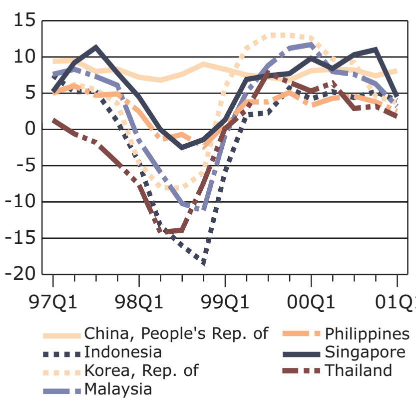
Asia's Recovery: A Regional Update

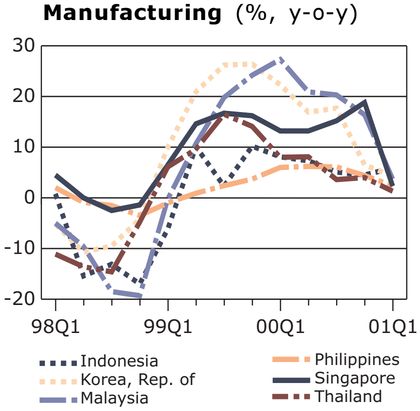
Growth and Recovery in 2001

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



Source: ARIC Indicators; National Bureau of Statistics (PRC); and Ministry of Trade and Industry (Singapore).

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



Source: ARIC Indicators; and Ministry of Trade and Industry (Singapore).

Real Sector Developments

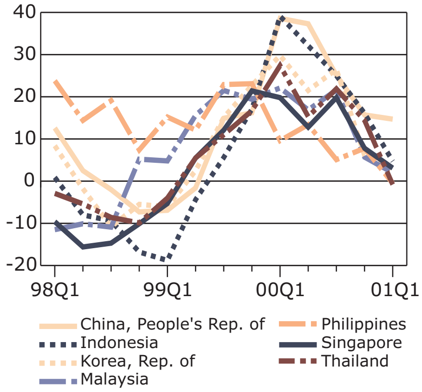
In line with the assessment of the March 2001 *Asia Recovery Report* (ARR) and the May 2001 *East Asia Economic Outlook* (EAEO), the global economic slowdown and the downturn in world electronics demand are taking their toll on the East Asian region (i.e., the 10 Association of Southeast Asian Nations [ASEAN] countries plus the Republic of Korea [henceforth, Korea] and the People's Republic of China [henceforth, PRC]). Except for the PRC, which continued to turn in strong growth of more than 8 percent in the first quarter of 2001, gross domestic product (GDP) growth is slowing across the region. In the first quarter of 2001, the five crisis countries (Indonesia, Korea, Malaysia, Philippines, and Thailand) taken together grew by 3.3 percent.[1] This represents a deceleration from the 4.6 percent growth they achieved in the last quarter of 2000 as well as from an average growth of 7 percent in the previous eight quarters.

The stronger a country's links to the US through trade and capital flows, the greater the impact on domestic growth. Similarly, countries with heavier dependence on electronics exports are seeing a larger dip in growth. Compared to 2000, growth rates in the first quarter of 2001 have more than halved in Korea and Malaysia. The deceleration is less pronounced but still significant in Indonesia, Philippines, and Thailand (Figure 1). Growth slowdown is not limited to the five crisis countries, but has been felt elsewhere in East Asia. For instance, growth in Singapore, a country with high dependence on electronics as well as exports to the US, slowed to 4.1 percent in the first quarter, from 11 percent in the last quarter of 2000 and an average of 8 percent in the previous eight quarters.

The recent growth deceleration cuts across sectors, but is most visible in manufacturing (Figure 2). Korea's manufacturing sector grew at a meager 4.3 percent in the first quarter of 2001, compared to an average growth of more than 18 percent in the previous eight quarters and a postcrisis high of 26.3 percent in the second half of 1999. Similarly, in Malaysia the manufacturing sector had to be content with only 3.7 percent growth in the first quarter of 2001, compared to 16.4 percent in the last quarter of 2000 and an average of 17.4 percent in the previous eight quarters. Singapore's manufacturing slowdown is

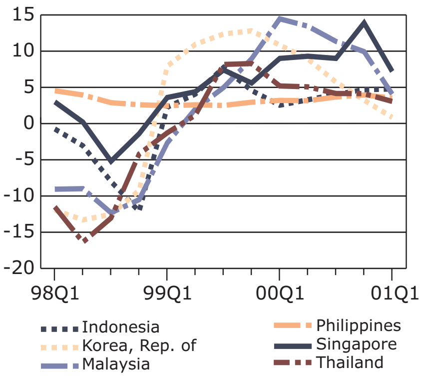
[1]All quarterly growth rates in this Update are calculated on a year-on-year basis.

Figure 3: **Growth of Merchandise Exports** (%, y-o-y)



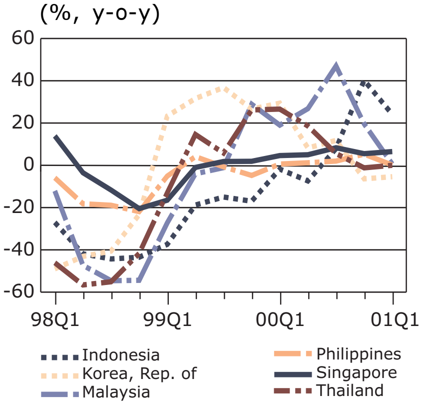
Source: ARIC Indicators; National Bureau of Statistics (PRC); and Ministry of Trade and Industry (Singapore).

Figure 4: **Growth of Real Private Consumption Expenditure** (%, y-o-y)



Source: ARIC Indicators; and Ministry of Trade and Industry (Singapore).

Figure 5: **Growth of Real Gross Domestic Investment**[1] (%, y-o-y)



[1]Data for Singapore refer to gross fixed capital formation.
Source: ARIC Indicators; and Ministry of Trade and Industry (Singapore).

comparable to that of both Korea and Malaysia: its manufacturing sector grew by just 2.3 percent in the first quarter of 2001, a huge cut from the 18.8 percent growth seen in the last quarter of 2000 and the average of more than 14 percent in the eight quarters since the beginning of 1999. Even in the Philippines, a country that has experienced only a modest growth deceleration, manufacturing sector growth has more than halved from 5.7 percent in the four quarters of 2000 to 2.4 percent in the first quarter of 2001.

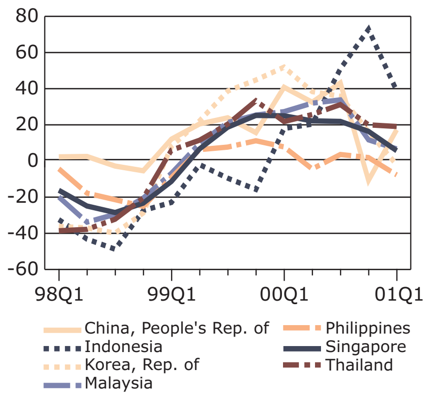
The sharp cuts in growth rates, aggregate and sectoral, were primarily due to a slump in the region's exports. Taken together, the dollar value of exports of the five crisis countries grew by 2.9 percent in the first quarter of 2001, compared to 28 percent in 2000. Substantial cuts in export growth were seen across the board (Figure 3). Korea's export growth slumped to 2.2 percent in the first quarter of 2001 from an average of more than 20 percent during the preceding six quarters. Respective figures for Malaysia were 2 percent and 18 percent, for the Philippines -0.5 percent compared to about 14 percent, and for Thailand -0.8 percent compared to 18 percent.

