Asia Economic Monitor 2003

July 2003 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.

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Highlights

Growth and Recovery in the First Half of 2003

- Growth slowed in most East Asian countries in the first quarter (except the PRC and Thailand) owing to softer exports and domestic demand.
- The slowdown deepened in the second quarter (except in Indonesia), as domestic demand weakened further due to the SARS outbreak.
- However, regional stock markets were buoyant in the second quarter due to global, regional, and country-specific factors.
- In the face of softening domestic demand, slowing growth, and falling inflation, most countries in the region continued to ease monetary and fiscal policies.

Post-SARS Economic Outlook for 2003 and 2004

- In recent months, the economic outlook for East Asia has improved somewhat.
- At the regional level, the SARS outbreak is now under control, removing a key uncertainty that clouded the outlook for East Asia.
- The external environment has also shown tentative signs of improvement:
  - With the quick end to the Iraq War, oil prices fell to about \$27–\$29 per barrel and are expected to soften further this year and next.
  - Although economic news from the US is still mixed and investment remains weak, several forward-looking indicators plus substantial monetary and fiscal stimulus suggest that the fragile recovery could strengthen in the second half of the year. The forward-looking indicators have, however, yet to pick up convincingly.
  - In Japan, several economic indicators have turned out to be better than expected.
  - Economic trends in Europe are not very encouraging, but a pickup in the US should provide better export and growth opportunities.
  - In the second quarter of this year, stock markets rebounded globally.

Continued overleaf

Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AEM	Asia Economic Monitor
AMC	asset management company
AML	Anti-Money Laundering
ARIC	Asia Recovery Information Center
ASEAN	Association of Southeast Asian Nations
BSP	Bangko Sentral ng Pilipinas
CDRAC	Corporate Debt Restructuring Advisory Committee
CPI	consumer price index
FSC	Financial Supervisory Commission
FSS	Financial Supervisory Service
GDP	gross domestic product
IBRA	Indonesian Bank Restructuring Agency
IMF	International Monetary Fund
ISM	Institute of Supply Management
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
NASDAQ	National Association of Securities Dealers Automated Quotation
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
PCOMP	Philippine composite index
PHIBOR	Philippine Interbank Offer Rate
PRC	People's Republic of China
REMU	Regional Economic Monitoring Unit (ADB)
ROA	return on assets
SARS	Severe Acute Respiratory Syndrome
SET	Stock Exchange of Thailand
SIBOR	Singapore Interbank Offer Rate
SPV	special purpose vehicle
STI	Straits Times Index (Singapore)
TAMC	Thai Asset Management Corporation
WHO	World Health Organization
q-o-q	quarter-on-quarter
y-o-y	year-on-year
B	baht
CNY	yuan
P	peso
Rp	rupiah
S$	Singapore dollar
W	won
¥	yen

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

The *Asia Economic Monitor* July 2003 Update was prepared by the Regional Economic Monitoring Unit of the Asian Development Bank and does not necessarily reflect the views of ADB's Board of Governors or the countries they represent.

- East Asia's growth should, therefore, pick up in the second half of this year and strengthen next year. Despite this improvement, the first half slowdown will reduce overall growth for 2003.
- The London-based Consensus Economics Inc.[1] now projects East Asia's average GDP growth to be 5.6% this year, compared to 6.6% last year. In 2004, East Asia is expected to post a higher growth of 6.3%.

Risks and Policy Issues

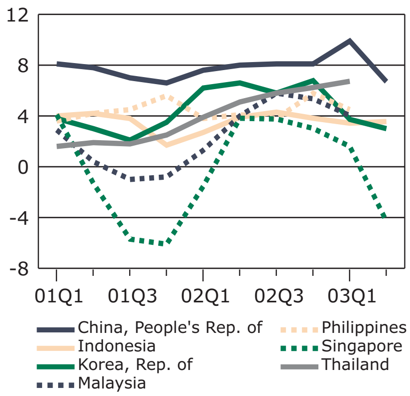
- The above baseline forecasts are, however, subject to four risks:
  - SARS could recur and set back growth prospects, although building on this year's experience, countries will be in a better position to deal with the disease.
  - Any increase in geopolitical risk could heighten uncertainty among consumers and investors.
  - The recent spate of encouraging data from industrial countries may not solidify.
  - The large external imbalances among industrial countries also remain a risk to global and regional economies.
- Monetary and fiscal policies in the region should continue to ease, even as countries push ahead with restructuring and reforms.

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

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

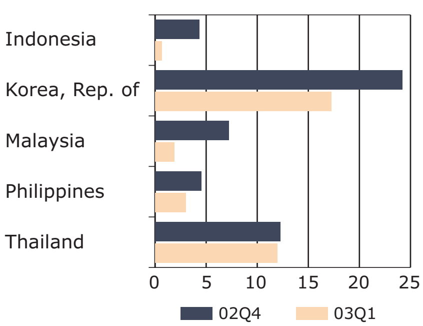
Growth and Recovery in the First Half of 2003

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



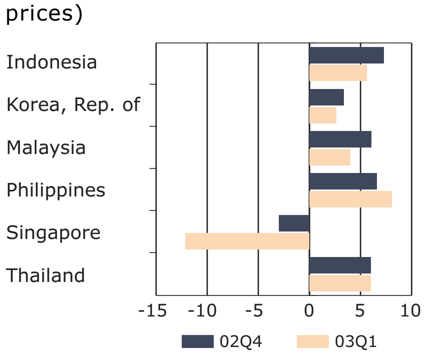
Source: ARIC Indicators.

Figure 2: **Growth of Exports of Goods and Services[1]** (y-o-y, %, at constant prices)



[1]Based on national income accounts.
Source: ARIC Indicators.

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



[1]Based on national income accounts.
Source: ARIC Indicators.

Real Sector Developments

In the first quarter of this year, gross domestic product (GDP) growth slowed across most of East Asia.[1] Of the seven countries in the region for which quarterly GDP data are available—People's Republic of China (PRC), Indonesia, Republic of Korea (Korea), Malaysia, Philippines, Singapore, and Thailand (hereafter referred to as the ASEAN5+2 countries)—five registered lower growth (Figure 1). Compared to the fourth quarter of last year, the growth slowdown was particularly pronounced in Korea, Singapore, Malaysia, and Philippines, while it was more modest in Indonesia. These five countries, taken together, grew by 4% compared to the 4.8% growth they had posted in the fourth quarter of last year.

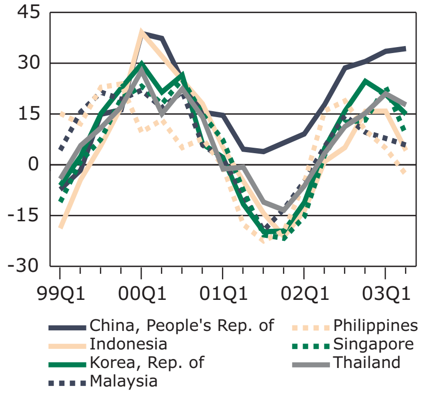
The exceptions to the regional slowdown were the PRC and Thailand. While growth in the PRC accelerated from 8.1% in the fourth quarter of last year to 9.9% in the first quarter of this year, Thailand managed a GDP growth of 6.7% (up from the 6.2% growth in the fourth quarter of last year). The higher growth in these two countries offset the slowdown in the other countries. As a result, for the ASEAN5+2 countries taken together, first quarter GDP growth came in at 7.1%, more or less the same rate as in the fourth quarter of last year.

The first quarter slowdown was driven by weaker exports and domestic demand. Because of a worsening external environment, exports slowed in most of the countries that experienced a growth slowdown (Figure 2). Similarly, growth in domestic demand slowed in these countries, with the exception of the Philippines (Figure 3).

In Indonesia, all the three components of domestic demand—private consumption, government consumption, and investment—contributed more or less equally to the slower growth in domestic demand. In Malaysia, despite steady growth in both private and government consumption, slower growth in domestic investment caused the softening of domestic demand. In Singapore, by contrast, domestic demand was held back by a sharp slowdown in private consumption.

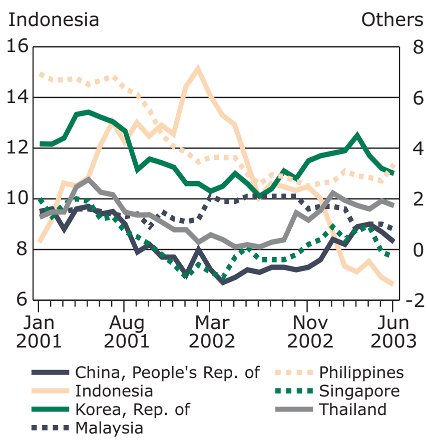
[1]Defined here as the 10 Association of Southeast Asian Nations countries (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China and Republic of Korea.

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



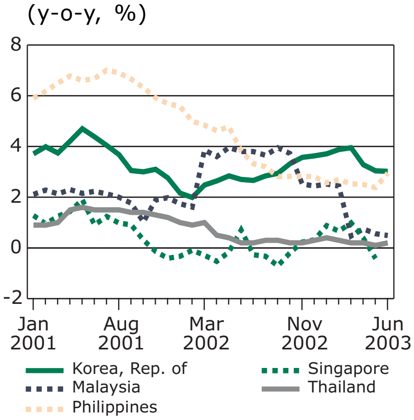
Note: 2003Q2 growth rate is based on 2 months' data (April and May) for Indonesia, Malaysia, Philippines, and Thailand.
Source: ARIC Indicators.

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



Source: ARIC Indicators.

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



Source: Bank of Thailand and REMU staff estimates.

In Korea, government measures to curtail the rapid growth of credit card transactions contributed to the softening of private consumption, while both domestic investment and government consumption grew steadily. In the Philippines, despite slower growth in government consumption (due to the fiscal consolidation program of the government), steady growth in both private consumption and investment contributed to an improvement in domestic demand. Meanwhile, the first quarter growth acceleration in the PRC and Thailand was broad based, with sturdy external demand reinforcing the healthy pace of domestic demand growth.

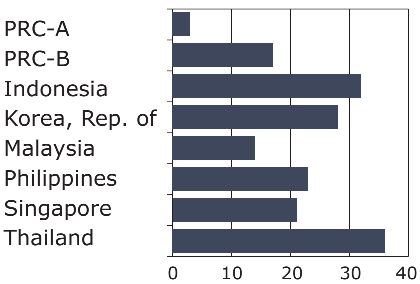
Official estimates of GDP growth for the second quarter of this year are available only for PRC, Indonesia, Korea, and Singapore. At 3.6%, Indonesia's second quarter growth came in slightly better than the 3.4% first quarter growth. However, in PRC, Singapore, and Korea, second quarter growth came in lower than in the first quarter. In the PRC, GDP growth slowed from 9.9% in the first quarter to 6.7% in the second, largely reflecting the effect of the outbreak of Severe Acute Respiratory Syndrome (SARS). The corresponding slowdown for Singapore is much sharper, from 1.6% growth to a 4.3% contraction. Korea's GDP growth slowed to about 3% in the second quarter of this year, from 3.7% in the first. According to estimates from Korea's central bank, on an annualized quarter-on-quarter basis, GDP actually contracted in both quarters, by about 1.6% in the first and 2.8% in the second, technically pushing the country into recession.

