ADB
Asia Recovery Report 2000

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The Asia Recovery Report (ARR) is a semi-annual review of Asia's recovery from the crisis that began in July 1997. The analysis is supported by high-frequency indicators compiled under the ARIC Indicators section of this web site.

This issue of the ARR focuses on the five countries most affected by the crisis: Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand. The recovery processes in these five countries together with their strengths and weaknesses are discussed. The theme of this ARR is external risks facing Asia's rebound from the crisis.

Contents

Boxes

Asian Development Bank

Highlights

- This year has seen the five countries most affected by the Asian financial crisis firmly in recovery mode, a process that began in 1999. However, although recovery has consolidated further, it is still far from complete.
- Recovery is proceeding on three tracks—the Republic of Korea (henceforth, Korea) has already surpassed its precrisis per capita income peak, Malaysia and Philippines are expected to do so this year, while Thailand will take about another year or so and Indonesia possibly even longer.
- Recovery is maturing—quarterly GDP growth rates (y-o-y) have basically stabilized in Indonesia, Philippines, and Thailand, and tapered off a little in Korea and Malaysia. The growth outturn for this year is projected to be higher than in 1999 in four of the affected countries. Korea's growth in 2000 is expected to moderate to a more sustainable pace.
- In Korea, recovery is improving cash flow positions of banks and corporates, prompting the flow of bank credit, which in turn is fueling further recovery. Lately, Malaysia also appears to be experiencing this "virtuous circle," but other countries are still behind.
- External and internal factors are responsible for the retreat in equity markets and exchange rates in the affected countries this year; but there are no reasons to suggest that Asia may plunge into a renewed financial crisis.
- Net private capital outflows predicted from the affected countries this year will not approach the levels seen in 1997 and 1998. The composition of capital being withdrawn is also different and does not reflect investor panic.
- The quality of recovery is improving, adding resilience to the affected countries, which are now in a much stronger position to absorb shocks.
  - While net exports had generally led recovery, domestic demand and intraregional trade are now starting to kick in. The recovery is thus becoming relatively less susceptible to gyrations in external demand outside the region.
  - There is now a greater clarity and coherence in macroeconomic management policies.
  - Headway is being made on structural rehabilitation of banks and corporates. In most countries, NPLs are falling and real bank credit is starting to stabilize or rise.

Continued overleaf

Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AMC	asset management company
ARIC	Asia Recovery Information Center
ASEAN	Association of Southeast Asian Nations
BNM	Bank Negara Malaysia
BOP	balance of payments
BPS	Badan Pusat Statistik
CAR	capital adequacy ratio
CDRAC	Corporate Debt Restructuring Advisory Committee
CDRC	Corporate Debt Restructuring Committee
CSIP	Capital Structure Improvement Plan
DOSRI	Directors, officers, stockholders, and related interests
EU	European Union
FDI	foreign direct investment
FRA	Financial Sector Restructuring Authority
FSS	Financial Supervisory Service
GDP	gross domestic product
HITS	Hyundai Investment Trust & Securities Co.
IBRA	Indonesian Bank Restructuring Authority
IMF	International Monetary Fund
IT	information technology
ITC	investment trust company
JCI	Jakarta Composite Index
JITF	Jakarta Initiative Task Force
KAMCO	Korea Asset Management Corporation
KDIC	Korea Deposit Insurance Corporation
KLCI	Kuala Lumpur Composite Index
KOSPI	Korean Stock Price Index
MSCI	Morgan Stanley Capital International
NASDAQ	National Association of Securities Dealers Automated Quotation
NPL	nonperforming loan
OPEC	Organization of Petroleum Exporting Countries
PHISIX	Philippine Stock Exchange Composite Index
PRC	People's Republic of China
PSE	Philippine Stock Exchange
SEC	Securities and Exchange Commission
SET	Stock Exchange of Thailand
SME	small- and medium-sized enterprise
SOE	State-owned enterprise
TPI	Thai Petrochemical Industry Plc
US	United States
WEO	World Economic Outlook
B	baht
P	peso
RM	ringgit
Rp	rupiah
W	won
y-o-y	year-on-year
Note:	"$" refers to US dollars, unless otherwise stated.

The *Asia Recovery Report 2000* was prepared by the Regional Economic Monitoring Unit of the Asian Development Bank and does not necessarily reflect the views of the ADB's Board of Governors or the countries they represent.

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- External positions have improved significantly. Foreign exchange reserves provide ample cover for short-term obligations and the maturity structure of external debt is improving.
- Property markets are starting to bottom out.

- But weak spots remain.
  - Fiscal positions are a cause for concern in Indonesia, Philippines, and to a lesser extent, Thailand.
  - Restructuring still has a long way to go.
  - Political uncertainties are hampering reform and recovery in several countries.
  - Social recovery needs to be accelerated.
- Earlier this year, there were concerns that US growth could slow sharply and impact adversely on Asia's recovery. This risk has receded somewhat, although it cannot be ruled out entirely. Even if US growth were to slow more sharply than most expect, say to about 2 percent rather than 3-4 percent in 2001, economic recovery would be impaired, but not derailed.
- The adverse impacts arising from the present high oil price levels would be manageable if they are maintained only up to the first quarter of next year. However, a prolonged period or further price increases could cause significant disruptions to the region's recovery.
- The recovery process should move forward further during the balance of this year and in 2001. But reforms should be continued in order to place Asia on the path to a new era of high growth and reduced vulnerability to external shocks.

