Tracking Asia's Recovery—A Regional Overview

Introduction

In year 2000, the gains in regional equity prices and currency values posted in 1999 were largely wiped out. But the real sector turned in its best performance since the crisis began. The five countries most affected by the crisis—Indonesia, Republic of Korea (henceforth, Korea), Malaysia, Philippines, and Thailand—grew collectively by an estimated 7.1 percent in 2000, compared to 6.9 percent in 1999. Bank and corporate sector restructuring also made some progress.

Despite a shadow cast over near-term prospects by the slowdown of the US and global economies, and a cooling off in the rapid growth of global electronics demand, regional incomes will expand in 2001, although at a slower pace than in 2000. This should help social recovery. Regional asset markets may fare better in 2001 compared to 2000, net private capital inflows may resume, and monetary policy is likely to remain broadly accommodating.

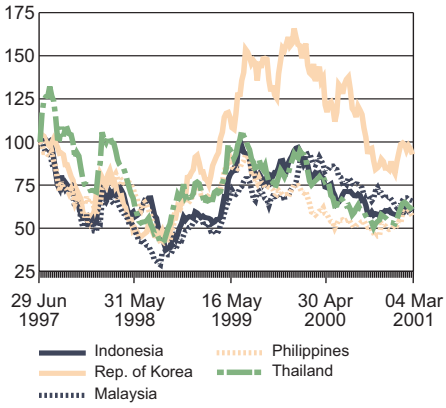
Although fears of a new crisis have been exaggerated, serious challenges remain. Corporate restructuring is slow and a backlog of more difficult cases, often involving multiple creditors and debtors, remains. Real asset markets have been slow to adjust, with liquidations, mergers, and takeovers comparatively few. The agenda of operational restructuring, including how corporations are managed and governed, and conduct their business, lags behind balance sheet restructuring. Financial sector recovery, too, is still only partial. Bank balance sheets, while stronger, remain fragile and credit flows are still stunted. Public debt has risen to a level where scope for deficit spending measures to offset demand shocks has been narrowed. Social recovery has lagged behind broader macroeconomic recovery and means have to be found to distribute the benefits of growth in a more equitable way. Prospects for sustained growth in the medium term—and beyond—will require measurable progress in each of these areas.

Recovery in 2000

Financial and Asset Market Developments

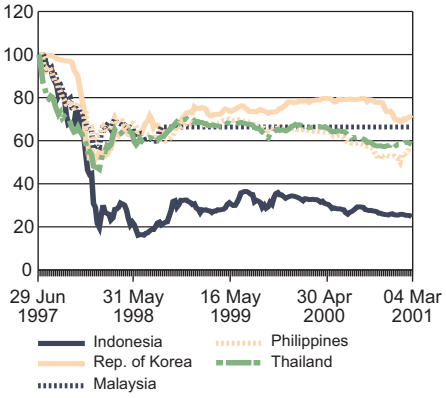
Despite an acceleration of growth, an erosion of equity values in 2000 left some regional equity markets more or less where they were at the

Figure 1: **Composite Stock Price Index*** (last week of 1997June=100)



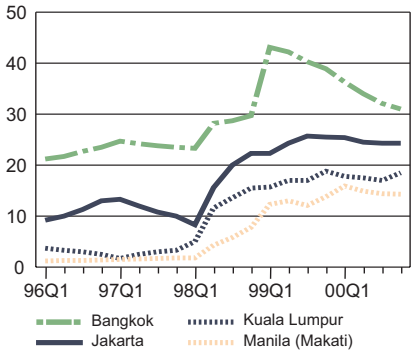
*Weekly averages of JCI (Indonesia), KOSPI 200 (Korea), KLCI (Malaysia), PHISIX (Philippines), and SET Index (Thailand).
Source: ARIC Indicators.

Figure 2: **Exchange Rate Index** (weekly average, last week of 1997June=100, $/local currency)



Source: ARIC Indicators.

Figure 3a: **Office Property Vacancy Rates** (%)



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

beginning of 1999 in local currency terms. While domestic factors, including, to varying degrees, heightened political risks, fragile fiscal balances, and concerns over the pace of bank and corporate restructuring, played their part in the erosion of equity values, the regional decline was also part of a broader global trend. Increases in US interest rates in late 1999 and early 2000, and a slowdown in the pace of electronics orders, which hit information technology (IT) stocks hard, also took their toll.

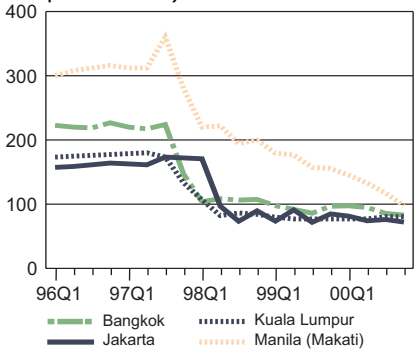
The first few weeks of 2001 have seen a welcome rally in most regional equity markets. Cuts in US dollar interest rates, with the prospect of more to come, the resolution of political uncertainties in some countries, and historically low price-to-earnings ratios have helped support demand for equities. Despite the continued poor performance of the NASDAQ, which is now at its lowest level in more than two years, local markets have sustained their gains. But the relief is still very much partial. Equity values in Indonesia, Malaysia, Philippines, and Thailand are (at end-February 2001) still about 30-40 percent below their June 1997 levels. In Korea, the corresponding gap is 7 percent (Figure 1). In dollar terms, losses measured relative to earlier peaks are larger still.

Through 2000, falling equity values were accompanied by a depreciation of domestic currencies compared to the US dollar—in Indonesia, by 27 percent; Korea, by 10 percent; Philippines, by 20 percent; and Thailand, by 14 percent (Figure 2). While not insignificant, these depreciations were no larger than those seen in some other currencies, such as the euro or Australian dollar. Again, global as well as domestic factors were at work. In particular, rising US dollar interest rates made assets denominated in regional currencies less attractive. International investors also shunned emerging markets across the globe for the safety of home-based, indexed portfolios.

Of course, concerns over the pace of reforms and political uncertainties played their part in the erosion of the value of domestic currencies. Scheduled debt repayments in Indonesia and Thailand also underpinned a strong demand for US dollars. In Korea, a weakening balance of payments position toward the end of the year placed the won under pressure. Meanwhile, rising world oil prices hit the currencies of net fuel importing economies such as the Philippines and Thailand, and continued ethnic unrest in Indonesia has increased selling pressure on the rupiah in recent weeks.

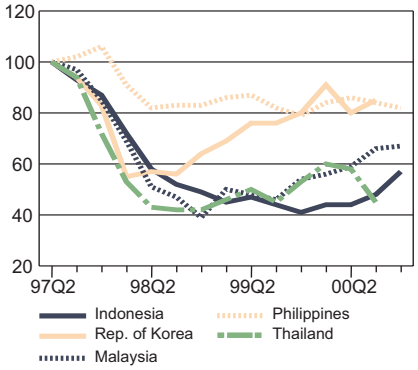
Property markets were badly hit during the crisis. While they have yet to recover, evidence is accumulating that the worst is over. Office vacancy rates remain high and have seesawed from quarter to quarter. Nevertheless, they have generally continued on a downward trend through most of 2000 (Figure 3a). In Malaysia, the office vacancy rate

Figure 3b: **Office Property Rents** ($ per square meter per annum)



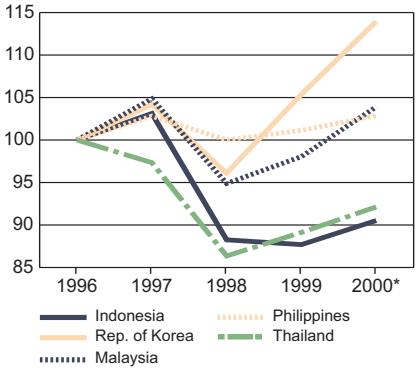
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Figure 4: **Real Gross Domestic Investment Index** (1997Q2=100), seasonally adjusted



Source: ARIC Indicators.

Figure 5: **GDP Per Capita Index** (1996=100)



*GDP for Indonesia, Malaysia, and Philippines are actual values. GDP for Korea and Thailand were based on projections by Consensus Economics. Population estimates were based on national population censuses, except for Indonesia, where the 2000 level was based on the 1999 growth rate.
Sources: ARIC Indicators; Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001; and national statistics offices of Indonesia, Korea, Malaysia, Philippines, and Thailand.

edged up in the last quarter. There were no signs of recovery in office rents in dollar terms (Figure 3b). The luxury residential property market is starting to pick up, but the pattern of recovery is patchy across cities and different segments of the market.

Real Sector Developments

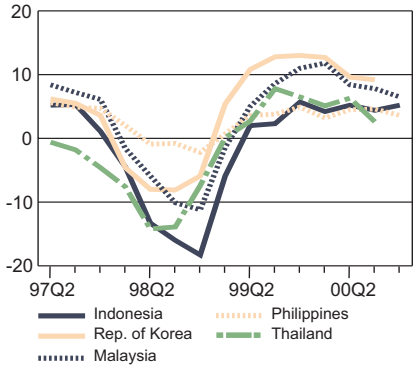
In contrast to the beleaguered asset markets, the real sector performed better in 2000 than in any year since the crisis. Indonesia grew by an estimated 4.8 percent, 0.8 percentage point higher than the Government's own projection. Although the official estimate of growth in 2000 is still not available for Korea, its outcome will likely surprise on the upside. Estimates suggest that year-on-year (y-o-y) growth in 2000 may have reached more than 9 percent. In Malaysia, meanwhile, growth surged to 8.5 percent in 2000, surpassing initial government estimates. For the Philippines, growth in 2000 is now officially estimated at 3.9 percent, quite close to what was expected. However, in Thailand, actual growth is likely to be about 4.5 percent, short of an initial projection of 5 percent.

The supply and demand components of growth are described in Box A. The main discernable feature here is that the structure of growth, both on the demand and supply side, has become more balanced. Even domestic investment, which had for a long time lagged behind, is beginning to pick up in some economies (Figure 4).

