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

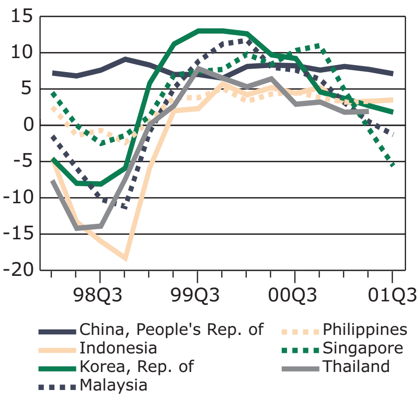
[1]Defined here as the 10 Association of Southeast Asian Nations countries (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam), plus the People's Republic of China and Republic of Korea.

[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 National Bureau of Economic Research of the US 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

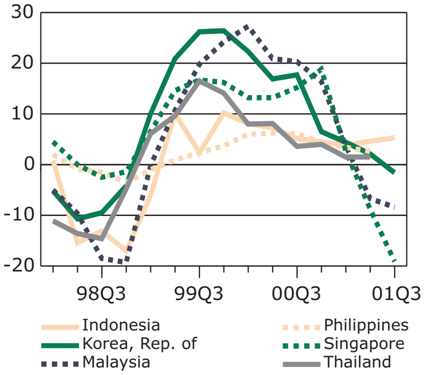
During this year, growth has slowed in most of East Asia (Figure 1). Those countries that are closely linked to the global economy through trade and capital flows have been more adversely affected than those where these linkages are weaker. Similarly, countries with heavier dependence on electronics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

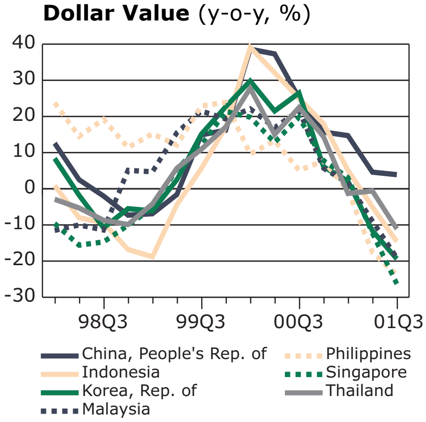


Sources: ARIC Indicators.

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.

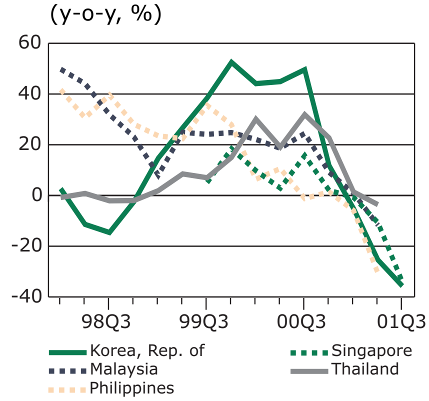
The growth slowdown has been driven by a sharp slowdown in the region's exports, as the world economy slowed and world trade decelerated. The dollar value of exports of the five crisis-affected countries (which account for about 60 percent of East Asia's exports) declined by 8.8 percent in the first 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, %)



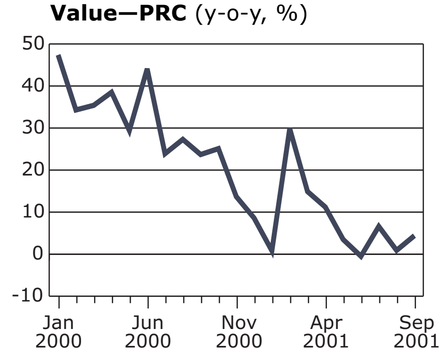
Source: ARIC Indicators.

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



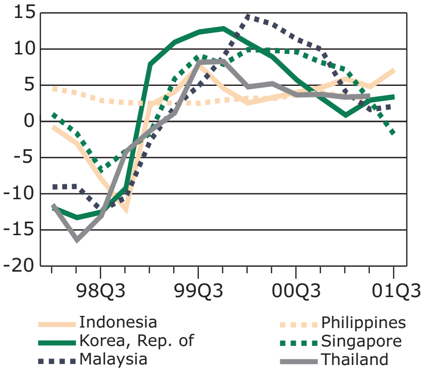
Sources: Bank of Korea; Bank Negara Malaysia; National Statistics Office, Philippines; Bank of Thailand; and Bloomberg.

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



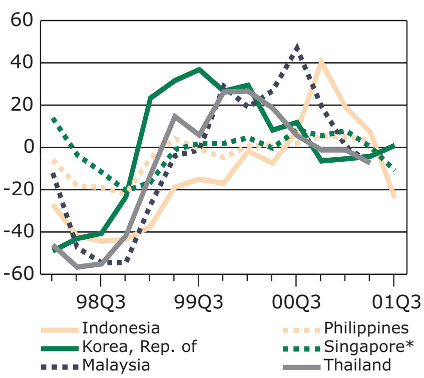
Source: ARIC Indicators.