Country-Specific Recovery Prospects

- Indonesia's recovery has consolidated further in the first half of the year. But financial restructuring, the number one item on the reform agenda, continues to be painfully slow.
- Korea is experiencing the strongest recovery in the region. However, the continuing problems of major *chaebols* and other conglomerates raise the risk of further banking problems.
- Malaysia is also growing quickly. It has made good progress on banking and corporate rehabilitation, but FDI, an important driver of Malaysia's growth in the past, still languishes.
- The pace of economic reform legislation in the Philippines has accelerated this year. Budgetary woes and the conflict in Mindanao are adversely affecting investor confidence, while the quality of governance remains a concern.
- Political uncertainty about the outcome of the forthcoming elections and the future direction of reforms continues to impact on Thailand's financial markets and economic performance.

Tracking Asia's Recovery—A Regional Overview

Recovery in 1999

Asia's recovery from the financial crisis of 1997 has turned out to be faster than expected. The economies of the most affected countries—Indonesia, Republic of Korea (henceforth, Korea), Malaysia, Philippines, and Thailand—started to bottom out in the second half of 1998. Recovery proper then began in early 1999 with the resumption of growth, initially driven by more accommodating fiscal and monetary policies, a favorable global economic environment, and supportive supply-side and relative price adjustments.

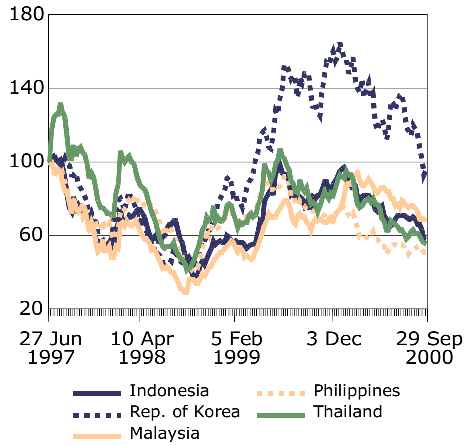
In general, net exports led the economic revival in a context of weak domestic demand. An exception was Korea, where exports dominated, but domestic demand contributed more strongly and sooner to growth than it did elsewhere.

On the supply side, manufacturing spearheaded recovery, with the electronics and electrical sectors growing particularly quickly in response to expanding global demand. In some countries, agricultural output benefited from more favorable weather conditions following the end of the *El Niño* and *La Niña* phenomena. Meanwhile, services performance was mixed, picking up fastest in economies where private consumption recovered, while construction activity continued to languish across the board.

On the structural front, banking sector recapitalization and restructuring made considerable headway in 1999, with capital adequacy and asset quality improving. Nevertheless, in most countries, the stock of real credit continued to shrink. The affected countries also began the process of corporate debt resolution and restructuring. In most cases, voluntary procedures for debt resolution were emphasized, but some countries made faster progress in this than others. Indonesia and Thailand took significant steps with the introduction of groundbreaking bankruptcy laws, while Korea, among others, introduced measures to strengthen corporate governance. In general, however, corporate restructuring lagged behind financial sector restructuring. Meanwhile, the fragmentary data that were available suggest that sometime toward the end of 1999, social recovery also began in the region.

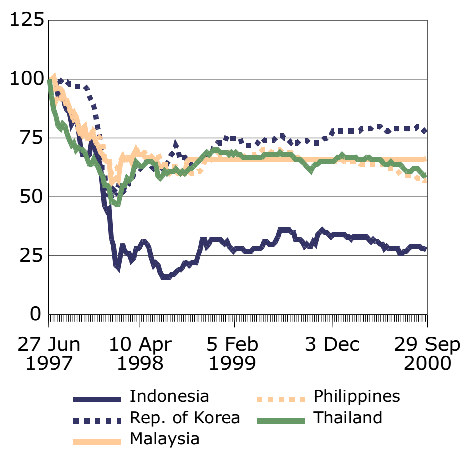
Recovery in 2000

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.

Financial and Asset Market Developments

The sharp rebounds in equity markets of 1999 have been seriously eroded, or even wiped out in some cases, during 2000 (Figure 1). In local currency terms, as of end-September, Korean, Indonesian, and Thai equities had fallen by almost 40 percent since the beginning of the year, while losses in the Philippines were a shade under 35 percent. Even in Malaysia, first quarter gains had been offset by subsequent losses and the market was off by 11 percent. In dollar terms, these losses were larger still in all countries with the exceptions of Korea and Malaysia.

