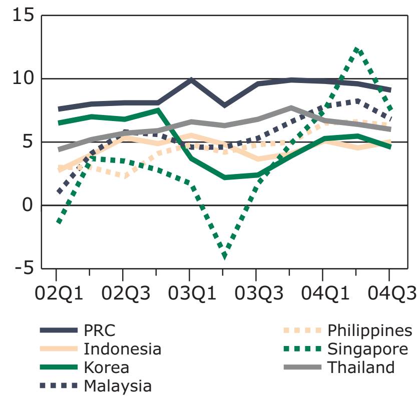
East Asia's Growth and Restructuring—A Regional Update

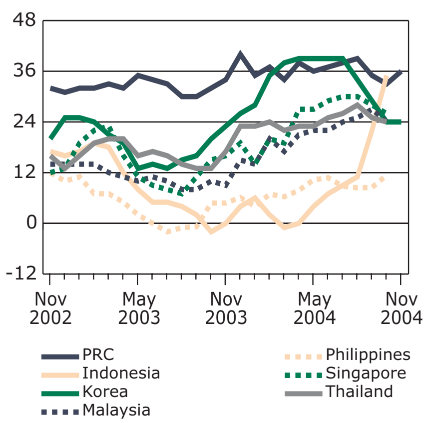
Recent Economic Performance

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



Source: ARIC Indicators.

Figure 2: **Growth of Merchandise Exports**[1]
(y-o-y, %)



[1]3-month moving average of dollar values.
Source: ARIC Indicators.

Real Sector Developments

East Asia[1] recorded strong growth this year, despite high oil prices and some loss of momentum (Figure 1).[2,3] The seven big economies in the region for which quarterly GDP data are available—People's Republic of China (PRC), Indonesia, Republic of Korea (Korea), Malaysia, Philippines, Singapore, and Thailand—posted an average 7.4% year-on-year GDP growth in the third quarter of 2004, compared with 8.1% in the previous quarter. In the first three quarters, these seven economies grew by an average 7.9%, compared with 6.9% average growth in 2003.

GDP growth in the PRC slowed to 9.1% in the third quarter from close to 10% at the beginning of the year, as the policies enacted over the past year and a half to slow the economy started to take effect. Singapore's expansion also moderated in the third quarter to 7.5% from the second quarter's cyclical high of 12.5%. Malaysia showed a similar trend, with growth moderating to 6.8% in the third quarter from 8.2% in the second. Korea's growth decelerated to 4.6% in the third quarter from 5.5% in the second as domestic demand remained weak. Indonesia's economy grew by 5% in the third quarter, at the high end of the 4-5% range over the past four quarters, helped by resilient private consumption and a healthy increase in fixed investment. The Philippines also recorded strong growth of 6.3% in the third quarter, only marginally lower than the 6.6% increase in the second quarter. Thailand's economy continued its slowdown from the peak rate reached in the fourth quarter of 2003, reflecting higher oil prices, unrest in the southern part of the country, and the effects of avian flu.

In 2004, East Asia's growth was driven by a combination of rapid increase in exports and continued strength in domestic demand. Monthly data indicate that growth in merchandise exports in most countries began to moderate recently from very high rates recorded in the first half of the year, except Indonesia (Figure 2). In the latest three months,

---

[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 the Republic of Korea.

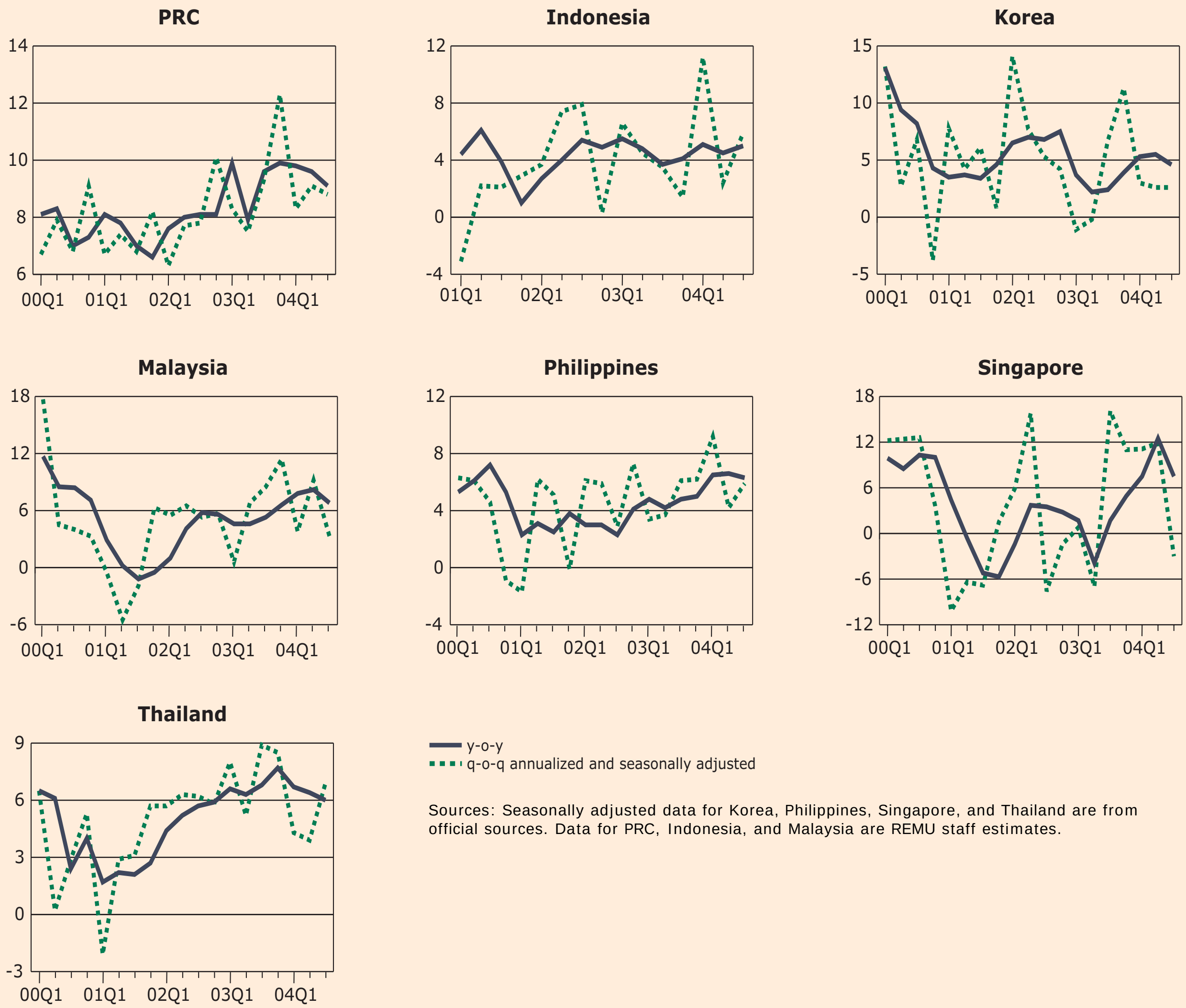
[2]Year-on-year, most countries' growth started to slow in the second and third quarters, whereas on a quarter-on-quarter basis the loss of growth momentum began earlier, toward the end of 2003 or the first quarter of 2004 (Box 1).

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

Box 1: **Slowing Growth Momentum in East Asia**

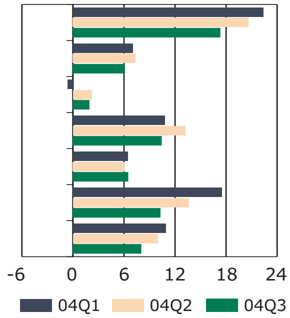
East Asia's growth momentum has been slowing in the past few quarters. Seasonally adjusted quarterly data indicate that the momentum in all countries is significantly slower than the peaks reached in the second half of 2003 or early this year. As would be expected, year-on-year growth has also begun to slow across the region since the first half of 2004, when it was inflated by the SARS-induced low base from a year earlier. In Indonesia, Philippines, and Thailand, third quarter seasonally adjusted GDP growth did quicken, but the faster pace partly reflects a technical correction to the sharp slowdown in the previous quarter. The overall picture in the region is of slowing growth, consistent with the outlook for the global and regional economies. The loss of momentum is due to four common factors: an end to the post-SARS bounce, a sharp rise in international oil prices, and expectation of higher interest rates in the US.

Figure B1.1: **GDP Growth Rates, y-o-y and q-o-q annualized and seasonally adjusted** (%)



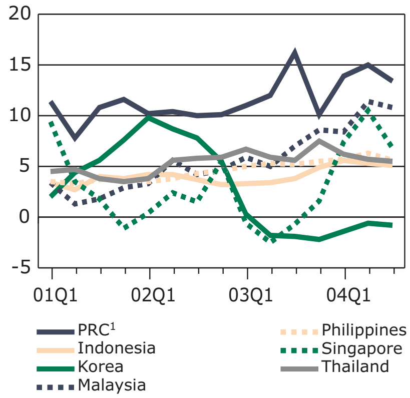
Sources: Seasonally adjusted data for Korea, Philippines, Singapore, and Thailand are from official sources. Data for PRC, Indonesia, and Malaysia are REMU staff estimates.

Figure 3: **Growth of Domestic Demand**[1] (y-o-y, %, at constant prices)



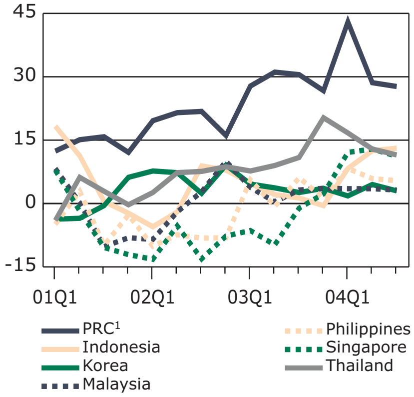
[1]Based on national income accounts except for PRC which is the sum of retail sales and fixed investment (at constant 1997 prices).
Sources: ARIC Indicators, Bloomberg, and CEIC.

Figure 4: **Growth of Private Consumption** (y-o-y, %, at constant prices)



[1]Growth of retail sales deflated by the retail price index (1997=100).
Sources: ARIC Indicators and Bloomberg.

Figure 5: **Growth of Fixed Investment** (y-o-y, %, at constant prices)



[1]Fixed asset investment (year to date, y-o-y growth).
Sources: ARIC Indicators and CEIC.

the US dollar value of exports grew between 24% in Korea, Malaysia, and Thailand, and 36% in Indonesia and the PRC. Indonesia's sharp increase in exports, starting in the third quarter, is attributed partly to the shift to a computerized system for data collection, which has been able to capture previously unrecorded exports. In the Philippines, the trend was less pronounced, with exports rising at a relatively modest rate for much of the year.