There was further recovery of incomes lost during the crisis years. By the end of 1999, per capita incomes in Korea had already surpassed their previous, 1997, peak level. During 2000, the Philippines joined Korea in recouping real incomes. Other countries narrowed the gap. Thanks to solid growth in 2000, Malaysia looks set to fully recover lost income by the end of 2001. However, it may not be until 2003 before Thailand makes up lost ground, and longer still before Indonesia can restore per capita incomes to precrisis levels (Figure 5).

The tempo of recovery is, however, slowing. As 2000 progressed, growth began to taper off, most noticeably in Korea, Malaysia, and Thailand (Figure 6). To some extent, this reflects the low base from which the earlier expansion of output was measured and a reversion to more sustainable rates of growth, particularly in Korea and Malaysia. But economic activity is now being affected by the slowdown in US and global growth that started in the second half of 2000. As Table 1 shows, this has been reflected in a sharp contraction in the rate of growth of exports in all countries.

Figure 6: **Real GDP Growth** (%, y-o-y)



Source: ARIC Indicators.

Table 1: **Exports—Percent Change of Latest* Seasonally Adjusted Monthly Level from Peak**

	All Exports		Electronics Exports	
	Peak	% Change From Peak	Peak	% Change From Peak
Indonesia	Sep 00	-4.3	. . .	. . .
Korea, Rep. of	Aug 00	-12.2	Sep 00	-15.0
Malaysia	Sep 00	-16.6	Aug 00	-12.7
Philippines	Dec 00	-23.3	Dec 00	-11.6
Thailand	Aug 00	-8.2	Nov 00	-3.4

. . . = not available.
*As of January 2001 for Indonesia and Philippines, November 2000 for Korea, December 2000 for Malaysia and Thailand.
Sources: Bloomberg; web sites of Bank of Korea, Bank Negara Malaysia, and Bank of Thailand.

Box A: **Drivers of Asia's Recovery—Sources of Growth**

Figures A-1 to A-10 break down the contribution of the components of demand and supply to overall gross domestic product (GDP) growth. Each bar in the charts is calculated as the product of the percentage change, measured year-on-year (y-o-y), in the expenditure or output category and its base share of GDP. Calculated in this way, the sum of the individual components of growth (from either the demand or supply side) is roughly equal to overall GDP growth.

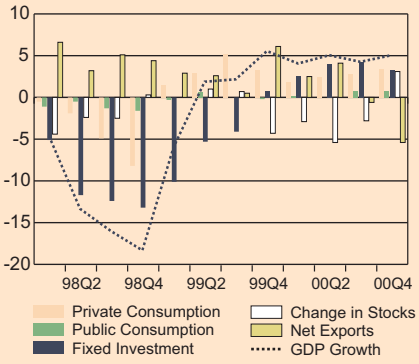
Figures A-1 to A-5 show that it was net exports that tempered the economic contraction and initially led the recovery in most of the affected countries. As recovery progressed, however, domestic demand increasingly became an important source of growth. This was most evident in Korea and Malaysia, where investment and private consumption have been contributing more than 50 percent to growth since late 1999. In Indonesia, too, the combined contribution to growth of private consumption and investment has been expanding since the second half of 2000. But, more important, the fixed component of domestic investment has begun to support growth in Indonesia, Korea, and Malaysia.

While external demand has remained an important source of growth in Thailand, public and private consumption have provided an additional impetus. As in Thailand, net exports continued to be a major contributor to growth in the Philippines. But private consumption has remained the most consistent growth source. Meanwhile, investment has been slowly increasing its contribution to growth since the middle of 2000, but this was more due to changes in stocks than to increased investment spending.

Figures A-6 to A-10 show the contribution to growth by production categories. In the initial stages of recovery, manufacturing led the way in Korea, Malaysia, and Thailand. As recovery advanced, services became another important source of GDP growth.

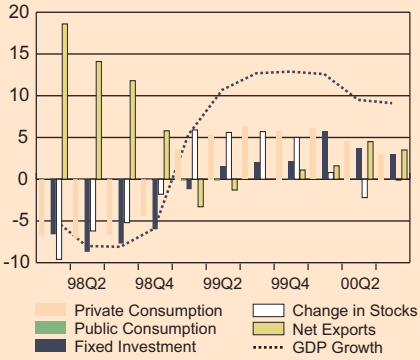
While manufacturing also supported Indonesia's recovery process, its contribution has been less pronounced than in Korea, Malaysia, and Thailand. It is the services sector that has largely propelled Indonesia's economic growth since the middle of 1999. In addition, agriculture has once again contributed positively to growth. In the Philippines, the manufacturing sector has recently begun to contribute to growth, although the services sector remained the dominant source. Agriculture's contribution, on the other hand, faded slightly in 2000.

Figure A-1: **Indonesia Contribution to Growth by Expenditure Categories** (%)



Sources: Statistics Indonesia and Bank Indonesia.

Figure A-2: **Republic of Korea Contribution to Growth by Expenditure Categories** (%)



Source: Ministry of Finance and Economy.

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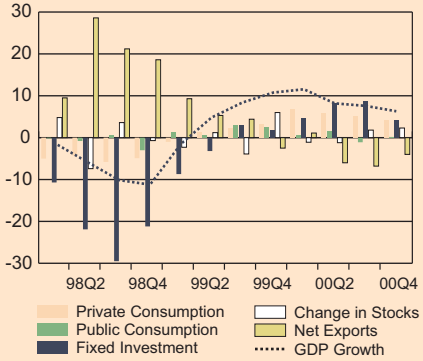
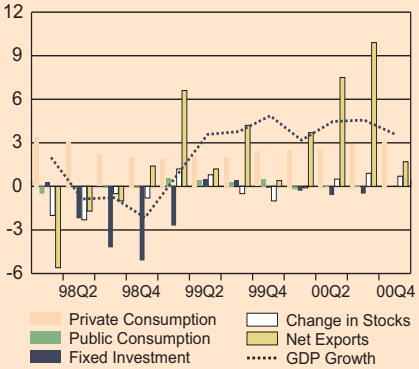
Figure A-3: **Malaysia Contribution to Growth by Expenditure Categories** (%)



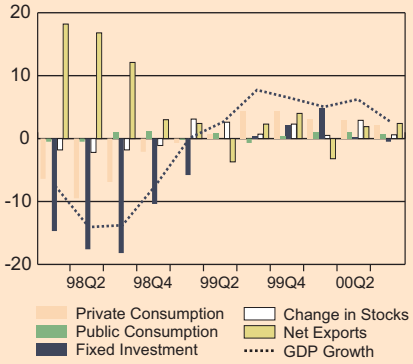
Sources: Bank Negara Malaysia and Department of Statistics.

Figure A-4: **Philippines Contribution to Growth by Expenditure Categories** (%)



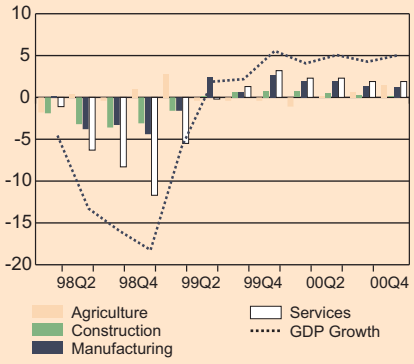
Source: National Statistical Coordination Board.

Figure A-5: **Thailand Contribution to Growth by Expenditure Categories** (%)



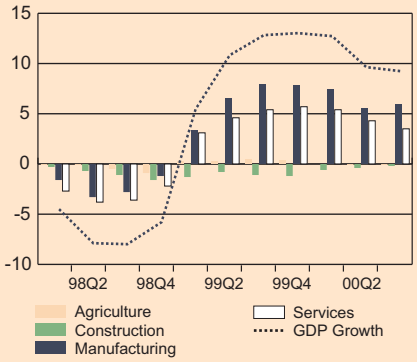
Source: National Economic and Social Development Board.

Figure A-6: **Indonesia Contribution to Growth by Production Categories** (%)



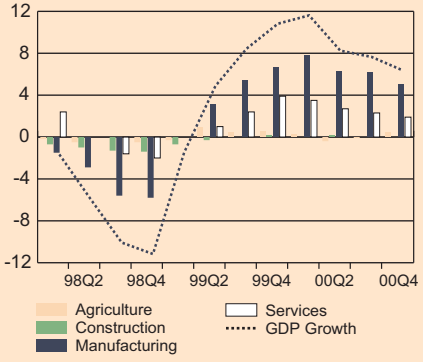
Sources: Statistics Indonesia and Bank Indonesia.

Figure A-7: **Republic of Korea Contribution to Growth by Production Categories** (%)



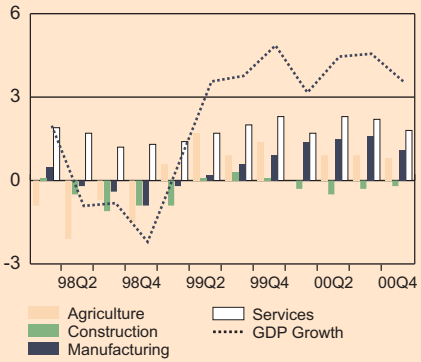
Source: Ministry of Finance and Economy.

Figure A-8: **Malaysia Contribution to Growth by Production Categories** (%)



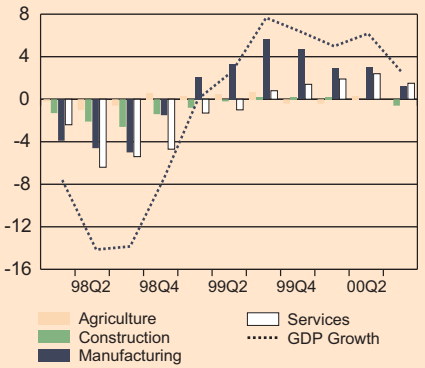
Sources: Bank Negara Malaysia and Department of Statistics.

Figure A-9: **Philippines Contribution to Growth by Production Categories** (%)



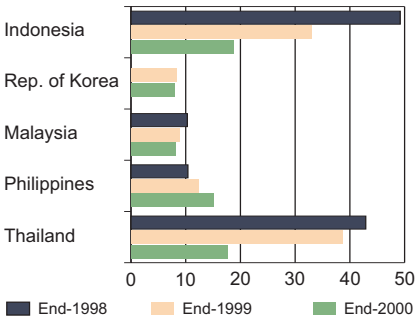
Source: National Statistical Coordination Board.

