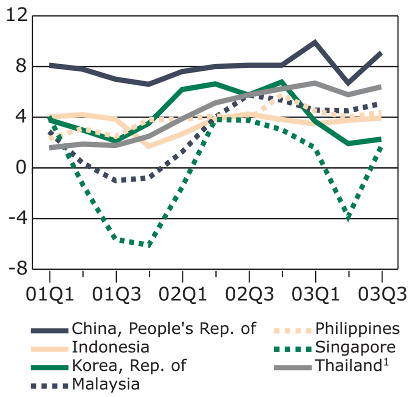
East Asia's Growth and Restructuring—Regional Overview

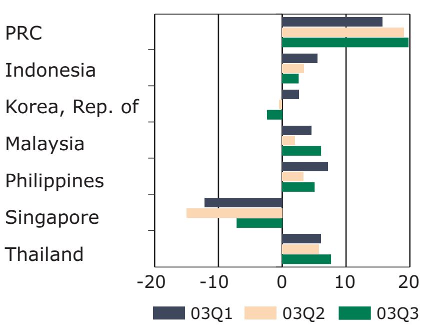
Economic Performance in 2003

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



[1]Based on advance estimates for the third quarter, 2003.
Source: ARIC Indicators.

Figure 2: **Growth of Domestic Demand[1]** (y-o-y, %, at constant prices)



[1]Based on national income accounts except for PRC which is the sum of retail sales and fixed investment (at constant 1997 prices).
Source: ARIC Indicators.

Real Sector Developments

Economic performance in East Asia[1] has been much better in the second half of 2003 than it was in the first. The region moved from a lackluster performance into a synchronized upswing in growth.

Growth in gross domestic product (GDP) across most of East Asia had slowed in the first half, mostly because the external environment turned unfavorable for the third time in as many years, and as a result of the outbreak of Severe Acute Respiratory Syndrome (SARS). As projected in the July 2003 Asia Economic Monitor (July AEM), with the control of SARS and the emergence of more positive economic news from the industrial countries, the decelerating trend in growth was generally reversed in the third quarter.

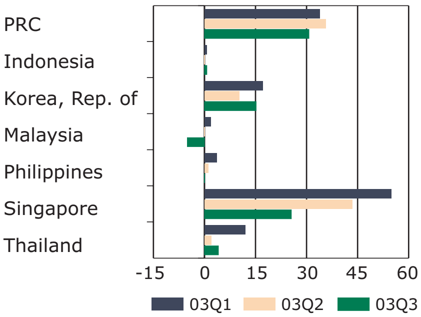
Growth has strengthened across the region since then. All seven East Asian countries for which quarterly GDP data are available—People's Republic of China (PRC), Indonesia, Republic of Korea (Korea), Malaysia, Philippines, Singapore, and Thailand—registered higher growth in the third quarter than in the second (Figure 1). These seven countries, which account for 98% of East Asia's total GDP, together grew by 6.4% in the third quarter compared with 4.7% in the second quarter.[2]

With the major exception of Korea, a strengthening of domestic demand underpinned the turn around in the third quarter (Figure 2). Domestic demand, which had slowed in the second quarter almost across the region primarily because of the SARS outbreak, turned around in the third quarter. Also, tourism recovered strongly across the region, except in Indonesia, where the recovery was delayed by the August terrorist attack in Jakarta. In most of these countries, private consumption bounced back from the SARS-induced slowdown in the second quarter. There are tentative signs that fixed investment is also picking up, after falling sharply in the immediate years after the 1997 financial crisis and remaining dormant since. In Korea, where the SARS-induced

[1]Defined here as the 10 members of the Association of Southeast Asian Nations (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.

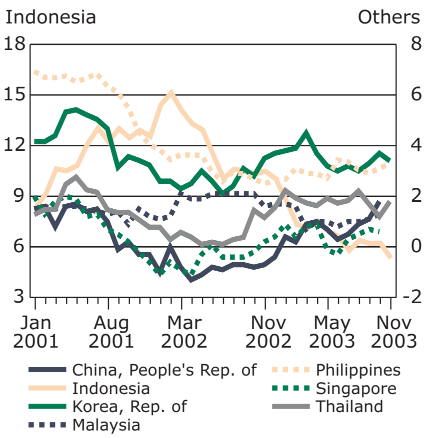
[2]Unless otherwise indicated, all growth figures are year-on-year.

Figure 3: **Growth of Exports of Goods and Services**[1] (y-o-y, %, at constant prices)



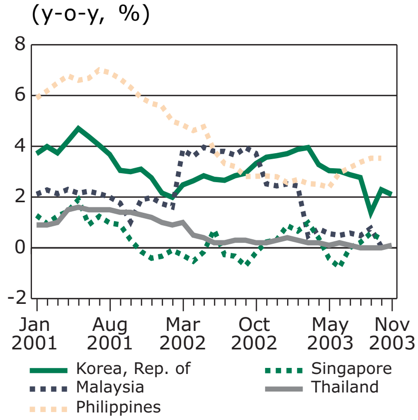
[1]Based on national income accounts except for PRC which is based on merchandise exports at 1997 prices.
Source: ARIC Indicators.

Figure 4: **Headline Inflation** (y-o-y, %)



Source: ARIC Indicators.

Figure 5: **Core Inflation** (y-o-y, %)



Source: Bank of Thailand and REMU staff estimates.

disruption was perhaps least severe, faster export growth, rather than domestic demand, was the driving force behind higher GDP growth in the third quarter (Figure 3). Korean consumers are adjusting their balance sheets following a surge in consumer credit in previous years. As a result, consumer spending continued to contract in the third quarter.

Although strengthening domestic demand and growth has been accompanied by some increase in prices, inflation remains low across the region with the exception of Indonesia[3] (Figure 4). Consumer price inflation is below 2% in Singapore, Malaysia, Thailand, and PRC, and below 4% in the Philippines and Korea. Even in Indonesia, annual inflation declined from more than 10% at the end of 2002 to about 6% in 2003. For some countries, core inflation (excluding the more volatile food and energy prices) is even lower than headline inflation (Figure 5). For example, core inflation is now close to zero in Malaysia, Singapore, and Thailand, and just above 2% in Korea. Overall, therefore, there are few signs that the current economic rebound in the region is causing excess demand pressures. However in the PRC, the fast pace of fixed investment has prompted a tightening of monetary policy in recent months.

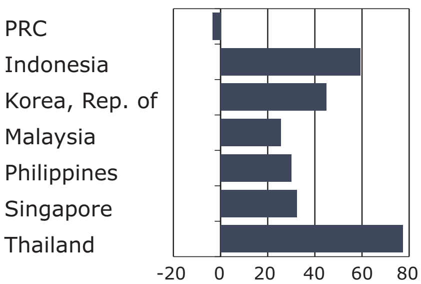
Financial Markets

East Asia's stock markets, after remaining generally subdued in the first quarter, began rising in the second quarter. This turn around reflected a number of positive factors that improved the region's growth outlook and corporate earnings prospects. These included the reduction of uncertainties associated with the Iraq war, the emergence of several positive economic indicators from the US and Japan, continued low interest rates, and above all, the quick, effective control of SARS (See July 2003 AEM for a more detailed discussion). There was also a turn around in portfolio investment to the stock markets of the five crisis-affected countries this year (see Box 1).

On top of their impressive gains in the second quarter, stock markets continued their buoyancy in the third quarter, except in the PRC. Since the beginning of the second quarter, gains in stock prices (in terms of local currency) were a whopping 78% in Thailand, followed by 60% in Indonesia, 44% in Korea, and between 25–35% in Malaysia, Philippines, and Singapore (Figure 6). These markets generally outperformed the US stock market. Relative to the broad Russell 3000 index in the US,

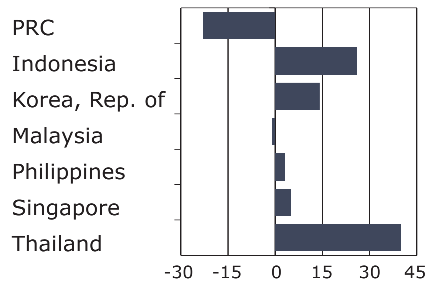
[3]Inflation remained high in Lao PDR (15% in August) and in Myanmar (61% in February).

Figure 6: **Percent Change in the Composite Stock Price Indexes**[1] (between end-March 2003 and week ending 5 Dec 2003, local index)



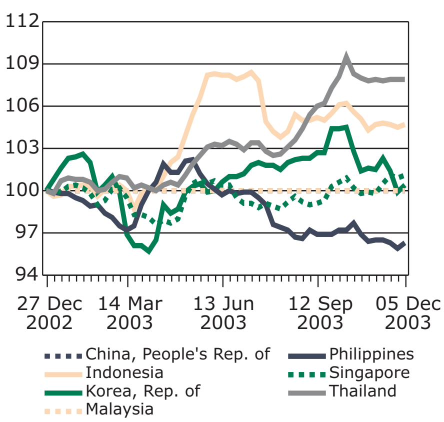
[1]Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand). For PRC, the index is based on the weekly average of the Shanghai A & B and Shenzen A & B indexes, weighted by the market capitalization of each market.
Source: REMU staff calculations derived from Bloomberg data.

Figure 7: **Percent Change in Stock Market Index**[1] **Relative to Russell 3000 Index** (between end-March 2003 and week ending 5 Dec 2003)



[1]Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand). For PRC, it is an index based on the weekly average of the Shanghai A & B and Shenzen A & B indexes, weighted by the market capitalization of each market.
Source: REMU staff calculations derived from Bloomberg data.

Figure 8: **Exchange Rate Indexes** (weekly average, last week of Dec 2002=100, \$/local currency)



Source: REMU staff calculations derived from Bloomberg data.

stock price indexes in most of these countries were higher (by about 40% in Thailand, 27% in Indonesia, 14% in Korea, over 3% in the Philippines and Singapore), while Malaysia's stock market performance more or less matched that of the US (Figure 7). This year's poor performance of the PRC's stock market has been largely due to continued uncertainties over government plans to divest state ownership in listed companies. Investors' concerns over the quality of corporate governance on the back of several recent corporate scandals also contributed to stock market weakness.