For the other countries, trends in exports suggest that the first quarter economic slowdown may have continued well into the second quarter. The continued weakness in the global economy put further pressure on East Asia's exports. As a result, except in the PRC, growth in the dollar value of merchandise exports moderated across the region (Figure 4). Domestic demand may have also further softened in the region because of the SARS outbreak. The cutbacks in consumer demand that resulted may have weakened domestic demand almost across the region.

In the face of softening domestic demand, slowing GDP growth, and the existence of substantial excess production capacity in the region, inflation continued to be low by historical standards, except in Indonesia (Figure 5). Even in Indonesia, the annual consumer price inflation has now fallen to less than 7%, from 15% about a year ago. Elsewhere in the region, inflation is even lower: less than 1% in Malaysia, PRC, and Singapore, less than 2% in Thailand, and about 3% in Korea and the Philippines. Core inflation (which excludes the more volatile food and energy items from the consumer price index) is even lower than headline inflation (Figure 6). Core inflation is negative (deflation) in Singapore, and close to zero in Thailand and Malaysia, while it is about 3% in Korea and the Philippines.

Asset Market Developments

Figure 7: **Percent Change in the Composite Stock Price Indexes**[1] (between end-March and mid-July 2003)

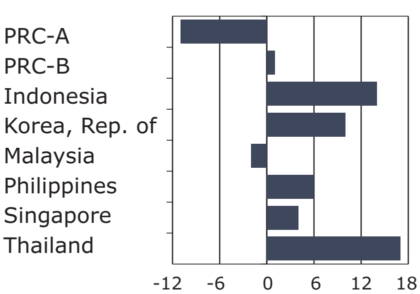


[1]Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand). PRC-A is the weekly average of the market capitalization weighted average of Shanghai-A and Shenzen-A index; PRC-B is the weekly average of the market capitalization weighted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

In the first quarter of this year, stock prices either fell (in the PRC and Korea) or remained unchanged (in the other countries). Compared to that lackluster performance, stock prices made impressive gains in the second quarter almost across the region, ranging from 3% in the PRC to 36% in Thailand (Figure 7).

Global, regional, and country-specific factors contributed to the strong second quarter gains in regional stock markets. At the global level, the quick end to the Iraq war (and its associated uncertainties), the unwinding of the bond market bubble (and hence the diversion of funds to the stock market), and some positive economic news from the US since May this year seem to have contributed to an upturn in the industrial country stock markets, raising East Asian stock markets as well. At the regional level, the control of the SARS outbreak contributed to a more positive growth outlook for the rest of the year. The continuation of robust growth contributed to strong gains in Thailand's stock markets, while Indonesia's stock market benefited from a host of factors including sharply falling interest rates, significant progress in addressing the security concerns arising out of the October 2002 Bali bombing, and its credit rating upgrade by Standard and Poor's in May this year.

Figure 8: **Percent Change in Stock Market Index**[1] **Relative to Russel3000 Index** (between end-March and mid-July 2003)

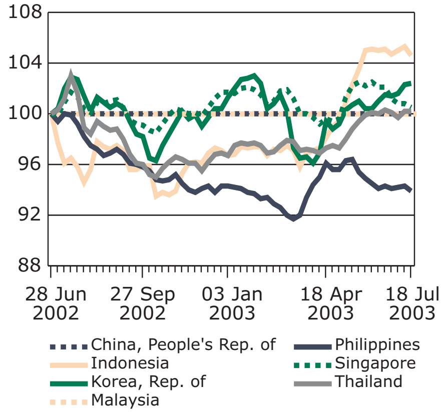


[1]Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand). For PRC, PRC-A is the weekly average of the market capitalization weighted average of the Shanghai-A and Shenzen-A index; PRC-B is the weekly average of the market capitalization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

It is difficult to separate effects of the global from regional and country-specific factors on regional stock market performance. Yet, second quarter movements in East Asian stock markets relative to the US market show that, while global factors provided a general boost to most regional stock markets, country-specific factors also played an important role in Thailand, Indonesia, Korea, and PRC. Relative to the US stock markets, stock price indexes in Thailand, Indonesia, and Korea increased since the end of the first quarter (by about 17%, 14%, and 10%, respectively) while stock prices declined in the PRC and Malaysia (the Shanghai A share price index declined by 11% while the KLCI in Malaysia declined by 2%). The stock indexes in the other countries increased more or less at the same pace as global stock prices, indicating that country-specific factors have been less important in the second quarter stock market rebound in these countries (Figure 8).

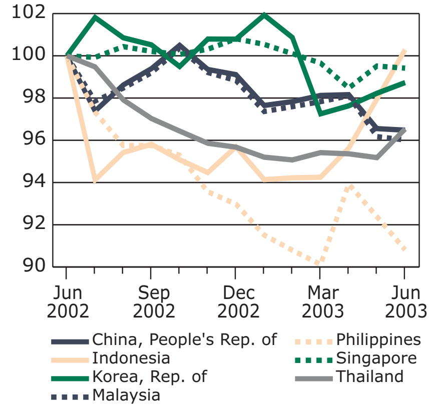
The second quarter rebound in the regional stock markets was accompanied by a general appreciation of regional currencies against the US dollar among the ASEAN5+2 countries (with the exception of

Figure 9: **Exchange Rate Indexes** (weekly average, last week of 2002Jun=100, $/local currency)



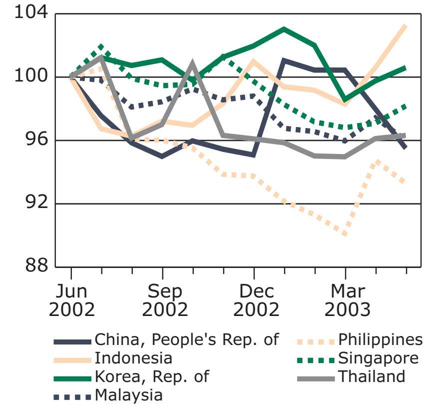
Source: REMU staff calculations derived from Bloomberg data.

Figure 10: **Nominal Effective Exchange Rate** (2002Jun=100)



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

Figure 11: **Real Effective Exchange Rate** (2002Jun=100)

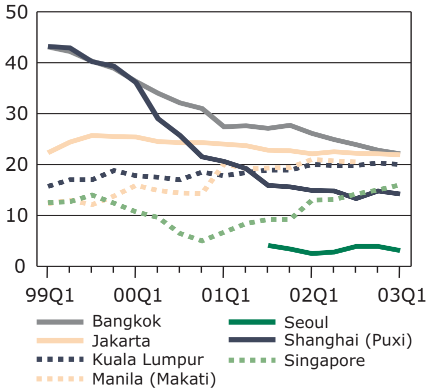


Note: An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: REMU staff calculations.

the PRC yuan and the Malaysian ringgit, which are pegged to the US dollar) (Figure 9). Since the end of the first quarter, the appreciation against the US dollar ranged from less than 1% for the Philippines and Singapore to 8% for Indonesia. The corresponding appreciation in the nominal effective exchange rates ranged from 1% for the Philippines to 6% for Indonesia (in the PRC and Malaysia, however, it depreciated by about 2%) (Figure 10). The real effective exchange rates have also generally appreciated except for the PRC (Figure 11).

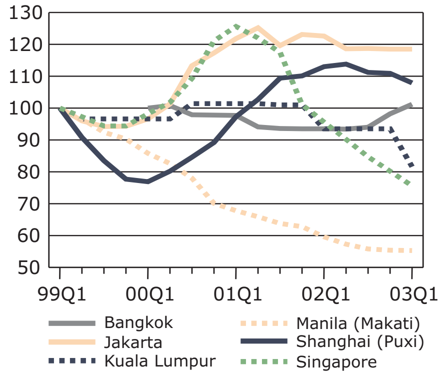
The real estate sectors in most countries generally remained subdued in the first quarter of this year, the latest period for which data are available. Although office vacancy rates declined somewhat in several countries (except Singapore, where vacancy rates increased), office rentals generally declined across the region (with the sole exception of Thailand, where they increased for the second quarter in succession) (Figures 12 and 13). The sharp compression in the region’s service-related industries due to the SARS outbreak suggests that property markets must have softened in the second quarter. Overall, despite the recent years’ decline, office vacancy rates remain high—in the range of 14% to 22% in the region, except in Korea, where the rate is only about 3%. The high vacancy rates and slower economic growth generally kept a lid on office rentals, which, in turn, have contributed to the low inflation environment in the region.

Figure 12: **Office Property Vacancy Rates** (%)



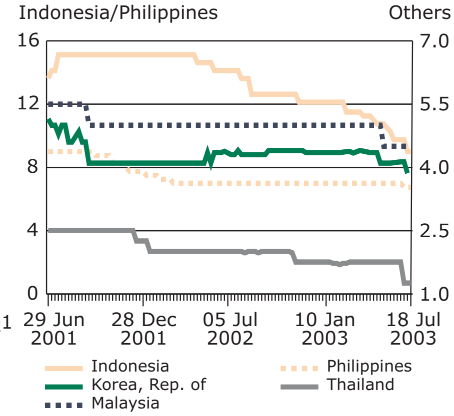
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Figure 13: **Office Rents** (per square meter per annum, local currency 1999Q1=100)



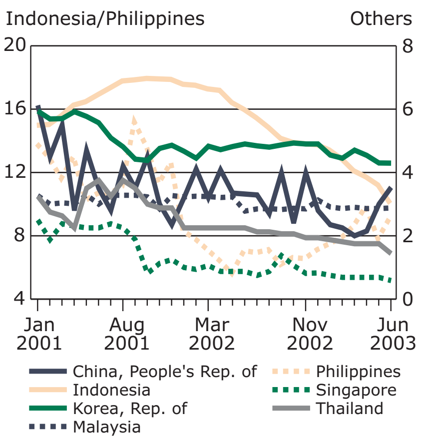
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

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



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

Figure 15: **Short-Term Interest Rates[1]** (nominal, end of month, % per annum)



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

Fiscal and Monetary Policies

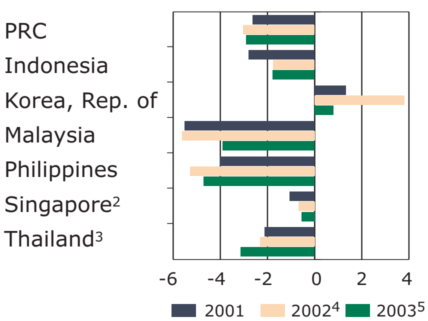
East Asian countries had responded to the economic uncertainties that prevailed since the 2001 slowdown with gradual interest rate reductions and modest fiscal stimulus measures. In the face of this year's slowing growth and the disinflationary environment, most countries have continued to maintain that policy stance.

Some central banks in the region have continued their low interest rate policies of the last two years, while others have cut rates, often from already low levels. During the year, the central bank policy interest rate was cut in Indonesia (by 315 basis points in eight installments), Korea (by 50 basis points in two installments of 25 basis points each in mid-May and early July), Malaysia (by 50 basis points in the third week of May), Thailand (by 50 basis points in the last week of June), and Philippines (by 25 basis points in the first week of July) (Figure 14).