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



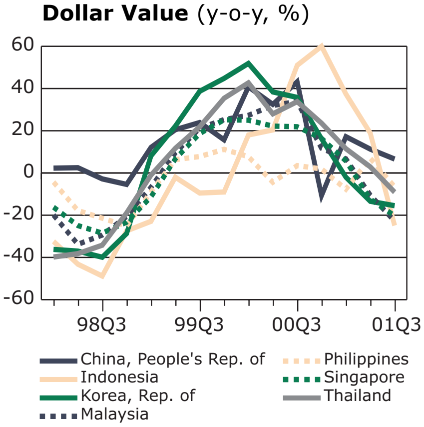
Source: ARIC Indicators.

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).

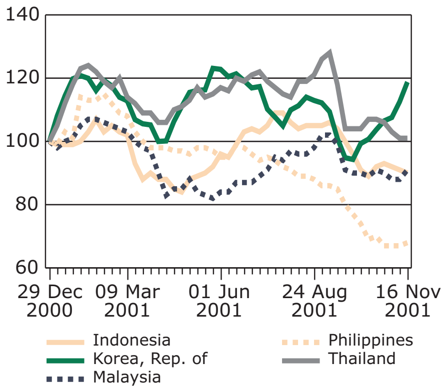
Declining export growth has reduced imports, particularly where import-intensity of exports is high. Further, slower economic growth has reduced the appetite for imports (Figure 8). The dollar value of imports of the five crisis-affected countries contracted by 6.3 percent in the first three quarters 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.

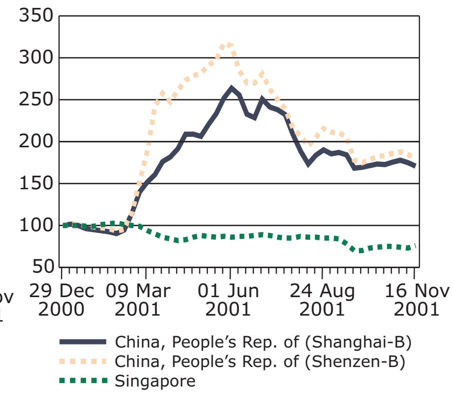
With the exception of the Indonesian rupiah, Brunei dollar, and Singapore dollar, most major regional currencies, after weakening against the US dollar in the first quarter, have remained relatively stable in the second and third quarters (Figures 11a and 11b). So far this year, the rupiah has depreciated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



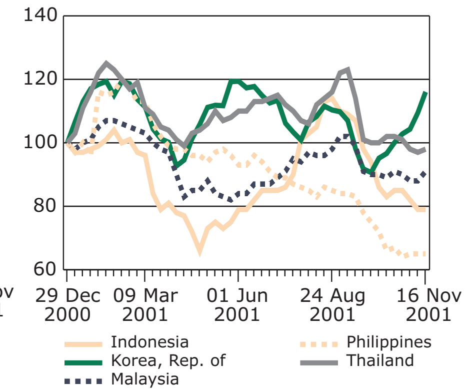
*Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), and SET Index (Thailand).
Source: REMU staff calculations derived from Bloomberg.

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



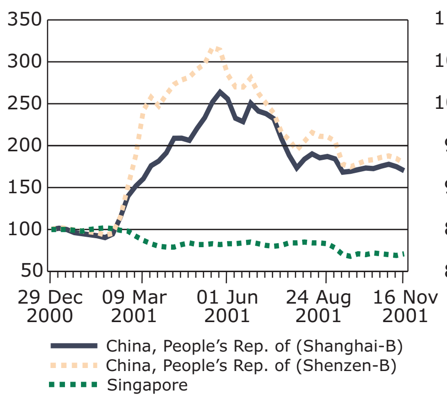
*Weekly averages of Shanghai-B (PRC), Shenzen-B (PRC), and SESALL (Singapore).
Source: REMU staff calculations derived from Bloomberg.

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



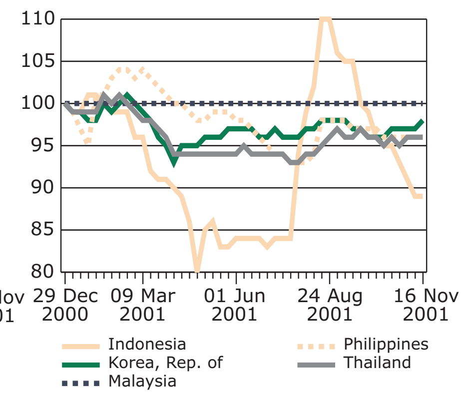
*Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), and SET Index (Thailand). The exchange rate used in the conversion to dollar is from the NY Composite.
Source: REMU staff calculations derived from Bloomberg.

