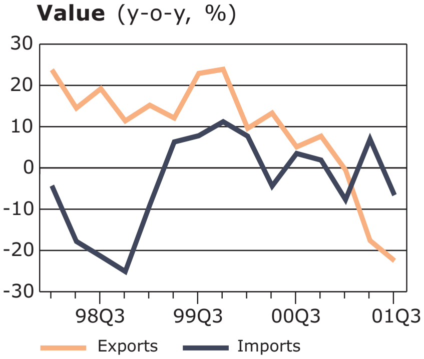
The inflation rate accelerated in the last half of 2000 and peaked in January 2001. It has since stabilized and averaged 6.5 percent in the first 10 months of the year (Figure 3). The weak peso and lagged effects of fuel price increases contributed to higher inflation compared to the average last year. The Consensus Economics forecast for inflation is 6.5 percent for the whole year. But the outcome could well be lower since the August, September, and October inflation rates have already shown clear signs of a deceleration.

Monetary policy was tightened in response to the peso's fall and higher inflation in the third quarter.

After the resolution of the political crisis in January, monetary policy was eased through the first half of the year. This is evident from the decline in the three-month interbank lending rate, from 15.9 percent at the end of 2000 to 11.1 percent in August 2001. However, the rapid depreciation of the peso at the start of the third quarter prompted the Bangko Sentral ng Pilipinas (BSP) the country's central bank, to tighten monetary policy. The liquidity reserve requirement was raised by 4 percentage points between July and August, supplemented by a reduction in the amount of over-the-counter sales of foreign exchange to residents without documentary requirements. BSP also applied existing regulations on foreign exchange transactions more strictly. However, interest rates were not raised and were even lowered by 25 bps in early October and a further 50 bps on 9 November. This move was partly in response to the potential adverse effects of the attacks on the US.

Balance of Payments

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

The trade surplus narrowed sharply.

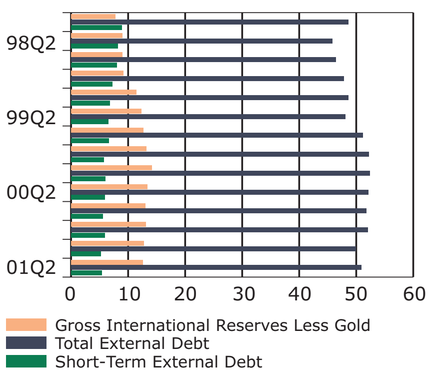
Owing to the unfavorable external environment, exports shrank by 22.5 percent in the first nine months of 2001 (Figure 4). A significant amount of the reduction was due to the fall of electronics exports, which comprise about 60 percent of the total. Since these are heavily import-dependent, the fall in electronics exports contributed to a slight contraction of merchandise imports in the same period. Other mitigating factors were slower output growth and a weaker peso. However, the overall trade surplus still narrowed sharply in the first nine months of 2001, from $4.2 billion last year to only $936 million this year. The contraction in exports continued into July and August. The lower trade surplus carried over into the current account. Data for the first half of this year indicate a current account surplus of $1.2 billion, which is less than half of the $3.6 billion surplus recorded in the same period in 2000.

The capital account weakened further.

In the first half of this year, net capital outflows amounted to $3.1 billion, nearly double the figure of $1.6 billion in the corresponding period of 2000. A sharp decline in equity investment underpinned capital account weakness. Political uncertainty at the start of year, poor economic prospects, and a decline in interest rates are the major domestic factors that could explain the fall in FDI inflows and rise in portfolio investment outflows. The capital account is expected to weaken further in the wake of the 11 September attacks and their impact on investors' risk aversion.

One item in the balance of payments accounts that has slowly been gaining notice is "other investments," particularly transactions related to "residents' investment abroad." In 1999 and 2000, there was a combined gross outflow of $33.2 billion classified under the latter account, while in the first half of 2001, outflows amounted to $7.3 billion. The aforementioned factors and trade credits could explain these figures but, lately, some analysts have proposed that the account be scrutinized more closely. The recently enacted Anti-Money Laundering Law should help in this regard.

Figure 5: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

The overall balance of payments and foreign exchange reserves positions worsened.

The smaller current account surplus and net capital outflow led to a balance of payments deficit of $606 million in the first half of 2001, compared to $513 million in the whole of 2000. Consequently, the central bank's gross international reserves (excluding gold) fell from $13.1 billion at end-2000 to $12.6 billion in June 2001 (Figure 5). However, the level of external debt in June 2001—$50.9 billion—was lower than the December 2000 figure of $52.1 billion.

Asset Markets

Exchange rate volatility increased.

Higher capital outflows and the poor export performance have weighed heavily on the exchange rate in the first seven months of the year. The peso trended downwards and approached record lows in late July and early August. However, a combination of tighter monetary policy, curbs on foreign exchange transactions, and tough talk from policymakers led to a sharp rebound. These gains were partially eroded in the aftermath of the attacks on the US. The peso has now (16 November 2001) depreciated by 4 percent against the dollar since the start of the year after falling by as much as 6.5 percent (Figure 6).

Figure 6: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)

Source: ARIC Indicators.

The stock market slump continued.

The stock market was unable to sustain the gains made after the resolution of the political crisis in January. Outflows of foreign portfolio investment contributed significantly to the decline of the PHISIX, while investor confidence was further shaken by concerns over peace and order in the country and the attacks on the US. The Philippine stock market has been one of the worst performing in the region, with equity prices declining by 31 percent since the start of the year. The slump was punctuated by the departure of two major foreign brokerages in August 2001.

A jump in office vacancy rates was recorded in early 2001.

After three consecutive quarters of decline, the office vacancy rate in Makati City, the country's financial center, increased sharply in the first quarter of 2001 (Table 2). There was only marginal improvement in the second quarter. A record supply of 206,000 square meters of new office space entered the market in the first quarter, which, when combined with sluggish economic growth, led to a 20 percent average vacancy rate in the first half of 2001. Meanwhile, higher personal consumption spending helped prompt a decline in the vacancy rate of retail property.

Table 2: **Property Vacancy Rates in Prime Business District in Manila (Makati)** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2
Office Property	4.3	5.8	7.8	12.3	13.3	12.1	13.8	15.9	14.9	14.4	14.3	20.1	19.2
Retail Property	...	...	...	9.3	11.0	12.9	12.6	...	13.0	...	11.2	...	10.5

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

Financial and Corporate Sector Developments

The rising NPL ratio sparks calls for an AMC.

The NPL ratio of commercial banks continued to climb steadily, reaching 18 percent in August 2001, in part due to the economic slowdown, the highest level since the outbreak of the crisis in 1997. It improved slightly to 17.9 percent in September. While the ratio remains manageable, its rising trend is a cause for concern. Unlike many of the crisis countries in the Asian region, the Philippines did not set up an AMC, primarily because the financial sector was relatively unscathed from the crisis. However, due to the rise in the NPL ratio, several banks have publicly endorsed the idea of introducing a State-organized AMC. This idea has been resisted by the Government, which has cited fiscal constraints and moral hazard issues as its reasons for maintaining an arm's-length approach. Instead, policymakers have encouraged local banks to establish their own shared AMC. Another proposal being floated is for foreign investment banks and accounting firms to either set up a private sector AMC or purchase local banks' NPLs outright.

The power reform bill was finally signed into law.

After languishing in Congress for more than five years, the Philippine Electric Power Industry Reform Act was passed in June 2001. The law paves the way for a restructuring of the power industry and the privatization of the debt-laden National Power Corporation—the government agency that has primary control over the generation, transmission, and distribution of electricity. This is the first major reform legislation of the administration, and was lauded as an indication of the Government's commitment to promote competitiveness in the Philippine economy. However, key issues remain surrounding certain provisions, particularly the transfer of debt to the successor to the NPC and the renegotiation of contracts with independent power producers. The implementing rules and regulations of the new law have yet to be drafted, a task that has been deemed urgent. There are also concerns that monopolies may emerge under the present procedure for privatization.

Social Sector Developments

Poverty incidence has been rising since the crisis.

The Philippines' steady gains in poverty alleviation in the 1990s were reversed by the Asian crisis. Aggregate poverty incidence increased from 31.8 percent in 1997 to 34.2 percent in 2000; jumping from 17.9 percent to 20.4 percent in urban areas and from 44.4 percent to 47.4 percent in rural areas. Contributing to the increase was a higher unemployment rate, from 7.9 percent in 1997 to 10.1 percent in 2000. Unemployment figures obtained from the April and July 2001 surveys indicate a slight improvement after a deterioration in the January survey. While employment in the agricultural sector improved, that in manufacturing and construction, which spearheaded growth prior to the crisis, remained weak. A notable development is the decline in the Gini ratio between 1997 and 2000. This indicates that upper income groups were more severely affected by the financial crisis.

Prospects and Policy Issues

Economic growth in the short-term hinges on the recovery of private investment.

The global downturn has been deeper than initial forecasts and recovery is not expected this year. Hence, any stimulus that will propel GDP growth in the second half should emanate from domestic sources. Personal consumption is unlikely to grow any faster and pump priming is not possible in the face of existing fiscal problems. Thus, the only possible source of stronger GDP growth is private investment. If the latter had been constrained by political uncertainty, then hopefully the resolution of the crisis in January and the positive outcome of the election in May will provide a boost to investor confidence. The government economic program outlined in July should also help. These factors make a recovery of private investment in the second half a distinct possibility, although some analysts believe it will be a drawn out process. Such skepticism is reflected in the 2.4 percent 2001 GDP growth forecast of Consensus Economics, which is lower than the official target of 3.3 percent. Higher investment and a more benign global economic environment should lead to higher output growth in 2002. Therefore, Consensus Economics forecasts a GDP growth of 2.8 percent next year.

Fiscal and monetary policy must support the recovery of private investment.

Despite the lower interest rates compared to the start of the year, domestic credit growth remained in negative territory in the second quarter of 2001. The rising NPL ratio has constrained bank lending, but the outcome is more a result of weak investment leading to low demand for credit. Policymakers have used the sluggish demand for credit since the onset of the 1997 crisis as an argument that monetary tightening over the past year did not adversely impact investment. However, once private investment recovers, monetary policy has to be calibrated to support recovery. Lower interest rates in the industrialized economies should provide more leeway for further easing of monetary policy.

Emphasis must be on improving tax revenues.

Domestic borrowing has been the favored means of financing the deficit since higher international bond spreads have discouraged foreign borrowing. In the context of low credit demand by private investors, crowding-out has been minimal and Treasury-bill rates have been steady. However, persistently high fiscal deficits may undermine the recovery of private investment. The most effective way to deal with this problem would be to improve tax effort—tax revenue as a percentage of GDP—which in 2000 fell below the 1990 level. It is difficult to blame cyclical factors as the decline has been systematic. One measure the Government has considered is reformulating the corporate tax code, wherein firms will pay a 20-26 percent tax on gross income instead of the current 32 percent tax on net income. However, improvements in tax administration, elimination of leaks and loopholes, and stricter enforcement of existing tax laws could go a long way toward improving the revenue base.

Conditions for effective inflation targeting must be put in place.

The BSP is soon scheduled to put into practice inflation targeting as its monetary policy framework. Many of the necessary ingredients for a successful transition are in place, particularly the credibility of the BSP as an independent institution. However, there are still concerns about its commitment toward a more flexible exchange rate system. While the exchange rate has experienced more volatility since the 1997 financial crisis, there were occasions when interest rate increases coincided with a sharp depreciation of the peso.

Rural sector development remains the key to poverty reduction.

Worsening poverty only underscores the need to improve anti-poverty programs in the Philippines. Three of every four people considered poor live in rural areas and a large majority are dependent on agriculture and agriculture-related industries for employment and income. Moreover, economic growth, not specific programs, accounted for a significant percentage of poverty reduction in the past. Thus, in terms of fiscal tools, the Government can focus on rural infrastructure and improving primary education. Meanwhile, government support can be extended to providers of microfinance and low-income housing programs.

Philippines: Selected ARIC Indicators

	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																				
GDP Growth (%)	5.8	5.2	-0.6	3.4	4.0	2.5	-1.4	-0.7	-2.4	0.7	3.8	3.8	5.1	3.3	4.3	4.6	3.8	3.2	3.3	. . .
Private Consumption Expenditure Growth (%)	4.6	5.0	3.4	2.6	3.5	4.5	3.9	2.9	2.6	2.5	2.6	2.5	2.9	3.2	3.2	3.7	3.9	3.5	3.2	. . .
Public Consumption Expenditure Growth (%)	4.1	4.6	-1.9	6.7	-1.1	-5.6	-0.5	-0.7	-1.1	12.9	6.2	4.8	3.2	-6.3	-1.2	0.2	3.0	3.0	-2.4	. . .
Gross Domestic Investment Growth (%)	13.3	11.7	-16.3	-2.0	2.3	-5.9	-18.2	-18.9	-21.9	-5.1	4.1	-0.7	-4.8	0.6	1.2	2.0	5.3	5.0	3.4	. . .
Agricultural Sector Growth (%)	3.8	3.1	-6.4	6.5	3.3	-1.7	-12.8	-2.8	-7.7	3.2	9.6	5.7	7.7	0.4	4.5	5.9	3.2	3.5	2.5	. . .
Manufacturing Sector Growth (%)	5.6	4.2	-1.1	1.6	5.6	2.0	-0.9	-1.5	-3.5	-1.0	0.9	2.4	3.7	6.0	6.2	6.1	4.4	3.4	2.6	. . .
Construction Sector Growth (%)	10.9	16.2	-9.6	-1.6	-5.0	1.1	-7.9	-16.9	-14.9	-12.8	1.8	5.2	1.6	-4.7	-8.6	-7.0	0.8	-4.0	6.6	. . .
Services Sector Growth (%)	6.4	5.4	3.5	4.0	4.4	4.3	3.8	2.8	3.0	3.0	3.9	4.2	4.8	4.0	4.9	4.9	3.9	4.2	3.4	. . .
Exports of Goods and Services Growth (%)	15.4	17.2	-21.0	3.6	17.7	-4.5	-19.4	-21.4	-34.8	-8.4	3.3	11.5	8.9	11.7	16.0	17.4	25.2	5.4	-4.1	. . .
Imports of Goods and Services Growth (%)	16.7	13.5	-14.7	-2.8	4.0	5.8	-12.5	-15.7	-32.8	-16.8	0.1	1.5	6.6	1.4	-3.7	-1.8	22.2	4.3	2.3	. . .
Inflation Rate (%)	9.0	5.9	9.8	6.6	4.3	7.9	9.9	10.5	10.7	10.0	6.7	5.5	4.5	3.0	3.9	4.5	5.9	6.8	6.7	6.4
Unemployment Rate (%)	7.4	7.9	9.6	9.6	10.1	8.4	13.3	8.9	9.6	9.2	11.9	8.5	9.6	9.5	13.9	11.2	10.1	11.4	13.3	10.1
Monetary and Fiscal Accounts																				
Growth of Broad Money, M2 (%)[1]	23.9	23.7	23.1	8.6	16.9	23.1	16.8	19.3	15.9	8.6	11.3	9.9	10.5	16.9	14.6	13.5	12.0	8.1	11.0	. . .
Three-Month Interbank Lending Rate (%)[1]		31.4	15.7	11.2	15.9	18.9	17.3	16.3	15.7	12.7	9.2	9.5	11.2	9.3	9.4	12.1	15.9	11.6	10.7	15.2
Growth in Real Bank Credit to Private Sector (%)[1]	38.8	20.2	-15.5	-6.3	-1.2	8.3	1.1	-8.7	-15.5	-14.0	-12.4	-10.8	-6.3	-3.6	-2.0	1.8	-1.2	-0.2	-3.9	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	11.0	12.7	14.9	. . .	9.7	11.6	11.0	13.6	. . .	. . .	12.7	. . .	. . .	. . .	14.9	16.6	16.6	. . .
NPL Ratio of the Commercial Banking System[1]	2.8	4.7	10.4	12.3	15.1	7.4	8.9	11.0	10.4	13.2	13.1	13.4	12.3	14.1	14.7	15.7	15.1	16.6	17.0	17.9
Average Stock Price Index	3,054.2	2,595.2	1,799.0	2,168.7	1,585.8	2,029.2	2,044.0	1,431.3	1,691.7	2,003.4	2,381.5	2,285.4	2,004.6	1,882.3	1,574.6	1,487.1	1,399.1	1,582.4	1,434.7	1,300.1
Central Government Fiscal Balance as % of GDP	0.3	0.1	-1.9	-3.8	-4.1	-1.9	-1.9	-0.3	-3.2	-4.9	-2.7	-4.8	-2.9	-3.0	-3.2	-4.3	-5.6	. . .	. . .	. . .
Central Government Debt as % of GDP[1]	53.2	55.7	56.1	59.6	65.3	. . .	. . .	. . .	56.1	. . .	. . .	. . .	59.6	62.0	62.6	63.5	65.3	64.5	65.3	. . .
Government Expenditure on Education (% of Total)	17.9	19.3	19.9	19.1	18.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	2.7	2.9	2.5	2.5	2.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																				
Growth of Merchandise Exports ($ fob, %)	17.8	22.8	16.9	18.8	8.7	23.8	14.5	19.2	11.4	15.2	12.1	22.9	23.9	9.6	13.3	5.1	7.7	-0.5	-17.6	-22.5
Growth of Merchandise Imports ($ cif, %)	22.2	10.8	-17.5	3.7	2.1	-4.3	-17.8	-21.4	-25.1	-9.0	6.3	7.8	11.2	7.7	-4.4	3.5	1.9	-7.7	7.0	-6.6
Current Account Balance as % of GDP	-4.8	-5.3	2.4	9.2	12.5	-0.2	1.1	3.2	5.0	8.7	7.1	14.0	11.6	8.2	11.4	14.6	15.6	8.6	-1.3	. . .
Net Foreign Direct Investment ($ Billion)[2]	1.3	1.1	1.6	1.4	1.6	0.2	0.2	0.2	1.0	0.6	0.4	0.3	0.6	0.5	0.3	0.3	0.6	. . .	. . .	. . .
Net Portfolio Investment ($ Billion)[2]	2.2	-0.4	0.1	5.6	0.05	0.3	-0.02	-0.3	0.1	1.8	2.2	0.3	1.3	0.3	-0.5	0.39	-0.1	-0.5	-0.2	. . .
Gross International Reserves Less Gold ($ Billion)[1]	10.0	7.3	9.2	13.2	13.1	7.8	9.0	9.0	9.2	11.4	12.3	12.7	13.2	14.2	13.4	13.0	13.1	12.8	12.6	. . .
Total External Debt as % of GDP[1]	50.5	54.9	73.3	68.6	69.8	63.3	64.5	70.0	73.3	71.8	68.5	69.4	68.6	68.2	67.8	67.8	69.8	68.5	71.4	. . .
Short-Term Debt as % of Gross International Reserves[1]	71.8	116.2	77.9	43.4	45.2	113.1	90.4	88.5	77.9	59.6	53.1	52.1	43.4	42.3	44.0	43.2	45.2	40.9	42.7	. . .
Short-Term Debt as % of Total Debt[1]	17.2	18.6	15.0	11.0	11.4	18.2	17.8	17.2	15.0	14.0	13.6	13.0	11.0	11.5	11.3	10.8	11.4	10.5	10.6	. . .
Real Effective Exchange Rate (1995=100)[3]	110.4	111.0	94.0	100.8	91.0	91.5	97.2	92.6	94.7	102.2	105.1	100.5	95.2	96.4	94.2	89.2	84.4	88.4	87.3	87.1
Average Exchange Rate (Local Currency to $)	26.2	29.5	40.9	39.1	44.3	40.7	39.4	42.9	40.6	38.7	38.0	39.3	40.4	40.7	41.9	45.1	49.4	49.2	50.8	52.1

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

Singapore

Real Sector

GDP growth fell sharply in the first three quarters of 2001.