Trends in regional exchange rates against the US dollar have been mixed (Figure 8). In the first 11 months of the year, while the Indonesian rupiah and the Thai baht appreciated against the US dollar (by 5% and 8% respectively), the Korean won and the Singapore dollar were little changed, as were the Malaysian ringgit and the PRC yuan which are de facto fixed to the US dollar. With about 4% depreciation against the US dollar, the Philippine peso bucked the regional trend. A number of factors contributed to the peso's weakness. These include concerns over fiscal sustainability, a worsening external payments position, and political uncertainties ahead of the 2004 elections.

Regional currencies, however, generally depreciated in nominal effective terms, except the Thai baht, which appreciated by about 2%. The levels of depreciation varied across countries. During the year, nominal effective currency depreciations amounted to 8% for the Philippines, Box 1: **Are Capital Flows Starting to Return to the Crisis Countries?**

The Institute of International Finance (IIF) estimates that net private capital flows to emerging markets will reach $161.9 billion in 2003 from a trough of $121.2 billion in 2002. In 2004, private flows to emerging markets are forecast to rise further to $185.7 billion. These improved prospects reflect both the expected recovery in the global economy and the positive shift in investor sentiment toward emerging markets. In terms of regional distribution of private capital, the Asia-Pacific region is expected to receive $84.2 billion this year, slightly over half of total private flows to emerging markets. After softening last year, private capital flows to emerging markets in Latin America are expected to reach $26.4 billion in 2003, a gain of $11.4 billion from 2002. Private capital flows to emerging markets in Europe are expected rise to $45.4 billion this year from $38.6 billion in 2002. For 2004, private capital flows are projected to increase in all regions, with emerging markets in Latin American posting the biggest gains.

Net private capital inflows to the five crisis-affected countries in Asia (Indonesia, Korea, Malaysia, Philippines, and Thailand) are expected to have increased slightly in 2003 to $11.7 billion from $11.1 billion in 2002 and $9.1 billion in 2001 (see Table 1), mainly because of an increase in portfolio investment into stock markets. The five stock markets have drawn in an estimated net $4.6 billion because of improved prospects and lower returns elsewhere. This compares with a net portfolio outflow of $600 million in 2002.

Other types of capital flows, however, have continued to slow this year. Net foreign direct investment into the five countries has fallen to an estimated $3.9 billion from $5.8 billion last year. Lending by commercial banks is down to $5 billion from $5.4 billion, and there has been a net outflow of $1.7 billion in nonbank credit as the countries repaid maturing debt. Only the Philippines and Korea were active in bond issuance.

In 2004, net private capital inflows to the crisis-affected countries are expected to increase further to $13.4 billion, mainly from more rapid inflows of both portfolio capital and FDI. The latter is expected to increase from $3.9 billion to $5.8 billion—the first increase in the level of inflows since 1999—and the former from $4.6 billion to $5.8 billion. Net borrowing from commercial banks is expected to decline further and nonbank credit is again likely to register an outflow as countries continue to pay down their debt.

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

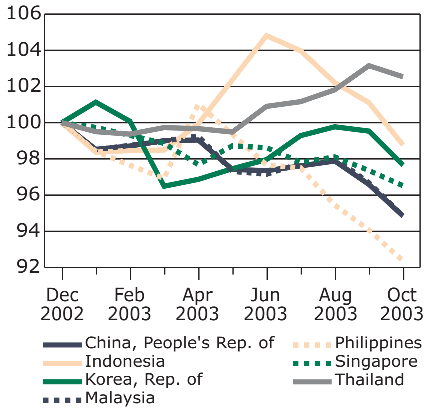
	1998	1999	2000	2001	2002e	2003f	2004f
Net private flows	-35.32	-4.62	16.58	9.07	11.10	11.69	13.43
Equity investment, net	17.81	30.51	24.61	19.52	5.23	8.45	11.60
Direct equity investment, net	13.54	15.96	13.08	9.88	5.83	3.90	5.80
Portfolio equity investments, net	4.26	14.55	11.53	9.64	-0.60	4.55	5.80
Private creditors, net	-53.12	-35.12	-8.03	-10.45	5.87	3.24	1.83
Commercial banks, credit flows, net	-47.66	-32.11	-10.91	-8.17	5.37	4.96	2.33
Other private creditors, net	-5.46	-3.01	2.89	-2.28	0.50	-1.72	-0.49

e = estimate; f = forecast
Note: Data are as of September 21, 2003.
Source: Institute of International Finance.

5% for Malaysia and the PRC, 3% for Singapore, 2% for Korea, and 1% for Indonesia (Figure 9).

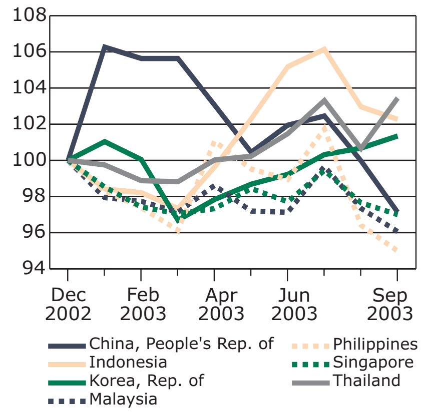
Given the low inflation environment in the region, nominal effective depreciations have generally translated into real effective depreciations. With the exception of Thailand, Indonesia, and Korea, regional currencies depreciated in real effective terms (Figure 10). These real

Figure 9: **Nominal Effective Exchange Rate** (Dec 2002=100)



Note: An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: REMU staff calculations.

Figure 10: **Real Effective Exchange Rate** (Dec 2002=100)



Note: An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: REMU staff calculations.

Figure 11: **Policy Rates**[1]
(end of week, % per annum)

[1]Indonesia: Deposit Facility Overnight Discount Rate; Korea: Overnight Call Rate; Malaysia: 3-month Intervention Rate; Philippines: Overnight Reverse Repurchase Rate; Thailand: 14-day Repo Rate.
Source: Bloomberg.

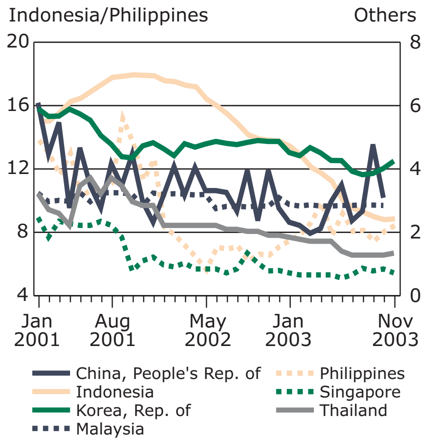
effective depreciations ranged from about 3% for the PRC and Singapore to 5% for the Philippines.

Fiscal and Monetary Policies

Since July, central banks in the region have generally kept policy interest rates unchanged (Figure 11), and short-term interest rates have thus remained relatively stable, many of them at historic lows. Short-term interest rates are now below 1% in Singapore, marginally higher than 1% in Thailand, about 3% in PRC and Malaysia, and about 4% in Korea (Figure 12). Only Indonesia and the Philippines have relatively high short-term interest rates above 8%. Adjusted for the modest rise in inflation, real short-term interest rates have fallen further. Real rates are now just over zero in Thailand, Singapore and Korea, about 1.5% in the PRC and Malaysia, about 3% in Indonesia, and about 5% in the Philippines (Figure 13).

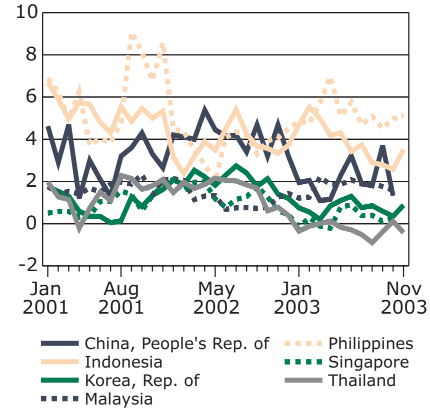
For some time, rapidly rising foreign exchange reserves have made monetary management in some East Asian countries more challenging. Favorable current account balances, and more recently, increased capital inflows have led to large reserve accumulations by several

Figure 12: **Short-Term Interest Rates**[1] (nominal, end of month, % per annum)



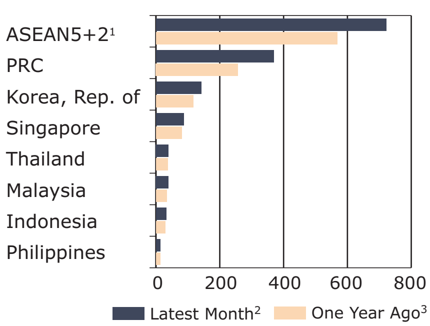
Source: ARIC Indicators.
[1]Three-month interbank lending rates—
PRC: Average trading rate in interbank borrowing and lending market (People's Bank of China); Indonesia: Weighted average of banks' interbank lending rates (Bank Indonesia); Korea: Certificate of deposit (3 months); Malaysia: Average of interbank deposit rates (Bank Negara); Philippines: PHIBOR (Bankers Association of the Philippines); Singapore: SIBOR (Association of Banks in Singapore); Thailand: Bangkok Bank's interbank offer rate (Bangkok Bank).

Figure 13: **Short-Term Interest Rates**[1] (real, end of month, % per annum)



Source: ARIC Indicators.
[1]Three-month interbank lending rates.

Figure 14: **Gross International Reserves Less Gold, End of Period** ($ billion)

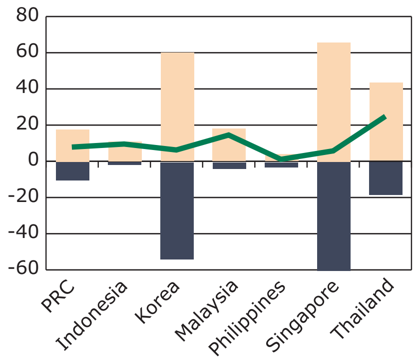


[1]PRC, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand.
[2]Refers to September for Korea and Thailand; August for others.
[3]From latest month.
Source: International Monetary Fund, *International Financial Statistics,* November 2003.

countries (Figure 14). If unsterilized, these large reserve accumulations would have led to faster increases in reserve money and to a real appreciation of regional currencies. However, the PRC, Korea, Singapore, and Thailand, seem to have sterilized these reserve accumulations to varying degrees. In the last year or so, the growth in reserve money in these countries has been much lower than the growth in foreign exchange reserves would suggest (Figure 15). The effects of reserve accumulations on domestic money supply and exchange rates were thus muted to varying degrees.