With these cuts in policy rates, short-term interest rates (three-month interbank rates) have generally trended downward in recent months, except in the PRC and the Philippines (Figure 15). Since December 2002, the three-month interbank lending rate has fallen by 370 basis points in Indonesia, 60 basis points in Korea, 50 basis points in Thailand, and 25 basis points in Malaysia and Singapore. Country-specific factors, such as concerns over the fiscal situation in the Philippines and increased open market operations in the PRC to tighten surging bank loan growth, especially to property developers and luxury home buyers, seem to have contributed to increases in interbank lending rates in these countries (by 200 basis points in the Philippines and by 70 basis points in the PRC). The three-month interbank rate now ranges from 0.6% in Singapore to 4.3% in Korea, except for Indonesia and the Philippines where the rate is much higher at 9% and 10%, respectively.

Singapore, which is a highly open economy, conducts monetary policy by targeting the exchange rate within an undisclosed range with respect to a trade-weighted basket of currencies. In response to the sharp slowdown in second quarter growth, the Monetary Authority of Singapore (the country's central bank) eased monetary policy by lowering its target for the Singapore dollar (by "re-centering" its trading band).

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



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

Several countries in the region have continued to maintain moderately expansionary fiscal policies this year. The budgeted fiscal balances for the year range from a surplus of 0.8% of GDP in Korea to a deficit of 4.7% of GDP in the Philippines, with Malaysia budgeting for a deficit of 3.9% of GDP, the PRC and Thailand for a deficit of about 3% of GDP, and Indonesia a deficit of 1.8% of GDP (Figure 16). Even Korea's budgeted surplus this year is lower than last year's figure by 3 percentage points of GDP. In addition to their original budgets, countries have introduced fiscal stimulus packages in the second quarter of the year, largely in response to the SARS-induced economic slowdown in key sectors. These supplementary packages add a further fiscal (and quasi-fiscal) stimulus equivalent to 2% of GDP in Malaysia, 0.7% of GDP in Korea, 0.2% of GDP in the PRC, and 0.1% of GDP in Singapore.

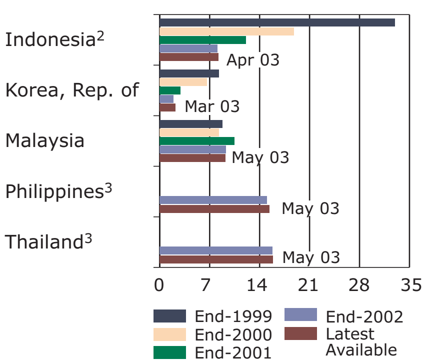
In the first few months of the year, for which data are available, actual fiscal trends in Malaysia and the Philippines were more or less in line with the budgeted stances, but actual positions in the other countries diverged to varying degrees. In the first six months of the fiscal year (January–June), the actual fiscal deficit in the Philippines was P80 billion, well within the target. Similarly, in Malaysia, in the first three months of the year (January–March), the fiscal deficit was about 31% of the budgeted deficit for the full year.

In Korea and the PRC, during the first five months of the year (January–May), revenues grew more or less as anticipated in the budget, but expenditure growth was much lower than had been planned in the budget. As a result, in the first five months, Korea posted a fiscal surplus that was three times the amount budgeted for the full year. In the same vein, the PRC posted a surplus of about CNY172 billion during January–May, while a deficit of CNY320 billion had been budgeted for the full year.

Indonesia's and Singapore's experiences were similar to those of Korea and the PRC. In the first three months of the year, Indonesia posted a surplus of Rp4,647 billion, compared to a deficit of Rp34,436 billion budgeted for the full year. In the first two months of Singapore's fiscal year (April–May), although revenues grew more or less as expected in the budget, expenditure disbursements were slower, and the budget was in surplus of about S$1.5 billion, while a deficit of S$0.9 billion had been budgeted for the full year. Meanwhile, in Thailand, better-than-anticipated revenue collections owing to improved overall economic performance and slower expenditure disbursements caused a smaller deficit of B22 billion in the first eight months of the fiscal year (October 2002 to May 2003), only 12% of the full year's budgeted deficit. The Government now expects the full year fiscal deficit to be less than 2% of GDP, much lower than the 3.1% initially budgeted.

Progress in Financial and Corporate Restructuring and Reforms

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



[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis.
[2]Data refer to NPLs in banking sector.
[3]Based on the new NPL definition adopted in September 2002 in the Philippines and December 2002 in Thailand.
Source: ARIC Indicators.

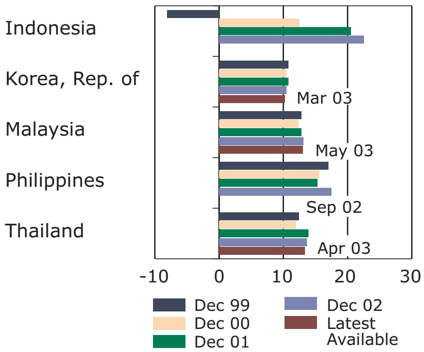
Nonperforming Loans, Capital Adequacy, and Bank Profitability

The latest available data show that the nonperforming loan (NPL) ratio of commercial banks stood at 8.2% in Indonesia, 2.2% in Korea, 9.2% in Malaysia, 15.4% in the Philippines, and 15.9% in Thailand[2] (Figure 17). Compared to the end-2002 figure, the NPL ratio edged up marginally in Philippines, Korea, and Indonesia, while it remained more or less unchanged in Malaysia and Thailand.

However, compared to their peak levels during the crisis years, NPL ratios have fallen significantly in all the crisis-affected countries, with the exception of the Philippines. This has been partly due to the transfer of NPLs from banks' balance sheets to publicly owned and centralized asset management companies (AMCs). Inclusive of assets still held by these AMCs, however, the NPL ratio remained as high as 18% in Indonesia and Thailand, suggesting that the task of debt restructuring is still substantial in the two countries. In Korea and Malaysia, the ratio of NPLs inclusive of assets unresolved and still held by AMCs was 8% and 9.6%, respectively. The Philippines does not have a centralized AMC, and this to some extent explains the country's relatively high NPL ratio.

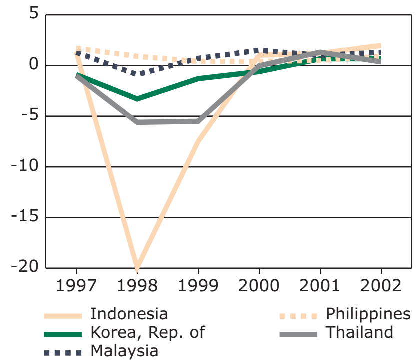
[2]At the end of last year, Thailand adopted a new NPL definition, which resulted in an increase of its NPL ratio by about 6 percentage points.

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



Source: ARIC Indicators.

Figure 19: **Banking Sector Profitability**[1] (%)



[1]Data refer to return on assets of commercial banks, with the exception of Malaysia, which refers to the banking/financial system.
Source: ARIC Indicators.

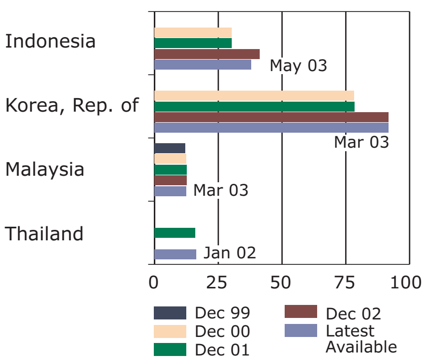
Because of bank recapitalization programs and consolidation activities, banking sectors in most crisis-affected countries have seen their capital positions strengthen in recent years. The latest available data show that the risk-weighted capital adequacy ratio of commercial banks stood at 22.5% in Indonesia, 10.2% in Korea, about 13% in Malaysia and Thailand, and 17.5% in the Philippines (Figure 18). These figures compare favorably with the 8% Basel norm. However, concerns have been raised that the capital adequacy of many banks in some of these countries may have been overstated because of inadequate provisioning for nonperforming assets.

Commercial banks' profitability, having recovered from negative levels during the crisis years, continued to consolidate in most crisis-affected countries. In 2002, the average rate of return on assets (ROA) ranged from 0.4% in Thailand to 2% in Indonesia (Figure 19). Compared to the 2001 figure, only Thailand showed a reduction in ROA, by 0.9 percentage point; the ROA of Korean commercial banks remained unchanged; while Indonesia, Malaysia, and Philippines saw increases in the ROA of commercial banks.

Asset Resolution by Asset Management Companies

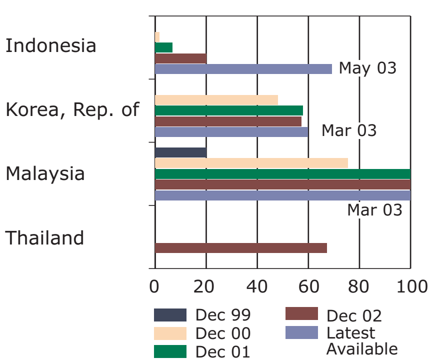
As of late 2002, the cumulative volume of NPLs transferred from banks and other financial institutions to centralized and publicly owned AMCs ranged from $12.5 billion in Malaysia to $91.8 billion in Korea

Figure 20: **NPLs Purchased by AMCs** ($ billion)



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

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



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

(Figure 20). However, the pace of asset resolution by the AMCs has varied significantly across the five crisis-affected countries (Figure 21). In Malaysia, Danaharta, the country's AMC, resolved (or identified the recovery strategies for) all the NPLs in its portfolio by September 2002. Due to a higher-than-expected default rate in acquired loans and the return of two acquired loans to the selling financial institutions, the expected recovery rate has decreased slightly, to 56% in March 2003 from 57% in December 2002.

In Korea, the latest available data show that 60% of the total NPLs acquired by the Korea Asset Management Corporation (KAMCO) was resolved as of March 2003, with an expected recovery rate of 47%. KAMCO stopped acquiring NPLs with public funds at the end of last year.

In Indonesia, asset disposal by Indonesia Bank Restructuring Agency (IBRA) did not proceed as smoothly as anticipated in the past few years, partly due to poor economic conditions and political uncertainties. The Bali incident caused further delays, as the sale and privatization of several state banks and companies were postponed. Since the beginning of this year, however, there has been a significant acceleration in the pace of IBRA's asset disposal, due to a better information campaign, improvement in sales mechanisms, and renewed market interest. As of May 2003, about 69% of the total $37.9 billion assets under IBRA's management was disposed, compared to 20% at end-2002 (Figure 21).

In Thailand, debt resolution by the Thai Asset Management Corporation (TAMC) reached the targeted 67% of the total book value of impaired assets by the end of 2002, with an estimated average recovery rate of 45%. Half of the resolved assets involved debt restructuring and the rest entailed the foreclosure of collateral. TAMC expects to complete the restructuring of all NPLs in its portfolio, amounting to B759 billion in book value, by the end of 2003. However, concerns exist about TAMC's low cash collection from restructuring, which as of end-2002 only reached about 1% of total book value of the cases for which restructuring decisions had been made.

The Philippines did not establish a centralized AMC after the Asian crisis. However, in response to the growing NPL problem in recent years, the country enacted Republic Act 9182, otherwise known as the SPV Act of 2002. This Act allows the formation of Special Purpose Vehicles (SPVs) to transact nonperforming assets of domestic banks and grants tax incentives for both SPVs and financial institutions. While the AMCs formed by other Asian countries are government-owned, SPVs in the Philippines are to be privately owned and managed. The Securities and Exchange Commission approved the implementing rules and regulations of the SPV Act in March of this year, and approved registration of the first SPV company in July.

In several crisis-affected countries, further progress has also been made in debt restructuring under voluntary schemes (see Box 1), and in the area of financial supervision and regulation (see Box 2).

