Asia Recovery Report 2000

May 2000 Update http://aric.adb.org

Contents

Asia's Recovery—A Regional Update *1*

Recovery in Asset Markets and the Real Sector *1*

Medium-term Aspects—Bank and Corporate Restructuring *8*

Longer Term Aspects—Social Recovery, Governance and Competitiveness *17*

Recovery Prospects and Risks *21*

The PRC, Singapore and Viet Nam Updates *27*

The PRC *27*

Singapore *29*

Viet Nam *31*

How to reach us

Asian Development Bank
Regional Economic Monitoring Unit
6 ADB Avenue, Mandaluyong City
0401 Metro Manila, Philippines

Telephone
(63-2) 632-5458/4444

Facsimile
(63-2) 636-2183

E-mail
aric_info@adb.org

Asia's Recovery—A Regional Update

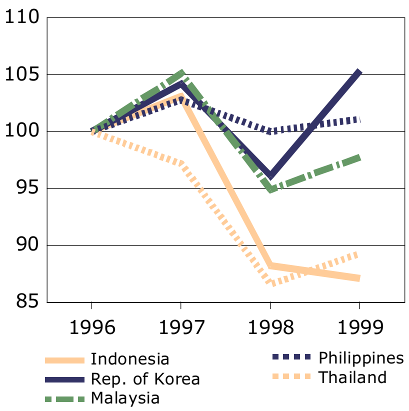
Recovery in Asset Markets and the Real Sector

Following more than a decade of rapid growth, Thailand's gross domestic product (GDP) contracted sharply in 1997. In that year, growth slowed in Indonesia, Republic of Korea (henceforth Korea), Malaysia and Philippines. Shortly thereafter, output began to contract in these economies too. By the end of 1998, GDP had fallen by 13.2 percent in Indonesia, 6.7 percent in Korea, 7.5 percent in Malaysia, 0.5 percent in Philippines, and 10.4 percent in Thailand. But these declines proved short-lived. By early 1999, economies had stopped contracting and embryonic signs of growth began to emerge. As 1999 progressed, economic recovery quickly gathered momentum. Korea made the biggest gains, its GDP growing by 10.7 percent. Output also expanded in Malaysia, Philippines and Thailand, growing at 5.4, 3.2 and 4.2 percent, respectively. While Indonesia lagged behind in the recovery process, output in 1999 stabilized and grew by 0.2 percent.

While the regional recovery is tangible, it is not yet complete. There are variations in the pattern of recovery across countries, and across the components of aggregate demand and supply. As is usually the case, recovery in financial and asset markets has preceded that in the real sector. Per capita real incomes have yet to climb back to their pre-crisis levels in Indonesia, Malaysia, Philippines and Thailand.

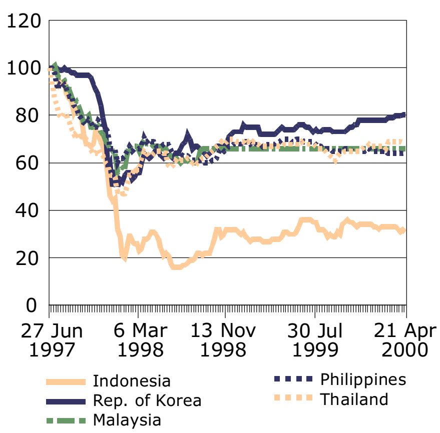
One way to gauge the extent of the recovery is to compare per capita incomes, measured in *local currency at constant prices*, with their pre-crisis peaks (Figure 1). For four of the five affected countries, 1997 is the most recent peak of per capita GDP. In Thailand, 1996 is the peak. By the end of 1999, only Korea had achieved a level of GDP per capita that exceeded its previous peak. In all other economies, GDP per capita still has lost ground to make up. At the end of 1999, the gap to the previous peak was

Figure 1: **GDP per Capita Indices** (1996=100)



Note: 1999 data on population are forecasts by ADB staff.
Sources: ADB, Key Indicators of Developing Asian and Pacific Countries; various national sources.

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



Source: ARIC Indicators.

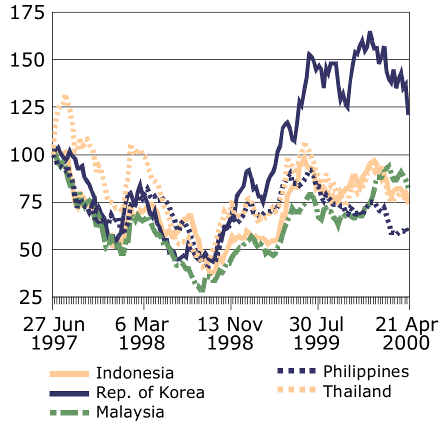
narrowest in the Philippines, mainly because GDP did not fall so much there. The gap is larger in Malaysia, and at its widest in Indonesia and Thailand. The speed with which these gaps will be closed depends, of course, on future growth. The time needed for the recovery of per capita incomes measured in US dollar terms will take even longer. Even when these gaps are closed, a process that could yet take some time to complete, incomes will remain substantially below what they would have been had they continued to grow at pre-crisis levels.

Asset Market Recovery. Following their initial precipitous collapse, exchange rates stabilized and, in early 1998, began to recover lost ground (Figure 2). Subsequently, the volatility in exchange rate movements that accompanied their collapse and partial recovery dissipated. Today, in nominal terms, the value of local currencies has become more stable, but they still buy 20 to 35 percent fewer US dollars than before the crisis in Korea, Malaysia, Philippines and Thailand, and about 70 percent fewer dollars in Indonesia.

Stock markets fell to their lowest point around mid-1998 (Figure 3). Since then they have recovered and all but the Philippine market made strong gains in 1999. In part, these gains were driven by the additional liquidity generated by current account surpluses and lower interest rates. The earlier rebound in equity values has not, however, been maintained. As of late April 2000, stock market indices in most affected economies were still about 15-40 percent lower than their pre-crisis levels in local currency terms and about 45-75 percent off in US dollar terms. Only in Korea have markets recovered almost fully both in local currency terms and in US dollars. But even in Korea, equities have performed poorly in 2000, with the KOSPI 200 declining by more than 30 percent since the start of the year.

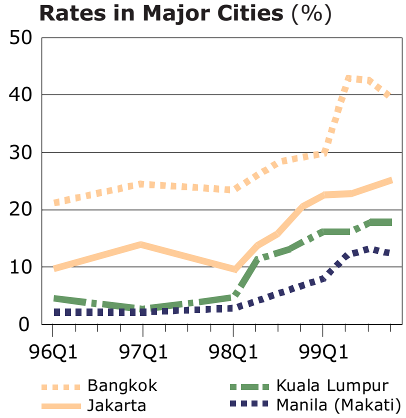
To some degree, the inability of regional equity markets to sustain 1999's gains has been a consequence of external factors, particularly rising interest rates in the United States and increases in world oil prices. But in some places it also reflects investors' concerns over the slow pace of financial and corporate restructuring. Corporate earnings have yet to show consistent signs of renewed vigor. In recent weeks, the downward drift in US equity prices and their heightened volatility have negatively affected regional markets. In the Philippines, where equity values have been losing ground since mid-1999, recent allegations of insider

Figure 3: **Composite Stock Price Indices*** (last week of 1997June=100, in local currency)



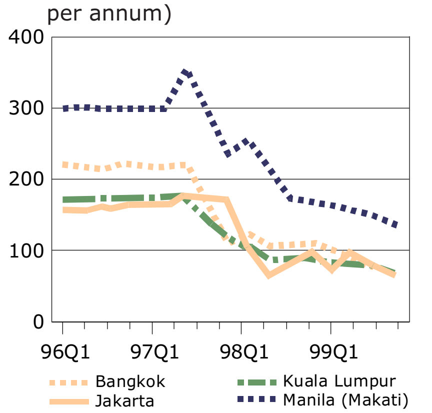
*Weekly averages of JCI (Indonesia), KOSPI 200 (Korea), KLCI (Malaysia), PHISIX (Philippines), and SET Index (Thailand).
Source: ARIC Indicators.

Figure 4: **Office Vacancy Rates in Major Cities** (%)



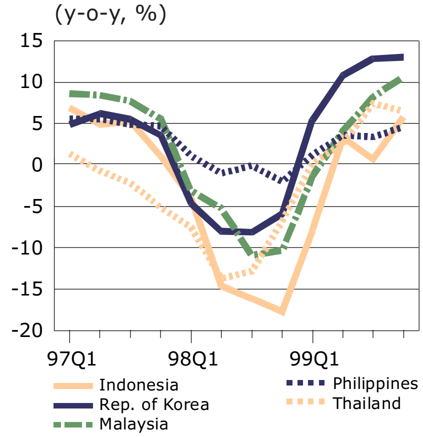
Source: Jones Lang LaSalle, Asia Pacific Property Digest, January 2000.

Figure 5: **Office Rents in Major Cities** (US$ per square meter per annum)



Source: Jones Lang LaSalle, Asia Pacific Property Digest, January 2000.

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



Source: ARIC Indicators.

trading and stock market manipulation have also undermined market confidence. In a generally turbulent environment, Malaysian equities have done well; the KLCI has increased by 10 percent to date this year.

In most economies, there are, as yet, few signs of recovery in the markets for physical assets. Property markets remain generally depressed. Although office vacancy rates have started to stabilize, rents in US dollar terms continue to soften (Figures 4 and 5). Loan assets also remain heavily discounted. In Korea, fast growth has brought about a quicker recovery in the prices of physical assets.

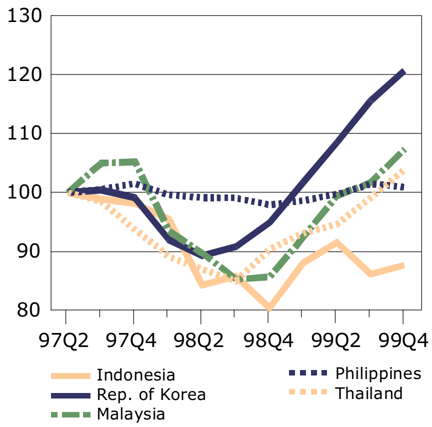
Recovery in the Real Sector. The pace of recovery in the affected countries has been faster than expected (Figure 6). Since the beginning of 1999, the Consensus Economics forecasts[1] of 1999 economic growth rates have been revised upwards almost every month for every country.