Figure A-10: **Thailand Contribution to Growth by Production Categories** (%)



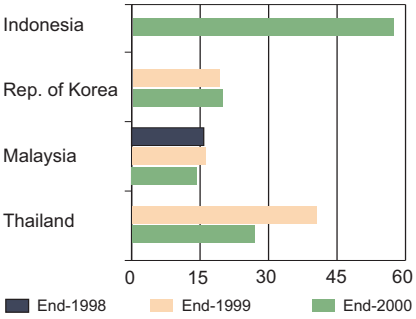
Source: National Economic and Social Development Board.

Figure 7: **NPLs of Commercial Banks*** (% of total commercial bank loans)



*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. End-2000 data for Korea are as of September. NPLs are on a three-month accrual basis.
Sources: Web sites of Bank Indonesia; the Financial Supervisory Service, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; and Bank of Thailand.

Figure 8: **NPLs Including Transfers to AMCs*** (% of total loans)



*NPLs cover the banking system for Indonesia and Malaysia and the financial system for Korea and Thailand. End-2000 data for Korea are as of September; for Malaysia, as of November for AMCs' NPLs and December for the banking system's NPLs. NPLs are on a three-month accrual basis.
Sources: Web sites of Bank Indonesia and the Indonesian Bank Restructuring Agency; Financial Supervisory Service and Korea Asset Management Corporation; Bank Negara Malaysia and Danaharta; and Bank of Thailand.

Bank and Corporate Restructuring

Work on restructuring the banking and corporate sectors continued in 2000. But much remains to be done.

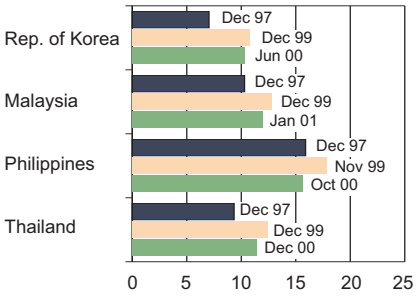
PROGRESS IN BANK RESTRUCTURING. Commercial banks' nonperforming loan (NPL) ratios, on a three-month accrual basis, continued to fall throughout 2000 in all the affected countries, except the Philippines, where the level edged up (Figure 7). By the end of 2000, Thailand's NPL ratio had declined to 17.7 percent, bettering the Government's year-end target of 25 percent. In Indonesia, as of December 2000, the ratio for the banking sector was reported at 18.8 percent, a substantial improvement on the peak levels recorded in early 1999.

Despite these achievements, NPL ratios, including those of Korea and Malaysia, remain high. While some debts have been restructured and voluntary servicing of previously impaired loans has recommenced, a substantial part of the NPL reduction can be accounted for by 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, a truer picture of underlying difficulties emerges (Figure 8). Although aggregate NPLs are falling, many of the problem loans transferred to AMCs are awaiting resolution through disposal or workouts.

A comparatively recent aspect of the NPL problem is the growing reclassification of previously restructured loans as nonperforming. In all the five 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. Doubts also exist over the classification and valuation of some loan assets, and therefore of the true magnitude of embedded losses in NPL portfolios. For some institutions, these are possibly much larger than has been disclosed.

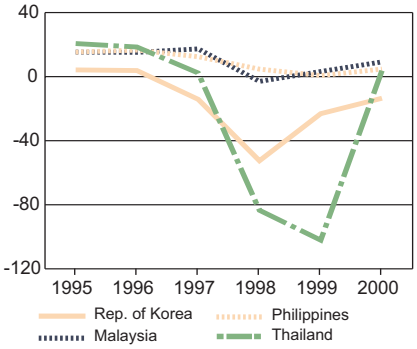
In all the affected countries, except Indonesia, official estimates of banking sector capital satisfies the current Basle Capital Accord minimum recommended standard of 8 percent (Figure 9). However, care has to be exercised in interpreting these ratios. Capital adequacy ratios (CARs) tend to be a lagging rather than a leading indicator of financial robustness. Also, in some cases, asset values may have been inflated to avoid loan loss recognition and provisioning needs. Besides, it is not clear that a CAR in excess of 8 percent provides adequate

Figure 9: **Capital Adequacy Ratios of Commercial Banks** (%)



Sources: Web sites of the Financial Supervisory Service, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; and Bank of Thailand.

Figure 10: **Banking Sector Profitability***



*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.

protection against the risks that banks in emerging markets face. Indeed, proposals contained in the New Basle Capital 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. Leaving these caveats aside, there was a notable deterioration in reported CARs for Korea, Malaysia, Philippines, and Thailand in 2000. Information is not available on capital adequacy for Indonesia's banking system. But among the seven banks that have been recapitalized with the assistance of the Indonesian Bank Restructuring Agency (IBRA), their CAR was reported to be about 10 percent as of December 2000.

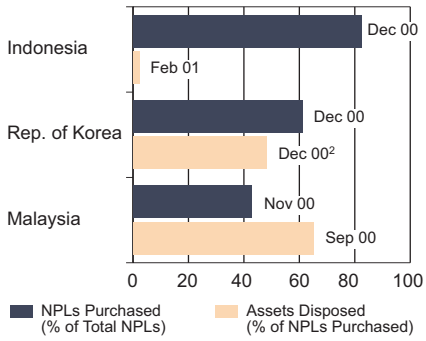
Domestic banks in all the affected countries, except the Philippines, incurred substantial losses during the crisis years, due to loan loss provisions, loan write-offs, and reduced lending. The fact that some banks are gradually returning to profitability suggests that margins must be improving as creditworthy borrowers pay off their debts (Figure 10). Going forward, this should eventually augur well for balance sheet strength.

The process of rehabilitating banks' balance sheets is closely intertwined with the task of restructuring corporate and other debts. During 2000, corporate debt restructuring, under the auspices of centralized and publicly-owned asset management entities, moved forward. Progress in the acquisition and disposal of impaired loan assets has been quickest in Korea and Malaysia (Figure 11). In Indonesia, while more than 80 percent of the banking system's NPLs have been transferred to IBRA, less than 3 percent have been disposed of. Meanwhile, the new administration in Thailand has recently announced its intention to create a centralized AMC that will carve out $28 billion of impaired loans from State and private banks.

The recovery of asset values has been greatest in Malaysia and lowest in Indonesia (Figure 12). Although recovery values have also been modest in Korea, assets were acquired by the Korea Asset Management Corporation (KAMCO) at a deep discount. Before expenses, the Korean and Malaysian AMCs made profits from their loan asset disposal activities.

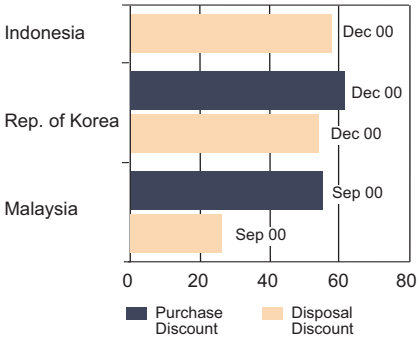
PROGRESS IN CORPORATE RESTRUCTURING. In tandem with asset disposal, measures intended to facilitate corporate restructuring have been moving forward. Nevertheless, problems remain. In Korea, resolving the financial difficulties of *chaebols* remains a pressing concern. In November 2000, the country introduced a corporate restructuring

Figure 11: **NPLs Purchased and Disposed of by AMCs[1]** (%)



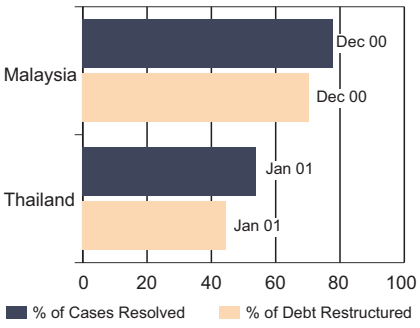
[1] NPLs purchased and disposed of refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia as of the dates indicated.
[2] NPLs acquired as of December 2000 as percent of total NPLs as of September 2000.
Sources: Web sites of Bank Indonesia, IBRA, KAMCO, Bank Negara Malaysia, and Danaharta.

Figure 12: **Discount Rates on NPL Purchases and Disposals by AMCs*** (%)



*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia as of the dates indicated.
Sources: Web sites of IBRA, KAMCO, and Danaharta.

Figure 13: **Government-Supervised Voluntary Workouts***



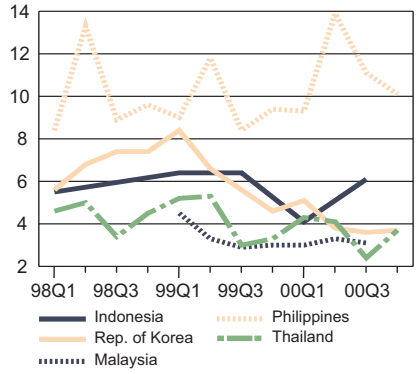
*Data refer to cases registered under CDRC (Malaysia) and CDRAC (Thailand).
Sources: Web sites of CDRC and CDRAC.

vehicle (CRV) system, which aims to improve Korean financial institutions' capital structures by removing from their balance sheets impaired loans owed by ailing firms that are already under workout programs. In December 2000, additional funding was also made available for the second round of corporate and financial restructuring.

However, the restructuring of the top Korean *chaebols* remains a formidable challenge. In November 2000, the Government forced Daewoo Motors (DM) into bankruptcy. But normal operations were unable to continue under receivership. Two of DM's three main plants closed as subcontractors refused to supply parts except for cash. Workers in Daewoo are resisting retrenchment proposals. Some 34 Daewoo executives and accountants have now had charges of fraud leveled against them for inflating the book value of assets. Amid the fallout from Daewoo, the Korean Government has softened its position somewhat on the restructuring of Hyundai Engineering and Construction (HEC).