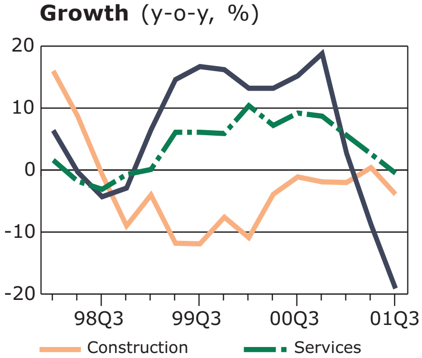
Singapore's economy has experienced an abrupt reversal of fortune. After posting robust growth of 9.9 percent in 2000, real GDP of Singapore experienced three consecutive quarter-on-quarter declines on a seasonally adjusted basis (Table 1). As a result, first half growth in 2001 fell sharply to 2 percent and more recent data show that third quarter performance was even worse, with output contracting by 5.6 percent. Slower economic growth in the industrialized countries, the protracted downturn in the global electronics market, and the subdued economic climate in East Asia led to a contraction in exports, on which Singapore is heavily dependent. Meanwhile, external risks were heightened following the 11 September attacks on the US. Thus, recovery is not expected in the second half of 2001. The official GDP growth forecast has been scaled down to -3 percent for 2001, a sharp turnaround from 5-7 percent growth expected at the beginning of the year.

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

	1997	1998	1999	2000	2001	2002
Official[1]	8.5	0.1	5.9	9.9	-3.0	-2.0-2.0
ADB[2]	—	—	—	—	-3.0	1.0
IMF[3]	—	—	—	—	-0.2	4.0
World Bank[4]	—	—	—	—	-0.6	4.7
Consensus Economics[5]	—	—	—	—	-2.6	1.7

[1]Ministry of Trade and Industry, *Economic Survey,* 3rd quarter 2001.
[2]ADB, *Asian Development Outlook 2001 Update,* November 2001.
[3]IMF, *World Economic Outlook*, October 2001.
[4]World Bank, *East Asia Update,* October 2001.
[5]Consensus Economics Inc., Asia Pacific Consensus Forecasts, November 2001.

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

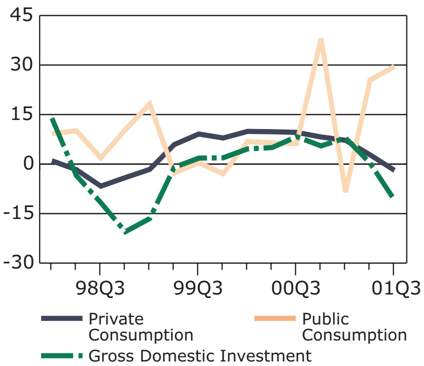


Source: ARIC Indicators.

The manufacturing sector was hardest hit.

Owing to the unfavorable external environment, electronic exports of Singapore slumped in the first three quarters of 2001. Since electronics comprises 57 percent of total merchandise exports, manufacturing activity was also adversely affected, shrinking by 3.9 percent in the first six months (Figure 1). The situation deteriorated further in the third quarter when manufacturing output fell by 19.1 percent—the sharpest decline on record. The collapse in manufacturing proved contagious and other goods-producing industries, including construction, also contracted in the third quarter after barely expanding in the first half. Only the services sector, which grew by a modest 3.8 percent in the first half, kept the Singapore economy afloat in the first half of the year. However, this sector likewise experienced a contraction in the third quarter of 2001. The global economic downturn also had an adverse impact on Singapore's trade activities as wholesale and retail trade slowed, as did transport and communications.

Figure 2: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

Domestic and external demand suffered, but net exports rose sharply.

Despite the deteriorating economic conditions, investment and consumption expenditure continued to expand in the first three quarters of 2001, although at a much slower pace (Figure 2). This was largely due to the growth of government spending. Public construction works such as the Mass Rapid Transport extension and school building and upgrading projects led to a surge in public investment in the first half of 2001. However, lackluster private spending—reflecting anemic business and consumer confidence—and a sharp draw down of inventories led to a fall in total domestic demand, which contracted by 5.2 percent in the first three quarters of 2001. Meanwhile, net exports of goods and services grew by 23.5 percent in the first three quarters of 2001 compared to a contraction of 6.1 percent in the same period last year. Thus, the slowdown in external demand was more than offset by a fall in imports.

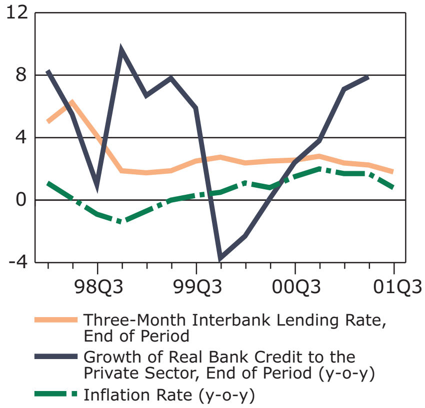
Fiscal and Monetary Developments

A more generous budget for FY2001 was announced.

A slight fiscal deficit was recorded in the first quarter of 2001, although the Government still recorded a strong surplus for FY2000 (ending March 31). While seasonal factors largely explain the first quarter deficit, data indicate heavy development spending. This was followed up with the announcement of a generous budget for FY2001, which contains measures to reduce corporate, property, and income tax rates. The tax concessions are geared mainly to improving economic competitiveness and avoiding a surge in unemployment. However, there is no doubt that the anticipation of elections this year influenced the budget process. In addition, the Government has earmarked substantial expenditure to upgrade property through the Housing Development Board. The fiscal stimulus was reflected in the relatively high growth of public investment in the first half of 2001.

The structure of the budget also took into account the slowing global economy. However, when economic difficulties became more pronounced, the Government unveiled off-budget measures in July. The rapid

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

deterioration of the economy prompted another set of measures, which was announced on October 12 (Box 6). Some analysts were disappointed with both packages, since the Government did not offer the expected cuts in the employers' contribution to the pension fund, which is considered the most effective fiscal instrument.

Monetary policy has been eased while exchange rate policy was modified.

In response to the economic downturn and to interest rates cuts in the US, monetary policy has been eased. In particular, the domestic three-month interbank rate declined from 2.81 percent in December 2000 to 0.88 percent in October 2001 (Figure 3). At the start of the year, the Monetary Authority of Singapore continued its stance of allowing a modest appreciation of the trade-weighted Singapore dollar. However, after the worsening external environment put pressure on the currency, MAS shifted to a neutral exchange rate policy stance.

Inflation remains fairly stable.

Consumer price inflation in the first nine months of 2001 was 1.4 percent, exceeding the 1.1 percent recorded in 2000. The uptick

Box 6: **Off-Budget Measures in Singapore**

To soften the impact of the output contraction in 2001, the Singapore Government unveiled a set of off-budget measures in the last week of July and the middle of October. The objective is to offset lower external demand by increasing domestic economic activity and enhancing competitiveness of local firms.

Policymakers in Singapore are aware of the limited effectiveness of traditional fiscal stimuli—e.g., increasing government expenditure—because of the openness of the economy. Hence the off-budget measures are calibrated to suit the uniqueness of the Singapore economy, aiming mainly to strengthen the competitiveness of domestic firms, particularly SMEs.

The measures are valued at S$2.2 billion for the July package and S$11.3 billion for the October package. They include a rebate on corporate, personal income, and property taxes, as well as rentals for commercial and industrial properties, government markets, and hawker stalls. The rebates are aimed at lowering transaction costs of the private corporate sector. The Government also increased its share of the risks involved in loans to SMEs, from 50 percent to 70 percent, while the Productivity and Standards Board (PSB) is working on a new loan insurance scheme for SMEs in which the Government defrays part of the insurance premium cost.

As another measure, port fees were reduced by 20 percent, a move likely driven by growing competition from Malaysia. Also, certain infrastructure projects were accelerated, in a step that is expected to inject an additional S$280 million in spending this year.

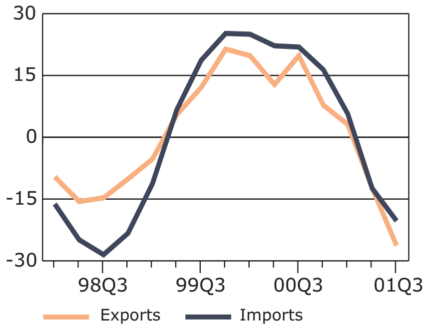
The October package also introduced a "New Singapore Shares" scheme, in which citizens receive securities that pay a guaranteed dividend for a fixed number of years, as well as bonus payments when the economy performs well. The distribution of shares is weighted to favor low-income earners. The scheme gives Singaporeans a direct stake in the growth and prosperity of the economy.

Aside from cushioning the Singapore economy from the adverse impacts of the unfavorable external environment, the off-budget measures are designed to dovetail with the goal of building the economy into a global SME hub. The idea is to encourage tie-ups between Singapore SMEs and those of other countries. PSB has already established bilateral cooperative arrangements with more than 90 foreign agency partners to aid in business matching. Meanwhile, the Trade Development Board has promoted trade facilitation arrangements with its overseas counterparts.

can be attributed to the depreciation of the Singapore dollar, higher global fuel prices, and increases in electricity tariffs. However, inflation has eased since June.

Balance of Payments

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

The trade surplus improved in the first half.

The trade surplus increased in each of the first two quarters of 2001, but for different reasons. In the first quarter, oil exports grew by 20.8 percent, offsetting the slowdown in non-oil exports, particularly electronics. In the second quarter, imports contracted by 7.8 percent, counteracting the 2.5 percent decline in total exports (Figure 4). The downtrend in exports can be partly attributed to the unfavorable external environment while sluggish domestic demand has translated into weak demand for imports. However, in the third quarter, the trade surplus shrank compared to its level in the corresponding period last year due to the faster decline in exports. The movements in the trade balance carried over into the current account, which also recorded a higher surplus in the first half of 2001 but a lower surplus in the third quarter.

But the overall balance-of-payments fell into deficit.

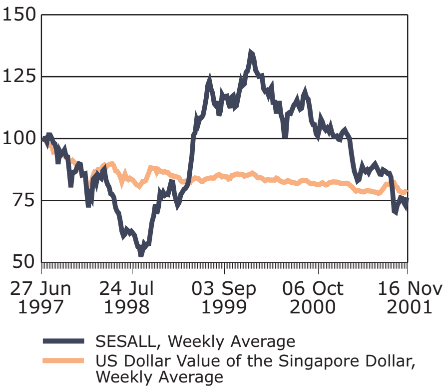
Despite the current account surplus, increased outflows from the capital and financial account led to a deficit in the overall balance-of-payments account in the first three quarters of 2001. Transactions in the "other investment" account largely contributed to the outflows in the first six months. These were a result of banks accumulating assets overseas, particular in the Asian Dollar Market. However, the trend was reversed in the third quarter due to the shift in funds from Asian Currency Units and other nonresident banks to the domestic bank and nonbank sectors. Meanwhile, net FDI declined substantially in the first three quarters of 2001 compared to the corresponding period last year. In contrast, net outflows of foreign portfolio investment moderated with the return of foreign interest in the local stock market. Since the start of the year, official foreign reserves have declined by S$5.9 billion and are now equivalent to eight months of imports.

Asset Markets

The Singapore dollar has depreciated against all major currencies.

The weaker BOP position, flagging economy, and uncertainty created by the US military action after the 11 September attacks on the US

Figure 5: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: REMU calculations derived from Bloomberg.

caused the Singapore dollar to depreciate against the US dollar. Thus, the currency's value is now (16 November 2001) 5.8 percent lower compared to the beginning of the year (Figure 5). But the Singapore dollar strengthened against the euro and the yen, and some regional competitors, notably the New Taiwan dollar. However, the situation has reversed since August due to the rapid economic deterioration.

Stock prices declined due to the unfavorable external environment.

The average volume of shares traded daily increased moderately in the second quarter of 2001, partly due to speculation about mergers of local banks. However, the All-SingEquities index has still lost 24.1 percent of its value so far during 2001 (16 November 2001), due largely to uncertain global economic conditions. The weakness in the stock market has delayed several IPOs, including those of the Port of Singapore Authority and Singapore Power.

Office and retail markets softened due to the economic slowdown.

After six straight quarters of declining vacancy rates, office and retail property markets softened in the first half of 2001 (Table 2). The downtrend is largely in response to the general economic slowdown. Vacancy rates in the office property sector increased in each of the first two quarters this year, while a slight rise was also recorded in the retail property sector. Nevertheless, vacancy rates are still below the levels reached in the aftermath of the 1997 financial crisis.

Table 2: **Property Vacancy Rates in Singapore** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2
Office Property	9.7	11.5	12.3	12.5	12.7	14.0	12.4	10.7	9.6	6.4	5.0	6.7	8.4
Retail Property	...	...	4.0	...	2.9	...	1.8	...	1.0	...	0.7	...	1.2

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

Financial Sector Developments

Financial sector reforms continue.

Singapore's financial system, which is already relatively efficient, is in the midst of a reform process. The key objectives are to increase foreign participation and create an efficient and competitive financial services industry. Earlier in the year, measures were taken to internationalize the Singapore dollar, while in June, there was significant progress in the consolidation of the domestic banking sector. Two banks have signified their intention to buy the country's fourth largest bank. In addition, Singapore's smallest bank is poised for a change in ownership.

Social Sector Developments

Rising unemployment is a concern.

One major outcome of the economic slump is a higher unemployment rate. From 2.4 percent in March 2001, the seasonally adjusted rate rose to 2.6 percent in June. Some analysts expect unemployment to average 3.5 percent this year, compared with 3.1 percent in 2000. This is likely since the seasonally adjusted rate jumped to 3.8 percent in the third quarter of 2001. Of particular concern is the Government response to minimizing unemployment and cushioning the impact of retrenchment. The decision not to reduce the employers' contribution to the pension fund was met with disappointment. Instead, the Government has pursued a flexible wage policy by requiring firms to add a monthly variable component to wages. The amount would depend on the performance of the firm.

Prospects and Policy Issues

Singapore's recovery hinges on the rebound of the global economy.

A full year contraction in GDP, is more likely in Singapore this year following the sharp global economic downturn. Thus, the Consensus Economics forecast for full year Singapore GDP growth (November 2001) has been revised to -2.6 percent, with a range of -2 to -3.2 percent. Meanwhile, the growth rate in 2002 hinges on the timing of the recovery of industrialized economies, particularly the US. In view of the existing global economic uncertainty, the Government expects GDP to continue to decline in the first half of next year. Its full year estimate is between -2 and 2 percent, centered on zero growth. This is even more pessimistic than the Consensus Economics forecast of 1.7 percent (November 2001), obtained from a survey of forecasts that range from -2 to 4.5 percent.

The long-term objective is still to prepare for the "new economy."

The slowdown in economic activity in 2001 should not deflect a program of long-term measures that would enable Singapore to take advantage of the opportunities provided by globalization. Labor policy will play a crucial role as there is a need to encourage foreign skilled workers to relocate to Singapore, particularly those in the IT sector. Education and skills training for adults will also be important in order to address the problem of retrenched unskilled workers.