Box 1: **Voluntary Corporate Workouts**

Indonesia
As of July 2003, the Jakarta Initiative Task Force (JITF) had registered 116 restructuring cases, with a total debt in face value of $29.3 billion. It has so far completed the mediation of 96 cases, with debt amounting to $20.5 billion, or 70% of its portfolio, an improvement of 5 percentage points since the end of 2002. With its term expiring this year, JITF needs to complete restructuring of the remaining 20 cases, amounting to nearly $8.7 billion, before the year ends.

Malaysia
The Corporate Debt Restructuring Committee officially concluded its operations in August 2002, after it successfully restructured 47 debt cases, worth RM43.97 billion in face value.

Thailand
As of 31 May 2003, the Corporate Debt Restructuring Advisory Committee (CDRAC) allowed a total of 15,386 cases of target debtors, with credits outstanding of B2,841.7 billion in face value, to enter the CDRAC process. Of these, 10,335 cases worth B1,388.9 billion were restructured, while 4,956 cases worth B1,269 billion were still in the process of restructuring or subject to legal proceedings. The legal proceedings, however, have suffered from long delays owing to congestion at the bankruptcy court. Meanwhile, as of end-April 2003, financial institutions completed restructuring 578,995 cases worth B2,812 billion in face value, while 35,604 cases valued at B115.8 billion are still in the restructuring process.

Korea
Since March 2003, SK Global, the trading arm of the SK Group and the country's third largest chaebol (conglomerate), has been on the brink of bankruptcy, after it was revealed that it had inflated 2001 earnings by more than W1.5 trillion ($1.2 billion) and hidden an additional W500 billion in bank loans. The trading company's creditors and its parent company, the SK Group, have been trying to work out a rescue plan. The latest proposal by the SK Group includes swapping about W850 billion in debt owed by SK Global to SK Corp., the SK Group's flagship company and Korea's largest oil refiner, for newly issued shares in the trading company. Despite opposition from foreign and minority shareholders, the board of SK Corp. approved the proposed debt-equity swap on 15 June, paving the way for domestic creditor banks of SK Global to approve its debt workout package on 17 June, converting W2.4 trillion out of their combined loans of W6.1 trillion into newly issued shares of SK Global. Market observers have raised concerns about SK Corp.'s move, which seems like the reprise of an old chaebol strategy of using stronger affiliates to keep weaker ones afloat. The SK Global scandal also suggests that, despite several years of reforms since the Asian crisis, corporate governance of Korea's large business conglomerates remains a major concern. Despite recent developments, the final fate of SK Global is still uncertain, as its domestic and foreign creditors have so far failed to reach an agreement on restructuring.

In the meantime, under the formal out-of-court workout program introduced in June 1998 for medium-sized firms, 55 out of a total of 83 companies submitted graduated as a result of rehabilitation and sell-offs, and 18 with no prospect of completing the workout have been put under court-mandated reorganization or set for liquidation. Consequently, the number of companies under the formal out-of-court workout program fell to 10 by the end of 2002.

Box 2: **Supervisory and Regulatory Reforms**

Indonesia

In 2002, Bank Indonesia undertook to comply with the Basel Core Principles for Effective Banking Supervision, including moving toward consolidated supervision. In March 2003, the Government signed a new letter of intent, which includes the 2003 program supported by the International Monetary Fund. One pillar of the 2003 program is the enhancement of financial system stability. To achieve this, the Government has developed a comprehensive plan for a sound financial sector safety net, which provides for the creation of a deposit insurance scheme, lender of last resort capacity for Bank Indonesia, and a supervisory and regulatory agency for the financial sector. The Government intends to prepare legislation in line with this plan for submission to Parliament during the second half of this year.

Korea

In response to the rapid growth of household loans and rising credit card delinquency ratios, the Financial Supervisory Commission (FSC) and Financial Supervisory Service (FSS) heightened monitoring and regulation of loans to the household sector. Regulation of credit card companies has also been tightened. Credit card companies are now required to maintain a capital adequacy ratio of 8%, write off loans that are unpaid for more than 6 months, and classify loans more strictly. In May 2003, in the wake of the SK scandal, the FSC/FSS announced major accounting supervisory tasks for 2003, consisting of (i) new accounting initiatives to further improve accounting rules and practices; (ii) strengthening of accounting supervision to raise accounting transparency; and (iii) development and implementation of accounting education programs for companies and accounting firms. In the same month, as part of efforts to strengthen regulation and supervision of nonbank financial institutions, which are considered lagging behind those of the banking sector, FSC/FSS announced new insurance supervisory initiatives aimed at promoting more efficient supervision of the insurance sector in light of the recently amended Insurance Business Act.

Malaysia

Partly in response to the increased usage of credit cards, Bank Negara, the country's central bank, is taking steps to increase consumer understanding and to promote the prudential use of credit cards. A guideline was issued on credit card operations in March 2003, giving issuers of credit cards six months to undertake the necessary system adjustments and ensure compliance. The new guidelines, revoking previously issued guidelines, set out the minimum requirements for credit card operations, covering new areas such as prudent lending requirements, usage of credit cards for unlawful activities, supplementary cardholders' liability, and liability for lost or stolen credit cards, and placed added emphasis on consumer awareness and education programs.

Philippines

Bangko Sentral ng Pilipinas (BSP), the country's central bank, has continued to take measures to implement the General Banking Law of 2000. In April 2003, BSP issued two guidelines concerning voluntary liquidation of a bank and forbidden acts of directors or officers of any bank declared insolvent or placed under receivership by the Monetary Board. To address weaknesses in the Anti-Money Laundering (AML) Act passed in September 2001 and bring it in line with international standards, Congress passed a revised version of the AML Act in March this year. Two key amendments were (i) provision of authority to the AML Council to scrutinize suspicious bank accounts without a court order, and (ii) reduction of the threshold amount of covered transactions from P4 million to P500,000. The amended AML Act has been signed into law.

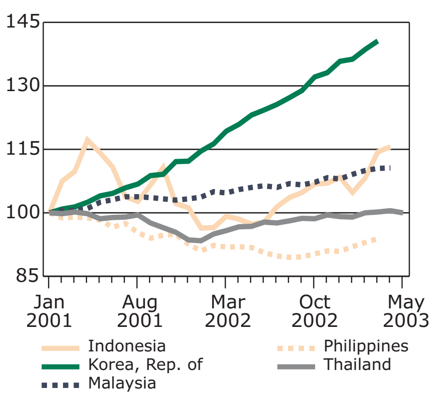
Thailand

Since the beginning of 2002, the Bank of Thailand has been working on a financial sector blueprint that aims to further modernize and enhance the productivity of the Thai financial sector. It also aims to increase access to a range of financial services by users in all market segments in both urban and rural areas. The drafting of the blueprint was completed in May 2003. The next steps include broad consultation with key stakeholders, development of an action plan, and implementation. To improve market discipline, the Government is taking measures to move from the current blanket government guarantee on deposits to limited deposit insurance. After designing a gradual and measured transition to limited deposit insurance, the Ministry of Finance held public hearings to communicate and receive feedback on the proposed policy from the banking and academic communities.

Trends in Bank Credit

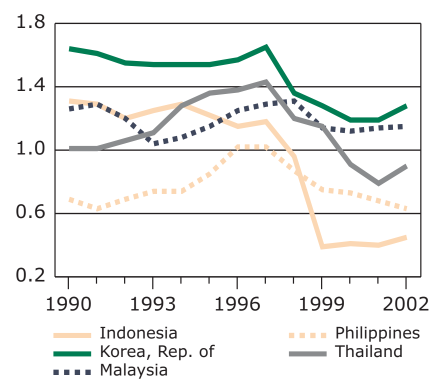
With the exception of the Philippines, all the crisis-affected countries saw the stock of real bank credit to the private sector—a composite indicator of the banking and corporate sector health—increasing during most months of 2002 (Figure 22). In most of these countries, however, real credit growth was driven largely by home and car loans to the household sector and consumer credit associated with the increased use of credit cards. In Korea, the rapid growth of household loans and rising credit card delinquency ratios prompted the Government to take tightening measures, including lowering the ceiling for new mortgages to 60% from 80% of the value of a property and increasing banks' minimum required provisioning for household loans. As a result, there has been some cooling off in household loans in Korea since late last year. In the Philippines, the stock of real bank credit continued to decline in 2002 until the third quarter, as many banks continued to be plagued by high levels of bad loans; it started to recover in October, however, possibly in response to new reform initiatives, particularly the passage of the SPV Act. In the early months of 2003, the stock of real bank credit to the private sector continued to grow in all the crisis-affected countries. Despite some recent improvements, credit-deposit ratios of banks—another composite indicator of banking and corporate sector health—remain subdued and far below precrisis levels (Figure 23).

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



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

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



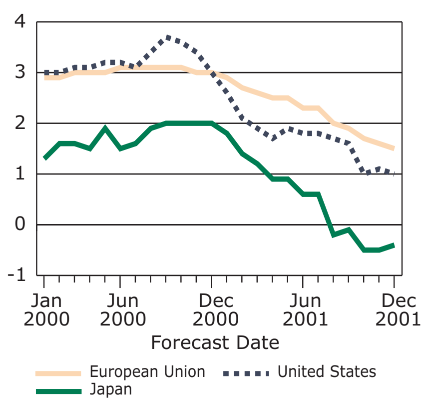
Source: International Monetary Fund, *International Financial Statistics* (May 2003).

Post-SARS Economic Outlook for 2003 and 2004

External Economic Environment

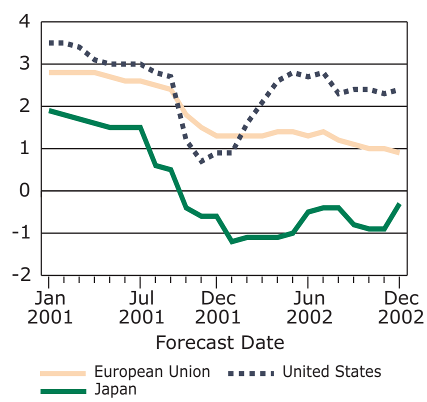
In the initial months of this year, the external environment facing East Asia turned unfavorable for the third time in as many years. In 2001, there was a synchronized economic slowdown in the G3 (U.S., Japan, and European Union) countries, followed by the tensions over Iraq in the second half of 2002, which ultimately escalated into a war in 2003. Accordingly, the G3 GDP growth forecasts for each of these years were marked down sharply by Consensus Economics (Figures 24 to 26). In recent months, however, the external environment facing East Asia has shown tentative signs of improvement. First, the Iraq war ended quickly, without the much-feared disruptions in the world oil market, thus removing one of the major uncertainties that had clouded global economic prospects in early 2003; oil prices have softened and are now around \$27–\$29 per barrel, and are expected to soften further. Second, although economic news from the US is still somewhat mixed and investment is still weak, several forward-looking indicators plus the substantial monetary and fiscal stimulus suggest that the fragile recovery could strengthen in the second half of the year. The forward-looking indicators have, however, yet to pick up convincingly. Third, in Japan, too, there has recently been a number of better-than-expected economic news. Fourth, although economic

Figure 24: **Consensus Forecasts of 2001 GDP Growth—G3** (y-o-y, %)



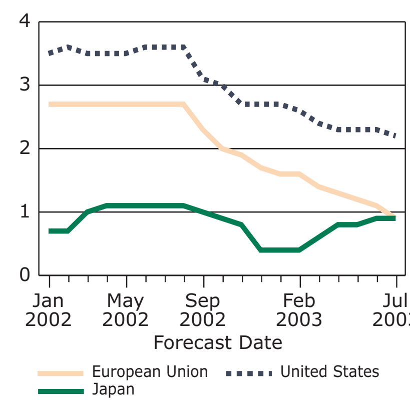
Source: Consensus Economics Inc., *Consensus Forecasts,* various issues.