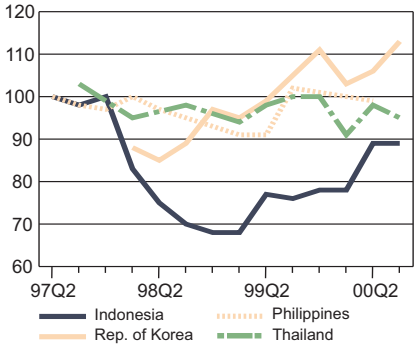
Despite impressive achievements by the Corporate Debt Restructuring Committee (CDRC), restructuring in Malaysia has tended to focus on lengthening the maturity of loans and forgiving interest payments rather than restructuring the operations of debtors. Thailand's Corporate Debt Restructuring Advisory Committee (CDRAC)

Figure 14: **Unemployment Rate** (%), seasonally unadjusted



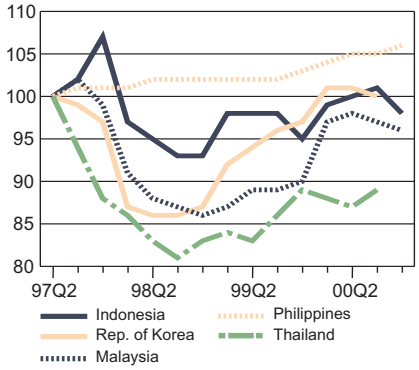
Source: ARIC Indicators.

Figure 15: **Real Wage Rate Index** (1997Q2=100), seasonally unadjusted



Source: ARIC Indicators.

Figure 16: **Per Capita Real Private Consumption Index** (1997Q2=100), seasonally adjusted



Source: ARIC Indicators.

has also made considerable progress in debt workouts (Figure 13), but there is a growing list of cases being referred to the bankruptcy courts. It seems unlikely that Thailand's bankruptcy courts will be able to deal with these expeditiously. In Indonesia, although debt rescheduling by the Jakarta Initiative Task Force (JITF) is still some $2.6 billion short of the April 2001 target agreed upon with the International Monetary Fund (IMF), there has been a significant acceleration in the pace of restructuring over the past six months.

Social Sector Developments

Economic recovery and renewed growth have led to an improvement in job prospects, increases in real wages and private consumption, and have contributed to a measure of social sector recovery.

In Indonesia, Korea, and Thailand, quarterly unemployment rates in 2000 were mostly lower than their respective levels one year earlier (Figure 14). The reduction was particularly sharp in Korea and Thailand as new jobs were created in an expanding economy. However, in the Philippines, despite positive growth, the recorded unemployment rate rose, as new jobs could not keep up with the expansion in labor supply. The underlying rate of population growth in the Philippines is 2.3 percent and the labor force is expanding at about the same rate each year.

Data on real wages are incomplete, but they show that the average real wage rate surpassed its precrisis level in Korea in the third quarter of 1999, reflecting improved labor market conditions (Figure 15). In the Philippines, the real wage index reached its precrisis level in the second half of 1999, but lost ground again in 2000. In Indonesia, although increasing, the real wage remains below its precrisis level. Real wage data are not available for Malaysia.

Real per capita private consumption began recovering in early 1999. In the Philippines it never fell below precrisis levels (Figure 16), while in Indonesia, Korea, and Malaysia it has recovered substantially, with Korea reaching its precrisis peak. However, in Thailand, real per capita private consumption was still about 10 percent below its precrisis level as of the third quarter of 2000.

World Bank data and projections suggest that the incidence of poverty has begun to fall with the renewal of economic growth. Based on a consumption poverty line of $1.5 per day per person, the incidence of poverty in Malaysia is negligible. In the Philippines, the share of the

poor in the total population is expected to fall from 27.5 percent in 1997 to about 25.4 percent in 2001. Indonesia has the highest incidence of poverty among the five countries, rising to a peak of 37 percent in 1999. This number is projected to fall to about 32 percent in 2001. In Thailand, it is projected to fall to 12.2 percent in 2001. However, with growth expected to slow in 2001, reductions in the incidence of poverty will come more slowly than anticipated just a few months ago.

Domestic and External Risks to Recovery

Since the last issue of the *Asia Recovery Report* (*ARR*) (October 2000), the downside risks to recovery in the affected countries have increased. In October 2000, the growth outturn in 2001 was projected to be higher than that in 2000 in Indonesia, Philippines, and Thailand; while in Korea and Malaysia, growth was expected to moderate to a more sustainable pace. In the last five months, however, there has been a heightening of downside risks. The US and global economies have slowed more quickly than anticipated, and the electronics sector is quickly losing momentum. Within the region, the picture is mixed. Political uncertainties have come to the fore in some countries but receded in others. Progress on reforms is uneven.

Domestic Risks

In the last few months of 2000, political uncertainties in Indonesia, Philippines, and Thailand had, to varying degrees, a negative impact on market sentiment and investor confidence. In Indonesia and Philippines, corruption allegations against sitting presidents caused jitters in equity and currency markets. Difficulties were further compounded by provincial ethnic conflicts. Pending elections created uncertainty in Thailand, although a coalition with a large majority has now been formed. Political risks have now receded in the Philippines following a peaceful change in administration.

In Indonesia, political uncertainties continue to cloud the horizon, bringing with them a number of serious economic problems. Largely as a consequence of measures taken to stabilize its financial system during the crisis years, the country now faces exceptionally difficult fiscal circumstances. Interest on government debt alone absorbed 54 percent of tax revenue in 2000, and is budgeted to absorb 42.5 percent in 2001. To finance these commitments, the Government

hopes to use the proceeds of the sales of impaired assets acquired by IBRA. While these sales are currently on target, more needs to be done to render the process transparent and to address the concerns of potential investors. The implementation of fiscal decentralization plans, in the absence of appropriate fiscal controls, also threatens budgetary stability.

In Indonesia, beyond asset disposal, there are difficult restructuring issues to be broached. Lenient treatment of debtors, many of whom are politically powerful, continues. Recent proposals threaten the independence of Bank Indonesia, while frequent changes of management at IBRA undermine its credibility. On top of this, inflation has edged up to 8.9 percent in the fourth quarter of 2000. Rising interest rates are needed both to combat inflation and support a currency that is being weakened by investor nervousness on reports of continued ethnic violence.

In the Philippines, the new administration faces a legacy of problems, some long-standing, others a consequence of mismanagement by the previous administration. Latest estimates suggest that the budget deficit in 2000 was more than twice its targeted level, resulting in a further increase in public debt. In this difficult context, measures are urgently required to relieve pressures on the poorest segments of the population.

The incoming administration in Thailand is still working out the details of how it will implement and finance the policies and programs on which it was elected. It has already announced the creation of a centralized Thailand Asset Management Company (TAMC) that will carve out $28 billion of impaired loans from the banking system. While this should help strengthen banks' financial positions, it may do little in the short run to get credit flowing as many potential borrowers are still perceived as bad risks. There are also concerns over the broad fiscal implications of proposed measures. Scope for fiscal relaxation is limited given that government debt has already escalated sharply. The suggested subjugation of monetary to fiscal policy and the implied abandonment of inflation targeting could also raise apprehensions about the coherence of the evolving macroeconomic policy framework.

Faltering progress on corporate restructuring in the affected countries will continue to pose risks to the financial sector, undermine confidence of domestic and foreign investors, and threaten the sustainability of recovery. While there has been progress on debt

resolution, the most difficult cases, often involving politically powerful and large debtors, have yet to be tackled. In Indonesia and, to a lesser extent, in Thailand, the insolvency framework remains biased against creditors and bankruptcy courts are not proving effective in spurring voluntary debt resolution. The slow pace of needed operational restructuring is another cause for concern. At a micro level, many companies remain too diversified and are burdened by excess capacity. Poor corporate governance practices, an absence of disclosure, and, on occasion, an inhospitable political climate have also deterred nonresidents from providing much needed finance and strategic expertise to restructuring efforts.

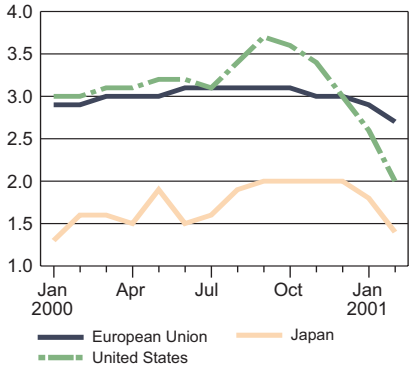
Nevertheless, several reforms were introduced in 2000, including the enactment of a Foreclosure Law and Debt Collection Regime in Thailand. In Korea, corporate restructuring vehicles were introduced. Also, the Securities and Exchange Commission law was amended in the Philippines. The effectiveness of these measures has, however, yet to be tested. More efforts are needed to help create an environment of improved corporate and financial governance that provides adequate protection for minority shareholders and creditors alike.

The confluence of these domestic risks is, in the short term, unlikely to trigger a new crisis. But if problems were to be left untended, the five countries would become more susceptible to shocks, possibly jeopardizing medium-term prospects of stable economic growth and a secure financial system.

External Risks

In the October 2000 issue of the *ARR*, two major external risks were discussed: high oil prices and a possible hard landing for the US economy. The first threat has receded somewhat. While the behavior of the Organization of Petroleum Exporting Countries (OPEC) and tensions in the Middle East have created uncertainties, as 2001 unwinds, a slowing global economy, the arrival of warmer weather in the Northern Hemisphere, and price-induced reductions in demand should put downward pressure on the price of oil. On the other hand, the global and US economies are slowing faster than most expected (Figure 17). The potential impacts on the affected countries of a coincident slowing of the US economy and a sharp downturn in the global electronics market merit careful scrutiny. Previously, dips in electronics growth have been mitigated to some extent by stable growth in the broader global economy.

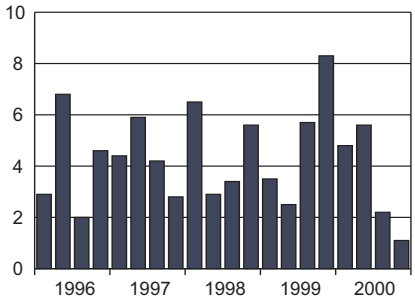
Figure 17: **Consensus Forecasts of 2001 GDP Growth** (%, y-o-y)



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

To these risks could be added the possible specter of another wave of destabilizing contagion in emerging markets. In late February 2001, Turkey was compelled to float the Turkish lira and remove exchange controls. Its equity market fell 18 percent in one day and $7 billion of foreign exchange reserves were lost. Overnight interest rates increased to more than 4,000 percent. These events followed investor reaction to the news that the International Monetary Fund (IMF) might have to suspend its three-month old assistance package to Turkey. Although Turkey accounts for only 2 percent of emerging market debt, ripples from these events were felt in Russia and as far away as Latin America, where equity markets, currencies, and spreads came under pressure. Although Asian exchange rates and bourses seem to have been largely unaffected by these events, they serve as a timely reminder of the merits of strengthening systems of risk management at national and regional levels. Needless to say, a conjunction of emerging market financial instability and a global growth slowdown would be particularly serious.