In Indonesia, Philippines, and Thailand, equity losses have been accompanied by a renewed depreciation of domestic currencies (Figure 2). Under most pressure was the Indonesian rupiah, which, as of end-September, had fallen by about 19 percent since the beginning of the year. Elsewhere, currency depreciation had also been significant: the Philippine peso depreciated by 13 percent and the Thai baht by 11 percent. In contrast, Malaysia's ringgit peg to the dollar has held firm and the Korean won, supported by strong inward investment flows and continued current account surpluses, has appreciated slightly since the start of the year.

The retreat in equity markets has been influenced by external and domestic factors. Externally, rising US interest rates have triggered downward adjustments in global equity markets, which, in general, have had an adverse impact on the regional markets. Higher global interest rates as well as uncertainty about their future path in mature markets may have encouraged substitution out of emerging market equities, including those of some of the affected countries, and into liquid dollar assets. This has been further encouraged by the lower weights assigned to emerging markets in some global indexes.

Another factor that has influenced regional equity markets is the worldwide corrections in prices of information technology (IT) stocks since the second quarter of this year. The IT sector in the affected countries has expanded in recent years, increasing exposure to fluctuations in IT stock prices originating in the developed world.[1] Prices of IT stocks tend to be more volatile and more closely correlated internationally than those of traditional non-IT stocks. Stock markets in the affected countries joined a worldwide rally of IT stock prices led by the US NASDAQ stock index in the second half of 1999 through February 2000. In the second quarter of 2000, however, investors' concerns over the sustainability of record high price-earnings ratios of IT stocks and expectations of further interest rate hikes by the Federal Reserve (Fed) led to a series of corrections in NASDAQ. The shock wave quickly spilled over to global equity markets and similar corrections took place in the affected countries' stock markets. There was also considerable volatility in global equity markets in the third quarter. Exacerbating the corrections has been a reversal or slowdown of portfolio equity inflows.

Domestic concerns have also dampened investor expectations and eroded confidence. These factors have included the slow pace of bank and corporate restructuring, limited progress in structural reforms, and, in some countries, deterioration in fiscal positions and perceived heightening of political risks.

The weakening of domestic currencies in Indonesia, Philippines, and Thailand can be explained by a variety of factors, some of which have also influenced equity valuations. First, rising US dollar interest rates and investor concerns over domestic economic and political problems have made domestic currency assets less attractive. Net private capital flows to Indonesia and Thailand have been negative so far this year, and a large amount of portfolio capital has left the Philippines (Box A, Table A-2). Second, changes in postcrisis monetary regimes now mean that authorities are less inclined to "defend" domestic currencies. Monetary policy is now more closely guided by inflation targets (formal or informal) than by exchange rates. And third, currencies of net oil importing countries (mainly the Philippines and Thailand) may have also come under pressure from high world oil prices.

[1] In 1999, market capitalization of IT stocks as a share of total market capitalization was 18.2 percent in Korea, 12.1 percent in Malaysia, and 14.8 percent in Thailand, compared to 33.3 percent in the US and 19.4 percent for Europe as a whole.

The recent retreat of equity markets and renewed currency depreciation, however, do not constitute a financial crisis. First, the magnitude of net private capital outflows is nowhere near as large as it was in 1997 and 1998 (Box A). Second, the composition of capital being withdrawn is also different. In 1997 and 1998, the main problems were nonrenewal of short-term credit by banks and investor panic. Now the problems are

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

Private capital flows staged a recovery in 1999 after their abrupt reversal precipitated the Asian financial crisis in 1997. But they are forecast to swing back to a negative level in 2000, amid fears that another crisis could be brewing in some, if not all, of the five affected countries.

Data from the *World Economic Outlook* (WEO), September 2000 issue, of the International Monetary Fund (IMF) show that the crisis started when private capital flows to the five affected countries turned from a net inflow of $67.4 billion in 1996 to a net outflow of $15.6 billion in 1997 and $28.2 billion in 1998 (Table A-1).

Capital flows have since varied across the five countries (Table A-2). Korea, where economic recovery is quite strong, has seen an across-the-board increase in all types of capital flows and has attracted the lion's share among the affected countries. Meanwhile, after large net outflows in 1998 and 1999, private long-term and short-term flows to Malaysia both turned positive in the first quarter of 2000. However, FDI inflows have still a long way to go to reach precrisis levels.

Net FDI to Indonesia, Philippines, and Thailand, by contrast, has either slowed down or become more negative in 2000. Portfolio capital has likewise flowed out of Indonesia and Philippines, although Indonesia's first quarter 2000 outflow figures show an improvement compared to the same period last year.

Despite these negative developments, there appears to be no imminent danger of a repeat of the 1997 crisis, for several reasons. First, the projected swing and turnaround of net private capital flows to the affected countries between 1999 and 2000 is only $25.3 billion compared to about $96 billion between 1996 and 1998. Moreover, net private capital flows are expected to be positive in 2001. Second, the composition of the category "other flows"—which was the primary source of the reversal in 1996-1998 and 1999-2000—is different in the two periods.