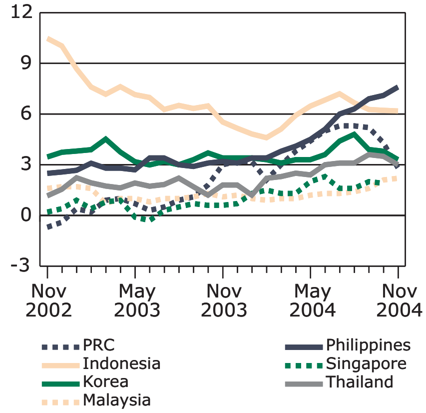
The strong export performance, particularly in relatively open economies such as Malaysia and Singapore, and the generally accommodative monetary conditions through much of the first half of the year, contributed to improved sentiment among consumers and businesses, resulting in an increase in domestic demand. Growth in domestic demand was highest in the PRC in the third quarter, with a continued, although slower, rise in fixed investment and robust consumption expenditure (Figure 3). Malaysia, Singapore, and to a lesser extent Thailand, also experienced a sustained increase in domestic demand, albeit at declining rates.

Private consumption rebounded strongly in PRC, Malaysia, and Singapore in the first half of 2004, before slowing in the third quarter. It remained robust in Indonesia, Philippines, and Thailand (Figure 4). It accounted for 60–70% of GDP growth this year in Indonesia, Malaysia, and Philippines, supported by low real interest rates, the continued buoyancy in consumer finance, and higher incomes particularly in the rural sector. Private consumption slowed modestly in Thailand, but still accounted for about half of GDP growth. In Korea, consumer spending has continued its decline since the second quarter of 2003, with the household sector winding down the large debt it incurred in previous years.

Fixed investment rose strongly this year in Indonesia and Singapore (Figure 5). In the PRC and Thailand, it slowed but continues to register double-digit growth. Several factors have contributed to the rise in investment, including the revival in demand for technology products, progress in corporate restructuring, improved corporate profitability, and ample liquidity in financial systems. In Korea and Malaysia, fixed investment growth remains modest, at 3–3.5% this year. In Korea, a general weakness in consumer spending, lingering problems in the corporate sector, and the trend toward production outsourcing (mainly to the PRC) seem to have adversely affected Korean firms' investment in new plant and equipment.

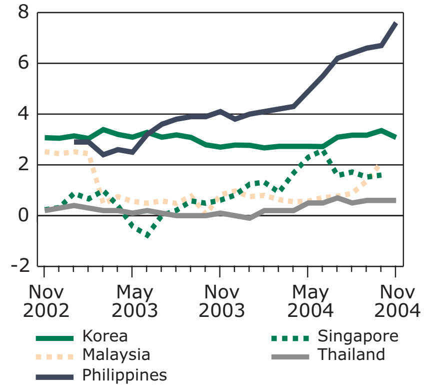
Inflation has risen this year, driven by faster growth, increases in commodity prices including fuel, and the acceleration in food prices.

Figure 6: **Headline Inflation Rates** (y-o-y, %)



Source: ARIC Indicators.

Figure 7: **Core Inflation Rates** (y-o-y, %)

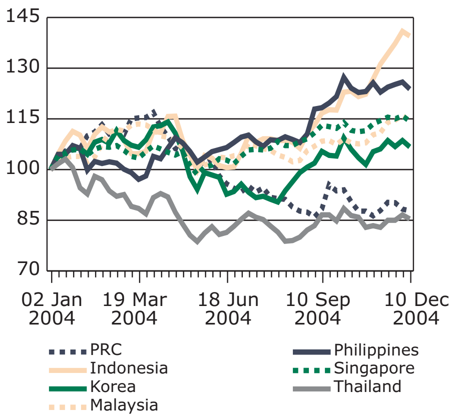


Sources: Bank of Thailand, Bangko Sentral ng Pilipinas, and staff estimates derived from Bloomberg data.

The most pronounced increases were in Philippines, Singapore, and Thailand, where the peak inflation rate was 2-3 times higher than a year earlier (Figure 6). In all these countries, except the Philippines, inflation has moderated somewhat recently, primarily reflecting a deceleration in food prices and stronger currencies. In the PRC, driven partly by a moderation in food prices, annual inflation has subsided after breaching 5% in August. Korea experienced a similar trend, with consumer prices rising to a peak of 4.8% in August before moderating to 3.3% in November. In contrast, Philippine consumer prices have risen persistently to 7.6% in November, compared with 3.1% a year earlier.

Core inflation also rose in 2004, although it has trended down in recent months, except in the Philippines and Malaysia (Figure 7). Singapore's core rate has moderated from its high in June, in part reflecting the authorities' stronger exchange rate policy, implemented in April. Similarly, Korea's core inflation moderated to 3% in November from 3.4% the previous month. It has risen in Malaysia, but remains relatively low at 2%. In Thailand, it is even lower at about 0.5%.

Figure 8: **Composite Stock Price Indexes**[1] (weekly average, first week of Jan 2004=100, local index)



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

Financial Markets

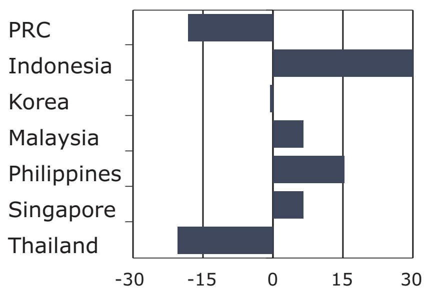
Generally, the region's stock markets have rebounded sharply in recent months, following weak performance from May to August (Figure 8). In part, the recent rebound likely reflects the better outlook for the United States (US) economy after a "soft patch" in the second quarter, and the recovery of the US stock market. The region has also benefited from this year's strength of commodity prices and the global electronics industry.

Thus far, the performance of stock prices (in local currency terms) in 2004 ranged from a 15% decline in Thailand to a 40% increase in Indonesia, with the stock markets in the Philippines increasing by a strong 24%. Besides global and regional factors, the peaceful conclusion of elections in Indonesia and the Philippines probably contributed to their improved stock market performance.

The decline in stock prices in Thailand appears to be partly a correction from the strong gains in 2003, in addition to several idiosyncratic shocks, such as the unrest in the south and the outbreak of avian flu. Relative to the US Russell 3000 index this year, Indonesia's stock index was 30% higher and the Philippine stock market was up 15% (Figure 9). Malaysia and Singapore recorded a 6.5% increase over the Russell 3000 index.

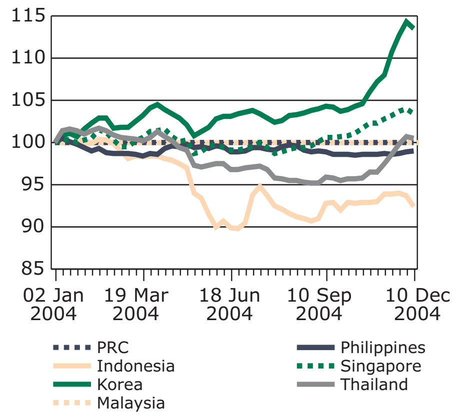
Among the five larger East Asian countries with flexible exchange rates, the currencies of Korea, Singapore, and Thailand have been appreciating against the US dollar since the third quarter of 2004, reflecting robust balance of payments and the general weakness of the US dollar against major global currencies (Figure 10). So far this year, the Korean won has appreciated by 14% against the US dollar, the Singapore dollar has been up 3.4%, and the Thai baht rose by 0.5% after depreciating about 5% through August. The Indonesian rupiah and the Philippine peso depreciated, reflecting their countries' relatively weaker external

Figure 9: **Percent Change in Stock Market Index[1] Relative to Russell 3000 Index** (between 3 Jan 2004 and week ending 10 Dec 2004)



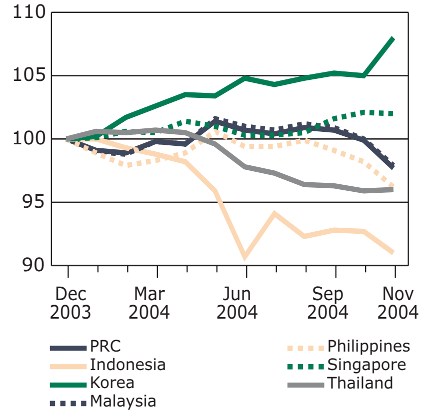
[1]Weekly averages of JCI (Indonesia), KOSPI (Korea), KLCI (Malaysia), PCOMP (Philippines), STI (Singapore), and SET (Thailand). For the PRC, the index is calculated based on the weekly averages of the Shanghai Composite and Shenzen Composite, weighted by the market capitalization of each market.
Source: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

Figure 10: **Exchange Rate Indexes** (weekly average, first week of Jan 2004=100, $/local currency)



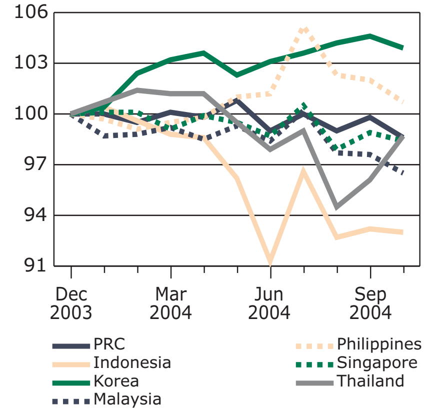
Source: REMU staff calculations derived from Bloomberg data.

Figure 11: **Nominal Effective Exchange Rate**[1] (Dec 2003=100)



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

Figure 12: **Real Effective Exchange Rate**[1] (Dec 2003=100)



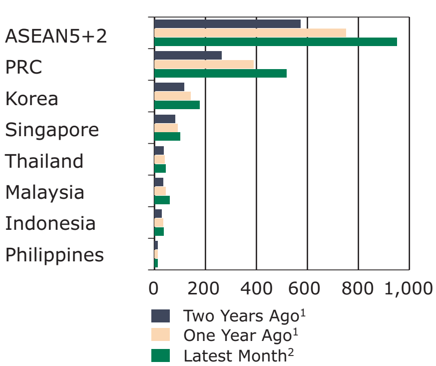
[1]An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: REMU staff calculations.

payments positions and the narrowing of their domestic/international interest rate differential. So far this year, the rupiah has depreciated by 7.6%. The Philippine peso has remained around 56 per US dollar for much of the year.

The broad weakness of the US dollar, and the concomitant strength of the currencies of East Asia's trading partners, have meant that nominal effective exchange rates have not appreciated as much as the appreciation of regional currencies against the US dollar (Figure 11). Only the Korean won and the Singapore dollar have appreciated—by 8% and 2% respectively. Real effective exchange rates show a similar pattern, with a few exceptions (Figure 12). Korea's real effective rate still shows an appreciation. However, in Singapore, lower inflation contributed to a depreciation in the real effective exchange rate. Conversely, in the Philippines, a higher inflation differential with trading partners led to an appreciation of the real effective exchange rate. In the PRC, the real effective rate has remained broadly stable since the beginning of 2004, as the weakness of the US dollar, to which the yuan is linked, was partly offset by the pickup in domestic inflation.

The central banks in some East Asian countries continue to intervene in foreign exchange markets to mitigate pressure for currency appreciation arising from current account surpluses and capital inflows (Box 2). This has contributed to a significant accumulation of foreign exchange reserves in recent months. Total foreign exchange reserves of the seven East Asian countries rose almost $200 billion—to $951 billion—over the past year (Figure 13). Most of the increase was in PRC, Korea, and Malaysia.