Singapore: Selected ARIC Indicators

	1996	1997	1998	1999	2000	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																
GDP Growth (%)	7.6	8.5	0.1	5.9	9.9	1.3	6.9	7.4	7.7	9.8	8.4	10.3	11.0	4.8	-0.5	-5.6
Private Consumption Expenditure Growth (%)	7.6	6.0	-2.9	5.3	9.4	-1.6	5.9	9.1	7.9	9.9	9.8	9.6	8.2	7.2	2.8	-1.9
Public Consumption Expenditure Growth (%)	19.3	7.1	8.0	5.0	13.7	18.2	-2.7	0.4	-2.9	6.8	6.4	6.2	38.0	-8.5	25.4	29.6
Gross Fixed Capital Formation Growth (%)	23.1	9.6	-6.4	-3.9	5.9	-16.5	-1.0	1.8	1.9	4.6	5.0	8.3	5.5	7.9	0.3	-10.9
Manufacturing Sector Growth (%)	2.9	4.5	-0.6	13.6	15.2	6.5	14.6	16.7	16.2	13.2	13.2	15.2	18.8	2.7	-8.8	-19.1
Construction Sector Growth (%)	23.1	16.1	3.0	-8.8	-4.6	-4.0	-11.8	-11.9	-7.6	-10.9	-3.9	-1.1	-1.9	-2.0	0.4	-3.9
Other Goods Industries Growth (%)[1]	3.5	0.1	-6.9	-1.1	-1.5	-8.3	1.9	2.5	-0.2	3.3	-7.2	-2.9	1.0	-5.5	-3.3	-10.1
Services Sector Growth (%)	8.1	9.6	-1.0	4.5	8.9	0.1	6.1	6.1	5.9	10.4	7.2	9.2	8.7	5.6	2.6	-0.5
Inflation Rate (%)	1.4	2.0	-0.3	0.0	1.3	-0.7	0.0	0.3	0.5	1.1	0.8	1.5	2.0	1.7	1.7	0.8
Unemployment Rate (%)[2]	2.0	1.8	3.2	3.5	3.1	3.9	3.3	4.0	2.9	3.4	3.5	2.5	2.9	2.4	2.6	3.8
Monetary and Fiscal Accounts																
Growth of Broad Money, M2 (%)[3]	9.8	10.3	30.2	8.5	-2.1	27.8	30.4	28.4	8.5	5.6	2.3	-2.2	-2.0	2.2	2.0	. . .
Three-Month interbank Lending Rate (%)[3]	3.1	6.8	1.9	2.8	2.8	1.8	1.9	2.5	2.8	2.4	2.5	2.6	2.8	2.4	2.3	1.8
Growth in Real Bank Credit to Private Sector (%)[3]	13.6	10.4	9.6	-3.7	3.6	6.7	7.8	5.9	-3.7	-2.3	0.1	2.4	3.8	7.1	7.9	. . .
Ratio of Loans to Deposit	1.3	1.4	1.3	1.1	1.2	1.2	1.1	1.1	1.1	1.1	1.1	1.2	1.2	1.2	1.2	. . .
Average Stock Price Index	558.6	490.3	349.7	520.3	556.8	388.1	526.2	569.7	599.0	612.3	542.3	559.6	512.7	487.4	428.4	411.2
Fiscal Balance as % of GDP	6.9	3.4	2.5	2.6	3.5	-10.7	6.0	11.3	2.5	-4.4	9.2	13.0	-4.0	-2.9	5.3	7.1
Government Expenditure on Education (% of Total)	18.2	16.7	19.5	18.4	19.5	11.6	17.2	24.8	24.3	14.4	25.7	27.1	18.3	18.9	19.0	25.9
Government Expenditure on Health (% of Total)	5.5	4.9	4.8	4.1	4.1	4.4	3.3	4.4	4.1	5.0	3.5	5.4	2.9	5.6	3.8	4.5
External Account, Debt, and Exchange Rates																
Growth of Merchandise Domestic Exports ($ fob, %)	5.7	-1.4	-12.6	8.5	14.7	-5.3	5.5	12.1	21.4	19.8	12.8	19.8	7.8	3.1	-12.3	-26.3
Growth of Merchandise Imports ($ cif, %)	5.6	0.8	-23.3	9.4	21.1	-11.3	6.7	18.7	25.2	25.0	22.2	21.9	16.4	5.7	-12.4	-20.3
Current Account Balance as % of GDP	14.1	19.0	24.8	25.9	23.6	24.4	26.7	24.4	28.0	24.2	22.6	25.5	22.2	25.2	26.5	24.8
Net Foreign Direct Investment ($ Million)	3,570.5	3,196.7	5,806.7	3,241.3	2,105.1	2,421.2	42.9	100.4	577.4	912.8	332.4	334.9	530.2	168.3	254.7	-6,629.9
Net Portfolio Investment ($ Million)	-11,773.1	-11,524.9	-7,062.9	-7,208.3	-13,796.7	-1,283.9	-2,405.8	-1,347.4	-2,039.6	-3,953.7	-3,582.1	-3,022.4	-3,254.4	-2,145.6	-1,441.5	-632.8

. . . = not available.
[1]Other goods industries comprise agriculture, fishing, and quarrying.
[2]Quarterly rates are seasonally adjusted.
[3]End of period.
[4]Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
[5]1998 refers to latest data available for the period 1990-1998.
Sources: Data on output and prices, merchandise exports and imports, current account balance, interbank lending rate, fiscal balance, government expenditure on education and health, foreign investments, and portfolio investments are from national sources; M2, real bank credit to private sector, and gross international reserves are from the International Monetary Fund, *International Financial Statistics,* April 2001; stock price index and nominal exchange rate are from Bloomberg; real effective exchange rate is based on REMU staff calculations.

Thailand

Real Sector

The economic slowdown continued in the first half of 2001.

The Thai economy registered growth of 1.9 percent (y-o-y) in the first half of 2001. The slowdown began last year, when first half growth of 5.8 percent dwindled to 3 percent in the second half. Although third quarter data for 2001 are yet to be released, there are signs that the slowdown has continued, due to protracted weaknesses in external and domestic demand. In the face of uncertain global economic prospects following the 11 September attacks on the US, the Bank of Thailand predicts that full year growth for 2001 will be between 1.3 and 1.8 percent, lower than the 3-4.5 percent growth it projected in January (Table 1).

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

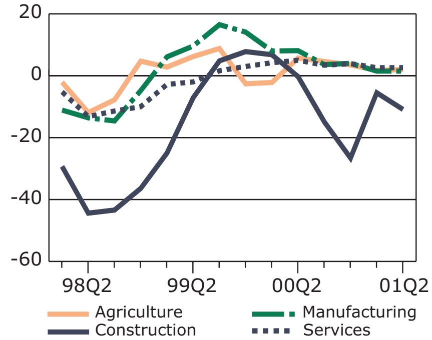
	1997	1998	1999	2000	2001	2002
Official[1]	-1.4	-10.8	4.2	4.4	1.3-1.8	1.0-3.0
ADB[2]	—	—	—	—	1.5	2.5
IMF[3]	—	—	—	—	2.0	4.0
World Bank[4]	—	—	—	—	1.6	3.0
Consensus Economics[5]	—	—	—	—	1.1	2.3

[1]Bank of Thailand, Inflation Report, 29 October 2001.
[2]ADB, *Asian Development Outlook Update,* November 2001.
[3]IMF, *World Economic Outlook*, October 2001.
[4]World Bank, *East Asia Update Regional Brief*, 17 October 2001.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, November 2001.

The manufacturing sector has been hit hard by the global slowdown.

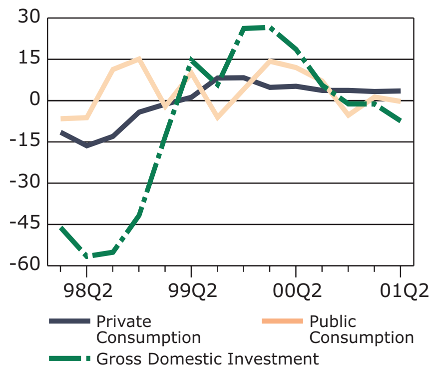
The deterioration in the US and global economies has hit the Thai manufacturing sector hard, with value added growing only by 1.5 percent (y-o-y) in the first half of 2001 (Figure 1), compared to 8.1 percent in the same period last year. The decline was mainly caused by an export slump, in particular in the electronics and electrical appliances sector, which declined by 1.2 percent. The index of manufacturing production showed an average drop of 4.7 percent in July and August from its first half average, suggesting that the manufacturing slowdown has continued in the third quarter. The deterioration in this sector is also reflected in industrial capacity utilization, averaging 53.2 percent in the first eight months of 2001, compared with 55.7 percent during the same period last year.

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



Source: ARIC Indicators.

Figure 2: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

The services sector was the main driver of the economy in the first half.

The services sector was the main driver of the economy in the first half, contributing 75 percent to total GDP growth. But it remains to be seen whether the sector could continue to drive growth in the second half, as the prolonged global slowdown and security concerns brought by the 11 September attacks on the US may hit tourism. Meanwhile, the construction sector remained in a slump, with output shrinking by 8.2 percent in the six months to June. With oversupply in most segments of the property markets, there is little prospect of a quick return to growth for this sector. Agricultural growth rose slightly to 1.9 percent in the first half, compared to a 1.3 percent growth during the same period last year. This sector could benefit from the Government's rural promotion policies, although it may take some time for the effects to be felt.

Private investment contracted, reflecting continuing corporate problems.

The external weaknesses have negatively affected consumer and business confidence. Private consumption growth dropped to 3.4 percent in the six months to June, from 5 percent a year earlier (Figure 2), and the composite private consumption index suggests that there was no improvement in consumer spending in the first two months of the third quarter. Investment demand contracted in the first half, by 4.3 percent, compared to growth of 22.6 percent in the first half of 2000. Much of this contraction was due to a decline in private investment. In addition to external weaknesses, the slump in private investment also reflects continued corporate distress and limited progress in corporate restructuring.

Fiscal and Monetary Developments

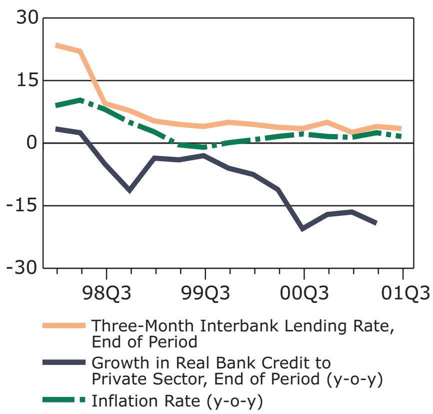
Fiscal deficits continue to support recovery.

The Government has continued to use expansionary fiscal measures to support growth and recovery. Allocations were made in April 2001 to support the rural economy and SMEs. As of August 2001, the central Government registered a budget deficit of B87.6 billion, which is expected to have reached B101.2 billion for the fiscal year ending September 2001. This represents about 2 percent of GDP, lower than the 2.2 percent recorded for fiscal year 1999/2000. For the current fiscal year 2001/02, the Government plans to spend a record B1.02 trillion to spur domestic consumption, which amounts to an equivalent of about 20 percent of GDP, almost twice the 11-12 percent registered in the previous two fiscal years. The Government indicated that it would spend as much as B30 billion in subsidizing local farmers by buying commodities such as rice and rubber at above-market prices.

But central government debt has climbed.

As of July 2001, total public debt stood at B2.9 trillion, equivalent to almost 60 percent of GDP, with central government debt alone accounting for more than 42 percent of the total. In 1997, before the Asian crisis, total public debt and central government debt were only 15 and 6 percent of GDP, respectively. The almost threefold increase is primarily due to costs arising from financial sector restructuring. The present levels of Thailand's public debt could soon limit the Government's fiscal options.

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Inflation will stay on target.

The consumer price index (CPI) rose by 2.5 percent (y-o-y) in the second quarter of 2001 (Figure 3), compared with 1.4 percent in the preceding quarter, mainly due to hikes in energy and farm prices. In the third quarter, the inflation rate fell back to 1.6 percent, as the increase in nonfood prices moderated. Core inflation, which excludes raw food and energy components, rose to 1.5 percent in the second and third quarters, from 1 percent in the first. The rise in prices was due to the baht's continued weakness and the country's reliance on imported fuel and materials. While fuel price reductions in June helped contain inflation, the baht faces continuing pressure. However, because of weak demand and excess capacity in many sectors, inflation is expected to stay within the 0-3.5 percent target range this year.

The focus of monetary policy appears to have shifted.

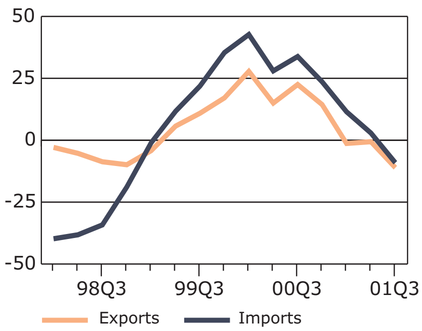
The Bank of Thailand raised the 14-day repurchase interest rate by 1 percentage point on 8 June. The move was interpreted by the market as signaling a shift in the focus of monetary policy toward exchange rate stabilization, despite the Government's recent affirmation of an inflation-targeting framework. The 14-day repurchase rate now stands at 2.5 percent. Interbank rates have also risen in line with the hike in the repurchase interest rate. There are concerns that the rate increase in the context of minimal inflation pressure could further burden the heavily indebted corporate sector and discourage investment. In the aftermath of the 11 September attacks on the US, some Asian countries trimmed interest rates in line with the US Federal Reserve. But the Bank of Thailand has indicated that it has no immediate plan to follow suit.

The stock of private sector credit continues to contract.

The contraction in the stock of private sector credit continued in the first half of 2001. The stock of real bank credit contracted by 19.4 percent during the 12 months to June this year. Credit shrinkage in part reflects the transfer of NPLs from banks' balance sheets to AMCs. But it was also a result of weak demand for loans because of continued corporate distress and banks' reluctance to lend except to their most creditworthy clients.

Balance of Payments

Figure 4: **Growth of Merchandise Exports and Imports** (y-o-y, %)



Source: ARIC Indicators.

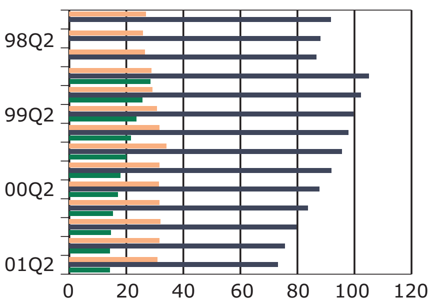
Exports registered negative growth in the first nine months of 2001.

Export growth, which has led Thailand's recovery since the 1997 crisis, lost its vigor this year (Figure 4). Following a broader regional trend, exports registered negative growth of 4.6 percent in the first nine months of 2001. The main factors that contributed to this slowdown were the fall in exports of electronics and computer parts to the United States. Meanwhile, imports grew by 1.3 percent in the nine months to September, reducing the trade surplus to just $1.5 billion during the period, the lowest level recorded since 1997. Imports of capital goods and fuels and lubricants accounted for most of the expansion, growing by 8.1 percent and 16.7 percent, respectively. The export slump is likely to become longer and broader in the wake of the 11 September attacks, as weaker global consumer confidence further dampens demand for Thailand's exports.

The current account surplus narrowed further, while the capital account continued to be in deficit.

The current account surplus shrank to $3.8 billion in the first eight months of 2001, compared with $6.5 billion during the same period in 2000. Despite the baht's weakness, tourism revenues failed to offset the export slump. The 11 September attacks are likely to further discourage tourism. The capital account registered a deficit of $3.3 billion in the first eight months of 2001, which is $4.3 billion lower than that recorded during the same period last year. The deficit reflected the repayment of foreign loans, with the Government beginning to repay its IMF loans toward the end of last year. Low domestic interest rates and the political uncertainty early this year may have also encouraged a movement of funds offshore. Given the worsening global

Figure 5: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

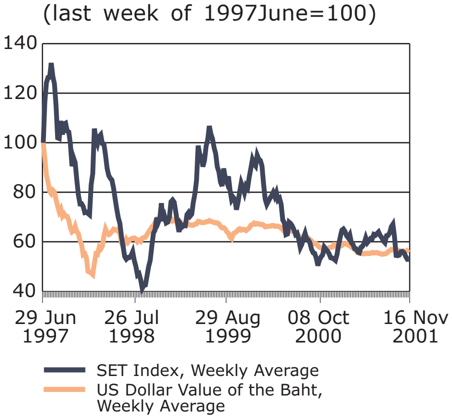
economic prospects and recent poor performance of the stock market, a further weakening of private capital inflows appears likely in the coming months.

But the external payments position remains comfortable.

Total outstanding external debt stood at $73 billion as of August 2001, down from $79.7 billion at the end of 2000. The private sector's repayment of short-term foreign loans has largely been responsible for the reduced overall debt burden (Figure 5). The ratio of short-term debt to total debt rose slightly to 19.5 percent at the end of August 2001, from 18.4 percent at the end of 2000. But with foreign reserves (excluding gold) standing at $32 billion as of September 2001, the external payments position is comfortable.

Asset Markets

Figure 6: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: ARIC Indicators.

The baht remains steady.

