ADB Asia Economic Monitor 2002

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

The *Asia Economic Monitor* (AEM) is a quarterly review of East Asia's growth and recovery, financial and corporate sector reforms, and social developments. It covers the 10 Association of Southeast Asian Nations member countries plus the People's Republic of China and Republic of Korea. The July 2002 Update features a chapter on "Five Years After the Crisis," which takes stock of what has been achieved in financial and corporate restructuring in East Asia since the 1997 crisis.

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Asian Development Bank

Highlights

Growth and Recovery in 2002

- Developments in the region over the last few months broadly support the key message of the April 2002 *Asia Economic Monitor* (AEM)—that East Asia in 2002 will make a faster-than-expected but moderate rebound from last year's economic slowdown.
- Data released in recent months show that growth has picked up across East Asia. Growth is also becoming more balanced with a turnaround in exports being complemented by strengthening domestic demand.
- With the recent slide in the US stock market, the May decline in retail sales, and the softening of consumer sentiment in June, risks to the US recovery may have increased. Yet, so far, these risks appear to be manageable and are unlikely to derail the moderate recovery in the US forecast in the April AEM. The external environment facing East Asia, therefore, continues to be favorable.
- The London-based Consensus Economics Inc.[1] now projects East Asia's average GDP growth to reach 5.8% in 2002, 0.6 percentage point higher than the forecast in the April AEM.
- With the maintenance of political stability and improvements in prudential indicators in most countries of the region, domestic risks to East Asia's current economic rebound appear to be receding somewhat.
- The single most important risk to the current forecast of a moderate rebound in East Asia may arise from any continuation of the recent deterioration in the US financial markets during the balance of this year.

Five Years After the Crisis

- Overall, given the severity of the crisis, the region's recovery has been reasonably good. In most countries, the pace of recovery has been faster than expected. However:
  - For four of the five crisis-affected countries (except Korea), the years since the crisis represent a lost half decade in terms of improvements in per capita incomes.

Continued overleaf

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

Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AEM	Asia Economic Monitor
AMC	asset management company
ARIC	Asia Recovery Information Center
ASEAN	Association of Southeast Asian Nations
CAR	capital adequacy ratio
CDRAC	Corporate Debt Restructuring Advisory Committee
CDRC	Corporate Debt Restructuring Committee
EWS	early warning system
FSS	Financial Supervisory Service
GDP	gross domestic product
IBRA	Indonesian Bank Restructuring Agency
IIF	Institute of International Finance
IMF	International Monetary Fund
IT	information technology
JCI	Jakarta Composite Index
JITF	Jakarta Initiative Task Force
KAMCO	Korea Asset Management Corporation
KLCI	Kuala Lumpur Composite Index
KOSPI	Korean Stock Price Index
Lao PDR	Lao People's Democratic Republic
MOU	memorandum of understanding
NASDAQ	National Association of Securities Dealers Automated Quotation
NBFI	nonbank financial institution
NPL	nonperforming loan
PCOMP	Philippine Stock Exchange Composite Index
PRC	People's Republic of China
REMU	Regional Economic Monitoring Unit (ADB)
ROE	return on assets
SET	Stock Exchange of Thailand
SME	small and medium enterprise
SOE	state-owned enterprise
STI	Straits Times Index (Singapore)
TAMC	Thai Asset Management Corporation
q-o-q	quarter-on-quarter
y-o-y	year-on-year

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

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- Although unemployment rates are trending down from their peak levels in Korea and Thailand, in all of the five-affected countries, they are still higher than the precrisis levels.

- The incidence of poverty today is higher than precrisis levels in Indonesia and Thailand.

• Encouraging progress has also been made in three broad areas: (i) strengthening macroeconomic management and building up foreign exchange reserves, (ii) restructuring the financial and corporate sectors, and (iii) enhancing regional self-help and support measures by promoting monetary and financial cooperation.

• Significant progress has been made in restructuring bank balance sheets. To varying degrees, nonperforming loan ratios have declined, capital adequacy ratios have increased, and bank profitability has improved. The performance of asset management companies in several countries in the region is also improving.

• There has been significant consolidation of the banking sector. Bank privatization and divestment are under way although much remains to be done. Prudential supervision and regulation of banks have also been strengthened.

• Restructuring of the corporate sector has been slower than that of the financial sector. However, even here, corporate debt-equity ratios have been reduced in several countries, most notably in Korea. Measures have also been introduced to strengthen corporate governance.

• These efforts are rapidly changing the economic and financial landscape of East Asia, making the region more responsive to market forces while at the same time enhancing resilience to external shocks. Overall, they are laying the foundation for sustained long-term growth.

• Building on these efforts, it is important that countries focus on expeditiously completing the remaining agenda of financial and corporate restructuring, which is substantive as well as challenging.

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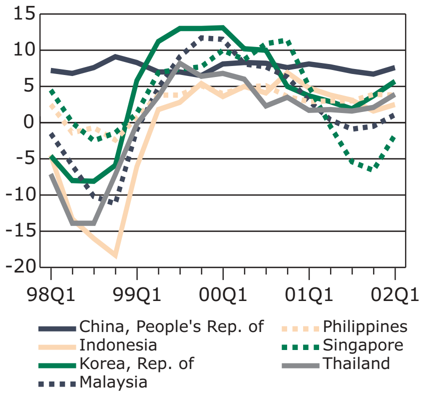
East Asia's Growth, Recovery, and Restructuring—A Regional Update

Growth and Recovery in the First Half of 2002

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

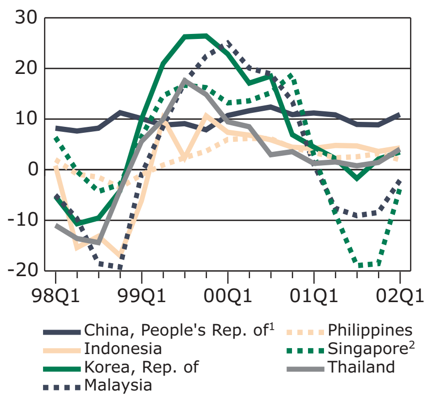


Note: Data from 1998–1999 are not consistent with revised annual GDP growth rates, as revised quarterly data for that period are not yet available.
Source: ARIC Indicators.

Real Sector Developments

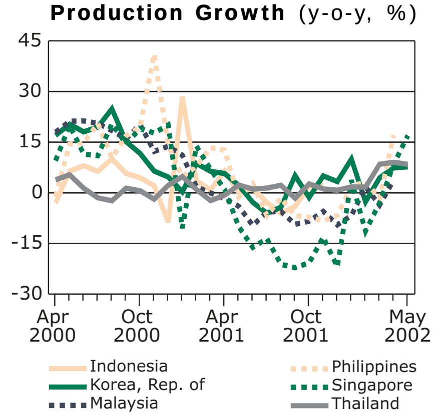
As forecast in the April *Asia Economic Monitor* (AEM), gross domestic product (GDP) growth has picked up almost everywhere in East Asia[1] in the first quarter of 2002—the latest quarter for which such data are available (Figure 1). The seven large economies of ASEAN5+2—Indonesia, Malaysia, Philippines, Singapore, and Thailand plus the People's Republic of China (PRC) and Republic of Korea (Korea)—taken together grew by 5.3%, representing an improvement from the 3.8% growth achieved in the last quarter of 2001 and the 4.3% growth for the full year 2001. Among them, first quarter growth ranged from -1.7% in Singapore to 7.6% in the PRC, with Korea managing an impressive 5.7% growth. While the turnaround in regional growth has cut across sectors, it was especially evident in manufacturing (Figure 2). Trends in monthly industrial production suggest that the economic rebound has continued well into the second quarter. For the latest month for which data are available, industrial production grew almost across the board (Figure 3). Although volatility remains, merchandise imports also posted strong growth during the period April–June this year—another indication that the economic rebound has continued in the second quarter (Figure 4).

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



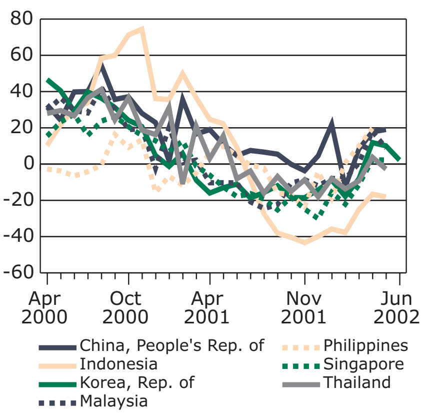
[1]Data refer to growth of industrial production.
[2]Data from 1998–1999 are not consistent with revised annual manufacturing growth rates, as revised quarterly data for that period are not yet available.
Source: ARIC Indicators.

Figure 3: **Industrial Production Growth** (y-o-y, %)



Source: ARIC Indicators.

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



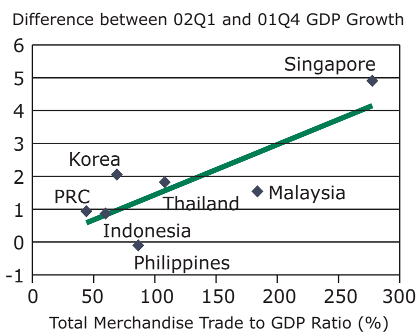
Source: ARIC Indicators.

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

The more open economies are picking up at the faster pace (Figure 5). This is to be expected as the resurgence in growth is driven primarily by a rise in global demand for the region's exports, although domestic demand has played a complementary role. In recent months, most countries have seen a significant turnaround in exports (Figure 6). For example, during April and May of this year—the latest months in the second quarter for which data for most countries are available—Philippine exports grew by 17%. Export growth for the other countries has also been positive but more modest: 5.5% for Korea (April–June), 4.5% for Malaysia (April–May), 3.3% for Singapore (April–May), and 2.8% for Thailand (April–May). Indonesia also posted an improvement, with its exports declining only by 2% (April–May) compared to a 14% drop in the first quarter of this year and a 23% dip in the last quarter of last year.

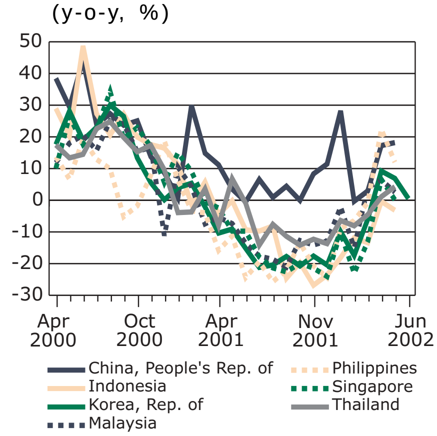
Helped by recent financial and corporate sector reforms as well as expansionary fiscal and monetary policies, domestic demand is complementing the export-led economic rebound in the region. Growth in domestic demand has accelerated in Korea since the first quarter of 2001, reaching 8% in the first quarter of this year (Figure 7). In Malaysia, growth in domestic demand decelerated during the first three quarters of last year but has since recovered. It also declined in Singapore during most of 2001, but there has been some recovery in the first quarter of this year. Similarly, in Indonesia, domestic demand, having decelerated sharply during most of last year, has bottomed out in the first quarter of this year. The Philippines and Thailand, meanwhile, have maintained a steady growth in domestic demand of about 2.5% in the last several quarters. In the PRC, domestic demand, after maintaining a robust

Figure 5: **Trade Openness and Growth**



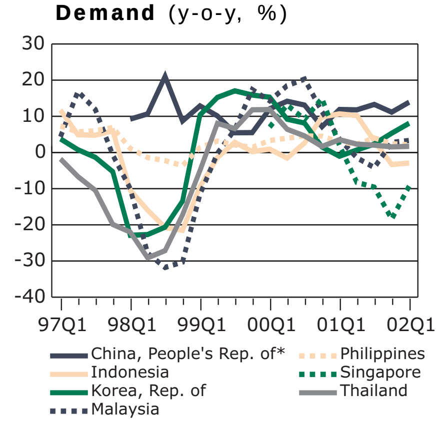
Source: ARIC Indicators.

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



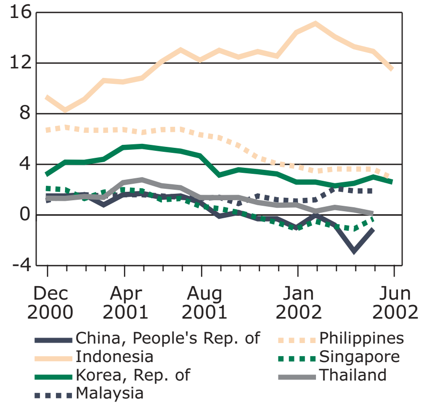
Source: ARIC Indicators.

Figure 7: **Growth of Domestic Demand** (y-o-y, %)



*Data refer to the growth of the sum of retail sales and fixed investment (1997=100).
Source: ARIC Indicators.

Figure 8: **Inflation Rates** (%)



Sources: ARIC Indicators.

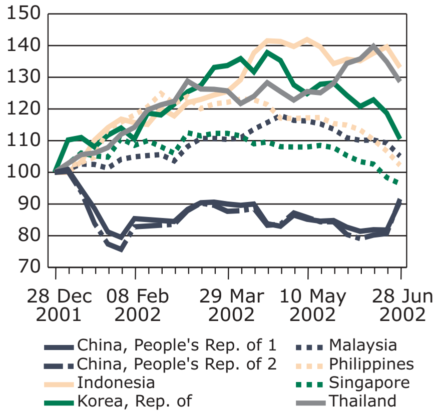
12% growth during last year, has grown even faster (at about 14%) in the first quarter of this year. This has not only enabled the country to cushion last year's export shock but also to support strong economic growth in the first quarter of this year.

In the first half of this year, inflation has generally remained subdued across the region (Figure 8). Except for Indonesia (where inflation is running at about 12%), inflation is now below 4% in the region, with prices, in fact, falling in the PRC and Singapore (at an annual rate of about 1%). Korea and Malaysia, though, have experienced an uptick in inflation in more recent months. Yet, at less than 3% in Korea and about 2% in Malaysia, inflation is still not a cause for concern.