Recovery has, however, been uneven. It has been most pronounced in Korea—so strong, in fact, that there are now latent inflationary pressures. In Malaysia and Thailand, it has also been impressive, but somewhat slower. Despite accommodating monetary policies and substantial deficit spending measures, inflationary pressures remain muted in both of these economies. The Philippines' relatively mild recovery of output is partly attributable to the fact that economic activity there did not contract to the same extent as in the other countries. In Indonesia, where political developments have had a decisive influence on the economy, output has only now stabilized after collapsing in 1998.

On the supply side, the agricultural sector has rebounded following the devastation caused by the El Niño and La Niña weather phenomena. This rebound has benefited mainly Indonesia, Philippines and Thailand. Indeed, in the Philippines, strong agricultural performance spearheaded growth in 1999.

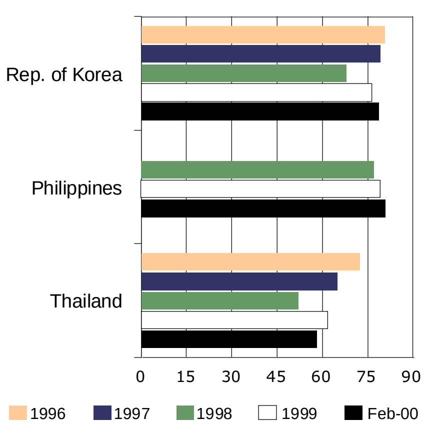
Elsewhere, the manufacturing sector has led the recovery process. The sector's strong recovery is largely attributable to a resurgence in export demand. The indices of the manufacturing sector value added in all the affected countries except Indonesia now exceed pre-crisis levels (Figure 7). In Korea, the capacity utilization rate in manufacturing is now close to its pre-crisis level (Figure 8). Although improved somewhat, the rate is still well below the pre-crisis level in Thailand and, possibly, in Indonesia, although data are not available for the latter. In the Philippines, the available data suggest that the capacity utilization in manufacturing has improved from its 1998 level. Capacity utilization rates are expected to increase in 2000 as recovery continues.

Figure 7: **Manufacturing Value Added Indices** (1997Q2=100), seasonally adjusted



Source: ARIC Indicators.

Figure 8: **Average Capacity Utilization in Manufacturing** (%)



Note: 1996-1999 data are yearly averages except those for the Philippines which are monthly averages. February 2000 data are averages for the month. The 1996 and 1997 data for the Philippines are not available.
Sources: National Statistics Office, Korea; National Statistics Office, Philippines; and the Bank of Thailand.

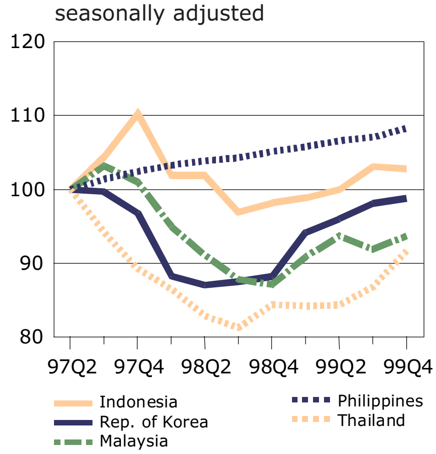
[1] Published by Consensus Economics, Inc., United Kingdom.

Latest data suggest that manufacturing is maintaining the strong momentum it acquired last year. In Korea, industrial production, which is heavily influenced by manufacturing sector performance, grew by 24 percent year-on-year in the first quarter. Malaysia's industrial production grew by 25 percent year-on-year in the first two months of this year. In Philippines and Thailand, year-on-year manufacturing production growth reached more than 9 and 8 percent, respectively, in the first two months of 2000.

On the demand side, the recovery was initially led by public consumption expenditure. Growth of public consumption expenditure was supported by the deficit spending measures that governments took in 1998.

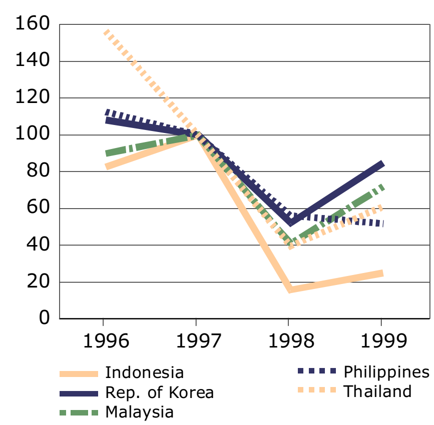
The picture with respect to private consumption demand is more mixed. In Korea, consumption has risen more or less in line with income. In the Philippines, private consumption never fell. In the other countries, renewed growth of consumption lagged behind broader recovery in income. Largely as a consequence, real private consumption remains below pre-crisis levels in all the affected countries except the Philippines (Figure 9). However, there are now early indications of a sustained recovery in private consumption demand. Consumer durable consumption and automobiles in particular are showing renewed strength (Figure 10).

Figure 9: **Real Private Consumption Expenditure Indices** (1997Q2=100), seasonally adjusted



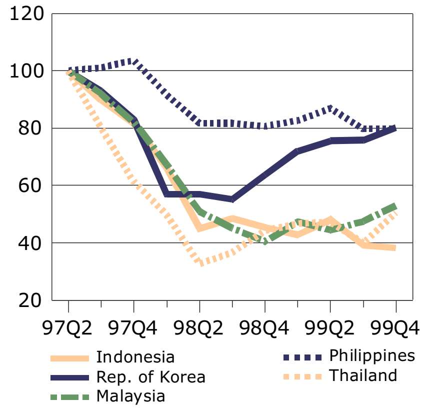
Source: ARIC Indicators.

Figure 10: **Light Automobile Sales Indices** (1997=100)



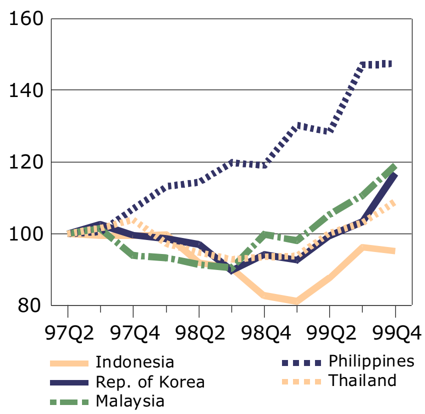
Source: Standard & Poor's DRI-Global Automotive Group.

Figure 11: **Real Gross Domestic Investment Indices** (1997Q2=100), seasonally adjusted



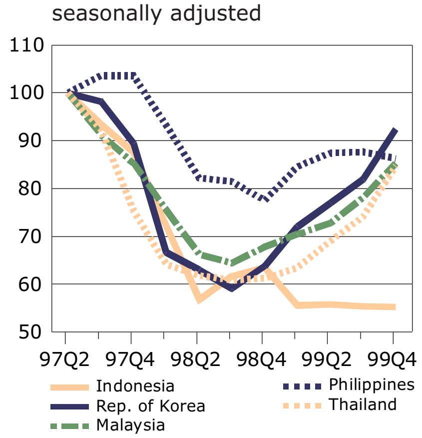
Source: ARIC Indicators.

Figure 12: **Quarterly Export Indices** (1997Q2=100), seasonally adjusted



Source: ARIC Indicators.

Figure 13: **Quarterly Import Indices** (1997Q2=100), seasonally adjusted



Source: ARIC Indicators.

Largely because of excess capacity, and debt overhang, investment remains generally depressed, although recently there have been some signs of improvement in Korea, Malaysia and Thailand. Despite this, real investments in plant and equipment remain well below pre-crisis levels in all of the countries (Figure 11).

Export demand, supported in part by a global upswing in the electronics industry, has played an important role in propelling recovery. Exports now exceed pre-crisis peak levels in Korea, Malaysia and Thailand (Figure 12). In the Philippines, exports remained largely immune to the crisis because of the country's tight links to the booming US market and the growth of its fledgling electronics industry.

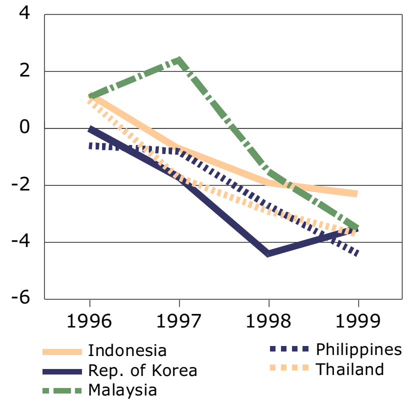
While import demand preceded more general economic recovery, this recovery started from very low levels. As a result, imports still remain below their pre-crisis peak levels in all the affected countries (Figure 13). However, strengthening import demand since early 1999 has meant that the contribution of net exports to growth has been declining, and suggests that domestic demand must become a more important contributor to growth if recovery is to be sustained.

Latest data point to continued strong recovery in external trade. In Indonesia, where the recovery in trade has lagged behind, exports grew at 44.7 percent and imports at 17.4 percent in the first two months of this year. In the Philippines, where import demand has also been slow to perk up, growth of about 9 percent was recorded over the first two months. Elsewhere, strong performances are being maintained or exceeded, with stellar growth rates for exports and imports in Korea, Malaysia and Thailand being posted in the first months of 2000.