Figure 13: **Gross International Reserves Less Gold, End of Period** ($ billion)



[1]From latest month.
[2]September 2004 for PRC, Philippines, and Singapore. October 2004 for others.
Source: International Monetary Fund, International Financial Statistics Online.

Box 2: **Private Capital Inflows to Reach Postcrisis High**

The Institute of International Finance (IIF) estimates that net private capital inflows to the five countries in East Asia most affected by the 1997 financial crisis (Indonesia, Korea, Malaysia, Philippines, and Thailand) are set to reach a postcrisis high of $33 billion in 2004 after quadrupling to $25.4 billion in 2003 (Table B2.1). This reflects strong global growth, an increase in risk appetite among investors, low interest rates, and strong economic fundamentals in the region. With slower global growth and the rise, albeit measured, of interest rates in 2005, net private capital flows to the five crisis-affected countries are likely to decline across the board to $24 billion in 2005, according to the IIF forecast.

All major components, except net portfolio equity inflows, are likely to have increased this year. Credit from commercial banks and other private lenders are the main contributors to the increase. Korean companies have again been active in the syndicated loan market this year. The Philippines and Thailand, which made net repayments to commercial banks in 2003, are expected to register net inflows this year. Net nonbank capital inflows are also estimated to increase sharply. With most bond spreads stable or tighter in the region, issuance by both corporates and sovereigns has been large. Four Korean companies issued bonds worth more than $500 million each while the Korean Government issued sovereign bonds in September. The Philippines continued to borrow heavily from international capital markets for deficit financing. While the Malaysian Government stayed away from the market this year, Malaysian banks and state-linked transport companies returned to the market starting mid-2004. Thailand, likewise, had its own share of corporate and sovereign bond issuances. The Indonesian Government, after an eight-year absence in international markets, issued dollar-denominated debt early this year.

Net equity investments are expected to remain at about $21 billion this year. A reduction in net portfolio equity is expected to be offset by increases in direct equity inflows. Lower inflows from portfolio equity investments reflect the weaker performance of regional stock markets in the middle of 2004.

Table B2.1: **Net Private Capital Flows to the Five Crisis-Affected Countries** ($ billion)

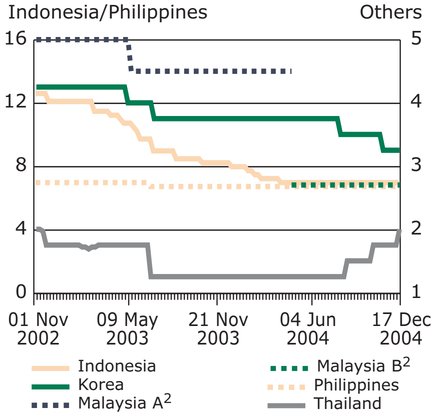
	1998	1999	2000	2001	2002	2003	2004f	2005f
Net private flows	-35.61	2.31	15.19	7.46	6.38	25.43	32.96	23.95
Equity investment, net	17.81	31.01	24.64	19.34	6.68	21.35	20.83	14.65
Direct equity investment, net	13.54	16.45	13.12	9.70	6.52	5.19	7.90	4.85
Portfolio equity investment, net	4.26	14.55	11.53	9.64	0.16	16.17	12.93	9.80
Private creditors, net	-53.42	-28.70	-9.46	-11.88	-0.30	4.07	12.13	9.30
Commercial banks, credit flows, net	-50.76	-27.70	-12.63	-6.61	2.37	0.20	5.40	4.88
Other private creditors, net	-2.65	-0.99	3.17	-5.27	-2.67	3.87	6.73	4.42

f = forecast
Note: Data are as of 1 October 2004.
Source: Institute of International Finance.

Monetary and Fiscal Policies

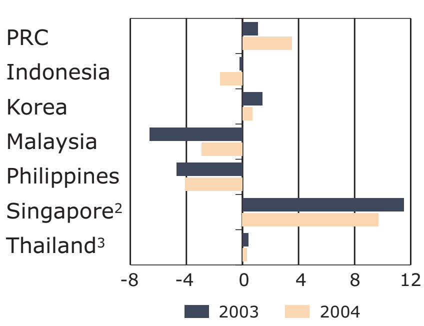
With inflation on the rise, several countries adopted tighter monetary policies this year. In the PRC, authorities continued to tighten monetary policy, most significantly with the end-October hike in benchmark interest rates (the first increase in nine years). This supplemented various administrative measures taken over the past year, which

Figure 14: **Policy Rates**[1]
(end of week, % per annum)



[1]Indonesia: Deposit facility overnight discount rate; Korea: Target overnight call rate; Malaysia A: 3-month intervention rate; Malaysia B: Malaysia overnight policy rate; Philippines: Overnight reverse repurchase rate; Thailand: 14-day repo rate.
[2]Malaysia changed its policy rate from 3-month intervention rate to overnight policy rate in April 2004.
Source: Bloomberg.

Figure 15: **Fiscal Balance**[1]
(% of GDP)



Note: Year to date (2004 and same period in 2003).
[1]Data refer to central government for Indonesia, Korea, Philippines, Singapore, and Thailand; federal government for Malaysia; and central and local government for the PRC. Refers to Jan–Sep except Indonesia (Jan–Jun), Singapore (Apr–Sep), and Thailand (Oct–Sep).
[2]Data are FY Apr–Mar.
[3]Data are FY Oct–Sep.
Sources: CEIC (PRC), Bank Indonesia, Ministry of Finance (Korea), Ministry of Finance (Malaysia), Bureau of the Treasury (Philippines), Ministry of Finance (Singapore), and Bank of Thailand.

included an increase in reserve requirements and restrictions on new lending to dampen credit and investment growth, to bring economic expansion to a more sustainable level.

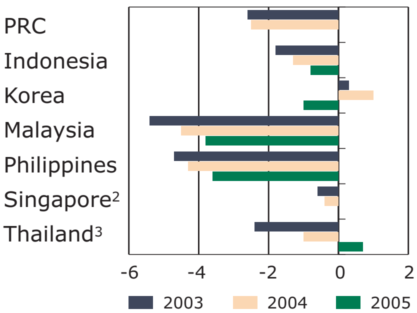
In Indonesia, the central bank lowered its policy rate through April (Figure 14). To mitigate inflationary pressures, however, it increased the statutory reserve requirement for banks (with more than Rp 1 trillion in third party funds) effective 1 July. In the Philippines, the liquidity reserve ratio for peso deposits in financial institutions was raised by two percentage points (to 10%) in February.

In Singapore, where the exchange rate is the monetary policy instrument, in April the monetary authority shifted its policy of zero appreciation for the Singapore dollar's nominal effective exchange rate to one of modest and gradual appreciation. Thailand raised its policy interest rate three times—in August, October, and December—by a total of 75 basis points. In contrast, Korea reduced its policy rate twice—in August and November—by a cumulative 50 basis points to support domestic demand.

With consolidation of the cyclical recovery, governments in the region have, in general, moved fiscal policies toward a more neutral stance. The fiscal outturn this year has been less expansionary than in 2003, with the exception of Indonesia, Korea, and to a lesser extent, Singapore (Figure 15). In Indonesia, the deficit in the first two quarters of 2004 was 1.6% of GDP, compared with 0.2% of GDP during the same period a year earlier and the projected full year budgetary gap of 1.3% of GDP. A key source of the larger-than-expected shortfall was higher fuel subsidies due to the spike in world oil prices. These subsidies will reach 3% of GDP this year, well above the 0.6% of GDP targeted in the budget, and are almost equivalent to total development expenditures. In line with budget projections, Korea's fiscal surplus narrowed to 0.7% of GDP in the first three quarters of the year from 1.4% a year earlier. With domestic demand still weak, and exports likely to decelerate in 2005, the government introduced additional fiscal stimulus equivalent to 0.5% of GDP through a supplementary budget in July.

Fiscal consolidation continued in PRC, Malaysia, Philippines, and Thailand. The PRC's fiscal surplus was 3.5% of GDP over the January-September period, compared with 1.1% of GDP a year earlier. Considering that fiscal accounts tend to show a seasonal deterioration in the fourth quarter, it is likely that the full-year outturn will come close to the budget projection for a deficit of 2.5% of GDP, similar to last year. In the Philippines, where fiscal sustainability is a major source of concern,

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



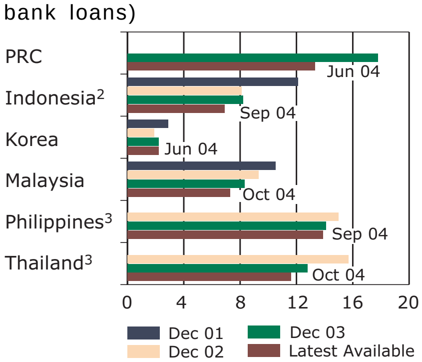
[1]Data refer to central government for Indonesia, Korea, Philippines, Singapore, and Thailand; federal government for Malaysia; and central and local government for the PRC. For Korea and Malaysia, 2003 budget deficit incorporates supplementary budgets.
[2]Data are FY Apr–Mar.
[3]Data are FY Oct–Sep.
Sources: 10th National People's Congress and Chinese People's Consultative Conference (PRC); Bank Indonesia (Indonesia); Ministry of Finance (Korea); Ministry of Finance, and Ministry of Planning and Budget (Malaysia); Bureau of the Treasury (Philippines); Ministry of Finance (Singapore); and Bureau of the Budget (Thailand).

the government has made modest progress over the past 2 years. The deficit in the first three quarters was 4.1% of GDP, compared with 4.7% a year earlier, and a budget projection of 4.3%. The outturn reflected both lower spending and a marginal increase in revenues. The improvement in the fiscal position was most significant in Malaysia, where the fiscal gap shrank to 2.9% of GDP in the first three quarters from 6.6% during the same period a year earlier and compared with a budget projection of 4.5%. Singapore, and to a lesser extent Thailand, continued to record fiscal surpluses.

Official projections for next year's deficits in countries that have announced preliminary budgets are narrower than this year's figures, suggesting that governments intend to continue fiscal consolidation (Figure 16). Korea is the only exception. Considering the weakness in domestic demand, prospects of decelerating export growth, and relatively low public debt, the government has projected a deficit of 1% of GDP for 2005, compared with a surplus of a similar magnitude projected for this year. In the Philippines and Indonesia, the fiscal gap is projected to narrow to 3.6% and 0.8% of GDP respectively.

Financial Restructuring and Prudential Indicators

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



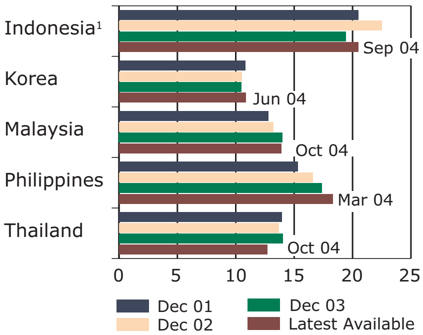
[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis.
[2]Data refer to NPLs in the banking sector.
[3]NPL criteria were changed so no comparable data are available prior to 2002.
Sources: ARIC Indicators and China Banking Regulatory Commission.