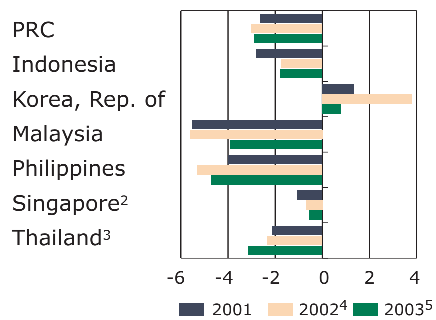
As noted in July, several countries continued to budget for moderately expansionary fiscal policies this year. The budgeted fiscal positions range from a surplus of 0.7% of GDP in Korea to a deficit of 4.7% of GDP in the Philippines (Figure 16). Subsequently, the original budgets were also supplemented by additional fiscal and quasi-fiscal stimulus packages equivalent to 2% of GDP in Malaysia, 0.7% of GDP in Korea, 0.2% of GDP in the PRC, and 0.1% of GDP in Singapore.

Figure 15: **Sources of Growth of Reserve Money** (latest value[1] compared with one year ago, %)



[1]July for Korea; August for PRC, Malaysia, Singapore and Thailand; and September for Indonesia and Philippines.
Source: REMU staff calculations based on data from the International Monetary Fund, *International Financial Statistics,* November 2003.

Figure 16: **Fiscal Balance[1]** (% of GDP)



[1]Data refer to central government for Korea, Philippines, Singapore, and Thailand; federal government for Malaysia; central and local government for PRC; and state budget for Indonesia.
[2]Data are for fiscal year April–March. Data for 2003 were calculated using GDP and CPI forecasts for 2003.
[3]Data are for fiscal year October–September.
[4]Based on revised budget.
[5]Based on programmed budget.
Source: ARIC Indicators, national web sites, Asian Development Bank, *Asian Development Outlook 2003 Update,* IIF country reports.

During the course of the year, actual fiscal trends were more or less in line with the budgeted targets in Indonesia and the Philippines, but actual fiscal outcomes in other countries diverged to varying degrees. Through September, the fiscal deficit was about two-thirds of its full year target in Indonesia, while in the first 10 months, the actual fiscal deficit was about 80% of its full year target in the Philippines. In both these countries, actual revenues as well as expenditures were largely in line with their corresponding budgetary targets.

In the first nine months of 2003, trends in actual revenue in the PRC were more or less in line with its target, but expenditure grew at a lower rate than anticipated in the budget. As a result, the first nine months of the year saw the PRC budget post a surplus of CNY87 billion, compared with the CNY320 billion deficit budgeted for the full year.

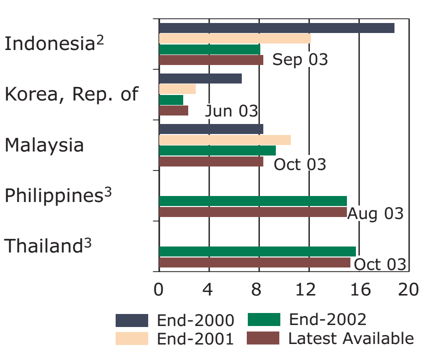
The experiences of Korea and Singapore were similar to that of the PRC. In the first nine months of the year, because actual expenditure grew at a lower rate than budgeted, Korea posted a fiscal surplus that was about twice the amount budgeted for the full year. Similarly, in April to September (the first six months of its fiscal year) Singapore posted a surplus of about S$9 billion, compared with the budget target of a deficit of S$1 billion for the full year. This was mostly due to shortfalls in actual expenditure from its budgeted level.

In Malaysia, in the first six months of the year, expenditure trends were largely in line with the budget, but because revenue did not keep pace, the budget posted a deficit equivalent to the full year target. If these trends continue, the actual fiscal deficit for the year could far exceed the original budget.

Thailand's experience was in sharp contrast to Malaysia's, with actual revenue growing much faster than budgeted, owing primarily to improved economic conditions and tax collections, and expenditures below the budgeted rate. In the fiscal year spanning October 2002 to September 2003, actual revenue collections were approximately 14.7% above amounts budgeted, while expenditures were about 3% lower. As a result, Thailand posted a surplus of B71.4 billion, compared with a deficit of B105.2 billion a year earlier.

Financial Restructuring and Prudential Indicators

Figure 17: **NPLs[1] of Commercial Banks** (% of total commercial bank loans)



[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis.
[2]Data refer to NPLs in the banking sector.
[3]NPL criteria were changed so no comparable data are available prior to 2002.
Source: ARIC Indicators.

Nonperforming Loans of Banks

In 2003, nonperforming loan (NPL) ratios of banks have either fallen or remained unchanged among the five crisis-affected countries, except in Korea where the ratio has increased marginally due to defaults on consumer loans. NPL ratios now range from about 2% in Korea to about 15% in the Philippines and Thailand, with Malaysia and Indonesia reporting NPL ratios of about 8% (Figure 17). These ratios are much lower than their peak levels at the height of the 1997 crisis.

The reduction of NPL ratios is largely the result of the transfer of substantial portions of bad debts from banks to centralized AMCs. These were set up by governments after the 1997 crisis to help clean up bank balance sheets. To a lesser extent, the drop in NPL ratios was also the result of voluntary corporate workouts directly between banks and their debtors (see Box 2).

Box 2: **Progress in Voluntary Corporate Workouts**

In addition to NPL resolution through AMCs, banks in the five crisis-affected countries have been restructuring problem debts through voluntary corporate workout schemes.

Indonesia

The Jakarta Initiative Task Force (JITF) reported the completion of 96 debt restructuring cases out of 117 registered cases as of October 2003. The completed cases involved $20.5 billion, or 70% of the $29.3 billion total face value of all the registered cases. This is a significant 13 percentage point improvement over 2002. However, JITF still needs to complete restructuring of the remaining 21 cases, amounting to almost $8.8 billion before the end of the year. A key impediment to restructuring is the lack of acceptable mechanisms to force equity owners to abandon control. This has led to a standoff with creditors rejecting debt write-offs in the face of owners' reluctance to relinquish corporate control.

Korea

The recent focus of *chaebols* workouts has been SK Global, now known as SK Networks, the trading arm of the SK Group and the country's third largest *chaebol*. SK Global plunged into crisis in March 2003 after it was found to have inflated 2001 earnings by more than W1.5 trillion, hiding an additional W500 billion in bank loans. To save SK Global from bankruptcy, the SK Group proposed a workout plan in June 2003 involving a swap of about W850 billion in debt owed by SK Global to SK Corp., the flagship company of the SK Group, for newly issued shares in the trading company. This paved the way for domestic creditor banks of SK Global to approve its debt workout package in June to convert W2.4 trillion of their combined loans of W6.1 trillion into newly issued shares of SK Global. Despite these developments, the final fate of SK Networks is still unsettled, as its domestic and foreign creditors have yet to reach an agreement on restructuring. In the meantime, under the formal out-of-court workout program introduced in June 1998 for medium-sized firms, 55 of a total 83 companies registered were dealt with through rehabilitation and/or sell-offs. Eighteen firms, with no prospect of completing the workout, have been put under court-mandated reorganizations or set for liquidation. Consequently, the number of companies under the formal out-of-court workout program fell to 10 as of end-2002.

Malaysia

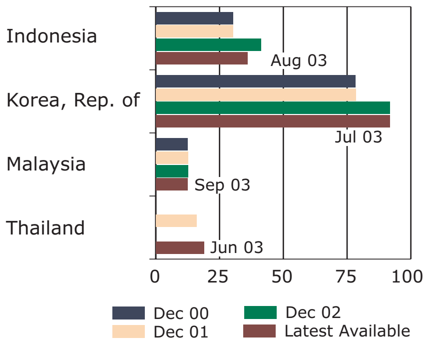
The Corporate Debt Restructuring Committee officially terminated operations in August 2002 after it completed restructuring 47 cases or 98% of those it accepted, worth RM43.97 billion in face value.

Thailand

As of end-September 2003, the Corporate Debt Restructuring Advisory Committee (CDRAC) had approved 15,386 cases of target debtors, with credits outstanding of B2,841.7 billion in face value, to enter the voluntary corporate workout process. Successfully restructured corporate debt totaled 10,346 cases with total credits outstanding of B1,398.3 billion, or 49.2% of CDRAC's portfolio. But around 44.3% of the total debt involving 4,945 cases remained unrestructured, and were either in the process of being filed or have already been filed by creditors for legal action. The delay in the debt restructuring process was primarily due to the buildup of complex cases filed in the courts. Meanwhile, as of end-September 2003, financial institutions have successfully restructured 606,661 cases amounting to B2,924.4 billion in face value, while 30,233 cases worth B107.9 billion, or roughly 3.8% of total debt, are still in the process of restructuring.