Asset Market Developments

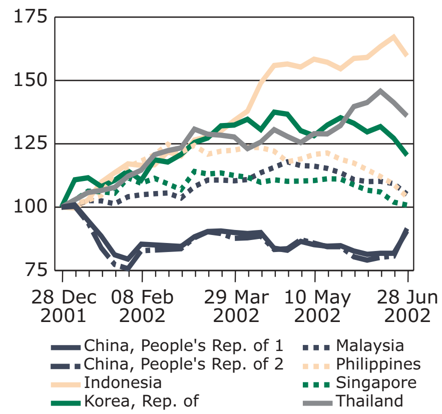
Regional stock markets posted strong gains in most East Asian countries during the first quarter of 2002. However, several of these markets have moderated again in recent weeks, following an overall decline in stock markets in the industrial countries. Despite the recent drop, during the first half of this year, most regional stock markets strengthened overall. In local currency terms, these gains ranged from 2% in the Philippines to 33% in Indonesia (Figure 9). The corresponding gains in dollar values range from 1% in Singapore to 60% in Indonesia (Figure 10). The notable exception to this trend has been the PRC, where

Figure 9: **Composite Stock Price Indexes*** (last week of 2001Dec=100, in local currency)



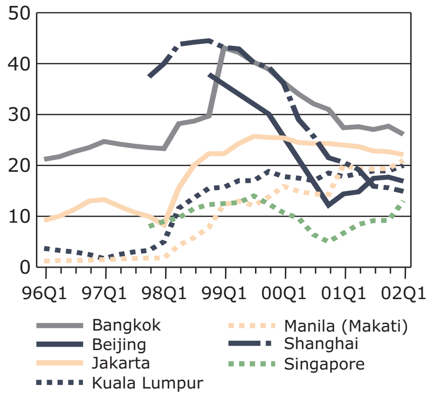
*Weekly averages of Shanghai-B (PRC 1), Shenzhen-B (PRC 2), JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand).
Source: REMU staff calculations derived from Bloomberg data.

Figure 10: **Composite Stock Price Indexes*** (last week of 2001Dec=100, $)



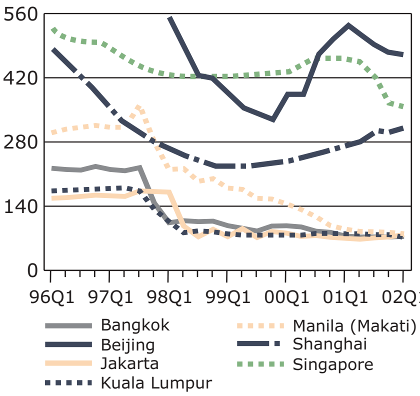
*Weekly averages of Shanghai-B (PRC 1), Shenzhen-B (PRC 2), JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand). The exchange rate used in the conversion to $ is from the NY Composite.
Source: REMU staff calculations derived from Bloomberg data.

Figure 11: **Office Property Vacancy Rates** (%)



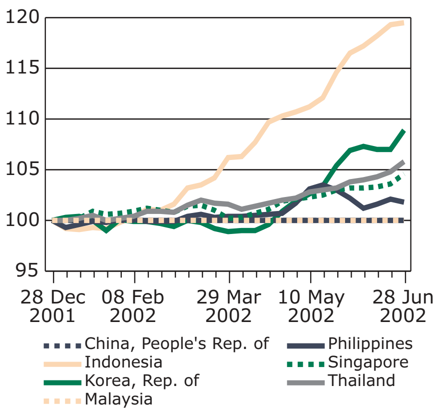
Source: Jones Lang LaSalle, *Asia Pacific Property Digest*, various issues.

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



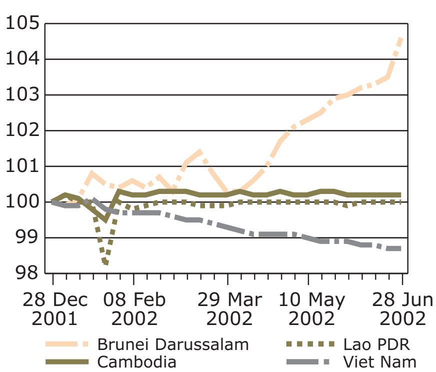
Source: Jones Lang LaSalle, *Asia Pacific Property Digest*, various issues.

Figure 13a: **Exchange Rate Indexes** (weekly average, last week of 2001Dec=100, $/local currency)



Source: REMU staff calculations derived from Bloomberg data.

Figure 13b: **Exchange Rate Indexes—Other East Asian Countries** (weekly average, last week of 2001Dec=100, $/local currency)



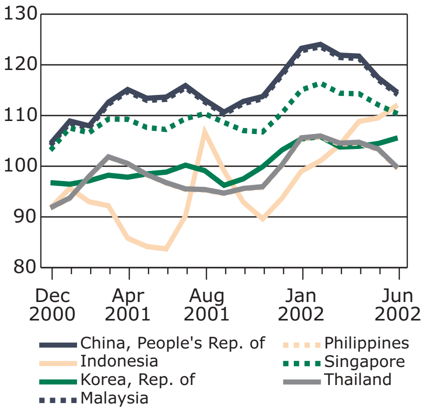
Source: REMU staff calculations derived from Bloomberg data.

stock prices have declined by about 9% in the first half of this year. Among the gainers, Indonesia's and Thailand's stock markets have attracted renewed investor interest as political uncertainties have receded. The Korean stock market has fared well, too, in recognition of the country's progress in financial and corporate reforms and restructuring. The Korean market has also been supported by the strong rebound in economic activity. Indeed, the recent moderation in Korea Stock Price Index (KOSPI) is largely due to bearish movement of US stock markets, and not due to domestic factors.

Despite the improving economic conditions, with the exception of the PRC, property markets still look weak (Figures 11 and 12). In the first quarter of 2002—the latest period for which data are available—office vacancy rates continued to rise in Manila, Kuala Lumpur, and Singapore. And they declined only marginally in Bangkok (from 27.7% to 26.1%) and Jakarta (from 22.7% to 22.1%). With the exception of Shanghai and Jakarta, office rental rates (in local currency) continued to decline.

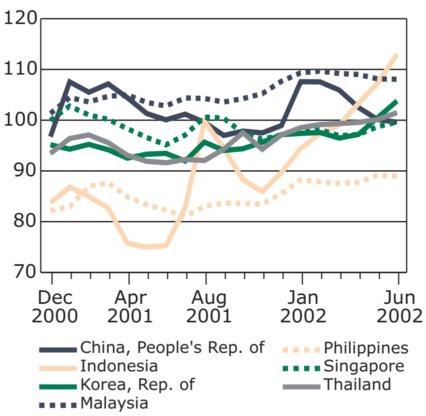
Most regional exchange rates, having remained stable against the US dollar in the first quarter of this year, have since appreciated (Figure 13a). The second quarter appreciation in the major regional currencies range from 1.8% for the Philippines to 19.5% for Indonesia. Meanwhile, the currencies of smaller countries in the region have experienced mixed trends (Figure 13b). The Brunei dollar has largely followed the currency to which it is pegged—the Singapore dollar—and has appreciated, while Cambodia's real and the Lao kip have remained stable, and Viet Nam's dong has depreciated mildly.

Figure 14: **Nominal Effective Exchange Rate Index** (2000=100)



Note: An increase is an appreciation. Trade weighted based on total trade with the European Union, Japan, and US.
Source: REMU calculations based on data from Bloomberg and IMF, *Direction of Trade Statistics*, April 2002.

Figure 15: **Real Effective Exchange Rate Index** (2000=100)



Note: An increase is an appreciation. Trade weighted based on total trade with the European Union, Japan, and US. Assumed inflation rates in June 2002 are the inflation rates in May 2002 except for Indonesia and Korea for which actual June inflation data were used.
Source: REMU calculations based on data from Bloomberg and IMF, *Direction of Trade Statistics*, April 2002.

The second quarter appreciation in regional currencies against the US dollar has prompted some analysts to wonder if it might dampen the regional rebound by reducing export competitiveness. However, with the exception of the rupiah and to a lesser extent the Korean won, since regional currencies have depreciated against the yen and the euro, the nominal effective exchange rates of most East Asian countries have depreciated in the second quarter (except Indonesia and Korea) (Figure 14). This together with low inflation has headed off any appreciation of real effective exchange rates and loss of export competitiveness (Figure 15). The real effective exchange rates of the PRC and Malaysia even depreciated in the second quarter of 2002. The exceptions were Indonesia and Korea, whose real effective exchange rates continued to appreciate (Figure 15).

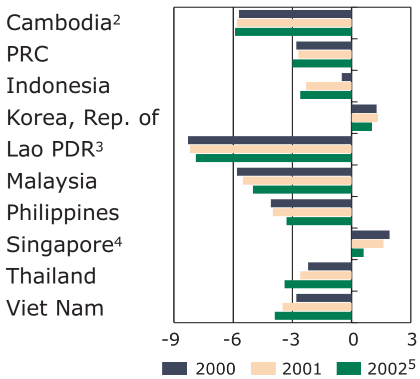
Fiscal and Monetary Policies

To varying degrees, East Asian countries have responded to last year's external shock with fiscal stimulus measures and interest rate reductions. With the US Federal Reserve holding interest rates unchanged since November 2001, and interest rates in many East Asian countries already at historical lows, the scope for further interest rate reductions has been limited. Most countries, therefore, have kept policy interest rates unchanged in the second quarter of this year. The exception was Korea, which, in response to the buildup of some inflationary pressures, raised the overnight call rate by 25 basis points in early May to 4.25% after holding it unchanged since September 2001.

The fiscal response has been more varied across countries than the monetary response. Compared to last year, Malaysia and the Philippines have adopted less expansionary fiscal stances for this year, Singapore and Thailand have adopted somewhat more expansionary policies, and the rest of the countries have not significantly changed their approach. This is reflected in the planned fiscal deficit/surplus for 2002 (Figure 16). Malaysia and the Philippines are planning to have lower fiscal deficits in 2002 compared to last year. In comparison, the planned fiscal deficit for 2002 is higher by 0.8 percentage points of GDP in Thailand, and Singapore is planning to have a much lower fiscal surplus in 2002 than in the previous year. The fiscal balances in other countries are only marginally different from last year's levels.

In Malaysia, as last year's downturn has run its course, the Government is adopting a less expansionary fiscal stance for 2002 and plans to gradually withdraw the fiscal stimulus that has supported

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



[1]Data refer to central government for Cambodia, PRC, Indonesia, Korea, Philippines, Singapore, Thailand, and Viet Nam; general government for Lao PDR; and federal government for Malaysia.
[2]Exclude grants.
[3]Exclude grants and for fiscal year ending September.
[4]Refer to the surplus/deficit excluding special transfers. Data for 2002 is for fiscal year 2002–2003.
[5]Based on programmed budget/preliminary estimates for 2002.
Source: Ministry of Trade and Industry (Singapore); Bank of Thailand (Thailand); National Statistics Coordination Board and Bangko Sentral ng Pilipinas (Philippines); Bank of Korea; ADB staff estimates; IMF; *Lao PDR: First Review Under Poverty Reduction and Growth Facility; Cambodia: Article IV.*

domestic demand over the past year. The fiscal stimulus, in the first quarter of this year, has left real government consumption at more than 13% higher than a year earlier, following 22% growth in the fourth quarter of last year. In response to increasing signs of an economic rebound this year, as well as the desire to keep a rein on the fiscal situation over the medium term, the Government plans to reduce the federal fiscal deficit from last year's 5.5% of GDP to 5% this year (Figure 16). This deficit reduction is to be achieved by a significant cut in government expenditure (from 29.3% of GDP to 24.7%) in the face of a projected decline in revenues (from 23.8% of GDP to 19.7%). Total development outlays, which include mostly investment in infrastructure, are to be cut by 15% this year following a 35% increase last year. In the first quarter of this year, fiscal trends have, however, turned out to be much less expansionary than was foreseen in the Budget. Despite a 11% increase in total government expenditures (compared to a decline of 6% budgeted for the full year), the federal fiscal deficit turned out to be only RM1.3 billion, or only about 7% of the RM18.6 billion planned for the full year. This was due to a 17% increase in revenues (as compared to a 7% decline budgeted for the full year).

Meanwhile, the Philippine Government's plan this year to reduce the fiscal deficit is intended not so much to slow the tempo of domestic demand as to correct the fiscal deterioration and limit the growth of public debt (which now stands at about 70% of GDP). The Government plans to bring the fiscal deficit down to 3.3% of GDP this year from 4% in 2001. This is to be achieved by both a cut in government expenditures (from 19.5% of GDP to 19.1%) and an increase in revenues (from 15.5% of GDP to 15.8%). However, due to a shortfall in revenues and an outstripping of expenditures, the fiscal deficit during the first five months of the year (January–May) amounted to P107 billion, equivalent of about 82% of the full year target of P130 billion.

Thailand's fiscal stance for 2002 is somewhat more expansionary than in 2001, although the Government has set a medium term ceiling on public debt (which is now about 58% of GDP) and targeted a balanced budget within the next five years. At 3.4% of GDP, the planned fiscal deficit for this year is higher than last year's actual deficit by 0.8 percentage point. Total government expenditures (including net lending to the rest of the economy) are projected to increase by 2 percentage points of GDP (from 17.9% to 19.9%), and revenues are expected to increase by 1.2 percentage points of GDP (from 15.3% to 16.5%). In the first five months of this year, the fiscal deficit amounted to B64 billion, or about 37% of the deficit target for the full year. At

11%, the year-on-year (y-o-y) growth in revenues was much higher than the 7% target for the full year. However, expenditures grew even faster, with the increase in expenditures during the first five months turning out to be 20% compared to an 11% expenditure target for the full year.

Singapore's fiscal stance is also more expansionary this year. The Government has budgeted for a fiscal surplus of 0.6% of GDP, compared to the actual surplus of 1.6% of GDP last year. In the first quarter of this year, the budget actually ran a deficit of S$2.6 billion, compared to the S$886 million surplus target for the full year. This was due to a sharp fall in revenues. In the first quarter, total revenues were 23% lower than a year ago, whereas total expenditures were 10% lower.

Korea is planning to take a similar fiscal approach to that of Singapore for this year: run a smaller fiscal surplus (of 1% of GDP) than last year (1.3% of GDP). However, in the first four months of the year, the budget ran a surplus that is equivalent to about three times the full year target. This was due to a sharp increase in revenues, while expenditures were more or less in line with their full year target. In the first four months, about 38% of the full year revenue target and about 28% of the full year expenditure target was realized.