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



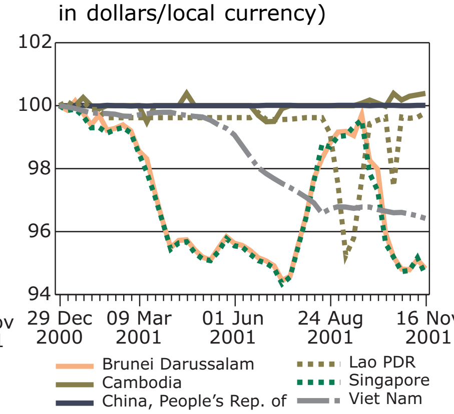
*Weekly averages of Shanghai-B (PRC), Shenzen-B (PRC), and SESALL (Singapore). The exchange rate used in the conversion to dollar is from the NY Composite.
Source: REMU staff calculations derived from Bloomberg.

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.

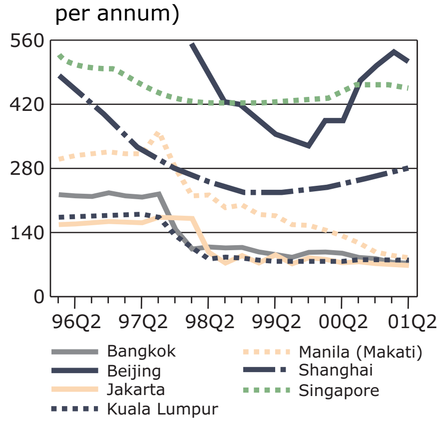
by 5 percent. In the first half of the year, the Malaysian ringgit came under some pressure in the face of sluggish export growth and falling foreign exchange reserves; and there was speculation that the ringgit's peg to the US dollar would be broken. Subsequently, foreign exchange reserves have stabilized 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.

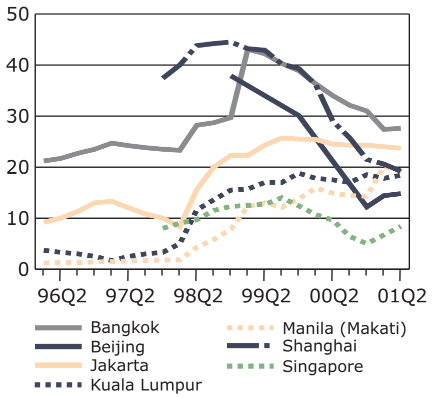
reserves continue to increase, reaching $200 billion by October 2001. However, sporadic weakening of the yen did raise concerns in the People's Bank of China, the country's central bank, about the exchange rate and competitiveness of the country's exports. Compared to end-2000, the Viet Nam dong has 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** (%)



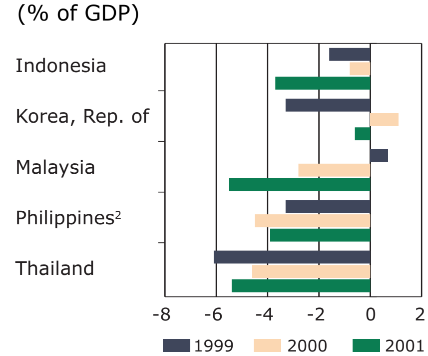
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

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).

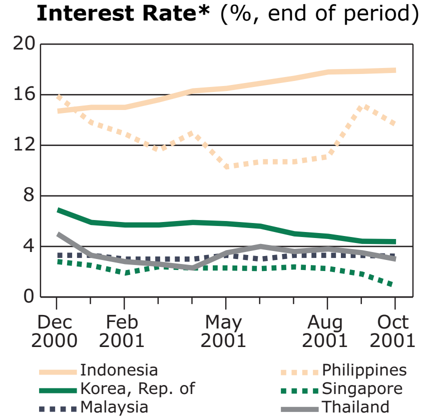
It is too early to judge the macroeconomic effects of these fiscal and monetary policy responses, especially because the latter work with substantial time lags. Given continued strong growth in the PRC, it appears that fiscal stimulus measures have helped to counter, at least partially, the externally 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)



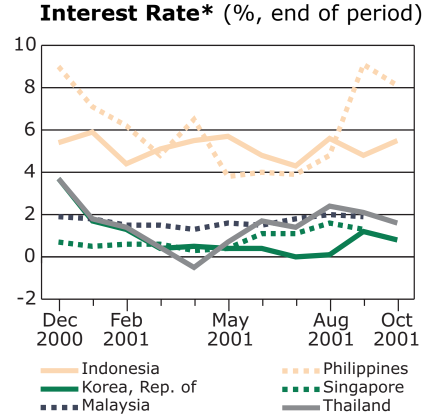
[1]Data refer to the central government budget for Indonesia, public sector budget for Malaysia, Philippines, and Thailand, and consolidated central government budget for Korea.
[2]As percent of GNP.
Source: Institute of International Finance, Country Economic Reports, various issues.