Figure 25: **Consensus Forecasts of 2002 GDP Growth—G3** (y-o-y, %)



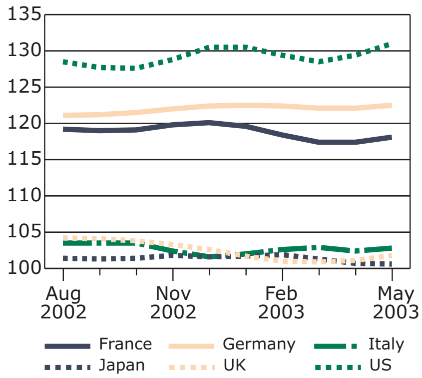
Source: Consensus Economics Inc., *Consensus Forecasts,* various issues.

Figure 26: **Consensus Forecasts of 2003 GDP Growth—G3** (y-o-y, %)



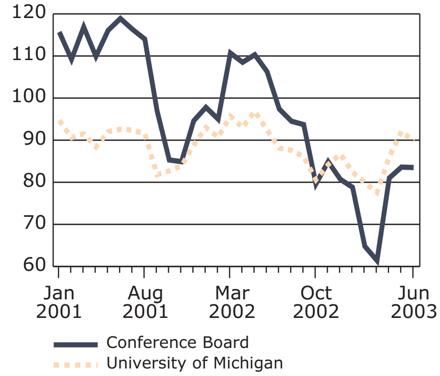
Source: Consensus Economics Inc., *Consensus Forecasts,* various issues.

Figure 27: **OECD Leading Indicators**



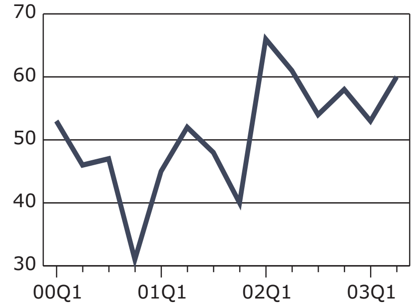
Source: OECD web site.

Figure 28: **US Consumer Confidence Index**



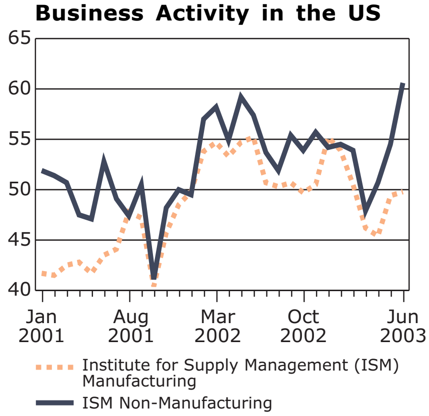
Note: Conference Board numbers are released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

Figure 29: **US Business Confidence Index (Conference Board)**



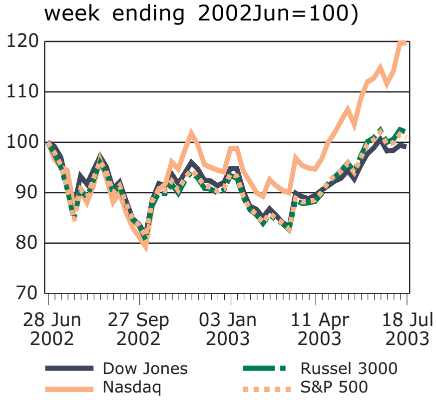
Source: Bloomberg.

Figure 30: **Surveys of Business Activity in the US**



Source: Bloomberg.

Figure 31: **US Stock Market Indexes** (weekly average, week ending 2002Jun=100)

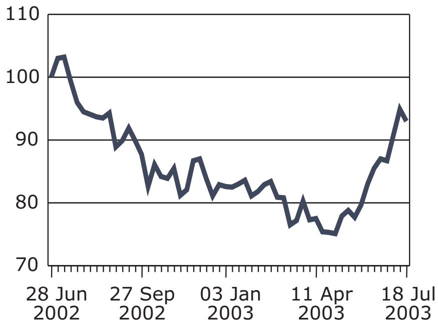


Source: REMU staff calculations derived from Bloomberg.

trends in Europe are not very encouraging, a pickup in the US economy should provide better export prospects for Europe; moreover, the big economies in Europe are undertaking tax cuts as well as long overdue structural reforms. However, unlike in the US, where composite leading indicators have trended up since the beginning of the second quarter, leading indicators in Japan and Europe show no distinct trend (Figure 27). Finally, in the second quarter of this year stock markets rebounded across the world.

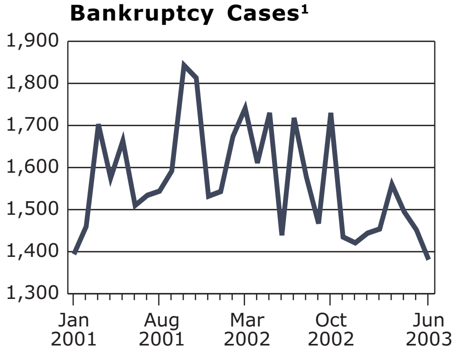
Recent economic indicators from the US—although some of them still have to pick up convincingly—suggest that the economy should experience a modest turnaround in the second half of 2003 and into 2004. First, US consumer confidence, after bottoming out in March, has trended up since, although it remains below the levels of early 2001 and early 2002 (Figure 28). Second, US business confidence improved in the second quarter of the year (Figure 29). Third, the second quarter also witnessed an improvement in the Institute of Supply Management (ISM) surveys of business activity, in both the manufacturing and service sectors (Figure 30). Fourth, since mid-March, the US stock market has made significant gains, with NASDAQ rising by about 33% and other stock price indexes such as the Dow Jones, Standard and Poor's 500, and Russell 3000, rising by about 20% (Figure 31). Fourth, although the unemployment rate (which is a lagging indicator of economic activity) hit a nine-year high of 6.4% in June, weekly jobless claims have generally trended down since mid-April. Added to all these, the aggressive policy actions by the Federal Reserve Board (FED) have brought the FED funds rate to a 45-year low of 1%. In mid-July, the FED reaffirmed that it

Figure 32: **Nikkei 225** (weekly average, week ending 2002Jun=100)



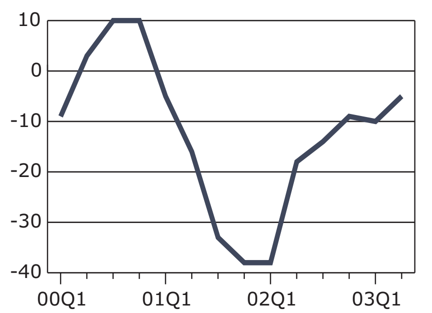
Source: REMU staff calculations derived from Bloomberg.

Figure 33: **Japan: Bankruptcy Cases**[1]



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

Figure 34: **Japan Tankan Survey—Business Conditions Indicator**[1]



[1]Large enterprise manufacturing.
Source: Bloomberg.

would keep interest rates low for as long as it takes to spur growth and stop disinflation. With the recent $350-billion stimulus package, the US fiscal stance has also eased considerably: in April last year, the fiscal deficit for 2003 was expected to be about 1% of GDP, but now it is expected to be 4.6% of GDP. The substantial monetary and fiscal stimulus in the pipeline should also hasten the hesitant US recovery. In the first and second quarters of this year, US GDP grew at an annualized rate of 2%. Consensus Economics forecasts annualized GDP growth to rise to 3.6% in the third and fourth quarters of 2003. Growth for this year is expected to be 2.2%, which is below trend (Table 1). US GDP is forecast to grow by 3.6% in 2004.

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

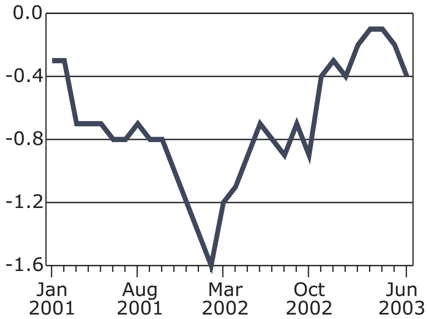
	2000	2001	2002	2003f	2004f
World	4.7	2.3	1.8	1.9	2.9
United States	3.8	0.3	2.4	2.2	3.6
Japan	2.8	0.4	0.1	0.9	0.6
European Union	3.4	1.6	1.1	0.9	2.0

f = forecasts
Source: Consensus Economics Inc., *Consensus Forecasts* (July 2003); and European Commission, *European Economy* (Spring 2003).

In recent months, economic news from Japan have turned out to be better than expected: the Bank of Japan upgraded its assessment of the economy in July for the first time in a year, although it cautioned that the country's financial system remains fragile. First, from the beginning of the second quarter to the second week of July, Japan's stock prices gained about 27%, taking the Nikkei stock price index to a 10-month high (Figure 32). Second, although the unemployment rate remains at a post-World War II high of 5.5%, the number of corporate bankruptcies fell in recent months, giving some hope that the worst of corporate distress may be over and corporate job opportunities may start improving soon (Figure 33). Third, the June Tankan Survey showed an improvement in business sentiment, with the Tankan business conditions index slowly edging toward positive territory (Figure 34).

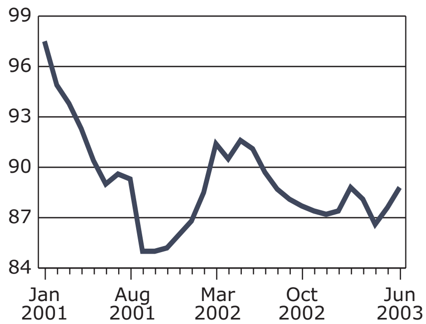
Finally, and perhaps most importantly, there are tentative signs that Japan may be emerging out of deflation: the annual consumer price deflation rate declined in recent months and prices are showing signs of stabilizing (Figure 35). Some of this positive news is at least partly due to the more aggressive monetary policy initiatives the Bank of Japan has taken in recent months. Since March this year, when the

Figure 35: **Japan: Deflation[1]**
(y-o-y, %)



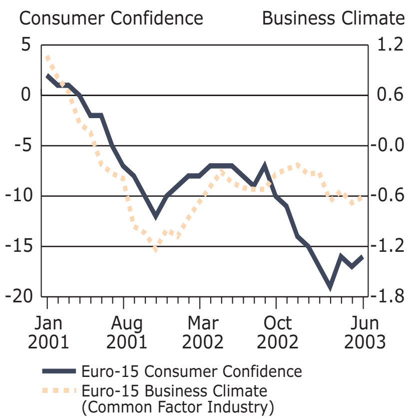
[1]Consumer price index.
Source: Bloomberg.

Figure 36: **German Business Climate Index (IFO Survey)**



Source: Bloomberg.