The PRC has been using fiscal stimulus to pump-prime the economy since the 1997 Asian financial crisis. These fiscal stimulus measures were used primarily to finance public investment in infrastructure, such as roads, ports, and electricity. The Government has continued this expansionary fiscal stance in 2002. At 3% of GDP, the fiscal deficit planned for 2002 is slightly higher than last year's deficit of 2.7%. The Government has, however, stated that it does not intend to continue its expansionary fiscal stance beyond this year, as there would be the danger of a gradual deterioration of Government finances. In the first four months of the year, due to a sharp increase in revenues, the budget actually ran a surplus (of about Y60 billion, compared to the full year deficit target of Y310 billion). In the first four months of the year, about 52% of the full year revenue target and about 36% of the full year expenditure target was realized.

For some time now, Indonesia has been constrained in formulating fiscal policy. Unlike in other countries in the region, inflation has remained high. And, although the country's fiscal deficits were not large in recent years, Indonesia already has the highest public debt to GDP ratio in the region (at about 100% of GDP). Thus, the Government has been forced to follow a prudent fiscal policy. However, the severe slump in aggregate economic activity following the 1997 crisis demanded a more accommodative fiscal stance. Balancing these conflicting objectives has posed a great challenge. Against this backdrop, the Government's plan for this year is to keep the fiscal deficit at 2.6% of GDP, slightly higher than last year's 2.3% figure.

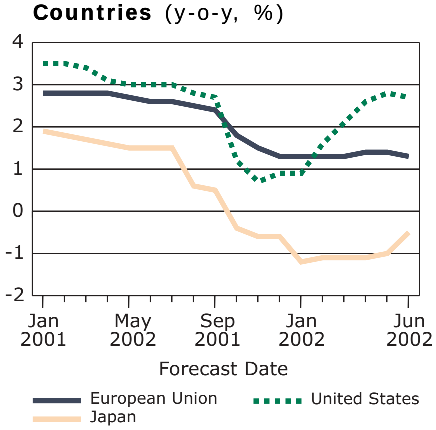
In the rest of the region, Cambodia, Lao People's Democratic Republic (Lao PDR), and Viet Nam plan little change to their fiscal stance for 2002 compared to last year. All three countries aim to run fiscal deficits ranging from 3.9% of GDP in Viet Nam to 7.9% of GDP in Lao PDR. Monthly or quarterly fiscal data for the year are not readily available for these countries, hence it is not possible to assess their progress in budgetary and fiscal policy within the year.

Prospects for East Asia's Growth and Recovery

External Economic Environment

Based on a number of economic and financial variables, the April AEM forecast a moderate recovery this year for the US that in turn would provide a mild lift to Europe. This, coupled with tentative signs of a bottoming out of the Japanese economy, pointed to an improving external economic environment for East Asia compared to the bleak picture foreseen in the immediate aftermath of the 11 September attacks on the US.

Figure 17: **Consensus Forecasts of 2002 GDP Growth—Industrialized Countries** (y-o-y, %)



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

With the recent slide in the US stock market, the May decline in retail sales, and the softening of consumer sentiment in June, risks to the US recovery may have increased. Yet, so far, those risks appear to be manageable, and are unlikely to derail a moderate US recovery this year (see Box 1). The annualized quarterly US GDP growth is expected to decline from the 6.1% posted in the first quarter of this year to more modest rates in the subsequent quarters. However, this will not derail a moderate US recovery for the year as a whole. This view is also supported by recent forecasts of US GDP growth by Consensus Economics, which, in its June survey, placed the mean forecast of 2002 US GDP growth at 2.7%. Although this is marginally lower than the 2.8% forecast in the May survey, it is an improvement on the 2.1% forecast of March (Figure 17). It is also higher than the International Monetary Fund (IMF) forecast of 2.3% and the Organisation for Economic Co-operation and Development (OECD) forecast of 2.5%, both made in April. The forecasts from 29 forecasters surveyed in June ranged from a low of 2.3% to a high of 3.3%. Hence, all are now forecasting a 2002 GDP growth that is higher than the mean forecast of 2.1% made in March. Hence, if anything, since March, the forecasts of US GDP growth for this year have been revised upwards.

Box 1: **Is the US Recovery Faltering?**

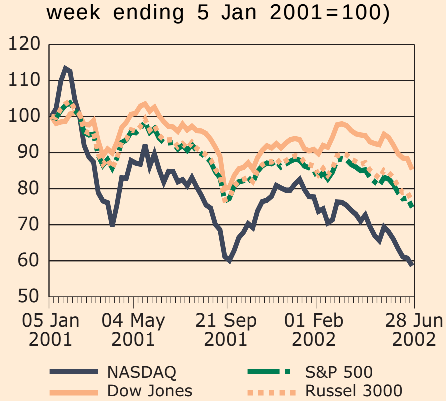
Trends in the US stock market since the release of the April AEM are raising concerns about the strength of the US recovery. In recent months, the US stock market has drifted downwards. Since mid-March 2002, the erosion in stock prices has ranged from 13% in the case of Dow Jones Industrial Average to 23% in the case of NASDAQ (Figure 1.1).

Such stock market declines may have negative wealth effects on consumption. Moreover, historically, when economies recover, stock prices rally as the outlook for corporate profits brightens. For example, in the first six months of the 10 postwar recoveries, increases in the Dow Jones Industrial Average ranged from 5% during the 1991 recovery to about 24% in the 1970 recovery. Against these historical experiences, the recent fall in US stock prices has raised concerns that the US recovery may be faltering. The 0.9% decline in US retail sales in May as well as the June fall in the consumer confidence indexes have further heightened those concerns, along with the weakness in the US dollar that has accompanied the stock market decline.

Stock market drift in recent months casts doubts on the strength and sustainability of the US recovery. However, this does not constitute a compelling reason to call for a major revision in the April AEM assessment of a moderate US recovery. First, the wealth effect may not be large, not only because statistical estimates of the fallout on household consumption have generally been small but also because other components of US household wealth, such as bonds and residential property, have remained strong. Second, the recent stock market decline reflects a reaction to the troubles of Enron, Global Crossing, WorldCom, and Tyco and is unlikely to be a leading indicator of faltering economic activity. It may simply reflect a one-off structural correction due to concerns about various aspects of corporate governance. Third, just as the late 1990s phase of the stock market boom leading up to the massive overvaluation of the market by early 2000 was unrelated to economic fundamentals, the recent decline may be similarly unrelated to economic fundamentals. The US stock market and the economy may, thus, be going separate ways. Drawing comparisons between earlier recoveries and the current one may, therefore, be misleading.

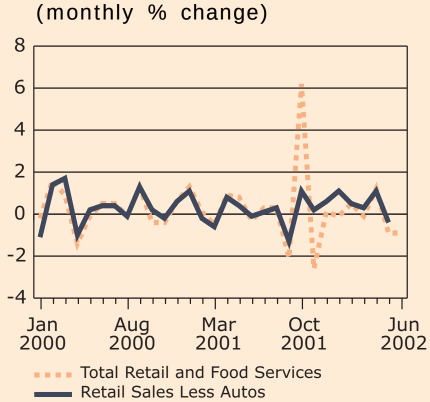
As for the drop in May retail sales, a decline in fuel-related expenditures (due to the softening of petroleum prices) contributed significantly to this decline. Moreover, historically, monthly retail sales figures tend to be volatile. In the 29 months since January 2000, retail sales increased in 12 months and declined in the remaining 17

Figure 1.1: **US Stock Market Indexes** (weekly average, week ending 5 Jan 2001=100)



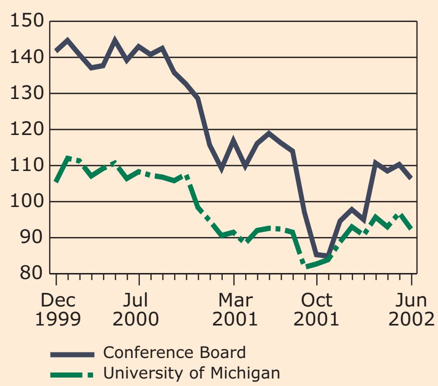
Source: REMU staff calculations derived from Bloomberg data.

Figure 1.2: **US Retail Sales** (monthly % change)



Source: Bloomberg.

Figure 1.3: **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.

Continued next page

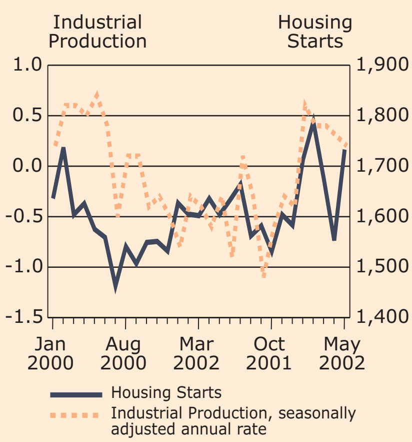
Box 1: **Is the US Recovery Faltering?** (Cont'd)

(Figure 1.2). As is the case with monthly retail sales, monthly movements in the Michigan consumer sentiment index are often volatile: in the first half of this year, it has increased in three months and declined in the other three (Figure 1.3). Similar monthly volatility can be seen in the Conference Board's consumer confidence index. Caution should, therefore, be exercised in drawing strong conclusions from the May fall in retail sales and the June decline in consumer sentiment.

The recent stock market decline has been accompanied by a weakening US dollar. On a trade-weighted basis, the US dollar is now lower by about 10% since January this year and is at a two-year low against the euro. Concerns are being raised that this depreciation will upset the recovery by sparking a withdrawal of capital from the US, at a time when the US needs capital inflows of about $1.2 billion a day to finance its current account deficit. However, such fears seem overblown. Although the fall in the US dollar has accompanied the stock market decline, it has not yet caused an outpouring of investment from the US markets. It appears that a 10% decline in the value of the US dollar from a strong position in the beginning of the year has not been a cause for concern among investors. Moreover, the depreciation of the US dollar so far has been slow and gradual. If anything, it must have, aided the US recovery by encouraging US exports, at a time when inflationary pressures in the US have remained subdued.

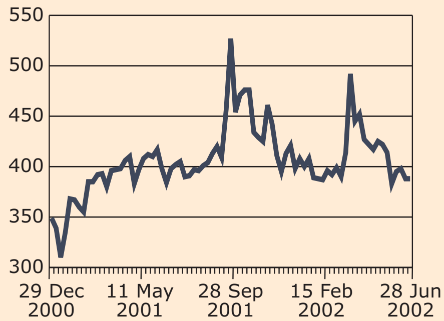
Other indicators also support the assessment of a moderate US recovery. First, the US continues to post strong housing starts figures (Figure 1.4). Second, industrial production, after rising sharply in the last quarter of 2001, continues to post positive growth. Third, weekly initial jobless claims continue to fall (Figure 1.5). Fourth, forward looking indicators of economic activity such as the Purchasing Managers indexes (which proxy the planned orders for goods by the purchasing managers of a sample of companies), both for the manufacturing and nonmanufacturing sectors, continue to be in the expansionary phase (Figure 1.6). Finally, US productivity growth has remained strong in recent quarters, even during last year's recession, suggesting that the real economy is robust despite the stock market fluctuations.

Figure 1.4: **US Industrial Growth** (%) **and Housing Starts** (thousands of units)



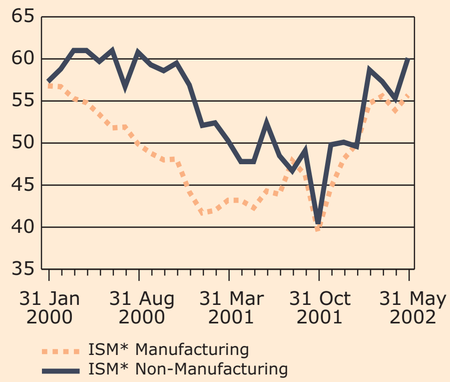
Source: Bloomberg.

Figure 1.5: **US Initial Jobless Claims, Weekly** (US dollars)



Source: Bloomberg.

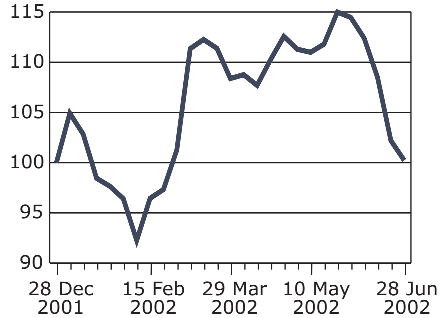
Figure 1.6: **Surveys of Business Activity in the US**



*Institute of Supply Management.
Source: Bloomberg.

The April AEM had noted that in Japan, the world's second largest economy, economic trends had been less encouraging than in the US, although signs of the economy bottoming out were visible. Data released since April show that in the first quarter of this year, the Japanese economy grew by a faster-than-expected annualized rate of 5.7%, mainly due to an increase in exports and long-awaited pickup in consumer

Figure 18: **Nikkei 225**
(weekly average, week ending 28 December 2001=100)

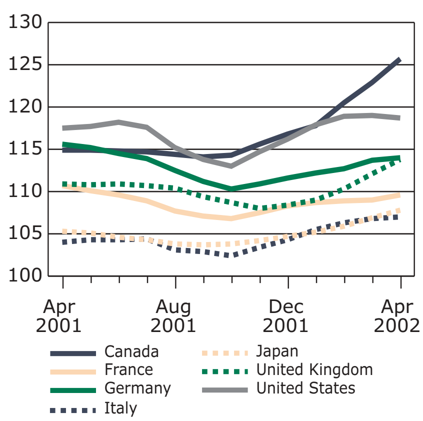


Source: REMU staff calculations derived from Bloomberg data.

spending. In line with global trends, the stock market has drifted down since May (Figure 18). However, trends in other indicators of economic growth (such as industrial production, exports, and imports) have been encouraging, prompting an upward revision in the growth forecast. For example, in April and May, exports rose 1.3% and 8.8%, respectively, from levels a year earlier. May also saw the fourth straight monthly rise in industrial production as expanding exports boosted demand for industrial products. In March, Consensus Economics predicted a GDP contraction of 1.1% in 2002. That forecast has now been revised upwards, yielding a lower GDP contraction of 0.5%. The Tankan survey in June showed the biggest improvement in business sentiment on record and the first rise since December 2000. Hence, on balance, the economic news flowing from Japan has improved since the release of the April AEM, although the recent appreciation in the yen against the US dollar is raising concerns about the sustainability of export growth.