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)



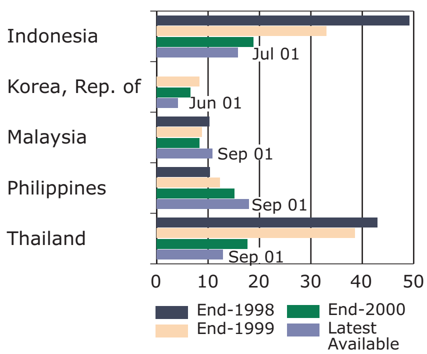
*Three-month interbank lending rate less inflation rate.
Source: ARIC Indicators.

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.

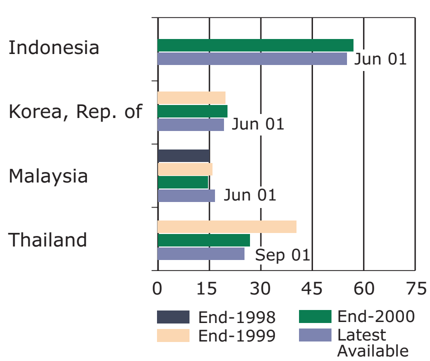
In some countries, the scope for continuation of expansionary fiscal policy is also constrained by the need for fiscal support for recapitalization and restructuring their banking systems and corporate restructuring. Moreover, public sector debt constrains further fiscal stimulus measures where public 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.

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.

Financial and Corporate Restructuring

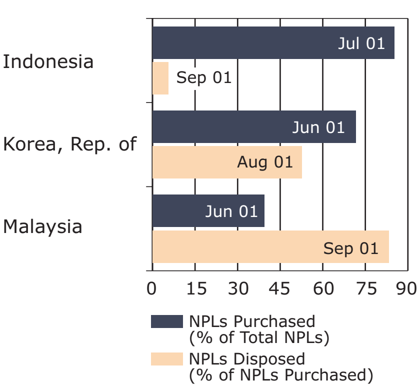
During most of this year, the pace of financial and corporate restructuring in several countries has been slowed by sluggish economic growth and subdued asset markets.

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.

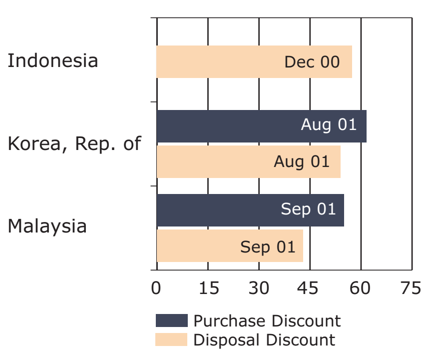
Capital adequacy ratios (CARs) of commercial banks in four of the five crisis-affected countries (Indonesia excluded) have exceeded the 8 percent Basle norm for some time (Figure 21). The Philippine banking system has a CAR of about 16 percent, while Korea, Malaysia, and Thailand maintain CARs in excess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



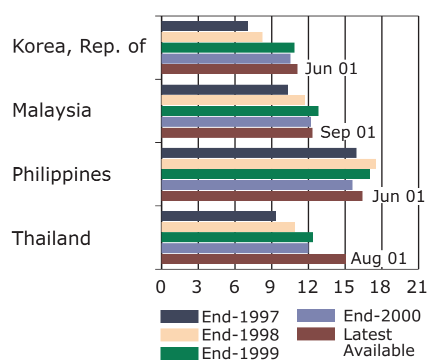
*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia, as of the dates indicated.
Source: ARIC Indicators.

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



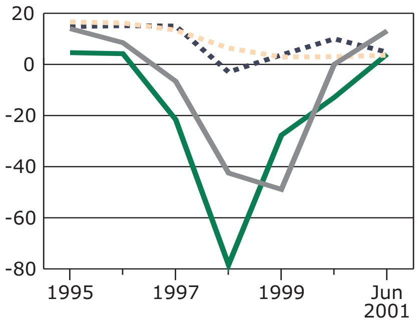
*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia, as of the dates indicated.
Source: ARIC Indicators.

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



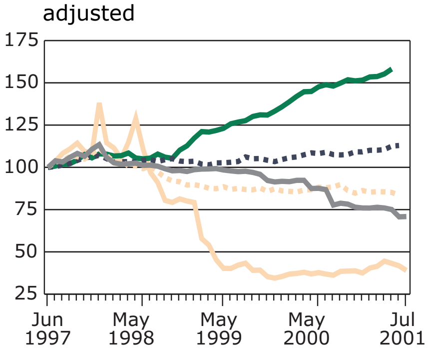
Source: ARIC Indicators.