Figure 37: **European Union Consumer Confidence[1] and Business Climate Indicators[2]**



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

new Governor took over, the Bank of Japan has shown greater flexibility in its policy of fighting deflation. Besides re-accelerating base-money growth, the Bank of Japan has attempted to improve the transmission mechanism by which quantitative easing translates into domestic demand. The central bank bought certain amount of shares issued by banks and announced that it will buy asset-backed securities with the aim of helping smaller firms. In another significant step, the Bank of Japan decided to address the NPLs of banks by funding the Industrial Revitalization Corporation set up in April this year. The Consensus forecast is for a GDP growth of 0.9% and 0.6% this year and next, respectively. There is a high probability that outcomes for the rest of this year and next year could surprise on the upside.

Recent economic trends in Europe have not been encouraging. Germany, the largest economy in Europe, may have been in recession in the first half of this year (with GDP declining in the first two quarters). Other European economies may have fared better than Germany, but growth in the region as a whole has been lackluster. Going forward, the rebound in the US economy should provide some boost to European exports. Within Europe too, a few factors point toward cautious optimism that the region may turn in better growth performance in the next year or so. First, the German business climate index from the IFO survey has trended up since April (Figure 36), and the business climate index for the 15 countries of the European Union taken together, after falling in the first quarter of the year, stabilized in the second quarter (Figure 37). Second, the consumer confidence index for the European Union countries, after falling in the six months to March this year, has trended upward since. Third, the short-term interest rate in Europe, since the 50-basis-point cut in early June to 2%, is the lowest in more than five decades. Fourth, fiscal policies in both Germany and France (which make up more than half of the Euro zone's GDP) have eased in recent weeks, even at the risk of breaching the fiscal deficit limits (of 3% of GDP) set under Europe's Stability and Growth Pact; while Germany cut income taxes effective January 2004 (by about $26 billion, which would reduce the average worker's tax bill by 10%), France's President has confirmed that he will press ahead with the 30% income tax cut that he promised in last year's election campaign. Finally, both Germany and France are now beginning to take the long overdue structural policy measures to prune mandatory social welfare expenses (such as pensions, health care, and unemployment insurance), which should reduce the cost of production for firms and, in turn, should lead to more corporate capital spending. Overall, although the European Union's growth this year will continue to be about 0.9% for the year as a whole, it should pick up to 2% in 2004.

Regional Economic Outlook

The improving external environment augurs well for East Asia's immediate growth prospects. Moreover, because of the efforts made by the countries in the region and elsewhere, the SARS outbreak has been controlled in a relatively short period of time, although its recurrence cannot be ruled out. The adverse impacts of SARS should be moderate, varying across countries according to the importance of travel-related services and their openness (see Box 3). Reflecting this optimism, Consensus Economics in its July survey either retained or

Box 3: **Economic Impacts of the SARS Outbreak on East Asia**

On 24 June 2003, about 100 days after issuing a global alert on Severe Acute Respiratory Syndrome (SARS), the World Health Organization (WHO) lifted its travel advisory against Beijing, the city worst affected by SARS, and simultaneously removed the country from the WHO list of places with recent local transmission of SARS. On 2 July, Toronto was removed from the list of places affected by SARS, and on 5 July, WHO announced that SARS was no longer spreading in Taipei,China and that it appeared to be contained worldwide. It has, however, warned that the disease could reoccur and that vigilance should continue through surveillance and control measures. This year's experience should place countries in a better position to deal with any recurrence. Since the global alert was issued, SARS had spread to 32 countries, infected over 8,400 people, and caused more than 800 deaths (Box Table 3.1).

Box Table 3.1: **SARS Cases and Deaths, as of 11 July**

	Total Cases	Total Deaths	Date of First Reported Case	Date of Last Reported Case
World	8,437	813	Nov-02	9-Jul
Asia	8,069	773	Nov-02	25-Jun
China, People's Rep. of	5,327	348	Nov-02	25-Jun
Hong Kong, China	1,755	298	22-Feb	11-Jun
Taipei,China	671	84	8-Mar	19-Jun
Singapore	206	32	13-Mar	18-May
Viet Nam	63	5	26-Feb	14-Apr
Philippines	14	2	14-Apr	15-May
Mongolia	9	0	17-Apr	6-May
Thailand	9	2	11-Mar	7-Jun
Malaysia	5	2	10-Apr	20-May
India	3	0	5-May	13-May
Korea, Rep. of	3	0	29-Apr	14-May
Indonesia	2	0	14-Apr	23-Apr
Japan	1	0	11-Apr	1-May
Macao, China	1	0	30-Apr	21-May

Source: WHO.

Although the SARS outbreak has been contained, its adverse economic impacts are likely to linger for some time. So far the fallout has been largely on the demand side, in particular, on services sectors, such as travel, hotels, and restaurants (Box Table 3.2). Due to many cancellations of business travel and trade fairs, exports and imports have also been disrupted to some extent. However, the SARS relief packages introduced in many countries have helped the affected sectors and businesses recover from the negative shocks caused by SARS (Box Table 3.3). If there is no recurrence of the disease, the overall impact of the SARS outbreak on this year's regional growth is likely to be moderate, varying across countries according to the importance of travel-related services and the openness of their economies. In fact, SARS, while having some adverse impacts, did not seriously dent investors' confidence—in the PRC in May, actual FDI rose by 48% over the same period last year—suggesting that the economic rebound could come sooner than expected.

Soon after the outbreak, most forecasters downgraded their 2003 growth projections for East Asia. The Asian Development Bank projected that if the SARS outbreak lasted for a quarter, it could reduce growth

Continued on next page

Box 3—*Continued*

Box Table 3.2: **Growth in Tourist Arrivals** (y-o-y, %)

	March	April	May	March–May
China, People's Rep. of	-6.5	-30.1	—	—
Hong Kong, China	3.9	-64.8	-67.9	-43.7
Taipei,China	-0.2	-50.7	-82.0	-42.0
Indonesia	-21.3	-37.6	-38.6	-32.3
Malaysia	-35.6	-58.6	-59.0	-50.5
Philippines	-9.9	-24.4	-33.0	-22.2
Singapore	-14.6	-67.3	-70.7	-50.1
Thailand	-11.0	-45.3	-55.0	-35.7

— = not available.
Source: Bloomberg and national sources.

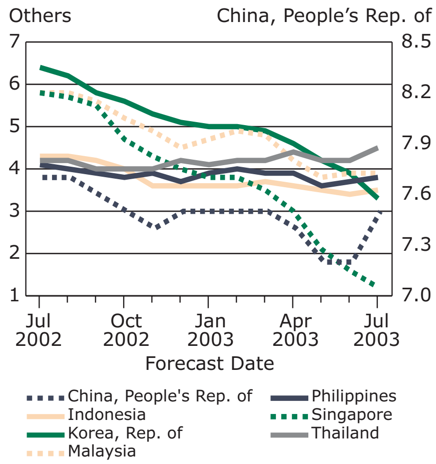
in Hong Kong, China by 1.8%; Singapore by 1.1%; Taipei,China by 0.9%; Indonesia, Malaysia, and Thailand by 0.5%–0.7%; the Philippines by 0.3%; and the PRC and Korea by 0.2%.The International Monetary Fund projected that if the SARS outbreak were to last for a quarter, it would reduce the growth of East Asia as a whole in 2003 by about 0.4 percentage point and that of the PRC by 0.2 percentage point. The World Bank expected the SARS outbreak to reduce East Asia's growth by 0.3 percentage point this year. The recent encouraging development in containing SARS, both in the region and worldwide, suggests that actual growth in the region is increasingly likely to be in line with these assessments. Private sector forecasters who reduced their growth projections by larger amounts earlier are now revising the projections upward.

Box Table 3.3: **SARS Economic Relief Packages**

Country	Date Announced	Size (US$ billion)	Description
China, People's Rep. of	02-May	2.7	• Waiver or reduction of taxes and administrative fees levied on affected industries • Interest subsidies for short-term loans to the air transport and tourism sectors
Hong Kong, China	23-Apr	1.5	• Waiver of rates payment • Reduction of water and sewage charges • Waiver of licensing fees • Tax rebates on salaries • Creation of new jobs • Relief loan guarantee scheme
Taipei,China	02-May	1.4	• Financial assistance to affected companies in the form of guaranteed bank loans and interest subsidies
Korea, Rep. of	12-July	3.8	• A supplementary budget
Malaysia	21-May	1.9	• A special relief guarantee facility to help the tourism sector • Restucturing and rescheduling of loans of workers in the tourism industry who have been subjected to pay cuts • Microcredit schemes • Income tax exemptions • Allocation of additional funds for entrepreneurial activities
Singapore	17-April	0.1	• Tax rebates • Reduction of administrative levies and dues • Loan Assistance Programme

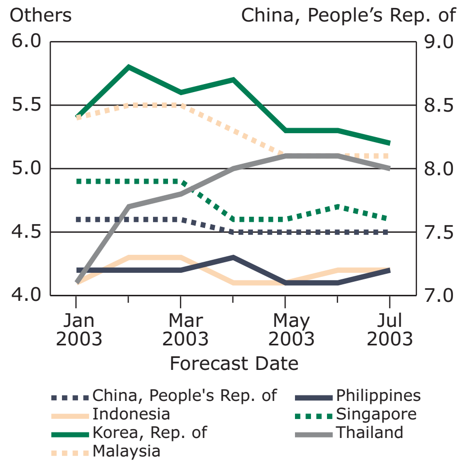
Source: JP Morgan, Bloomberg news, and ARIC SARS Watch (http://aric.adb.org/infocus/sarswatch.asp).

Figure 38: **Consensus Forecasts of 2003 GDP Growth—ASEAN5+2** (y-o-y, %)



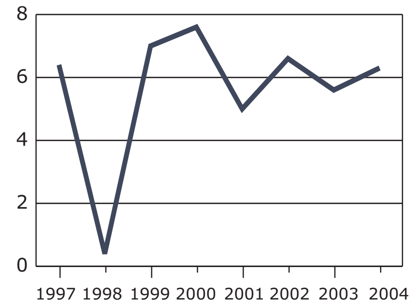
Source: Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* various issues.

Figure 39: **Consensus Forecasts of 2004 GDP Growth—ASEAN5+2** (y-o-y, %)



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

Figure 40: **Real GDP Growth—East Asia** (%)



Source: 2003 and 2004 growth rates are based on Consensus Economics Inc., *Asia Pacific Consensus Forecasts* (July 2003).

upgraded its 2003 and 2004 GDP growth forecasts for most East Asian countries except Korea and Singapore (Figures 38 and 39).

East Asia's lackluster growth in the first half should pick up in the second half of this year and strengthen in 2004. Despite the expected improvement in the third and fourth quarters, the first half slowdown will pull down the region's average growth for the year as a whole to 5.6%, compared with the 6.1% forecast made in the February 2003 *Asia Economic Monitor* (AEM) as well as the 6.6% growth the region posted last year (Figure 40). Therefore, most major countries in East Asia will post lower overall growth this year than in 2002. Singapore is expected to post the lowest growth, a little over 1%, and the PRC is expected to post the highest growth, at 7.5%. Meanwhile, growth is expected to be in the range of 3% to 5% in Brunei Darussalam, Cambodia, Indonesia, Korea, Malaysia, Philippines, and Thailand, and between 6% and 7% in Lao PDR and Viet Nam (Table 2).

Looking ahead, growth is expected to strengthen in 2004 almost across the region, ranging from about 4% in Indonesia and the Philippines to 7.5% in the PRC, with most other countries expected to post growth above 5%. East Asia is thus forecast to grow by 6.3% in 2004.