Outside of the five crisis countries, Singapore's exports grew by just 3 percent in the first quarter of 2001, down from an average rate of about 16 percent in the previous six quarters. Although the PRC's exports maintained robust growth, they have still slowed to 14.7 percent in the first quarter of 2001 from an average of 24.6 percent in the previous six quarters. Available evidence, though, shows that the PRC's export slowdown has intensified somewhat in the second quarter of 2001.

Decelerating export demand has been accompanied by softening domestic demand, especially private demand, in many countries (Figures 4 and 5). Slowing growth and the large decline in stock prices that occurred in 2000 are adversely affecting both consumer confidence and business investment. Private domestic demand is weakening as a result. This is especially so in Korea, Malaysia, and Singapore. In the Philippines, no significant deceleration in private consumption is noticeable, but domestic investment continues to be subdued.

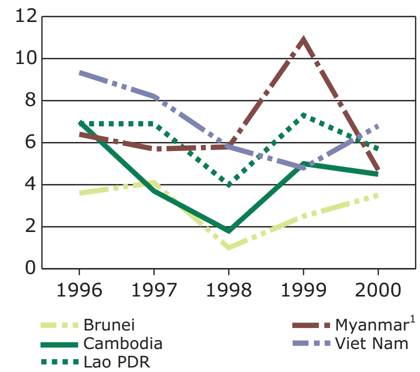
In tandem with declining export growth and slowing domestic economic activity, regional import demand remains soft. The dollar value of imports to the five crisis countries increased by only 3 percent in the first quarter of 2001, down from an average growth of 36 percent in the previous six quarters. Import compression is taking place as import-intensive processing exports, which dominate the manufacturing sectors of most East Asian economies, are taking a beating in the external market.

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



Source: ARIC Indicators; and Ministry of Trade and Industry (Singapore).

Figure 7: **Real GDP Growth**
(%)



[1]Fiscal year data.
Sources: ADB, *Key Indicators for Developing Asian and Pacific Countries 2000*; EIU, *Country Report;* IMF Staff Reports; and official estimates.

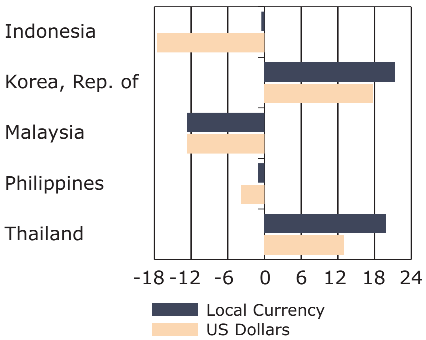
Even imports of goods unrelated to processing exports are softening as weak consumer demand is constraining regional imports. Import compression is particularly significant in Korea, Malaysia, Philippines, and Singapore (Figure 6). Since both Indonesia and Thailand have experienced milder GDP decelerations, they are not witnessing much import compression. Despite sluggish exports, softening imports have enabled countries to keep their trade balance in surplus. In the first quarter of 2001, the combined trade balance of the five crisis countries amounted to $12.7 billion.

For the smaller ASEAN countries, quarterly data on GDP growth are not available. Available annual data for 2000 show that adverse weather affected growth in Cambodia and Lao People's Democratic Republic (Lao PDR). On the other hand, enterprise reforms spurred growth in Viet Nam, while high oil prices buoyed growth in Brunei Darussalam (Figure 7). Although more recent data are not available for these countries, it is unlikely that they have been insulated from the ongoing regional economic slowdown as they have significant trade and investment links with their bigger ASEAN neighbors.

Financial and Asset Market Developments

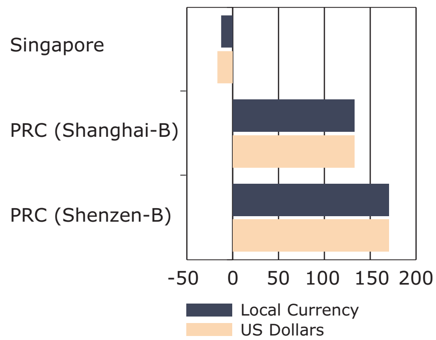
The March ARR had noted that, in the first few weeks of 2001, regional equity prices were regaining some of the ground lost in 2000. It was thought that cuts in US interest rates, the resolution of political

Figure 8a: **Composite Stock Price Index—Crisis-Five, as of Week Ending 15 June 2001[1]** (% change from end-December 2000)



[1]Weekly averages of JCI (Indonesia), KOSPI (Korea), KLCI (Malaysia), PCOMP (Philippines), and SET Index (Thailand). The exchange rates used in the conversion to dollars are from the NY Composite.
Source: REMU staff calculations derived from Bloomberg.

Figure 8b: **Composite Stock Price Index—Other East Asian Countries, as of Week Ending 15 June 2001[1]** (% change from end-December 2000)

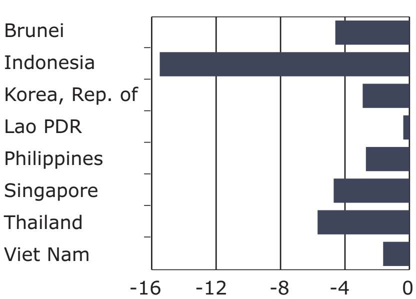


[1]Weekly averages of SESALL (Singapore), Shanghai-B (PRC), and Shenzen-B (PRC). The exchange rates used in the conversion to dollars are from the NY Composite.
Source: REMU staff calculations derived from Bloomberg.

uncertainties in some parts of the region, and historically low price-earnings ratios were helping equity prices to recover from the beating they took in 2000. Despite the continued poor performance of the US NASDAQ, which then was at its lowest level in more than two years, it appeared that local markets would sustain their gains. But as the year progressed, that perception had to be reassessed. Reflecting US stock market trends and domestic uncertainties, with the exception of the PRC, regional equity prices have remained volatile in the first half of 2001. They increased during January–February, declined during March–April, and recovered somewhat in May–June. Between December 2000 and now, equity values have increased in PRC, Korea, and Thailand, but have fallen in other countries (Figures 8a and 8b).

In the foreign exchange market, regional currencies have weakened in recent months, with the exceptions of the Malaysian ringgit, the PRC's renminbi, and the currencies of some of the smaller ASEAN countries (Figure 9). Among the crisis countries (excluding Malaysia, which has pegged its exchange rate at RM3.8 to the US dollar since September 1998), currency depreciations against the US dollar since end-2000 have ranged from 2.7 percent in the Philippines to about 15 percent in Indonesia. Outside the crisis five, the Singapore dollar has depreciated by about 5 percent since December 2000.

Figure 9: **Exchange Rates, as of Week Ending 15 June 2001** (% change from end-December 2000)



Source: REMU staff calculations derived from Bloomberg.

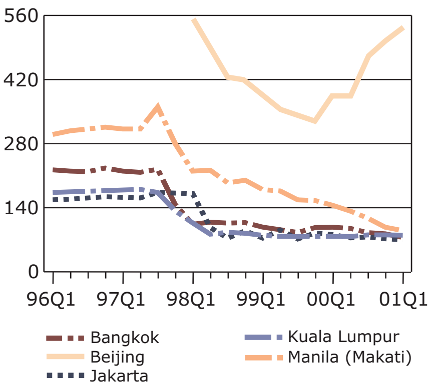
While these depreciations are significant, they should be viewed from the larger perspective of the emerging global and regional trends in exchange rates. Since the beginning of the year, most currencies, including those of the Organisation for Economic Co-operation and Development (OECD) countries, have depreciated against the US dollar. For example, the euro now is more than 10 percent lower compared to its 2001 peak achieved in early January. Closer to home, the Australian dollar has weakened by about 9 percent since early January 2001, on concerns of slowing growth.