The baht remains steady after a significant decline in the early months of 2001 (Figure 6). The currency's present level, about 1.8 percent lower than at the beginning of this year against the US dollar, reflects some uncertainty about the economic prospects in 2001 of not only Thailand but also the region as a whole. The country's export slowdown, the weakening of other regional currencies, concerns over slow progress in bank and corporate restructuring, and earlier political uncertainty have all worked to put the baht under pressure. Low nominal baht interest rates have also induced residents to swap baht for foreign currency deposits. But there has generally been limited reaction in the foreign exchange market to the 11 September attacks, with the baht remaining stable as of mid-November.

The equity market lost all its gains following the 11 September attacks.

After a dismal performance in 2000, the Thai equity market improved during 2001, with the Stock Exchange of Thailand (SET) index climbing 23.2 percent in value as of 10 September. Commercial banks' return to profitability, due mainly to wider interest spreads and lower costs, have contributed to the renewed investor interest. Further, the establishment of the centralized TAMC, which plans to reduce NPLs in the banking system to just 10 percent of total loans, has helped to buoy market sentiment. However, the 11 September attacks wiped out most of the gains in the equity market, with the SET index losing 17 percent of its value (16 November 2001).

The economic slowdown is hurting property market recovery.

The high-end office property market in Bangkok continued to improve in the first quarter of 2001, with the vacancy rate for grade A office space declining to 27.4 percent from 31 percent in the preceding quarter (Table 2). However, the market softened in the second quarter, with the vacancy rate edging up to 27.6 percent, due to the overall economic slowdown. The total physical uptake of office space in the second quarter was just one third of the level seen in the first quarter. The source of demand consisted more of relocations as the demand for new space subsided. The market softening has put some pressure on office rentals. As of end-June 2001, the average net rent of Grade A premises declined by 3.6 percent in local currency from the previous quarter.

Table 2: **Property Vacancy Rates in Bangkok** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2
Office Property	28.2	28.7	29.7	43.1	42.2	40.3	38.9	36.6	34.0	32.1	31.0	27.4	27.6

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

Financial and Corporate Sector Developments

The headline NPL ratios continue to fall.

As of September 2001, NPLs in the banking system stood at 12.9 percent of total outstanding loans, representing a sharp drop from the 17.9 percent registered in December 2000. However, much of the improvement was a result of the transfer of impaired assets of State-owned banks to a specialized AMC. Therefore, NPLs of State-owned banks showed a more significant decline, from 21.6 percent of total loans at the end of 2000 to 7.5 percent in September 2001. But distressed assets in the entire financial system, including those transferred to AMCs, remain at 25.3 percent of total loans. Further, many loans that were earlier rescheduled are becoming nonperforming anew. In December 2000, reentry NPLs accounted for a little more than 54 percent of the increase in NPLs. By August 2001, their share had increased to 66 percent. With the jump in State banks' new NPLs in September, reentry NPLs now account for about 56 percent of the increase in total NPLs.

A centralized asset management company has been set up to expedite debt restructuring.

The Government established TAMC in June 2001 to consolidate the management of nonperforming assets in State as well as private banks, and to expedite corporate restructuring, especially of large multi-creditor corporate loans. TAMC is poised to acquire about half of the financial system's NPLs, including almost all (B1.1 trillion) of State banks' NPLs and about one quarter (B250 billion) of private banks' NPLs by the end of 2001. The law establishing TAMC provides a framework for it to manage and resolve distressed loans. It has so far signed agreements with 29 lenders to buy as much as B1.26 trillion of bad loans.

Social Sector Developments

The unemployment rate declined in the third quarter.

Thailand's unemployment rate rose sharply in the aftermath of the 1997 financial crisis, reaching a peak in the first half of 1999. Since then, the rate had been sliding as economic recovery brought more jobs. This decline, however, stopped in the last quarter of 2000, as the Thai economy started to feel the impact of the global slowdown. The unemployment rate remained at 4.2 percent in the first two quarters of 2001, little changed from the 4.3 and 4.1 percent registered in the first and second quarters of last year, respectively. By the third quarter, however, unemployment had dropped to 2.1 percent, from 2.4 percent in the same period of 2000.

The incidence of poverty has increased.

The Asian crisis had marked socioeconomic impacts, with the World Bank estimating that poverty incidence in Thailand, based on consumption of $2 per day, rose after the crisis to 33.2 percent, from 28.2 percent in 1996. The figure is estimated to have topped 30 percent up to 2000. Hopes that poverty incidence might be pushed back to the 1996 level this year appear to have been dashed by the global slowdown and 11 September attacks.

Prospects and Policy Issues

The pace of recovery is set to decelerate significantly in 2001.

The pace of Thailand's recovery is likely to decelerate significantly in 2001 due to the difficult external environment. The Ministry of Commerce recently suggested that exports could decline by as much as 8.1 percent over the entire year. The 11 September attacks on the US have added another element of uncertainty to an already weak global economy. While supportive macroeconomic policies could help to stimulate domestic demand and contain the country's vulnerability to external developments, deficit spending measures are constrained by already high levels of public debt. Nevertheless, the Government is prepared to stimulate the economy when needed. A reserve budget of B58 billion has been allocated for ready projects to help achieve a growth rate of 1.5 to 2 percent this year. The latest Consensus Economics survey (November 2001) provides a wide range of growth projections for 2001, from 1.8 to –0.2 percent, with a mean of 1.1 percent (compared to 4.4 percent growth in 2000), indicating that significant uncertainties surround the country's near term prospects. Its mean growth projection for 2002 is 2.3 percent.

Bank and corporate restructuring remains the major challenge.

The banking and corporate sectors in Thailand remain fragile, posing significant risks to recovery. Despite the substantial fall in headline NPLs, distressed assets in the entire financial system, including those transferred to AMCs, remain high. New and reentry NPLs have been rising in recent months, in part due to the weakening economy. While private banks as a whole have returned to profitability, State-owned banks continue to make losses. In the corporate sector, many companies remain heavily indebted, reflecting the high level of distressed assets in the banking system. Difficulties in the banking and corporate sectors are likely to be heightened if the economy weakens further. The establishment of TAMC is a welcome step toward accelerated financial and corporate restructuring. But TAMC's success will depend crucially on whether it can effectively implement its mandate. This will require, among others, transparent operational procedures, the maximum use of commercial criteria, effective legal enforcement, and minimum political interference. The legal framework for debt restructuring outside TAMC also needs to be enhanced as the TAMC targets mainly the State banks. Above all, the current economic difficulties should not be allowed to lead to an easing off on restructuring and reform efforts.

The privatization program is off to a slow start.

The Government plans to privatize 18 leading State-owned enterprises (SOEs) over the next three years. Nine SOEs had initially been identified to come under a national holding company. But the Government's intention to maintain State control over management and rule out foreign strategic partners has generated concerns about the ultimate success of the program and its commitment to push forward with the required public sector reforms. Nevertheless, the plan to sell government shares to the public through the stock exchange could deepen and strengthen the capital markets. While this could effectively boost the size of the stock market by 50 percent, transparency in management and operations of the national holding company is crucial for the program's success. To date, only the plan to privatize the Petroleum Authority of Thailand is well advanced.

Rural support programs should balance efficiency and equity.

The new administration was elected on a platform intended to accelerate economic and social recovery in Thailand. Given the need to stimulate the economy, it has prioritized fiscal measures to boost rural incomes, including suspending farmers' debts and creating village revolving funds. This strategy diverted more than B300 billion to rural communities in fiscal year 2000/2001, and an additional B58 billion will be invested in the current fiscal year beginning October 2001. While the emphasis on the recovery of the economy of rural Thailand is particularly welcome, interventions should balance efficiency with equity and social support considerations.

Thailand: Selected ARIC Indicators

	1996	1997	1998	1999	2000	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																				
GDP Growth (%)	5.9	-1.4	-10.8	4.2	4.4	-7.6	-14.2	-13.9	-7.4	0.1	2.7	7.8	6.5	5.3	6.4	2.9	3.2	1.8	1.9	. . .
Private Consumption Expenditure Growth (%)	5.8	-1.1	-11.5	4.0	4.3	-11.5	-16.4	-13.0	-4.2	-1.3	1.2	8.2	8.3	4.8	5.2	3.7	3.7	3.3	3.5	. . .
Public Consumption Expenditure Growth (%)	11.9	-2.7	3.6	0.9	6.5	-6.6	-6.2	11.3	15.1	-2.1	10.0	-6.1	4.1	14.3	12.0	7.1	-5.3	1.3	-0.3	. . .
Gross Domestic Investment Growth (%)	6.8	-22.7	-50.3	7.2	11.8	-46.1	-56.6	-55.1	-41.7	-13.0	14.6	5.8	26.2	26.6	18.6	5.6	-1.2	-1.23	-7.4	. . .
Agricultural Sector Growth (%)	4.0	-0.4	-3.2	2.7	2.7	-2.1	-11.9	-7.8	4.7	2.8	6.2	8.8	-2.6	-2.2	5.7	4.6	3.5	1.7	2.0	. . .
Manufacturing Sector Growth (%)	6.5	1.4	-11.1	11.5	5.9	-11.1	-13.6	-14.6	-4.8	6.1	9.6	16.5	14.1	8.0	8.1	3.6	4.0	1.5	1.5	. . .
Construction Sector Growth (%)	6.9	-26.4	-39.0	-5.4	-9.7	-29.3	-44.4	-43.4	-36.4	-25.0	-7.1	4.8	7.8	6.8	-0.3	-14.9	-26.6	-5.5	-10.9	. . .
Services Sector Growth (%)	5.3	-1.2	-10.0	-0.1	4.1	-5.2	-13.2	-11.4	-10.0	-2.8	-2.0	1.6	3.0	4.2	5.0	3.4	3.9	2.6	2.6	. . .
Exports of Goods and Services Growth (%)	-5.5	8.3	6.5	9.9	17.1	14.8	8.7	5.5	-1.3	-0.6	4.6	14.0	21.4	21.9	17.4	20.9	9.7	-2.0	-1.4	. . .
Imports of Goods and Services Growth (%)	-0.5	-11.4	-21.7	10.6	22.0	-26.5	-27.8	-21.3	-9.3	-7.8	15.7	13.8	19.6	44.5	16.5	23.8	9.3	-3.4	-6.9	. . .
Inflation Rate (%)	5.8	5.6	8.1	0.3	1.5	9.0	10.3	8.1	5.0	2.7	-0.4	-1.0	0.1	0.8	1.6	2.2	1.6	1.4	2.5	1.6
Unemployment Rate (%)	1.1	0.9	4.4	4.2	3.6	4.6	5.0	3.4	4.4	5.2	5.3	3.0	3.3	4.3	4.1	2.4	3.6	4.2	4.2	2.1
Monetary and Fiscal Accounts																				
Growth of Broad Money, M2 (%)[1]	17.0	12.6	16.5	9.7	5.4	16.5	15.7	13.8	12.7	9.7	8.6	6.2	3.4	5.4	4.1	3.8	4.5	3.4	5.5	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	26.0	7.8	5.0	5.0	23.5	22.0	9.5	7.8	5.3	4.5	4.0	5.0	4.5	3.8	3.5	5.0	2.6	4.0	3.5
Growth in Real Bank Credit to Private Sector (%)[1]	9.4	13.6	-11.3	-6.0	-17.1	3.4	2.5	-5.0	-11.3	-3.6	-4.0	-3.0	-6.0	-7.5	-11.1	-20.5	-17.1	-16.5	-19.2	. . .
NPL of the Financial System[1]	. . .	. . .	45.0	38.9	17.9	. . .	32.7	39.7	45.0	47.0	47.4	44.7	38.9	37.3	32.0	22.9	17.9	17.6	12.7	12.9
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	42.9	38.6	17.7	. . .	31.0	37.9	42.9	46.2	46.5	43.9	38.6	36.9	31.8	22.4	17.7	17.4	12.6	12.9
Average Stock Price Index	1167.9	597.8	353.9	421.1	342.5	473.1	361.5	246.0	335.0	357.1	461.8	450.5	415.0	432.7	358.2	304.0	275.0	309.8	305.0	312.3
Central Government Fiscal Balance as % of GDP	0.9	-0.3	-2.8	-3.3	-2.2	0.01	0.6	-8.5	-3.4	-0.01	-4.2	-4.2	-5.0	-1.5	-1.1	-2.0	-4.3	-2.6	0.5	. . .
Central Government Debt as % of GDP	3.8	6.3	14.6	21.5	23.6	5.4	9.0	10.2	14.6	18.6	19.8	20.9	21.5	21.1	21.9	23.0	23.6	24.1	24.0	. . .
Government Expenditure on Education (% of Total)	. . .	25.4	26.2	25.7	25.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	8.2	7.8	7.4	7.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																				
Growth of Merchandise Exports ($ fob, %)	-1.9	3.8	-6.8	7.4	19.6	-2.9	-5.3	-8.7	-9.9	-4.2	5.7	10.9	17.1	27.8	15.0	22.5	14.4	-1.3	-0.6	-11.1
Growth of Merchandise Imports ($ cif, %)	0.6	-13.4	-33.8	16.9	31.3	-39.8	-38.2	-34.2	-18.9	-1.0	11.7	21.9	35.4	42.7	28.0	33.8	23.6	11.5	2.9	-9.1
Current Account Balance as % of GDP	-7.9	-2.0	12.7	10.2	7.7	16.4	10.1	12.6	12.0	12.7	7.5	10.1	10.4	10.2	5.4	7.4	7.6	4.7	3.7	. . .
Net Direct Investment, ($ Billion)	. . .	3.3	7.4	5.9	3.4	2.2	2.5	1.4	1.2	1.0	1.9	1.2	1.8	0.7	0.7	0.7	1.2	0.7	1.0	. . .
Net Portfolio Investment, ($ Billion)	. . .	4.4	0.4	0.4	-0.1	0.5	-0.1	-0.1	0.0	-0.1	0.1	0.2	0.2	0.27	0.1	-0.4	-0.1	0.0	-0.7	. . .
Gross International Reserves Less Gold ($ Billion)[1]	37.7	26.2	28.8	34.1	32.0	26.9	25.8	26.6	28.8	29.2	30.7	31.6	34.1	31.6	31.5	31.6	32.0	31.7	31.0	31.9
Total External Debt as % of GDP[1]	59.6	70.1	93.3	78.4	65.3	67.0	73.7	78.2	93.3	86.5	83.0	79.7	78.4	74.9	70.6	67.6	65.3	63.4	63.1	. . .
Short-Term Debt as % of Gross International Reserves[1]	126.5	146.3	98.6	57.4	45.9	. . .	. . .	. . .	98.6	88.0	76.8	68.7	57.4	57.0	54.3	48.4	45.9	44.8	46.3	. . .
Short-Term Debt as % of Total Debt[1]	43.9	35.0	27.1	20.6	18.4	. . .	. . .	. . .	27.1	25.1	23.7	22.2	20.6	19.6	19.5	18.3	18.4	18.8	19.6	. . .
Real Effective Exchange Rate (1995=100)[2]	109.2	102.4	90.0	93.5	86.9	77.3	92.5	93.5	96.8	97.3	97.5	91.9	87.4	92.0	89.3	84.9	81.4	85.2	84.1	84.2
Average Exchange Rate (Local Currency to US$)	25.3	31.4	41.4	37.8	40.2	47.1	40.3	41.1	37.0	37.1	37.2	38.3	38.8	37.7	38.7	41.0	43.4	43.3	45.4	44.9

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

Viet Nam

Real Sector

Real GDP growth strengthened in the first three quarters of 2001.

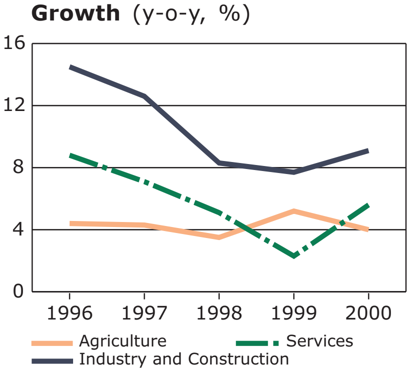
Initial government estimates indicate that Viet Nam's economy grew by 7 percent in the first three quarters of 2001, compared to 6.7 percent for the whole of 2000 (Table 1). The growth was driven by continued strong performance from the industrial sector and domestic demand, and contrasts with the economic slowdown seen in other Asian countries.

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

	1997	1998	1999	2000	2001	2002
Official[1]	8.2	5.8	4.8	6.7	7.1	over 7.0
ADB[2]	—	—	—	—	6.0	6.2
IMF[3]	—	—	—	—	4.5	6.0
World Bank[4]	—	—	—	—	4.9	5.8
Consensus Economics[5]	—	—	—	—	6.1	5.9

[1]IMF Staff Report, July 2000, IMF Article IV 2000 and official estimates from General Statistics Office (GSO).
[2]ADB, *Asian Development Outlook 2001 Update*, November 2001.
[3]IMF, *World Economic Outlook,* October 2001.
[4]World Bank, *East Asia Update*, October 2001.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, November 2001.

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



Source: ARIC Indicators.

Growth in the agriculture sector slowed.

Agricultural growth slowed to 2.1 percent in the first half of 2001, compared to 4 percent for the whole of 2000 (Figure 1). This was due to the disappointing winter-spring crop of paddy rice, which fell slightly, and low prices of agricultural goods.

But growth in the industrial and construction sector accelerated.

The slowdown in agriculture was more than offset by the stronger first semester performance of the industrial and construction sector, which is officially estimated to have grown by 10.9 percent compared to 9.1 percent for the whole of 2000. In particular, industrial output grew by 14.1 percent in the first half of 2001. Again, this was due to strong private sector and foreign-invested sector performance, which grew by 17.6 percent and 15.1 percent, respectively. Among the leading performers in the industry were motor bike assembly, cement, ceramic products, and electric motors.