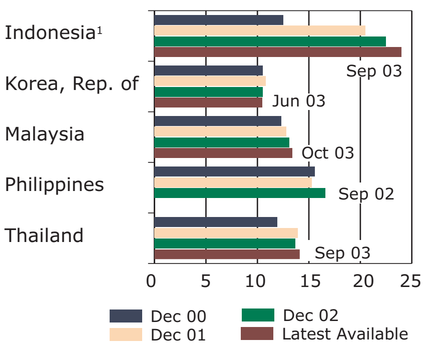
As of mid-2003, the cumulative volume of NPLs acquired by centralized AMCs among the five crisis-affected countries ranged from $12.5 billion in Malaysia to $91.8 billion in Korea (Figure 18). The Philippines does not have a centralized AMC. Instead, the Government passed the Special Purpose Vehicle (SPV) Act in December 2002 that provides a regulatory framework for privately-owned SPVs to buy NPLs from banks. However, as of end-November 2003, only one SPV had been approved. Its first possible deal, currently being studied, is for purchasing assets

Figure 18: **NPLs Purchased by AMCs** ($ billion)



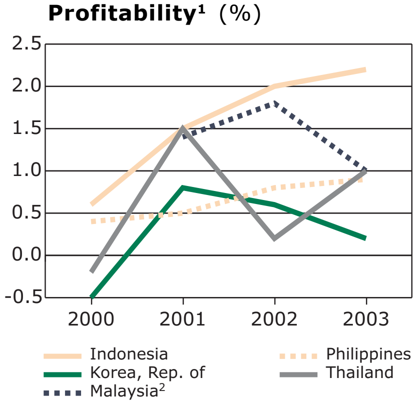
Source: REMU staff calculations based on data from IBRA, KAMCO, Danaharta, and TAMC.

Figure 19: **Capital Adequacy Ratios of Commercial Banks** (%)



[1]Refers to CAR of the banking system.
Source: ARIC Indicators.

Figure 20: **Banking Sector Profitability**[1] (%)



[1]Return on assets of commercial banks, latest available.
[2]Malaysia data from 2001.
Sources: World Bank, *East Asia and Pacific Regional Overview,* October 2003; Ministry of Finance and Economy, Korea.

worth an estimated P14 billion from Metrobank—the country's largest commercial bank.

Outside the five crisis-affected countries, NPL ratios vary. The four state-owned commercial banks in the PRC had an average NPL ratio of about 20% as of June 2003, a reduction of 3.5 percentage points from the January 2003 figure. Data on NPLs in the other East Asian countries are not readily available, but they are believed to be significant in Cambodia, Lao PDR, and Viet Nam.

Capital Adequacy and Bank Profitability

The capital positions of banking systems in the five crisis-affected countries have strengthened in recent years. Publicly funded bank recapitalization programs and consolidation initiatives including closure of weak banks, mergers, and acquisitions are the main reasons. The latest available data show that among the five countries, the risk-weighted capital adequacy ratios of commercial banks stood at 24% in Indonesia, 17% in the Philippines, more than 13% in Malaysia and Thailand, and about 10% in Korea (Figure 19). While these figures compare favorably with the 8% Basel norm, there are concerns that the capital adequacy figures in some of these countries may not truly reflect the current conditions of their banking systems because of potentially inadequate provisions for nonperforming assets.

Bank profitability, after recovering from negative levels during the crisis years, continued to improve in most crisis-affected countries. A combination of the overall improvement in economic conditions, higher interest margins, better cost controls, and lower provisioning contributed to the improvement. Latest available data show that the rate of return on assets (ROA) ranged from 0.2% in Korea to more than 2% in Indonesia, with Malaysia, Philippines, and Thailand reporting figures of about 1% (Figure 20).

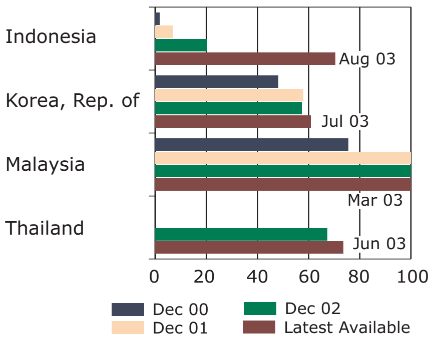
Asset Resolution by Asset Management Companies

As noted in July, the pace of asset resolution by AMCs varied significantly across the five crisis-affected countries, as did the recovery rate from the assets resolved.[4]

The percentage of assets resolved by the AMCs ranged from about 61% in Korea to 100% in Malaysia, with the AMCs in both Indonesia

[4]Asset resolution means the sale or restructuring of nonperforming assets.

Figure 21: **NPLs Resolved by AMCs**[1] (% of NPLs purchased)



[1]Refers to those held by IBRA in Indonesia, KAMCO in Korea, Danaharta in Malaysia, and TAMC in Thailand, as of dates indicated.
Source: ARIC Indicators.

and Thailand now completing resolution of about 70% of assets acquired from financial institutions (Figure 21).

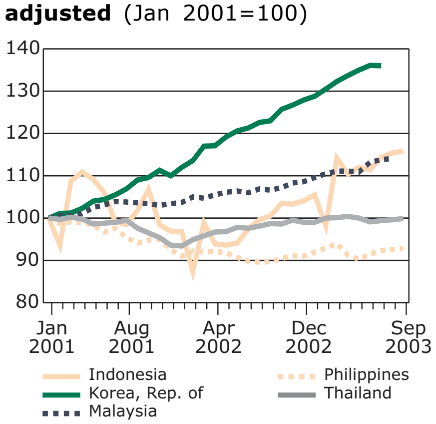
Since the beginning of 2003, progress made by the Indonesian Bank Restructuring Agency (IBRA) has been particularly impressive. With improvements in sales mechanisms and market conditions, 70% of the NPLs acquired by IBRA were resolved by September. This represents a dramatic increase from the 20% asset resolution posted at end-2002. IBRA now aims to complete asset resolution by February 2004, when its mandate expires. Similarly, considering that the Thai Asset Management Company (TAMC) started its operations in June 2002, the 70% asset resolution achieved to date compares favorably with other countries in the region, although there are concerns that the TAMC's cash collection has been slow. Half of the asset resolution done by the TAMC was for debt restructuring, with the rest involving foreclosure of collateral. TAMC expects to complete restructuring of all NPLs in its portfolio, amounting to B759 billion in book value, by the end of 2003.

Latest available data show that the recovery rate of the assets resolved by the AMCs was highest in Malaysia (58% as of September 2003), followed by Korea (47% as of July 2003), Thailand (46% as of June 2003), and Indonesia (27%).

Supervisory and Regulatory Reforms

In an effort to reduce the vulnerability of financial and corporate sectors to future shocks, governments and other regulatory agencies among the crisis-affected countries have continued to streamline supervisory and regulatory frameworks governing their financial and corporate sectors (see Box 3).

Figure 22: **Real Bank Credit**[1] **Five Crisis-Affected Countries, seasonally adjusted** (Jan 2001=100)



[1]Claims on the private sector: deposit money banks.
Source: ARIC Indicators.

Trends in Bank Credit

Except for the Philippines, all the crisis-affected countries saw the stock of real bank credit to the private sector—a composite indicator of banking and corporate sector health—increasing in recent years. Even in the Philippines, credit rose in recent months, possibly on the expectation that the burden of bad loans on banks will gradually drop with the implementation of the SPV Act (Figure 22). Despite these recent improvements, however, credit-deposit ratios of banks—another composite indicator of banking and corporate sector health—remain subdued and far below precrisis levels. This indicates that the

Box 3: **Supervisory and Regulatory Reforms**

Indonesia
The Government issued an Economic Policy Package (White Paper) in September 2003. A main pillar of the package is the financial sector program, which includes policies to strengthen the financial sector safety net, continue bank restructuring, bolster state bank governance, and improve capital market supervision. Bank Indonesia (BI) is also working on the design of the Indonesian Banking Landscape, which will be completed by the end of 2003 and implemented in stages by 2014. The focus of the design is to improve and close gaps in many areas of the banking industry including the structure of the system, regulation and supervision, internal control and management, supporting infrastructure, and protection and empowerment of users of banking services. Progress has also been made in regulatory reform of the financial sector. In 2004, BI intends to initiate the implementation of the Basel Core Principles.

Korea
The Financial Supervisory Commission (FSC) and Financial Supervisory Service (FSS) in July 2003 instructed overseas units of domestic financial institutions to review and step up the internal controls for, and compliance with, the local laws and regulations in the prevention of money laundering. As part of efforts to help financial institutions provide improved credit access to corporate borrowers, FSC/FSS also announced in July a new plan to conduct a comprehensive review of regulations on corporate financing in light of the continuing slump in business investments and corporate financing. In August, the revised Bank of Korea Act was passed, and it will be implemented starting in 2004. The revised Act is expected to help strengthen the Bank of Korea's oversight function over payment and settlement systems. Also in August, the FSC/FSS announced new legislative and supervisory measures to ensure safe and uninterrupted operations of the electronic network systems of financial service providers in the event of work strikes, natural disasters, or in other emergencies. In terms of corporate reform, the new insolvency bill is currently under review by the related committees of the National Assembly. The new bill aims to consolidate and strengthen three separate bankruptcy codes on corporate failure, composition, and liquidation. Another bill, on the introduction of class action suits—which will promote the rights of minority shareholders and transparency in the management of companies—is pending in the legislative agenda.

Malaysia
The blueprint for the development of the financial sector is outlined in the Financial Sector Masterplan that was introduced in 2000. As part of that Masterplan, Bank Negara Malaysia (BNM) proposed a broad framework for the implementation of a deposit insurance scheme in August 2003. To further enhance the legislative framework for Islamic banking operations, BNM formed the Law Review Committee in June 2003 to review specific legislation affecting Islamic banking operations. To create conditions for more market-driven corporate restructuring, the 1965 Malaysian Companies Act has been amended to ensure that an ailing company cannot make an ex parte application to a court for a restraining order against probable action by creditors. Further, the government introduced special powers under the Danaharta Act, which allows for the appointment of special administrators to manage distressed companies.

Philippines
Bangko Sentral ng Pilipinas (BSP), the country's central bank, has continued to introduce measures to implement the General Banking Law that was enacted in 2000. Key focuses this year have been on the establishment of real time gross settlement system compatible with international standards, aimed to reduce the settlement risk for high value payments among banks and the improvement of corporate governance in banks. To facilitate the implementation of the SPV Act of 2002, BSP issued accounting guidelines in September 2003 on the sale of nonperforming assets to SPVs. BSP is also working closely with other regulatory agencies such as SEC and Bureau of Internal Revenue in implementing the SPV Act. Finally, Congress is expected to pass the Securitization Bill soon, which will promote corporate restructuring by giving SPVs more flexibility in supervising and disposing acquired assets.