Forces Driving the Recovery. At a macroeconomic level, the forces driving the recovery process that has been described above can be summarized as follows:

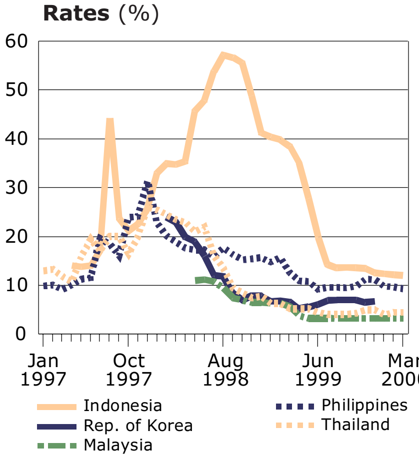
- Domestic policies have played an important role. After an initial bout of austerity, a move to more accommodating monetary policies and large deficit spending programs helped nurture the recovery. Most of the affected economies are now experiencing large fiscal deficits (Figure 14). Short-term nominal interest rates have also come down sharply and are now either below their pre-crisis levels or close to them (Figure 15). However, except

Figure 14: **Central Government Fiscal Balance** (as % of GDP)



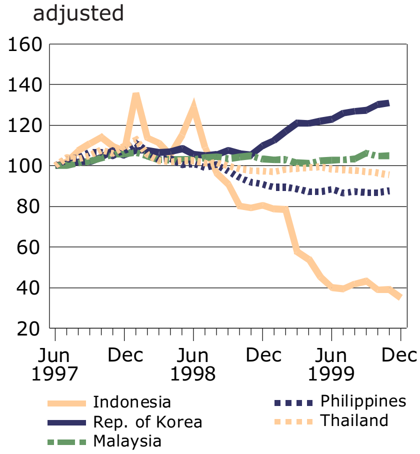
Source: IMF, World Economic Outlook, April 2000.

Figure 15: **3-Month Interbank Rates** (%)



Source: ARIC Indicators.

Figure 16: **Real Bank Credit*** (1997June=100), seasonally adjusted



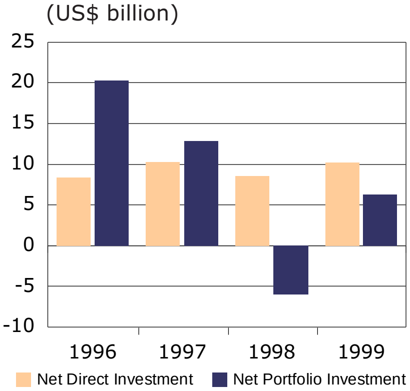
*Claims on the private sector: deposit money banks.
Source: ARIC Indicators.

in Korea and, more recently, in Malaysia, the more accommodating monetary stance has not yet been reflected in a growth of the stock of private sector credit (Figure 16). In part, this is because non-performing loans (NPLs) have reduced the stock as they have been removed from the balance sheets of banks and converted into other instruments. Nevertheless, lower interest rates have undoubtedly eased the distress experienced by businesses and helped support recovery in regional equity markets. The major steps taken in financial and corporate restructuring have also started to bear fruit. Much more, of course, remains to be done.

- The investor panic that triggered the Asian crisis has subsided. Partly, this is because whatever capital was going to be withdrawn has now been pulled out. In fact, the flight of capital had more or less abated by the middle of 1998. Although inflows of direct equity and portfolio investment in 1999 (Figure 17) were not sufficient to stem the outflow of capital arising from negative net transfers from banks, they have helped to ease constraints on domestic absorption. To a large degree, better-informed domestic investors led foreign investors back into the region's equity markets. According to the Institute of International Finance, net capital outflows from the five affected countries in 1999 were about US$2.5 billion. This year, as recovery consolidates further, net private capital inflows are expected to reach a total of US$5.3 billion.

- External developments also turned out to be more favorable than expected. At the beginning of 1999, deflationary risks cast a shadow over the global economy and there were fears that regional currencies may again come under pressure. But the global economy has shown itself to be more resilient than even the most optimistic observer could have hoped. The latest World Economic Outlook (WEO) issued by the International Monetary Fund (IMF, April 2000) indicates that global output growth in 1999 grew by 3.3 percent, which is 1.1 percentage point higher than what was projected at the end of 1998, and 0.3 percentage point higher than the average global growth since 1990. The US economy has played a crucial role in supporting global demand during the recent turbulence. Over the past two years, the United States has accounted for more than 50 percent of the growth of global demand. A steady renminbi and careful management of the Hong Kong dollar's link to the US dollar by the government of the Hong Kong, China have helped stabilize regional currencies.

Figure 17: **Net Direct and Portfolio Investment Flows to the Five Affected Countries** (US$ billion)



Sources: IMF, World Economic Outlook, April 2000.

- Luck has played a role in Asia's recovery, just as it compounded underlying difficulties in 1997. In particular, favorable weather conditions raised agricultural output, especially in Indonesia and the Philippines. The negative effects of the global electronics downturn that occurred from 1996 through 1998 have now been reversed. Rising global electronics demand has helped boost Korean, Malaysian and Thai exports. But rising oil prices have proven something of a mixed blessing. They have worked in favor of net exporters of fuel, such as Indonesia, but against net importers, such as Korea, Philippines and Thailand.

- Recovery is increasingly being supported by strong trade links that exist among the regional economies. To a degree, renewed growth within the region will become self-propelling as the benefits of expanding demands spill across borders.

Medium-term Aspects—Bank and Corporate Restructuring

Weaknesses in the financial and corporate sectors were at the heart of the Asian crisis. They still pose a threat to the recovery process. Tackling the high levels of NPLs and corporate bad debt, and the institutional and operational inefficiencies they reflect, is the biggest challenge the affected countries face in sustaining recovery over the medium term. Failure to tackle these problems could yet cause economies to slip and get caught in a low growth, high debt trap.

Approaches to Bank and Corporate Restructuring. The affected countries have taken differing approaches to bank and corporate sector rehabilitation. From the very beginning, Indonesia, Korea and Malaysia have chosen a more government-led approach to banking sector restructuring. In these economies, the governments have guided the restructuring process through liquidity support and nationalization of troubled banks, and have established centralized agencies to manage NPLs and re-capitalization programs. In Thailand, a more nuanced approach has been followed. The Thai authorities intervened directly in the restructuring of finance companies and have also absorbed the losses of state banks. However, the Thai government has favored a more market-oriented approach to the restructuring of private banks.

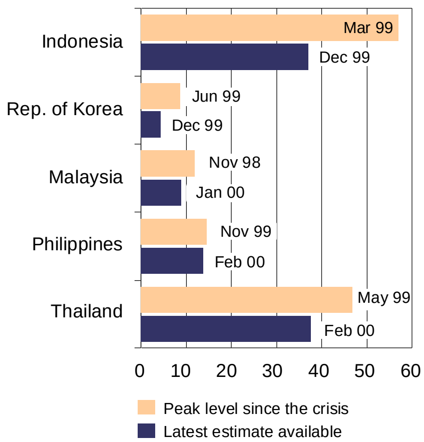
Although public capital has been made available to assist the re-capitalization process, the primary responsibility for finding new capital and resolving NPLs has been left with the private banks themselves. In the Philippines, despite some signs of stress in the banking sector, circumstances did not warrant any explicit bank restructuring measures.

The process of corporate restructuring has generally been more decentralized. In all the economies, the governments have now provided frameworks and set rules to help debtors and their creditors reach agreements. While the processes have been voluntary, corporate debt restructuring agencies have, in some cases, played quite an active role in forging agreements through pursuing target cases, and by other means. Added impetus has been given to these processes through the promulgation of new bankruptcy laws in both Indonesia and Thailand.

In Korea, the sheer size and influence of the *chaebols* have required that the government take a more direct role in the corporate restructuring process. For the smaller *chaebols*, restructuring focused on voluntary debt settlements along the lines of the London Approach and has been led by designated lead banks. The five largest *chaebols*, through government initiatives, have entered specific agreements with their lead banks, with debt resolution agreements being closely monitored by the Financial Supervisory Services (FSS). This process has been centrally coordinated and guided by, on occasion, direct government interventions. The Corporate Restructuring Coordination Committee (CRCC) was established to resolve differences where settlement plans could not be agreed upon among debtors and creditors.

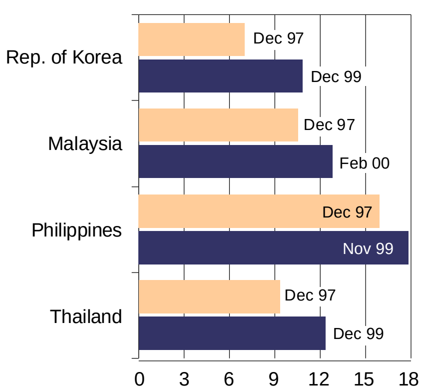
Progress in Bank Restructuring. Progress in bank restructuring varies across the five affected countries. There are several reasons for this. First, initial banking sector conditions differed significantly among countries, with distress greatest in Indonesia and the least in the Philippines. Second, economic growth itself helps rehabilitate bank balance sheets and, therefore, the recovery of banking systems has been influenced by macroeconomic developments. Third, the different ways in which problems have been tackled and reforms undertaken have been registered in different ways on bank and non-bank balance sheets.

Figure 18: **NPLs of Commercial Banks*** (as % of total commercial bank loans)



*NPLs cover only commercial banks for Korea, Malaysia, Philippines and Thailand, and the banking sector for Indonesia; and exclude those transferred to AMCs.
Sources: Policy Implementation in 1999 and Policy Directions for 2000, the Bank Indonesia web site (data approximated from a chart in the Report); the Financial Supervisory Services web site, Korea; Ministry of Finance and Economy, Korea; the Bank Negara Malaysia web site; the Bangko Sentral ng Pilipinas web site, Philippines; the Bank of Thailand web site.

Figure 19: **Capital Adequacy Ratios of Commercial Banks*** (%)



*Cover only commercial banks for Korea, Philippines and Thailand, and the banking sector for Malaysia.
Sources: The Financial Supervisory Services web site, Korea; Ministry of Finance and Economy, Korea; Monetary and Financial Developments, the Bank Negara Malaysia web site; the Bangko Sentral ng Pilipinas, Philippines; Philippines Update, East Asia Quarterly Brief, March 2000, World Bank web site; and the Bank of Thailand web site.