Bank loans fell steeply in 1997 and 1998 as short-term credits were not rolled over. Since then, bank lending to the affected countries has not recovered. The projected sharp increase in the net outflow of other private capital in 2000 is mainly a result of accelerated loan repayments (WEO, 2000). In 1997 and 1998, the decision not to renew short-term loans was largely unexpected and proved quite disruptive. In the more recent case, however, the loan repayments had been anticipated and scheduled. Hence, they have not led to major balance sheet adjustments.

The net FDI inflows to all five countries is projected to decelerate from $13.1 billion in 1999 to $9.1 billion in 2000. Since FDI flows are not usually intermediated through domestic banks, the projected turnaround in total net private flows is not likely to be as problematic as it was in 1997. In the latter case, capital outflows were dominated by short-term transactions, which were largely intermediated through the banking sector. Nevertheless, the slowdown in FDI will still have some impact on the medium-term growth prospects of these countries.

Therefore, contagion on the same scale as that seen in 1997 is unlikely given the differences in capital flows now compared to then. But these recent developments do underscore the need to speed up the economic reform process, as well as the urgency of achieving political stability and improved governance.

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

	1995	1996	1997	1998	1999	2000F	2001F
Net Private Capital Flows	53.9	67.4	-15.6	-28.2	2.9	-22.4	10.6
Direct Investment, Net	8.8	9.8	9.8	10.4	13.1	9.1	9.0
Portfolio Investment, Net	18.8	25.5	8.4	-8.2	12.8	13.2	3.3
Other Private Capital Flows, Net	26.3	32.0	-33.8	-30.4	-23.0	-44.6	-1.7
Net Official Flows	0.7	-6.1	15.7	19.5	-6.7	5.0	-2.1

F = forecast.
Source: IMF, *World Economic Outlook,* September 2000.

Continued next page

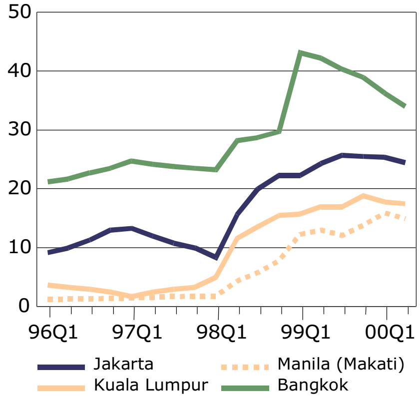
Box A: **Capital Flows to the Five Affected Countries** (Cont'd)

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

	1995	1996	1997	1998	1999	Jan-Jun 1999	Jan-Jun 2000
Indonesia[1]							
Net Private Flows	9,923	11,369	-3,483	-19,609	-11,294	-3332	-2,302
Net Direct Investment	3,743	5,594	4,499	-400	-2,817	-245	-1,494
Net Portfolio Investment	4,100	5,005	-2,632	-1,878	-1,792	-1,994	-23
Other Private Flows, Net[2]	2,080	770	-5,350	-17,331	-6,685	-1,093	-785
Net Official Flows	336	-522	2,880	9,971	5,353	3,461	1,286
Net Capital Flows	10,259	10,847	-603	-9,638	-5,941	129	-1,016
Rep. of Korea							
Net Private Flows	17,793	24,409	-13,884	-13,027	9,354	3,245	12,602
Net Direct Investment	-1,776	-2,345	-1,605	673	5,136	1,339	2,070
Net Portfolio Investment	11,591	15,185	14,295	-1,878	8,676	4,934	8,297
Other Private Flows, Net[2]	7,978	11,569	-26,574	-11,822	-4,458	-3,028	2,235
Net Official Flows	-519	-485	15,806	9,660	-6,924	-3,316	277
Net Capital Flows	17,273	23,924	1,922	-3,368	2,430	-71	12,879
Malaysia[1]							
Net Private Flows	5,180	9,180	546	-3,461	-8,381	-1,541	1,603
Net Private Long-Term	4,172	5,079	5136	2,165	1,553	270	679
Of which Net Direct Investment	3,327	3,528	3,648	1,860	2,524	400	762
Net Private Short-Term	1,008	4,101	-4,590	-5,626	-9,934	-1,811	924
Net Official Long-Term	2,451	297	1,651	545	1,763	84	-33
Net Capital Flows	7,631	9,477	2,197	-2,916	-6,618	-1,457	1,570
Philippines[3]							
Net Direct Investment		1,338	1,113	1,592	805	490	118
Net Portfolio Investment		2,179	-351	80	347	290	-398
Other Flows, Net[2,4]		7,558	5,831	-1,194	-2,159	947	567
Net Capital Flows		11,075	6,593	478	-1,007	1,727	287
Thailand							
Net Private Flows			-5,930	-11,735	-10,021	-6,659	-7,843
Net Direct Investment			3,298	7,361	5,854	2,855	1,448
Net Portfolio Investment			4,386	352	383	66	430
Other Private Flows, Net[2]			-13,614	-19,448	-16,258	-9,580	-9,721
Net Official Flows			1,587	1,993	2,114	2,246	55
Net Capital Flows			-4,343	-9,742	-7,907	-4,413	-7,788