Not many changes in the immediate economic outlook for Europe have occurred in the last three months. The 1.6% increase in German retail sales in May (over April)—the fastest growth in six months—suggests that Euro-zone has maintained a reasonable pace of growth in recent months. Also, the Reuters–NTC Research Purchasing Managers Index for June continued to remain close to 52, signaling that the 12-nation Euro-zone's manufacturing has grown throughout the second quarter of this year. However, since the index remains well below levels seen in 2000 when the Euro-zone economy was growing by more than 3%, indications are that Europe is likely to post only a modest growth this year. Thus, the April AEM's assessment of the European economic outlook largely remains intact, although the recent appreciation of the euro against the US dollar is raising concerns that European exports may be adversely affected. In March, Consensus Economics predicted 2002 GDP growth of 1.3% for the European Union. That forecast remains unchanged in its June survey.

Figure 19: **OECD Leading Indicators**



Source: OECD web site.

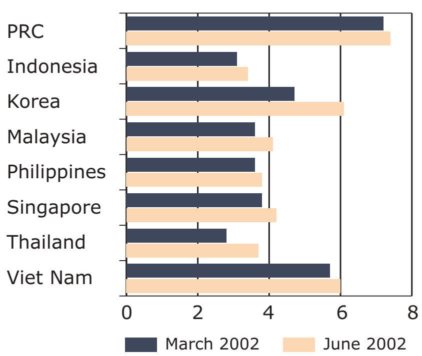
With a moderate recovery still the most likely outcome for the US, GDP growth for Japan revised upwards, and growth prospects unchanged for Europe, East Asia continues to face a favorable external environment, despite the recent declines in the US stock market. Trends in leading indicators for developed countries support this view (Figure 19), as do the recent upward revisions in the forecast of global growth for 2002. In March, Consensus Economics predicted an average GDP growth of 1.4% in 2002 for about 70 countries (including developed as well as emerging market economies) it covers. That forecast has been revised upwards to 1.7% for the June survey, similar to last month's UN forecast of 1.75% world GDP growth for this year.

Regional Economic Outlook

With the external environment continuing to be favorable and domestic demand firming up across East Asia, the moderate regional rebound forecast in the April AEM is broadly on track. The June Consensus Economics Survey for the region—the latest of these surveys—confirms this assessment.

Consensus Economics is now forecasting East Asia's GDP growth to reach 5.8% in 2002, 0.6 percentage point higher than the forecast in the April AEM. For the region excluding the PRC, the corresponding upward revision is larger—about 0.9 percentage point. Similarly, at 4.8%, the June GDP growth forecast for the five crisis-affected countries is about 0.9 percentage point higher than the March forecast.

Figure 20: **2002 GDP Growth Forecast (Consensus Economics)**



Source: Consensus Economics Inc., *Asia-Pacific Consensus Forecasts,* March and June 2002.

In absolute terms, among the countries for which consensus forecasts are available, the PRC will continue to be the fastest growing country in the region (Figure 20 and Table 1). And at more than 6%, Korea's growth is moving closer to its historical trend. Other countries in the region will achieve more modest growth rates. But given last year's slowdown, even these represent a significant swing in their economic performance.

For 12 consecutive years, in 2002 the PRC will post an annual GDP growth in excess of 7%. This growth is likely to be driven by a combination of much improved export prospects and continued strength of domestic demand. According to the June Consensus Economics forecast, the dollar value of exports is expected to post 11% growth this year, improving over last year's figure of 6.8%. Underpinned by strong consumer confidence and a stable business investment climate, domestic demand is expected to play a major role in maintaining the growth momentum. In the coming months, domestic demand will get a further boost from the Government's plan to hike civil servants' salaries in July.

In recent months, forecasts for Korea's GDP growth for this year have been revised upwards the most. Reflecting the rapidly improving economic conditions in the country, between March and June this year, Consensus Economics revised its forecast by 1.4 percentage points—from 4.7% to 6.1%. Coupled with the improved external environment, robust growth in household consumption and fixed investment are expected to underpin this year's GDP growth. In the June Survey of Consensus Economics, exports are forecast to grow by 7% this year —

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

						June 2002 Forecasts				Difference[1]		Average	
	1997	1998	1999	2000	2001	2002		2003		2002	2003	1987–1996	1998-2002
						Mean	Low/High	Mean	Low/High				
Brunei Darussalam	3.6	-4.0	2.6	2.8	1.5	3-4	. . .	. . .	. . .	. . .	. . .	1.4	1.3
Cambodia	3.7	1.5	6.9	5.4	5.3	4.5	. . .	6.1	. . .	0.0	. . .	6.2	4.7
China, People's Rep. of	8.8	7.8	7.1	8.0	7.3	7.4	7.0/8.0	7.7	7.0/8.8	0.1	0.1	10.0	7.5
Indonesia	4.7	-13.1	0.8	4.9	3.3	3.4	2.5/3.9	4.2	3.8/5.2	0.0	0.1	7.6	-0.1
Korea, Rep. of	5.0	-6.7	10.9	9.3	3.0	6.1	5.0/6.8	6.0	4.1/7.3	1.4	0.2	8.1	4.5
Lao PDR	6.9	4.0	7.3	5.9	5.5	5.8	. . .	6.1	. . .	0.8	. . .	5.2	5.7
Malaysia	7.3	-7.4	6.1	8.3	0.4	4.1	3.5/5.0	5.7	4.5/6.7	0.5	0.4	9.1	2.3
Myanmar	5.7	5.8	10.9	6.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	2.7	. . .
Philippines	5.2	-0.6	3.4	4.4	3.2	3.8	. . .	4.3	. . .	0.2	0.3	3.7	2.8
Singapore	8.5	-0.1	6.9	10.3	-2.0	4.2	3.0/5.4	5.8	4.6/7.0	0.4	0.0	9.1	3.9
Thailand	-1.4	-10.5	4.4	4.6	1.8	3.7	3.0/4.5	4.2	3.5/4.8	0.9	0.3	9.5	0.8
Viet Nam	8.2	4.4	4.7	6.1	5.8	6.0	. . .	6.7	. . .	0.3	0.0	7.0	5.4
East Asia[2]	6.2	-1.4	6.9	7.6	4.3	5.8	. . .	6.2	. . .	0.6	0.2	8.8	4.6
East Asia exc. PRC[2]	4.5	-7.3	6.8	7.4	2.4	4.8	. . .	5.3	. . .	0.9	0.2	8.0	2.8
ASEAN[2]	4.2	-7.8	3.7	6.0	1.9	3.8	. . .	4.7	. . .	0.5	0.2	8.0	1.5
Five Crisis-Affected	4.1	-8.2	6.8	7.2	2.7	4.8	. . .	5.2	. . .	0.9	0.2	8.0	2.7

. . . = not available
[1]Difference from April 2002 AEM estimates/forecasts.
[2]Exclude Brunei Darussalam and Myanmar.
Sources: Asian Development Bank, *Asian Development Outlook 2002;* official sources; Consensus Economics Inc., *Asia Pacific Consensus Forecasts* (March and June 2002), Department of Economic Planning and Development, *Brunei Economic Bulletin* (January 2002), *Brunei Statistical Yearbook (1999)*.

a significant improvement from last year's 14% decline. Historically low interest rates, a recent rally in the stock market, and declining unemployment are expected to boost domestic demand. The Bank of Korea's decision to leave interest rates unchanged in June (having increased the overnight rate by 25 basis points in May to ward off potential inflationary pressures and overheating in the stock market) will further support domestic demand. The recent weakening of the US dollar and the consequent appreciation of the won should help keep inflationary pressures in check. Coupled with the expected delay in the US interest rate hike, this should enable the Bank of Korea to postpone further upward adjustments in the interest rate, thus supporting domestic demand and growth.

In Singapore, the rebound in the export sector is expected to lead to a GDP growth of 4.2% this year, with a strengthening of domestic demand playing a useful supportive role. Although this would still be much below the country's trend growth rate, it represents a major turnaround from last year's 2% GDP contraction. Consensus Economics forecasts exports to grow by 6% this year—a big improvement from last year's 12% decline. Helped by low interest rates, private consumption, which had almost remained stagnant last year, is expected to post mild positive growth this year. Data for investment intentions in the manufacturing sector point to a recovery in fixed investment from last year's 4.6% decline.

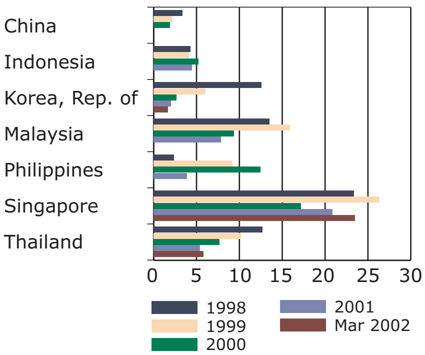
Malaysia's sharp slowdown of last year has run its course. The recovery in the US and last year's accommodative fiscal policies are expected to lift the economy. The recent weakening of the US dollar might further improve Malaysia's export prospects, given the ringgit's peg to the US dollar. This year's GDP growth is now forecast to be 4.1%, which is a significant improvement from last year's near-zero growth. Exports are forecast to grow by about 3% this year in comparison to the 11% decline posted last year. The turnaround in exports is expected to add to the improvement in consumer confidence brought on by the revival in the stock market, greater focus on retail lending by domestic banks, and rising civil servant salaries. Growth in private consumption is expected to be better than last year's 2.8% figure, while fixed investment is expected to turn around from last year's 2.1% decline.

Philippine GDP growth is forecast to improve from 3.2% last year to 3.8% in 2002, pushing GDP growth close to its historical trend. Being dependent heavily on the US market, the modest US recovery should strengthen Philippine exports this year. Exports are set to rise significantly this year, compared to a 16% drop last year. Driven mostly by growth in private consumption, domestic demand is likely to maintain the 3% growth it posted last year.

At 3.7%, Thailand's GDP growth forecast for this year is a significant improvement from the 1.8% figure posted last year. (The Government is projecting a higher growth rate.) Data released recently indicate that growth is likely to be driven mainly by a revival in exports, supported by domestic demand. Exports are forecast to grow by 3% this year, having declined by 7% in 2001. A combination of low interest rates and government spending is likely to support domestic demand—both in terms of consumption and investment.

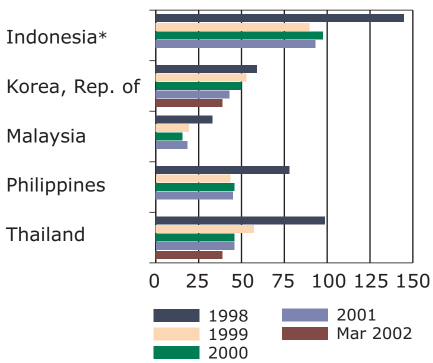
Indonesia's 3.4% GDP growth forecast for this year is little changed from last year's figure. Exports are expected to post 3% growth this year, after declining by 12% in 2001. However, domestic demand is likely to remain more subdued this year. Consensus Economics expects a moderation in private consumption growth from last year's 6% growth. Similarly, growth in fixed investment is likely to moderate from last year's 4% growth.

Figure 21: **Current Account Balance** (% of GDP)



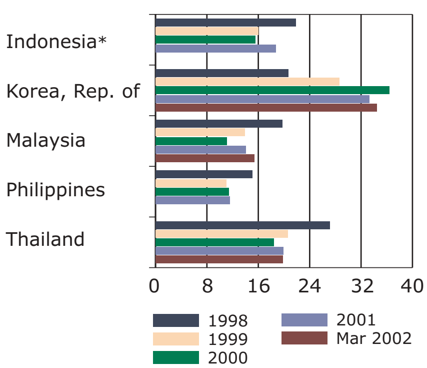
Source: ARIC Indicators.

Figure 22: **Short-Term External Debt** (% of Gross International Reserves)



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

Figure 23: **Short-Term External Debt** (% of Total External Debt)



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

Among the remaining East Asian countries, this year's growth is expected to be 6% for Viet Nam (slightly higher than last year's 5.8%), 5.8% for Lao PDR (better than the 5.5% achieved last year) and 4.5% for Cambodia (worse than last year's 5.3%), and 3–4% for Brunei Darussalam (better than the 1.5% last year).

Risks to Regional Growth and Recovery

With the maintenance of political stability and improvements in prudential indicators in most countries in the region, domestic risks to East Asia's current economic rebound appear to be receding somewhat. Almost all East Asian countries, including the five crisis-affected countries, continue to run current account surpluses (Figure 21). Foreign exchange reserves have improved significantly and more than cover the entire short-term external debt (Figure 22). The short-term to total debt ratios and total external debt to GDP ratios are now lower than those at the height of the 1997 crisis (Figure 23). These countries' banking sectors are slowly returning to health. Reflecting many of these developments, international credit rating agencies have improved their assessments for some countries such as Korea, Malaysia, and Philippines (Table 2).

On the external front, the threat of a sharp increase in the international prices of petroleum products has also subsided, despite continued instability in the Middle East. Moreover, the estimate of this year's expected external private capital inflows to the region has now been revised upwards (see Box 2). This should also support the region's economic rebound. The single most important risk to the current forecast of a moderate rebound in East Asia may arise from any continuation of the recent deterioration in the US financial markets during the balance of this year.

The decline so far in the US stock market is unlikely to derail the moderate rebound in the US economy. However, if this continues and deepens during the rest of the year, it could upset the current assessment of the US recovery. Such a risk cannot be completely ruled out given: (i) the continued uncertainty about the information technology sector (see Box 3), and (ii) the ongoing revelations of accounting malpractices and corporate governance loopholes in the world's leading economy. At this stage, what could upset the current assessment of a moderate US recovery is not what has already been revealed about accounting malpractices but what may possibly be unearthed, as we move into the second half of the year. If many more cases of corporate malpractices surface in the immediate future, investor confidence in the US corporate sector and stock market, which is already weakening, could deteriorate sharply. And any confidence

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

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

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

Box 2: **Will a Moderate US Recovery Lead to Increased Capital Flows in the Crisis-Affected Countries?**

In 2001, according to the latest estimates of the Institute of International Finance (IIF), net private capital flows to the five crisis-affected countries remained positive but only at about half of their level of 2000 (Table 2.1). Net private inflows declined to $5 billion in 2001 from $10.3 billion in 2000, largely due to net inflows of equity investment that fell to $19.8 billion in 2001 from $24.9 billion the year before. Meanwhile, net flows of private creditors remained more or less unchanged at about $14.8 billion. The revised estimate of net private capital flows represents a better-than-expected outcome from the previous IIF estimate of $8.8 billion outflows in 2001 (see Box 1, April AEM).