Domestic and foreign investments began to recover.

The enactment of the New Enterprise Law in June 1999 and its implementation in January 2000 greatly simplified administrative and registration procedures. As a result, more than 12,000 enterprises were added in the first eight months of 2001 and the number of new company registrations surged to more than 14,400 in 2000 with a total capital of around D14.5 trillion ($1 billion).

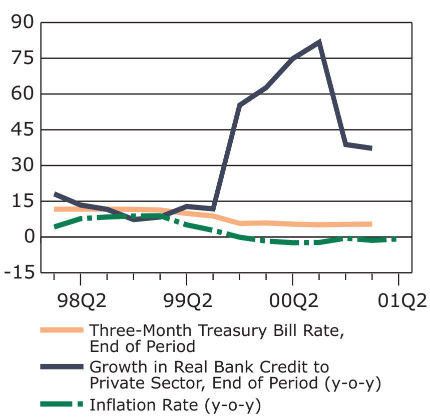
Foreign direct investment also began to recover in 2001. More than 360 foreign-invested projects were approved in the first 10 months of the year with total capital of about $1.99 billion. This is a more than 34 percent increase in the number of projects and around a 19 percent increase in capital compared with the same period last year. However, disbursements amounted to only about $42 million. There was concern that disbursements would be adversely affected by the slowdown in regional economies, which are among the leading sources of Viet Nam's FDI inflows. On the other hand, this could be partly offset by increased FDI inflows from Europe, particularly France and the Netherlands.

Fiscal and Monetary Developments

The budget deficit is poised to be lower than targeted.

To further stimulate economic growth, the National Assembly approved a larger budget deficit of 6.1 percent of GDP in 2001, compared to the 4.9 percent recorded in 2000. However, the budget deficit over the first half of 2001 was estimated at less than 0.2 percent of GDP. The actual deficit could be lower than targeted because of higher than expected revenue and slower disbursement of capital funds. Revenue in the first 10 months of 2001 already comprised 94 percent of the annual target, up by 10.2 percent over the same period last year. This was largely due to record growth in crude oil tax revenue, which rose by more than 90 percent over the same period as a result of an underestimation of projected world oil prices. This gives the Government more room for fiscal stimulus to help achieve its growth target in 2001 as well as in 2002.

Figure 2: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Deflationary pressures have eased slightly.

The deflationary trend continued in 2001, with consumer prices falling by an average of 0.9 percent in the first seven months following an average decline of 1.7 percent in 2000 (Figure 2). This was in part accounted for by the fall in food prices. However, the rate of price declines has been slowing as deflationary pressures began to ease and a positive inflation rate was reported in July. In particular, the price of rice has begun to rise. This, together with rising nonfood prices and the recent depreciation of the dong, is expected to lead to a slight quickening of inflation later in the year.

There has been some tightening in domestic credit policy in 2001.

In 2000, the State Bank of Viet Nam (SBV) adopted expansionary monetary and domestic credit policies. Broad money grew by almost 40 percent and domestic credit by about 38 percent. This was due to the rise in foreign currency deposits and substantial loosening of domestic credit in accordance with policies to stimulate domestic demand. SBV's annual credit growth target in 2001-2002 is lower at around 20 percent, in line with IMF and World Bank recommendations to help the banking system's credit risk management and support banking reform. In particular, slower credit growth reduces the risk to already weak State-owned commercial banks (SOCBs), since their loans are mostly to unproductive SOEs and run the risk of becoming nonperforming.

In addition, SBV raised the reserve requirement on dollar deposits from 12 to 15 percent in early May, in an effort to discourage the use of dollars. Thus, dollar interest rates offered to depositors by banks declined. Higher interest rates on foreign currency deposits compared to dong deposits had led to a growth of foreign currency deposits of 57 percent in 2000. In contrast, dong deposits grew by just 12 percent. But with low deposit rates and weak confidence in the banking system, both dollar and dong deposits hardly rose in the first quarter of 2001. This, in turn, constrained credit growth. Bank lending grew by just 1.6 percent in the first quarter of 2001, making the lower credit growth target still difficult to achieve. Because of the potential adverse effect of the SOCBs' sluggish lending activities on economic growth, SBV cut its basic rate four times in 2001, with the latest undertaken in early October.

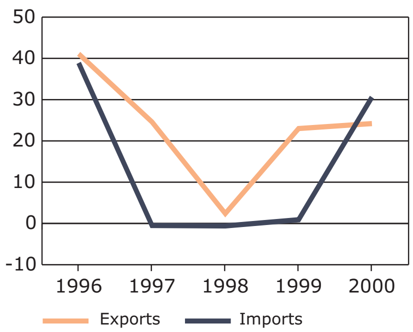
The gradual move toward market-determined interest rates continued in 2001. SBV removed the ceiling on dollar loan interest rates in June, and allowed in August locally-based companies to borrow foreign exchange from overseas lenders at negotiated rates.

Balance of Payments

Trade performance weakened.

Official estimates indicate that export growth significantly slowed in the first half of 2001 to 14.8 percent, compared to the 24 percent figure seen in 2000 (Figure 3). Here, the regional slump was to blame,

Figure 3: **Growth of Merchandise Exports and Imports, Dollar Value**
(y-o-y, %)



Source: ARIC Indicators.

as Viet Nam trades heavily with Asian countries that have been adversely affected by the US slowdown. Viet Nam's export earnings were also hit by the depressed prices of agricultural goods and lower crude oil prices, although there was an increase in volume terms. Almost half of the increase in the value of non-oil exports came from just two sources—fisheries products, and vegetables and fruits. Exports of manufactures continued to stagnate, with only modest growth in textiles and garments (12.7 percent), and a decline in the exports of footwear and electronics by 3.2 percent and 20.5 percent, respectively. Initial estimates show that export growth further weakened to 7.3 percent in the first 10 months of the year, well below the 16 percent target set by the National Assembly.

Growth of imports is also estimated to have declined to 8.8 percent in the first half of 2001, and further to 2.8 percent in the first 10 months of the year. In particular, the import value of passenger cars and motorcycles rose by 97 percent and 55 percent, respectively, over the same period, which is in line with the rapid growth of consumer goods industries. The trade deficit was estimated at around $219 million at the end of July 2001, down 62 percent on the corresponding period last year. The Government expects the deficit to reach $400 million by the end of the year, well below last year's $892 million.

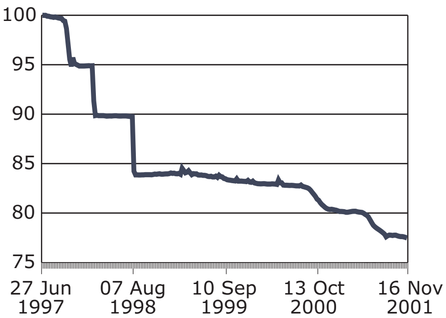
Gross official reserves increased from $2.5 billion in 1999 to $3.1 billion in 2000, and to an estimated $3.6 billion in 2001—enough to cover about 13 weeks of imports.

Asset Markets

The dong was allowed to depreciate.

The relative stability of the dong in 2000 continued until May 2001 (Figure 4). But downward pressure on the currency increased significantly in the second and third quarters, after SBV reduced the foreign exchange surrender requirement from 50 to 40 percent in mid-May. The smaller supply of US dollars led to a faster depreciation of the dong—by 3.2 percent against the dollar in the first eight months of 2001. This is equivalent to the total depreciation of the dong from end-1999 to end-2000. The relatively faster depreciation of the dong was also aimed at boosting external competitiveness, in line with the depreciation of other regional currencies. The Government, however,

Figure 4: **Exchange Rate Index—US Dollar Value of the Dong, Weekly Average** (last week of 1997June=100)



Source: ARIC Indicators.

remains concerned about increasing the debt-servicing burdens of SOEs with dollar-denominated debts in managing the currency's crawling peg.

The stock market is still in its nascent stage.

Viet Nam's one-year old stock market expanded marginally in 2001, with only one new firm listed and another to follow soon. Qualified firms are still reluctant to list due to the prerequisite financial disclosure and anticipated pressure on management. The State Securities Commission is also highly cautious in handing out licenses. Thus, only six out of some 700 equitized firms have listed to date. The establishment of the stock market should help in the process of equitization and privatization of SOEs. But the slow rate of reform of SOEs indicates that stock market activity will continue to be limited.

Financial and Corporate Sector Developments

The banking sector remains weak.

Although banks have become more diversified and some financial deepening has occurred, the sector remains weak. The capital-to-asset ratio of the banking system is less than 4 percent, with an even lower ratio of 2.6 percent for SOCBs in 2000. Thus, SBV plans to recapitalize and restructure the banking system over a three-year period.

Restructuring of SOEs has proceeded slowly.

In contrast to the significant improvement in the performance of private businesses, the reform of SOEs continues to be sluggish. The number of completed equitizations rose from 52 in 1998 to 225 in 2000, but slowed down to about 113 in the first eight months of 2001. There are still more than 5,500 enterprises that are owned by the national, provincial, and municipal governments. The Government's plan to restructure around half of them in the next five years will be difficult to achieve because of strong resistance from the SOEs, which are unwilling to break their close links to the Government and the banks. There were also difficulties in settling outstanding arrears and bad debts. SOEs include most of the largest firms in the country, and are believed to absorb close to half of the credit extended by the banking system.

Social Sector Developments

In the face of rapid growth in the 1990s, there has been a sharp decline in poverty incidence in Viet Nam. From about 70 percent in the late 1980s, the proportion of the population living below the official poverty line declined to about 58 percent in 1992/93, and further to 37 percent in 1997/98. The share of the population below the food poverty line also fell from 25 percent to 15 percent from 1993 to 1998. The economic slowdown in 1998 is expected to have slowed down the pace of poverty reduction.

Prospects and Policy Issues

Growth of around 6 percent is expected in 2001.

Viet Nam's economic performance continued to be robust in the face of weakening elsewhere in the region, partly because it was not reliant on technology exports to the US. However, the global slowdown had an impact on its export markets and foreign investment. Low commodity prices also led to slower growth in the agricultural sector. Thus, the high rate of growth in the first semester is not likely to be sustained in the second. Some slowdown was already evident, with real GDP growth decelerating to 7 percent in the first nine months of 2001. Official estimates indicate that Viet Nam's 2001 real GDP will likely grow by 7.1 percent, compared to the official target of 7.5 percent and growth of 6.7 percent in 2000. Achieving this lower target is conditional on policy measures to boost economic growth in the fourth quarter to around 7.4 percent. Consensus Economics foresees a more rapid slowdown and expects real GDP growth of 6.1 percent and 5.9 percent for 2001 and 2002, respectively.

On 3 October 2001, the US Senate passed legislation on the landmark bilateral trade agreement (BTA) between the United States and Viet Nam. The BTA will next go to Viet Nam's National Assembly for approval, which is expected in November when it returns to session. The BTA is expected to lead to increased foreign investments and exports to the US, particularly if the external environment improves.

Reform of SOEs and SOCBs is crucial for macroeconomic stability and growth.

In April 2001, the International Monetary Fund approved a three-year arrangement for Viet Nam under the Poverty Reduction and Growth

Facility for SDR 290 million (about $368 million). The World Bank followed in May with a $250 million loan in the form of a Poverty Reduction Support Credit. Both aim to further increase economic growth and thus reduce poverty by accelerating structural reforms. Key elements include the reform of SOEs and restructuring of SOCBs. By opening up the economy to more competition, enhancing transparency, and promoting efficient investment, more jobs are likely to be created in rural and urban areas.

SOE reform has become critical, not just for the survival and strengthening of its sector, but also to safeguard fiscal stability and free up budgetary resources for other important areas of government spending. The reform of SOEs is also a necessary component of the restructuring of SOCBs. The buildup in debt by the SOE sector—a large part of which is not being serviced—has weakened banks' asset quality. Thus, action on the reform plan must be sustained, together with safeguards to strengthen SOE financial discipline and curb credit to SOEs.

Economic reform is expected to continue to be a contentious issue. Concerns have thus been raised that the pace of the economic reform program is unlikely to accelerate in the near future and the scope of the reforms will remain limited. On the other hand, the establishment of a steering board under the leadership of the Deputy Prime Minister to oversee banking reforms is seen as indicative of the Government's commitment to the reform process. The Government also decided in early October to establish AMCs at SOCBs to deal with the problem of NPLs and promote the banking reform process.

Viet Nam: Selected ARIC Indicators

	1996	1997	1998	1999	2000	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3
Output and Prices																
Real GDP Growth (%)	9.3	8.2	5.8	4.8	6.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Agricultural Sector Growth (%)	4.4	4.3	3.5	5.2	4.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Services Sector Growth (%)	8.8	7.1	5.1	2.3	5.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Industrial and Construction Sector Growth (%)	14.5	12.6	8.3	7.7	9.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Inflation Rate (%)	5.7	3.2	7.3	4.1	-1.7	8.9	5.1	2.8	-0.1	-1.7	-2.4	-2.3	-0.5	-1.4	-0.8	. . .
Unemployment Rate (%)	5.9	6.0	6.9	7.4	6.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts																
Growth of Broad Money, M2 (%)[1]	25.7	24.3	23.5	66.4	35.4	27.5	30.1	30.2	66.4	73.5	70.0	67.4	35.4	34.5	. . .	. . .
Growth in Real Bank Credit to the Private Sector (%)[1]	24.5	26.3	4.2	210.3	40.5	3.8	129.3	133.6	223.3	240.5	74.8	81.7	38.8	37.2	. . .	. . .
Loans to Deposit Ratio	0.7	0.7	0.6	1.1	1.1	0.6	1.1	1.0	1.1	1.1	1.1	1.1	1.1	1.0	. . .	. . .
Central Government Fiscal Balance as % of GDP	-1.3	-4.8	-2.6	-2.8	-3.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Education (% of Total)[2]	8.6	9.3	9.6	9.6	9.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)[2]	4.4	3.9	3.9	3.7	3.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rate																
Growth Rate of Merchandise Exports ($ fob, %)	41.1	24.6	2.4	23.0	24.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Growth Rate of Merchandise Imports ($ cif, %)	38.9	-0.5	-0.6	0.9	30.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Gross International Reserves less Gold ($ Billion)[1]	1.7	2.0	2.0	3.3	3.4	2.1	2.4	2.8	3.3	3.6	3.5	3.5	3.4	3.3	. . .	. . .
Ratio of M2 to GIR[1]	2.9	2.9	3.1	3.1	4.0	3.1	3.0	2.7	3.1	3.2	3.4	3.6	4.0	4.5	. . .	. . .
Current Account Balance as % of GDP	-9.9	-6.5	-4.6	4.1	1.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Foreign Direct Investment ($ Billion)	. . .	0.2	0.8	0.7	0.8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Total External Debt ($ Billion)[1]	. . .	10.1	10.8	11.1	13.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Total External Debt as % of GDP[1]	. . .	40.7	41.7	40.7	43.8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Short-Term Debt as % of Gross International Reserves[1]	. . .	26.7	14.5	18.0	49.8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Short-Term Debt as % of Total Debt[1]	. . .	5.2	2.7	5.4	12.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Real Effective Exchange Rate (1995=100)[3]	110.1	116.0	120.3	117.6	113.2	120.5	121.5	116.9	111.6	114.2	113.2	112.4	113.0	114.2	115.6	. . .
Average Nominal Exchange Rate (Dong per $)	11,015.0	11,572.0	13,343.8	13,931.0	14,164.0	13,870.7	13,897.2	13,948.3	14,005.6	14,053.5	14,074.6	14,117.7	14,418.0	14,547.6	14,641.6	14,963.0

. . . = not available.
[1]End of period.
[2]2000 numbers are based on budget.
[3]Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and merchandise esports and imports are from General Statistics Office; fiscal balance is from Asian Development Bank (ADB), *Asian Development Outlook 2001*; current account balance is from ADB, *Asian Development Outlook 2001 Update*; M2, gross international reserves, real bank credit, loan to deposit ratio, ratio of M2 to reserves, and inflation rate are from International Monetary Fund (IMF), *International Financial Statistics,* September 2001; government expenditure on health and education are from IMF, *IMF Staff Report,* July 2000; nominal exchange rates are from Bloomberg; total and short-term external debt, foreign direct investment, and unemployment rate are from World Bank, *East Asia Update,* October 2001. Real effective exchange rate is based on REMU staff calculations.

Corporate Restructuring in East Asia

Introduction

Corporate restructuring was recognized as key to the affected countries' recovery process and long-term viability of their corporations in the aftermath of the 1997 Asian financial crisis. Governments of these countries have pursued various approaches to corporate restructuring, aided to different degrees by macroeconomic policies. In Indonesia, Korea, Malaysia, and Thailand, problem debts of large firms are being worked out voluntarily among creditors under government-sponsored processes or being liquidated and restructured under court supervision, while smaller firms' debts are mainly being dealt with on an out-of-court basis or through bankruptcy procedures. Financial sector restructuring and structural reforms, including reforms on bankruptcy and corporate governance, have been supporting the process of corporate restructuring. Meanwhile, Government-owned AMCs are helping to alleviate financial burdens of corporations and hold large amounts of nonperforming assets. The Philippines was less affected by the crisis, so the Government did not take specific measures on corporate restructuring. But there, there have been a number of reforms aimed at improving prudential regulation of the financial and corporate sectors.