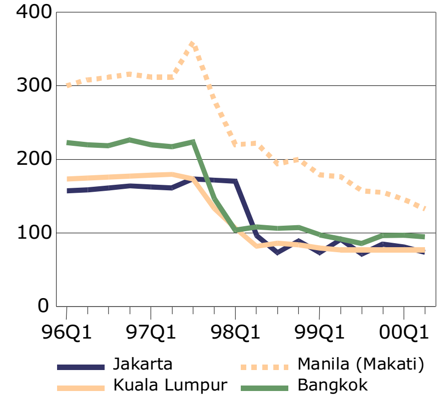
[1]Comparative data for 2000 and 1999 are only from January to March.
[2]Other private flows (net) include capital flows arising from long-term, medium-term, and short-term debt; trade credits; and changes in nonresident accounts in the banking system. The data were obtained as a residual. The sum of the capital and financial accounts was taken to be total net capital flows for the Philippines and Thailand.
[3]Data follow the old balance-of-payments definitions. Comparative data for 2000 and 1999 are only from January to April.
[4]For the Philippines, other flows include official flows.
Sources: IMF, International Financial Statistics CD-ROM (Indonesian data); International Department, Bank Negara Malaysia; *Selected Philippine Economic Indicators,* July 2000, Bangko Sentral ng Pilipinas; and web sites of Bank of Korea, Bank Negara Malaysia, Bangko Sentral ng Pilipinas, and Bank of Thailand.

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



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

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

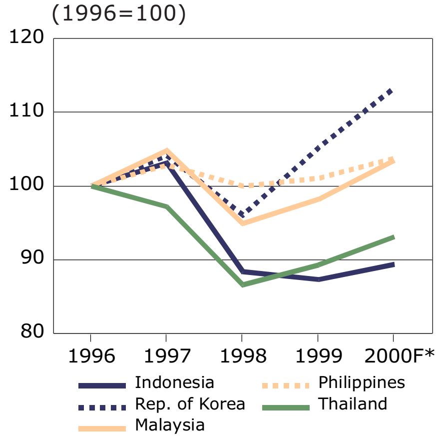


Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

scheduled debt repayments and slowdown or withdrawal of foreign direct investment (FDI) and portfolio capital. Third, as discussed later, the quality of recovery is improving and the affected countries are now in a much stronger position to absorb shocks.

In the property sector, markets now appear to be bottoming out. Slowly, empty offices are beginning to fill up and demand for mortgage finance is growing. Vacancy rates, although remaining high, have begun to fall in Bangkok, Kuala Lumpur, Jakarta, and Manila (Figure 3a). With the exception of Manila, office rentals have also stabilized (Figure 3b). Recovery at the lower- and medium-end of the residential property sector has been particularly strong. Heavily discounted prices have attracted strong purchasing interest in all the affected countries. As a consequence, housing starts, sales, and prices are now all rising, auguring well for consumer confidence and durable goods spending.

Figure 4: **GDP Per Capita Index** (1996=100)



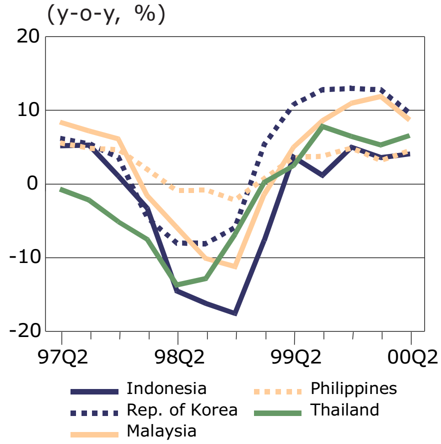
*Forecasts for 2000 were based on GDP projections by Consensus Economics and national population censuses, except for Indonesia. Population projection for Indonesia was based on the 1999 growth rate.
Source: ARIC Indicators; Consensus Economics, Inc., *Asia Pacific Consensus Forecasts,* September 2000; and national statistics offices of Indonesia, Korea, Malaysia, Philippines, and Thailand.

Real Sector Developments

One way to gauge the extent of recovery is to compare per capita income levels in local constant prices with their precrisis levels (Figure 4). By the end of 1999, only Korea had exceeded its previous peak level of GDP per capita. Per capita incomes have yet to climb back to their precrisis levels in Indonesia, Malaysia, Philippines, and Thailand.

Korea remains the frontrunner in the recovery, buoyed by some sort of virtuous circle between growth and structural rehabilitation that appears to be in operation. Solid recovery is improving the cash flow positions of banks and corporations, and bank credit is starting to flow once again. Credit flows, in turn, are facilitating domestic demand and fueling recovery. Lately, Malaysia also appears to be experiencing this virtuous circle, but other countries are still behind. The Philippines and Thailand got off to a slower start in the first quarter compared to their growth performance in the last two quarters of 1999, but second quarter growth was higher than expected. Meanwhile, in Indonesia, too, a nascent recovery appears to have taken root.