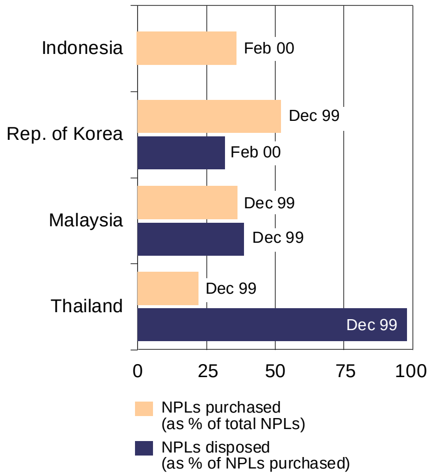
Systemic financial distress led to sharp increases in NPL ratios on bank and non-bank financial institutions alike in all of the affected countries. Isolating and comparing the evolution of NPLs is, however, not a straightforward task. Different countries have adopted differing definitions of NPLs. The accuracy of NPL data is also likely to vary across place and over time. More recent figures are likely to be more accurate than earlier ones. NPL ratios are also sensitive to the range of financial institutions covered. Ratios would increase if the loans housed in asset management companies (AMCs) were consolidated with those remaining on the balance sheets of financial institutions.

Partly because government-backed AMCs have purchased a significant share of NPLs from banks, the reported NPL ratios in the banking sector are lowest in Korea and Malaysia (Figure 18). In Thailand, where private banks have been left to work out their bad debts and NPLs with creditors, using the Corporate Debt Restructuring Advisory Committee (CDRAC) and other mechanisms, the ratio of NPLs in the banking system remains comparatively high, though it is now falling. In the Philippines, where banks have also been left to manage their assets, the NPL ratio has increased since the outbreak of the crisis, largely because of weaknesses of thrift banks, but may have peaked now. In Indonesia, the situation remains highly problematic. While some progress has been made in transferring NPLs from the banking sector to the asset management unit of the Indonesia Bank Restructuring Agency (IBRA), the sheer size of the problem has left the banking sector with a high level of NPLs.

One of the attractions of removing NPLs from bank balance sheets and housing them in asset management companies is that it strengthens balance sheets of banks and, thereby, eases constraints on lending. NPL removal, together with targeted public sector financial assistance and private sector capital infusions, have been effective in strengthening the capital backing of banks. Banking sector capital adequacy ratio has improved in all the affected countries where data are available (Figure 19).

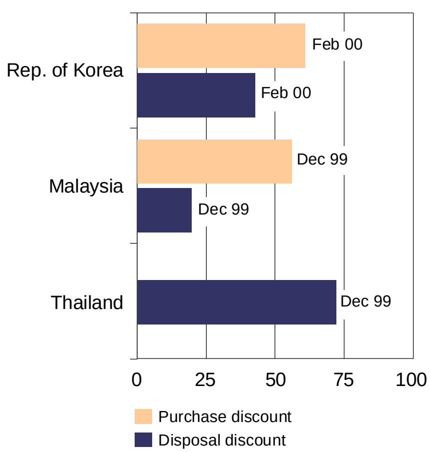
Aspects of the financial operations of public owned AMCs provide an additional perspective on the pace and nature of restructuring. Publicly owned AMCs have been the major vehicles for removing NPLs from banking systems in Indonesia, Korea and Malaysia. In all cases, a substantial portion of non-performing loans have been left to banks to work out themselves, either for logistical reasons or because the authorities wish to mitigate the risks

Figure 20: **NPLs Purchased and Disposed by AMCs***



*NPLs purchased and disposed refer to those by IBRA (asset management unit; data on disposal not available) in Indonesia, KAMCO in Korea and Danaharta in Malaysia as of the dates indicated. In the case of Thailand, these refer to assets taken over from the 56 suspended finance companies and disposed by the FRA. The exact data on asset disposals by the FRA are not available. But according to the World Bank, the FRA has almost finished liquidation of all the assets taken over from the closed finance companies.
Sources: The Indonesia Bank Restructuring Agency web site; the Korea Asset Management Corporation web site; the Danaharta web site, Malaysia; Thailand Economic Monitor, Feb. 2000, World Bank-Thailand web site; and Indonesia Update, East Asia Quarterly Brief, March 2000, World Bank web site.

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



*NPLs purchased and disposed refer to those by KAMCO in Korea and Danaharta in Malaysia as of the dates indicated. In the case of Thailand, the assets of the 56 suspended finance companies were transferred to the FRA (which is not an AMC). The disposal discount refers to that at which the assets were disposed by the FRA.
Sources: The Korea Asset Management Corporation web site; the Danaharta web site, Malaysia; Thailand Economic Monitor, Feb. 2000, World Bank-Thailand web site; Thailand Update, East Asia Quarterly Brief, March 2000, World Bank web site.

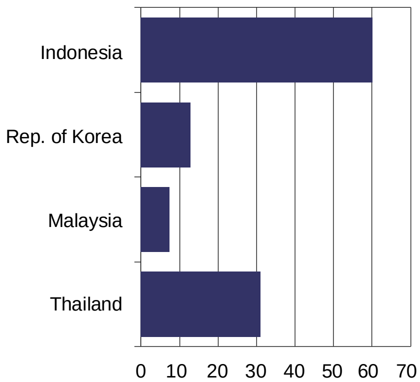
of moral hazard. In Indonesia, the asset management unit of IBRA has now purchased about 36 percent of the total NPLs of the financial system (Figure 20). In Korea, as of the end of 1999, more than 52 percent of total NPLs of the financial system had been transferred to Korea Asset Management Corporation (KAMCO). In Malaysia, Danaharta had purchased about 36 percent of total NPLs by the end of 1999. AMCs have typically acquired NPLs at a big discount: almost 60 percent in Korea and 56 percent in Malaysia (Figure 21).

In Thailand, the Financial Restructuring Agency (FRA) and a government-backed AMC were established as early as 1997. However, their mandate was limited to managing the bad debts of finance companies, not those of commercial banks. The FRA took over the assets of 56 out of 58 suspended finance companies and had almost completed the liquidation of these assets by the end of 1999. Thailand's AMC has acted as a bidder of last resort for the FRA's assets, and has purchased about 30 percent of the face value of the assets taken over by the FRA. Information on asset disposal by the AMC is not readily available.

In assessing the performance of AMCs, it is important to bear in mind that their mandates vary somewhat. Quick disposal of assets is more of a priority in Indonesia and Korea than in Malaysia, where there is a greater emphasis on the restoration of value to the assets acquired. Fast disposal of assets under AMCs' control brings three benefits. First, the revenues raised help to ease fiscal burdens and may also help strengthen bank balance sheets when there are revenue sharing arrangements in place. Second, by putting assets back to work, disposal helps speed economic recovery directly. Third, the disposal of NPLs helps asset markets to adjust by providing reference prices and by making markets more liquid. But if demand for non-performing loans is subdued, hasty disposal may prove counterproductive and entail high fiscal costs.

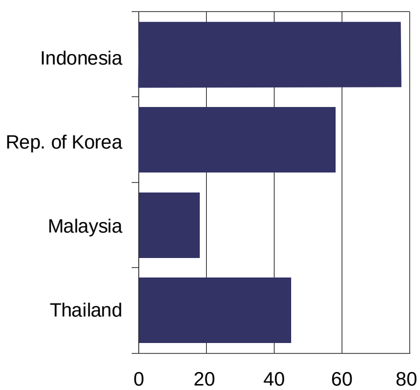
IBRA reports that it has now raised about $2.5 billion from asset sales. While this exceeds 1999-2000 fiscal targets, the process in Indonesia is still comparatively slow. Sales of several banks have been delayed, and cases against debtors are, in general, proceeding slowly. By comparison, the process of asset disposal has been quick in Korea (Figure 20). Even in Malaysia, where fast disposal is not an immediate priority, the process is moving ahead. AMCs have, in general, been able to recover more from disposal than they paid to acquire NPLs (Figure 21). As of the end of 1999

Figure 22: **Total Public Funds Used for Financial Restructuring*** (as % of 1999 GDP)



*Refer to government bonds issued for financial restructuring as of 1999.
Sources: IMF, World Economic Outlook, April 2000, for Indonesia, Korea, and Thailand; and the Danaharta and Danamodal web sites for Malaysia.

Figure 23: **State Ownership in the Financial Sector** (%)*



*Refer to % of financial sector assets owned by the government as of mid-1999.
Source: Claessens, S., et al. (1999), "Financial Restructuring in East Asia: Halfway There?," World Bank web site.

and early 2000, the average discount on the face value of assets was about 44 percent in Korea, and 20 percent in Malaysia. In Thailand, assets have been sold at a discount that averages about 72 percent. As recovery strengthens, discounts have generally edged down.

Public funds have been used extensively to support financial restructuring (Figure 22). In some countries, this has significant fiscal implications.[2] Government-led recapitalization programs have resulted in the state owning substantial proportions of assets in the financial sectors (Figure 23). The privatization of nationalized financial institutions, mainly banks, is progressing more slowly than originally anticipated.

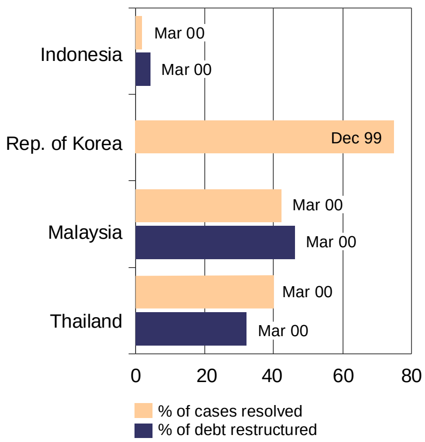
Progress in Corporate Restructuring. In all the five countries, the resolution of corporate debt has been slower than the recapitalization and restructuring of the banking sector. To supplement market and bankruptcy process, arrangements for voluntary workouts, along the lines of the London Approach, have been adopted in Indonesia, Korea, Malaysia and Thailand. In the Philippines, this responsibility lies with the Securities and Exchange Commission (SEC). Across the region, a substantial amount of corporate bad debt is now undergoing such government-sponsored voluntary settlement.[3]

Debt resolution, however, has been proceeding at an uneven pace (Figure 24). In Indonesia, of 331 cases registered with the Jakarta Initiative Task Force (JITF), only 2 percent in terms of number and less than 4 percent in terms of value have been resolved as of March 2000. In the other countries, the process has been more encouraging.

In Korea, substantial progress has been made in restructuring four of the five largest *chaebols*. The FSS reports that Hyundai, Samsung, LG and SK have now met the overall requirements of the Capital Structure Improvement Plans (CSIPs) for 1999. The debt-to-equity ratios of the four conglomerates have now fallen below the targeted level of 2.0 as of the end of 1999. Their debt-equity ratios average 1.73, compared to 3.55 in 1998.