These changes in the regional exchange rates are also occurring at a time when many countries in the region have shifted from pegged exchange rates to more flexible rates, with inflation targeting as the key objective of domestic monetary policy. In such a regime, it is only natural that shocks, both internal and external, are reflected in the exchange rate. Being open economies with large dependence on trade, the crisis countries are sensitive to the slowing global economy and the downturn in the electronics cycle. These economic developments are being felt in regional exchange rate movements, although sporadic spikes in the rates were also caused by other factors, such as the outbreak of social and political unrest in Indonesia, and the hostage crisis in the Philippines.

Movements in the Japanese yen have also dragged regional currencies down. Since April 2001, concerns have been raised that a weaker yen would discourage exports to Japan from the developing countries in the region, and impact adversely on their growth. Moreover, a weaker yen is also seen as making the exports of countries such as Korea, Malaysia, and Singapore to markets in North America and Europe less competitive vis-à-vis Japan. On both these counts, whenever the yen has depreciated against the US dollar, many regional currencies have followed suit.

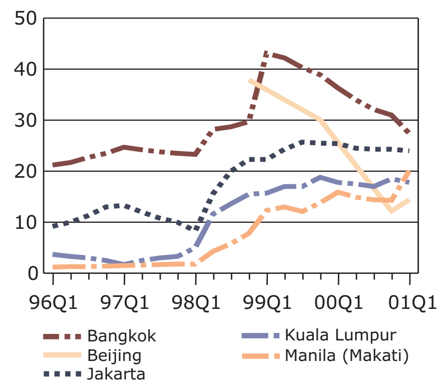
The March ARR had noted that in the property markets, office vacancy rates were recovering somewhat while office rentals were still declining in most countries. A notable exception to that trend then was the PRC where declining office vacancy rates were also accompanied by increasing office rentals. Data available for the first quarter of 2001 are generally in line with that assessment. In the first quarter of 2001 with the exception of the PRC (where office rentals continued to increase) and Malaysia (where they remained stable), office rentals have continued to decline (Figure 10a). Movements in office vacancy rates have, however, been more varied. While they continued to decline in Malaysia and Thailand, they increased in the Philippines and PRC, and remained more or less unchanged in Indonesia (Figure 10b).

Figure 10a: **Office Property Rents** ($ per square meter per annum)



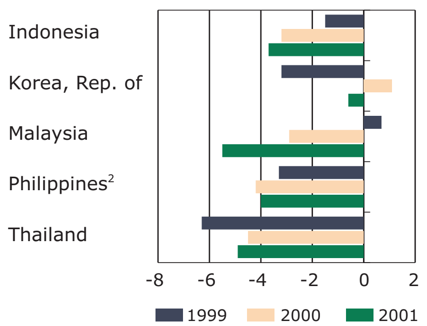
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Figure 10b: **Office Property Vacancy Rates** (%)



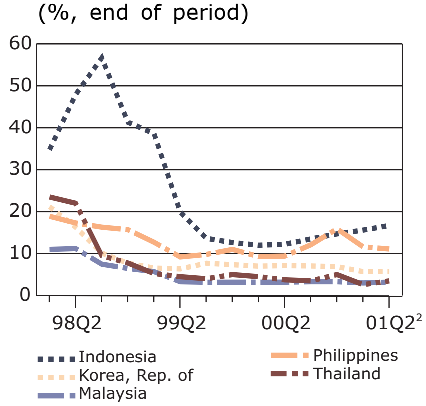
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Figure 11: **Government Fiscal Balance[1]** (% of GDP)



[1]Data refer to central government budget for Indonesia; public sector budget for Malaysia, Philippines, and Thailand; and consolidated central government budget for Korea.
[2]Percent of GNP.
Source: Institute of International Finance, *Regional Overview: Asia,* 30 April 2001.

Figure 12: **Short-Term Nominal Interest Rate[1]** (%, end of period)



[1]Three-month interbank lending rate (three-month certificate of deposit rate for Korea).
[2]As of mid-June 2001.
Source: ARIC Indicators and Bloomberg.

Fiscal and Monetary Policies

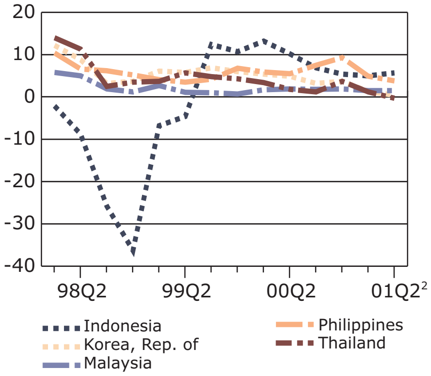
In response to the economic slowdown, with some exceptions, fiscal and monetary policies in the region have generally remained accommodative. Korea raised its expenditure budget by 11.3 percent for 2001 and also front-loaded two thirds of these expenditures during the first half of the year. The new Government in Thailand also intends to use fiscal stimulus to bolster domestic demand, but in a more limited way than was suggested during the election campaign. Recently, Malaysia announced a spending package of RM3 billion (the equivalent of about 1 percent of GDP) aimed at stimulating growth. The new Government in the Philippines has not yet presented its budget for 2001. Despite calls for a reduction in the fiscal deficit, it has stated that the deficit for the year will be held at 4 percent of GDP, only marginally lower than the 4.2 percent figure for 2000. The government deficit in Indonesia will increase from 3.2 percent of GDP in 2000 to 3.7 percent in 2001. Among the five crisis countries, projected fiscal/public sector deficits in 2001 range from 0.6 percent of GDP in Korea to 5.5 percent in Malaysia (Figure 11).

Outside the five crisis countries, the PRC and Singapore have also responded with accommodative fiscal policies to cushion the economic slowdown. In the PRC, expansionary fiscal policy, introduced as a temporary measure in the wake of the Asian crisis in 1998, has now become a permanent tool to counter slower export growth and softening domestic demand. The State budget deficit, which has been running at about 3 percent of GDP since 1998, has been maintained around that level for 2001. To boost household consumption and business investment, Singapore is providing a 10 percent tax rebate for 2001 apart from cutting personal and corporate income taxes for 2002.

With few exceptions, monetary policy has also been eased across the region, especially after the interest rate cuts by the US Federal Reserve Board. In the wake of these monetary policy responses, interest rates have come down significantly in many countries in the region. Compared to the beginning of 2001, short-term nominal interest rates are now lower by between about 1 percentage point in Korea and 4 percentage points in the Philippines (Figure 12). There has also been a corresponding reduction in real interest rates (Figure 13). In a reversal of its earlier accommodative monetary policy, Thailand in early June 2001 increased the bank deposit rate by 2.5 percentage points. It is not yet clear whether lending rates will also be adjusted upward soon.

Given that inflation has edged down this year in most countries, these fiscal and monetary responses may have been appropriate. Moreover,

Figure 13: **Short-Term Real Interest Rate**[1]
(%, end of period)



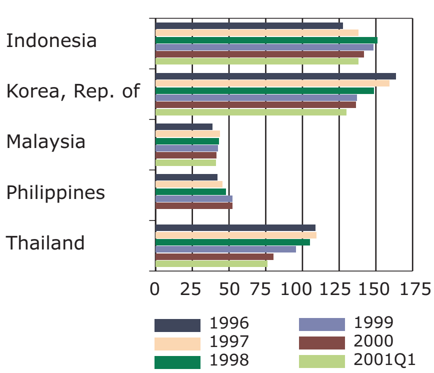
[1]Three-month interbank lending rate less inflation rate (three-month certificate of deposit rate for Korea).
[2]Based on latest CPI data available; May for Indonesia, Korea and Philippines; April for Malaysia and Thailand.
Sources: ARIC Indicators and Bloomberg.

the external payments positions have improved in recent years. Current account imbalances and external indebtedness have been reduced significantly, and foreign exchange reserve positions have strengthened (Figures 14 through 16). With these improvements in the external payments positions, easing of fiscal and monetary policies is less likely to have destabilizing effects on the exchange rates. However, there are limits to which fiscal stimulus measures could be used to counter external shocks.