Figure 5: **Real GDP Growth** (y-o-y, %)

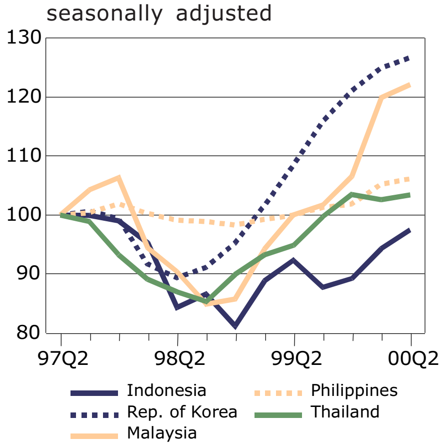


Source: ARIC Indicators.

In the first half of 2000, quarterly growth rates (year-on-year [y-o-y]) have basically stabilized in Indonesia, Philippines, and Thailand, while in Korea and Malaysia they have tapered down a little compared to earlier levels (Figure 5), which, to some extent, reflects the low base from which the expansion of output in 1999 was measured after a deep recession. Recovery is now maturing and its pace is moderating somewhat to a more sustainable level in Korea and Malaysia. The growth outturn for 2000 is forecast to be higher than in 1999 in all countries except Korea.

On the supply side, recovery continues to be led by the manufacturing sector, a process largely attributable to the continuing world IT boom, which has encouraged the production of IT-related manufactures for overseas markets. Manufacturing value added indexes in all the affected countries, with the exception of Indonesia, now exceed precrisis levels (Figure 6).

Figure 6: **Manufacturing Value Added Index** (1997Q2=100), seasonally adjusted

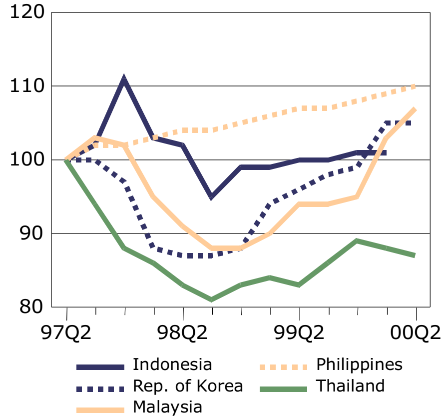


Source: ARIC Indicators.

The agricultural sector performed poorly in the first half of 2000 in all the affected countries. In Indonesia, this was possibly caused in part by social unrest in several provinces. Largely because property markets still remain weak and recovery in fixed investment has yet to gather greater momentum, the construction sector continues to be a drag on the recovery process in four of the five countries. The exception is Indonesia, where the sector posted 13 percent growth spurred by fiscal stimulus. In contrast, the services sector has performed strongly in all five countries in 2000, supported by growing domestic demand.

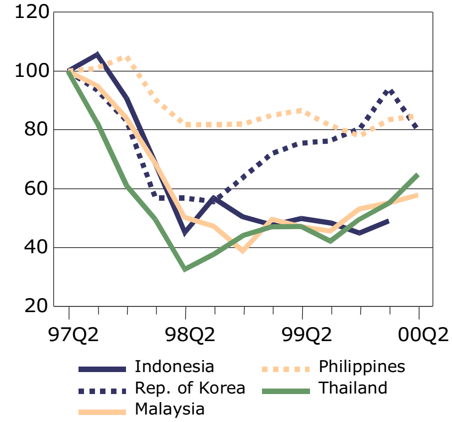
On the expenditure side, domestic demand and exports are now both driving recovery. With the exception of Thailand, private

Figure 7: **Real Private Consumption Index** (1997Q2=100), seasonally adjusted*



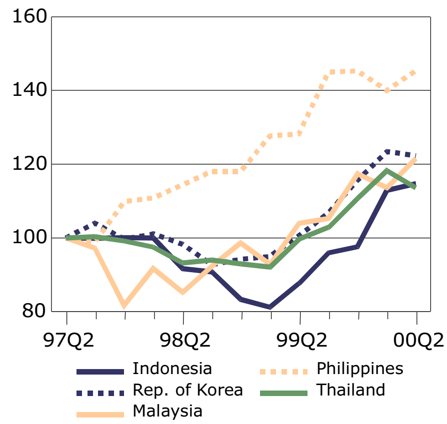
*Data for Indonesia are seasonally unadjusted.
Source: ARIC Indicators.

Figure 8: **Real Gross Domestic Investment Index** (1997Q2=100), seasonally adjusted*



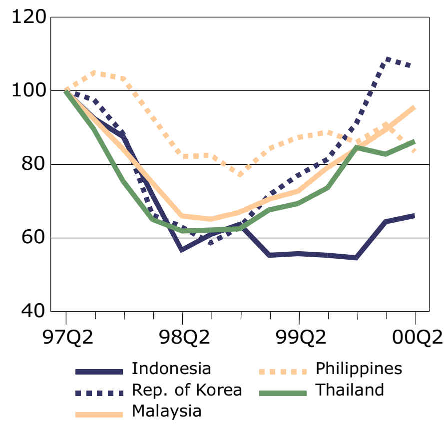
*Data for Indonesia are seasonally unadjusted.
Source: ARIC Indicators.