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



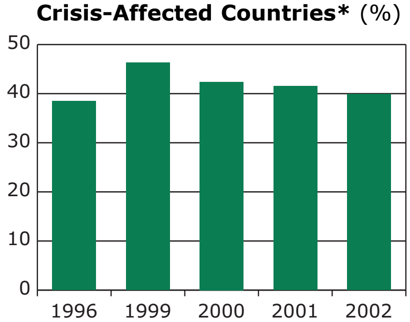
*Data refer to average return on equity of commercial banks except for Malaysia, which refer to listed commercial banks only. Data for Korea is as of March 2001.
Sources: Web sites of the Financial Supervisory Service, Bangko Sentral ng Pilipinas, Stock Exchange of Thailand, and Bloomberg.

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.

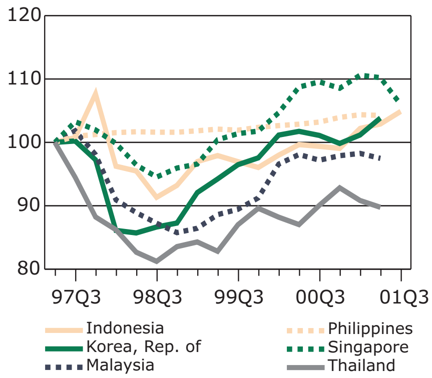
Progress in restructuring the corporate sector has proceeded much more slowly than in the financial sector. While the crisis-affected countries have gone some way toward reducing their excessive debt-equity ratios, rescheduling corporate debt, and lengthening debt maturity, operational restructuring 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.

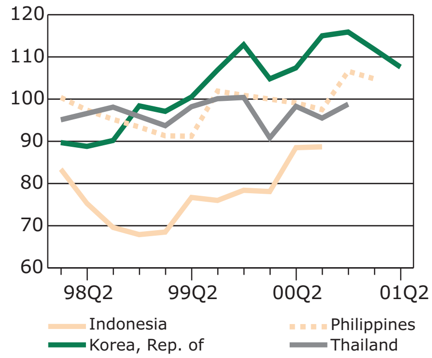
The pace of poverty reduction has probably received a setback from this year's economic slowdown. Latest World Bank estimates support this view. Although there are some differences across countries, in the five crisis-affected countries taken together, the incidence of $2 per day poverty is estimated 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



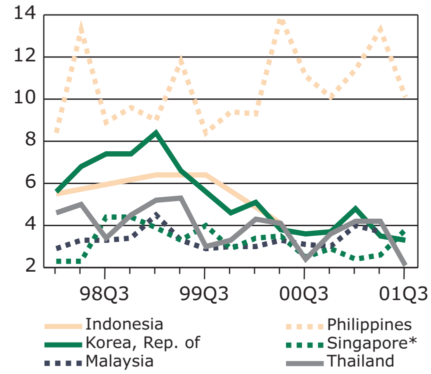
Source: ARIC Indicators.

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.

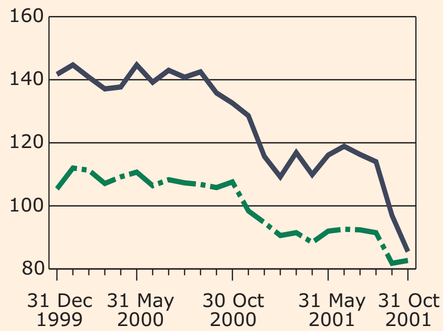
Moreover, as the September Update of the ARR cautioned, unlike previous downturns (which were caused mainly by a contraction in consumer demand after central banks raised interest rates to rein in inflation), this year's global slowdown was caused by a boom-bust cycle in investment, especially in the 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

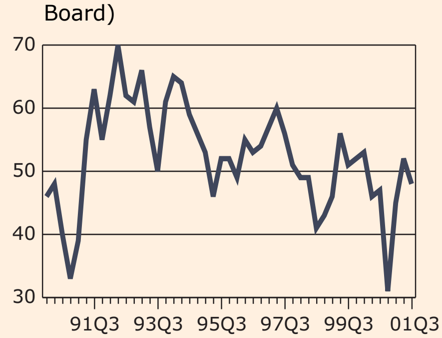
Box 1: **The 11 September Attacks—Impacts on the US**

Figure 1.1: **US Consumer Confidence Index**



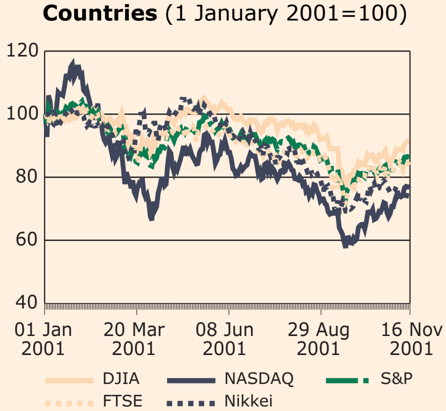
Conference Board numbers released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

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.