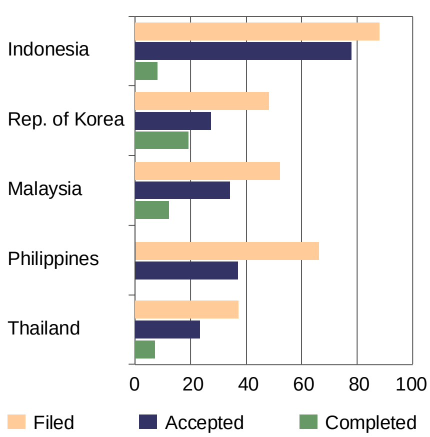
[2] Since the restructuring process has still a long way to go, the total cost of restructuring is expected to increase further.
[3] Data on restructuring outside the government-supervised schemes are incomplete.

Figure 24: **Progress in Government-supervised Voluntary Workouts***



*Indonesia: data refer to the cases registered under JITF. Korea: data refer to the cases registered under the CRA framework and do not cover the top five *chaebols.* Data on % of debt restructured are not available. Malaysia: data refer to the cases registered under CDRC. Thailand: data refer to the target cases registered under CDRAC.
Sources: Updates of Indonesia and Korea, East Asia Quarterly Brief, March 2000, World Bank web site; CDRC web site, Malaysia; CDRAC web site, Thailand.

Figure 25: **Number of Bankruptcy Cases Filed, Accepted and Completed Since the Crisis***



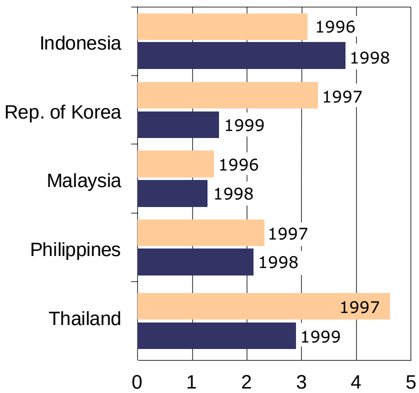
*For Indonesia, Korea and Malaysia until August 1999; for the Philippines until September 1999; for Thailand until December 1999.
Sources: Global Economic Prospects 2000, World Bank web site; Thailand Update, East Asia Quarterly Brief, March 2000, World Bank web site; Lamberte, M., 2000, "The Philippines: Challenges for Sustaining the Economic Recovery," Philippine Institute for Development Studies web site.

The four conglomerates also out-performed agreed targets in terms of asset divestiture and capital infusions. In March 2000, the Fair Trade Commission announced that cross guarantees between *chaebol* affiliates had been completely eliminated. Significant progress has also been made in restructuring Daewoo. Debt restructuring plans have been settled for the 12 Daewoo affiliates. An agreement was reached with foreign creditors resolving some $4.8 billion in unsecured loans, removing one of the largest impediments to Daewoo's corporate restructuring. Labor unrest, however, continues to slow the pace of reform implementation. For smaller *chaebols* and independent firms, 104 cases have so far been registered under the Corporate Restructuring Accord (CRA) framework, of which, 78 plans, representing 75 percent of applications filed, have been agreed upon as of December 1999.

As of March 2000, the Malaysian Corporate Debt Restructuring Committee (CDRC) had resolved 42 percent in terms of number and about 46 percent in terms of value of the total cases it has handled. The CDRAC of Thailand has also met with some success in debt restructuring. As of March 2000, of the 7,102 target cases it has handled, about 40 percent in terms of number and 32 percent in terms of value have been completed. Outside the government-supervised restructuring framework, Thai financial institutions have also reported that, as of February 2000, they have restructured about 52 percent of the total debt that has gone through workouts carried out by financial institutions themselves.

So far, the use of formal bankruptcy procedures has been limited in all the five countries (Figure 25). In part, this is a reflection of business cultures that, historically, have favored out-of-court settlements and private negotiations. The high costs of resorting to formal bankruptcy procedures due to biases against creditors in insolvency proceedings and ineffective judicial systems in some of these countries also deter creditors from taking legal action against defaulting borrowers. New insolvency laws in Indonesia and Thailand provide a more credible framework that may compel debtors to negotiate settlements with their creditors. In Malaysia and Korea modern bankruptcy laws existed before the crisis. The governments in all of the affected countries are taking measures to improve the effectiveness of the judiciary in handling bankruptcy cases. The recent ruling in favor of Thai Petrochemical Industry creditors in Thailand and the ASTRA ruling in favor of IBRA in Indonesia suggest that bankruptcy laws will increasingly be implemented as they are intended.

Figure 26: **Debt-Equity Ratios of the Corporate Sector**

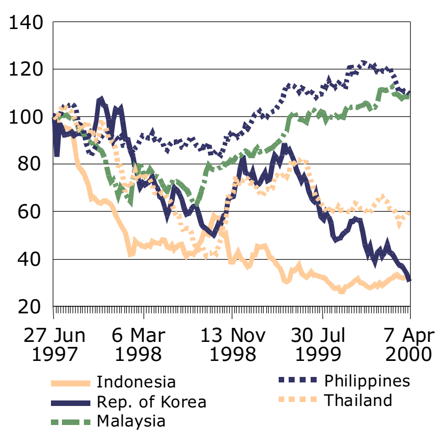


Sources: Country papers, Conference on Asian Corporate Recovery: Corporate Governance and Government Policy, World Bank web site; Business World, Philippines; Korea Herald web site; Thailand: Selected Issues, IMF web site.

Debt-equity ratios of the corporate sectors in most of the affected countries reached high levels when the crisis broke out nearly three years ago. Since then, because of the financial and operational restructuring measures taken, the ratios have fallen in all the countries except in Indonesia (Figure 26). The ratio was already close to the international average[4] in Malaysia in 1998 and by 1999 had fallen towards this average in Korea. However, the debt to equity ratios remain high in the Philippines, and particularly high in Indonesia and Thailand.

Market Assessment of Progress in Bank and Corporate Restructuring. One difficulty in assessing restructuring and recovery programs is how to isolate their impacts from those of other events. Some perspective as to the success or otherwise of restructuring programs can be gained from market data. Equity indices, credit ratings, and real bank credit growth, among other pieces of information, provide an indication of the private sector's assessment of progress of restructuring and rehabilitation.

Figure 27: **Ratios of Financial to General Stock Price Indices** (weekly average, last week of June1997=100)



Source: ADB calculations derived from Bloomberg.

- **Banking Sector Equity Index.** One summary indicator of market assessment is the performance of financial (or banking) sector equity relative to broader stock market indices. If the banking sector equity outperforms the broader market over a period of time, this would tend to suggest a bullish outlook, and could be interpreted as market endorsement of restructuring and re-capitalization efforts. On the other hand, a lackluster performance of this indicator means that doubts remain about the effectiveness of restructuring efforts.

  Indonesian financial stocks have under-performed the broader market during the crisis (Figure 27). Investors reacted positively when a major restructuring program was announced in September 1998. But this optimism was short-lived and financial stocks have since lost ground relative to other sectors.

  Despite episodic recoveries, financial sector stocks in Korea have fared worse than the overall market since late 1997. By early 2000, they had surrendered about 65 percent of their value to the overall market index. Despite the generally positive com-

4 For example, the debt-equity ratio was 1.07 in the US in 1995 and 1.48 in Germany in 1995.

mentary on Korean banking sector restructuring, financial sector equity values would seem to indicate that market participants are not yet convinced of the earnings prospects for Korea's banks. Slow progress in restructuring the *chaebols* and concerns about the true extent of their debt are likely to have had a negative influence on the market's assessment of financial stocks.

In Thailand, banking stocks have lost considerable ground to the broader market since mid-1997. Although they staged a recovery at around the time of the announcement of Thailand's financial restructuring package, they have subsequently fallen back and are now under-performing the broader market. While market participants seem to have been skeptical about the pace of restructuring, recent days have seen reports of a welcome return to profitability for Thailand's commercial banks.

In Malaysia, financial stocks underperformed the stock market until September 1998. Since then, and following the commencement of operations of Danaharta and Danamodal, the market valuations of financial stocks have recovered. By mid-1999, Malaysian financial sector stocks were outperforming the broader market relative to the June 1997 benchmark. This reflects a positive view of restructuring and its impact on prospective earnings.

In the Philippines, financial stocks outperformed the broader market in 1999 but this should be seen in the context of a lackluster performance by Philippine equities. However, market participants have clearly welcomed ongoing consolidation with mergers of large banking groups and the strengthening effect that is expected to follow in the medium term.

- **Real Bank Credit Growth.** Real bank credit growth can also give some indication of the general health of the banking and corporate sectors. Slow growth or a contraction in the stock of credit can occur when bank's balance sheets are too weak to support new lending. However, the stock of credit will also be influenced by demand factors, so that data should be interpreted with care.

The scale of the problems in Indonesia's banking and corporate sectors and the slow progress of restructuring led to a sharp fall in the stock of real bank credit. As yet, it shows no signs of recovery. On the other hand, despite the fact that Korea's financial system was among the worst hit by the crisis, impressive progress in financial restructuring has strengthened bank's balance sheets to a point where they have been able to resume lending. This is reflected in an increase in the stock of real bank credit. Since the second half of 1999, real bank credit has also been increasing in Malaysia. In both the Philippines and Thailand, the stock of real bank credit was still below pre-crisis levels at the end of 1999 (Figure 16).

- **Sovereign Credit Ratings.** Sovereign credit ratings provide a broad barometer of the general economic health of a country. But since sovereign ratings provide a ceiling for non-sovereign financial and corporate borrowers in any given country, they also provide an indirect assessment of the health of the financial and corporate sectors. After the crisis, the sovereign credit ratings for all five countries were revised sharply downwards to levels below investment grade. Subsequently, sovereign credit ratings for Korea and Malaysia have been positively reassessed (Table 1). Ratings for the Philippines are stable while Indonesia is on watch for a possible further downgrade.