Figure 9: **Merchandise Export Index*** (1997Q2=100), seasonally adjusted



*Data from national sources.
Source: ARIC Indicators.

Figure 10: **Merchandise Import Index*** (1997Q2=100), seasonally adjusted



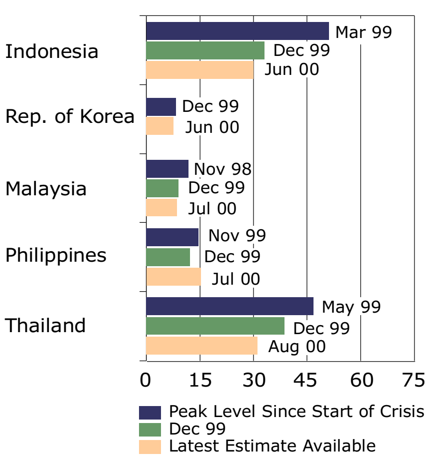
*Data from national sources.
Source: ARIC Indicators.

consumption expenditure indexes now exceed their precrisis levels (Figure 7). Gross domestic investment is also picking up, especially in Korea, Malaysia, and Thailand. Whereas changes in stocks dominated gross domestic investment earlier in Korea and Malaysia, fixed investment is now gaining ground. However, gross domestic investment remains well below precrisis levels across the board (Figure 8). With governments shifting their focus to consolidating their fiscal positions, public consumption expenditure growth is slowing. The exception is Thailand, where it continued to expand in the first half of 2000, reflecting continuing fiscal measures to stimulate domestic demand.

Exports continued to grow strongly in all the affected countries spurred by continuing expansion of the global economy and the IT boom. Exports now exceed precrisis levels in all five countries (Figure 9). With recovery becoming more broad based in 2000, growth of imports, which were compressed during the crisis due to weak domestic demand, accelerated in most affected countries (the exception was the Philippines). However, apart from Korea, imports are still below precrisis levels (Figure 10). In general, the acceleration of import growth has also led to a decline of net exports' contribution to growth.

Looking ahead, fast growth is likely to see Malaysia regaining lost ground in per capita income sometime this year (Figure 4). In the Philippines, where incomes did not fall by as much as in other countries, lost income may also recover by the end of this year. Based on current projections, the shortfall in Thailand will be 7 percent by the end of this year. It would, therefore, take another year or so of solid growth to get back to its 1996 level of per capita income. However, Indonesia, even under favorable circumstances, may take another two years or more for its per capita income to reach precrisis levels.

Figure 11: **NPLs of Commercial Banks*** (% of total commercial bank loans)



*NPLs cover only commercial banks for Korea, Malaysia, Philippines, and Thailand, and the banking sector for Indonesia. Commercial banks include domestic and foreign banks, except for Korea, where foreign banks are not covered. NPLs exclude those transferred to AMCs. NPL criteria are based on the three-month definition. For Korea, the NPL criteria were changed in December 1999, and the earliest available data under the new criteria are for December 1999.
Sources: Web sites of Bank Indonesia (*Review on Economy, Monetary, and Banking*, July 2000—data approximated from a chart in the report); FSS, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; and Bank of Thailand.

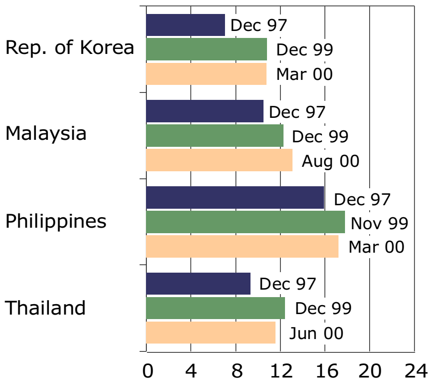
Bank and Corporate Restructuring

The process of bank and corporate restructuring moved forward again in 2000. But it still has a long way to go.

PROGRESS IN BANK RESTRUCTURING. Nonperforming loan (NPL) ratios continued to fall in the first half of 2000, except in the Philippines (Figure 11). The most important reasons for the declines are the activities of special purpose agencies that have removed NPLs from banks' balance sheets; the absorption of loan debt by governments; economic recovery, which has permitted borrowers to renew servicing of their loans; and workouts, which have led to loan restructuring.