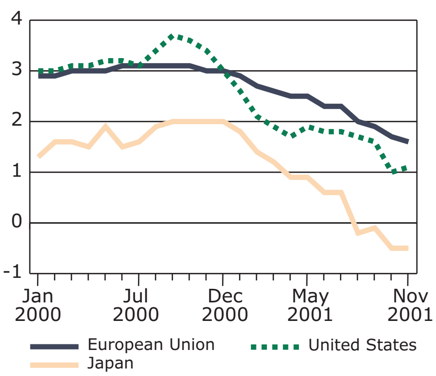
(down from the 1.3 percent forecast made before 11 September) and world GDP growth at 2.4 percent (slightly lower than the 2.6 percent forecast made before 11 September) (Table 2). This figure of 2001 world GDP growth is higher than the rates posted during the previous global recession years of 1975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

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.

Capital Flows Channel

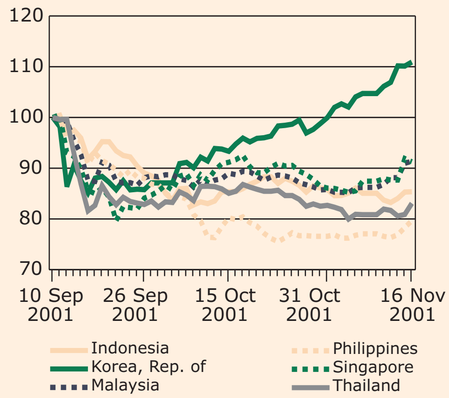
Even before 11 September, the weakening global economy was causing a decline in capital flows to the region. The 11 September attacks have worsened investor sentiment to the region. In the immediate aftermath of the attacks, bond market spreads increased in all East Asian countries (Figure 3.2). However, 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.

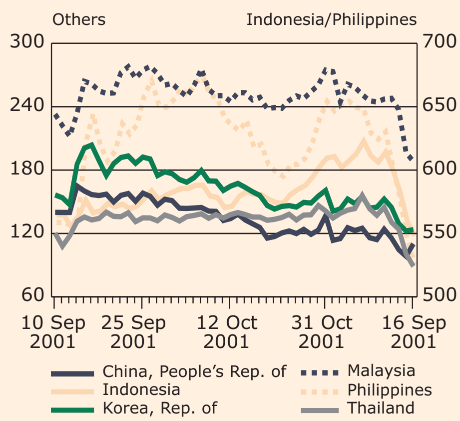
Apart from trade volumes, terms of trade are also likely to be affected by a contraction in global demand for goods and services. Although manufactures tend to dominate the external trade of most regional economies, the high share of electronic exports in total exports and the sharp contraction in their 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).

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



Source: Bloomberg.

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



Source: Bloomberg.

Services Sector Linkages

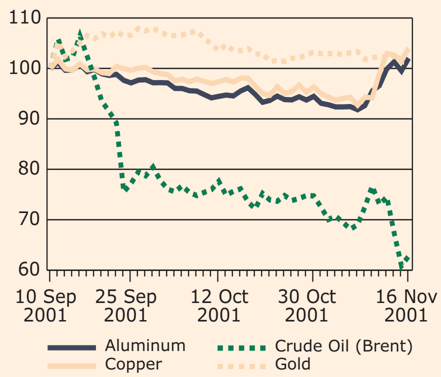
Tourism and airlines are two service sectors that are likely to be most affected following the 11 September attacks. The effect on the tourism sector is, however, likely to be highly varied across countries, depending on the share of tourism in the economy, which ranges from around 1.9 percent of GDP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

Continued next page

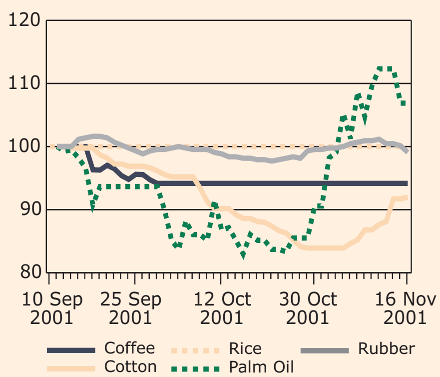
Box 3: **The 11 September Attacks—Transmission Mechanisms to East Asia** (Cont'd)

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, %)