However, progress in corporate restructuring has been modest. Banks have often had insufficient capacity to absorb losses without facing a serious threat of closure. In most of the countries, they operate with a full government guarantee on their liabilities, reducing any incentive to undertake deep restructuring. Banks also have limited technical capacity to restructure, while their long-standing links with corporations have complicated the restructuring processes in some countries. AMCs have helped in restoring banks' balance sheets, but they have not played a sufficiently constructive role in the financial and operational restructuring of corporations. Also, structural reforms, especially in areas of bankruptcy and corporate governance, have often lacked enough depth to force debtors to undertake the necessary financial and operational adjustments.

These have all left many corporations still burdened with high debts, and operating with low profitability, high leverage, and low liquidity. Thus, in light of a worsening global environment, corporate viability remains a major and critical policy concern in most crisis-affected Asian countries.

What Has Been Achieved?

Restructuring refers to several related processes: recognizing and allocating financial losses, restructuring financial claims of financial institutions and corporations, and operational restructuring. Recognition or resolution involves the allocation of existing losses and associated redistribution of wealth and control. Losses, i.e., the differences between market value of assets and nominal value of liabilities, can be allocated to shareholders—by dilution; to depositors and external creditors—by reduction of (the present value) of their claims; to employees—by cutting back on wages and suppliers; and to the government, that is, the public at large—through increasing taxes, cutting expenditures, or inflation. Financial restructuring for corporations can take many forms: reschedulings (extensions of maturities), lower interest rates, debt-for-equity swaps, debt forgiveness, indexing interest payments to earnings, etc. Operational restructuring includes improvements in efficiency and management, reductions in staff and wages, the sale of assets (for example, cutting subsidiaries), and enhanced marketing efforts with the aim of boosting profitability and cash flows.

When confronted with high levels of financial and corporate distress after the Asian crisis, most countries initially chose a decentralized approach. Banks and other creditors were expected to work out the problems of overindebted corporations on a case-by-case basis, while governments provided support to the banking system—through recapitalization, transfer of NPLs to AMCs, and other measures.

It was soon recognized, however, that a completely decentralized approach would not suffice, given the large scale of corporate sector distress and coordination problems among creditors. Thus, a larger role for government was both necessary and unavoidable. For most countries, with the exception of the Philippines, the model became large-scale corporate restructuring under a government-sponsored out-of-court process, the so-called London approach.

Outside the London approach (in various forms), there has been some purely market-based restructuring through court (bankruptcy proceedings) or voluntary actions, including mergers and acquisitions. Public AMCs have played an important role in separating NPLs from the banking system and thus restoring financial stability to crisis-affected countries. Such large holdings have led AMCs also to be a major player in corporate restructuring. Further, much operational restructuring has been happening outside these fora, driven often by the lack of new financing, especially for small and medium enterprises (SMEs).

To complement these approaches, other reforms have aimed at strengthening the capital bases of weak banks, improving the financial system's structure, and bolstering corporate governance. Also, there have been changes to tax regimes regarding restructured debt and easier accounting and tax treatment of debt-for-equity swaps.

Government-sponsored voluntary workouts

Recognizing the scale of the restructuring challenges, all countries (with the exception of the Philippines) set up, through agreements among creditors, out-of-court processes for the screening and restructuring of large, distressed corporations. The out-of-court frameworks themselves have been built on the London approach for corporate reorganization first enunciated in the UK in the early 1990s. The London approach encourages creditors to follow certain principles—minimize their losses, avoid unnecessary liquidation of viable debtors, and ensure continued financial support to viable borrowers—in out-of-court restructuring agreements. Since the London rules were not designed for cases of system-wide corporate distress and allow for only informal sanctions from the Bank of England for noncompliance, the crisis-affected Asian countries have adopted more formalized approaches. These have involved accords under contract law through which creditors agree among themselves to follow certain processes and actions. The governments also enhanced the frameworks in several other ways, by adopting time-bound deadlines and sanctions for noncompliance, and creating formal arbitration mechanisms. These enhancements have also meant a larger role for government compared to the out-of-court processes in the UK and elsewhere.

These processes initially varied widely between countries, but they have converged more recently. There are three important ways in which frameworks can differ. First, have all (or most) financial institutions signed on to the accord under regular contract or commercial law? If so, agreements reached among the majority of creditors can be enforced on other creditors without going through formal judicial procedures. Second, is formal arbitration with specific deadlines part of the accord? Without such arbitration, an out-of-court system has to rely on the formal judicial process to resolve disputes—with associated costs and delays. Third, under the accord, are there penalties that can be imposed for failure to meet deadlines?

Not all countries immediately adopted these three features (Table 1). In Indonesia, for example, there was no formal arbitration in place by mid-1999. Malaysia's Corporate Debt Restructuring Committee (CDRC) is meant to provide a platform for workouts, but the committee does not have legal powers. The severity of penalties has also varied, with several countries initially not penalizing failure to meet deadlines and other breaches. Even enforcement of existing sanctions has been weak. Based on these criteria, the framework in Thailand was initially the most conducive to out-of-court restructuring, followed by those in Korea and Malaysia. Indonesia's framework has been the least conducive.

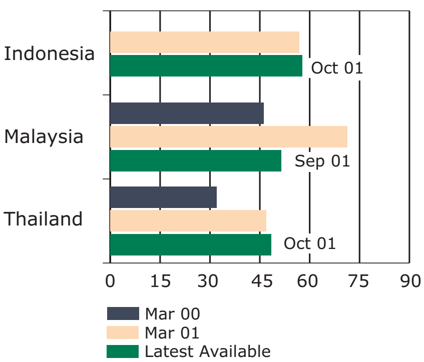
Table 1: **Features of Out-of-Court Corporate Restructuring Processes**

	Indonesia		Korea		Malaysia		Thailand	
Name of initiative or coordinating body	Jakarta Initiative Task Force (JITF)		Corporate Restructuring Coordination Committee (CRCC)		Corporate Debt Restructuring Committee (CDRC)		Corporate Debt Restructuring Advisory Committee (CDRAC)	
Basic approach	Forum for negotiations, followed by adoption of time-bound mediation procedures		Forum for negotiations, superseded in the fall of 2001 by a legal approach (Law on Corporate Restructuring)		Forum for negotiations		Forum for facilitation, superseded by contractual approach, i.e., Debtor-Creditor Agreements (DCAs)	
	mid-1999	**end-2000**	**mid-1999**	**end-2000**	**mid-1999**	**end-2000**	**mid-1999**	**end-2000**
All or most financial institutions signed on to accord	No	No	Yes	Yes	Yes	Yes	Yes	Yes
Accord provides for formal arbitration with deadlines	No	Yes	No	Yes	Yes	Yes	Yes	Yes
Accord imposes penalties for noncompliance	No	No	Yes	Yes	No	No	Yes	Yes
Resolution of intercreditor disputes	Nothing special		Possibility to have loan of opposing creditor purchased; also arbitration committee consisting of private experts		Nothing special, apart from suasion by central bank		Mediation in case only 50-70 percent of creditors approves workout. Any bank with large exposure can opt out	
Current default structure for failure to reach agreement	JITF may refer uncooperative debtors to government for possible bankruptcy petition		Foreclosure, liquidation through court receivership		Foreclosure, liquidation or referral to AMC with super-administrative powers		If less than 50 percent support the proposed workout, DCA obliges creditors to petition court for collection of debts	

Source: Mako (2001) and country sources for 2000; Claessens, Djankov, and Klingebiel (2001) for 1999.

The countries have improved their frameworks, however, over the past three years. Most have tried to put in place more meaningful sanctions and deadlines, although the effectiveness of these measures varies. As of mid-2001, all countries except for Indonesia had at least two of the three key features in place. Of the four crisis-affected countries, Korea has now the most well defined setup, since it codified the framework in the fall of 2001—including all three features as well as others—in a law on corporate restructuring. Malaysia and Thailand have also established relatively strong frameworks, while Indonesia's framework remains weak, since not all financial institutions are obliged to sign on to the accord and there are still few effective sanctions for failure to meet deadlines. In practice, however, and regardless of the tightness of the framework, there remains slippage in implementation in all four countries.

Figure 1: **Government-Supervised Voluntary Workouts***



*Data refer to cases registered under JITF (Indonesia), CDRC (Malaysia), and CDRAC (Thailand).
Source: Web sites of JITF, Bank Negara Malaysia, CDRC, and Bank of Thailand.

Reflecting in part improvements to the out-of-court mechanisms, and the general increased experience with restructuring approaches, the number of corporations and amount of debt being restructured under the programs have steadily increased since inception. By October 2001, about 58 percent of debt referred to JITF in Indonesia had been resolved. In Malaysia, more than 75 percent of debt transferred to CDRC had been resolved as of mid-2001. But with CDRC's acceptance of 11 new cases in the third quarter, the percentage of debt resolved declined to 51 percent. In Thailand, only 48 percent of debt had been restructured as of October 2001—only 5 percentage points better than year-ago figures (Figure 1).

While restructuring has, thus, accelerated over the last year or so through out-of-court processes, most work in this regard over the last three years has been in the form of temporary financial relief. This has meant that some of the restructured debt has reverted back to nonperforming status, sometimes even within a few months after restructuring. In the case of Thailand, in the middle of 1999, for example, 13 percent of the restructured debt reverted to nonperforming status within just a few months.

Court-supervised restructuring and bankruptcy

Creditors in most crisis-affected countries, except Korea and Malaysia, regarded court-supervised restructuring as an unattractive option, because of initial weaknesses in the bankruptcy regimes.[1] As a result, restructuring via out-of-court processes was also impeded, because creditors lacked the means to force borrowers to come to the negotiation table in good faith, meaning there was little credible threat of using

[1]Each country has its own, particular set of laws and institutions relating to restructuring and liquidation, including different definitions and naming conventions. In Thailand, the restructuring process is known as "business organization," in Indonesia and the Philippines as "suspension of payments," in Malaysia as "schemes of arrangement," and in Korea as "composition" and "company reorganization." See also ADB (2001a; 2001b).

bankruptcy procedures to force restructuring or liquidation. Many of these weaknesses were rooted in the countries' respective legal systems, with many having a long history of pro-debtor bias and poor creditor rights. This pro-debtor bias was often aggravated by the limited efficacy of the judicial system.

Some of these deficiencies have since been corrected, as bankruptcy regimes have been improved (Table 2). For instance, Thailand introduced a reorganization procedure in its bankruptcy law in 1999. Indonesia revised its bankruptcy law in 1998 and set up special commercial courts to help in corporate restructuring. In Korea, bankruptcy and restructuring procedures were working relatively well before the crisis. Nevertheless, amendments were made to the corporate reorganization act, composition act, and bankruptcy law to improve the speed and efficiency of the system. The Malaysia bankruptcy system was also in good shape before the crisis and few changes were needed. Until recently, the Philippines had made little progress in bankruptcy reform, with its law dating back to 1909 (some amendments were made in 1976). The new securities code enacted in 2000, however, transferred some functions of the Securities and Exchange Commission in resolving corporate disputes—including suspension of payments—to the courts, with a view to strengthening the system of dealing with insolvency.

Table 2: **Bankruptcy Regimes—Creditor Rights (as of mid-2001)**

	Indonesia	Korea	Malaysia	Philippines	Thailand
Restrictions on reorganizations	1	1	1	0	1
No automatic stay on assets	1	1	1	0	1
Secured creditors first paid	0	1	1	0	0
Management does not stay on in reorganizations	1	1	1	0	1
Creditor rights score (sum)	3	4	4	0	3

1 denotes "yes" and indicates strong creditor rights.
0 denotes "no" and indicates weak creditor rights.
Source: ADB (2001a; 2001b).

Improved bankruptcy regimes and the establishment of specialized courts have led to an increase in the use of bankruptcy to resolve financial distress. From low bases, the number of cases filed using bankruptcy procedures increased sharply between mid-1999 and mid-2001—by about 30 times in Indonesia and about 60 times in Thailand. The largest increase, however, has come from the government-sponsored out-of-court programs deferring corporations to court-supervised restructuring. In Thailand, for example, about half of the court-supervised restructuring has come from this source. Some of the increase in the number of cases is also accounted for by personal and small enterprise bankruptcies, which represent only a small fraction of overall NPLs. There may have been improvements to the formal regimes, but these have not eliminated many of the institutional problems facing the judicial systems of some countries. For instance, in Indonesia, bankruptcy judges are still in short supply, meaning creditors have little effective ability to clamp down on recalcitrant borrowers. As a consequence, the number of cases actually completed remains low as of mid-2001 (Table 3).

Table 3: **In-Court Restructuring (as of August 1999 and mid-2001)**

	Indonesia		Korea		Malaysia		Thailand	
	Aug 1999	Mid-2001	Aug 1999	Mid-2001	Aug 1999	Mid-2001	Aug 1999	Mid-2001
Number of registered cases	88	2,656	48	...	52	1,200	30	1,830
Number of cases started	78	2,348	27	...	34	...	22	135
Number of restructured cases	8	230	19	...	12	...	8	50
Restructured debt/total debt (percent)	4	...	8	...	...	...	7	...

. . . = not available.
In-court restructuring in Indonesia refers to IBRA cases only.
Source: Claessens, Djankov, and Klingebiel (2001); and country sources for updates.

Restructuring by asset management companies and state-owned banks

Governments themselves have become large claimants on the corporate sectors, and as such they have become a major direct party to the restructuring. Four affected countries (the Philippines is the exception) now have a publicly-owned AMC, which together held a total of some $135 billion in assets as of the third quarter of 2001, or about 59 percent of all NPLs in these countries (Table 4). The AMCs' mandates allow for asset disposition to the private sector through various means, minimizing the direct role of government in the restructuring of individual corporations.

In practice, however, asset disposition has been slow for various reasons, including difficulty in valuing assets, thin markets for selling assets, the fear of selling them too cheaply, and social and political pressures. Claims on large, difficult-to-restructure corporations have often remained with AMCs. More recently, the rate of dispositions has accelerated in Malaysia, where Danaharta had disposed of 83 percent of NPLs by September 2001, and in Korea, where KAMCO had a 53 percent disposition rate by August 2001. But IBRA has barely disposed of any of its large nonperforming asset holdings, achieving less than 6 percent as of September 2001. Total holdings by AMCs thus remain a large percentage of all NPLs.

Table 4: **Holdings of NPLs and Powers of AMCs**

	Indonesia	Korea	Malaysia	Thailand
Name of AMC	Indonesian Bank Restructuring Agency (IBRA)	Korea Asset Management Corporation (KAMCO)	Danaharta	Thai Asset Management Corporation (TAMC)
NPL holdings: In $ billion* In local currency	(Sep 01) $32.0 Rp310.9 trillion	(Aug 01) $77.8 W99.5 trillion	(Sep 01) $12.7 RM48.1 billion	(Oct 01) $12.9 B577.3 billion
NPLs purchased as a percent of total NPLs	(Jul 01) 85.2	(Jun 01) 71.6	(Jun 01) 39.4	(Oct 01) 40.9
NPLs disposed as a percent of NPLs purchased	(Sep 01) 5.6	(Aug 01) 52.6	(Sep 01) 83.3	Minimal yet
Special powers	Power to seize debtor assets	None	Appointment of special administrators for business restructuring. Foreclose on collateral.	TAMC-administered business restructuring largely bypasses court processes. Foreclose on collateral.
Asset disposition and management	Debt and business restructuring; outsourcing of medium-sized loans; auctions of smaller loans; foreclosure.	Auction; public sale; equity partnership; and securitization.	Private auction; tenders; securitization; special administration (business restructuring).	Debt and business restructuring; outsourcing; foreclosure.

*Converted using exchange rates as of dates indicated.
Source: Various sections of this web site and IMF, *Thailand Recent Economic Developments*, 20 August 2001.

With their continued large holdings, AMCs, sometimes with other government agencies, are often the most important creditor, among many others. Further, some AMCs have special powers. In Malaysia, for example, Danaharta is allowed to foreclose more easily on collateral; in Indonesia, IBRA can seize debtor assets; and in Thailand, the TAMC-administered restructuring largely bypasses the court process. Therefore, AMCs have the ability to set the pace and intensity of restructuring in the out-of-court programs, introducing additional financial as well as social and political dimensions.

In several complex restructuring cases, AMCs have been able to play a lead role. These include such companies as Daewoo and Huyndai in Korea, Renong and UME in Malaysia, and ATP in Thailand. In these cases, AMCs, together with other (government) agencies, such as the Korean Development Bank and the Malaysian Employee Provident Fund, have taken the lead in providing financial relief and initiating debt restructuring.

However, concerns remain as to whether AMCs are sufficiently aiding corporate restructuring, even in these large cases. Experiences in other countries suggest that AMCs can often delay, rather than speed up, restructuring (Box 7) and that the ingredients for fast disposition of assets using AMCs are more likely to be met in advanced and developed countries than in emerging markets. Indeed, the nature of the claims—mostly in the corporate sector—and the conditions in some crisis-affected Asian countries (limited skills, often weak institutional frameworks, and political constraints) have led some to suggest that AMCs could best focus on fast disposition of assets and should attempt only a limited role in corporate restructuring.