The compression in net direct equity investments in 2001 was mainly due to the fall in net foreign direct investment by about 32% (from $13.3 billion in 2000 to $9 billion in 2001). Outflows on account of net private creditors remained roughly unchanged because the moderation in repayments of bank credits was fully offset by an increase in debt repayments to nonbank private creditors. The large net outflow in nonbank credit was mainly due to a sharp increase in debt repayments by Indonesia, Korea, and Thailand—partly a reflection of cheaper domestic borrowing opportunities in the latter two countries.

What are the prospects for private capital flows this year? On the one hand, a recovery in the US may boost capital flows into Asia as greater export demand increases expected profits and investment opportunities in the crisis-affected countries. On the other hand, recovery in the US may also be associated with an uptick in US interest rates, leading to a contraction in capital flows into the crisis-affected countries. Empirical evidence, however, suggests that in the 1990s, unlike in previous decades, the correlation between growth in the industrial countries and capital flows to emerging markets has tended to be positive. This could be because of increased integration of emerging markets to the global economy that permits outsourcing of production activities to them.

Most recent IIF forecasts suggest that net private capital flows to the crisis-affected countries could rise from $5 billion in 2001 to $12.8 billion this year. This is expected to result mainly from an increase in equity investments and the moderation of net repayments to overseas lenders. Further increases in capital inflows are expected in 2003.

Table 2.1: **Net Private Capital Flows to the Five Crisis-Affected Countries** ($ billion)

	1995	1996	1997	1998	1999	2000	2001	2002f	2003f
Net Private Flows	**93.35**	**118.53**	**4.37**	**-37.33**	**-1.44**	**10.25**	**4.96**	**12.83**	**18.47**
Equity Investment, net	**16.13**	**19.95**	**6.16**	**16.60**	**35.07**	**24.91**	**19.81**	**20.35**	**15.75**
Direct Equity Investment, net	4.14	4.77	6.81	13.29	15.27	13.32	9.02	8.00	6.60
Portfolio Investment, net	11.99	15.18	-0.66	3.32	19.80	11.59	10.80	12.35	9.15
Private Creditors, net	**77.22**	**98.58**	**-1.79**	**-53.94**	**-36.51**	**-14.66**	**-14.85**	**-7.52**	**2.72**
Commercial Banks, credit flows, net	63.73	69.17	-17.57	-48.39	-32.33	-15.67	-9.73	-7.49	0.44
Other Private Creditors, net	13.49	29.41	15.78	-5.54	-4.18	1.01	-5.12	-0.03	2.27

f = forecast
Source: Institute of International Finance.

crisis in the stock market could cause a large and abrupt weakening of the US dollar.

So far, the depreciation of the dollar has been slow and orderly, and, if anything, somewhat supportive of the US recovery. However, if a confidence crisis in the US corporations and the financial markets were to occur, there is the risk of a sharp withdrawal of capital from the US, leading to a large swing in the value of the US dollar. This, in turn, could potentially derail the US recovery by undermining consumer spending and business investment. The IMF has recently mentioned that it may seek coordinated actions if the dollar falls rapidly.

A faltering US recovery and a sharp depreciation of the US dollar could deal serious blows to East Asia. First, both will stunt East Asia's exports.

Box 3: **Uncertain Outlook for the IT Sector**

A rash of bad news has rocked the information technology (IT) and telecommunications sectors during June, leaving a general and widespread "antitech sentiment" pervading the markets.

Hopes earlier in the year of an impending bottoming-out in the chips sector—and with it a broader tech recovery—in the second half of this year have been dashed. Thus, the IT sector as a whole may have lost its luster—yet again.

The current gloom follows profit warnings and downward revisions in sales projections by a number of firms in the personal computer (PC) and fixed-line communications equipment sectors. To make matters worse, the US Justice Department is investigating allegations of anticompetitive behavior to push up DRAM prices in the global memory chip market.

In the PC sector, Apple noted that it would miss its April–June quarterly profit projection by about 10% and sales by about 9%. This bad news follows similar forecasts from Hewlett-Packard, which announced that revenue in the fiscal year ending October would fall 9–10% percent compared to 2001. It also warned that global tech spending is not expected to recover in 2002.

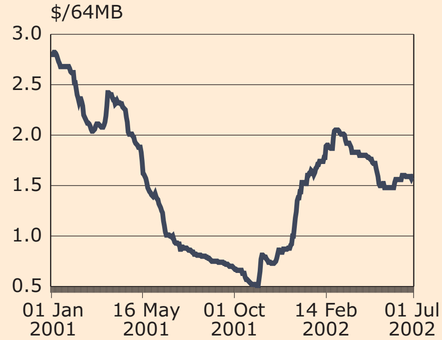
The telecommunications sector also remains vulnerable, making the long-awaited turnaround increasingly difficult to call. Most analysts are predicting that the industry's problems could actually get worse before getting better, following a wave of bad news in early June. Lucent Technologies, the world's largest maker of telecom equipment, announced that declines in sales would be greater than expected, by about 15% this quarter, as its main corporate customers reduce spending. Similarly, Sprint had its debt rating lowered to a notch above junk status as the company said it would sign up fewer wireless customers. Historically, the telecoms sector tends to recover about six months later than the economy as a whole, but some analysts fear that this might not be the case this time. They point to bigger structural problems such as overcapacity in the industry that will require painful rationalization before the situation improves.

Earlier in the year, it appeared that the downturn might be over for semiconductor manufacturers. New chip orders reached a 10-month high in January 2002, reflecting improved conditions in user industries such as vehicles and instruments. Inventories of semiconductors were also trending down. But the recent negative news from end users such as the PC industry has cast doubts on the ability of this highly cyclical industry to rebound. This led Advanced Micro Devices, for instance, to warn that second quarter revenue could fall as much as 26% below analysts' estimates. The only silver lining is that many chip manufacturers seem to be able to rely on a wider set of customers, and dependence on the PC industry has reportedly diminished. Wireless communications (e.g., cellular phones), data networking, broadband and optical networks, and consumer electronics (e.g., handheld computers, digital televisions and cameras, DVD players, Internet audio/MP3 players, video game consoles, and smart cards) have emerged as steady consumers. Although such diversification can be a cushion, some of these other customers, such as cellular phones, are also facing difficulties in the re-emerging broad tech slowdown.

Adding to the uncertainty are the US Justice Department investigations into leading memory chip makers such as Micron Technology and Samsung Electronics. Their alleged anticompetitive behavior to push up DRAM prices appears to have been in response to DRAM prices trending down since early in the year. However, prices appear to have stabilized recently (see Figure 3.1).

With all the negative news from tech companies in June, many experts are beginning to gradually push their forecasts for the timing of a recovery in the IT sector further into the future. Few now see any realistic prospect for recovery in the second half of this year, and some analysts have even begun raising doubts about next year's prospects. It should be noted, however, that analysts are basically questioning the timing of a recovery in this sector, rather than forecasting any significant further deterioration. And in such a highly volatile sector, prospects could easily turn around as quickly as they have deteriorated.

Figure 3.1: **Computer Chips Spot Price***



*Price data from January 2001 up to 18 April 2002 are for 64 MB PC 100 and data after 18 April 2002 are for 64 MB PC 133.
Source: Bloomberg.

Second, given the global integration of the stock markets, a significant drop in the US stock market could spill over to regional stock markets, adversely affecting domestic demand and growth in the region. Third, a faltering US recovery and weak US dollar would reduce growth prospects of Europe and Japan, which would, in turn, further dampen East Asia's economic rebound.

Overall, the US continues to be the major driver of global growth and recovery. A robust US economy and healthy US dollar are important to ensure that this year's global rebound remains on track. As one of the most globally integrated subregions in the world, East Asia's rebound is inextricably linked to the health of the US and world economy.

Five Years after the Crisis

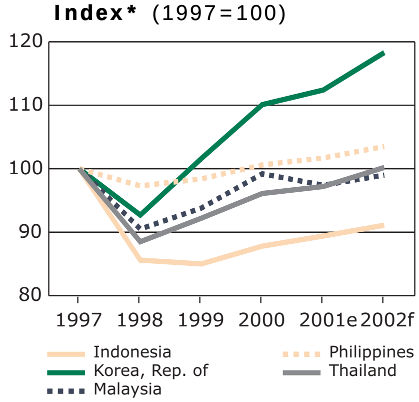
Real Sector Trends — An Overview

The five years since the onset of the Asian financial crisis in July 1997 represent the most turbulent half decade in East Asia's recent economic history. Overall, given the severity of the crisis, the region's recovery has been reasonably good. In most countries, the pace of recovery has been faster than expected.

However, five years on, growth rates in the five affected countries are still below their precrisis trend levels (see Table 1 on page 15). At 2.7%, the average annual growth rate achieved by the five countries since the crisis is much lower than the 8% average annual figure they achieved during the decade before the crisis. The gap is particularly large for Indonesia and Thailand. And although it is narrower for other countries, it is still significant. Malaysia's average GDP growth has fallen from 9.1% during the precrisis decade to 2.3% since the crisis, while at 4.5%, Korea's average growth in the postcrisis years is almost half the 8.1% growth achieved before the crisis. The corresponding decline in average growth for the Philippines is from 3.7% to 2.8%.

The sharp decline in average growth after the Asian financial crisis had serious implications for per capita incomes, unemployment, and poverty in the region. Even with this year's faster-than-expected economic rebound, real per capita incomes will be lower than their 1997 levels in Indonesia, hover around the 1997 level in Malaysia and Thailand, and be only marginally higher in the Philippines (Figure 24). Among the five crisis-affected countries, only Korea has made significant gains in per capita GDP since the 1997 crisis. For the other four countries, the last five years are effectively a lost half decade in terms of improvements in per capita incomes.

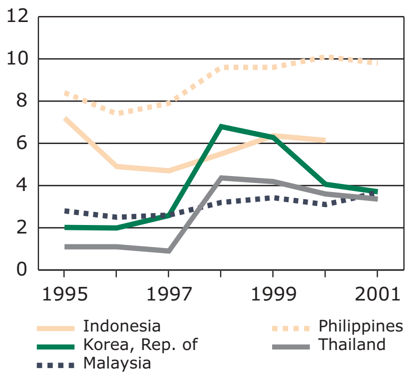
Figure 24: **GDP Per Capita Index*** (1997=100)



e=estimate; f=forecast
*Except for census years, population data are estimates. 2002 population was calculated using growth rates in 2001. GDP forecasts are from Consensus Economics Inc.
Sources: ADB, *Asian Development Outlook*, April 2002; Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, June 2002; various national sources.

The 1997 crisis and the recession that followed in 1998 led to a sharp contraction in employment in the five affected countries. As a result,

Figure 25: **Unemployment Rate** (%)



Source: ARIC Indicators.

unemployment rates shot up. The recovery in 1999 and 2000 enabled Korea and Thailand to reduce the unemployment rates from their peak levels at the height of the crisis. Unemployment rates in the two countries have been brought down from 6.8% to 3.7% and 4.4% to 3.4% during the period 1998 to 2001, respectively (Figure 25). On the other hand, Indonesia, Malaysia, and the Philippines have not seen much reduction in the unemployment rates following the recovery years of 1999–2000. In all of the affected countries, unemployment rates remain higher today then during the precrisis years.

Losses in per capita incomes and depressed employment conditions have also proven a setback to progress in poverty reduction. According to latest World Bank estimates, in 2002 the incidence of $2-a-day poverty in the five affected countries taken together is likely to be around 41% compared to about 39% in 1996 (Table 3). Two countries account for this increase in poverty incidence: Indonesia (from 51% to 56%) and Thailand (from 28% to 32%). Poverty incidence has fallen in Malaysia and in the Philippines.

Table 3: **Poverty Incidence, $2 per person per Day—Five Crisis-Affected Countries*** (%)

	1996	1999	2000	2001	2002
Indonesia	50.5	65.1	58.9	57.8	56.4
Korea, Rep. of	0.0	0.2	0.2	0.2	0.2
Malaysia	11.5	8.1	5.1	5.5	5.1
Philippines	46.5	45.0	46.8	45.1	44.0
Thailand	28.2	33.4	35.6	34.2	32.3
Five Crisis-Affected	**38.5**	**46.8**	**43.7**	**42.6**	**41.4**

*Data for 1997 and 1998 are not available.
Source: World Bank, *East Asia Half-Yearly Update,* April 2002.

Despite these gaps in the five years since the crisis, progress has been made in three broad areas: (i) strengthening macroeconomic management (by permitting greater flexibility in exchange rates supplemented in several countries by a system of inflation targeting, and reducing the level of external debt and increasing its average maturity) and building up foreign exchange reserves; (ii) restructuring the financial and corporate sectors; and (iii) enhancing regional self-help and support measures by promoting monetary and financial cooperation. These efforts are laying the foundation for sustained economic growth in the longer term and enhancing the region's resilience to external shocks.

As pointed out in the previous chapter, prudential indicators relating to the external payments situation of most East Asian countries have improved in recent years (see Page 17). Countries have also made significant progress in financial and corporate sector restructuring. These measures at the national levels have been augmented by efforts to promote regional monetary and financial cooperation (see December 2001 AEM, and update in Box 4).

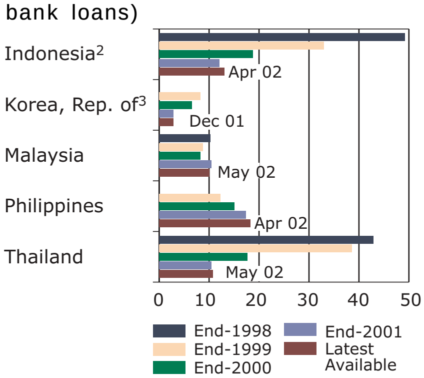
These efforts are rapidly changing the economic and financial landscape of East Asia, making the region more responsive to market forces while at the same time enhancing resilience to external shocks. Overall, they are laying the foundation for sustained long-term growth.