Nonperforming Loans, Capital Adequacy, and Bank Profitability

In 2004, nonperforming loans (NPLs) as a percentage of total outstanding loans continued to fall in most East Asian countries: by 4.5 percentage points (to 13.3%) in the PRC, 1.3 percentage points (to 6.9%) in Indonesia, 1 percentage point (to 7.3%) in Malaysia, 0.2 percentage point (to 13.9%) in the Philippines, and 1.2 percentage points (to 11.6%) in Thailand (Figure 17). The large reduction in the NPL ratio in the PRC was due to outright sales and the transfer of NPLs from state-owned commercial banks to asset management companies (AMCs). Despite this large reduction, the NPL ratio in the PRC remains relatively high. Korea had the lowest NPL ratio at a little over 2%.

The average risk-weighted capital adequacy ratio (CAR) of commercial banks is above the 8% BIS norm in all five countries affected by the 1997 financial crisis—Indonesia, Korea, Malaysia, Philippines, and

Figure 18: **Capital Adequacy Ratios of Commercial Banks** (%)



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

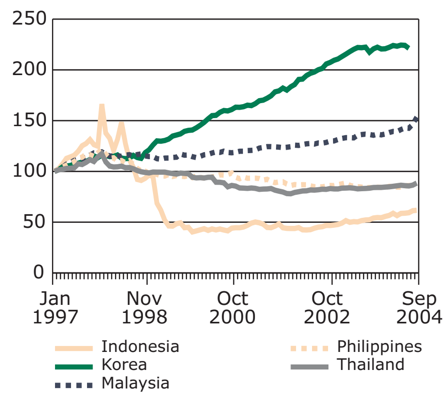
Thailand (Figure 18). In the PRC, the government has issued rules requiring all banks to maintain a minimum risk-weighted CAR of 8%, allowing a transition period through the end of 2006.

Coupled with the generally improved economic conditions in these countries, healthier balance sheets and stronger capital positions have enabled banks to increase credit volume and post better profitability in recent years.

Outstanding real bank credit in Indonesia has increased by about 44% from its recent low in mid-2002, partly driven by household loans (Figure 19). During the same period, outstanding real bank credit increased by 8% in Thailand. Korea and, to a lesser extent, Malaysia, experienced rapid growth in outstanding real bank credit after the crisis. In Korea, after more than doubling since 1997, real bank credit has flattened as the Korean Government took measures to control the burgeoning household debt. In the Philippines, however, real bank credit has yet to recover strongly.

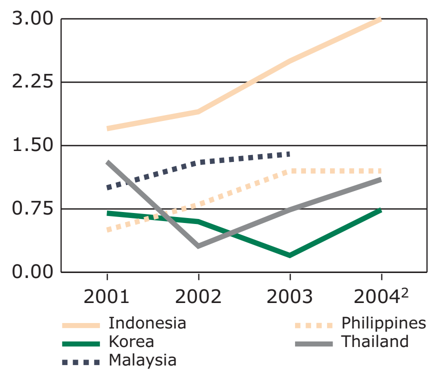
In 2003, four of the five crisis-affected countries saw rates of return on assets (ROA) for commercial banks increasing particularly in Indonesia, Philippines, and Thailand (Figure 20). Only Korea's ROA deteriorated, mainly because of higher provisions for loans to credit card companies and households. Data available for 2004 suggest a further improvement in ROAs of major commercial banks in Indonesia and Thailand. In Korea,

Figure 19: **Real Bank Credit[1]—Five Crisis-Affected Countries, seasonally adjusted** (Jan 1997=100)



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

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



[1]Rate of return on assets for all commercial banks in Indonesia, Philippines, and Thailand; domestic commercial and specialized banks in Korea; and banking/financial system in Malaysia.
[2]As of June 2004 for the Philippines and September 2004 for Indonesia, Korea, and Thailand.
Sources: Bank Indonesia; Financial Supervisory Service, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; and Bank of Thailand.

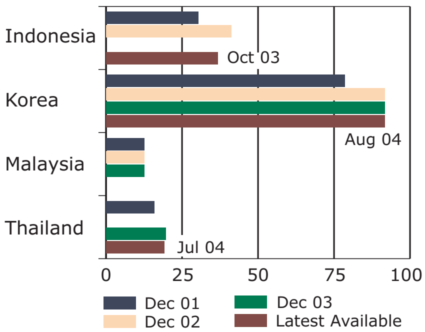
the ROA for domestic commercial and specialized banks has also improved this year.

Asset Resolution by Asset Management Companies

Centralized, government-owned AMCs in Indonesia, Korea, Malaysia, and Thailand have made significant progress in resolving NPLs absorbed from distressed banks after the 1997 Asian financial crisis, with some completing their original mandates and ceasing operations.

The Indonesian Bank Restructuring Agency (IBRA) closed operations in February 2004 after disposing about 77% of the $36.8 billion in NPLs acquired (Figures 21 and 22). Its remaining assets were divided between two entities. In March 2004, the government established a new AMC, PT Perusahaan Pengelola Aset, to manage Rp108 trillion in “free and clear” bank assets on behalf of the Ministry of Finance. Assets not declared “free and clear” were transferred to a “cleanup” team at the Ministry of Finance.

Figure 21: **NPLs Purchased by AMCs** ($ billion)

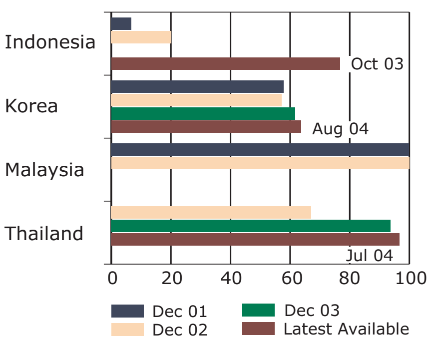


Source: REMU staff calculations based on data from IBRA, KAMCO, Danaharta, and TAMC.

As of August 2004, the Korea Asset Management Corporation (KAMCO) disposed 63.6% of the $91.8 billion NPLs acquired with public funds after the crisis, with a recovery rate of 48.1%.

Malaysia’s Danaharta ceased NPL acquisition in 2001, and resolved all of its $12.6 billion acquired NPLs by September 2002. As of September 2004, Danaharta collected 86% of its total expected recovery, and expects to achieve a recovery rate of 59% in 2005 when it is due for closure.

Figure 22: **NPLs Resolved by AMCs**[1] (% of NPLs purchased)



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

Since its inception, the Thai Asset Management Company (TAMC) had acquired $19.1 billion in NPLs from the banking sector. By July 2004, 96.7% have been resolved with an expected recovery rate of 48.5%. The government recently proposed to allow the Asset Management Corporation, the government-owned AMC setup in 1997 to clean up NPLs of closed finance companies, to purchase distressed assets from banks.

Among the five crisis-affected countries, only the Philippines did not create a centralized AMC. Instead, it enacted a law allowing for the establishment of special purpose vehicles (SPVs) to resolve NPLs. After a slow start, 36 SPVs had been registered by September 2004. Distressed bank assets worth P4.5 billion had been certified as eligible for sale to SPVs as of October 2004, with another P34.4 billion under review. By November 2004, six deals had been concluded between banks and SPVs. The government has proposed a new bill that would extend tax incentives provided by the SPV law beyond April 2005.

Banking Sector Divestment and Consolidation

Bank recapitalization programs implemented after 1997 in most crisis-affected countries left the government as the majority shareholder in many banks. Divestment of this state ownership is now under way, with some countries having made significant progress. Meanwhile, the banking sectors of these countries have also consolidated significantly.

In Indonesia, after a slow start, the divestment program has gathered steam since 2003, with government ownership divested through sales to strategic foreign investors or via initial public offerings. In March 2004, the government sold a 10% stake in Bank Mandiri, the largest domestic bank, while retaining a majority shareholding. In November 2004, the sale of government stakes in two other commercial banks was completed. Despite these developments, the government still retains substantial bank assets. The Indonesian Banking Architecture Program, launched in late 2003, envisions the consolidation of the banking system within 10 to 15 years.

In Korea, the recapitalization program led to the nationalization of seven commercial banks following the 1997 crisis. As its exit strategy, the government chose to sell its bank holdings either to foreign investors or to stronger domestic commercial banks. The government currently retains controlling stakes in just three commercial banks.

In Malaysia, Danamodal, the government agency for bank recapitalization, ceased operations in 2003 after redeeming all its bonds. Following two extensions, the bank consolidation plan was completed in 2003, reducing the number of domestic financial institutions from 54 to 10. The government is currently focusing on the liberalization of the Islamic banking system and awarded Islamic banking licenses in October 2004.

In the Philippines, there were more than 10 mergers and acquisitions involving commercial and thrift banks between 2000 and 2003. The number of commercial banks decreased from 53 in 1998 to 42 by June 2004.

In Thailand, the Financial Sector Master Plan for bank restructuring was approved in January 2004 with an implementation period of two years. The plan aims to rationalize the structure of the financial sector, and has led to the merger of three financial institutions including two commercial banks. Tax incentives to encourage bank mergers were recently approved.

Voluntary Corporate Workouts

To help resolve distressed corporate debts, Indonesia, Korea, Malaysia, and Thailand established government-supervised out-of-court corporate workout programs. The Jakarta Initiative Task Force in Indonesia and the Corporate Debt Restructuring Committee in Malaysia have ceased operations after successfully mediating most of the registered restructuring cases. In Korea, of the 83 companies that were registered under its Corporate Restructuring Agreement for voluntary workout, 57 had been completed, 19 terminated before completion, and 7 are still undergoing workout as of end-2003. In Thailand, as of October, the Corporate Debt Restructuring Advisory Committee has successfully restructured B1,493.3 billion, with B2.9 billion under negotiation and B955.1 billion undergoing legal proceedings.

Financial and Corporate Reforms

Financial and corporate reforms in recent years can be classified into two categories: those targeted at improving the institutional and organizational framework for financial regulation and supervision; and those targeted at strengthening prudential regulations, corporate governance, and legal enforcement:

- **Cambodia.** Prudential regulations have been strengthened with the issuance of guidelines on minimum capital requirements, corrective procedures for undercapitalized banks, loan loss provisioning, and single borrower limits. The central bank is in the process of developing capacity for off-site and on-site supervision. And it has also moved to strengthen accounting standards to conform to international norms.

- **PRC.** The Bank of China, one of the four state-owned commercial banks, was transformed into a joint-stock bank in August 2004. A new Bankruptcy Law was submitted to the National Assembly in September 2004, with adoption expected in early 2005. The proposed law covers state-owned and private enterprises and foreign investment holding companies, but does not cover financial institutions.

- **Indonesia.** The central bank has begun the Indonesian Banking Architecture Program that includes a phased implementation from 2004 to 2013 of the Basel Core Principles for Effective Banking Supervision. A deposit insurance law was passed by parliament in

August 2004 creating the Indonesia Deposit Guarantee Corporation (LPS).