Box 7: **Cross-Country Experiences with AMCs**

A review of seven centralized approaches to using AMCs shows that most AMCs did not achieve their stated objectives when it came to corporate restructuring. The review distinguishes corporate restructuring AMCs from bank rehabilitation AMCs. In two out of three cases, corporate restructuring AMCs did not achieve their narrow goals of expediting restructuring. Only the Swedish AMC successfully managed its portfolio, acting in some instances as lead agent in the restructuring process. Rapid asset disposition vehicles fared somewhat better, with two out of four agencies—Spain and the US—achieving their objectives. The few successes suggest that AMCs can be effectively used, but only for narrowly defined purposes of resolving insolvent and unviable financial institutions and selling their assets. But even achieving these objectives required many ingredients: an asset that could be readily liquefied (real estate), professional management, political independence, appropriate funding, adequate bankruptcy and foreclosure laws, good information and management systems, and transparency in operations and processes.

Source: Klingebiel, 2001.

Besides the AMCs, governments also have played a large role in corporate restructuring, as state-ownership of financial institutions has risen sharply due to nationalization and other restructuring. If AMC holdings and state-owned financial institutions are considered together, the state owned on average some 50 percent of financial assets in crisis-affected East Asian countries in the middle of 1999, and this figure has risen further subsequently. In Indonesia, as of January 2000, State-owned banks and IBRA together held about $42 billion out of the $60 billion in domestic corporate sector claims, with the share of NPLs held by the State even larger. Meanwhile, State-owned and controlled banks represent more than half of Korea's total banking system assets and an even larger share of the nonperforming assets. This State ownership, while perhaps inevitable, has often further delayed the restructuring process.

Voluntary workouts outside government-sponsored and in-court frameworks

There has been much restructuring of SMEs outside the government-sponsored programs and formal in-court processes. In Korea, for example, the less distressed, smaller *chaebols* were not included in the out-of-court program, but actually underwent significant restructuring as they had little access to new financing. In 1998, Korean banks' lending to SMEs fell by almost 10 percent, while their lending to larger corporations rose by 9 percent. Philippine SMEs have found it more difficult to obtain financing because they were unable to use their most important assets—i.e., inventories and accounts receivable—as collateral to obtain bank loans. In general, the lack of new financing for many smaller publicly-listed firms and most SMEs and the pressure on them to repay loans have meant that they have been forced to restructure on their own, through asset disposition and operational adjustments, including labor shedding. These hard-budget constraints result in speedier corporate restructuring. However, this is not necessarily the most efficient approach, as restructuring has been applied unevenly and without proper consideration of financial viability and financing needs.

Some governments have tried to counter the cutback in banks' loans to SMEs by developing special programs or restructuring approaches (Box 8). But in spite of these measures, many SMEs have often been heavily affected due to their links to larger firms, which have cut them off from suppliers' credit or even forced them to extend financing. In Korea, for example, SMEs bore the brunt of the crisis as many of them were suppliers to large *chaebols*. Thus, the number of SME failures climbed to 8,200 in 1997 and 10,500 in 1998.

Box 8: **Special Programs and Restructuring Approaches for SMEs**

Governments have responded to SME distress with streamlined approaches for resolving SME debt and arranging financing:

- In Korea, as the recession deepened in 1998, the authorities strengthened banks' incentives to lend to SMEs and improved SMEs' access to credit. Important policies were to require the rollover of loans and expansion of credit guarantees to reduce the default risk on banks' books, and apply a lower risk weight in the calculation of Bank for International Settlements ratios than do collateralized loans.
- In Malaysia, company borrowers with total outstanding credits of less than RM50 million can seek financing support from the Loan Monitoring Unit of the central bank while the company pursues restructuring.
- In Thailand, where about 600,000 SMEs accounted for some 40 percent of NPLs, CDRAC introduced a simplified process to reach agreement in an SME within 45 days and identified more than 12,000 SME cases for monitoring and follow-up. By end-July 2001, 73 percent of these cases were completed or being processed, while the remaining 27 percent were subject to legal action. In addition, the Bank of Thailand (BOT) set targets for financial institutions to resolve 15,000 SME cases each month. BOT also led a consortium to purchase promissory notes issued by creditworthy SMEs at a discount. It has priced the facility at below the average cost of funds to the banks in order to encourage its use.
- In Indonesia, no special measures were taken to tackle SMEs' financing problems.

Source: Various sections of this web site.

Another voluntary channel for restructuring has involved mergers and acquisitions (M&As). The number of M&As, particularly those that are cross-border, increased sharply in the affected countries following the crisis. Total cross-border M&As, defined as acquisitions of more than 50 percent of equity by foreign investors, increased from some $3 billion in 1996 to about $22 billion in 1999. The biggest rise was seen in Korea, accounting for $13 billion of M&As in 1999, and Thailand, which saw $4 billion in M&As. For the four countries (Indonesia, Korea, Malaysia, and Thailand) as a group, the rise in M&As managed to offset a decline in FDI in greenfield projects (those designed to build new means of production), keeping overall FDI resilient. Malaysia, which had a history of significant FDI, however, saw a decline in M&As following the crisis.

The new wave of M&As was triggered in part by important policy changes in answer to the crisis. These included the liberalization of investment in nontraded sectors and changes in competition policy. Much of the M&A activity has, as a result, been directed to such activities as wholesale and retail trade, real estate, and financial services. As such, M&As will have an important impact by increasing competition and introducing modern operational practices. Cross-border M&As have been less of a direct force in corporate restructuring, however, in part because their size has been small relative to the total debt to be restructured. Also, the benefits of M&As are longer term, making the process less important as a stimulus for short-term economic recovery. But in some deeply affected sectors, including wholesale and retail services and real estate, M&As have been useful in bringing in capital and expertise. They have also helped particularly with the reprivatization of nationalized financial institutions, which over time will help directly and indirectly with the restructuring of the countries’ financial sectors.

Outcomes in financial and operational restructuring

So far, corporate restructuring has achieved only modest results. Nominally, Korea has made the most progress, as debt-equity ratios have fallen by more than half since 1997. This was partly a direct result of government policies that required corporations to bring their debt-equity ratio down to 200 percent. But it has been suggested that the progress in lowering debt-equity ratios among Korean *chaebols* has been achieved partly using various accounting measures, including overvaluation of affiliated party transactions, and revaluations of securities and foreign exchange holdings. Further, reflecting the limited desire of corporations to adjust their financial structures, much of the new equity raised during the period when the Korean stock market was experiencing a sharp recovery in 1999 was used to acquire new assets rather than to retire debt. In the other crisis-affected countries, there has been little progress in reducing leverage, which actually increased in many cases as currency devaluation has raised the foreign currency components, debts have been rescheduled, and new equity has been scarce. In Indonesia, Malaysia, Philippines, and Thailand, the weighted average leverage of selected publicly listed corporations (those included in composite indexing) at the end of 2000 was still above that in 1995 and 1996 and sometimes greater than the peak levels of 1997 (Table 5).

Table 5: **Debt-Equity Ratios of Selected Listed Companies (weighted average)**

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	2.4	4.7	2.1	1.7	4.4	3.1
1996	2.6	4.7	2.4	1.7	4.5	3.2
1997	4.2	6.0	2.6	2.0	7.0	4.3
1998	3.4	4.7	2.6	1.8	6.1	3.7
1999	3.7	2.8	2.7	2.0	6.0	3.4
2000	4.4	2.1	2.5	2.1	6.3	3.5
Average number of firms	259	200	456	182	317	1,414

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. Companies with negative reported equity values are excluded.

In large part, this lack of improvement in debt-equity ratios reflects the amounts of debt financing—in the form of bank loans and bonds—going to weak corporations, and the limited debt-for-equity conversions. A large share of claims is still held by often weakly capitalized commercial banks. These banks have few incentives to engage in debt-for-equity conversions as they are often able to carry restructured, but still poorly-performing, loans at low provisioning requirements. Also, commercial banks and AMCs often prefer to rollover claims rather than convert them to equity as they lack the skills to manage the latter process.

The lack of improvement in leverage also reflects an unwillingness of corporate owners to dilute their claims and invite in more outsiders. This is aggravated by a general shortage of equity in the region. Following an initial increase in prices, domestic stock markets have been in decline in the last two years and foreign investors have shown limited interest, at least recently, to commit resources. Low stock prices deter controlling shareholders even more from converting debt into equity or from issuing new stock.

At least nominally, the structure of debt financing has improved somewhat. The median share of long-term debt out of total debt has increased by some 10 percentage points since 1995 in Korea and may have risen by even more in the Philippines. In Indonesia, Malaysia, and Thailand, progress has been more limited, and there has even been some decline in the share of long-term debt among Thai corporations. Improvements in the share of long-term debt have, however, not always been due to normal market forces. In Korea, most restructuring as of mid-2000 involved extensions of maturities, and lowering of interest payments and other financial relief measures. Further, these aggregate numbers hide large changes in the financial structures of corporations. As they have restructured, *chaebols* in Korea increased their reliance on corporate bonds while decreasing that on bank debt. For non-*chaebols*, on the other hand, the proportion of corporate bonds fell, while the proportion of bank debt in total debt surged. As many bonds were issued by weak (but perceived as too big to fail) *chaebols*, they had to be restructured, with banks absorbing some of the losses. Daewoo and Hyundai have been the most notable, but not only, examples. In Malaysia, there was a similar situation. The financial restructuring schemes adopted in the workouts typically involved one or a combination of the debt restructuring and capital reduction methods.

Although financial restructuring provided corporations with some temporary relief, this often did not lead to sustainable financing, in which firms are able to cover interest expenses from operating income. The weighted ratio of earnings before interest and taxes with depreciation added (EBITDA) to interest payments for publicly listed corporations reached a low in 1998 in the five crisis-affected countries as interest rates were high and earnings were depressed (Table 6). Except in the Philippines, the weighted coverage ratio has recovered since. However, by 2000, the ratio still had not reached its 1995/96 level, except in Korea. And these ratios themselves are inflated to the extent firms obtained financial relief, through rescheduling or lower interest rates, lowering their actual interest payments, and increasing the coverage ratio. Further, while interest rates in the region are now below historic averages, thus alleviating debt service burdens, they are likely to rise as economies recover.

This poor interest coverage is also reflected in the fact that the share of corporations with nonviable financial structures, as measured by interest coverage of less than 1, although below the peak of 1998, remains high. About 27 percent of corporations in the five countries could not make interest payments from operating income in 2000 (Table 7), with the Philippines being the most vulnerable.

Table 6: **Interest Coverage Ratio of the Selected Listed Companies** (weighted average)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	6.5	3.2	9.5	12.0	5.9	7.4
1996	6.3	2.8	6.5	11.3	5.0	6.4
1997	4.3	2.9	5.4	7.6	3.4	4.7
1998	-1.1	1.9	3.1	5.2	1.2	2.0
1999	-0.9	3.1	3.5	3.8	1.7	2.6
2000	2.6	4.1	5.0	3.5	2.9	3.5
Average number of firms	316	200	516	182	341	1,555

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. Interest coverage ratio was computed as EBITDA divided by Interest Expense.

Table 7: **Share of Selected Listed Companies with Interest Coverage Ratio of Less than One** (%)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	4.9	4.5	6.1	21.0	13.8	10.0
1996	7.3	9.2	9.6	24.3	15.6	13.2
1997	16.3	13.0	14.6	27.7	25.8	19.5
1998	37.1	24.2	33.8	41.3	41.9	35.7
1999	33.5	10.5	29.1	45.2	32.4	30.1
2000	29.1	9.9	27.5	43.3	24.2	26.8
Average number of firms	316	200	516	182	341	1,555

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. Interest coverage ratio was computed as EBITDA divided by Interest Expense.

The limited progress is all the more worrisome since, compared to international levels, interest coverage ratios in the crisis-affected East Asian countries remain low. For comparison, the average interest coverage in the US (in 1996) was around 5, and in order to earn an A-rating based on Standard & Poor's rating requirements, a US company typically needs a ratio of operating cash flow to interest of more than 8.

What Remains to be Done?

As the analysis above indicates, there is still much restructuring to be carried out, both financial and operational.

Financial restructuring

A large share of corporate sector debt is still to be restructured. The total amount of nonperforming assets in the five crisis countries remains high. While much debt has been taken off banks' books by AMCs, and thus relieved the financial system, on net and using officially reported figures, the NPL share of debt today is not much lower in Korea compared to the end of 1999 (Table 8). Only in Thailand has the share of NPLs declined—by some 15 percentage points since end-1999. What is even more disconcerting is that this lack of progress in reducing NPLs has taken place in a benign international and a positive domestic environment. Interest rates have been low and there has been a resumption of economic growth. The task of speeding up restructuring will be even more challenging as the world economy faces a period of slower growth. Financial data on listed firms also suggest that many corporations do not have viable financial structures in terms of leverage, share of short-term debt, and interest coverage.

Table 8: **Share of NPLs, Including those Transferred to AMCs** (%)

Month/Year	Indonesia	Korea	Malaysia	Philippines*	Thailand
December 1998	. . .	. . .	15.0	11.0	. . .
June 1999	. . .	. . .	16.4	. . .	. . .
December 1999	. . .	19.7	15.8	12.7	40.5
March 2000	. . .	21.5	15.6	. . .	39.0
June 2000	. . .	21.2	15.4	14.5	33.9
September 2000	61.7	20.3	14.9	. . .	31.0
December 2000	57.1	20.3	14.5	14.9	26.8
March 2001	57.2	19.9	15.6	16.6	26.5
June 2001	55.2	19.3	16.6	16.6	25.1
September 2001	. . .	. . .	. . .	. . .	25.3

. . . = not available.
*The Philippines does not have a centralized AMC. Numbers refer to the banking system.
Source: ARIC Indicators.

Thus, the task of financial restructuring continues. In principle, financial restructuring can be accomplished relatively quickly, as rapid financial restructuring of some corporations has shown. In Korea, for example, through court-supervised receiverships and out-of-court workouts, the controlling shareholders and management of many *chaebols*—including some of the biggest precrisis names—have completely lost out or seen their shareholdings severely diluted and their managerial discretion circumscribed. These types of financial restructurings, and their signaling value toward other controlling shareholders and managers, have helped to accelerate operational restructuring. It is important, however, that all financial restructuring is undertaken in a way that ensures that deep operational restructuring will follow. In particular financial restructuring needs to alter the incentive structures of the owners, creditors, and managers such that they will want to pursue sustainable operational restructuring. While much of the financial restructuring to date may have been the appropriate response to a systemic crisis and did achieve some temporary financial stabilization, its potential for promoting real, operational restructuring remains to be proven. Data on the performance of corporations in crisis-affected countries to date suggest too little improvement.

Operational restructuring

It is clear that the easiest part of operational restructuring has already been completed. The rapid disposition of noncore assets, simple forms of labor reductions, and fast price and wage adjustments occurred early in the crisis. Helped by a recovery in aggregate demand in 1999 and 2000, data on profitability and other performance indicators suggest that this restructuring has resulted in some gains. Following the sharp decline in 1998, publicly listed firms saw some recovery in their return on assets (ROA) in 1999 and 2000 (Table 9). ROA was positive for Korea, Malaysia, and Philippines in 1999 and 2000. The average ROA for the five countries, however, was still negative in 1999 and zero in 2000. In 1998, return on equity (ROE) had seen an even sharper decline than ROA, as interest burdens exceeded operating incomes. Paralleling the increase in ROA, ROE recovered in 1999 and 2000, although in Thailand it was still negative in 1999. For the five countries as a whole, though, the weighted average ROE increased from a low of -6 percent in 1998 to reach 5 percent in 2000.

ROEs in Table 9 do not cover companies with negative equity value. On average, as the bottom part of this table shows, between 20 and 30 percent of listed companies in the sample remained loss making in 2000.

This pattern in profitability suggests that restructuring over the past few years has achieved operational gains through increased efficiency, divestiture of unprofitable businesses, and adjustment in prices. Profitability has a large cyclical component, however, and it is consequently hard to separate the effects of restructuring from those due to an overall beneficial environment during 1999-2000. Conversely, the recent decline in profitability of East Asian corporations may be a result of the global and regional economic slowdown rather than an easing off on restructuring. Although it is difficult to pinpoint the exact contribution of operational restructuring, it is clear, also from anecdotal evidence, that the process must continue, as it typically takes several years to complete.

Table 9: **Profitability of Selected Listed Companies: Return on Assets and Equity**

Return on Assets (%, weighted average)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	4.0	2.0	4.0	5.0	2.0	3.0
1996	3.0	0.0	4.0	5.0	2.0	2.8
1997	-1.0	0.0	2.0	3.0	-5.0	-0.2
1998	-25.0	-1.0	-2.0	2.0	-2.0	-5.6
1999	-3.0	2.0	0.0	1.0	-5.0	-1.0
2000	-3.0	1.0	1.0	1.0	0.0	0.0
Average number of firms	316	200	516	182	341	1,555

Return on Equity (%, weighted average)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	12.6	11.4	12.5	12.7	13.4	12.5
1996	12.5	2.6	12.1	12.8	10.9	10.2
1997	-3.4	-1.6	8.5	8.0	-36.4	-5.0
1998	-19.3	-1.0	-3.3	6.6	-13.1	-6.0
1999	10.0	7.3	3.2	3.5	-32.9	-1.8
2000	8.2	5.5	5.1	2.0	4.6	5.1
Average number of firms	259	200	456	182	317	1,414

Percentage of Companies with Negative Returns

Year	Indonesia	Korea	Malaysia	Philippines	Thailand	Average
1995	3.5	7.1	6.3	10.3	4.5	6.4
1996	4.7	23.2	6.6	10.0	13.1	11.5
1997	36.3	30.0	15.5	17.1	57.5	31.3
1998	37.7	27.6	33.8	30.8	37.9	33.6
1999	22.0	11.0	27.7	30.3	40.2	26.3
2000	27.3	20.5	21.6	30.4	28.9	25.7
Average number of firms	316	200	516	182	341	1,555

Note: Staff calculations using Bloomberg data; composed of corporations whose stocks are included in the composite indexes of the respective markets. For Korea, only the companies comprising the KOSPI 200 (Korean Stock Price Index) are included. ROE = Net Profit(Loss)/Total Stockholders' Equity. In the case of ROE, companies with negative reported equity values are excluded.