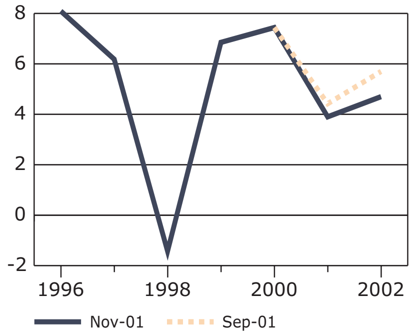


Figure 29b: **Weighted Average GDP Growth Rates*—East Asia excluding PRC** (y-o-y, %)

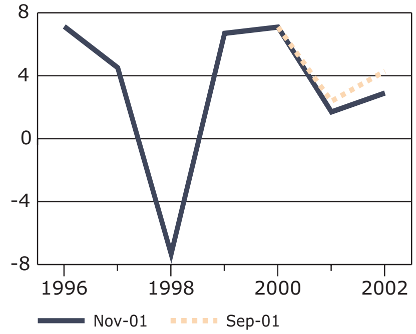
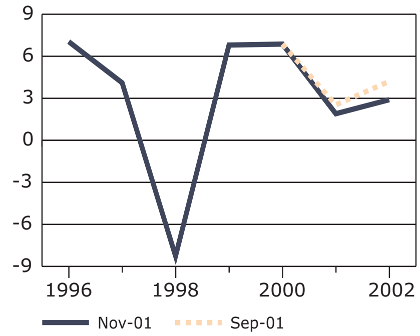


Figure 29c: **Weighted Average GDP Growth Rates*—Five Crisis-Affected Counries** (y-o-y, %)



*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.

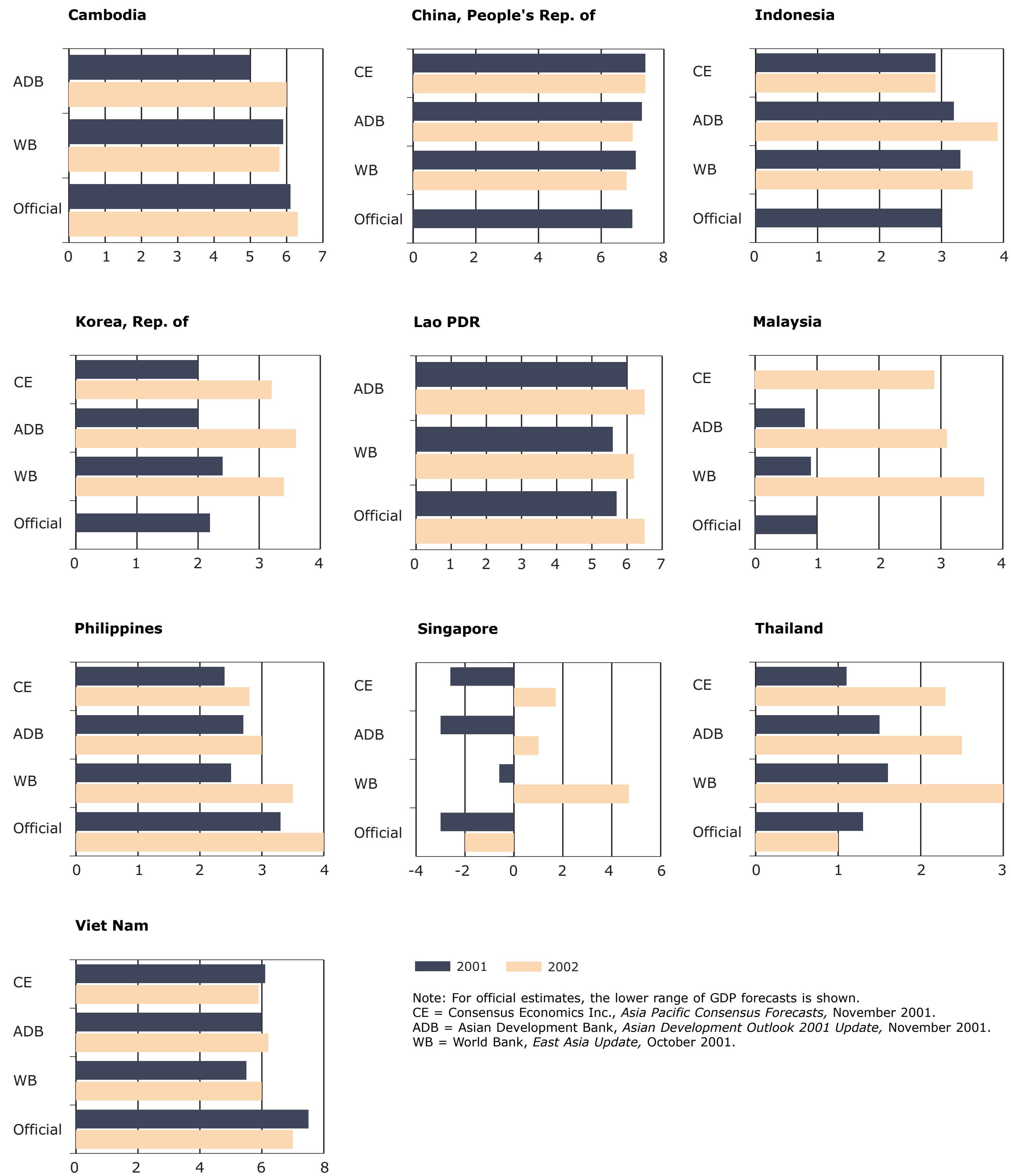
Among the East Asian countries, growth this year is expected to be robust only in the PRC (7.4 percent), Cambodia (6.1 percent), Viet Nam (6.1 percent), and Lao PDR (5.7 percent). GDP is expected to contract in Singapore by 2.6 percent, to remain stagnant in Malaysia, and to grow by less than 3 percent 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.