- **Korea.** Efforts to strengthen supervision of nonbank financial institutions (NBFIs) have continued with most of the rules promulgated by the Financial Supervisory Commission focusing on strengthening risk management and disclosure practices of NBFIs. A new bankruptcy law for individual debtors was passed in March 2004.

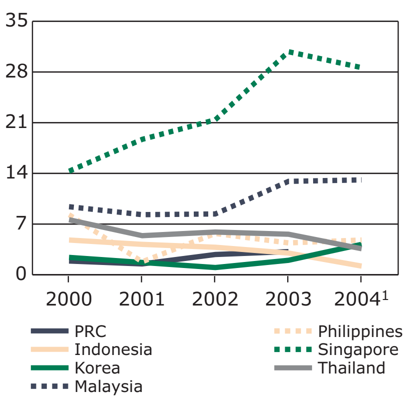
- **Malaysia.** In an effort to boost Islamic banking, the central bank is strengthening supervisory rules for Islamic banks. Amendments to the securities law introduced provisions governing the reporting of irregularities by auditors.

- **Philippines.** The charter of the Philippine Deposit Insurance Corporation was amended, restoring its power to examine member banks. A Securitization Act was also signed into law. The government launched its Financial Sector Restructuring Agenda that includes several proposals to strengthen financial regulation and improve corporate governance.

- **Thailand.** At the end of 2003, the Bank of Thailand released guidelines on the management of market risk arising primarily from movements in interest rates, equity prices, exchange rates, and commodity prices. In August 2004, it adopted a more stringent scheme requiring banks to increase provisioning for distressed assets not undergoing formal restructuring or involved in litigation.

- **Viet Nam.** The National Assembly passed a new bankruptcy law in June 2004, taking effect in October.

Figure 23: **Current Account Balance** (% of GDP)

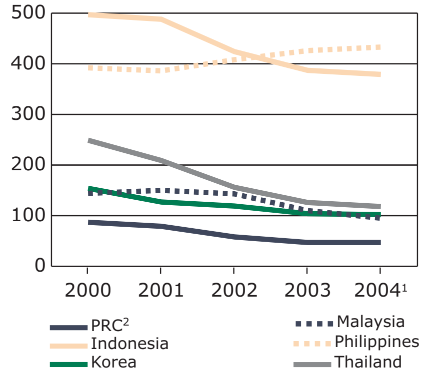


[1]As of June for Malaysia and the Philippines; September for Indonesia, Korea, Singapore, and Thailand.
Sources: REMU staff estimates and ARIC Indicators.

Prudential Indicators

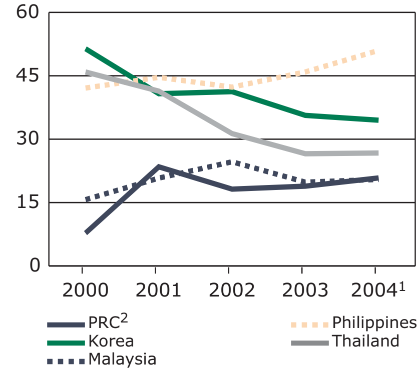
Improved health of financial sectors in East Asia has also been accompanied by better external payments positions and other prudential indicators. Current accounts were in surplus in 2003 for the sixth consecutive year in PRC, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand. Available data for 2004 show that, although falling in some countries, the current account surplus to GDP ratios ranged from 1.2% in Indonesia to 28.6% in Singapore, with data unavailable for the PRC (Figure 23). These sustained current surpluses and strong private capital inflows have resulted in a continued buildup of foreign reserves. Consequently, most countries in the region have

Figure 24: **Total External Debt** (% of gross international reserves)



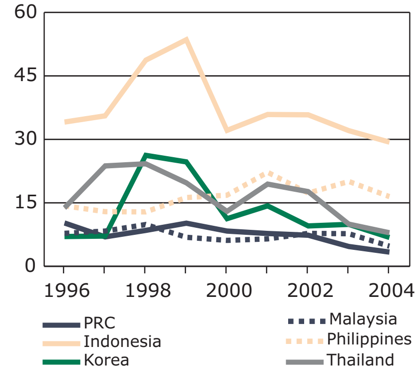
¹As of June, except Indonesia (March).
²External debt definition was revised in 2001.
Source: ARIC Indicators.

Figure 25: **Short-Term External Debt** (% of gross international reserves)



¹As of June.
²External debt definition was revised in 2001.
Source: ARIC Indicators.

Figure 26: **Total Debt Service** (% of exports of goods, services, and income)



Note: As of July for Philippines and PRC; August for Indonesia, Korea, and Thailand; and September for Malaysia.
Source: Institute of International Finance.

seen stable or falling external debt to foreign reserve ratios (Figures 24 and 25). An exception is the Philippines, where large external financing requirements have caused an increase in both ratios of total and short-term external debt to foreign reserves since the end of 2002. The debt service ratio has been falling in recent years for PRC, Indonesia, Korea, Malaysia, and Thailand, and the available data suggest that this has continued in 2004 (Figure 26). In the Philippines, the debt service ratio was on a rising trend in recent years, but fell during the first half of 2004.

Strong external payments positions, improved macroeconomic fundamentals, and healthier banking sectors have led to an improved perception of credit risk in most of East Asia. Following the series of credit rating upgrades last year, ratings and outlooks have been further revised upward this year for PRC, Malaysia, and Thailand by at least one major global rating agency. However, the credit outlook for the Philippines was revised downward by Fitch Ratings in December 2004 largely due to concerns over the fiscal position.

Economic Outlook, Risks, and Policy Issues

External Economic Environment

This year, most industrial countries are set to post robust growth despite high oil prices and some loss of momentum in the second and third quarters. The external economic environment facing East Asia has thus continued to be favorable. Next year, it is expected to be less favorable, with growth in several industrial countries, especially the US and Japan, set to slow from this year's high levels, and the global electronics sector, particularly the semiconductor subsector, likely to soften (Box 3). According to the International Monetary Fund (IMF), 2004 annual global GDP growth will be 5%, the highest in about three decades, driven by

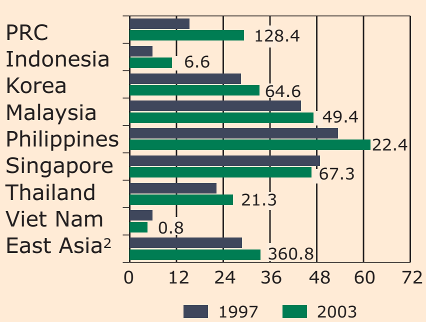
Box 3: **Electronics Cycle and East Asia's Exports**

East Asia's dependence on the global electronics cycle has increased in recent years. The share of electronics exports to the region's total exports rose from 29% ($193 billion) in 1997 to 34% ($361 billion) in 2003 (Figure B3.1). Among East Asian countries, Philippines, Singapore, and Malaysia's share of electronics exports to total exports is highest, while that of Viet Nam and Indonesia is lowest.

The continued recovery of the world market for electronic products this year was one of the main contributors to the buoyancy of the region's exports. Sales in the semiconductor segment, for example, strengthened further in 2004, building on the recovery begun in 2002, following the burst of the information technology (IT) bubble in 2000. World semiconductor sales in August 2004 were 1% higher than its peak in September 2000. Much of the strength in receipts came from unit sales rather than higher prices, reflecting a surge in demand for wireless goods in particular.

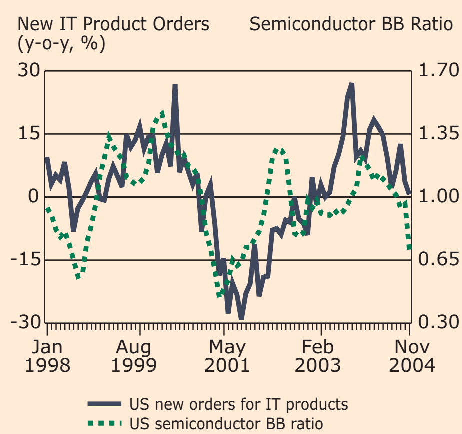
The market for technology products is likely to soften in 2005, contributing to slower growth in the region's exports. For instance, compared with the broader stock market, more companies in the US technology sector reported third quarter earnings that were below expectations. Leading indicators, such as US new orders for IT products and the semiconductor book-to-bill ratio are also showing a downturn, following a strong increase since last year (Figure B3.2). The book-to-bill ratio fell to below 1.0 in October for the first time since September 2003, suggesting that orders have fallen short of current sales. Some analysts expect production in key segments of the electronics industry to outpace demand, contributing to an increase in inventory levels and lower prices in the first quarter of 2005, when demand is at its seasonal low. The spot price of dynamic random access memory (DRAM) chips in November 2004 was about 30% below its April peak (Figure B3.3).

Figure B3.1 **Electronic Products**[1] **Share of Total Exports** (%)



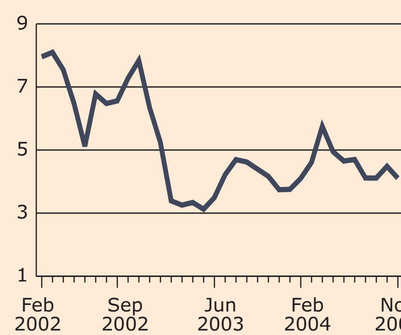
Note: Numbers indicate the value of electronic products exports in 2003 ($ billion).
[1]Summation of SITC 752, 76, 77.
[2]Brunei Darrusalam, Cambodia, Lao PDR, and Myanmar are excluded.
Source: UN Commodity Trade Statistics Database.

Figure B3.2 **US New Orders for IT Products and Semiconductor BB Ratio in the US**



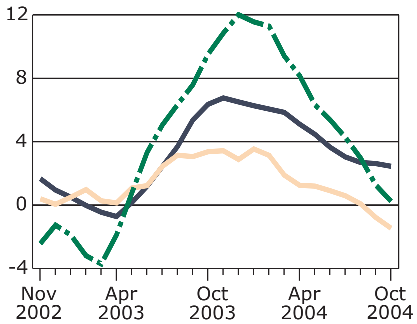
Source: US Bureau of Census, Semiconductor Industry Association.

Figure B3.3 **DRAM Spot Price—256M DDR** ($/unit)



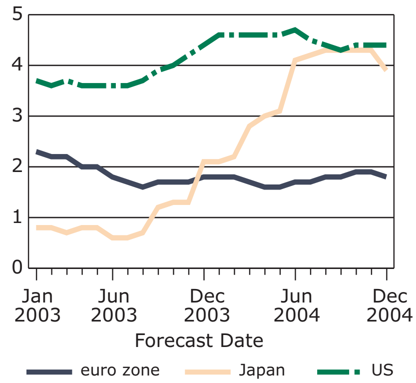
Source: DRAMeXchange, Bloomberg.

Figure 27: **OECD Six-Month Rate of Change of the Trend Restored CLI, Annualized** (% change)



Source: OECD web site.