Table 1: **Sovereign Credit Ratings**

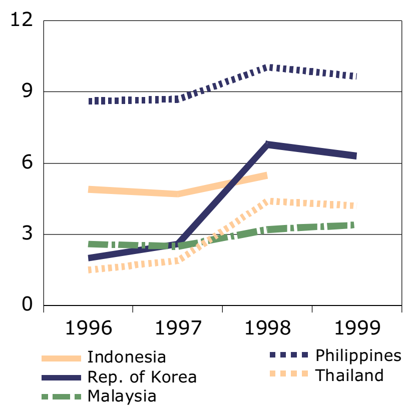
Item	Indonesia		Korea		Malaysia		Philippines		Thailand	
Moody's Foreign Currency LT	B3 B2	19 March 98 9 January 98	Baa2 Baa3	16 December 99 12 February 99	Baa3 Baa2	3 December 98 23 July 98	Ba1 Ba2	18 May 97 23 January 97	Ba1 Baa3	21 December 97 1 December 97
S&P Foreign Currency LT	CCC+ B-	15 May 98 11 March 98	BBB BBB-	11 November 99 25 January 99	BBB BBB-	10 November 99 15 September 98	BB+ BB	21 February 97 30 May 95	BBB- BBB	8 January 98 24 October 97
Fitch IBCA Foreign Currency LT	B- B+	16 March 98 21 January 98	BBB+ BBB-	30 March 2000 19 January 1999	BBB BBB-	7 December 99 26 April 1999	BB+	8 July 99	BBB- BB+	24 June 99 14 May 98

Note: Moody's: Baa bonds are considered medium-grade obligations. Interest payments and principal security appear adequate for the present. Ba bonds are judged to have speculative elements, their future cannot be well assured. B bonds generally lack characteristics of the desirable investments. Standard & Poor's: BBB bonds have adequate protection parameters, but adverse economic conditions could lead to weakened repayment capacity. BB bonds have a speculative element. B bonds are more vulnerable to nonpayment than BB bonds. CCC bonds are currently vulnerable to nonpayment. Fitch IBCA: BBB bonds are investment grade, good credit quality bonds. BB bonds are speculative with a possibility of credit risk developing. B bonds are highly speculative, with a significant credit risk.
Source: Bloomberg.

Outlook. Looking ahead, it is likely that further resources for the re-capitalization of banks will need to be found in Indonesia, but possibly too in Thailand. Particularly in Indonesia this could present formidable fiscal problems. In Thailand, private capital may be more forthcoming. Given the more modest scale of the capital shortfalls in Korea and Malaysia, economic recovery should go a long way towards healing bank balance sheets. In the Philippines, the private sector is being left to address additional capital needs. Over the longer term, the future safety of financial sectors in the affected countries will depend not only on buttressing balance sheets, but also on further strengthening of operational restructuring and the regulatory and supervisory systems, and improving banking and corporate governance.

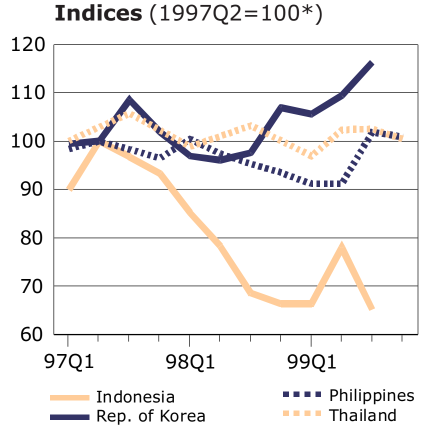
Longer Term Aspects—Social Recovery, Governance and Competitiveness

Figure 28: **Unemployment Rates** (%)



Source: ARIC Indicators.

Figure 29: **Real Wage Rate Indices** (1997Q2=100*)

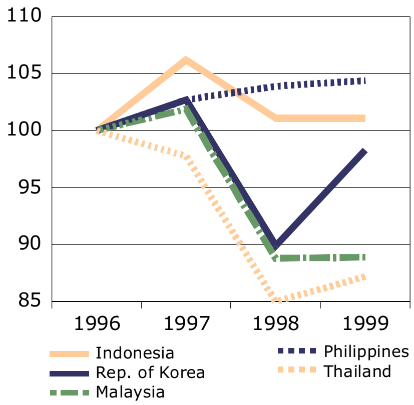


*For Thailand, 1997Q1=100; Prior to 1999, data for Thailand are available only for the first and third quarters.
Source: ARIC Indicators.

Sustaining and further accelerating the recovery in the social sector remains a critical challenge facing the affected countries. The crisis has demonstrated forcefully that informal safety nets provide inadequate protection in a turbulent environment. This is why social recovery still lags behind economic recovery. While social support systems in the region have been strengthened significantly, much more remains to be done. As these economies move forward, institutional arrangements must be found to better protect the most vulnerable and least well-off segments of society. More generally, continuing investments in the health, education and general welfare of the broad mass of the population should be a priority. An approach that empowers people rather than provides unsustainable subsidies is more likely to reconcile legitimate social objectives with economic efficiency and dynamism. While some growth may be possible without these changes, it will inevitably be of lower quality, more difficult to sustain, and more vulnerable to adverse shocks.

Although results have been mixed, several indicators for the affected countries suggest some measure of social recovery, albeit slow. Unemployment rates fell somewhat in most of the affected countries in 1999 (Figure 28), although they remain above their pre-crisis levels. Care should be taken, however, in interpreting these data, as falling unemployment rates could partly be a result of declining labor force participation rates. Further, it is possible that falling unemployment masks an increase in low paid jobs. However, in Korea, Philippines and Thailand, real wage indices now exceed their respective pre-crisis levels (Figure 29).

Figure 30: **Per Capita Real Private Consumption Indices** (1996=100)



Source: ARIC Indicators.

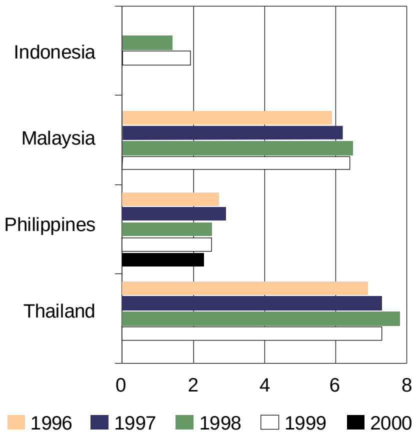
A further indicator that suggests some social recovery in the affected countries is per capita real consumption, which has recovered some portion of the ground lost earlier during the crisis, particularly in Korea (Figure 30). However, compared to the recent peak of 1997, per capita real consumption in 1999 was still 4.8 percent lower in Indonesia, 4.3 percent lower in Korea, and 12.8 percent lower in Malaysia. For Thailand, per capita real household consumption peaked in 1996. In 1999, it was still 12.8 percent lower than the 1996 level. The only exception is the Philippines, which did not see a drop in per capita real household consumption during the crisis. Again care should be taken in interpreting aggregate consumption data because if income distributions have become more unequal, and there is some evidence that this might be the case, then the consumption of the poorest may not be increasing or recovering as quickly as the economy-wide average.

Some of the countries are committing larger amounts of resources to social sectors such as public health, education and social protection (Figures 31, 32 and 33). For example, in three of the affected countries (Malaysia and the Philippines are exceptions), the share of government expenditure on social safety nets and welfare in the total budget increased in 1999 to address the social issues arising from the crisis. Among the five countries, only Korea has a formal system of unemployment benefits, which was introduced in the aftermath of the crisis. Consequently, Korea has the highest social safety net expenditure. Social safety net provisions in other countries cover only basic welfare, and, in the case of Malaysia, housing.

The Asian crisis had a marked impact on poverty levels, although less than initially predicted. In all of the affected countries, rising unemployment and falling real wages brought hardship to the poor. However, there are now some signs that levels of poverty are starting to fall, albeit slowly, as recovery gets underway in these countries. Encouraging signs are emerging from the worst affected of the five, Indonesia, where the impact of the crisis and political circumstances sparked fears of a sustained increase in poverty. According to the latest survey data,[5] poverty levels in 1999 have fallen back to almost pre-crisis levels. These data, however, have to be interpreted with extreme care because the sample size, at only 10,000 families, was small.

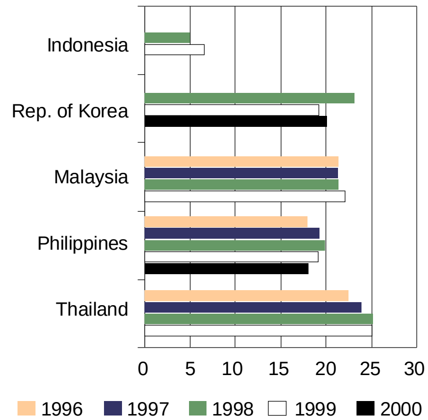
[5] Provincial Poverty and Social Indicators, selected from the Indonesia National Social and Economic Survey (SUSENAS) 1993-1999.

Figure 31: **Central Government Expenditure on Health** (as % of total budget)



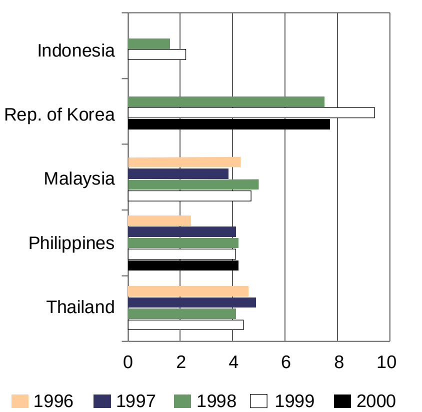
Sources: Web sites of Bank Negara Malaysia and the Ministries of Finance of Indonesia and Thailand; Republic of the Philippines, FY2000 Budget of Expenditures and Sources of Financing.

Figure 32: **Central Government Expenditure on Education** (as % of total budget)



Sources: Web sites of Bank Negara Malaysia and the Ministries of Finance of Indonesia and Thailand; Ministry of Finance and Economy, Synopsis of the Budget of the Republic of Korea, December 1998 and 1999; Republic of the Philippines, FY2000 Budget of Expenditures and Sources of Financing.