- **PRC.** The PRC has weathered the difficulties posed by the SARS outbreak quite well. Although GDP growth slowed from an exceptionally high 9.9% in the first quarter, second quarter growth was still a healthy 6.7%. Some of the adverse effects of the SARS

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

	1997	1998	1999	2000	2001	2002	July 2003 Forecasts 2003	July 2003 Forecasts 2004	Difference[1] 2003	Difference[1] 2004	Average 1998–2002
Brunei Darussalam	3.6	-4.0	2.6	2.8	1.5	4.1	4.0[2]	—	0.0	—	1.4
Cambodia	4.3	2.1	6.9	7.7	6.3	4.5	5.0	5.5	0.0	-0.5	5.5
China, People's Rep. of	8.8	7.8	7.0	7.6	7.3	8.0	7.5	7.5	0.0	-0.1	7.5
Indonesia	4.7	-13.1	0.8	4.9	3.4	3.7	3.5	4.2	-0.1	0.1	-0.1
Korea, Rep. of	5.0	-6.7	10.9	9.3	3.1	6.3	3.3	5.2	-1.7	-0.2	4.6
Lao PDR	6.5	3.0	6.8	5.9	5.7	5.8	6.0	6.5	0.2	—	5.4
Malaysia	7.3	-7.4	6.1	8.5	0.3	4.1	3.9	5.1	-0.8	-0.3	2.4
Myanmar[3]	5.7	5.8	10.9	13.7	11.1	—	—	—	—	—	—
Philippines	5.2	-0.6	3.4	4.4	4.5	4.4	3.8	4.2	-0.1	0.0	3.2
Singapore	8.5	-0.9	6.4	9.4	-2.4	2.2	1.2	4.6	-2.6	-0.3	3.0
Thailand	-1.4	-10.5	4.4	4.6	1.9	5.3	4.5	5.0	0.4	0.6	1.1
Viet Nam	8.2	4.4	4.7	6.1	5.8	6.4	6.9	7.3	0.2	0.3	5.5
East Asia[4,5]	6.4	0.4	7.0	7.6	5.0	6.6	5.6	6.3	-0.5	-0.1	5.3
East Asia exc. PRC[4,5]	4.7	-6.7	7.0	7.6	2.4	5.1	3.5	5.0	-1.0	0.0	3.1
ASEAN[4,5]	4.4	-6.7	4.1	6.2	1.9	4.1	3.6	4.8	-0.5	0.1	1.9
ASEAN5+2	6.4	0.4	7.0	7.6	5.0	6.6	5.6	6.3	-0.5	-0.1	5.3
Five Crisis-Affected	4.2	-7.8	7.2	7.4	2.9	5.4	3.6	4.9	-0.9	0.0	3.0

— = not available
[1]Difference between July 2003 forecasts and the February 2003 forecasts.
[2]Upper end of government forecast of 2003 GDP growth of 3–4%.
[3]For FY April–March.
[4]Excludes Myanmar for all years and Brunei Darussalam in 2004.
[5]New weights were used to compute aggregate GDP numbers.
Sources: Official sources for historical data; Consensus Economics Inc., *Asia Pacific Consensus Forecasts* (July 2003); ARIC Indicators; World Bank, *World Development Indicators* for weights.

outbreak could linger for some time. Despite this, third and fourth quarter GDP growth is expected to be robust, and GDP growth for the full year is forecast to be a strong 7.5%, the same as the February 2003 forecast. Growth is forecast to continue at the same level next year. Continued growth in exports and domestic demand is likely to support the strong GDP growth. Given low inflation, modest public debt, and sizable foreign exchange reserves, the PRC can support growth through fiscal and monetary easing.

➲ **Indonesia.** Having been largely free from SARS, Indonesia's economy did not slow in the second quarter. In fact, at 3.6%, growth in the quarter was slightly better than in the first, yielding a 3.5% growth rate for the first half of this year. Maintenance of a more or less similar growth rate is forecast for the second half. Full year growth is thus forecast to be about 3.5%, only marginally lower than both the February 2003 forecast of 3.6% and last year's growth of 3.7%.

Driven by increased exports as well as private consumption, GDP growth is forecast to improve to 4.2% in 2004. Although Indonesia's public debt has improved in the last two years, it still constitutes about 75% of GDP. The scope for fiscal easing to support growth thus appears limited.

- **Korea.** After bouncing back strongly from the 1997 financial crisis, Korea is now in the downward phase of its business cycle, with softening domestic demand a major cause of the slowdown in the first half of this year. Growth for the full year is forecast to be 3.3%, lower than the 5% forecast made in February 2003 as well as the 6.3% growth achieved last year. Growth is forecast to improve next year to 5.2%. With exports forecast to improve only marginally, higher growth next year will be driven primarily by private consumption and fixed investment. Given the low level of public debt, Korea can support growth by monetary easing and fiscal expansion, but it needs to address persistent difficulties of implementing budgeted fiscal programs during the course of a year.

- **Malaysia.** Trends in monthly exports suggest that second quarter GDP growth may have been lower than the 2.6% figure for the first quarter. Given the expected improvements in the external environment and the substantial fiscal stimulus in the pipeline, growth should pick up in the second half of this year. Growth for the full year 2003 is thus expected to be 3.9%, only marginally lower than the 4.1% posted last year, but significantly lower than the February 2003 forecast of 4.7%. Looking ahead to 2004, growth should strengthen to about 5%. Better growth in both exports and domestic demand underpins the stronger forecast for next year. Given moderate public debt and low inflation, Malaysia still can support growth through both monetary and fiscal easing.

- **Philippines.** Slowing exports suggest that second quarter growth may have been lower than the 4.5% posted in the first quarter. For the full year, GDP growth is now forecast at 3.8%, more or less the same as the February 2003 forecast and close to the country's longer-term trend growth rate. Growth next year is forecast to improve to about 4%, on the continued strength of private consumption and improved exports. The Philippines is at present in the process of consolidating its fiscal position to lower public debt (about 70% of GDP) to more sustainable levels. The scope for supporting growth through fiscal stimulus is thus limited. Easing monetary policy could also lead to a depreciation in the peso, which, in turn, would inflate the burden of public debt, a significant portion of which is denominated in foreign currencies.

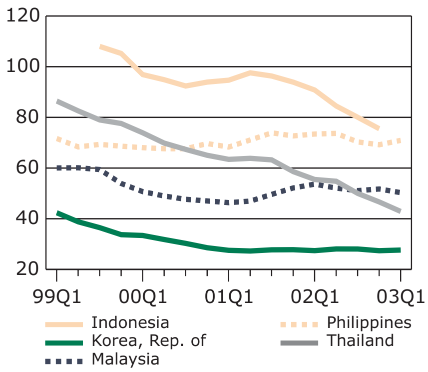
- **Singapore.** Singapore's high incidence of SARS and its heavy dependence on trade and tourism caused a steeper-than-expected 4.3% GDP contraction in the second quarter. Monetary policy has already been eased in response to the sharp slowdown. Coupled with an improving external environment and the control of SARS, the monetary easing should enable the economy to post better growth in the third and fourth quarters. Despite this expected improvement, growth for this year as a whole will reach only about 1.2%, much lower than both the February 2003 forecast of 3.8% and last year's growth of 2.2%. GDP growth will strengthen to 4.6% in 2004, as both exports and domestic demand regain momentum. Given its small public debt, Singapore is well placed to ease fiscal policy, but the effects of such easing could be small given the country's high dependence on international trade and tourism.

- **Thailand.** Growth may have slowed somewhat in the second quarter from the better-than-expected 6.7% in the first quarter, given the importance of the travel and tourism sector (which slowed due to SARS) in the economy. The latest Consensus forecast is for a 2003 growth of 4.5%, 0.4 percentage point higher than the February 2003 forecast. Growth is forecast to strengthen to 5% in 2004 because of an expected improvement in both exports and domestic demand. Several factors suggest that Thailand could surpass the current forecast, including high consumer confidence, low interest rates, and other supportive government policies. Moreover, given its moderate public debt and low inflation, Thailand has reasonable scope to support growth using fiscal policy; but as in the case of Korea, it needs to address the recurrence of large divergences of actual fiscal outcomes from budgeted levels.

- **Viet Nam.** Viet Nam effectively contained the SARS outbreak at an early stage and thus minimized its adverse impact on growth. GDP is now forecast to grow by 6.9% this year, 0.2 percentage point higher than the February 2003 forecast. Growth is forecast to strengthen to 7.3% next year. Strong domestic demand, driven partly by growth in private investment and partly by expansionary fiscal policy, is expected to drive the country's healthy growth outlook.

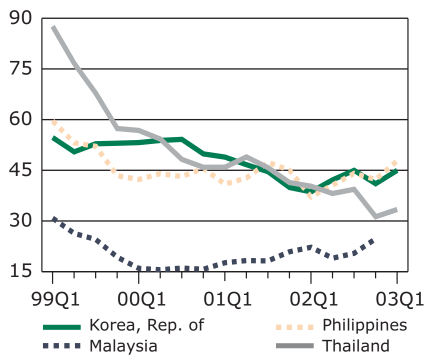
- **Other countries.** Among other countries in the region, growth this year is expected to be 4% in Brunei Darussalam, 5% in Cambodia, and 6% in Lao PDR. The improvements in the growth outlook for the region as a whole should enable these countries to post higher growth next year.

Figure 41: **Total External Debt** (% of GDP)



Source: ARIC Indicators.

Figure 42: **Short-Term External Debt** (% of Gross International Reserves)



Source: ARIC Indicators.

Risks to Regional Outlook and Policy Issues

Since the 1997 financial crisis, East Asia's prudential indicators have improved significantly. External debt-to-GDP ratios have fallen across the region (Figure 41). Consecutive years in which most major countries in the region have run current account surpluses enabled them to build up sizable foreign exchange reserves, which now more than cover their entire short-term external debt (Figure 42). Banking sectors in the region are gradually returning to health, although the agenda of restructuring and reforms is far from complete.

Given that the region is currently experiencing low and falling inflation, a concern has been raised that the region could fall into a deflationary situation. Because of the room for maneuver in monetary and fiscal policies that most countries in the region have, this threat is not likely to be realized. Countries should, however, remain vigilant and be prepared to take any preemptive measures should the need arise (see Box 4).

There are, however, four risks that could derail the current forecast of a growth pickup in the region: (i) the recurrence of SARS, (ii) an escalation in global geopolitical tensions, (iii) an unexpected reversal in the outlook for major industrial countries, especially the US, and (iv) the growing current account imbalances among industrial countries.

First, although SARS is under control, the World Health Organization has cautioned that its recurrence cannot be completely ruled out. If it recurs, regional growth prospects could be set back, although on the basis of this year's experience, countries may be in a better position to manage a recurrence of the disease.

A second risk to the expected pickup in the region's growth could arise from a sudden escalation in geopolitical tensions. Despite the quick end to the war, the situation in Iraq in particular and the Middle East in general poses significant uncertainties. The possibility of increased terrorist activities globally also exists. Closer to home, some Asian countries run the risk of a sudden resurgence in terrorism (such as last year's hostage crisis in the Philippines and terrorist bombings in Indonesia), as also the possibility of a sudden rise in geopolitical tensions on the Korean peninsula.