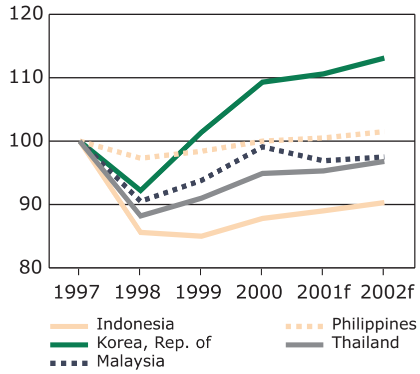
Lower growth this year and the next will also impact adversely on the pace of poverty reduction among these countries. Recent World Bank estimates support this assessment. Also, as discussed earlier, the pace of financial and corporate sector reforms has slowed in some countries this year because of 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** (%)



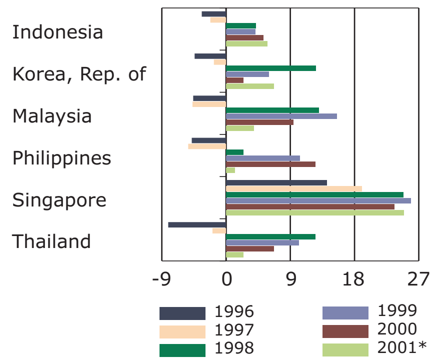
Note: For official estimates, the lower range of GDP forecasts is shown.
CE = Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* November 2001.
ADB = Asian Development Bank, *Asian Development Outlook 2001 Update,* November 2001.
WB = World Bank, *East Asia Update,* October 2001.

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)

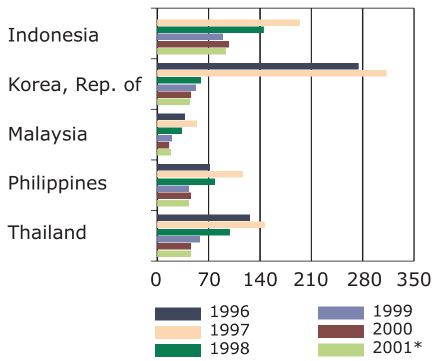


*2001 data until 2Q2001, except Indonesia (data are until 1Q2001) and Singapore (data are until 3Q2001).
Source: ARIC web site and Ministry of Trade and Industry (Singapore).

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.

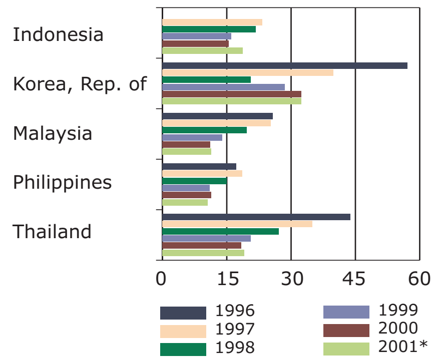
Judged by several prudential indicators, today the region is more resilient to a 1997-type crisis. Almost all East Asian countries, including the five crisis-affected countries, now run current account surpluses (Figure 32). Foreign exchange reserves have improved significantly and more than cover the 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)



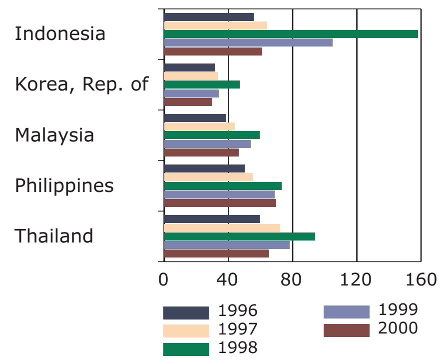
*Data as of June 2001.
Sources: ARIC Indicators except data for Indonesia which are taken from Nomura International and Bisnis Indonesia.

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.