In countries such as Indonesia, Philippines, and Thailand, there have been sharp increases in public debt levels due to the fiscal deficits of recent years. Public sector debt is now about 90 percent of GDP in Indonesia, about 70 percent in the Philippines, and in the range of 35-50 percent in Korea, Malaysia, and Thailand. These debt levels could easily get out of hand if caution is not exercised in time. Even in the PRC, once the quasi-fiscal expenditures, which are not included in the official budget, are taken into account, the public sector deficit could now be as high as 8 percent of GDP, and the Government debt stock about 50 percent of GDP. The fiscal implications of reforming the social security system and resolving the legacy of banking system nonperforming loans (NPLs) suggest that the public sector deficit could increase to about 10 percent of GDP and public debt could increase to two thirds of GDP in the next year or two.

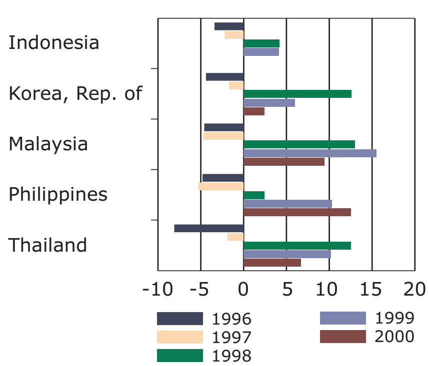
Another compelling reason why fiscal expansion should be pursued cautiously in East Asia is that most of the region's economies are still saddled with high NPL ratios. The task of resolving the NPL problem and recapitalizing banks is going to be highly challenging. Drawing on

Figure 14: **Total External Debt**
($ billion)



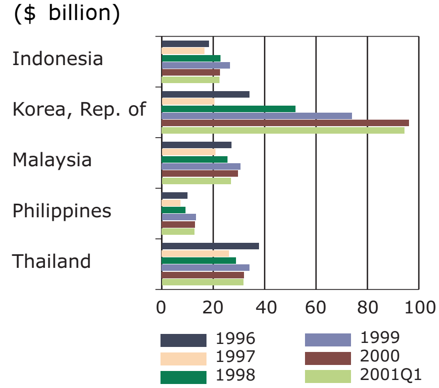
Source: ARIC Indicators.

Figure 15: **Current Account Balance** (% of GDP)



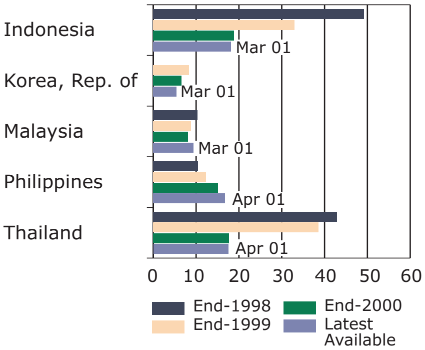
Source: ARIC Indicators.

Figure 16: **Gross International Reserves Excluding Gold**
($ billion)



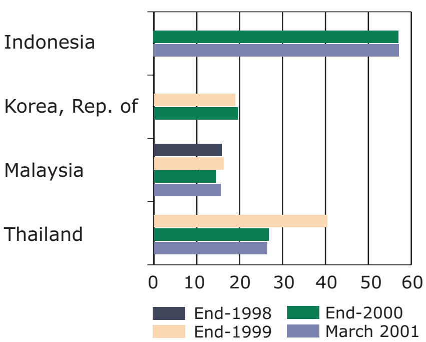
Source: ARIC Indicators and IMF, *International Financial Statistics,* May 2001.

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



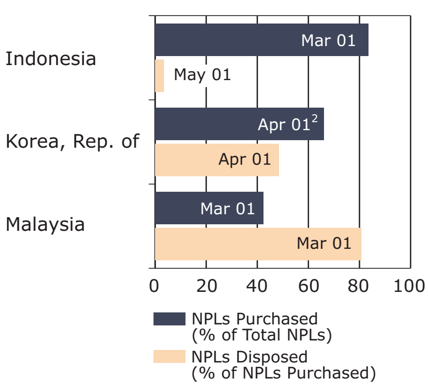
[1]Banking sector for Indonesia. Data on NPLs exclude those transferred to AMCs. The NPL criteria for Korea were changed in December 1999, so no comparable data are available prior to that date. NPLs are on a three-month accrual basis.
Source: ARIC Indicators.

Figure 18: **NPLs Including Transfers to AMCs** (% of total loans)



Source: ARIC Indicators.

Figure 19: **NPLs Purchased and Disposed of by AMCs**[1] (%)



[1]Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia as of the dates indicated.
[2]NPLs acquired as of April 2001 as percent of total NPLs as of December 2000.
Source: ARIC Indicators.

experience elsewhere, it is likely that substantial additional public funding will be required to satisfactorily address these challenges. That would make fresh claims on fiscal resources. Given these likely future fiscal commitments, it would be unwise to fritter away fiscal resources on public expenditure programs in the pursuit of countercyclical fiscal policy. Instead, these resources could be used to finance well-designed bank restructuring programs. In short, it would be preferable to use fiscal resources for addressing deep-rooted structural problems in the economy rather than for countering cyclical fluctuations in economic activity.

Financial Sector Restructuring

Despite the slowing growth and the attendant hardships, the five crisis countries are making progress in financial sector restructuring. The process is also moving forward in some other countries, particularly Cambodia, PRC, and Viet Nam (Box). With the exception of Malaysia and Philippines, commercial banks' NPL ratios, on a three-month accrual basis, continued to fall in 2001 compared to end-2000 (Figure 17). In the Philippines, the NPL ratio continues to rise, reaching 16.7 percent as of April 2001. The NPL ratio in Malaysia increased significantly from 8.1 percent at end-2000 to 9.4 percent by March 2001. Korea's NPLs declined appreciably to 5.4 percent by 2001, while modest declines were also observed in Indonesia and Thailand.

As the March ARR had cautioned, these NPL ratios should be interpreted with care. While NPLs have fallen because some debts have been restructured and voluntary servicing of previously impaired loans has recommenced, a significant part of the reduction in banking system NPLs reflects the transfer of problem loans from banks' balance sheets to asset management companies (AMCs). When NPLs still held by AMCs are added to those in the banking system, the picture is much less promising (Figure 18). They are much higher than those in bank balance sheets alone—close to 60 percent in Indonesia, about 27 percent in Thailand, and in the 14-20 percent range in Korea and Malaysia.

The high aggregate NPL ratios reflect the slow pace of disposal of assets by the AMCs. Malaysia was an exception, with Danaharta having disposed of three fourths of the assets it acquired (Figure 19). In Korea, asset disposal has progressed, but around 50 percent of the assets acquired by Korea Asset Management Corporation (KAMCO) are still to be disposed of. In Indonesia, while more than 80 percent of the banking system's NPLs have been transferred to the Indonesian Bank Restructuring Agency (IBRA), only a small proportion of these

Box: **Financial Sector Reforms in Cambodia, PRC, and Viet Nam**

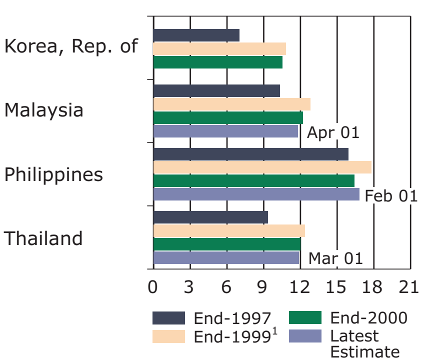
In 1999, the PRC set up four AMCs to resolve the NPLs of the major State-owned banks. It also infused $34 billion to recapitalize the State banks. By 2000, the four AMCs had taken over NPLs from the four big banks worth about Y1.4 trillion, equivalent to 10 percent of the total assets of these banks. In a legal sense, however, the banks remain liable for losses on these NPLs, since the Government has not explicitly agreed to guarantee the AMCs' financing. Capital adequacy figures are not reported in the PRC, but unofficial private estimates suggest that many banks would have negative net equity if assets were to be classified according to international standards. Ultimately, financial sector restructuring in the PRC will depend upon success of SOE reforms.