Figure 18: **US GDP Growth** (%, quarter-on-quarter, annualized)



Source: Bloomberg.

Slowing Global and US Economies

When the October 2000 issue of the *ARR* was produced, the US economy appeared to be gliding toward a soft landing. Economic data released toward the end of 2000 and in the early part of 2001 suggest, however, that manufacturing activity, consumption spending, and retail sales have been slowing much more quickly than anticipated. GDP grew by an annualized 1.1 percent in the fourth quarter of last year, down from more than 5 percent in the first half (Figure 18). The US Federal Reserve Board (Fed) was sufficiently concerned about these developments to reduce interest rates by 50 basis points (bp) in early January 2001, ahead of its scheduled federal open market committee meeting. Fearing that growth might be close to zero at the beginning of this year, the Fed then cut its federal funds rate by another half percentage point, to 5.5 percent, at its open market committee meeting on 31 January 2001. Not since 1984 have interest rates been cut by 100 bp in a single month.

Some believe that the US economy is already contracting. Since the first quarter of 2000, the NASDAQ has slumped, surrendering value equivalent to 40 percent of US GDP, and is now trading at levels not seen for two years. The implied loss of personal and corporate wealth is substantial. As earlier capital gains had been fueling consumption, and compensating for reduced saving out of personal income, incomes may now have to be diverted from consumption to servicing debts and maintaining wealth. The demand repercussions of this could be substantial.

There seem to be two main threats to the Consensus forecast of 2 percent growth for the US economy in 2001. The first is that investment spending may slow much more quickly than most anticipate. There is accumulating evidence that the cash flow and earnings positions of corporate America are quickly deteriorating. If these trends are maintained, then investment expenditures are likely to be pared back even further, leading to a more protracted and perhaps sharper slowdown than is now expected. A large dip in investment expenditures would also put at risk the productivity gains that are the locomotive of the "New Economy."

The second risk to US growth lies in weakening household, corporate, and, possibly, bank balance sheets. Although equity prices have already fallen, they and other asset prices could drop further and perhaps significantly from their current levels. Making an objective assessment of this risk is difficult since it depends on the extent to which earlier investment decisions have been sensible, expectations of future earnings potential, and whether policy actions can forestall potential dangers. In the short run, demand would also likely suffer if falling US dollar asset prices were to precipitate capital outflows and an accompanying depreciation of the US dollar.

There is a variety of possible ways in which a US slowdown could impact on Asia. The most obvious transmission mechanism would be through trade. But direct investment, financial flows, asset prices, including exchange rates, and the terms of trade may all be affected.

A look at the broad historical record does not provide much insight about how the affected countries are likely to respond to a slowing US economy. Evidence of the past three decades suggests that there has never really been much of a connection between undulations in US economic activity and the pace of growth in most countries of the region. However, there are reasons to think that this relationship may have changed. Today, capital moves more freely across borders than ever before, allowing asset prices to respond quickly to events all over the globe. Moreover, the composition and pattern of trade flows have undergone significant changes in the past decade. An increasing proportion of intra-regional and extra-regional trade is linked through interconnected supply chains and is being driven by capital expenditure on electronics goods in the US.

Can growth elsewhere in the global economy provide additional markets for the affected countries' exports to insulate them from any impacts of a US slowdown? Japan, the second largest trading partner of many regional economies, now looks unlikely to sustain an acceleration of growth. Although investment intentions are strong, industrial

production, consumer spending, business confidence, and prices are down and falling. Underlying structural problems are proving difficult to resolve and, reflecting this, a major credit rating agency has just downgraded Japanese government debt. In early March, the Nikkei fell to a 16-year low. The Japanese Government recently revised its estimate of growth in the third quarter of 2000 from 0.2 percent to -0.6 percent, which came after just two quarters of growth. After downgrading its view of the economy twice in the past two months, the Bank of Japan recently cut its mostly symbolic discount rate on loans from 0.5 percent to 0.35 percent and then to 0.25 percent. Programs for quickening the pace of structural reforms are being drawn up. The Government predicts that the economy will grow by 1.2 percent in the fiscal year ending 31 March 2001 and 1.7 percent in fiscal year 2001. Since Japan is also heavily dependent on exports to the US, slowing growth in the US will add to the country's difficulties.

With about 10 percent of its exports destined for the US market, Europe is relatively less reliant on the US economy than Japan and is not as likely to be affected by a slowdown. Nevertheless, economic growth in 2001 in Europe is also likely to edge lower amid weaker global demand. A prospective appreciation of the euro is expected to reduce export growth. The European Central Bank predicts that the growth outturn for 2001 will be just below 3 percent. While Europe is not an unimportant market for the affected countries, it ranks a distant fourth behind the US, Japan, and the other regional economies of East and Southeast Asia. Diversifying and increasing market penetration in Europe is likely to take some time.

Neither can intra-regional trade be expected to insulate the region from a drop in external demand. Although intra-regional trade links have been strengthening in recent years, the bulk of intra-regional exports still consist of the shipment of components among linked production sites. Since this trade ultimately reflects a derived demand for final goods from more developed countries, such as the US, a slowdown in the US economy will hit intra-regional as well as extra-regional trade. The expected strong growth in the People's Republic of China (PRC) and a broadly stable outlook for India in 2001 should, however, provide some modest support for export demand.

While slower growth in the US and global economy will undoubtedly hit export growth, its knock-on impacts on domestic demand are more difficult to unravel. As net export growth slows, domestic demand will be affected through the usual income channels. But lower US interest rates provide scope for a more accommodating monetary policy.

Indeed, interest rates have already come down in Korea, Philippines, and Thailand. In this context, exchange rates could drift lower and provide some support for net exports. But where banks are reluctant to lend and borrowers are cautious about earnings prospects, the full benefits of easier liquidity may fail to materialize.

A second channel through which the trade impacts of a slowing US economy could be offset is through capital flows. Accompanying rising US interest rates was a net outflow of capital from the region in 2000 (see Box B). It is possible that lower US dollar interest rates and recovery in the region could tempt international investors back to the regional equity markets. Indeed, net inflows of private capital are projected for 2001. If capital inflows materialize, they will help support domestic demand through beneficial wealth effects and, if the flows are not sterilized, through the monetary transmission mechanism too. However, these offsets to reduced export demand are by no means certain and, if they occur, are likely to be of small order. (In the section on foreign direct investment starting on page 76, the evolving patterns of FDI inflows and their influence on recovery are examined in detail.)

It is by no means straightforward to infer what these external developments could mean for growth in the affected countries in 2001. However, using the same framework that was developed in the *ARR* October issue, the possible impacts on the region of a range of growth outcomes for Europe, US, and Japan have been estimated. In Box C, these calculations are explained. Depending on the assumptions made, the range of estimated impacts can vary widely. If demand for exports is highly elastic, and global growth is at the bottom end of the range of current estimates, the estimated impacts are not insignificant, ranging from a slowing of 1 percentage point of growth in Indonesia and Korea to more than 2 percentage points in the Philippines. Naturally, the more insulated an economy is from swings in external demand, the less the measured impact will be for any configuration of projected growth rates in the global economy.

There are a number of limitations surrounding the calculations shown in Box C. One immediate concern is that they may not adequately capture the large dependence of some regional economies on electronics. One way to compensate for this would be to inflate demand elasticities to capture the anticipated disproportionate slowing of electronics exports relative to global GDP growth. But a clearer impression of the possible downdraft resulting from the slowing momentum of global electronics demand can be obtained by looking at what happened in similar, previous episodes and tracing the effects on income and demand.

Box B: **Capital Flows to the Five Affected Countries**

Net private capital flows to the five affected countries remained negative in 2000, for the third consecutive year since their sharp fall precipitated the East Asian financial crisis in 1997. The continued outflow of private capital was one cause of the currency depreciations last year. However, prospects are now brighter, with net private capital flows projected to move into positive territory.

Data from the Institute of International Finance (IIF) show that net repayments to commercial banks continued to be the main source of outflows (Table B-1). However, these moderated between 1999 and 2000. The recorded net outflows are also an indication of subdued credit demand and a reluctance of international creditors to lend, as domestic banks and corporations continue to consolidate their balance sheets. In addition, lower domestic interest rates have made domestic credit sources more attractive. Net outflows to commercial banks are projected to ease from $15.3 billion in 2000 to $5.8 billion this year. On the other hand, outflows of nonbank credit have been relatively steady since 1998.

Meanwhile, net equity investment declined in 2000 after a brief surge in 1999. This was mainly due to a reduction of net portfolio inflows in the affected countries. Volatility of equity prices in industrialized countries and the rise in US interest rates led to the protracted weakness of equity prices in the five affected countries.

However, experiences were mixed among individual countries in 2000 (Table B-2). Thailand experienced a sharp reduction in net portfolio inflows while Indonesia and Malaysia recorded smaller, but still significant, net outflows. Only Korea managed an increase in net inflows of portfolio investment, largely during the first part of the year. IIF reports that the reduced demand for electronics exports led to increased pessimism in the earnings capacity of technology stocks, resulting in significant portfolio equity outflows from Korea and Malaysia in the second half of 2000. Meanwhile, the Philippines experienced a $738 million turnaround in portfolio flows—from a net inflow of $254 million in the first 11 months of 1999 to a net outflow of $484 million in the corresponding period in 2000. Apart from external factors, the Philippines—along with Indonesia and Thailand—was buffeted by political uncertainty. Confidence in the Philippine stock market was also shaken by allegations of insider trading.