Figure 28: **Consensus Forecasts of 2004 G3 GDP Growth** (y-o-y, %)

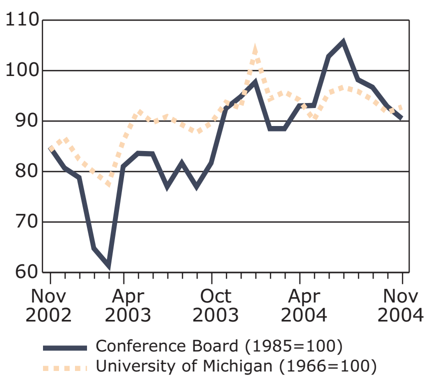


Source: Consensus Economics Inc., *Consensus Forecasts*, various issues.

several favorable factors—including continued strong growth in US business spending, recovery in Japan, and the rapid growth of fixed investment in the PRC. Looking ahead, with some softening in US consumer spending and Japan's economic growth, global economic growth is expected to slow to about 4% in 2005, still above the long-term trend rate of about 3.5%. OECD's Composite Leading Indicators (CLIs) through September 2004 also point to slower global economic expansion beginning late this year or in early 2005 (Figure 27).

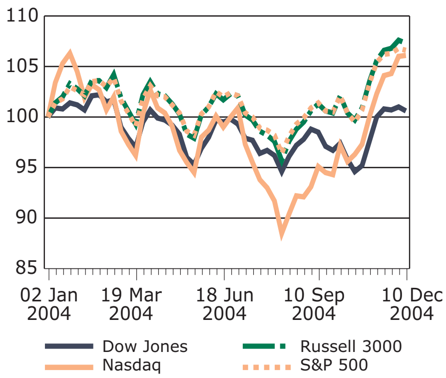
In the US, despite a soft patch in the second quarter, GDP growth for the first three quarters of 2004 was a strong 4.6%. Nonfarm employment has also increased by an average of close to 200,000 per month in the first 11 months of the year, notwithstanding large month-to-month fluctuations. US GDP growth for 2004 is now forecast at 4.4%, only marginally lower than the 4.5% forecast in the July AEM (Figure 28). Looking ahead, US consumer confidence remains robust (despite the recent decline), major US stock price indexes have generally risen since mid-August, and unemployment remains low by historical standards (Figures 29, 30, and 31). Moreover, external demand for US products is likely to increase modestly, as US imports and exports respond to the US dollar's cumulative depreciation since 2002. However, as US interest rates continue to rise at a measured pace (the most recent increase was on 14 December by 25 basis points), business investment will moderate to a more sustainable level from this year's

Figure 29: **US Consumer Confidence Index**



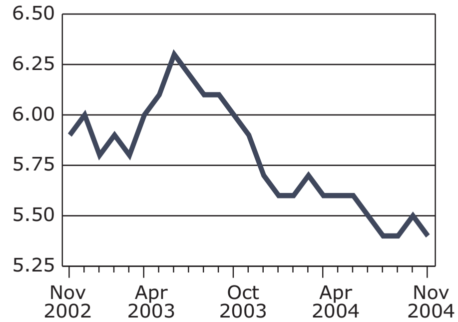
Note: Conference Board numbers are released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

Figure 30: **US Stock Market Indexes** (weekly average, 2 Jan 2004=100)



Source: REMU staff calculations derived from Bloomberg.

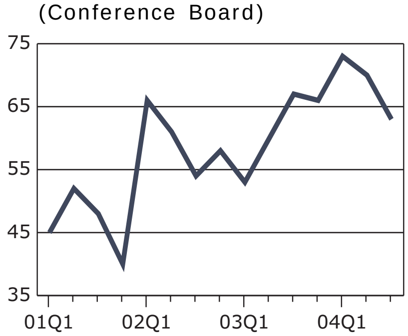
Figure 31: **US Unemployment Rate** (%)



Source: Bloomberg.

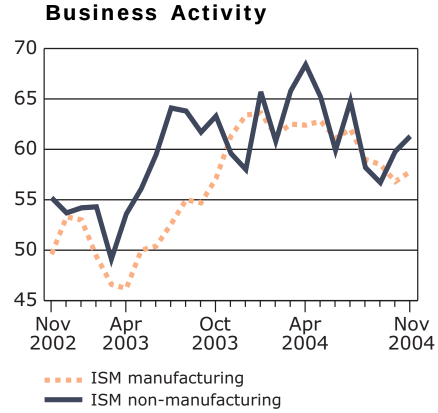
strong growth. Some evidence that business investment is already slowing comes from the recent decline in the US business confidence index and the Institute for Supply Management (ISM) surveys of business activity (Figures 32 and 33). Higher interest rates could also contribute to a softening of consumer spending in the months ahead, as housing prices moderate and households increase savings. On balance, therefore, US GDP growth is forecast to slow next year. Yet, at 3.5%, the current forecast for next year's US GDP growth is if anything marginally higher than its long-term potential growth.

Figure 32: **US Business Confidence Index** (Conference Board)



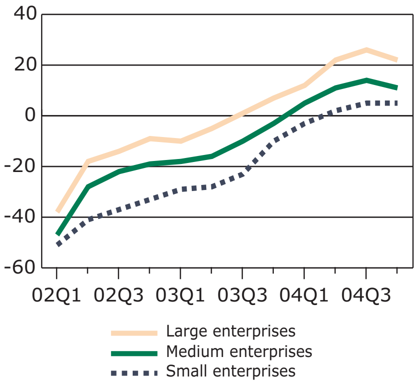
Source: Bloomberg.

Figure 33: **Surveys of US Business Activity**



Source: Bloomberg.

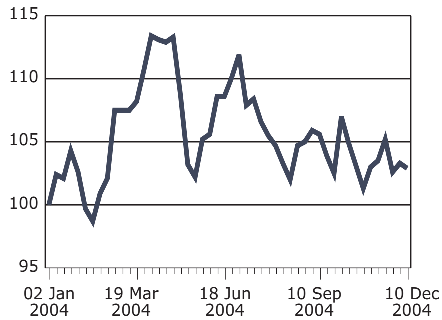
Figure 34: **Japan: Tankan Survey—Business Conditions Indicator** (Manufacturing)



Source: Bloomberg.

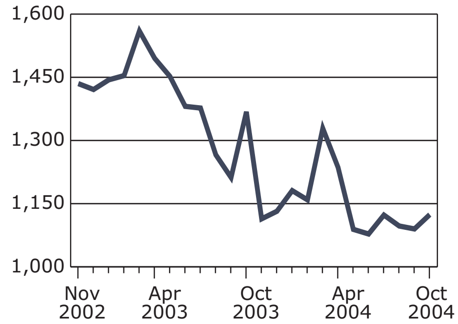
Japan's economic growth in 2004 has been much better than in recent years, irrespective of whether one uses the old GDP series or the revised series using the chain-weighted method. Despite the slowdown in the second and third quarters, GDP grew by 4.7% in the first three quarters of the year, based on the old series. The comparable figure using the revised series is 3.3%. Looking ahead, the Tankan survey points to robust expansion in the manufacturing sector (Figure 34). The business conditions indicator slowed somewhat in the fourth quarter, but the slowdown was less than expected by markets. Moreover, stock markets have rallied in recent months, corporate bankruptcies continued to decline, consumer prices are increasing after a long period of deflation, and unemployment remains low by historical standards (Figures 35, 36, 37, and 38). Using the old GDP series, current forecasts place GDP growth for 2004 at 3.9%. Looking ahead, the Bank of Japan recently predicted that deflation (prevalent since 1997) would end during the coming fiscal year. However, in 2005, Japan's economy is projected to

Figure 35: **Nikkei 225** (weekly average, 2 Jan 2004=100)



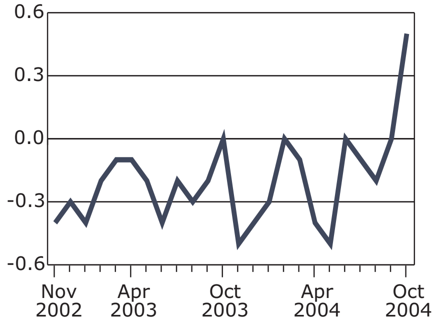
Source: REMU staff calculations derived from Bloomberg.

Figure 36: **Japan: Bankruptcy Cases**[1]



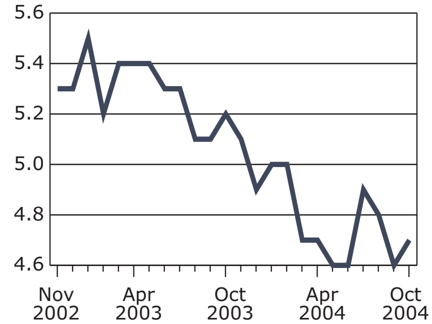
[1]Companies with total debts of ¥10 million or more.
Source: Bloomberg.

Figure 37: **Japan: Consumer Price Index** (y-o-y, %)



Source: Bloomberg.

Figure 38: **Japan: Unemployment Rate, Seasonally Adjusted** (%)

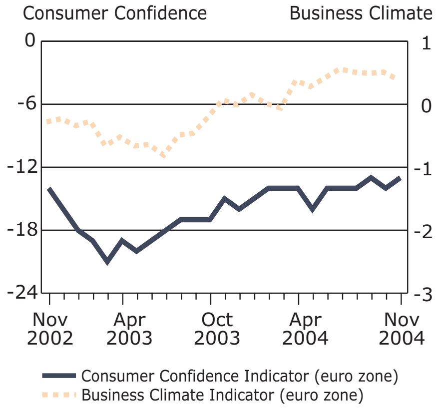


Source: Bloomberg.

slow from this year's high growth. Current forecasts place next year's GDP growth (using the old series) at 1.5%.

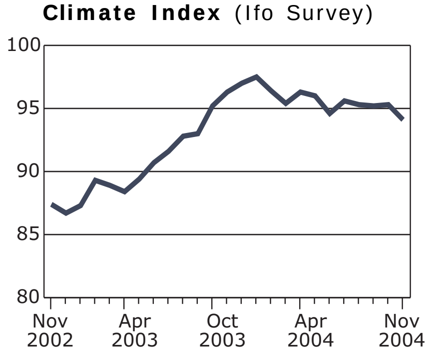
Although the euro zone's recent growth performance compares poorly with that of the US, this year's GDP growth has been better than last year's marginally positive figure. Despite some decline in the growth momentum in the second and third quarters, GDP growth for the first three quarters of 2004 averaged 1.8%, well above the 0.5% growth achieved in 2003. Moreover, in recent months both consumer confidence and business climate indicators have generally improved, albeit slowly (Figure 39). Yet, outside France and Spain, euro zone growth has been driven largely by external demand. In particular, Germany, the largest euro zone economy, saw sluggish consumer spending hold back growth, partly reflecting increased household savings in response to cuts in future benefits under recent pension reforms. German business confidence is declining as well (Figure 40). In the third quarter, a decline in exports (the first in five quarters) exacerbated sluggish consumer spending, which led to quarterly GDP growth of only 0.4%, the slowest annualized growth in more than a year. Domestic demand also remains soft in Italy, the third largest euro zone economy. In 2005, the appreciation of the euro against the dollar should gradually rebalance sources of growth away from external demand toward domestic demand. Combined GDP of the 12 countries sharing the euro is now forecast to grow by 1.8% in 2004 and 1.7% next year.