The need to undertake deeper operational restructuring is all the more necessary as the profitability and cash flows of East Asian corporations has traditionally been low by international standards. The average ROA for a panel of 35 countries was some 6.5 percent in 1999, while the five East Asian countries before the crisis had an ROA of less than half of this, at only about 3 percent. Also, operational margins, that is, EBITDA as a percent of sales, for East Asian corporations were only two thirds of the average level achieved by this panel of 35 countries in 1995/96. Data thus suggest that the operational restructuring of debtors has been less than successful and that much of the more difficult restructuring has often been postponed, at least for the large corporations.

Other evidence also suggests that relatively little operational restructuring has occurred for the large corporations and that corporate restructuring deals continue to emphasize financial over operational restructuring. For example, examination of the JITF deals concluded during 2000 shows a large reliance on term extensions, conversions into equity, or convertible bonds. Other more fundamental restructuring took place on average in only 5 percent of deals over the whole of 2000, a figure that fell steadily to only 2 percent in the last quarter of that year.

This limited effectiveness of operational restructuring relates to the main agent put in charge of the process in the countries. In many cases, management has not been changed and existing owners have remained in control. Banks are typically not imposing much operational restructuring on large corporations. They 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.

The large role of government in the restructuring process, through the nationalization of banks and establishment of AMCs, has meant that, on average, governments now own (directly or indirectly) corporate sector assets equal to more than 75 percent of GDP in four of the crisis-affected East Asian countries. This transfer of distressed assets has in most cases been effective in isolating financial sector problems and providing financial relief to corporations. It has, however, not necessarily led to operational restructuring.

Experiences from other countries suggest that AMCs are best used for financial rather than operational restructuring. One reason is the lack of expertise and skills at commercial banks and AMCs. But political factors also limit the ability of publicly owned agencies to force through difficult restructuring. For instance, governments are reluctant to fire excess workers and close nonviable businesses. More generally, they have practiced various forms of regulatory forbearance vis-à-vis banks and other financial institutions to soften the impacts of financial and operational restructuring. This has not only involved the mitigation of social impacts, but also the propping up of large distressed companies, often those controlled by the politically well-connected. In addition, governments have to continue to balance the interests of various constituencies, such as demands for wage increases from workers, with the viability of the corporate sectors.

Operational restructuring should be left to the private sector because it is better skilled for the task and enjoys more freedom from political pressure. Encouraging quick divestiture of assets by AMCs, state-owned banks, as well as private banks would thus be the most effective approach to accelerate operational restructuring. Banks should not be allowed to continue carrying nonperforming or poorly restructured loans at low provisioning levels and should be encouraged to divest assets.

A reflection of the slow progress of corporate restructuring in East Asia has been the weak stock market performance of the region's corporations. Following an initial rebound, there has been a steady decline in most countries' equity prices. Several market indexes have now fallen to half of their precrisis levels and some markets are only marginally above the absolute lows of 1998. This decline has been led by financial institutions, where prices have been tumbling since 1998, but has become broader based since early 2000. In the fall of 2001, several markets reached levels not seen since the midst of the crisis in late 1997 and early 1998. In US dollar terms, the declines in stock prices have been even sharper as currencies have depreciated.

What Are the Constraints and Policy Issues Going Forward?

It will take a package of measures to speed up corporate restructuring, including financial sector reform, better restructuring mechanisms, altering the lead agent undertaking restructuring, and making changes to the corporate governance and competition frameworks.[2]

To better restructure workout firms, further improvements are needed in the incentive framework under which financial institutions operate.

This incentive framework for banks includes accounting, classification, and provisioning rules, i.e., financial institutions need to be asked to

[2] For further country-specific details regarding legal and financial changes needed, see ADB (2001a; 2001b).

realistically mark their assets to market. Loan classification criteria in some crisis-affected countries are still not forward-looking enough to force financial institutions to come to grips with problem debtors quickly (Table 10). In Malaysia, banking institutions were given an option of reporting NPLs using either the standard of three months or six months past due. But they were not required to use forward-looking criteria. In Korea, the Government tightened loan classification requirements for firms that had undergone restructuring, bringing them under the new "forward-looking criteria," but only in late 2000. Indonesia still does not have tight criteria for loan provisioning and interest accruals. Not all countries limit the upgrading of restructured loans until the corporation has a sustained record of repayments and viable financials. Other barriers to corporate restructuring such as tax and accounting rules need to be addressed. Governments should continue to review issues such as the tax treatment of mergers and debt-equity swaps, personal liability of state-owned banks' management in extending relief, protection for public shareholders, transfer taxes, and other policies, and evaluate whether they serve a useful public policy purpose or only hinder restructuring.

In addition, the prudential and legal system needs to limit forbearance and ensure that undercapitalized financial institutions are properly disciplined, while giving an incentive to banks to come to grips with their problem loans. Marginally capitalized banks tend to engage more

Table 10: **Regulatory and Loan Restructuring Frameworks, as of early 1997 and mid-2000**

Country	Loan Classification		Loan Loss Provision		Interest Accrual		Overall Index	
	Early 1997	Mid-2000	Early 1997	Mid-2000	Early 1997	Mid-2000	Early 1997	Mid-2000
Indonesia	2	3	1	2	1	2	1.3	2.3
Korea	2	3	3	3	3	4	2.7	3.3
Malaysia	2	2	1	2	3	3	2.0	2.3
Thailand	1	3	1	2	1	4	1.0	3.0

Note: Countries are scored on a scale of 1 to 4 for each variable, with 4 indicating best practice and 1 indicating furthest away from best practice, as follows:

Loan classification
1 = loans considered past due at more than 360 days
2 = loans past due at more than 180 days
3 = loans past due at more than 90 days
4 = repayment capacity of borrower taken into account

Loan loss provisioning
1 = 0% substandard, 50% doubtful, 100% loss
2 = 10–20% substandard, 50% doubtful, 100% loss
3 = 20% substandard, 75% doubtful, 100% loss
4 = present value of future cash flow or fair value of collateral

Interest accrual
1 = up to 6 months, no clawback
2 = up to 3 months, no clawback
3 = up to 6 months, with clawback
4 = up to 3 months, with clawback

Sources: World Bank (2001); Lindgren, et al. (2000); Claessens, Djankov, and Klingebiel (2001).

in cosmetic corporate restructuring, such as maturity extension or interest rate reduction on loans to nonviable corporations, rather than debt write-offs. Incentives to undertake restructuring can be strengthened by linking government financial resources directly to the actual financial corporate restructuring undertaken by banks. For example, a capital support scheme in which additional fiscal resources are linked to actual corporate restructuring through loss sharing arrangements can induce banks to conduct deeper restructuring. A proper incentive structure also means limited ownership links between banks and corporations in order to reduce the chances of the same party being both debtor and creditor.

A framework to support out-of-court corporate restructuring efforts must be backed up by an efficient court-supervised process.

The fact that the frameworks for out-of-court corporate workouts have been more effective in Korea and Malaysia than in Indonesia and Thailand is in part a reflection of clear differences in the ability of each country's insolvency and creditor rights system to impose losses on debtors. In Korea, where the bankruptcy regime was quite credible to begin with, many controlling shareholders have seen their shareholdings severely diluted and managerial discretion controlled. But, even there, bankruptcy has affected SMEs much more than the large corporations and some heavily indebted corporations have been able to avoid bankruptcy for long periods. Bankruptcy has also been an effective threat in Malaysia. In other affected countries, there is a more widespread inability to force out existing shareholders and bankruptcy is not a viable threat.

While the formal bankruptcy regimes in the region today are much improved compared to a few years ago, legal enforcement remains limited. There are technical and political reasons for this, as courts are overworked and understaffed, and often subject to political pressures. Anecdotal evidence of the uncertainties introduced by the courts is plentiful. Although it will take time, further reforms to enhance the efficiency and integrity of the bankruptcy process, including the introduction of specialized bankruptcy courts, will be necessary. In the meantime, the London-type approaches can be tightened in some of the crisis-affected countries, outside arbitration should be pursued more actively, and market-based alternatives to current debt resolution mechanisms could be explored.[3]

[3] See, for example, Hausch and Ramachandran (2001).

The large role of the state in restructuring, while inevitable in the first phases of the crisis, now needs to be reduced. More and earlier involvement of outside investors is necessary to achieve deep operational restructuring.

Banks—often owned by the state or operating under an extensive government safety net—and public AMCs have been slow to divest assets. Governments should reduce ownership of corporate sector assets, while banks need to be encouraged to divest through a proper prudential framework. AMCs should dispose of their assets faster with less consideration for price and state-owned banks need to be privatized to strategic shareholders. But while a larger role for private investors is called for, the process will have to be carried out in a way that assures that assets do not end up in the hands of the same owners that contributed to the problems. And it will have to take into account political sensitivities concerning foreign ownership.

Banks and public AMCs should refrain from directly managing nonperforming assets. Instead they can retain outside professionals—on some incentive compensation basis, whenever possible—to conduct due diligence, structure and negotiate corporate workouts, and manage asset sales. Banks also have limited experience in managing corporate shareholdings or exercising corporate governance. Thus, the management of converted equity should be outsourced to asset management/corporate professionals, including through equity partnerships. To dispose of assets, a menu of approaches should be available to banks and AMCs. Vehicles for offloading NPLs and managing debt have been lacking and tools such as corporate restructuring vehicles (CRVs), venture funds, equity partnerships, and others need to be used more actively. A CRV, for example, can manage debt-swapped equities temporarily obtained from commercial banks receiving initial funding from an investment group and at a later stage from the capital markets. Korea has recently assigned CRVs a formal role in the out-of-court restructuring process, including in the new corporate restructuring law. When large-scale disposal of assets is difficult, amid depressed asset prices or because of political sensitivities, solutions may have to lie in mixed public-private arrangements and other ways to effectively reprivatize assets. Under these arrangements, ownership remains for some period with the state, but there are private sector incentives in the management of the assets.

The pace of implementing corporate governance reforms must be accelerated.

The investment and financing behavior of publicly-listed companies has often been considered one of the major vulnerabilities that led to the financial crisis. Thus, as part of the structural reform process, changes in the corporate governance framework have focused on publicly listed corporations. The changes have covered a broad spectrum of issues, including trying to ensure better discipline from the respective domestic financial systems, improving disclosure of financial transactions, adopting rules for internal management of corporations, and conducting better capital market regulation and supervision.

An important aspect of the corporate governance reforms has been improved equity rights. Table 11 summarizes the progress that has been made in enhancing the rules for equity investors in four key areas: one-share, one-vote; proxy by mail; shares not blocked; and cumulative voting possible. The table shows that all five countries have come closer to international standards in the rules governing corporations. Over this period, Korea has made the most progress, as it now satisfies three of these four key criteria for effective corporate governance, compared to only one in 1996. Significant deficiencies still remain, however, in the corporate governance frameworks of Malaysia, Philippines, and Thailand. By this criterion, Indonesia had already well established formal equity rights in 1996. In addition to these changes, countries have brought in other measures to enhance equity holders' rights. In March 2000, Malaysia adopted a code on corporate governance. In Korea, the accounting and auditing standards board was strengthened, the threshold to file a derivative action against a company was lowered, and all listed companies were required to appoint independent directors. As disclosure was a key weakness, Thailand mostly focused on reinforcing accounting and auditing standards and practices. Many new or improved accounting and auditing standards were issued, an accounting standards board was established, and disciplinary measures for noncompliance were enhanced. Thailand also clarified the roles and duties of company directors. However, progress on other critical aspects of corporate governance has been slow.

Table 11: **Equity Rights, as of 1996 and mid-2000**

	Indonesia		Korea		Malaysia		Philippines		Thailand	
	1996	Mid-2000	1996	Mid-2000	1996	Mid-2000	1996	Mid-2000	1996	Mid-2000
One-share, one-vote	1	1	1	1	1	1	0	0	0	0
Proxy by mail	1	1	0	0	0	0	0	0	0	0
Shares not blocked	1	1	0	1	1	1	1	1	1	1
Cumulative voting	1	1	0	1	0	0	1	1	1	1
Equity rights score (sum)	4	4	1	3	2	2	2	2	2	2

Note: "1" denotes that equity rights are in the law.
Source: La Porta et al. (1998) for 1996, updated on the basis of Zhuang et al. (2000 and 2001).

Still, great difficulties remain in fully enforcing corporate governance changes. Enforcement of the minority rights rules especially are still weak in many countries. In Korea, for example, although a cumulative voting system to improve minority rights was introduced in the commercial code, about 80 percent of listed companies were able to exclude it from their articles of incorporation. And as of end-2000, not a single company has brought in a cumulative voting system in electing board members. Also, more than half of the *chaebols* continue to spend more on donations than on dividends, indicating that they have not achieved a real improvement in shareholder value, as intragroup transfers frequently occur at the cost of minority shareholders. In Indonesia, the enforcement of many laws has been limited.

In addition to greater enforcement, several other reforms are still pending. These include changes to the capital markets framework; the adoption of better internal control by improving financial reporting, and audit and accounting standards; and boosting shareholder protection by upholding the rights of minority shareholders and preventing insider trading. Some of these reforms are already underway, but could be put in place faster. With better enforcement, these changes will help to improve operational performance and reduce the potential vulnerabilities of the countries' corporate sector.

Reforms have to continue to take into account the special corporate governance issues facing East Asian corporations. Specifically, the share of outside investors and nonmanager owners remains small in most East Asian corporations, limiting the traditional corporate governance problems of diffused shareholders and separation between managers and owners. Corporate governance problems arise, therefore, mainly in two areas: weak protection of minority rights and lack of market discipline. The weak protection of minority rights has sometimes allowed the expropriation of small shareholders by large controlling shareholders. This has raised the costs of external financing for these and other firms operating in the same environment and undermined the efficient allocation of investment. Reducing this problem will require improved minority rights. Without changes in these areas, financial risks will not decline, as insiders will continue to increase leverage to maximize their benefits.

The framework for competition must be improved.

Strengthening the degree of market competition in the real (and financial) sector must be part of the reform processes. These involve a wide range of trade and FDI deregulation measures, as well as deregulation of some unnecessary domestic rules. In many countries, following the crisis, tariff barriers were slashed. In Korea, for example, effective rates were cut from 4.4 percent in 1996 to 2.8 percent in 1998. Also, progress has been made in reducing nontariff barriers, an issue on which countries such as Korea have attracted criticism from their trading partners. Meanwhile, progress has been made in liberalizing the FDI regime, including hostile, cross-border M&As in several countries. The elimination of ceilings on foreign equity ownership in several stock markets and the (near) elimination of restrictions on foreign companies or individuals purchasing land in countries such as Thailand have also enhanced the competitive framework.

Less progress has been made on improving the framework for domestic transactions. In developing countries, the main institutional barriers to domestic competition are government regulations on entry and exit of firms. In Korea, for example, an arduous bureaucratic store-opening evaluation process has contributed to low productivity in the retail sector. And in spite of many efforts by the Korean Free Trade Commission, informal cartels and exclusive supply and distribution contracts are still prevalent among the *chaebols*. Countries in East Asia also have on average a high threshold for defining market dominance—a 50 percent to 75 percent market share of the largest firm, compared to 40 to 50 percent in the European Union.

The current economic slowdown may make corporate restructuring and reform more painful, but should not be allowed to become a delaying factor.

The deterioration of the global economy further limits the strategy of simply trying to “grow out” of the banking and corporate sectors’ problems. Poorer export and growth performance limits the growing out option directly, as NPLs will not decline on account of improved corporations’ prospects alone. As noted, NPL ratios have increased in several of the crisis-affected countries as growth slowed in early 2001. The declines in growth rates may further constrain corporations' cash flows in all sectors and lead to an even bigger rise in the proportion of NPLs.

Declines in stock markets, increases in sovereign spreads, and a growing tendency for investors to pull back from emerging markets will make new external financing harder to come by and more costly. To address these challenges, it is critical that restructuring efforts are intensified. Slow-paced and low-quality restructuring will not reduce the still high financial vulnerability of firms and financial institutions to economic shocks. Corporate and financial restructuring combined with institutional and governance reforms, thus, requires renewed efforts if the region is to benefit from the eventual recovery. This will have to involve more rapid disposition of assets by AMCs; faster progress on operational restructuring; and deeper reforms of the regulatory, supervisory, and corporate governance regimes.

Overall lessons

A key lesson from other countries' approaches to systemic crisis is that governments need to have a consistent, overall framework for banking and corporate restructuring. This includes, among others, a consistency between the institutional development of a country and the realism of certain approaches. Clearly, institutional deficiencies can rule out certain approaches in some countries, although they may be best practice in others. These best practices can include, for example, a heavy reliance on a market-based corporate restructuring approach—where banks are recapitalized and asked to work out debts. But in an environment where corporate governance and financial system regulation and supervision are weak, this may be a recipe for asset stripping or looting, rather than sustainable restructuring. Clearly, from this context alone, emerging markets will need different approaches in systemic restructuring from developed countries.

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