Net FDI also declined in 2000 for the five affected countries. The deceleration in Korea is partly attributable to a large increase in direct investment abroad by local firms. FDI was also limited by the failure to complete the planned sales of Daewoo Motor Company and Hanbo Steel to foreign investors. In the case of Thailand, FDI inflows slackened as attractive opportunities to purchase local assets diminished. The Philippines, meanwhile, experienced a modest gain in the first 11 months of 2000.

Table B-1: **Capital Flows to the Five Affected Countries** ($ Billion)

	1995	1996	1997	1998	1999	2000e	2001f
Net External Financing	98.1	118.6	39.5	-15.2	-4.9	-1.2	-6.8
Net Private Flows	94.2	119.5	4.9	-38.7	-5.2	-3.8	1.9
Equity Investment, Net	15.5	16.8	5.2	16.8	30.1	15.6	13.6
Direct Investment, Net	4.4	4.8	6.8	12.3	14.6	9.5	9.0
Portfolio Investment, Net	11.0	12.0	-1.7	4.5	15.4	6.1	4.6
Private Creditors, Net	78.7	102.7	-0.3	-55.5	-35.3	-19.3	-11.7
Commercial Bank Credit, Net	64.9	69.6	-17.4	-48.8	-29.3	-15.3	-5.8
Nonbank Credit, Net	13.8	33.2	17.2	-6.7	-6.0	-4.1	-5.9
Net Official Flows	3.9	-0.9	34.6	23.5	0.2	2.6	-8.6
International Financial Institutions	-0.5	-1.9	22.7	19.7	-4.6	2.5	-7.9
Bilateral Creditors	4.4	1.0	11.9	3.8	4.9	0.1	-0.8

e = estimate; f = forecast.
Source: IIF, January 2001.

Continued next page

Box B: **Capital Flows to the Five Affected Countries** (Cont'd)

Table B-2: **Capital Flows to Individual Countries** ($ Million)

	1995	1996	1997	1998	1999	Jan-Sep 1999	Jan-Sep 2000
Indonesia							
Net Private Flows	10,252	11,510	-339	-13,848	-15,831	-7,576	-6,956
Net Direct Investment	4,345	6,194	4,677	-356	-2,745	-1,820	-2,806
Net Portfolio Investment[1]	5,907	5,005	-2,632	-1,878	-1,792	-1,827	-1,429
Other Private Flows[2]	. . .	-311	-2,384	-11,612	-5,385	-3,929	-2,721
Official Flows	336	-547	2,880	9,971	5,352	5,255	2,760
Net Capital Flows	10,588	10,963	2,541	-3,875	-4,570	-2,321	-4,196
Republic of Korea[3]							
Net Private Flows	17,793	24,409	-13,884	-13,027	9,354	7,027	11,223
Net Direct Investment	-1,776	-2,345	-1,605	673	5,136	4,142	2,870
Net Portfolio Investment	11,591	15,185	14,295	-1,878	8,676	6,900	11,692
Other Private Flows[2]	7,978	11,569	-26,574	-11,822	-4,458	-4,016	-3,340
Official Flows	-519	-485	15,806	9,660	-6,924	-7,044	336
Net Capital Flows	17,273	23,924	1,922	-3,368	2,430	-18	11,559
Malaysia							
Net Private Flows	5,180	9,180	546	-3,461	-8,381	-6,796	-3,619
Private Long-Term	4,172	5,079	5,136	2,165	1,553	1,326	1,247
Of Which Net Direct Investment	3,327	3,528	3,648	1,860	2,524	. . .	. . .
Private Short-Term	1,008	4,101	-4,590	-5,626	-9,934	-8,123	-4,866
Official Long-Term	2,451	297	1,651	545	1,763	1,651	294
Net Capital Flows	7,631	9,477	2,197	-2,916	-6,618	-5,145	-3,325
Philippines[3]							
Net Direct Investment	. . .	1,338	1,113	1,592	998	791	1,058
Net Portfolio Investment	. . .	2,179	-351	80	347	254	-484
Other Flows (net)[4]	. . .	7,558	5,831	-1,194	-3,028	-1,746	-5,506
Net Capital Flows	. . .	11,075	6,593	478	-1,683	-701	-4,932
Thailand							
Net Private Flows	. . .	. . .	-7,623	-15,483	-13,836	-13,197	-7,785
Net Direct Investment	. . .	. . .	3,298	7,361	5,854	4,018	2,217
Net Portfolio Investment	. . .	. . .	4,386	352	383	230	4
Other Private Flows[2]	. . .	. . .	-15,307	-23,196	-20,073	-17,445	-10,006
Official Flows	. . .	. . .	3,280	5,741	5,929	5,694	1
Net Capital Flows	. . .	. . .	-4,343	-9,742	-7,907	-7,503	-7,784

. . . = not available.
[1] For 1995, Indonesian data on other private flows are included in net portfolio investment.
[2] Other private flows (net) include capital flows arising from medium- and long-term debt, trade credits and short-term debt, and changes in nonresident accounts in the banking system. In Indonesia and Korea, other private flows were obtained as the difference between the category "other investment flows" and the category "official flows," both of which are reported. In Thailand, net capital flows are taken to be equal to the capital and financial account. Other private capital flows were obtained as a residual.
[3] Comparative data for 2000 and 1999 are from January to November for Korea and Philippines.
[4] For the Philippines, net capital flows are taken to be equal to the capital and financial account. The category "other flows" was obtained as a residual. Official flows could not be segregated on a consistent basis up to 1995.
Sources: Bank Indonesia; Bank of Korea web site; Department of Statistics Malaysia web site; International Department, Bank Negara Malaysia; Bangko Sentral ng Pilipinas and its web site; and Bank of Thailand web site.

Box C: **The Impact of a Global Slowing of Trade on Affected Countries**

The calculations reported below are based on the estimation of export impact multipliers for each economy. The multipliers draw on observed consumption, import and export shares, and the geographical pattern of trade of the affected countries. The calculations entail many simplifying assumptions. Among other factors, they assume constant relative prices and terms of trade, and they ignore the secondary transmission of income impacts across regional borders.

Three scenarios are considered. These take high, low, and central growth projections for each global region, drawn from Consensus Economics and other sources. All growth rates are expressed in terms of the *change* on the 2000 outcome. For example, a slowing of growth from 5 percent to 2 percent is a –3 percentage point change.

A range of demand responses to slowing global growth is considered. Evidence suggests that import demands of industrialized economies may be income elastic. It is also possible that exports from small open economies, including those of East Asia, are likely to respond more than proportionately to growth of global trade and income, possibly by as much as a factor of 2. If elasticities were large, the impacts of a global slowing on the crisis economies would be felt more acutely. Impacts are calculated for a range of income elasticities: low (0.5), middle (1), and high (2).

The main results are presented in Table C-1. The calculations suggest that in conditions of low global growth, income elastic demand case growth rates could fall by anything between 1 percentage point in Indonesia and Korea, to about 2 percentage points in the Philippines. The large response in the Philippines is explained by its disproportionate dependence on the US economy. A slowing of 2 percentage points in the Philippines growth rate would take growth below the threshold needed to sustain growth of per capita incomes.

Other scenarios and elasticity assumptions produce less pronounced impacts on country growth. For example, taking the Consensus estimates of the change in growth and applying unitary income elasticities, the estimated slowdown in Philippine growth is reduced to 0.62 of a percentage point. Under these assumptions, the impacts are modest for other countries too.

Note that income elasticities have a multiplicative effect on our calculations. Thus, if demand elasticities were actually 2 and not unitary, the estimated impacts in the Consensus column would all be doubled. Likewise, impacts in the middle column are halved if income elasticities are unity and not 2. It is also worth noting that in the past, Consensus estimates seem to have been a lagging indicator of future growth, so outcomes in 2001 could track lower than the current Consensus view.

Table C-1: **The Estimated Impact of a Global Slowdown on GDP Growth** (percentage points)

	High Growth/Low Elasticity	Low Growth/High Elasticity	Consensus Growth/Unitary Elasticity
Indonesia	-0.08	-1.06	-0.27
Korea, Rep. of	-0.09	-1.01	-0.29
Malaysia	-0.14	-1.56	-0.44
Philippines	-0.21	-2.17	-0.62
Thailand	-0.12	-1.39	-0.39

Notes:
1. All changes are measured by year-on-year swings in GDP growth rates.
2. Low growth scenario (in percentage points): US GDP growth swings by -4.1, Europe by -1, and Japan by -1.5.
3. Central estimate (in percentage points): US growth swings by -2.6, Europe by -0.5, and Japan by -0.4.
4. High growth scenario (in percentage points): US growth swings by -2.1, no growth swings in Europe and Japan.
5. Elasticity estimates: high=2, central=1, low=0.5.

Sources: Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001, and REMU staff estimates.

Global Electronics Slowdown

A particular source of vulnerability for the region's exports is the disproportionate dependence of some economies on electronics. Exports of IT goods alone from the region to the US have grown more than fourfold in the space of a decade. High-tech products account for more than a third of total exports of the five affected countries, ranging from 13 percent in Indonesia to more than one half in Malaysia and Philippines. There is already evidence in recent monthly export numbers that electronic exports, which helped propel East Asia's recovery, are

being adversely affected by a decline in US orders. In both Malaysia and Thailand, exports are contracting when measured against their performance in the same month last year. The rapidity with which declines in US capital expenditure on IT products have registered in regional export growth is striking. If, going forward, US capital expenditure contracts sharply, as some fear, there will be more fallout for the region, through reduced orders and adverse movements of terms of trade. While earlier downswings in global electronics cycles have tended to be comparatively short-lived, they have not before coincided with an abrupt slowing of global and US economic growth.

A clue to the possible consequences of a global electronics slowdown for regional electronics export demand can be derived from the experience of 1995 and 1996, the last instance of such a slowdown. During 1995-1996, the rate of growth of worldwide semiconductors sales swung by a massive -49 percentage points, from growth of 40 percent in 1995 to -9 percent the following year. The growth rate of electronics imports (measured in US dollar terms) to the US from Asia swung by about -34 percentage points over the same period. The swing in electronics exports in the affected countries ranged from -36 percentage points for Korea to -19 percentage points for Thailand. In Malaysia, the swing in growth was -24 percentage points. In both Indonesia and the Philippines, export growth actually accelerated over the period as new production platforms were being established at that time, and output and export growth was being measured from an extremely low base.