Figure 39: **Euro zone 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 40: **German Business Climate Index** (Ifo Survey)

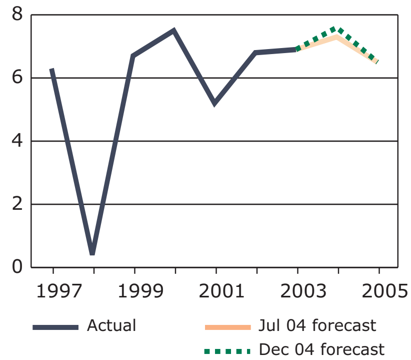


Source: Bloomberg.

Regional Economic Outlook

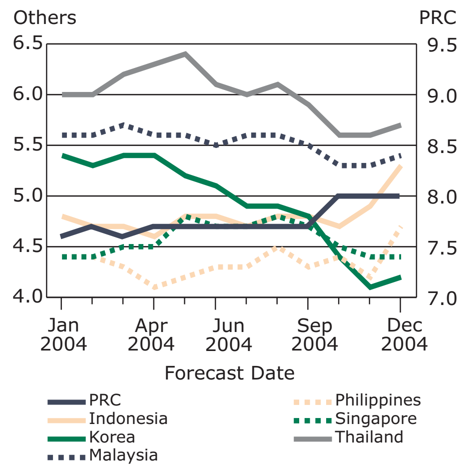
Partly due to the favorable external environment and partly due to robust domestic demand, growth among most East Asian countries continues to be strong. Despite high oil prices and some loss of growth momentum, the December survey of Consensus Economics projects East Asia's average GDP growth in 2004 at 7.6% (Figure 41), the highest since the 1997 financial crisis. This is also higher than the 7.3% growth forecast presented in the July 2004 AEM. Looking ahead, with the external economic environment expected to be less favorable, and the PRC continuing to rein in growth, East Asia is expected to register a more moderate, yet still solid, 6.5% growth next year—the same as projected in the July AEM. With the exception of Indonesia and Lao PDR, all East Asian countries are forecast to grow at a slower pace next year—albeit with significant differences across countries, depending upon the degree of economic openness to international trade and exposure to the PRC market (Table 1). Since July, Consensus Economics has revised its 2005 growth forecasts downward for Korea, Malaysia, Singapore, and Thailand, and upward for PRC, Indonesia, and Philippines (Figure 42).

Figure 41: **Real GDP Growth—East Asia** (%)



Source: Same as Table 1.

Figure 42: **Consensus Forecasts of 2005 ASEAN5+2 GDP Growth** (y-o-y, %)



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

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

								Dec 2004 Forecasts		Difference[1]		Average
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2004	2005	1998–2003
Brunei Darussalam	3.6	-4.0	2.6	2.8	3.0	2.8	3.2	. . .	. . .	. . .	. . .	1.7
Cambodia	6.8	3.7	10.8	7.0	5.7	5.5	5.2	4.5	2.3	-0.9	-3.1	6.3
PRC	8.8	7.8	7.0	7.6	7.3	8.0	9.4	9.3	8.0	0.6	0.3	7.8
Indonesia[2]	4.7	-13.1	0.8	4.9	3.8	4.3	4.5	4.9	5.3	0.3	0.6	0.9
Korea	4.7	-6.9	9.5	8.5	3.8	7.0	3.1	4.8	4.2	-0.6	-0.7	4.2
Lao PDR	6.9	4.0	7.3	5.8	5.8	5.9	5.8	6.5	7.0	0.5	0.8	5.8
Malaysia	7.3	-7.4	6.1	8.9	0.3	4.1	5.3	7.1	5.4	0.6	-0.2	2.9
Myanmar[3]	5.7	5.8	10.9	13.7	11.3	10.0	10.6	. . .	. . .	. . .	. . .	. . .
Philippines	5.2	-0.6	3.4	6.0	3.0	3.1	4.7	5.9	4.7	1.1	0.4	3.3
Singapore	8.6	-0.9	6.9	9.7	-1.9	2.2	1.1	8.3	4.4	1.4	-0.3	2.8
Thailand	-1.4	-10.5	4.4	4.8	2.2	5.3	6.9	6.1	5.7	-0.5	-0.3	2.2
Viet Nam	8.2	4.4	4.7	6.1	5.8	6.4	7.1	7.3	7.1	0.0	0.0	5.8
East Asia[4,5]	6.3	0.4	6.7	7.5	5.2	6.8	6.9	7.6	6.5	0.3	0.0	5.6
East Asia exc PRC[4,5]	4.5	-6.8	6.4	7.4	2.9	5.4	4.0	5.6	4.8	0.0	-0.3	3.2
ASEAN[4,5]	4.4	-6.7	4.1	6.5	2.1	4.1	4.8	6.3	5.3	0.5	0.1	2.5
ASEAN5+2[5]	6.3	0.4	6.8	7.5	5.2	6.8	6.9	7.6	6.5	0.3	0.0	5.6

. . . = not available.
[1]Difference between December 2004 forecasts and the July 2004 forecasts.
[2]GDP growth from 1997–2000 is based on 1993 prices, while growth from 2001 onwards is based on 2000 prices.
[3]For FY April–March.
[4]Excludes Myanmar for all years; Brunei Darussalam in 2004 and 2005.
[5]Aggregates are weighted according to gross national income levels from the World Bank's World Development Indicators.
Sources: ARIC Indicators for 1997–2003; 2004–2005 forecasts for ASEAN5+2 and Viet Nam are from Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, Jul 2004 and Dec 2004; Asian Development Bank, *Asian Development Outlook 2004 Update* for other countries.

Individual Country Outlook

- **Brunei Darussalam.** GDP is estimated to have grown by less than 1% in the first half of this year despite higher oil prices, reflecting temporary lower oil and gas production due to the repair and upgrade of existing facilities. Given the low growth in the first half, it is unlikely that the government's full year growth target of 3-4% can be met. A recent IMF assessment places 2004 GDP growth at 1%.

- **Cambodia.** In the first half of 2004, robust garment exports—the main manufacturing industry—suggest that Cambodia's GDP has expanded at a healthy rate. Growth for 2004 is forecast to be 4.5%, but will slow to 2.3% in 2005, mainly reflecting the expected adverse impact of ending garment quotas on 1 January 2005 under the multifiber agreement.

- **PRC.** PRC's GDP grew by 9.5% in the first three quarters of the year. GDP growth for the full year is now forecast at 9.3%, revised upward from the 8.7% July forecast. Almost all drivers of growth—personal consumption, fixed investment, and exports—have grown at faster rates than initially expected. In recent months, government efforts to cool the economy have led to a modest slowing of growth in bank credit and money supply. However, fixed investment growth in 2004, although below last year's level, is still expected to be a strong 25%. Looking ahead, recent policy measures are expected to lead to a significant slowdown in fixed investment growth next year. A slowing global economy will also result in lower export growth in 2005, from about 30% this year. Both are expected to slow GDP growth to about 8% next year.

- **Indonesia.** GDP grew by 4.9% in the first three quarters of the year, primarily driven by robust private consumption and a pick up in investment. GDP growth for the full year is now forecast at 4.9%, 0.3 percentage point higher than the AEM July forecast. Continued strength in private consumption and a further improvement in investment are expected to enable the country to post higher GDP growth of 5.3% in 2005, 0.6 percentage point higher than the July forecast. The successful completion of the first-ever direct presidential election has raised hopes that many of the constraints on economic growth will be addressed in the months ahead.

- **Korea.** The Korean economy is adjusting following the household credit boom. In the first three quarters of the year, GDP grew by 5.1%, driven mainly by exports. Domestic demand continues to be weak, with private consumption declining for most of the year. Growth momentum, already slowing in the first three quarters, is expected to slow further in the last quarter, leaving GDP growth for 2004 forecast at 4.8%. This is a downward revision from the 5.4% forecast in the July AEM. Household consumption, after declining for two consecutive years, is expected to grow marginally in 2005. However, driven by a slowdown in industrial countries and in the PRC, exports are expected to slow significantly next year. Thus, growth in 2005 is expected to slow to 4.2%, about 0.7 percentage point lower than the July 2004 forecast.

- **Lao PDR.** GDP is estimated to have grown by 6.5% in the first half of the year, with the same rate likely during the second half, leaving a full year GDP growth forecast of 6.5%, 0.5 percentage point higher than the July forecast. With commodity prices probably remaining strong, 2005 GDP growth is forecast higher at 7%, about 0.8 percentage point higher than the July forecast.

- **Malaysia.** Driven by strong exports and consumer spending, Malaysia's GDP grew by 7.6% in the first three quarters of the year. For 2004, GDP is forecast to grow by 7.1%, higher than the 6.5% July forecast. Next year, GDP growth is expected to be lower at 5.4%, due to softer global growth, reduced demand in the global electronics industry, and the economic slowdown in the PRC.

- **Myanmar.** The official GDP growth target for the year is 10%. However, a recent IMF report forecasts GDP growth of 3.6% this year and 3.3% growth for 2005. Growth is likely to come from the oil and gas sector, as the global demand for energy increases. Additional gas reserves were found early in the year, raising prospects for exports and increased foreign direct investment.

- **Philippines.** Supported by strong personal consumption, and to a lesser extent exports, Philippine GDP grew by a better-than-expected 6.5% in the first three quarters of the year. With consumer spending slowing, partly due to high oil prices and weaker export growth in the last quarter, GDP growth for 2004 is forecast to be 5.9%. This figure is more than 1 percentage point higher than the July forecast. The winding down of the global electronics cycle, weaker growth in industrial countries, and the PRC economic slowdown are expected to lead to a lower 4.7% GDP growth next year.

- **Singapore.** Despite the recent loss of growth momentum, Singapore's economy grew by 9.1% in the first three quarters of the year. A combination of strong export performance and robust domestic demand underpinned this solid performance. GDP is now forecast to grow by 8.3% in 2004, which not only represents a major expansion from last year's 1% growth, but also is 1.4 percentage points higher than the July forecast. Going forward, however, a slowing global economy and a soft landing of the PRC economy will put downward pressure on Singapore's economy. As a highly open economy, reduced export prospects would also put downward pressure on Singapore's domestic demand. Next year's GDP growth is thus forecast to be much lower at 4.4%.

- **Thailand.** Thailand's GDP grew by 6.4% in the first three quarters of the year, with all major components of demand—private consumption, fixed investment, and exports—contributing to this robust growth. For 2004 as a whole, GDP is forecast to grow by 6.1%, half a percentage point lower than the July forecast. Next year, export growth is likely to slow significantly with the slowdown in industrial countries and the PRC, while fixed investment and private consumption are expected to continue to grow at similar rates as this year. On balance, therefore, GDP growth is forecast to slow to 5.7% next year, again lower than the July forecast of 6.0%.

- **Viet Nam.** It is estimated that Viet Nam's GDP grew by 7.4% in the first three quarters of the year. Growth was supported by robust exports and healthy domestic demand, especially investment. For 2004, GDP is forecast to grow by 7.3%. A marginally lower GDP growth of 7.1% is forecast for next year. Both these figures are unchanged from July forecasts.

Risks and Policy Issues

The growth forecasts for next year are subject to three main risks, two external and one internal to the East Asian region: (i) continued high oil prices, (ii) a disorderly adjustment of the US current account deficit, and (iii) a hard landing for the PRC economy.