Figure 33: **Central Government Expenditure on Social Safety Nets*** (as % of total budget)



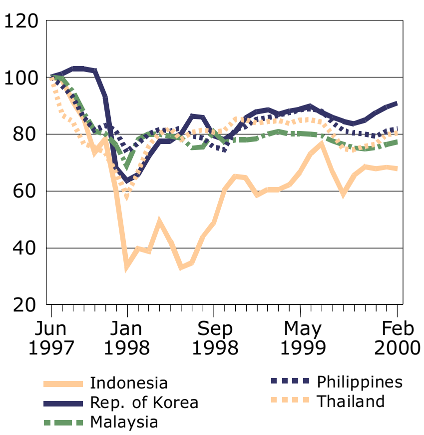
*Indonesia: social welfare; Korea: social safety nets including unemployment benefits; Malaysia: social welfare including welfare services, sports, labor, local government and housing; Philippines: social welfare including social security and employment; Thailand: social security and welfare.
Sources: Web sites of Bank Negara Malaysia and the Ministries of Finance of Indonesia and Thailand; Ministry of Finance and Economy, Synopsis of the Budget of the Republic of Korea, December 1998 and 1999; Republic of the Philippines, FY2000 Budget of Expenditures and Sources of Financing.

Studies with a larger sample size are required if more reliable results are to be obtained. In other countries, more recent data are needed to make similar assessments. But fast recovery is expected to have had some positive impact on reducing poverty provided it is not associated with greater inequality in the distribution of income.

Beyond social recovery, the affected countries, in particular Indonesia, Philippines and Thailand, still face a big challenge in improving the quality of life for millions of their citizens who still live in poverty. In Asia as a whole, according to the most common international definition of poverty—those who live on less than $1 a day measured in 1985 dollars—about one in four, or 900 million people, were poor in 1998. This is about more than twice as many poor people than those living in the rest of the developing world combined. In Indonesia, the same poverty definition gives a national headcount index of 20.3 as of December 1998. The Philippine official estimate of national headcount index in 1997 was 36.8, based on a poverty threshold of about US$3 per person per day at 1985 purchasing power parity (PPP) dollars. In Thailand, the share of the poor was estimated at 13 percent in 1998. But quality of life cannot—and should not—be defined by dollar income alone. A broad definition of the quality of human life must include other aspects of human deprivation: illiteracy, malnutrition, bad health, poor access to water and sanitation, vulnerability to economic shocks, and lack of political freedom. Fighting poverty and addressing broad aspects of quality of life will remain the most pressing issues facing many Asia countries, including those affected by the crisis, for many years to come.

The crisis has brought to the fore issues of governance in the public and corporate sectors. Too much has probably been made of the weaknesses that clearly existed before the crisis. Fast growth coexisted with these prior to the crisis, and growth has now resumed with only modest changes. But this is no reason for complacency. Good governance can and does contribute significantly to both the quantity and quality of growth. In an increasingly interdependent global economy, good practices are likely to assume greater importance in assuaging investor concerns and attracting needed capital and expertise. Governments have a key role to play in developing institutional frameworks conducive to good governance and ensuring that they function effectively.

Figure 34: **Real Effective Exchange Rate Indices***
(1997June=100)



*Traded vs. non-traded goods prices.
Source: ARIC Indicators.

After the sharp appreciation of real effective exchange rates since the beginning of 1998 (Figure 34), issues related to competitiveness have also resurfaced. While the affected countries have focused on getting back on their feet, competition from other countries within the region and outside has continued to intensify in key export markets. On a global scale, excess capacity is now apparent in a number of sectors. Prices of electronics and electrical machinery and equipment, telecommunications equipment, computer equipment and office machines, and transportation equipment have all fallen sharply in recent years. And prices of exports from East Asian nations have fallen more sharply than those from other regions. This, no doubt, contributed to the 1998 contraction in the nominal dollar value of exports from the affected countries. Electronics prices have recovered since then, although they are now falling back again, indicating that the prices of these products are quite sensitive to the balance between supply and demand. Partly because of the recovery in electronics, export growth rates recovered strongly in 1999 in all the affected countries except Indonesia. Export volumes have been buoyed by strong world demand, but have also responded, although with a lag, to depreciated real exchange rates.

There are, however, competitive pressures facing Indonesia and, to a lesser degree, Thailand and the Philippines in markets for labor-intensive exports. These may increase with the entry of the PRC into the World Trade Organization (WTO), although that would also provide new opportunities for trade. With intensifying export competition, the region’s major trading partners may give in to pressures to apply anti-dumping and other protective measures to limit the market penetration of Asian exports. Another potentially serious challenge arises from the failure of the Seattle Ministerial Conference of the WTO. The lack of consensus on further liberalization of trade on a most-favored nation basis through multilateral negotiations may encourage countries to focus on strengthening regional ties on a discriminatory basis. These preferential arrangements carry the potential of trade diversion and may further limit the market access of the crisis-affected countries in regions such as the Americas and Europe.

Going forward, to sustain a recovery in international trade, it will be essential for regional economies to improve their access to markets overseas. This may require a more focused and coordinated voice in negotiations over multilateral trade liberalization. Domestic constraints also need to be addressed. Wise investments in education and human resources, as well as infrastructure, and further deregulation of investment and liberalization of trade policies will help achieve this. Moving resources from activities in which comparative advantage is fading into others where opportunities are expanding is a perpetual challenge.

Recovery Prospects and Risks

Medium-term Prospects. Having proved overly pessimistic in 1999, the accepted view now is that recovery in the affected countries will be consolidated and further strengthened in 2000. Consensus Economics expects the Indonesian economy to grow by 4.2 percent, but projections vary within quite a large range of 3.0 to 5.5 percent (Table 2). To varying degrees, growth is also expected to pick up in Malaysia, Philippines and Thailand. But Consensus Economics expects growth to slow down in Korea, falling to 7.7 percent, after the pronounced recovery that has already taken place there. The range of projections is, however, rather wide from 6.0 to 9.6 percent, suggesting that there are still significant underlying uncertainties. Three factors underlie these generally reassuring assessments. First, monetary and fiscal policies are expected to remain broadly accommodating. Second,

Table 2: **GDP Growth and Projections** (%)

Country	1996	1997	1998	1999	2000 Consensus Economics[1]	2000 Official[2]	2000 ADB[3]	2000 IMF[4]	2000 World Bank[5]
Indonesia	7.8	4.7	-13.2	0.2	4.2 (3.0-5.5)	3.0-4.0	4.0	3.0	3.0
Rep. of Korea	6.8	5.0	-6.7	10.7	7.7 (6.0-9.6)	6.0	7.5	7.0	6.0
Malaysia	10.0	7.5	-7.5	5.4	6.4 (5.0-7.6)	5.8	6.0	6.0	6.0
Philippines	5.8	5.2	-0.5	3.2	3.9	4.0-5.0	3.8	4.5	4.0
Thailand	5.9	-1.7	-10.4	4.2	5.2 (4.1-6.0)	4.5	4.5	4.5	5.0

Note: Data for 1996-1999 are from ARIC Indicators.
[1] Consensus Economics Inc., Asia Pacific Consensus Forecasts, March 2000; Figures in parentheses represent the range of forecasts.
[2] Official government projections were obtained from the following sources: Indonesia—Bank Indonesia, Policy Implementation in 1999 and Policy Direction for 2000, January 2000; Rep. of Korea—Ministry of Finance and Economy, Korea Economic Update, 24 January 2000; Malaysia—Bank Negara Malaysia, 2000 Budget Speech, 25 February 2000; Philippines—National Economic and Development Authority, 1999 Economic Performance and 2000 Prospects, 28 January 2000; Thailand—Bank of Thailand, Revised Economic Forecasts for the Thai Economy, 29 February 2000.
[3] ADB, Asian Development Outlook 2000, April 2000.
[4] IMF, World Economic Outlook, April 2000.
[5] World Bank, East Asia and Pacific Quarterly Brief, 22 March 2000.

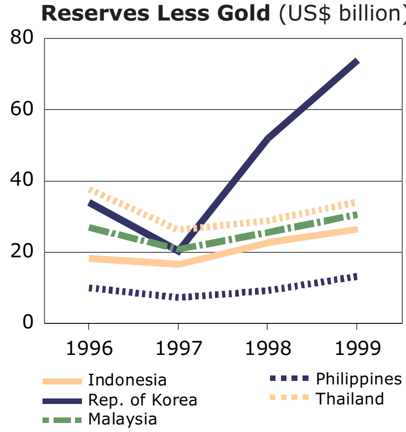
favorable conditions in the global economy are expected to continue. Third, output is still somewhat below potential. As the gap is closed, growth will be supported. As growth is consolidated, social recovery should progress further.

With uncertainty lifting, domestic sector private demand is expected to play a stronger role in propelling growth in 2000 than it has done so far. While public consumption is expected to stabilize as governments focus more on fiscal consolidation, the upward trend in private consumption will continue and investment demands are expected to pick up. However, net exports may shrink, as imports rise with the general tide of economic activity.

In 2000, financial markets in the affected countries should be driven more by fundamentals. Although stock markets have softened somewhat since early this year, there should be less volatility in the future. Regional financial markets should be more attractive to investors seeking diversification opportunities. Real estate prices should also start to nudge up. Rising domestic demand should improve credit flows in the economy, and cash flow positions of banks and corporates. Fiscal deficits are also likely to narrow. Taken together, these developments should make domestic assets more attractive to foreign and domestic investors.

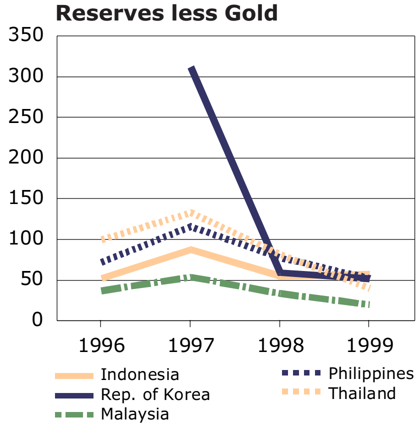
Tangible as the recovery process is, it remains prone to risks in both the domestic and global economic environment. On a posi-

Figure 35: **Gross International Reserves Less Gold** (US$ billion)



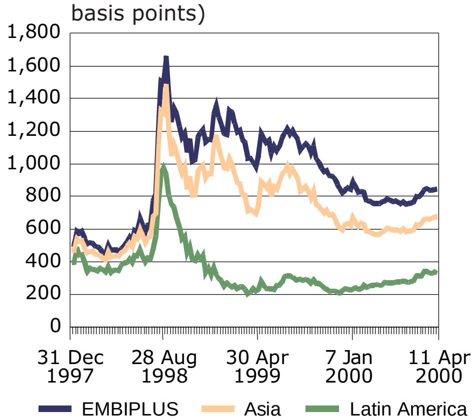
Source: ARIC Indicators.