Looking forward, projections by *Electronic Business* suggest a slowdown in the growth of semiconductor equipment sales in the Americas from nearly 63 percent in 2000 to just 8 percent in 2001, or a change of -53 percentage points, not too dissimilar to what occurred between 1995 and 1996. For the world as a whole, the projected change in the sales growth rate is a staggering -72 percentage points. Semiconductor sales worldwide grew by an estimated 83 percent in 2000. *Electronic Business* projects that growth will slow to just 9.5 percent in 2001. Gyrations of this magnitude in the growth of demand would have significant repercussions for the region's electronics exports. Asia supplies 40 percent of the global electronics markets. Electronics also contributes substantially more to total exports and to GDP in the affected countries than it did before the onset of the crisis. In Box D, estimates of these effects are provided.

These calculations illustrate the diversity of the five economies in their susceptibility to the global electronics cycle. Korea and Malaysia are much more exposed to an electronics downturn than Indonesia, with the Philippines and Thailand lying somewhere between.

Last, an estimate of the combined impact of the projected slowdown of electronics and nonelectronics exports can be obtained by amalgamating the calculations summarized in Boxes C and D. A range of estimates is shown in Table 2. The lower bound estimates of the reduction in growth are obtained by combining the baseline/unit elastic results shown in column 3 of Table C-1 with the results of Table D-1. The upper bound estimates draw on the low global growth, high income elasticity assumptions. In both cases, there is an assumed deceleration of electronics export growth by 20 percentage points. For comparison, the Consensus projections of the change in growth between 2001 and 2000 are shown.

Box D: **The Estimated Impact of Slowing Electronics Demand**

The estimates shown in the table below are obtained from a simplified input-output model. This model assumes that in each economy the electronics sector is an enclave, neither buying inputs nor selling outputs to other industries. External demand for electronics is exogenous (and price inelastic). Electronics activity contributes value-added to the domestic economy, and this, in turn, creates final demand. If the demand for electronics exports contracts, a reduction of income occurs because of the direct contraction of electronics' value-added, and through its induced effects on consumption demand.

While these channels are important, others are missed. If the enclave assumption is inaccurate, inter-industry effects are suppressed. Equally, any impact on demand of balance of payments repercussions or adverse terms of trade movements are not captured. As in all input-output models, adjustments on the supply side are also not accommodated.

In Table D-1, the estimated impact on GDP growth of a 20 percentage point reduction in the growth rate (measured in volume) for each economy's electronics exports is shown.

If the growth of electronics exports were to slow by 20 percentage points between 2000 and 2001 (from say 30 percent growth to 10 percent), the calculations here suggest that GDP growth could slow in Malaysia by almost 2 percentage points. Underpinning this estimate is Malaysia's high dependence on electronics exports and a moderate contribution to value-added. In Korea, which is much less dependent on electronics exports, the estimated reduction of growth for the same shock is 1.2 percentage points. While Korea's share of electronics exports in total exports is about one half of Malaysia's, its electronics industry contributes more value-added per unit of gross output, and so direct income losses and those through induced reductions in domestic demand are commensurately larger.

In the other economies of the region, the impact of a 20 percentage point reduction in electronics export growth is somewhat more muted, though not negligible. In the Philippines, which is highly dependent on electronics exports, effects are contained because of the low value-added content of its electronics industry. Likewise, the limited value-added imparted by Indonesian and Thai industries mitigates impacts in those countries, and the share of their electronics exports in total exports is also smaller.

Note that in these calculations, value-added share parameters are educated guesses rather than direct observations. Input-output data of recent vintage are not available. Increasing the assumed value-added content of electronics increases measured reductions in income growth more than proportionately.

Table D-1: **The Estimated Impact of a Reduction in Electronics Export Growth on GDP Growth** (percentage points)

	Indonesia	Rep. of Korea	Malaysia	Philippines	Thailand
Value-Added Share	0.20	0.50	0.35	0.20	0.25
20 Percentage Point Reduction in Electronics Export Growth	-0.35	-1.24	-1.96	-0.66	-0.41

Table 2: **Overall Impact of Reduced Export Growth on GDP Growth** (percentage points)

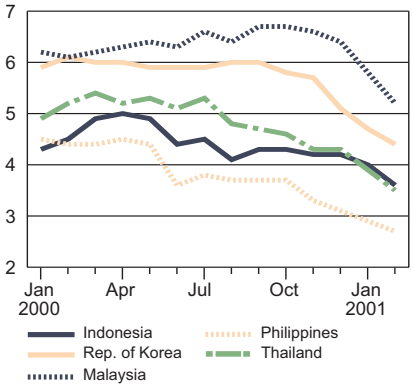
	Estimated Impact of Slower Export Growth	Consensus Change in Projected Growth
Indonesia	-0.6 to -1.3	-1.2
Korea, Rep. of	-1.5 to -2.2	-4.7
Malaysia	-2.4 to -2.9	-3.3
Philippines	-0.9 to -1.6	-1.2
Thailand	-0.7 to -1.6	-0.7

Note: The numbers in this table are obtained by adding the estimated reductions in growth in Table D-1 of Box D, to the estimated reductions in growth in Table C-1 of Box C, weighting the latter by the share of nonelectronics exports in total domestic exports.
Sources: Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001, and REMU staff estimates.

In three out of the five economies, the most recently reported Consensus projection of the change in growth is bracketed by our calculations, while in Korea and Malaysia, Consensus estimates suggest that a sharper deceleration of growth may occur. Taken together, these calculations suggest that the anticipated slowing of global economies and the electronics industry has had a significant impact on expectations of growth prospects in 2001.

Recovery Prospects

Figure 19: **Consensus Forecasts of 2001 GDP Growth** (%, y-o-y)



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

Amid heightened risks, what are the immediate economic prospects for the affected countries? Figure 19 shows the Consensus projections of 2001 growth for the affected countries during the past year or so. Prospects have been successively downgraded especially in the past few months. To the extent that the recent trends suggest that Consensus projections lag rather than lead events, the actual outcome in 2001 may fall short of the most recent projections. On the other hand, if the slowdown in the US proves to be V-shaped rather than U- or L-shaped, then the effects of a recovery in US demand in the second half should be felt quickly and growth would then accelerate going in to 2002.

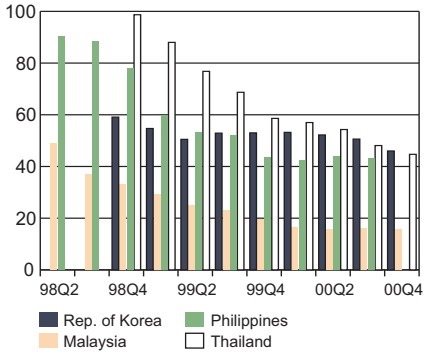
Although growth is already slowing in most economies, fears of a new crisis are exaggerated. A variety of prudential indicators suggest that the region is now much less vulnerable than before. Perceived credit risks are diminishing (Table 3), external debt levels are improving, and foreign exchange reserves provide ample cover for short-term maturing obligations (Figure 20). Real exchange rates also remain highly competitive (Figure 21). While problems are not yet over for domestic

Table 3: **Foreign Currency Long-Term Sovereign Credit Ratings***

		Moody's		Standard & Poor's		Fitch	
Indonesia	Current Outlook	Stable		Negative		Stable	
	Ratings	B3	20-Mar-98	B-	2-Oct-00	B-	16-Mar-98
		B2	9-Jan-98	SD	17-Apr-00	B+	21-Jan-98
		Ba1	21-Dec-97	CCC+	30-Mar-99	BB-	8-Jan-98
				SD	29-Mar-99	BB+	23-Dec-97
				CCC+	15-May-98	BBB-	4-Jun-97
				B-	11-Mar-98		
				B	27-Jan-98		
				BB	9-Jan-98		
				BB+	31-Dec-97		
				BBB-	10-Oct-97		
Rep. of Korea	Current Outlook	Stable		Positive		Stable	
	Ratings	Baa2	16-Dec-99	BBB	11-Nov-99	BBB+	30-Mar-00
		Baa3	12-Feb-99	BBB-	25-Jan-99	BBB	24-Jun-99
		Ba1	21-Dec-97	BB+	18-Feb-98	BBB-	19-Jan-99
		Baa2	10-Dec-97	B+	22-Dec-97	BB+	2-Feb-98
		A3	27-Nov-97	BBB-	11-Dec-97	B-	23-Dec-97
		A1	4-Apr-90	A-	25-Nov-97	BBB-	11-Dec-97
				A+	24-Oct-97	A	26-Nov-97
						A+	18-Nov-97
Malaysia	Current Outlook	Stable		Positive		Positive	
	Ratings	Baa2	17-Oct-00	BBB	10-Nov-99	BBB	7-Dec-99
		Baa3	14-Sep-98	BBB-	15-Sep-98	BBB-	26-Apr-99
		Baa2	23-Jul-98	BBB+	24-Jul-98	BB	9-Sep-98
		A2	21-Dec-97	A-	17-Apr-98	BBB-	13-Aug-98
				A	23-Dec-97		
Philippines	Current Outlook	Negative		Negative			
	Ratings	Ba1	18-May-97	BB+	21-Feb-97	BB+	8-Jul-99
		Ba2	12-May-95	BB-	2-Jul-93		
Thailand	Current Outlook	Stable		Stable		Stable	
	Ratings	Baa3	21-Jun-00	BBB-	8-Jan-98	BBB-	24-Jun-99
		Ba1	21-Dec-97	BBB	24-Oct-97	BB+	14-May-98
		Baa3	1-Dec-97	A-	3-Sep-97		
		Baa2	27-Nov-97	A	29-Dec-94		
		Baa1	2-Oct-97				
		A3	8-Apr-97				

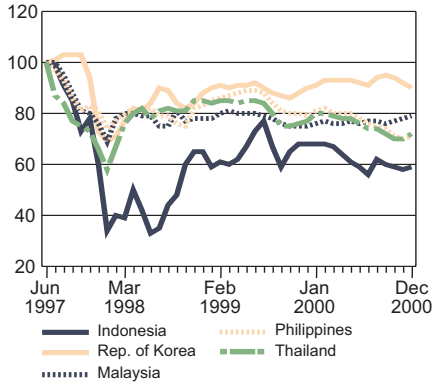
*See Annex for descriptions of ratings.
Sources: Web sites of Moody's, Standard & Poor's, and Fitch.