Since the Government announced in 1998 a three-year plan to return about 6,600 loss-making SOEs to profitability, some progress has also been made in SOE reforms. By 2000, 62 percent of these loss-making SOEs had reportedly made profits. In July 2000, the Government gave its consent to proposals for bankruptcy for about 1,000 of them, with emphasis particularly placed on liquidation of large loss-making SOEs. Despite these achievements, the PRC still faces formidable challenges in reforming its banking and corporate sectors. For successful resolution of NPLs, the AMCs need to be given legal powers to restructure the management and operations of defaulting enterprises. There is also a need to reform the insolvency law.

In Viet Nam, State banks are thought to have a growing portfolio of NPLs, owed mostly by unprofitable SOEs. Currently under consideration is a proposal to carve out NPLs and absorb the cost in the national budget. For this measure to have durable benefits, it would have to be accompanied by initiatives to strengthen the management of State banks, and to limit the practice of directing credit to SOEs.

Meanwhile, in Cambodia, efforts are being undertaken to strengthen the banking system. The banking supervision capacity of the National Bank of Cambodia (NBC) has been upgraded and is being further strengthened. The new law on Banking and Financial Institutions (promulgated in November 1999) requires that all existing commercial banks apply for a new license within six months. Substantial progress was made in 2000 in bank relicensing and in consolidating the banking system. On 31 July 2000, NBC closed three insolvent banks. The remaining 26 banks were classified into the following three categories based on viability: relicensed unconditionally (four branches of foreign banks); relicensed with corrective measures (14 banks); and nonviable (eight banks). NBC publicly announced on 8 December 2000 that the eight nonviable banks would be liquidated.

Figure 20: **Capital Adequacy Ratios of Commercial Banks** (%)

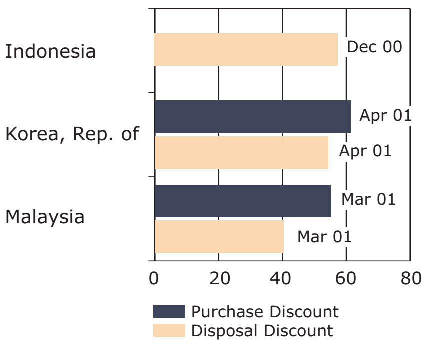


[1]November 1999 for the Philippines.
Source: ARIC Indicators.

have been disposed of. Thailand's private banks have set up their own AMCs, for which asset disposal data are somewhat scanty. The new administration in Thailand has announced its intention to create a centralized AMC that will carve out $28 billion of impaired loans from State and private banks. The centralized AMC is expected to be operational soon. The Philippines is also considering establishing a centralized AMC. Besides the slow pace of asset disposal by the AMCs, a comparatively recent aspect of the NPL problem is the growing reclassification of previously restructured loans as nonperforming.

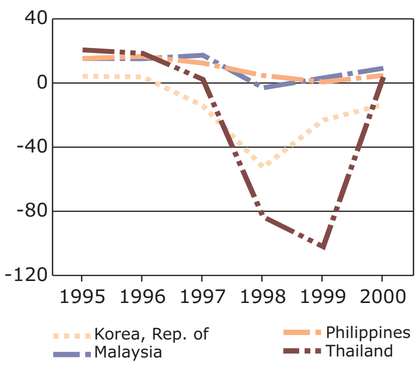
With the exception of Indonesia, capital adequacy ratios (CARs) of commercial banks exceed the 8 percent Basle norm (Figure 20). The Philippine banking system leads the way with a CAR of more than 15 percent, while Korea, Malaysia, and Thailand have CARs exceeding 10 percent. AMCs in Korea and Malaysia have made a profit (Figure 21).

Figure 21: **Discount Rates on NPL Purchases and Disposals by AMCs[1]** (%)



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

Figure 22: **Banking Sector Profitability[1]**



[1]Average return on equity of commercial banks. Figures for Malaysia, Philippines, and Thailand for 1995-1999 were calculated using data from Bloomberg. For 2000, data used were based on information from Malaysian banks' web sites (referring to the fiscal year); Bangko Sentral ng Pilipinas web site (as of the third quarter); and the Stock Exchange of Thailand web site. Figures for Korea were taken from the Financial Supervisory Service.
Sources: Web sites of the Financial Supervisory Service, Bangko Sentral ng Pilipinas, Stock Exchange of Thailand, and selected Malaysian banks; calculations from Bloomberg data.

In Indonesia, for the seven banks that have been recapitalized with the assistance of IBRA, the CAR was below 11 percent as of March 2001. However, the CARs for the other banks are much lower. Indonesia's target is to reach an 8 percent CAR for the banking system as a whole by the end of 2001.

As in the case of NPL ratios, the reported CARs should be used with caution in judging banking sector health. More often than not, CARs tend to be lagging rather than leading indicators of financial robustness. Besides, it is not clear that a CAR in excess of 8 percent provides adequate protection against the risks that banks in emerging markets face. Indeed, proposals contained in the New Basle Accord, published on 16 January 2001, encourage regulators in emerging markets to set minimum capital standards in excess of 8 percent on a bank-by-bank basis, where risk profiles so warrant.

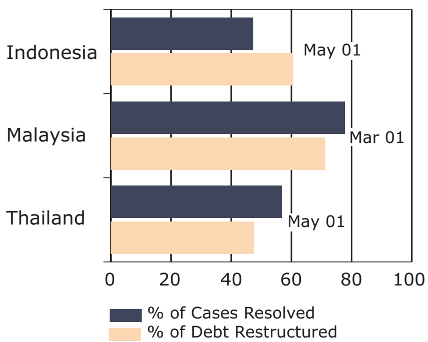
The profitability of banks, as measured by the average return on equity, has generally improved among the crisis countries (Figure 22). Despite this improvement, banking sector profitability continues to be negative in Korea. It is positive, but below precrisis levels, in Malaysia, Philippines, and Thailand. However, the fact that some banks are gradually returning to profitability suggests that margins are improving, with creditworthy borrowers paying off their debts. Going forward, this should eventually augur well for balance sheet strength.

Corporate Restructuring

The process of rehabilitating banks' balance sheets is intertwined with the task of restructuring corporate and other debts. Along with financial sector restructuring, the region's countries are making efforts at corporate restructuring, both within the government-sponsored voluntary workout frameworks and outside such frameworks (Figure 23). In general, the crisis countries have gone some way toward reducing their excessive debt-equity ratios, while rescheduling debt and lengthening the maturity of corporate debt. But the pace of corporate restructuring has been slower than that seen in the financial sector.

In Korea, despite some reduction in the debt-equity ratios of the top *chaebols*, corporate restructuring remains a formidable challenge, especially in view of the difficulties encountered in restructuring Hyundai and Daewoo. In Malaysia, the Corporate Debt Restructuring Committee (CDRC) has resolved about 72 percent of the corporate debt that was referred to it by March 2001. This is a significant achievement. Yet,

Figure 23: **Government-Supervised Voluntary Workouts[1]**



[1]Data refer to cases registered under Jakarta Initiative Task Force (Indonesia), CDRC (Malaysia), and CDRAC (Thailand).
Source: ARIC Indicators.

debt resolution in Malaysia has also tended, as with most other countries, to focus on lengthening the maturity of loans and forgiving interest payments rather than restructuring the operations of debtors. Thailand's Corporate Debt Restructuring Advisory Committee (CDRAC) has also made some progress in debt workouts by restructuring about 47 percent of the debt referred to it. However, growing numbers of cases are now being referred to Thailand's bankruptcy courts. For various reasons, including inadequate staffing, the courts are finding it difficult to deal with these cases expeditiously, resulting in a large backlog of unresolved cases.