If oil prices remain high, or worse, increase further, East Asia's growth in 2005 will be significantly below current forecasts. Brent crude has risen by 32% year-on-year so far this year, although it fell to an average of $38 a barrel in the first half of December from its peak of almost $50 in October. East Asian economies and financial markets have performed well despite high oil prices for several reasons. First, real oil prices have not gone up as much as during earlier oil shocks—

they are less than half their peak 1979–80 level. Second, economies have become more energy-efficient in production. Third, much of the rise in prices this time reflects stronger demand, mitigating the risk of stagflation, although fears about disruption of supply at a time when capacities are stretched and speculative activity in markets have also been significant factors. Fourth, the regional economies are less vulnerable given their large foreign exchange reserves. The International Energy Agency (IEA) forecasts a slowdown in growth of world demand for oil to 1.8% in 2005 from an estimated 3.3% this year, reflecting subdued demand from the PRC and a deceleration in global economic growth generally. Slower demand growth should lead to lower prices, all else equal. However, OPEC's recent decision to cut supply, combined with geopolitical uncertainty, suggests that the risk of high oil prices remains. Also, six-month Brent crude futures averaged $39.6 per barrel in the first half of December, indicating that markets expect prices to remain firm in the near term.

A disorderly adjustment of the US current account deficit constitutes another risk to East Asia's growth prospects. The US current account deficit—4.4% of GDP in 2000—is now close to 6% of GDP, with no signs of it receding. And this is despite a significant depreciation of the dollar against the euro, and to a lesser extent, against the yen. There is a growing concern that the US economy could fall into a crisis of confidence that would lead to a disorderly fall of the US dollar, a sharp rise in US interest rates, and a deep contraction of the US economy, perhaps bringing down the global economy as well. With the sharp depreciation of the US dollar in recent weeks, after a period of relative stability, concerns over the realization of this risk have heightened.

The hoped-for soft landing for the PRC economy appears to be on track. Growth in money supply and bank credit is slowing, and GDP growth is expected to slow by a full percentage point next year—after easing marginally in recent quarters. Also, inflation slowed to 2.8% in November. However, there is a risk that the economic slowdown could be sharper than expected. If this happens, it would hurt next year's growth prospects in several East Asian countries. A hard landing would disproportionately affect countries that derive a significant part of export growth from PRC demand. Exports to the PRC as a share of GDP ranges from about 2% for Indonesia to 11-12% for Malaysia and Singapore, with Korea's exports accounting for about 7% of GDP. However, should the PRC economy experience a sharper-than-expected slowdown, it would in turn lower the risk of higher oil prices given that the PRC's rapid growth has been a significant factor in this year's rise in oil prices.

The key policy challenge facing East Asia over the next year or two is to sustain robust GDP growth at a time when US interest rates and domestic inflation rates are on an upward path. The policy challenge is made more difficult by the uncertainty over international oil prices and the adjustment of the US current account deficit. The sharp increase in oil prices has already put upward pressure on inflation in several East Asian countries, and a continuation of high oil prices, or worse still, any further increase, would not only add inflationary pressure but also damage growth. The need for the winding down of US current account deficit could also negatively affect East Asia's exports, which have been a significant external source of growth in recent quarters. Keeping inflation under control would require tighter fiscal and monetary policies. But that would restrain domestic demand at a time when external demand is expected to soften.

Against this emerging global and regional economic backdrop, an appropriate policy response should have three key components: (i) tighter fiscal and monetary policies, (ii) greater exchange rate flexibility, and (iii) structural reforms to create an environment conducive for a sustained increase in domestic demand, especially private investment in countries where it has been subdued since 1997. Such a policy mix could keep inflation under control but at the same time enable countries to achieve robust economic growth by bringing about a better balance between external and domestic demand. Within this overall framework, the importance of each component of the policy mix would, of course, vary significantly across countries depending upon their specific circumstances.

Fiscal Consolidation

There is a case for fiscal consolidation across the region, especially among the larger economies, with the notable exceptions of Korea and Singapore. In Korea, in the face of weak domestic demand, slowing growth momentum, and concerns about a severe contraction in construction activity, the July supplementary budget is a welcome initiative. Given Korea's comfortable fiscal position, including low public debt, there is scope for further fiscal easing to support domestic demand. And as Singapore's fiscal position continues to be comfortable, there is scope for using fiscal stimulus, if required, although the openness of the economy to trade tends to make fiscal stimulus less effective in spurring domestic demand and growth.

Among the other East Asian countries, the need for fiscal consolidation is perhaps strongest in the Philippines. The fiscal situation remains precarious, with a consolidated nonfinancial public sector debt over 100% of GDP. The fiscal program for 2004 targets the national government deficit to decline to 4.2% of GDP from 4.6% of GDP in 2003. Fiscal trends until now show that the government is on track to achieve the target. While this is laudable, there is a strong case for expeditious reductions in both the national government deficit and the deficits incurred by public enterprises. Effective implementation of the legislative measures to increase tax revenues recently proposed, and the completion of power sector reforms, including privatization, are crucial for achieving further fiscal consolidation in the coming years.

Indonesia has made significant progress in fiscal consolidation in recent years, with the central government generally incurring a deficit of less than 2% of GDP and running a primary surplus. This year's fiscal deficit is expected to be even lower at about 1.3% of GDP, mainly due to much higher revenues. Yet, at more than 50% of GDP, the public debt to GDP ratio is on the high side. Therefore, continuing fiscal consolidation is appropriate, among other things, focusing on reducing fuel subsidies, which could partly be used for reducing the fiscal deficit and public debt, and partly for increasing the much needed development expenditures.

In the PRC, given the need to rein in public investment and slow GDP growth, there is a strong case for a restrictive fiscal policy. The existence of a sizable public debt, when an under-funded public pension system and other public sector contingent liabilities are taken into account, makes a further case for fiscal consolidation.

Malaysia and Thailand have both implemented fiscal consolidation programs in recent years, after having used expansionary fiscal policies to spur growth in the immediate aftermath of the 1997 financial crisis. Governments in both countries also plan to carry the fiscal consolidation program forward. This appears to be an appropriate response, given the macroeconomic situation: although growth is slowing, it remains robust.

Tighter Monetary Policy

With the exceptions of Malaysia and Thailand, and to a lesser extent Korea, monetary policy needs to be tightened, especially with inflation edging up almost across the region. In some of these countries, weak external payments positions also underscore the need for tighter monetary policies.

In Malaysia, where underlying inflationary pressures remain modest and the external payments position is strong, there may not be a compelling case for tightening monetary policy despite the fixed exchange rate. Thailand has tightened monetary policy by raising interest rates in recent months, probably because headline inflation has slowly edged up. However, the core inflation of about 0.5% is well below the 3.5% upper limit of the official inflation target. Coupled with a flexible exchange rate regime, this suggests that Thailand need not necessarily tighten monetary policy further, even as US interest rates go up, unless core inflation rises sharply.

In Korea, core inflation of about 3% in November is at the mid-point of the central bank's 2.5-3.5% target range, requiring monetary policy to be either tightened or kept neutral. However, weak domestic demand and slowing GDP growth supports the case for an accommodative monetary policy stance. Striking a balance between these conflicting demands is a challenge. Against this backdrop, the Bank of Korea recently cut the overnight interest rate by 50 basis points in two installments, to 3.25%.

The economic outlook for the PRC, Indonesia, Philippines, and some of the smaller countries in East Asia, such as Lao PDR and Viet Nam, appears to require tighter monetary policies over the next year or so. In Indonesia, with inflation in recent months hovering between 6% and 7%, there is a case for monetary tightening. Similarly, in the Philippines both headline and core inflation are above 7%, much above the official target of 4-5%, requiring a tightening of monetary policy.

In the PRC, given the need to rein in investment and slow GDP growth, the authorities implemented a series of administrative measures to control bank credit and money supply growth. The central bank also supplemented the administrative measures by raising benchmark interest rates for the first time in nine years at the end of October. There is a case for continuing a tighter monetary policy in the months ahead, especially as investment growth, although slowing, remains high.

Inflation has also been rising in recent months (and/or remains high) in some of the smaller East Asian economies, making the case for restrictive monetary policies. In Viet Nam, inflation was close to 9% in the first nine months of 2004, breaching the initial official target, while in Lao PDR, although inflation has been falling in recent months, it still averaged about 12% the first eight months of the year.

Greater Exchange Rate Flexibility

Greater flexibility in exchange rates would provide more room for maneuver in macroeconomic policy making for East Asia, even as US interest rates increase. To the extent that greater exchange rate flexibility is accompanied by a general appreciation of regional currencies (given that several countries still run current account surpluses and hold large foreign exchange reserves), it would enable East Asian countries to shift sources of growth from external to domestic demand. It would also contribute to an orderly resolution of the US current account deficit.

However, greater flexibility of East Asian exchange rates alone will not be enough to bring about an orderly adjustment of global imbalances. As was discussed in the recent G-20 meeting, a shared approach is required. Greater exchange rate flexibility in East Asia should be seen as part of a global approach to resolve global current account imbalances, which would also include policies aimed at lowering the fiscal deficit and boosting savings in the US, continuing robust growth in Japan, and improved growth in Europe. PRC authorities have made it clear that they intend to move to a more flexible exchange rate regime when conditions are appropriate.

Structural Reforms

Along with greater exchange rate flexibility, invigorating private investment is crucial for rebalancing the sources of growth away from external demand to domestic demand in many East Asian countries. It is encouraging that fixed investment has grown at fairly robust rates this year in most of the crisis-affected countries. Yet, investment/GDP ratios have not risen much from the lows reached in the aftermath of the 1997 financial crisis. In several countries, continued current account surpluses reflect, at least partly, weak private investment. There is therefore a need to improve the investment climate in these countries. This in turn underscores the need for expeditious completion of the remaining financial and corporate sector restructuring and reform agenda:

- In some countries, such as PRC, Philippines, and Thailand, the NPL ratio remains high by international standards, and more effort is needed to reduce it further. For many transition economies, the capital positions of commercial banks need to be strengthened to meet the 8% international norm.

- Although bank divestment has gathered pace in recent years, governments still own substantial portions of domestic banking assets, in particular Indonesia, Thailand, and most of the transition economies. Bank divestment and privatization efforts should be intensified.

- Many countries still have a long way to go in opening their banking industries to foreign banks. This will not only help to improve banks capital positions, but also bring international best practices to the banking sector and enhance competition.

- Authorities should also pay adequate attention to the supervision of nonbank financial institutions. With rapid financial innovation in this segment, insufficient prudential regulation could expose the financial system to systemic risks.

- In corporate restructuring, although voluntary workouts have made significant progress, workouts through the courts have been slow due to weaknesses in insolvency frameworks and in judicial systems. Some countries amended bankruptcy laws after the 1997 financial crisis, but continue to face challenges in implementation. To speed up court-led corporate workouts, insolvency reforms need to be complemented with judicial reforms. As for most transition economies, restructuring and reform of state-owned enterprises remains a daunting task.

Publication Stock No. 120504