Yet, it is important to reiterate that the remaining agenda of economic reforms and restructuring is still long and substantive. The process requires continuous efforts in an ever-changing global environment. As soon as a country finishes one stage of reform, progress in the next stage becomes imperative. East Asia's recent achievements as well as the future challenges in restructuring and building up resilience to shocks should, therefore, be viewed in this broader perspective. Against this backdrop, this chapter attempts a stocktaking of what has been achieved in financial and corporate restructuring in East Asia since the 1997 crisis.

Financial and Corporate Restructuring

Nonperforming Loans, Capital Adequacy, and Bank Profitability

Figure 26: **NPLs[1] of Commercial Banks** (% of total commercial bank loans)



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

Compared to their peak levels during the crisis, nonperforming loan (NPL) ratios have fallen substantially in most of the affected countries. The Philippines is the notable exception, with the NPL ratio of the commercial banking sector on the rise during the past few years. The latest available data indicate that the NPL ratios range from 2.9% in Korea to 18.2% in the Philippines (Figure 26).

Caution should, however, be exercised in interpreting the recent improvements in NPL ratios. With the exception of the Philippines, to varying degrees, the reductions in NPL ratios in the affected countries were brought about by the transfer of NPLs from banks' balance sheets to the publicly-owned and centralized asset management companies (AMCs). While this has enabled banks to resume lending and support recovery, the real test of restructuring also hinges on the progress in asset disposal by AMCs. Malaysia's Danaharta had resolved nearly all of its acquired assets by the end of 2001. Korea has also made significant progress in disposing of assets acquired by the Korea Asset Management Corporation (KAMCO). In Indonesia, however, asset disposal by the Indonesian Bank Restructuring Agency (IBRA), although improving, has proved to be more difficult and slower. In Thailand, a

Box 4: **Progress in Monetary and Financial Cooperation in East Asia**

Box 5 of the December 2001 AEM highlighted the ongoing efforts to promote monetary and financial cooperation in East Asia in the areas of information exchange and regional surveillance processes, mechanisms for resource provision, and moving beyond the Chiang Mai Initiative to harmonize macroeconomic and exchange rate policies. This box reviews more recent progress.

Bilateral Swap Arrangements under the Chiang Mai Initiative

To date, seven bilateral swap arrangements (BSAs)—Japan-Korea, Japan-Thailand, Japan-Philippines, Japan-Malaysia, PRC-Thailand, PRC-Japan, and PRC-Korea with a combined size of $19 billion—have been concluded and signed (Figure 4.1). The most recent one was signed between the PRC and Korea on 24 June 2002. There has also been significant progress on three BSAs (Korea-Malaysia, Korea-Philippines, and Korea-Thailand). While negotiations on another four have started, negotiations on four more have yet to be initiated. In addition, in line with the Chiang Mai Initiative, the existing swap arrangements between Japan and Korea and Japan and Malaysia have been renewed with a combined size of $7.5 billion. The Chiang Mai Initiative is significant not only for the resources it can bring to crisis prevention and management, but also for its potential to establish a set of institutions to support regional monitoring and peer review.

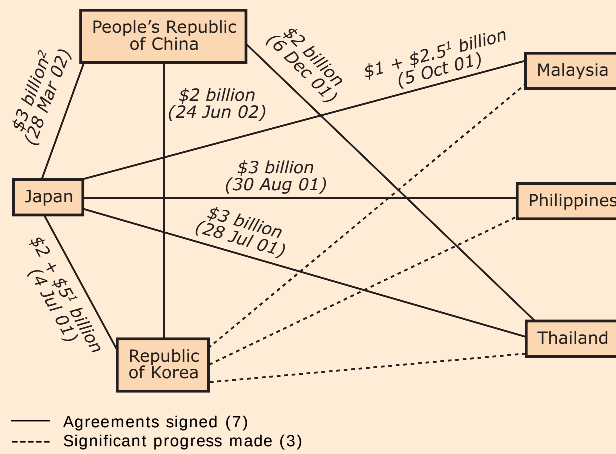
Establishment of the ASEAN+3 Regional Early Warning Systems

The establishment of an ASEAN+3 regional early warning system (EWS) prototype was alluded to in the communiqué of the ASEAN+3 Finance Ministers' meeting in Honolulu in May 2001. Subsequently, ADB provided a technical assistance to develop a regional EWS prototype to help detect emerging macroeconomic, financial, and corporate sector vulnerabilities and prevent financial crises. The prototype, which is still under development, comprises four components: (i) a set of macroprudential indicators, broadly defined as indicators of health and stability of financial systems; (ii) a non-parametric EWS model designed to assess the probability of a currency crisis within a 24-month horizon based on the signaling approach; (iii) a parametric EWS model designed to assess the probability of a currency crisis with a 24-month time horizon based on probit analysis; and (iv) a set of leading indicators of business cycles.

ASEAN+3 Study Group

Another initiative of the ASEAN+3 Finance Ministers at their May 2001 Honolulu meeting was to establish a study group to discuss ways of strengthening economic reviews and policy dialogues. The ASEAN+3 Study Group to Examine Ways of Enhancing Effectiveness of Economic Reviews and Policy Dialogues has recommended a two-phased approach. In Phase 1, the existing arrangements for economic review and policy dialogue are to be strengthened by making the process more credible and subject to more extensive discussions by the finance ministers and deputies. The frequency of the ASEAN+3 Finance Deputies meeting has also been increased to three times a year. In Phase 2, an independent, professional third party is to help prepare reviews and assessments, as well as issue papers on emerging problems affecting the region.

Figure 4.1: **Bilateral Swaps — Signed and in Advanced Stage**



Note: Negotiations on four BSAs (Japan-Indonesia, Japan-Singapore, PRC-Malaysia, and PRC-Philippines) have been initiated. Negotiations have yet to start on four more BSAs (PRC-Indonesia, PRC-Singapore, Korea-Indonesia, and Korea-Singapore).

[1]Swap arrangement under the New Miyazawa Initiative.

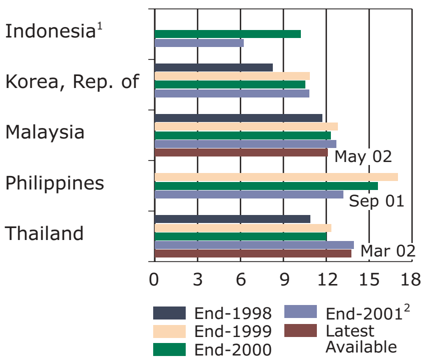
[2]Two-way yen-renminbi swap arrangement.

Kobe Research Project

The Kobe Research Project is an initiative of the Asia-Europe Finance Ministers to promote greater cooperation including monetary and financial cooperation in East Asia by learning from the experience of Europe. Under this Project, six research studies have been undertaken by institutions and individuals in Asia and Europe.[1] ADB has contributed to three of these studies. The initial results of the Project were presented to ministers at the Fourth Asia-Europe Finance Ministers' Meeting in Copenhagen on 5–6 July 2002.

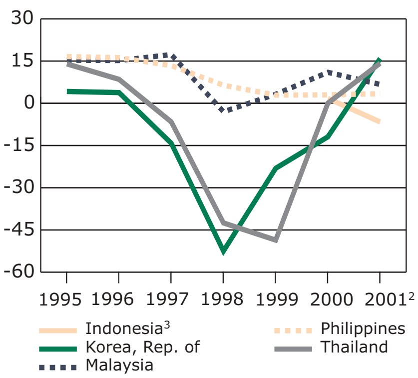
[1]The six studies were: (i) Exchange Rate Regime for Asia and EU Accession Countries, (ii) Requirements for Successful Currency Regime, (iii) Strengthening Financial Cooperation and Surveillance, (iv) Enhancing Regional Monitoring and Instruments, (v) European and Asian Financial Systems and Perspectives, and (vi) China in a Regional Monetary Framework. ADB contributed to studies (i), (iii), and (v) by preparing reports on Monetary and Financial Cooperation in East Asia, Issues in Development of Bond Markets, and Development of a Regional Early Warning System Prototype.

Figure 27: **Capital Adequacy Ratios of Commercial Banks** (%)



[1]For seven recapitalized banks (BII, Bank Universal, Bank Patriot, Bank Artamedia, Bank Prima Express, Bukopin, and Lippo).
[2]Except for Philippines which is for September 2001.
Source: ARIC Indicators.

Figure 28: **Banking Sector Profitability[1]** (%)



[1]Data refer to average return on equity of all commercial banks except for Malaysia, which refer to listed commercial banks only.
[2]Except for the Philippines, where datum is annualized estimate for 2001.
[3]Average ROE of seven recapitalized banks (BII, Bank Universal, Bank Patriot, Bank Artamedia, Bank Prima Express, Bukopin, and Lippo) as reported by IBRA.
Sources: Web sites of the Financial Supervisory Service, Bangko Sentral ng Pilipinas, Stock Exchange of Thailand, IBRA, and Bloomberg.

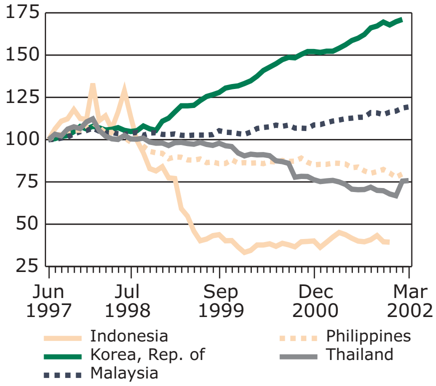
centralized AMC was set up only last year and asset disposal is still in its early stage, although this is proceeding according to plan. Inclusive of assets still held by these centralized AMCs, the NPL ratio remained as high as 50% in Indonesia and more than 20% in Thailand as of the end of 2001. Unlike other countries in the region, the Philippine Government has not set up a publicly-owned and centralized AMC to take over banks' NPLs, and this to some extent explains the country's relatively high NPL ratio.

Because of the success of bank recapitalization programs in most affected countries, banking sectors have seen their capital adequacy ratios (CARs) improving in recent years. The only exception is the Philippines, where there has been no publicly-funded recapitalization and the CAR of commercial banks has declined somewhat. Even so, the country's CAR is still well above the 8% Basel standard, as is also the case in Korea, Malaysia, and Thailand (Figure 27). In Indonesia, CAR data are not available for the entire banking sector. But for the seven banks recapitalized by IBRA, the average CAR was 6.2% as of end-December 2001.

Banking sector profitability has also improved in most countries (Figure 28). In Korea, the average return on equity (ROE) of all the domestic commercial banks rose to 15.9% in 2001, a big turnaround from -11.9% in 2000 and -52.5% in 1998. In Thailand, the average ROE of all commercial banks, domestic and foreign, rose to 14.3% in 2001 from a near-zero level in 2000 and -42.5% in 1998. In the Philippines, the average ROE of all domestic and foreign banks in 2001 was 3.4%, compared to 3% in 2000 and 2.9% in 1999. In Malaysia, the average ROE of all the listed commercial banks rose from -2.9% in 1998 to 11% in 2000. In 2001, however, there was evidence that banking sector profitability worsened in Malaysia, with the average ROE of the listed commercial banks declining to 6.7% in 2001, possibly due to the economic slowdown. The average ROE of Indonesia's seven recapitalized banks turned negative in 2001 compared to 1.7% in 2000.

In Korea and Malaysia, the stock of real bank credit to the private sector has continued to grow, reflecting success in reforms and strong domestic demand (Figures 29). In Thailand, after three and a half years' consecutive contraction, real bank credit appears to have stabilized since early this year. Indonesia, meanwhile, saw its stock of real bank credit stabilize in most of 2001, but comparable data for 2002 are not yet available. In the Philippines, however, real bank credit has been declining since early 2001.

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



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

Banking Sector Consolidation and Divestment

The banking sectors of the five crisis-affected countries have undergone substantial consolidation in recent years.

- **Malaysia.** The country has advanced furthest in this direction. The banking sector merger program announced in mid-1999 resulted in 52 domestic banking institutions being consolidated into 10 banking groups. The Government has recently indicated that the banking sector will be further consolidated, with the 10 groups expected to be merged into six to eight banks over the next 10 years.

- **Korea.** The number of banks fell from 33 to 20 by the end of last year. In 2001, three large new financial groups, Woori, Shinhan, and Kookmin, were formed. Woori is a financial holding company that groups together a number of financial companies that have received government funds for recapitalization, while Kookmin Bank, now the country's largest lender, was created through a merger of Kookmin Bank and Housing & Commercial Bank.

- **Philippines.** Banking industry consolidation has continued. As a result of three mergers and the exit of 19 banks in 2001, the number of Philippine banks has fallen to 929. These comprise of 44 commercial banks, 104 thrift banks, and 781 rural/cooperative banks.

- **Thailand.** Bank consolidation is also under way. The Ministry of Finance in March 2002 approved the merger of Bangkok Metropolitan Bank with Siam City Bank. Bank consolidation is seen as an effective way to promote financial restructuring, enhance stability of the financial system, and improve the competitiveness of domestic banks in the domestic and international markets.

- **Indonesia.** The banking restructuring program over the past years has left the country with five state banks, 26 regional development banks, and 80 private banks. Further consolidation is seen as a priority to carry forward and complete the country's bank restructuring process.

The current wave of bank consolidation has been seen as a positive development in the restructuring, reforming, and modernizing of banking sectors in the region. Some also see these as a broad movement away from the family-owned banks toward more "corporatized" banks. Concerns have, however, been raised that the consolidation process has largely been led by the governments rather than driven by market forces. Further, the enlargement of bank sizes should not substitute efforts to improve banks' internal risk management. To avoid excessive concentration of the banking sector, suggestions have been made that bank consolidation should be carried forward through mergers between small and medium-sized banks, rather than led by large banks, and that entry barriers for foreign banks should be lowered further.

As highlighted in previous issues of AEM, financial restructuring has involved the government injecting a large amount of capital into or nationalizing troubled banks in many affected countries, resulting in the state owning a high proportion of the banking sector. Although governments are committed to privatizing these nationalized banks and divesting state ownership in the sector, the process of privatization and divestment has been slow over the past few years due partly to poor market conditions and political sensitivity in selling bank assets to foreign buyers. But there are signs that the pace of bank privatization and divestment is picking up.