In most countries, the operational restructuring of troubled businesses has not kept pace with the restructuring of their financial obligations. Ultimately, an improvement in debt servicing capacity requires a return to operational profitability. Progress in operational restructuring of the corporate sector has generally been patchy in all five crisis countries. There are several constraints on operational restructuring of the corporate sectors, including excessive concentration of ownership of businesses, political interference, worker resistance, inadequate insolvency and bankruptcy laws, and ineffective judiciary.

The continued concentration of ownership and control of corporations in the hands of a few powerful families or business groups in some countries is cited as a key constraint on speedier operational restructuring of their corporate sectors. Despite recent measures to strengthen minority shareholder rights, this is a constraint that is difficult to change. However, the sooner the governments are able to deal with the issue, the faster will be the progress in corporate restructuring.

In some countries, resistance from powerful owners of businesses is fortified by worker opposition to the labor retrenchment that arises in restructuring business units. The inadequate social safety nets in many of these countries are a primary source of such worker resistance. It is, however, encouraging that many countries are strengthening social safety nets and reforming their nascent social security systems. This should help reduce labor resistance to corporate restructuring.

The confluence of an inadequate legal framework on insolvency and bankruptcy and the ineffective enforcement of such laws makes debt resolution and corporate restructuring extremely difficult. Meanwhile, in some countries, insolvency and bankruptcy laws tend to work against creditors. Thus it is encouraging that these countries have recently passed laws to improve the legal framework related to insolvency and bankruptcy. To speed up corporate restructuring, however, effective legal enforcement is as important as their enactment. Strengthening of the judiciary is also urgently required through adequate provision of qualified personnel and their intensive training.

Risks to Regional Growth and Recovery

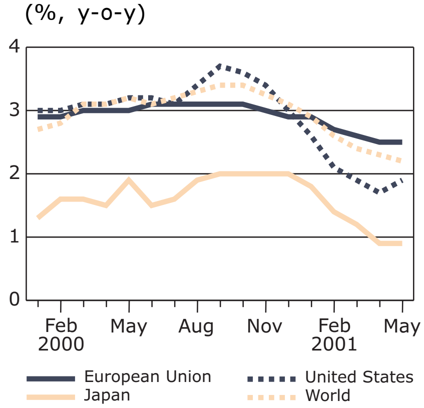
Since the release of the March ARR, downside risks to growth in many of the region's economies have increased somewhat. On the domestic front, several factors that impinge on economic performance have worsened in recent months. The political situation in Indonesia has deteriorated and significant policy drift continues as a result. The charges of concealed wealth against the new Prime Minister in Thailand cast doubts on political stability. Several ministerial statements also appear to have questioned the need for market-oriented reforms. In the Philippines, despite a favorable outcome in the May elections for President Arroyo's party and approval of the crucial power sector reform bill, the recent hostage crisis has once again jolted investor confidence. In Malaysia, the ratio of short-term external debt to foreign exchange reserves has remained stable, but the country has been losing foreign exchange reserves at the rate of about $800 million a month since December 2000. As for Korea, concerns are being raised that all the three parties involved in the reform process—the government, the *chaebols*, and the trade unions—are showing reluctance to push ahead with the more difficult and politically challenging reforms. Such "'reform fatigue" is not limited to Korea but characterizes, to varying extents, governments and the corporate sectors in other countries too.

External risks to the region's growth have also increased somewhat with the faster-than-expected slowdown in the US, Japan, and Europe. Economic data released for the US since March 2001 indicate that the economic slowdown in 2001 is likely to be deeper than initially anticipated. US GDP growth for the first quarter of 2001 has now been revised down to 1.3 percent, compared to the preliminary estimate of 2 percent published by the Department of Commerce in April 2001. Despite aggressive interest rate reductions by the Federal Reserve Board in recent months, more than a year of heavy losses in the stock market that wiped out wealth equivalent to about 50 percent of US GDP is finally taking its toll on US consumer confidence and business investment. This month's report from the Federal Reserve suggested that the economy was barely growing and was suffering from weaknesses across many industrial sectors. Moreover, inflation in May 2001 came in at a 10-year high of 3.6 percent. Although inflation is less of a problem in the U.S. than in Europe, if it edges up in the coming months, the scope for further monetary easing, beyond the 50 basis points (bp) expected by the market this week, may be limited. The Federal Reserve would then find itself in a tight spot in striking a balance between the need to spur growth and to keep inflation in check—the kind of dilemma that is also restraining the European Central Bank from cutting interest rates.

Emerging trends in Japan, the second largest economy in the world, are not encouraging either. The Tankan Surveys of recent months have painted a bleak picture of the country's economic prospects. Investor and business confidence continue to slide, while deflation is running at about 1 percent per annum. In response, the Bank of Japan effectively cut the interest rate to zero in late March. The Japanese Government followed this up with the announcement of a policy package, including measures to accelerate write-offs of banks' NPLs. Although there is a new Government that is widely perceived to be proreform, the task of restructuring the banks is going to be highly challenging. In the meantime, GDP actually shrank by 0.8 percent in the first quarter of 2001 and there is a possibility that the country may have already slipped into its fourth recession in a decade. There is growing consensus that GDP growth will be revised downwards further for the full year 2001.

With US growth likely to decline sharply and Japanese growth prospects remaining subdued, there had been some hope that Europe, which accounts for one fourth of world GDP, could fill the vacuum and drive global growth in 2001. However, data released in recent months have dashed these hopes too. Leading indicators from European countries point toward a significant slowdown, although at a slower pace than in the US. Moreover, since inflation in the 12 Euro-zone countries continues to be higher than the 2 percent target, the European Central Bank is reluctant to lower interest rates to spur growth. The European Central Bank has already cautioned that the troubled international environment might deliver a bigger-than-expected blow to Europe. The key message from Europe is that, while it will provide a modest cushion to the global slowdown, it cannot act as an engine of rapid global growth.

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



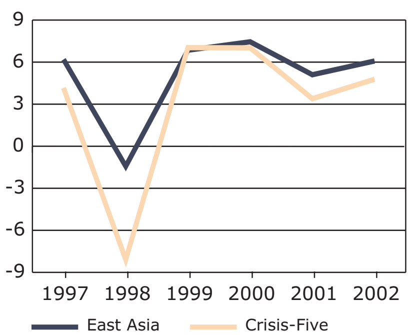
Source: Consensus Economics Inc., *Current Economics,* various issues.

Growth projections for the major industrialized countries have thus been revised down in the last few months (Figure 24). The London-based Consensus Economics Inc. (which collates forecasts of about 200 economic and financial forecasters—including fund management companies—for more than 70 countries around the world) now forecasts

US GDP growth in 2001 to be 1.9 percent, compared to its 2.1 percent forecast presented in the March ARR and 3.7 percent in September 2000. Similar downward revisions have been made for Japan and Europe. Further downward revisions in subsequent months cannot be ruled out. Projected composite growth in 2001 for the 70 countries that Consensus Economics covers has been revised down from 2.6 percent when the March ARR was released to 2.2 percent now. Most of these projections are broadly in line with the latest forecasts made by other institutions such as the International Monetary Fund (IMF), World Bank, and Institute of International Finance.