Thailand
The Bank of Thailand completed its financial sector blueprint in May 2003. Next steps consist of broad consultation with key stakeholders, development of an action plan, and implementation. After more than two and a half years of review, the Legal Reform Committee for Development of Thailand (LRC) finally submitted a three-point revision of the Bankruptcy Act on 15 September 2003. The LRC recommended the reform of the legal framework of bankruptcy liquidation for individual debtors. Currently, the bankruptcy act is in the parlimentary process.

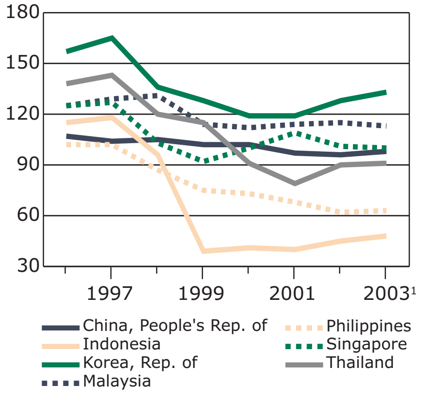
postcrisis agenda for financial and corporate restructuring is far from over (Figure 23).

Prudential Indicators

As for East Asia's vulnerability to external shocks, most prudential indicators in the region remain strong.

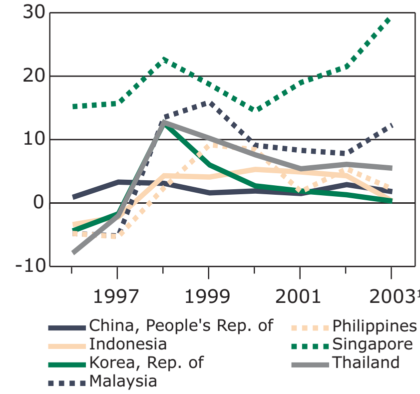
First, most major countries in the region continue to run current account surpluses (Figure 24). Second, bolstered by these surpluses and with larger capital inflows in recent months, foreign exchange reserves are sizable and have been on the rise. Third, external debt-service ratios are now lower than at the height of the crisis, except in the Philippines (Figures 25a and 25b). And finally, the ratio of external debt (both

Figure 23: **Credit-Deposit Ratios of Commercial Banks** (%)



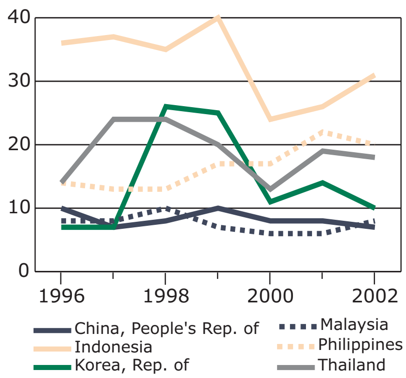
[1]2003 refers to July 2003 for Korea and August 2003 for other countries.
Source: International Monetary Fund, *International Financial Statistics,* November 2003.

Figure 24: **Current Account Balance** (% of GDP)



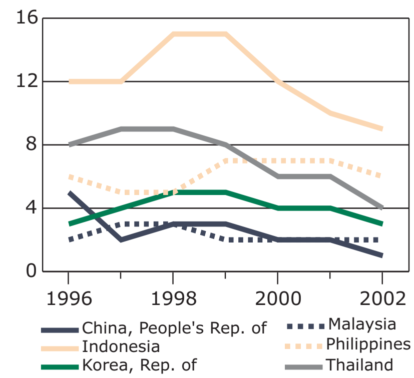
[1]Data refer to 2003Q1 for Indonesia, 2003Q1–Q3 for Singapore and 2003Q1–Q2 for others.
Source: ARIC Indicators.

Figure 25a: **Total Debt Service** (% of exports of goods and services)



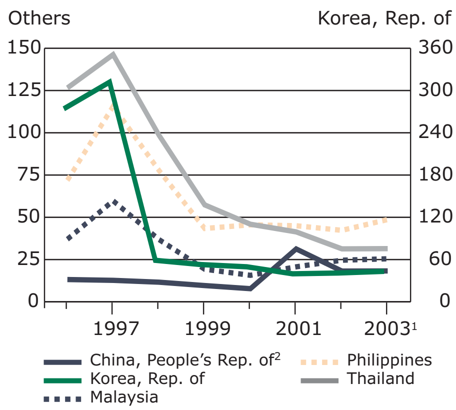
Source: Institute of International Finance.

Figure 25b: **Interest Payments** (% of exports of goods and services)



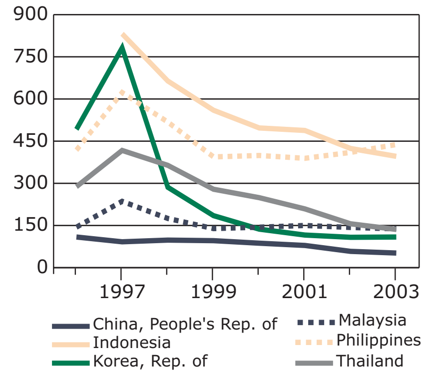
Source: Institute of International Finance.

Figure 26: **Short-Term External Debt** (% of gross international reserves)



[1]Data refers to end-September 2003 for Thailand and end-June 2003 for others.
[2] External debt definition changed in 2001 (revisions in the coverage).
Source: ARIC Indicators.

Figure 27: **Total External Debt** (% of gross international reserves)



[1]Data refer to end-September 2003 for Thailand and end-June 2003 for others.
[2]External debt definition changed in 2001 (revisions in the coverage).
Source: ARIC Indicators.

short-term and total) to foreign exchange reserves has fallen in recent years (Figures 26 and 27).

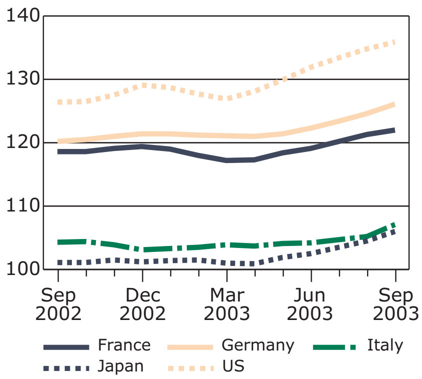
Coupled with improved bank balance sheets and reduced debt-equity ratios in corporate sectors, the strong external payments position has significantly reduced the vulnerability of most East Asian countries to possible external shocks. This has led to a better perception of credit risk in the region, as shown by the sovereign ratings of several countries. Ratings for the PRC, Indonesia, Malaysia, Singapore, and Thailand were all raised by at least one of the three global rating agencies. Only the sovereign credit rating of the Philippines was lowered this year because of weaknesses in public finances and balance of payments, and the political uncertainties associated with the next year's presidential election.

Economic Outlook, Risks, and Policy Issues

External Economic Environment

Since the July AEM, the external economic environment facing East Asia has improved significantly. In July, there were tentative signs of a

Figure 28: **OECD Leading Indicators**

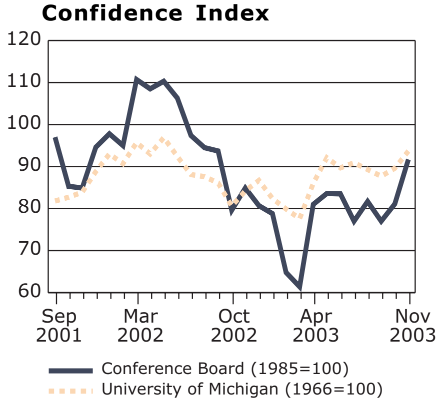


Source: OECD web site.

modest global economic upturn, with a rebound in stock markets around the world and improvements in several forward-looking economic indicators in the US. Developments since give cause for greater optimism. First, supported by encouraging corporate earnings, the global stock market rally has continued. Second, driven by strong domestic demand (partly supported by substantial monetary and fiscal stimulus) and rapid productivity growth, the US economic rebound has strengthened. Third, in recent months there has been a consolidation of Japan's economic recovery. Finally, even in Europe, where GDP stagnated in the first half of 2003, a gradual turn around is underway. Composite leading indicators for the major industrial countries also point to a strengthening of growth in the months ahead (Figure 28).

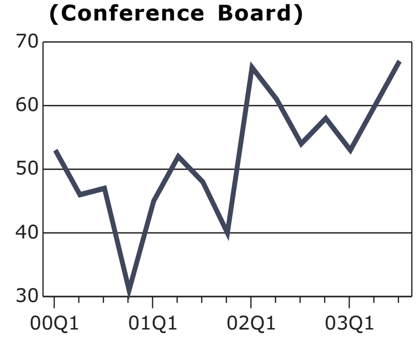
The tentative economic recovery in the US, evident a few months ago, has strengthened and become more balanced. This is borne out by a number of recent economic trends. Forward-looking indicators such as consumer confidence, business sentiment, ISM surveys of business activity, and the stock market indexes generally continue to improve (Figures 29–32). At the same time, actual economic performance also improved significantly. First, driven by strong growth in domestic demand, third quarter GDP growth came in at an annualized rate of 8.2%, the highest quarterly growth in 20 years, beating market forecasts (Figure 33). Second, heralding the much-awaited turn around in capital spending, business fixed investment (real equipment and

Figure 29: **US Consumer Confidence Index**



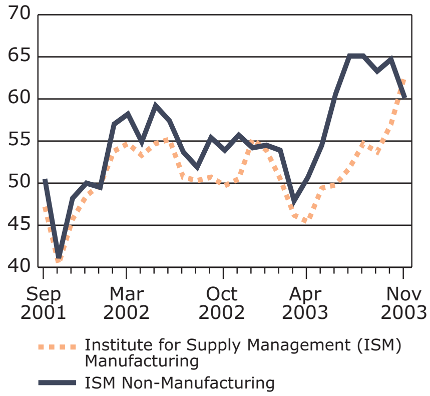
Note: Conference Board numbers are released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

Figure 30: **US Business Confidence Index (Conference Board)**



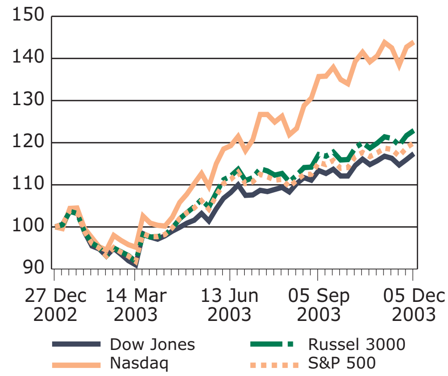
Source: Bloomberg.