- **Indonesia.** After 18 months and three attempts, the Government's 51% stake in Bank Central Asia was sold in early 2002 for an estimated Rp5.6 trillion. The Government had also planned to sell its 30% stake in the country's largest bank, Bank Mandiri, by end-June 2002 and a 51% stake in Bank Niaga this year. However, due to some legal problems over the capital structure, the sale of Bank Mandiri has been postponed to the third quarter. In the case of Bank Niaga, due to low bids, the authorities had to scrap the original sale plan. A new sale strategy has been revealed, under which the Government will sell up to a 20% share of the Bank Niaga directly into market and will relaunch the sale of a majority stake in the bank by end-June 2002, with a view to completing the sale by mid-September. The Government has also finalized a plan to divest the remaining IBRA banks and submitted the plan to Parliament in early June.

- **Korea.** The process of divestment started in the immediate aftermath of the 1997 financial crisis, although much remains to be done. In 1999, the Government offered Seoul Bank and Korea First Bank for sale. The Korea First Bank was subsequently sold to Newbridge Capital Ltd., an American-owned investment firm. However, as of early June 2002, the sale of Seoul Bank had still not been completed. The Government now plans to sell a 51% stake in Seoul Bank by the end of July 2002. In January 2002, the Government announced a plan to use the economic recovery as an opportunity to sell off most of its controlling stakes in banks over the next three to four years. In May this year, Woori financial holding company offered a 11.8% stake for sale in a public offering and in June listed its shares on the Korean Stock Exchange.

- **Malaysia.** 2001 saw the completion of the divestment of Danamodal's 100% equity stake in MBf Finance Berhad. As of end-December 2001, about 72% of original investment in troubled banks by Danamodal, a government-owned special purpose agency tasked to recapitalize illiquid but viable banks, had been repaid.

Asset Disposal by Centralized Asset Management Companies

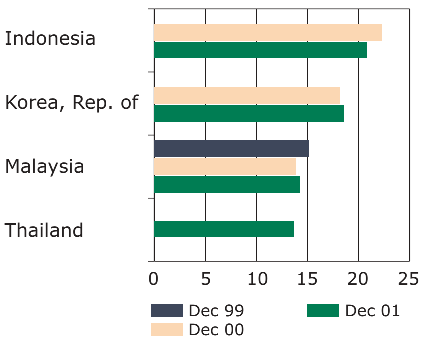
In the aftermath of the crisis, AMCs were established to clean up bank balance sheets in several countries.

- **Malaysia.** The country has been the front-runner. As of end-March 2002, Danaharta had acquired (in face value) about RM47.75 billion in NPLs from troubled financial institutions, about 14% of the country's GDP in 2001 (Figure 30). It has resolved nearly all of these nonperforming assets (Figure 31) at an estimated recovery rate of 55%. With an average discount rate of 54.4% for its acquired NPLs, Danaharta is expected to turn in a small profit by 2005 when it will be dissolved.

- **Korea.** As of May 2002, KAMCO had acquired (in face value) a total of $81 billion in NPLs, about 19% of GDP in 2001, from troubled financial institutions at an average discount rate of about 62%. KAMCO has disposed of about 59% of these assets at an average recovery rate of 46%. By the end of this year, KAMCO will stop purchasing NPLs.

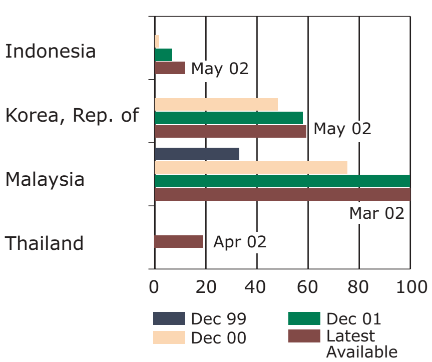
- **Indonesia.** Because of poor economic conditions, political uncertainties, an ineffective bankruptcy system, and political resistance to sell at a huge discount, the pace of asset disposal by IBRA has been slow. As of May 2002, IBRA had acquired (in face value) a total of Rp360 trillion in NPLs, about 21% of GDP in 2001, from troubled financial institutions. IBRA has managed to dispose of only about 12% of these nonperforming assets. In an attempt to speed up asset disposal, in early June 2002, IBRA launched its largest-ever asset sale program of bank loan assets worth Rp150 trillion ($17 billion). The sale, which is open for local and international investors, involves 2,500 credit portfolios consisting of restructured and non-restructured loans. The sale process is expected to be completed by August 2002. IBRA is targeting a recovery rate of around 30% from the loan sales. If successful, this would bring the country's aggregate NPL ratio (inclusive of

Figure 30: **NPLs Purchased by AMCs*** (% of GDP)



*Refer to those by IBRA in Indonesia, KAMCO in Korea, Danaharta in Malaysia, and TAMC in Thailand, as of the dates indicated.
Source: REMU calculations based on data from KAMCO, Danaharta, IBRA, and TAMC.

Figure 31: **NPLs Disposed of by AMCs*** (% of NPLs purchased)



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

NPLs acquired but not yet disposed of by IBRA) down to about 30%. For 2002, despite suggestions of overoptimism, IBRA is aiming for a significant acceleration of its net cash recoveries to Rp36 trillion, up from a target of Rp27 trillion for 2001. A further Rp7.5 trillion in AMC bond recoveries is targeted for 2002. IBRA aims to return all assets under its management to the private sector by its sunset date of February 2004.

- **Thailand.** The Thailand Asset Management Company (TAMC), which was set up last year, was to acquire about half of the financial system's NPLs. As of the end of 2001, it had almost completed the transfer of eligible nonperforming assets from State-owned and private banks and AMCs amounting (in face value) to B698.4 billion at an average discount rate of 67%. Of this amount, more than 80% was transferred from State-owned financial institutions. The transfer was less than what was originally envisaged. The discrepancy was largely due to the fact that many cases had already been filed for court proceeding. In the meantime, debt resolution is also under way. In the first quarter of 2002, TAMC achieved its debt resolution target of B100 billion. As of the end of April 2002, it had resolved 238 debtor cases with a total face value of B132.7 billion, about 19% of the total NPLs it acquired.

Corporate Workouts

In addition to resolving bad debts through centralized AMCs, debt restructuring is also being carried out on a voluntary basis under the so-called London approach framework.

- **Indonesia.** The Jakarta Initiative Task Force (JITF) was created to serve as a mediator and facilitator of specific restructuring cases, particularly those involving foreign lenders. Compared to IBRA, debt restructuring under JITF is more successful. As of end-May 2002, JITF had received a total of 130 registered cases with debt value amounting to $30.3 billion, and completed the mediation of 71 cases with debt value of $15.4 billion, consisting of 48 cases worth $10.6 billion that had reached legal closures and 23 cases worth $4.8 billion that was still awaiting final closure following a memorandum of understanding (MOU) signing. In 2002, JITF is targeting the restructuring of additional debt of $4 billion–5 billion and bringing $2 billion–3 billion restructured debt to the legal closure stage. There have been concerns, however, over the quality of debt restructuring by JITF, as debt rescheduling was still the predominant method of restructuring, which in 2001 accounted for 53% of total value of the restructured debt.

- **Malaysia.** The Corporate Debt Restructuring Committee (CDRC) successfully assisted five companies in finalizing debt restructuring agreements with their respective lenders during the first quarter of 2002, addressing debts of about RM2.8 billion. CDRC was set up after the crisis to provide a platform for borrowers and creditors to work out feasible debt restructuring schemes without having to resort to legal proceedings. Only viable companies with a total borrowing in excess of RM50 million from more than one bank are eligible for workouts under this framework. As of end-March 2002, 42 cases had been successfully finalized under CDRC's sponsorship, thereby resolving debts totaling RM37.4 billion. Nine cases with cumulative debts of RM17.2 billion are outstanding. CDRC targets the resolution of all these cases by end-July 2002. It stopped accepting new cases as of March 2002, consistent with its targeted closure date of end-July 2002.

- **Korea.** Corporate restructuring has been separated into three tiers: the top-five *chaebol* including Hyundai, Daewoo, Samsung, SK Telecom Co. Ltd., and Lucky Goldstar; the heavily-indebted medium-sized *chaebol* ranked 6 to 64 by asset size; and the cash-strapped small and medium enterprises sector (SMEs). Progress is being made at all the three tiers. Daewoo, the No. 2 *chaebol*, has been declared bankrupt and broken up. In April 2002, General Motors agreed to buy 67% of Daewoo Motor. The remaining 33% will be purchased by Daewoo's creditors as agreed in the MOU signed in September 2001. Creditors of Daewoo will also commit new working capital amounting to $2 billion to help retool the facilities. Hyundai group has splintered, with its component entities going their separate ways. American International group and WL Ross signed an MOU in August 2001 to buy stakes in three Hyundai financial subsidiaries. In September 2001, creditors of Hynix (formerly Hyundai Electronics) agreed to a debt equity swap of nearly $3 billion and rolled over maturing debts. Samsung, LG, and SK groups have been forced to focus on their core competencies by divesting collateral business lines. Renault took over Samsung's car line. At the second tier, companies in formal workout programs have been rehabilitated, sold, or liquidated. Sixteen of the top 30 conglomerates of 1997 are no longer in the list. Debt-to-equity ratios at the top 30 groups have been brought down, from an average of 519% in 1997 to 171.2% at the end of 2000.

- **Thailand.** After the crisis, the Government created the Corporate Debt Restructuring Advisory Committee (CDRAC) to encourage and/or expedite out-of-court debt restructuring. As of end-April 2002, CDRAC had approved 14,850 target debtors with credits outstanding of B2,625 billion to enter the voluntary workout process. Of these approved target debtors, 10,109 cases with credits outstanding of B1,280 billion had been successfully restructured. But 4,679 cases with credits outstanding of B1,190 billion remained unrestructured, and were either in the process of being filed or have already been filed in courts by their creditors. The failure of CDRAC to facilitate debt restructuring more expeditiously, which to some extent made the Government resort to the creation of TAMC, is due to a number reasons. Among others, CDRAC did not have sufficient legal power to deal with debt cases. Moreover, most cases that had been filed in the courts were piled up, causing disruption to the debt restructuring process. In addition to restructuring under the process sponsored by CDRAC, debt cases are also being worked out by financial institutions themselves. From 1998 to the end of March 2002, a total of 494,409 cases with credits outstanding of B2,497 billion had been successfully restructured by financial institutions.

One of the weak areas of corporate restructuring has been court-led restructuring. Despite efforts to improve bankruptcy regimes in most affected countries after the crisis, many weaknesses remain and these have led to the limited number of completed cases of court-led restructuring and liquidation (see Special Chapter on Corporate Restructuring in the December 2001 AEM and discussion later).

Reforms in Financial Supervision and Regulation

The five crisis affected countries have also made important efforts to strengthen supervision and regulation of their financial systems.

- **Indonesia.** The Government's focus has so far been on restructuring troubled financial institutions. But the country has also introduced over the past few years measures to improve the financial supervision and regulation framework. In January 2002, Bank Indonesia issued revised regulations raising the minimum capital adequacy requirement to 8%. According to the regulations, banks that cannot meet the new requirements within specified periods will be transferred to IBRA for resolution. During 2002, Bank Indonesia intends to complete all the specific actions in its master plan aimed at improving compliance with the Basel Core Principles for Effective Banking Supervision, including moving toward consolidated supervision. To enhance transparency and market discipline, it will begin monthly publication of key individual bank financial data. Plans are also afoot for the establishment of an integrated financial sector supervisory agency—the Financial Sector Supervisory Institution.

- **Korea.** Financial sector supervision was consolidated into the Financial Supervisory Commission in early 1998. Later this became the Financial Supervisory Service (FSS) with new management. The FSS has operational autonomy, can license and de-license financial institutions, and has supervisory responsibilities. Regulations governing the operations of banks have also been strengthened to bring them broadly in line with Basel recommendations. In April 2002, FSS issued new guidelines aimed at lowering the ratio of loans classified as substandard, doubtful, or presumed loss that are held by nonbank financial institutions (NBFIs) to improve overall asset quality. Under the guidelines, institutions are expected to enter into an agreement with FSS to reduce securities borrowing and lending ratios to 10% or lower within varying target dates. NBFIs that fail to meet the new guidelines are encouraged to undertake significant restructuring steps. In May 2002, FSS instituted new minimum mandatory loan loss provisioning ratios for domestic banks' household loans and credit card receivables.

- **Malaysia.** Several measures have been introduced to strengthen banking regulation and supervision, focusing on risk-based and consolidated supervision. The Financial Sector and Capital Market Master Plans, released last year, propose to achieve full integration of the domestic financial system into the globalized market over a 10-year period. More recently, Malaysia included discount houses in the liquidity framework coverage, with a view to improving prudential regulation. The framework requires discount houses to project maturity of assets, liabilities, and off-balance sheet requirements, and maintain adequate liquidity surplus to meet expected obligations and sustain unexpected withdrawals for at least one month. Malaysia also strengthened the institutional capacity of the Islamic banking institutions, broadened the range of financial products and services, intensified research and development efforts, and strengthened the regulatory framework.

- **Philippines.** Reforms are aiming to improve banks' risk management practices by shifting to a risk-based capital adequacy framework, strengthen prudential supervision and regulation, and promote sound bank governance. The most significant move was the passage of the General Banking Law in 2000 and the introduction of regulations to implement the Law. In September 2001, the country passed the Anti-Money Laundering Law. More recently, a House Bill was approved paving the way for the creation of privately-owned Special Purpose Asset Vehicles to acquire, manage, and dispose of NPLs and assets of financial institutions. The counterpart Bill is under consideration by the Senate.

- **Thailand.** Over the past few years, loan classification, provisioning, and interest accrual and capital adequacy rules have been tightened with a view to bringing them up to international standards. To further strengthen financial sector governance, the Government has drafted two key pieces of legislation, the new Financial Institutions Act and Bank of Thailand Act. The two proposed acts are being debated in Parliament. The new Financial Institutions Act will standardize the regulatory framework for banks, finance companies, and credit fonciers, and provide a legal basis for the consolidated supervision of financial conglomerates. It will also tighten regulations in a variety of areas, including interconnected lending, disclosure standards, and penalties and prevention against fraud. The new Bank of Thailand Act, on the other hand, will strengthen the Bank of Thailand's independence and accountability. Under this new Act, objectives of the Bank of Thailand will be limited to maintaining price stability and safeguarding the stability of the financial system.

Reforms in Corporate Governance

In all five affected countries, important reforms have been introduced since the crisis in areas of shareholder protection, transparency and disclosure, bankruptcy regimes, as well as prudential regulation and supervision of financial systems to bring corporate governance systems up to international standards.