Regional Economic Prospects

Figure 25: **Weighted Average GDP Growth Rates of East Asia and Crisis-Five Countries**[1] (%, y-o-y)



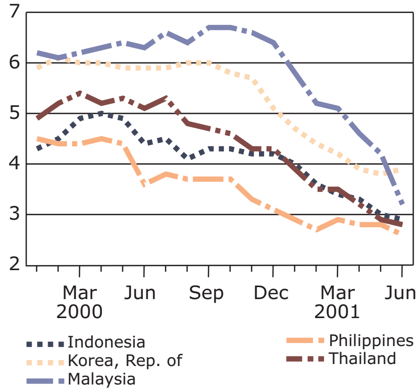
[1]GDP growth rates weighted by GDP levels in US dollars.
Sources: ADB, *Asian Development Outlook 2001,* April 2001; Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* June 2001; IMF; and country sources.

The worsening external and domestic environment points to a continuation of low economic growth at least over the next few months. Accordingly, the 2001 growth projections for most countries in the region have been revised downwards in recent months. Consensus Economics Inc. has downscaled its average 2001 growth projection in the five crisis countries from 3.9 percent at the time of the March ARR to 3.4 percent now, less than half the growth outturn of 7 percent last year (Figure 25). Similarly, the 2001 growth forecast for the East Asian region has been scaled down to 5.1 percent compared to 5.6 percent when the March ARR was issued. This compares poorly with the 7.5 percent growth achieved by the East Asian region in 2000.[2]

Among the five crisis countries, Korea and Malaysia are likely to see the sharpest slowdowns, reflecting their high dependence on exports, the US market, and global electronics demand. The latest Consensus Economics Inc. (June 2001) projection is for a growth rate of 3.9 percent for Korea (compared to 4.4 percent in the March ARR) and 3.2 percent for Malaysia (compared to 5.2 percent in the March ARR). At the time of the March ARR release, Consensus Economics Inc. had projected a 2001 growth rate of 3.6 percent for Indonesia. That projection has now been revised down to 2.9 percent. Similarly, the growth forecast of 3.5 percent in 2001 for Thailand has been cut to 2.8 percent. A combination of external and domestic factors has led to a similar downward revision of growth forecast for the Philippines—from 2.7 percent at the time of the release of the March ARR to 2.6 percent now

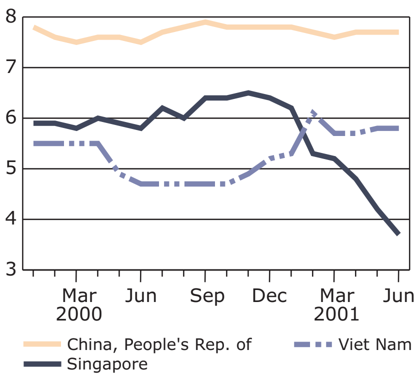
[2]Weighted average growth rates are based on individual country forecasts by Consensus Economics Inc. except for Cambodia and Lao PDR, which are taken from ADB's *Asian Development Outlook,* April 2001.

Figure 26a: **Monthly Consensus Forecasts of 2001 GDP Growth—Crisis-Five** (%, y-o-y)



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

Figure 26b: **Monthly Consensus Forecasts of 2001 GDP Growth—Other East Asian Countries** (%, y-o-y)



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

(Table 1 and Figure 26a). Outside the five crisis countries, downward revisions in growth have been made for most countries in the region, except for the PRC and Viet Nam. For instance, Singapore's 2001 growth forecast has been scaled down from 5.3 percent then to 3.7 percent now (Table 1 and Figure 26b).

Table 1: **Consensus Forecasts of 2001 GDP Growth** (%)

	ARR, March 2001	ARR, June 2001	Difference
China, People's Rep. of	7.7	7.7	0.0
Indonesia	3.6	2.9	-0.7
Korea, Rep. of	4.4	3.9	-0.5
Malaysia	5.2	3.2	-2.0
Philippines	2.7	2.6	-0.1
Singapore	5.3	3.7	-1.6
Thailand	3.5	2.8	-0.7
Viet Nam	6.1	5.8	-0.3
Crisis Five	3.9	3.4	-0.5
East Asia[1]	5.6	5.1	-0.5

[1]ASEAN countries (excluding Brunei and Myanmar), Korea, and PRC. For Lao PDR and Cambodia, used growth rates and GDP weights from ADB, *Asian Development Outlook,* April 2001.
Source: Consensus Economics, Inc., *Asia Pacific Consensus Forecasts,* June 2001.

Amid all these downward revisions of growth for 2001, there is, however, a silver lining on the horizon. The US economy may now be decelerating more sharply than earlier anticipated, but there is a growing consensus among analysts, international financial institutions, and the financial press that the slowdown is going to be short-lived. Among other factors, the aggressive interest rate reductions by the Federal Reserve so far this year will enable the economy to pick up some of the lost momentum by early next year, if not later this year. Therefore, most forecast that growth for the US and therefore the world economy will be higher in 2002 compared to 2001. For example, Consensus Economics now forecasts next year's GDP growth to be 3 percent in the US (up from 1.9 percent in 2001), 1.5 percent in Japan (up from 0.9 percent in 2001), 2.7 percent among the Euro-zone economies (up from 2.5 percent in 2001), and 2.9 percent for the world (up from 2.2 percent in 2001). The IMF and the Institute of International Finance predict similar accelerations of growth.

The expectation that the global slowdown will be relatively short-lived is good news for East Asia. Following the global trend, most economies in the region will continue to post low growth in the next few months. However, going into 2002, if not in the last quarter of this year itself, growth will pick up. Latest growth projections for 2001 and 2002 for the regional economies from different sources generally confirm this assessment (Figure 27). Consensus Economics predicts 4.8 percent average growth for the five crisis countries in 2002, and 6.1 percent growth for the East Asian region as a whole.