Figure 31: **Surveys of US Business Activity**



Source: Bloomberg.

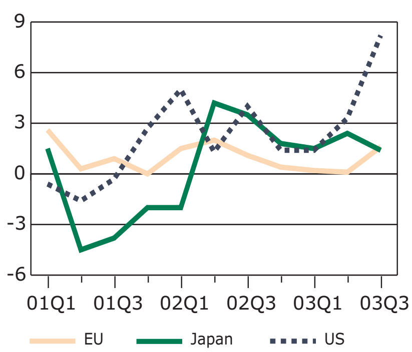
Figure 32: **US Stock Market Indexes** (weekly average, week ending Dec 2002=100)



Source: REMU staff calculations derived from Bloomberg.

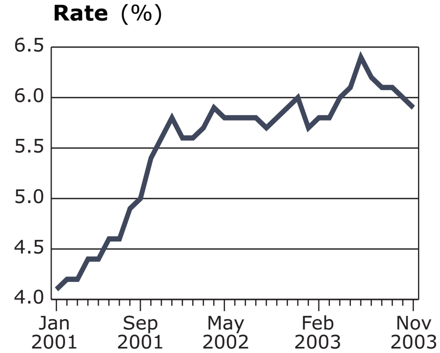
software spending) grew at an annualized rate above 15% in the third quarter on top of an 8% increase in the second quarter. Finally, there are signs that pressure on the job market is easing—employment grew for the fourth month in a row in November, and the unemployment rate fell from 6.1% in September to 5.9% in November (Figure 34). Considering that the current US recovery is the only one in post-war history that has gone on for close to two years without producing a sustained rise in employment, these employment figures of recent months are encouraging. Taking these factors into account, full year

Figure 33: **G3 GDP Growth Rates** (q-o-q, %, annualized)



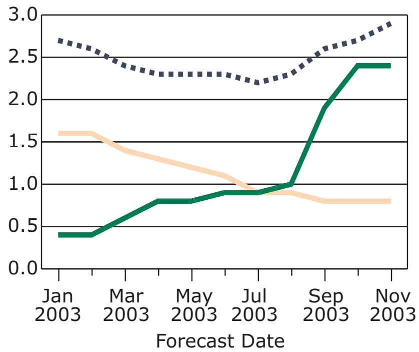
Source: Bureau of Economic Analysis (US), Economic and Social Research Institute (Japan), European Union On-Line.

Figure 34: **US Unemployment Rate** (%)



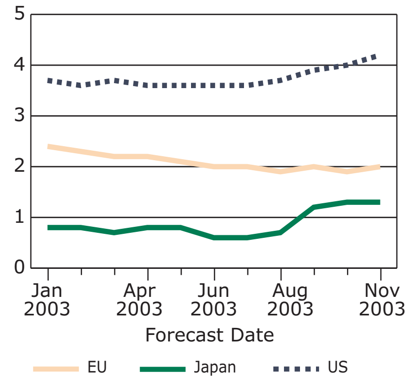
Source: Bloomberg.

Figure 35: **Consensus Forecasts of 2003 G3 GDP Growth** (y-o-y, %)



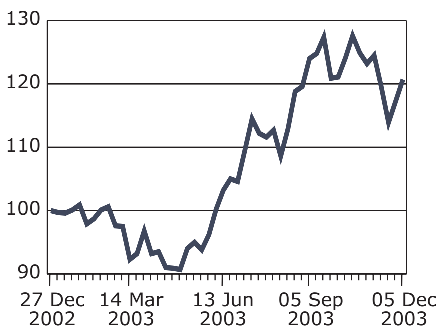
Source: Consensus Economics Inc., *Consensus Forecasts,* various issues.

Figure 36: **Consensus Forecasts of 2004 G3 GDP Growth** (y-o-y, %)



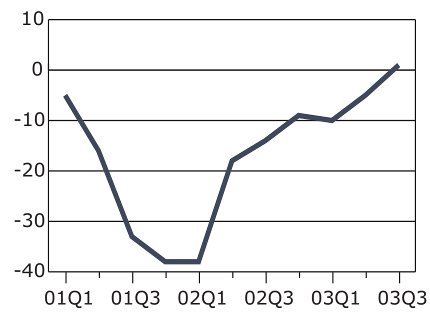
Source: Consensus Economics Inc., *Consensus Forecasts,* various issues.

Figure 37: **Nikkei 225** (weekly average, week ending Dec 2002=100)



Source: REMU staff calculations derived from Bloomberg.

Figure 38: **Japan Tankan Survey—Business Conditions Indicator**[1]

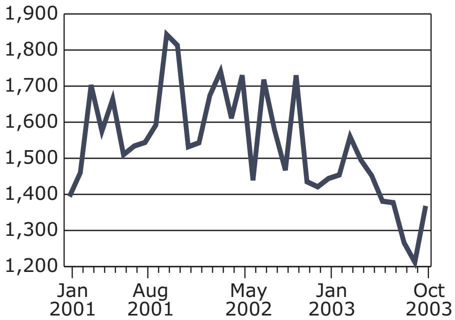


[1]Large enterprise manufacturing.
Source: Bloomberg.

US GDP growth for 2003 is now placed at 2.9%, higher than the July forecast of 2.2% (Figure 35). Similarly, the GDP growth forecast for the US in 2004 has been revised to 4.2%, up from the 3.6% figure projected in July (Figure 36).

Japan's second and third quarter GDP growth was 2.4% and 1.4% respectively, and other economic indicators improved. The stock market continues to be buoyant, and business sentiment continues to improve (Figures 37–38). Corporate bankruptcies are declining (Figure 39),

Figure 39: **Japan: Bankruptcy Cases**[1]

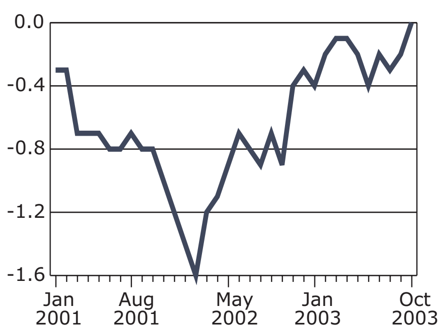


[1]Companies with total debts of ¥10 million or more.
Source: Bloomberg.

suggesting that the worst of corporate distress may be over, and deflation is slowly but steadily waning (Figures 40 and 41). Because of this, Japan's GDP growth forecast for 2003 has been revised up sharply from 0.9% in July to 2.4%. Helped partly by recent aggressive monetary policy initiatives and partly by the recent banking reforms and corporate restructuring, business investment is now forecast to grow by close to 10% this year, as compared with the July forecast of less than 4%. Similarly, private consumption this year is now forecast to grow by 1%, double the rate forecast in July. Looking ahead, business investment growth is forecast to slow from this year's level, leading to a slower GDP growth of 1.3% in 2004. Even then, the new projection is more than double the July forecast.

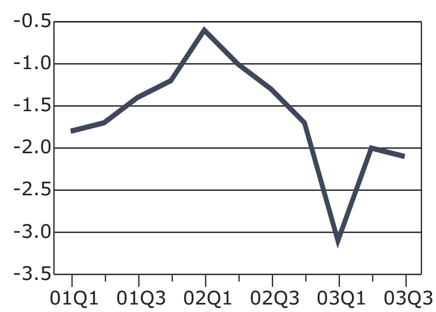
Although the economic situation in Europe continues to be less encouraging, the worst appears to be over and a turn around is underway. Germany, Italy, and Netherlands were all in recession in the first half of this year. But for the third quarter, all three posted positive growth. GDP for the European Union (EU) as a whole, after stagnating in the first two quarters, posted an annualized 1.6% growth in the third quarter. Several forward-looking indicators in Europe also point to gradual improvements over the next six months or so. First, the business confidence index for the EU economies, after declining in the

Figure 40: **Japan: Consumer Price Index** (y-o-y, %)



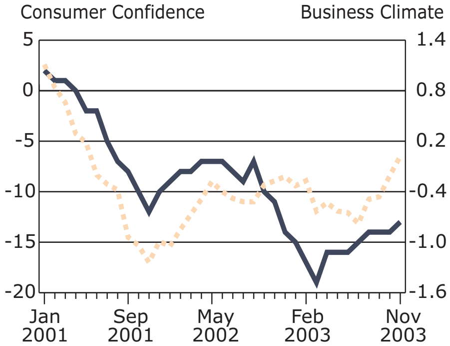
Source: Bloomberg.

Figure 41: **Japan: GDP Deflator** (y-o-y, %)



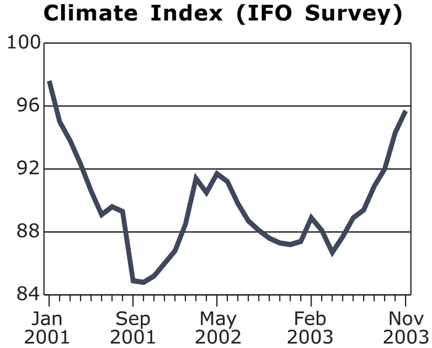
Source: Economic and Social Research Institute, Japan.

Figure 42: **European Union Consumer Confidence[1] and Business Climate Indicators[2]**



[1]Consumer Confidence Indicator: The arithmetic average of the answers (balances) to four questions on the financial situation of households and general economic situation (past and future) together with that on the advisability of making major purchases.
[2]Business Climate Indicator: Movement of indicator is linked to the industrial production of the euro area. May be interpreted as a survey result; a high level indicates that, overall, the survey points to a healthy cyclical situation.
Source: Bloomberg.