Shareholder Protection. Reforms in this area have focused mainly on strengthening the system of the board of directors and minority shareholders' rights.

All five affected countries have introduced voluntary codes of corporate governance that largely follow international best practices. These codes require that at least 20–35% of board members of listed companies be independent and that independent board committees be set up to deal with important corporate matters, in particular, auditing. To strengthen protection of shareholders, especially minority shareholders, listed companies are required to grant shareholders such rights as proxy and cumulative voting and filing class action suits; to make shareholder approval of important transactions mandatory; and to require directors to disclose their business interests and remuneration.

Listing rules have also been revised to accommodate many of the provisions stipulated in codes of corporate governance. Stock exchanges across the region have mostly tightened rules of penalty and sanction for noncompliance.

In many countries, corporate laws have been amended to strengthen legal protection for shareholders. In Korea, the Securities and Exchange Act was revised to clarify the fiduciary responsibility of directors and lower the threshold for exercising rights to file class action suit, make proposals at a general shareholders' meeting, inspect company's financial accounts, and request the dismissal of directors or internal auditors. In the Philippines, the Securities Regulation Code enacted in 2000 introduced stricter rules related to listing, shareholder representation, board structure, and legal action against directors. Thailand amended the Public Limited Company Act in 2001 to provide mechanisms to prevent directors from making use of companies' opportunities for their own benefit and to ensure that minority shareholders can exercise their rights in making decisions for the company.

Transparency and Disclosure. Many countries have introduced changes in accounting and auditing rules to move closer to international standards. In Indonesia, major initiatives have been taken to harmonize the Financial Accounting Standards with International Accounting Standards (IAS). In Korea, legal changes have been made so that domestic accounting practices conform to international standards. Group companies are now required to compile consolidated financial statements. In Malaysia, accounting standards are among the highest in East Asia and are generally consistent with the IAS. Nevertheless, the issue of compliance and enforcement is being addressed. In the Philippines, accounting standards are also moving closer to international norms. Embodied in its May 2000 Accountancy Law, the Thai Government has started upgrading its accounting and audit standards to conform to the IAS.

Voluntary codes of corporate governance, listing rules, and corporate laws in the affected countries generally contain more stringent disclosure requirements and tougher penalties for noncompliance.

- **Indonesia.** Listed companies are required to appoint a corporate secretary responsible for corporate disclosure. Company annual reports must provide audited and annotated financial statements and a company profile. Reports must be available on the Internet and at local registries.

- **Korea.** Listed companies are required to include in their annual reports details of business goals and strategies, financial conditions, shareholder rights, cross-shareholdings, cross-debt guarantees, directors' compensation, and events likely to affect share prices, including dealings benefiting insiders and transactions that could change corporate control.

- **Malaysia.** Companies' annual reports must fully disclose information on the overall financial performance of the company, the extent of compliance with principles of good governance, and the state of internal control.

- **Philippines.** Financial reporting has been tightened. Companies are also required to detail all transactions and provide minutes of meetings to directors and shareholders.

- **Thailand.** Companies are required to provide shareholders with sufficient and timely information on the company's financial position before shareholders' meetings, information that may affect shareholder rights and investments, and information on company directors' holdings and purchases and sales of company securities.

Bankruptcy Reform. As part of corporate restructuring efforts, Indonesia, Korea, Malaysia, and Thailand in the immediate aftermath of the crisis set up mechanisms for voluntary and informal corporate workouts modeled on the London approach. There have also been efforts to address weaknesses in formal bankruptcy procedures.

- **Indonesia.** The Government amended its bankruptcy laws in 1998 and established a new commercial court to deal with bankruptcy cases. In 2000, the Government passed the Company Bankruptcy and Debt Restructuring and/or Rehabilitation Act, modeled on US Chapter 11, to facilitate reorganization of illiquid but financially viable companies. It also increased sanctions on uncooperative debtors and empowered the Attorney General to deal directly with cases, improving the incentives for debtor participation.

- **Korea.** The Government amended the bankruptcy laws in 1998, simplifying legal proceedings for corporate rehabilitation and bankruptcy filing, streamlining provisions for nonviable firms to exit markets, and improving credit bank representation during resolution. The authorities also attempted to expedite court insolvency proceedings granting district courts authority to process cases. In September 2001, a Corporate Restructuring Promotion Law (CRPL) was passed to address some of the remaining problems in corporate workouts.

- **Malaysia.** Malaysian bankruptcy laws were sound by international standards even before the crisis. Further reforms have been introduced to expedite the resolution of NPLs. Danaharta was allowed to sell NPLs it acquired from distressed banks and appoint special administrators to manage and restructure these assets. Authorities also reduced companies' ability to impose restraining orders on creditors under Section 176 of the Bankruptcy Act. In 2001, the Kuala Lumpur Stock Exchange (KLSE) introduced practice notes and guidelines, thus increasing the disclosure and reporting obligations of distressed companies on the KLSE.

- **Philippines.** Early this year, a draft of a new insolvency law was proposed and is under consideration for approval in the Congress. The proposed Corporate Recovery Act, to replace the Insolvency Law that was enacted in 1909 and Presidential Decree 902-A issued in 1976, provides debt relief and recovery measures to financially distressed enterprises and offers four modes of rehabilitation: pre-negotiated rehabilitation, fast-track rehabilitation, court-supervised rehabilitation, and dissolution-liquidation. Meanwhile, the Interim Rules of Procedure developed by the Supreme Court in December 2000 to govern rehabilitation cases and the Securities Regulation Code, which transferred the quasi-judicial jurisdiction of the Securities and Exchange Commission over suspension of payments and rehabilitation proceedings to the Regional Trial Courts, remain in place.

- **Thailand.** A Bankruptcy Act Amendment was introduced in March 1999 that prevents a company from being forced into bankruptcy due to temporary liquidity problems. The amendment introduced the Framework for Corporate Debt Restructuring to the Bankruptcy Act of 1940, along the lines of Chapter 11 of the US Bankruptcy Code.

Remaining Agenda

Despite these encouraging developments in the affected five countries, as well as positive moves in many of the other economies of East Asia (see Box 5), the road to completing financial and corporate restructuring in the region is still long.

Box 5: **Financial and Corporate Restructuring in Other East Asian Countries**

Cambodia

Cambodia's banking system is well capitalized with a capital asset ratio of about 30%, although this reflects the small asset size due to the limited loan portfolio. The NPL ratio is high, estimated at about 20% at end-December 2000.

Cambodia is undertaking a comprehensive bank restructuring program, which is nearing completion. The National Bank of Cambodia (NBC) has been closing banks that were insolvent or not complying with the law. As of end-December 2001, 18 private banks remained, of which five banks were fully relicensed and 13 banks were subject to corrective action. Most remaining banks are profitable, except those that require corrective actions and are likely to be closed at the final stage of restructuring.

To complement its weakness in bank supervision, NBC has imposed tougher prudential regulations, such as prohibiting banks from transferring domestically collected funds abroad. There are concerns, however, that too strict prudential regulation may prevent the efficient allocation of funds and discourage banking sector development.

PRC

By end-April 2002, outstanding NPLs at State-owned commercial banks in the PRC were reported at 24.54% of the total loans. Banks have been recapitalized and their NPLs have been transferred to newly established AMCs. AMCs are tapping foreign markets for some of the NPLs. Huarong auctioned off Y16.6 billion of NPLs, of which Y10.8 billion was sold to a consortium led by Morgan Stanley that included Lehman Brothers. Cinda Asset Management signed an agreement with Goldman Sachs, Deutsche Bank, and Lonestar Capital to dispose of its bad assets from China Construction Bank. Orient Asset Management will sell between 15% and 20% of its Y267 billion of nonperforming assets to foreign investors for the Bank of China. Great Wall Asset Management is also expected to auction about Y15 billion of NPLs to international investors this year. Officials expect the nonperforming assets to sell for up to 30%, which is deemed optimistic considering that the international average recovery rate is much lower.

Improvements have been made to the PRC's prudential rules, particularly with respect to loan classification. A new, more stringent asset classification system has been adopted. The four major banks have also been requested by the People's Bank of China to reduce the NPL ratio to 15% by the end of 2004. Measures to strengthen State bank governance and credit risk management are being undertaken such as establishing boards of directors, upgrading credit risk analysis and approval practices, and improving accounting standards. In early 2002, as part of its World Trade Organization (WTO) entry commitment, the PRC loosened controls on foreign-owned and joint-venture banks and financial companies offering yuan services, exposing domestic banks to further competition.

Alternative approaches to corporate restructuring have also been developed, such as the Changchuan Approach, which involves the transfer of profitable assets into a new entity funded by the major creditor who gets repaid by the funds generated. The PRC is also considering a new bankruptcy law that includes a corporate rescue procedure.

Lao PDR

Based on reports by State commercial banks, NPLs constituted about 52% of outstanding loans at end-2000. To address this problem and improve bank performance, individual bank restructuring plans have been developed. Restructuring plans involve the phased recapitalization of the State commercial banks starting in September 2002 based on meeting operational and financial targets, merger of the two smaller banks plus a rationalization of banking operations, the use of strengthened debt resolution procedures, and introduction of international management advisers.

Banks are gradually adopting commercial lending practices. They have set up systems for credit risk analysis, started classifying all loans, and been instructed to make full provision for NPLs on their post-2000 loans on the basis of Bank of Lao PDR regulations. To prevent further losses, there are continuing restraints on total lending and on lending to defaulting borrowers.

Complementing bank restructuring is enterprise reform, which will initially target five of the largest SOEs. Prices of key utilities are being adjusted to improve SOE finances. The largest SOE defaulting borrower has been turned over to the Ministry of Finance for restructuring.

Singapore

As part of the comprehensive reform of domestic banking announced in 1998, Singapore liberalized further the retail and wholesale banking markets in 2001, to allow foreign banks to engage in broader business in these markets. Reforms of the regulatory and supervisory environment to enhance the safety and soundness of the financial system were carried out. These included setting guidelines on the issuance of new capital instruments for Singapore banks, and revising the framework for valuation and capital adequacy requirements for insurance companies, licensed securities dealers, and futures brokers.

Singapore has also introduced legislation to regulate capital markets. In October 2001, the Securities and Futures Act was passed to provide a comprehensive rule book on capital markets, create a flexible regulatory framework, help develop a disclosure-based regime, and boost market enforcement. The Monetary Authority of Singapore has issued a revised Code on Takeovers and Mergers effective from 1 January 2002, which brings the Singapore rules closer to those in other economies in the region, including Hong Kong, China.

In 1999, Singapore embarked on a comprehensive review of its corporate governance practices, disclosure and accounting standards, and corporate regulatory framework. In 2001, the Code of Corporate Governance and report on disclosure and accounting standards was completed and accepted by the Government. At present, public consultation on the draft report on company law

Continued next page

Box 5: **Financial and Corporate Restructuring in Other East Asian Countries** (Cont'd)

and regulatory framework and its recommendations is ongoing. Singapore is also planning to set up a private sector-led council on corporate disclosure and governance to advise the Government on matters relating to corporate governance, accounting standards, and disclosure requirements.

The Government is reviewing the role of government-linked companies (GLCs), and is considering divestment from some of them. In line with this, Temasek Holdings, the investment arm of the Ministry of Finance that owns and manages the GLCs, is working out a charter with the Ministry of Finance that will spell out Temasek's mission, role, and responsibilities.

Viet Nam

As of end-2001, the Government estimated that NPLs in the banking system amounted to $1.29 billion, or about 11% of the total lending. But, using international accounting standards, NPLs are believed to be a lot higher. The Government has launched a three-year restructuring drive to reduce its NPLs and has set a maximum bad loan ratio of 5% of the total lending by commercial banks.

Several reforms to the banking sector are also under way, such as the reduction of directed credit and allowing freer foreign bank operations. New efforts to strengthen banks' regulatory framework and supervisory oversight in line with international best practices are outlined in the 2001 Memorandum on Economic and Financial Policies with the IMF.

Since 1992, Viet Nam has equitized 800 State-owned enterprises (SOEs) and transferred, sold, or leased more than 100 others. It plans to divest a further 1,800 small SOEs by 2004, either through acquisition or outright privatization. In June 2002, the Government set up a supervision group for SOE restructuring. The Board for State-owned Enterprise Renewal is expecting the number of equitized SOEs to increase by 300% in the next five years. Of the more than 5,600 SOEs at present, 2,000 will be converted to limited liability companies, 2,000 will be equitized, 734 will remain unchanged, and the remainder will be sold or leased. But currently, enterprise reform is proceeding slower than planned because of problems in resolving inter-enterprise debt, valuation of assets, and handling labor redundancy.

In the financial sector, in several countries, particularly Indonesia and Thailand, a significant proportion of nonperforming assets remains to be resolved. Although privatization of the nationalized banks and divestment of state ownership in the banking sector are under way, a lot more needs to be done, particularly in Indonesia, Korea, and Thailand. Further, while bank consolidation is welcome, it is not a substitute for efforts to improve banks' internal risk management.

In the corporate sector, debt equity ratios have declined in several countries most notably in Korea (Table 4). However, in many countries,

Table 4: **Debt-Equity Ratios of Selected Listed Companies** (weighted average)

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

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

operational restructuring still lags behind balance sheet restructuring. Creditors still find it difficult to enforce their claims through the courts, leading to a limited number of completed cases of court-led restructuring. The weaknesses in the bankruptcy regimes also impede restructuring via out-of-court processes.

Measures to strengthen bank prudential supervision and regulation, and changes in the legal and regulatory framework for the corporate sector have been impressive, but these are no guarantees for sound financial and corporate governance. Strict compliance and effective enforcement are equally important, if not more, and these are still big challenges facing all the affected countries.

Effective enforcement requires tackling broad governance issues, including areas such as the transparency, accountability, and responsiveness of government; effectiveness and efficiency of the legal and judicial system; the rule of law and control of corruption; and political stability. Despite efforts to tackle problems in all these areas over the past few years in the affected countries, a recent study by the World Bank reveals that there is still much ground to be covered.[2]

[2]Kaufman, Daniel, Aart Kraay, and Pablo Zoido-Lobaton. (2002), "Governance Matters II: Updating Governance Indicators for 2000/01," World Bank (http://www.worldbank.org/wbi/governance/govdata2001.htm).