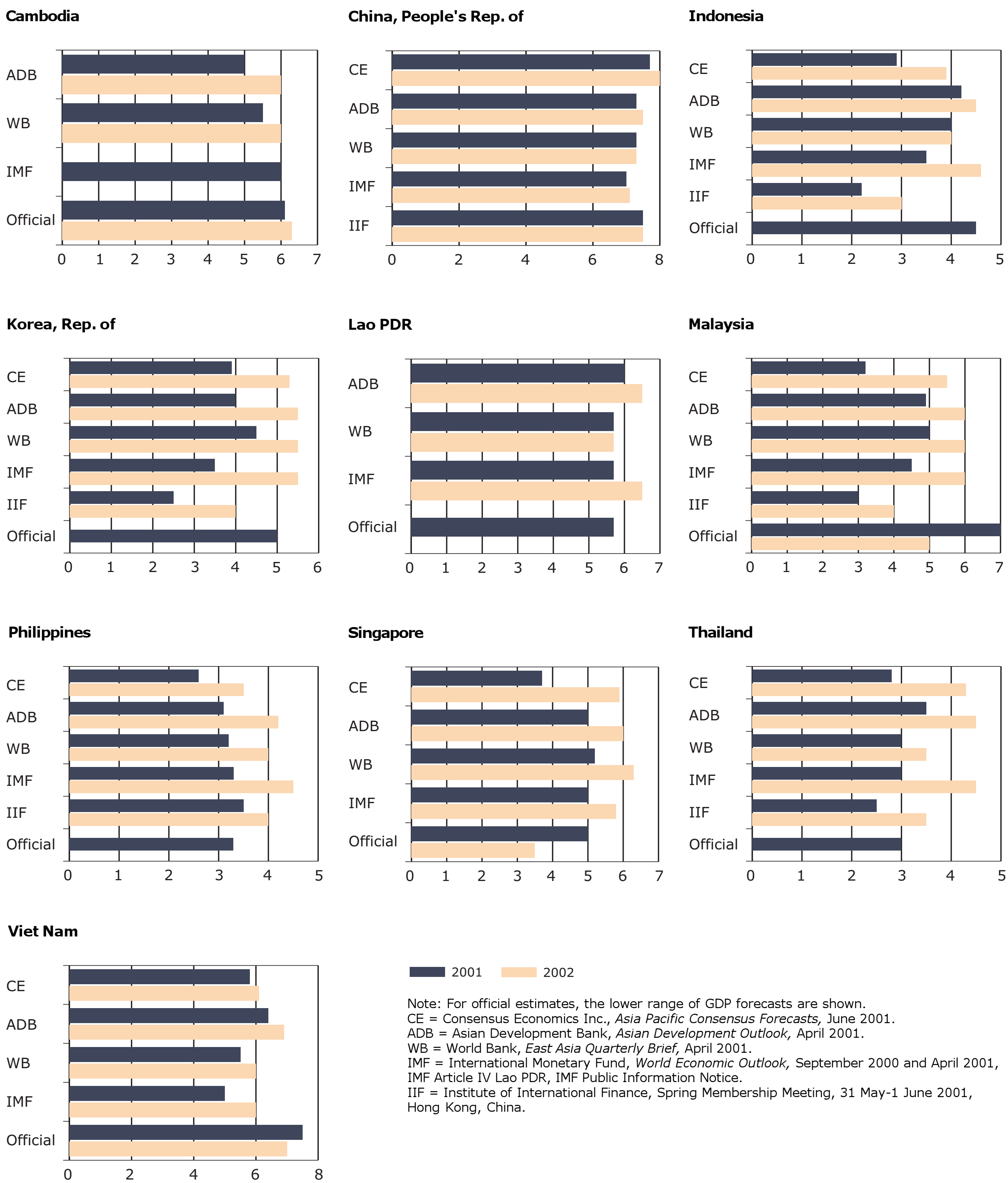
Once again, just as Korea and Malaysia are taking the sharpest cuts in the 2001 growth, going forward to 2002 they are also the ones most likely to benefit from the pickup in growth momentum in the US and the global economy. The latest Consensus Economics forecasts have growth in 2002 picking up to 5.3 percent in Korea and 5.5 percent in Malaysia. In Indonesia, Philippines, and Thailand, growth is forecast to edge up to the 3.5 to 4.3 percent range in 2002, close to the rates they achieved in 2000. Outside the crisis five, Singapore's growth is forecast to pick up to 5.9 percent in 2002, while the PRC and Viet Nam should post growth rates of 8 percent and 6.1 percent, respectively.

An improvement in the region's growth in 2002 is a strong possibility, but it is by no means guaranteed. Even assuming that the external environment improves by early 2002, there are serious domestic concerns that will have to be addressed quickly if the region is to benefit from the global recovery. In recent months, many countries have seen unfavorable political developments, especially Indonesia. Restoring political stability is crucial for restoring investor confidence, pursuing the reform agenda, and putting countries in a position to benefit from the expected upturn in the global economy in 2002.

Despite the progress to date in financial and corporate restructuring, there is no room for complacency. The more difficult phase of restructuring is yet to come. Note that despite some upgrading of the sovereign credit ratings in recent years, even Korea and Malaysia, which have made the most progress in restructuring among the crisis five, are yet to reach precrisis levels of ratings (Table 2). Private capital inflows to the crisis countries continue to be stunted. With repayments of official debt that was incurred as part of the IMF-led assistance packages falling due, net official flows to many of these countries are going to be substantially negative over the medium term.

Finally, even with the expected pickup in growth rates in 2002, per capita GDP in Indonesia (which accounts for 50 percent of the total population of the five crisis countries) will be 6 percent lower than precrisis levels, while that in Thailand will just about regain lost ground. Moreover, since social recovery generally lags behind recovery in GDP, even with the most favorable growth outcome in the next year, the region's recovery process would be far from complete.

Figure 27: **Comparative 2001 and 2002 GDP Growth Forecasts for East Asian Countries** (%)



Note: For official estimates, the lower range of GDP forecasts are shown.
CE = Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* June 2001.
ADB = Asian Development Bank, *Asian Development Outlook,* April 2001.
WB = World Bank, *East Asia Quarterly Brief,* April 2001.
IMF = International Monetary Fund, *World Economic Outlook,* September 2000 and April 2001, IMF Article IV Lao PDR, IMF Public Information Notice.
IIF = Institute of International Finance, Spring Membership Meeting, 31 May-1 June 2001, Hong Kong, China.

Table 2: **Foreign Currency Long-Term Sovereign Credit Ratings***

	Item	Indonesia		Rep. of Korea		Malaysia		China		Philippines		Singapore		Thailand		Viet Nam	
Moody's	Current Outlook	Stable		Stable		Stable		Stable		Negative		Stable		Stable		Stable	
	Ratings	B3	20-Mar-98	Baa2	16-Dec-99	Baa2	17-Oct-00	A3	10-Sep-93	Ba1	18-May-97	Aa1	18-Jan-96	Baa3	22-Jun-00	B1	9-Jul-98
		B2	9-Jan-98	Baa3	12-Feb-99	Baa3	14-Sep-98	Baa1	8-Nov-89	Ba2	12-May-95	Aa2	24-May-94	Ba1	21-Dec-97	Ba3	17-Apr-97
		Ba1	21-Dec-97	Ba1	21-Dec-97	Baa2	23-Jul-98	A3	18-May-88	Ba3	1-Jul-93	Aa3	20-Sep-89	Baa3	27-Nov-97		
		Baa3	14-Mar-94	Baa2	10-Dec-97	A2	21-Dec-97							Baa1	1-Oct-97		
				A3	27-Nov-97	A1	15-Mar-95							A3	8-Apr-97		
				A1	4-Apr-90									A2	1-Aug-89		
				A2	18-Nov-86												
Standard & Poor's	Current Outlook	Negative		Positive		Stable		Stable		Negative		Stable		Stable			
	Ratings	CCC+	21-May-01	BBB	11-Nov-99	BBB	11-Nov-99	BBB	21-Jul-99	BB+	21-Feb-97	AAA	6-Mar-95	BBB-	8-Jan-98		
		B-	2-Oct-00	BBB-	25-Jan-99	BBB-	15-Sep-98	BBB+	14-May-97	BB-	2-Jul-93	AA+	6-Sep-91	BBB	24-Oct-97		
		SD	17-Apr-00	BB+	18-Feb-98	BBB+	24-Jul-98	BBB	20-Feb-92			AA	24-May-89	A-	3-Sep-97		
		CCC+	31-Mar-99	B+	22-Dec-97	A-	17-Apr-97							A	29-Dec-94		
		SD	30-Mar-99	BBB-	11-Dec-97	A	23-Dec-97							A-	26-Jun-89		
		CCC+	15-May-98	A-	25-Nov-97	A+	29-Dec-94										
		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		Stable		Positive		Stable		Stable		Stable		Stable			
	Ratings	B-	16-Mar-98	BBB+	30-Mar-00	BBB	7-Dec-99	A-	11-Dec-97	BB+	8-Jul-99	AA+	18-Nov-98	BBB-	24-Jun-99		
		B+	21-Jan-98	BBB	24-Jun-99	BBB-	26-Apr-99							BB+	14-May-98		
		BB-	8-Jan-98	BBB-	19-Jan-99	BB	9-Sep-98										
		BB+	22-Dec-97	BB+	2-Feb-98	BBB-	13-Aug-98										
		BBB-	4-Jun-97	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.
*Please refer to Annex in Regional Overview of the *Asia Recovery Report,* March 2001 for description of ratings.
Sources: Web sites of Moody's, Standard and Poor's, and Fitch.