Figure 43: **German Business Climate Index (IFO Survey)**



Source: Bloomberg.

first seven months, started edging up since July (Figure 42). Second, the German IFO business confidence index, which began trending up in April, continued its rise in recent months (Figure 43). Third, the consumer confidence index for the EU countries, taken together, has increased in six consecutive months since March. Coupled with low interest rates, expansionary fiscal policies, and some of the recent structural reform initiatives in Germany and France, these factors indicate that a gradual turn around is underway. The first half slowdown will, however, pull down the EU's GDP growth for this year as a whole to 0.8%. GDP growth next year is expected to improve to 2%.

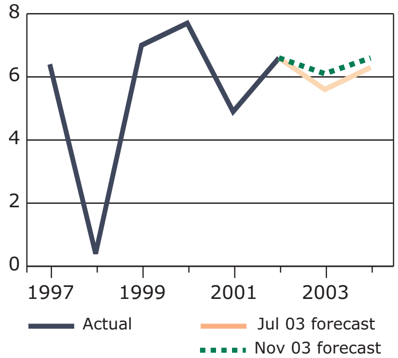
Regional Economic Outlook

Greater optimism over the external economic environment in the US and Japan, and to a lesser extent in Europe, has improved growth prospects for East Asian countries. Compared with the cautiously optimistic note of the July AEM, the outlook is now more upbeat with the continuation of synchronized growth. In addition to the improving external environment, two other factors—the continued strength in domestic demand in several countries and the sharp rebound of the PRC economy from its second quarter slowdown—augur well for East Asia's immediate economic prospects.

In part because of the progress in postcrisis restructuring and the fiscal and monetary easing of recent years, continued strength in domestic demand will support the regional rebound. A key positive trend in the region in recent years is stronger consumer spending, spurred by lower interest rates, fiscal stimulus measures, the success in recapitalizing and restructuring financial and corporate sectors, and a switch to consumer lending by financial institutions. In the last 18 months, consumer spending accounted for more than one-third of the growth in GDP in Indonesia and the Philippines, and more than half in Thailand. There are also tentative signs that private investment, after remaining subdued for some time, is starting to pick up in several crisis-affected countries, Thailand in particular.

The rapid growth of the PRC and the increase in its imports, together with the growth of intra-regional trade, is also providing impetus for East Asian growth. The last two years have seen a surge in production and trade integration between the PRC and the rest of East Asia. In particular, the PRC has emerged as a center for global production networks and a market for exports of specialized components and

Figure 44: **Real GDP Growth—East Asia** (%)



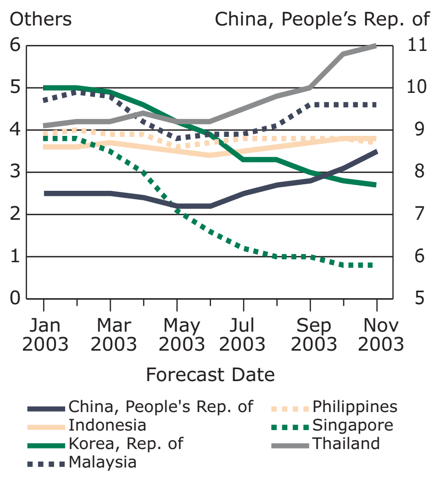
Sources: ARIC Indicators; Consensus Economics Inc., *Asia Pacific Consensus Forecast* (July and November 2003); World Bank, *World Development Indicators.*

other intermediate inputs. The PRC's importance as the driver of intra-regional trade is increasing.

This year's combined GDP growth for the East Asian countries is now estimated at 6.1%, higher than the July forecast of 5.6% (Figure 44). Since July, growth forecasts have been revised up for Thailand (by 1.5 percentage points), the PRC (by 1 percentage point), Malaysia (by 0.7 percentage point), and Indonesia (by 0.3 percentage point). They have been revised down for Korea (by 0.6 percentage point), Lao PDR (by 0.5 percentage point), and Singapore (by 0.4 percentage point). For the other countries, growth forecasts have not varied significantly. (Figure 45 and Table 2).

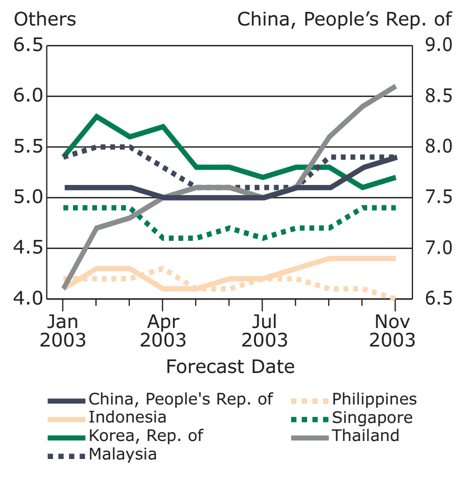
In 2004, combined GDP growth for the region is forecast to strengthen to 6.6%. This figure is 0.3 percentage point higher than the July forecast, with an upward revision for most countries. Compared with this year, growth next year is expected to strengthen in all East Asian countries, with the exception of the PRC, where it will slow somewhat as part of the Government's plan to engineer a soft-landing of the economy (Figure 46). Despite this moderation, the PRC's projected growth of about 8% means it will likely remain the fastest growing economy in the region.

Figure 45: **Consensus Forecasts of 2003 GDP Growth—ASEAN5+2** (y-o-y, %)



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

Figure 46: **Consensus Forecasts of 2004 GDP Growth—ASEAN5+2** (y-o-y, %)



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

Table 2: **Annual GDP Growth Rates** (%)

							Nov 2003 Forecasts		Difference[1]		Average
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2003**	**2004**	**1998–2002**
Brunei Darussalam	3.6	-4.0	2.6	2.8	3.0	3.4	4.0[2]	. . .	0.0	. . .	1.6
Cambodia	6.8	3.7	10.8	7.0	5.7	5.5	5.0	5.5	0.0	0.0	6.5
China, People's Rep. of	8.8	7.8	7.0	7.6	7.3	8.0	8.5	7.9	1.0	0.4	7.5
Indonesia	4.7	-13.1	0.8	4.9	3.4	3.7	3.8	4.4	0.3	0.2	-0.1
Korea, Rep. of	5.0	-6.7	10.9	9.3	3.1	6.3	2.7	5.2	-0.6	0.0	4.6
Lao PDR	6.9	4.0	7.3	5.8	5.8	5.9	5.5	6.0	-0.5	-0.5	5.8
Malaysia	7.3	-7.4	6.1	8.5	0.3	4.1	4.6	5.4	0.7	0.3	2.4
Myanmar[3]	5.7	5.8	10.9	13.7	11.1	. . .	. . .	. . .	. . .	. . .	. . .
Philippines	5.2	-0.6	3.4	6.0	3.0	4.4	3.7	4.0	-0.1	-0.2	3.2
Singapore	8.5	-0.9	6.4	9.4	-2.4	2.2	0.8	4.9	-0.4	0.3	3.0
Thailand	-1.4	-10.5	4.4	4.6	1.9	5.3	6.0	6.1	1.5	1.1	1.2
Viet Nam	8.2	4.4	4.7	6.1	5.8	6.4	7.0	7.4	0.1	0.1	5.5
East Asia[4,5]	6.4	0.4	7.0	7.7	4.9	6.6	6.1	6.6	0.5	0.3	5.3
East Asia exc PRC[4,5]	4.7	-6.7	7.0	7.7	2.3	5.1	3.5	5.2	0.0	0.2	3.1
ASEAN[4,5]	4.4	-6.7	4.1	6.4	1.7	4.1	4.0	5.1	0.4	0.4	1.9
ASEAN5+2[5]	6.4	0.4	7.0	7.7	4.9	6.6	6.1	6.6	0.5	0.3	5.3
Five Crisis-Affected[5]	4.2	-7.8	7.2	7.6	2.7	5.4	3.6	5.1	0.0	0.2	3.0

. . . = not available
[1]Difference between November 2003 forecasts and the July 2003 forecasts.
[2]Upper end of government forecast of GDP growth of 3–4% for 2003 from the Department of Economic Planning and Development's *Brunei Economic Bulletin.*
[3]For FY April–March.
[4]Excludes Myanmar for all years and Brunei Darussalam in 2004.
[5]Aggregates are weighted according to gross national income levels from the World Bank's *World Development Indicators.*
Sources: ARIC Indicators for 1997-2002; Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* November 2003 for ASEAN5+2 and Viet Nam's 2003–2004 forecasts; Asian Development Bank, *Asian Development Outlook Update 2003* for other forecasts, except for Brunei Darussalam.

Individual Country Prospects

- **Brunei Darussalam.** GDP growth this year will likely exceed the Government's forecast of 3-4%. With regional economies recovering from SARS and a global rebound gathering pace in the second half, growth prospects for next year in the non-oil sector have improved. However, this could be offset by a projected decline in oil prices. The main challenge facing the government is to reduce the country's vulnerability to oil price fluctuations.

- **Cambodia.** GDP is forecast to grow by 5% this year, down from 5.5% in 2002. The slowdown is due mainly to the adverse effects on tourism following the SARS outbreak and uncertainties related to this year's elections and subsequent delay in forming a new government. Supported by stronger exports, particularly garments, higher commodity prices, and increased tourism receipts, growth is expected to strengthen to about 5.5% in 2004. With the central government fiscal deficit exceeding 6% of GDP the past two years, and with lower-than-expected revenue collection, fiscal sustainability continues to be a policy concern.

- **PRC.** Driven by strong fixed investment, steady private consumption, and a vibrant export sector, the PRC's GDP growth is expected to be 8.5% this year, higher than the July forecast of 7.5%. The upward revision reflects a substantial markup of fixed investment and export growth. Fixed investment is expected to grow by more than 20%, while the dollar value of exports is expected to grow by 30%. With fixed investment increasing rapidly, monetary policy has been tightened in recent months. This should help cool fixed investment growth, and lead to a modest reduction in GDP growth to 7.9% in 2004. With the economy booming, there is little reason for continued fiscal stimulus. Fiscal policy could thus shift to a more neutral stance—a process already becoming evident. There may also be a need for continuing to tighten monetary policy as in recent months to further rein in fixed investment and credit expansion.