Third, there is a possibility that the recent spate of encouraging data from industrial countries may not solidify. Some of these countries could slide back into economic weakness. Past experiences suggest that industrialized economies showing encouraging signs of rebound could subsequently disappoint economic forecasters. The scale of disappointment can be seen by the sharp downward revisions forecasters made to growth forecasts since 2001 (Figures 24 to 26).

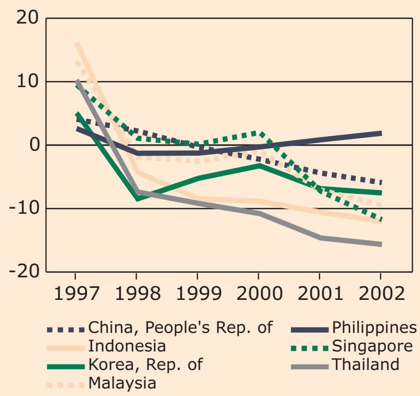
Box 4: **From Disinflation to Deflation: Is there a Risk?**

At present, many East Asian countries are experiencing falling and historically low inflation rates—disinflation, for short. Experience worldwide shows that countries experiencing disinflation tend to run the risk of falling into deflation. Does East Asia face such a risk?

Several factors determine inflationary or deflationary pressures in a country, but perhaps the single most important indicator of such pressures is the degree of excess production capacity, or output gap as it is often called. Generally, a country tends to have falling inflation rates when actual GDP (output) is significantly below its long-term trend (potential) level; conversely, it tends to have rising inflation rates when actual GDP is significantly above its long-term trend level. On average, in the postcrisis years, many countries in East Asia have grown at rates far below their long-term trend rates. Hence, many of them now have significant negative output gaps (Box Figure 4.1). The ongoing disinflation in the region is largely a reflection of these output gaps.

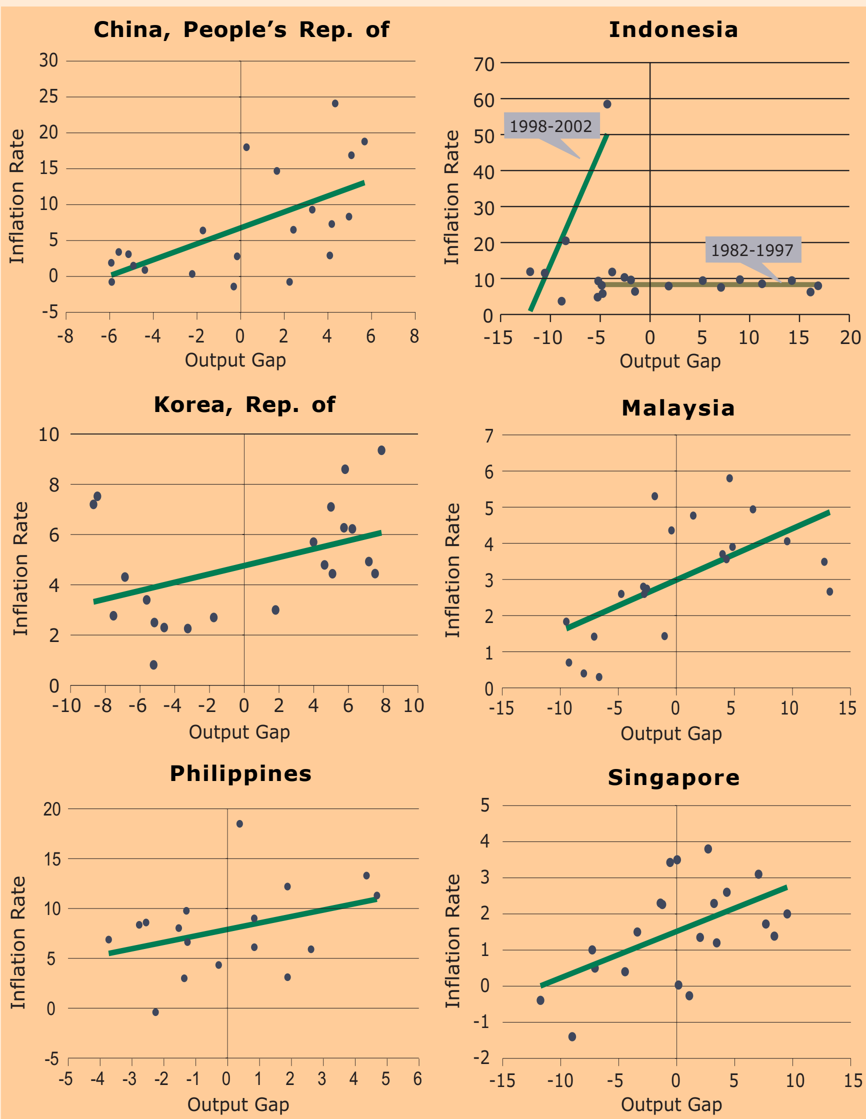
Data for the last two decades for most East Asian countries also support a positive relationship between inflation and output gaps (Box Figure 4.2). Regression results using a simple but fairly standard model of inflation further confirm the positive relationship between inflation and output gap for most countries in the region (Box Table 4.1).

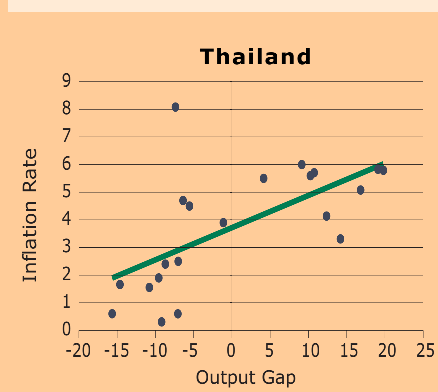
Box Figure 4.1: **Output Gap[1]**



[1]The output gap is the percentage difference between actual GDP (at constant prices) and its trend level. The trend level of GDP is obtained using a semilog regression of the actual GDP on time.
Source: REMU staff estimates.

Box Figure 4.2: **Inflation Rates and Output Gaps, 1982–2002**





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Box 4—*Continued*

Reducing the large output gaps by achieving robust economic growth is crucial for halting the current disinflation and stopping countries from falling into a deflationary environment. Expected improvements in the external environment should help countries in the region post robust growth and reduce the output gaps, as should also the substantial monetary and fiscal stimulus already in the pipeline in several countries. Moreover, with a few exceptions, reasonable scope exists for a further easing of monetary and fiscal policies in the region. Hence, although both the current disinflationary trends and the existence of significant output gaps are causes for concern, the possibility of the region falling into a deflationary spiral appears low. Based on a composite index of vulnerability to deflation that incorporates factors such as actual inflation, output gaps, asset prices, and credit growth, a recent International Monetary Fund (IMF) paper has also come to a similar conclusion: despite the low inflationary environment, the risk of most East Asian countries' falling into a deflationary trap is low.[1]

Encouraging as these conclusions are, the region's policymakers must remain vigilant and should be ready to take preemptive monetary and fiscal measures to avoid further disinflation/deflation, should the need arise. This is especially important, because—as is well known—deflation is very difficult to fight once it sets in.

[1]IMF, Deflation: Determinants, Risks, and Policy Options—Findings of an Interdepartmental Task Force, 30 April 2003.

Box Table 4.1: **Regression Results (dependent variable: percentage change in CPI)**

Independent Variables	PRC	Indonesia	Korea	Malaysia	Philippines	Singapore	Thailand
Output Gap	0.82	0.12	0.25	0.08	0.65	0.10	0.13
	(2.71)**	(1.64)	(4.08)**	(2.02)*	(1.50)	(2.41)**	(5.16)**
Lagged Inflation Rate	0.40	0.26	0.25	0.37		0.31	0.10
	(2.30)**	(2.79)**	(3.07)**	(2.82)**		(2.59)**	(1.00)
Percentage Currency Depreciation	0.12	0.19	0.05				0.05
	(1.43)	(11.34)**	(1.18)				(1.29)
Asian Crisis Dummy	-7.05	2.97	3.09	2.86		-2.00	3.94
	(-1.36)	(1.34)	(1.19)	(2.77)**		(-1.96)*	(2.29)**
Constant	3.31	3.37	2.98	1.63	7.90	1.01	2.89
	(1.88)*	(2.74)**	(5.10)**	(3.31)**	(7.62)**	(3.14)**	(5.50)**
Adjusted R^2	0.57	0.92	0.56	0.60	0.07	0.49	0.69

t-values in parentheses; * = 10 percent level of significance; ** = 5 percent level of significance.

The output gap is the percentage difference of actual GDP (at constant prices) from its trend level. The trend level of GDP was obtained using a semilog regression of the actual GDP on time. Whenever autocorrelation was detected, it was corrected using standard methods.

Data for all countries are from 1982–2002, except for the Philippines, which are from 1986–2002. For PRC, Korea, Malaysia, Singapore, and Thailand, the Asian Crisis Dummy is equal to 1 for 1998, and 0 otherwise. For Indonesia, the Asian Crisis Dummy is equal to 1 for 1998–2002, and 0 otherwise.

Source: REMU staff estimates.

Finally, large current account imbalances among industrial countries could lead to sharp exchange rate movements. These imbalances remain a source of concern, especially if they induce a disorderly adjustment involving further sharp movements in exchange rates.

Against this backdrop of risks, policymakers in the region should remain vigilant and take preemptive measures should the need arise. In particular, countries should continue to be alert and take preventive measures against the recurrence of SARS.

On the economic front, fiscal and monetary policies should continue to be accommodative to support growth, at least until these uncertainties settle. As the recent issues of the AEM have argued, the case for such a policy stance is particularly strong, as the region has low inflation, a large excess production capacity, a robust balance of payments, and sizable foreign exchange reserves. It is encouraging that during the year, central bank policy rates were cut in several countries, and Singapore eased monetary policy by lowering its target for the Singapore dollar. As for fiscal policy, with some exceptions (such as Indonesia and the Philippines) there is reasonable scope for some easing across the region. It is also encouraging that, partly in response to the SARS-induced slowdown in growth, several countries have recently announced fiscal stimulus packages through supplementary budgets. Countries that have encountered difficulties in implementing budgeted fiscal programs should expeditiously address those difficulties, so that fiscal performance conforms to budgeted stances.

Monetary and fiscal easing alone will be less effective in supporting growth if the financial and corporate sectors do not return to good health. In a typical postcrisis environment, where the corporate sector is reluctant to invest and the financial sector is hesitant to lend, the normal channels through which lower interest rates (and to some extent even fiscal easing) stimulate aggregate demand and growth tend to be less effective. A typical indicator is the depressed credit-deposit ratio of banking systems (especially in the five crisis-affected countries), which remains subdued and far below precrisis levels even with falling interest rates, as banking systems have excess liquidity but credit growth is stunted. This underscores the importance of expeditiously completing the remaining agenda of financial and corporate restructuring and reforms.

It is encouraging that since 1997, countries in the region have made significant progress in addressing weaknesses in their financial and corporate sectors. Yet, as some recent issues of the AEM have reiterated, the remaining agenda of reforms and restructuring is substantive. Although the health of the banking system is better today than it was at the height of the 1997 crisis, much more needs to be done in improving banking systems' transparency, disclosure, and overall governance standards. Governments in the region also face serious challenges in implementing and enforcing measures introduced in the postcrisis years to strengthen financial sector regulation and supervision. Moreover, in some countries, weaknesses in the legal framework for insolvency continue to hamper corporate debt resolution. Greater efforts are needed to address these weaknesses.