Figure 20: **Short-Term External Debt*** (% of Gross International Reserves, End of Period)



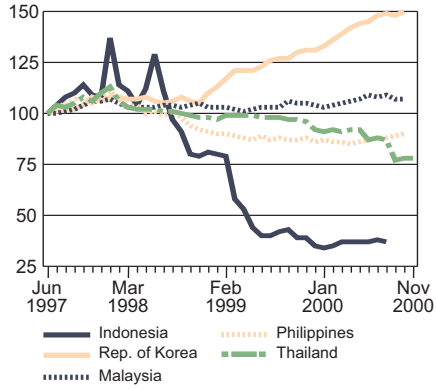
*Data from national sources.
Source: ARIC Indicators.

Figure 21: **Real Effective Exchange Rate Index*** (1997June=100)



*Traded vs. nontraded goods prices.
Source: ARIC Indicators.

Figure 22: **Real Bank Credit Index*** (1997June=100), seasonally adjusted



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

banking sectors and firms saddled with debts, there has nevertheless been identifiable improvement over the past 12 months. NPL ratios have declined and some commercial banks are beginning to return to profitability. In Korea and Malaysia, the stock of real bank credit extended to the private sector is growing and exceeds its precrisis level (Figure 22). It has stabilized in Indonesia, turned around in the Philippines, but continues to fall in Thailand.

There are other factors, too, that better place the region to ride out shocks. With the adoption of more flexible exchange rates and the move toward explicit inflation targeting, there is greater clarity and coherence about macroeconomic policies in most economies. Monetary policy rules now recognize that with only one instrument, the authorities can pursue only one objective. In most countries, the authorities have sensibly decided that this should be to contain inflation. The recovery process is also more broad based than before. On the demand side, consumption and investment demands are increasingly supporting growth, and, on the supply side, services activity is expanding alongside manufacturing.

In sum, reduced financial sector vulnerability, strengthened external payments positions, greater coherence in macroeconomic policy frameworks, and somewhat more balanced growth mean that the affected countries are in a stronger position to absorb shocks. Nevertheless, to ensure sustained recovery, it is crucial for them to seriously tackle residual problems in their banking and corporate sectors. If banks remain reluctant to extend credit, and potential investors are encumbered by debts, the investments needed to propel growth into the future will be stunted.

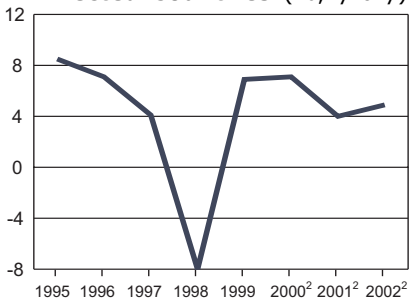
This year, the average growth rate for the affected countries is, according to Consensus estimates, expected to slow to 4 percent from an estimated 7.1 percent in 2000 (Figure 23). In terms of individual countries, Korea and Malaysia are likely to see the biggest drops in their growth, partly because of their high dependency on exports and the US market. But the exceptionally fast growth rates they posted in 2000 were, in any case, difficult to sustain. Consensus Economics (February 2001) projections for 2001 are for a growth rate of 4.4 percent in Korea and 5.2 percent in Malaysia (Table 4). The main challenges for Korea are to accelerate corporate restructuring and to bring the banking sector back to profitability. For Malaysia, one concern is that, with a pegged exchange rate, domestic absorption will have to bear the brunt of an adjustment to slower growth of external demand and a deteriorating current account position.

Table 4: **GDP Growth Projections** (%)

	Indonesia		Rep. of Korea		Malaysia		Philippines		Thailand	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
Official[1]	4.8	4.5-5.5	8.0	5.0-6.0	8.5	7.0	3.9	3.8-4.3	4.0-4.5	3.0-4.5
ADB[2]	—	4.2	9.2	3.9	—	4.9	—	3.1	4.2	3.5
IMF[3]	—	5.0	8.8	6.5	—	6.0	—	3.3	5.0	5.0
World Bank[4]	—	4.0	8.5	6.5	—	6.0	—	3.5	4.5	4.5
Consensus Economics[5]	—	3.6	9.1	4.4	—	5.2	—	2.7	4.2	3.5

[1] Indonesia—Bank Indonesia, *Policy Evaluation in the Year 2000 & Policy Directions for 2001*, 10 January 2001; Rep. of Korea—Ministry of Finance and Economy, *First-Half Economic Achievements of the Kim Dae-jung Administration*, 9 September 2000, and *Korea Economic Update*, 19 January 2001; Malaysia—Ministry of Finance, *GDP by Industrial Origin*, 24 October 2000; Philippines—National Economic and Development Authority, *Press Release,* 26 January 2001; Thailand—Bank of Thailand, *Inflation Report*, January 2001.
[2] Staff estimates, March 2001.
[3] IMF, *World Economic Outlook*, September 2000, and IMF, Public Information Notice No. 01/21, 13 March 2001 (for the Philippines).
[4] World Bank, *East Asia's Recovery: Maintaining Momentum*, 30 November 2000.
[5] Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, February 2001.

Figure 23: **Average[1] GDP Growth Rate of the Five Affected Countries** (%, y-o-y)



[1]Weighted by GDP shares in dollar terms.
[2]Consensus forecasts were used for Korea and Thailand in 2000, and for all countries in 2001 and 2002.
Sources: ARIC Indicators and Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* February 2001.

For Indonesia and Thailand, the consensus view is that growth is likely to fall to about 3.5 percent in 2001. In the former, external factors are not biting as hard as the risks from internal constraints. Indonesia is an oil-exporting nation less dependent on manufacturing exports to the US market than other countries of the region. But the threat of accelerating inflation in Indonesia reduces scope for a more accommodating monetary policy to combat slowing growth. A resolution of political uncertainties, and faster progress in asset disposal and bank restructuring are required to restore investor confidence.

In Thailand, political uncertainty has receded. It remains to be seen, however, whether structural reforms will be accelerated under the new administration. Its focus on tackling the problems of rural Thailand is laudable, but this should be carried out in a way that does not jeopardize fiscal balances, nor undermine the efficient functioning of credit and other markets.

The Consensus Economics projection for the Philippines is for 2.7 percent growth in 2001, down from 3.9 percent in 2000. The heavy dependence of the Philippine economy on electronics exports and its tight links to the US economy mean that there could be significant knock-on effects from slowing US growth. The large deficit left by the previous administration and a comparatively high rate of underlying inflation limit the Government's ability to support domestic demand through fiscal or monetary means. If the Government takes firm actions to resolve its fiscal problems, then private investment could recover and GDP could grow by 3 to 3.5 percent.

To sum up, growth in 2001 in the affected countries will be significantly lower than in 2000. In 2002, growth should accelerate provided the

US economy picks up and electronics exports turn the corner. Positive growth rates should mean that broad social and economic recovery continues through this period, although at a slower pace than in 2000.

In the short term, macroeconomic policy should aim to support domestic demand. Amid rising debt levels, accommodation on the monetary front may be easier to accomplish than further deficit spending measures. However, within prudent fiscal limits, there remains scope for ensuring that public expenditure programs are targeted better on the poor and the more vulnerable elements of society. Ultimately, to support growth over the medium term, reform agendas should not be allowed to drift. In particular, measures to ensure a quicker and more efficient resolution of debts are still needed, as are initiatives to spur restructuring of moribund businesses. Implementation of reforms may be more difficult in a context of slower growth, but the costs of inaction are likely to increase in a less hospitable global environment. There is no room for complacency.

Annex: **Description of Long-Term Sovereign Credit Ratings**

Moody's	
Investment Grade Ratings	
Aa1 / Aa2 / Aa3	Bonds judged to be of high quality by all standards. They are rated lower than bonds with the highest ratings (Aaa) because margins of protection for Aa may not be as large, fluctuations of protective elements may be of greater amplitude, or there may be other elements present that make the long-term risk appear somewhat larger than for Aaa securities.
A1 / A2 / A3	Bonds considered as upper-medium-grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present that suggest a susceptibility to impairment sometime in the future.
Baa1 / Baa2 / Baa3	Bonds considered as medium-grade obligations (i.e., neither highly protected nor poorly secured). Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time.
Speculative Grade Ratings	
Ba1 / Ba2 / Ba3	Bonds that have speculative elements; their future cannot be considered as well assured.
B1 / B2 / B3	These bonds lack characteristics of a desirable investment. Assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.

Standard & Poor's	
Investment Grade Ratings	
AAA	The obligor's capacity to meet its financial commitment on the obligation is extremely strong.
AA+ / AA / AA-	Bonds with this rating differ from highest rated obligations only by a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.
A+ / A / A-	More susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitments on the obligation is still strong.
BBB+ / BBB / BBB-	Exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.
Speculative Grade Ratings	
BB+ / BB / BB-	Bonds that have significant speculative characteristics but are less vulnerable to nonpayment than other speculative issues. It faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.
B+ / B / B-	These bonds have significant speculative characteristics and are more vulnerable to nonpayment than obligations rated as BB. The obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment in the obligation.
CCC+/CCC/CCC-	This obligation is currently vulnerable to nonpayment and is dependent on favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation.
SD	The obligor has failed to pay one or more of its financial obligations (rated or unrated) when it came due.

Continued next page

Annex: **Description of Long-Term Sovereign Credit Ratings** (Cont'd)

	Fitch
Investment Grade Ratings	
AAA	Highest credit quality. Denotes the lowest expectation of credit risk. They are assigned only in cases of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
AA+ / AA / AA-	Very high credit quality. Denotes a very low expectation of credit risk. They indicate very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A+ / A / A-	High credit quality. Denotes a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.
BBB+ / BBB / BBB-	Good credit quality. Indicates that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category.
Speculative Grade Ratings	
BB+ / BB / BB-	Indicates that there is a possibility of credit risk developing, particularly as the result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.
B+ / B / B-	Indicates that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.