- **Indonesia.** Driven largely by robust private consumption, Indonesia's GDP is now expected to grow 3.8% this year, compared with the 3.5% July forecast. In 2004, growth is forecast to reach 4.4%, supported by improved exports from the rebound in the global economy and continued strength in domestic demand. Indonesia has done significant fiscal consolidation in recent years. And the improved economic outlook gives further room to continue the process. This is more important now, as macroeconomic stability next year will be a challenge given scheduled presidential elections. The Government is well aware of this, and has outlined a medium-term program to preserve macroeconomic stability, strengthen the financial sector, and promote investment, exports and employment.

- **Korea.** Despite impressive export growth of 17% over the first three quarters, Korea's GDP is forecast to grow by 2.7% this year, down from the 3.3% July forecast. The downward revision largely reflects a sharp slowdown in private consumption, from about 7% growth in 2002 to close to zero this year. In response, the Government introduced a series of measures, including supplementary budgets, along with tax and interest rate cuts in the second half of the year. These measures should help reinvigorate private consumption. Coupled with the increasing pace of the global rebound, they should help spur growth to over 5% next year. Monetary policy in Korea could continue to be accommodative. Given the comfortable public finance position, Korea maintains ample scope for fiscal pump priming should the need arise. But, as previously noted, it needs to address persistent difficulties in implementing budgeted fiscal programs during the course of the year.

- **Lao PDR.** GDP is expected to grow about 5.5% this year, down from the 6% forecast made in July. The downward revision comes from slower credit growth and weaker private investment, and the SARS-induced weakness in tourism. With a more favorable external environment in 2004, a pickup in tourism and an increase in private investment, GDP growth should rise to 6.0%. Maintaining macro-economic stability remains a key challenge for the Government, as inflation is expected to accelerate to 14% this year from 11% in 2002.

- **Malaysia.** Malaysia's GDP is expected to grow by 4.6% this year, higher than the 3.9% July forecast. An upward revision in private consumption, subdued in the second quarter due to SARS, is behind this markup in growth. Stronger domestic demand and a pickup in export growth should help GDP growth reach 5.4% in 2004. In recent years, Malaysia used fiscal policy as a key countercyclical tool to deal with the external economic slowdown. With growth prospects improving, the Government's plans for fiscal consolidation and a balanced budget in 2006 are appropriate. With low inflation, comfortable foreign exchange reserves, and a current account surplus, Malaysia should be able to maintain low interest rates for some time. Coupled with faster operational restructuring of the corporate sector, this should help reinvigorate private investment, which continues to remain weak.

- **Myanmar.** GDP growth this year is likely to be lower than the Government's target of 10.7% set in the latest five-year plan period (2001–2005). The weaker growth performance was caused by a number of factors, including slower growth in natural gas production and sluggish manufacturing, which continues to suffer from shortages of power and essential imported inputs. Growth prospects for 2004 are uncertain, as continued sanctions are likely to affect the country's exports.

- **Philippines.** GDP is forecast to grow by 3.7% this year (more or less the same as the July forecast), driven largely by private consumption, which, in turn, has been supported by significant increases in overseas remittances. However, given the better-than-expected growth in the third quarter, full year growth could surprise the current forecasts on the upside. Growth is expected to be about 4% in 2004. Much of this improvement, however, hinges on favorable developments in the political, security, and fiscal situations. The Government was successful for the first 10 months in keeping its fiscal deficit within budgeted levels in 2003. Looking ahead, there is a need to move beyond short-term achievements and focus on sustained improvements in tax collection. Moreover, the quasi-fiscal deficits arising from public sector enterprises need to be better addressed.

- **Singapore.** Expected 2003 GDP growth has been reduced from 1.2% in July to 0.8%. The downward revision reflects slower growth in fixed investment and a larger-than-anticipated contraction in the second quarter. With substantial improvement in both exports and domestic demand, GDP growth is forecast to accelerate to 4.9% next year. Given comfortable public finances, Singapore is well placed to ease fiscal policy if the need arises. However, the effects of any easing could be small, given the country's high dependence on international trade and tourism. Moreover, Singapore's actual fiscal performance on expenditures in the first six months of this year was well off budgeted levels—a pointer to possible difficulties in implementing fiscal stimulus measures.

- **Thailand.** As anticipated in July, forecasts of Thailand's GDP growth for this year and the next have been revised up. Growth in 2003 is expected to reach 6.0% (from the 4.5% July figure), while next year's growth is projected at 6.1% (from the 5% July figure). A markup of all major components of demand—private consumption, fixed investment, and exports—underpin the upward revisions. Helped by better-than-expected revenue collections and lower-than-expected expenditures, Thailand achieved notable fiscal consolidation in the past two years. Public debt, which had increased sharply in the postcrisis years, has now fallen below 50% of GDP. However, the recent rise in credit from state-owned banks to fund off-budget expenditures should be monitored closely to limit any potential increase in nonperforming loans of banks and contingent liabilities of the Government.

- **Viet Nam.** GDP is forecast to grow by 7% this year, slightly higher than the July forecast. Currently, Viet Nam is the fastest growing ASEAN country. GDP growth is projected at 7.4% in 2004 because of continued strong domestic demand and exports. With good revenue collection, the fiscal deficit for 2003 is likely to be lower than earlier projected. The Government continued its reform efforts, including restructuring state-owned banks, reforming state-owned enterprises, liberalizing trade, creating a more favorable environment for foreign investment, promoting the private sector, and strengthening economic cooperation with neighboring countries. Continuation of these efforts is essential for sustaining this impressive growth into the medium term.

Risks to the Regional Outlook and Policy Issues

Since July, risks to the region's growth prospects receded significantly. The July AEM cautioned that if the emerging positive trends in industrial economies did not solidify, East Asia's immediate growth prospects would dim. With third quarter growth strengthening in major industrialized countries, that risk has diminished. In July, there were also concerns that the region could fall into a deflationary spiral, although the probability of that happening appeared low. Developments since then further support that assessment. Although inflation continues to be low regionally, it has either stabilized or edged up slightly since mid-year.

Still, despite this recent decline in both external and domestic risks, growth forecasts continue to face a number of risks. These include: a recurrence of SARS; possible political uncertainties associated with forthcoming elections in several countries; an escalation of terrorism or increase in geopolitical tensions; creeping global protectionism and; large and growing global current account imbalances.

Although SARS is under control, the World Health Organization cautions its recurrence cannot be ruled out, especially in the winter months. If this occurs, regional growth prospects could be set back, although now most countries have systems in place to manage any recurrence.

Forthcoming legislative/presidential elections in several countries in the region (Indonesia, Korea, Malaysia, Philippines, and Thailand) over the coming 18 months, and the economic uncertainties these elections may bring, pose another risk to the region's economic prospects.

Also, while countries have made significant progress in the fight against terrorism, it is always a risk. The possibility of a rise in geopolitical tensions on the Korean peninsula remains an issue as well.

Externally, large global current account imbalances remain a source of concern, especially if they induce disorderly exchange rate adjustments and/or increased trade friction among countries. Protectionism, along with the stalemate at the WTO trade negotiations, pose risks to the global trading environment. An open global trading environment is crucial for East Asia, as the region relies heavily on foreign trade and investment.

With the improved economic outlook and reduction of risks, fiscal policies may have to shift from expansionary to more neutral stances. However, the current low interest rates could be maintained for some time.

In an effort to counter the recent economic slowdown, fiscal easing in several countries helped. But now that growth is on an upward track and likely to strengthen, there is no compelling case for continuing fiscal expansion. For countries such as the PRC, Malaysia, and Thailand that followed expansionary policies, this provides an opportunity to move toward more neutral fiscal policies, as improved economic activity will draw extra revenue as well as a reduction in cyclically-sensitive government expenditures. With actual revenues increasing faster than budgeted, and/or expenditures growing below budgeted rates, budget deficits are starting to come under control or move into surplus. For those countries with more significant structural fiscal problems — such as the Philippines, and to a lesser extent Indonesia, which achieved significant fiscal consolidation the past two or three years — this provides an opportunity to further consolidate fiscal positions. However, given the low inflation and large excess capacity in the region, current monetary policies of maintaining low interest rates could continue for some time (with the possible exceptions of the PRC and the Philippines).

Improved economic prospects also provide a window of opportunity for countries to focus on issues related to reserve management and foreign exchange policies, including exchange rate policy. The continued accumulation of large amounts of foreign reserves has significant opportunity costs, especially now as the return on these reserves is low. Large reserve accumulation also complicates macroeconomic management. If unsterilized, it leads to faster growth in base money and credit expansion, and potentially excessive investment and asset price inflation. This can result in a build up of vulnerabilities similar to those that existed at the time of the 1997 crisis. Sterilization has its own limitations, as it could lead to higher interest rates, which in turn could lead to larger capital inflows and the need for ever larger levels of sterilization. In order to manage such risks, there may be merit for countries in the region to take a fresh look at reserve management and foreign exchange policies, including exchange rate policy.

The increased growth momentum in the region also provides an opportunity to address expeditiously the remaining agenda of financial and corporate sector reforms and restructuring. Although the health of the region's banking systems is better today than at the height of the 1997 crisis, governments faced significant challenges in implementing and enforcing the measures introduced in the postcrisis years to strengthen financial sector regulation and supervision. Also, faster progress needs to be made in the operational restructuring of corporate sectors by addressing the weaknesses in legal frameworks for insolvency. This is especially important to support the nascent revival in private investment currently underway. The mandates of asset management companies and the voluntary out-of-court mechanisms set up in the aftermath of the 1997 crisis have either expired or are about to do so. In some countries, a large number of cases have been transferred to the courts, further underscoring the need for strong legal frameworks to speed resolution. Moreover, as banks increasingly enter consumer finance—a trend already evident in many countries—they are likely to face many difficult challenges, as developing an efficient consumer finance business is often more difficult than lending to corporate borrowers. It would be easier for governments to address these weaknesses during the upward phase of the business cycle than during a downturn.