Figure 36: **Short-term External Debt as % of Gross International Reserves less Gold**



Note: Figures for Indonesia represent short-term external debt as a % of net international reserves. The 1999 figure for the Philippines is as of end September.
Source: ARIC Indicators; for Indonesia, International Department, Bank Indonesia.

Figure 37: **Emerging Market Bond Indices** (JP Morgan EMBI+ basis points)



Source: JP Morgan.

tive note, contagion and financial volatility in the global economy seem to have faded through 1999, and the affected countries of Asia are now in a much better position to withstand shocks. In all five affected economies, foreign exchange reserve positions have strengthened considerably over the past 12 months (Figure 35) and now provide higher coverage of short-term external debt (Figure 36). The calm response in global financial markets to the devaluation of the Brazilian real in early 1999 marked a return to more orderly market dynamics. Ecuador's default hardly registered at all in Asian markets. Spreads on Asian debt narrowed throughout 1999 in response to improving regional economic conditions (Figure 37), although they have recently edged up with falling long-term yields in the US.

External Risks. The IMF now projects the global economy to grow by 4.2 percent in 2000, a significant upward revision from its October 1999 projection of 3.4 percent (IMF, WEO, October 1999 and April 2000). Most of the additional growth is expected to be provided by the US economy, where the IMF's forecast for 2000 has been raised to 4.4 percent. First quarter growth rate was 5.4 percent on an annualized basis, the third consecutive quarter of growth above 5 percent. Domestic demand in the US continues to grow strongly, with unemployment at an unprecedented low rate.

Recent US performance has raised questions about long-held assumptions regarding macroeconomic relationships. One view is that underlying structural changes are allowing the US economy to sustain faster growth than before (for any given inflation target). A conjunction of relatively low inflation and accelerating growth seems to support this proposition. Proponents of this view claim that dramatic productivity growth associated with rapid technological advances and demographic and institutional shifts, which make for much more flexible labor markets, are the pillars of the so-called New Economy.

As yet, it would seem the Federal Reserve Board (Fed) is not quite persuaded by this thesis. Whatever changes may be taking place in the US economy, the view of the Fed appears to be that the current alignment of unemployment, growth and inflation is not sustainable. Concerned by latent inflationary pressures, the Fed has gradually raised overnight borrowing rates. Beginning June 1999 the Fed has raised the federal funds rate by five quarterly increments totalling 125 basis points. By historical standards, this tightening has been mild. Recent economic data, particularly those that indicate strong growth and higher inflation in the first quarter of 2000, suggest that further short-term interest rate increases may be in the pipeline.

In crucial ways, US prospects hinge on the stability of beliefs about asset prices and earnings growth. Increasing market volatility seems to suggest that perceptions rather than fundamentals have increasingly come to influence behavior. A collapse of the stock market could cause widespread financial distress and turn a soft landing into a hard one. A hard landing of the US economy would adversely impact global demand, trade and asset markets.

There are a number of developments that could unhinge beliefs. First, faster than expected growth of domestic demand may necessitate sharp increases in US interest rates and trigger substantial corrections in equity prices and a depreciation of the US dollar. Signs of overheating are emerging in the US, increasing the prospects of more agressive interest rate increases by the Fed. Second, glaring imbalances in personal savings and the current account balance may leave the US economy vulnerable to shifts in international investors' appetite for US dollar assets. Third, the productivity spurt that underpins the New Economy doctrine may not last. If productivity slips, the gap between expected and actual earnings might be so large as to cause a collapse in stock prices. Seen from this perspective, the recent fall in NASDAQ may be a blessing in disguise. Slowing down the torrid expansion of paper wealth in the US may help curb growth of domestic demands.

Prospects in Japan in 2000 will depend crucially on private sector growth. The large fiscal stimulus at the end of 1999 should mean that growth in 2000 at least matches 1999's outcome, but improvement will depend on a recovery in private investment and consumption demand. The Japanese economy grew by 0.3 percent in 1999, and the WEO projects that it will grow by 0.9 percent in 2000. Recent economic data suggest that, driven by private sector activities and private consumption, growth has picked-up somewhat in the first quarter of 2000.

Japan has embarked on a complex banking and corporate restructuring and reform program. Substantial fiscal resources have been devoted to this program. Over the medium term, restructuring efforts will help remove ingrained inefficiencies and establish a strong foundation for future growth. However, the more immediate impact of reform is unlikely to be expansionary. Once difficult adjustments have been completed, a reinvigorated financial and corporate sector should help propel the Japanese economy forward.

Growth in Europe is expected to pick up further in 2000. Possible obstacles to this include the possibility of sharp reductions in US equity prices that may carry over into European markets. Some further monetary tightening in the Euro area is also possible. In the United Kingdom, interest rates have been raised in response to strong demand and a tightening labor market. Despite the expected near-term decline in inflation to a record low, the medium-term outlook is far less benign and, therefore, further rate increases cannot be ruled out. The WEO also projects economic growth to pick up in other non-Euro Western European economies.

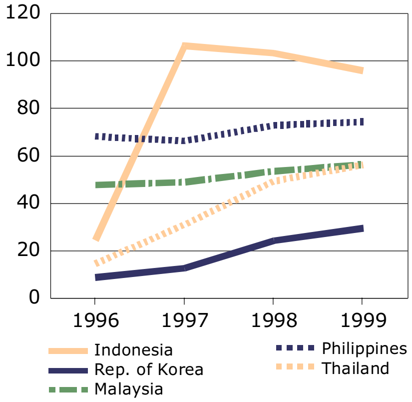
On the positive side, global market conditions are expected to improve for commodity-exporting developing countries over the course of the year. Oil prices have increased sharply since early 1999 and, following the end-March agreement among members of the Organization of Petroleum Exporting Countries (OPEC) to raise production, the prices have fallen somewhat and now stabilized. On average, oil prices in 2000 are expected to be substantially higher than in 1999. Oil-exporting countries, including Indonesia, will benefit from gains in terms-of-trade. The anticipated acceleration of global growth in 2000 should provide stronger support for non-fuel commodity prices and create favorable demand conditions for export-oriented East Asian economies, including those affected by the crisis.

Domestic Risks. As the recovery takes hold, concern is mounting that it may be used as a pretext to postpone or cancel reforms. This is a risk brought about by the swift rebound. Some have suggested that a more cautious approach to reform may now be needed to allow growth to take firmer root. They point out that the initial impact of restructuring is likely to be deflationary as retrenchments and bankruptcies occur, and that this could disrupt the recovery. The argument then runs that since growth can ease the debt burden, it should be accorded a higher priority than reforms. Only once growth is more firmly established should reforms proceed. In an environment where growth is more firmly anchored, it is suggested, reforms will meet with less resistance and entail lower costs.

While this reasoning has its appeal, much depends on the severity of the underlying difficulties, and the rate of economic growth that can realistically be expected. While the expected high growth in Korea and Malaysia may go a long way towards resolving their debt problems, projected growth for Indonesia and Thailand is likely to have much less of a remedial effect given the extent of debt overhang. If the expected growth did not take place, and reforms were deferred, debts could escalate further and this would make the entire restructuring process much more painful than it might otherwise be. In these circumstances, newly replenished bank capital could also be put at risk.

A "growth first" strategy is not only risky, it may invite a recurrence of problems at a later date, particularly if underlying structural difficulties are not tackled. Accumulated experience indi-

Figure 38: **Gross Public Debt**
(as % of GDP)



Source: IMF, World Economic Outlook, April 2000.

cates that the best chances for durable recovery require perseverance with reform. Encouraging economic activity by postponing or canceling needed but difficult reforms can exact a high cost in terms of a reduction in long-run potential growth.

A sensible middle road is to combine reform with policies that provide needed, and affordable, support for demand. However, the scope for accommodating demand policies is narrowing. Large deficits and rising public debt levels would raise questions about the fiscal sustainability of further pump priming (Figure 38). Although current account surpluses permit greater freedom over monetary policy, rising global interest rates may eventually require a less accommodating monetary stance too. In the Philippines, interest rates are already edging up.

Longer-term Prospects. Looking beyond the next year or two, an important issue is whether the crisis will have lingering effects on Asia's potential for growth. Has the crisis permanently blunted Asia's prospects for economic catch-up?

Those who are pessimistic about growth prospects point to the institutional weaknesses that the crisis has brought into sharp relief. Since strengthening and modernizing institutions is a time-consuming activity, and there is a great deal of uncertainty about whether the needed changes can and will be made, Asia's prospects for growth are diminished. Growth that rests on the rapid accumulation of capital may also be more difficult in the future, because diminishing returns and inefficiencies may set in quickly, especially in the presence of weak financial and corporate sectors. Other factors that could permanently damage growth prospects would include protectionism in the industrialized countries and the breakdown of the world trading system.

While the growth pessimists' views cannot be immediately discounted, much will depend on the choices that are made about policies and institutions. If policy and institutional reforms are continued, growth should be sustained and become less vulnerable to external shocks. Ultimately, the crisis could indeed appear to be a moderate disturbance in Asia's rise and dynamism. Continued high rates of domestic savings, sound macroeconomic policies, investments in education and infrastructure, improved governance and public administration, and openness to trade and foreign investment, will help ensure that Asia continue to close the income gap with the industrialized countries. It bears underlining that fast economic growth is vital if poverty is to be eradicated and broad-based gains in living standards are to resume. While the crisis undoubtedly brought pain, it may galvanize reform efforts and with the benefit of hindsight turn out to have been a temporary setback.