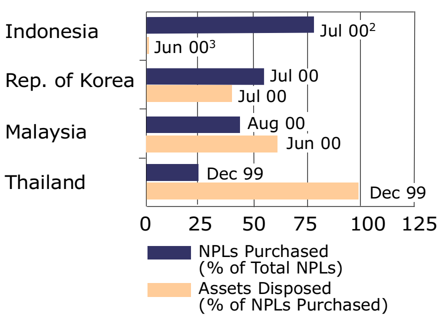
The NPL ratio for Korea is now the lowest among the five countries. The Financial Supervisory Service (FSS) of Korea introduced new and tighter criteria for classifying NPLs in December 1999, leading to an increase in the NPL ratio from that based on the old criteria. In Korea and Malaysia, the NPL ratios for commercial banks are now less than 10 percent. By contrast, Thailand's NPL ratio remained above 30 percent by August 2000,

Figure 12: **Capital Adequacy Ratios of Commercial Banks*** (%)



*Cover only commercial banks for Korea, Philippines, and Thailand, and the banking sector for Malaysia. Commercial banks include domestic and foreign banks, except for Korea, where foreign banks are not covered. The ratios are risk-weighted, but each country may have a different risk-weighting scheme.
Sources: Web sites of FSS, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; and Bank of Thailand.

Figure 13: **NPLs Purchased and Disposed of by AMCs[1]** (%)



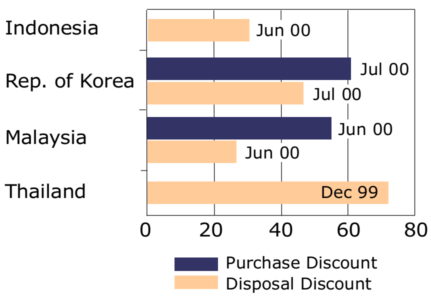
[1]Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia as of dates indicated. In the case of Thailand, these refer to assets taken over from the 56 suspended finance companies and disposed of by the FRA. The exact data on asset disposal by the FRA are not available. But according to the World Bank, the FRA has almost finished liquidation of all assets taken over from the closed finance companies.
[2]NPLs acquired as of July 2000 as percent of total NPLs as of June 2000.
[3]NPLs disposed as of June 2000 as percent of NPLs acquired as of July 2000 (data for banking sector NPLs are approximations).
Sources: Web sites of Bank Indonesia; IBRA; KAMCO; Bank Negara Malaysia; Danaharta; and the World Bank (*Thailand Economic Monitor,* February 2000).

but the Government has set a target of 25 percent by the end of this year. In Indonesia, too, the NPL ratio has fallen, but data are not reported as systematically or in as timely a manner as elsewhere. As of June 2000, the NPL ratio was reported to be about 30 percent for the country's banking system as a whole. Meanwhile, in the Philippines, the NPL ratio has edged up a little over the first half of this year, partly because the denominator against which they are measured (i.e., the total stock of loans) has shrunk.

The reduction in NPLs has helped to strengthen the capital position of the respective banking systems (Figure 12). In all the affected countries, the capital adequacy ratio (CAR) is well above the Basle Capital Accord minimum recommended standard of 8 percent. Capital adequacy has also been strengthened by the infusion of new equity by existing as well as new owners; the contribution of equity by governments or their special purpose agencies; and, in some places, by increased profitability and reductions in loan loss provisioning. In Indonesia, data on capital adequacy for the banking system as a whole are not available. But among the seven banks that have been recapitalized with the assistance of the Indonesian Bank Restructuring Authority (IBRA), the CAR is a little more than 11 percent.

During 2000, debt restructuring through asset management companies (AMCs) has made further progress in Korea and Malaysia, as well as Indonesia (Figure 13). The Korea Asset Management Corporation (KAMCO) purchased more than 50 percent of the banking system's NPLs by July 2000 and had disposed of 40 percent of those it had acquired. Danaharta had acquired a little more than 40 percent of NPLs in the Malaysian banking system by August 2000, amounting to about 15 percent of the country's GDP. It is estimated that, as of June 2000, Danaharta had disposed of 61 percent of the NPLs under its jurisdiction. In Indonesia, it is estimated that more than 75 percent of the total NPLs in the banking system, amounting to 60 percent of GDP, are now under IBRA's control. However, uncooperative and politically powerful debtors, and an inadequate legislative and regulatory environment have hampered the recovery of asset values in the country. As of June 2000, only 0.35 percent, representing corporate loans, of acquired NPLs has been disposed of by IBRA. In Thailand, it was reported that almost all the loans of closed financial institutions acquired by the Financial Sector Restructuring Authority (FRA) had been disposed of by December 1999. No data on debt restructuring by commercial banks are available, but some banks are reportedly back to profitability.

Figure 14: **Discount Rates on NPL Purchases and Disposals by AMCs*** (%)



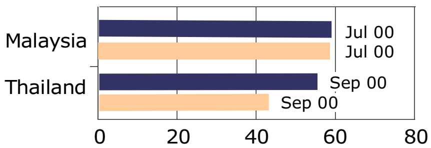
*Refer to those by IBRA in Indonesia, KAMCO in Korea, and Danaharta in Malaysia as of the dates indicated. Data on purchase discount by IBRA are not available. In the case of Thailand, the assets of the 56 suspended finance companies were transferred to the FRA (which is not an AMC). The disposal discount refers to that at which the assets were disposed of by the FRA.
Sources: Web sites of IBRA; KAMCO; Danaharta; and the World Bank (*Thailand Economic Monitor,* February 2000 and Thailand Update, *East Asia Quarterly Brief,* March 2000).

In its recent sale of corporate loans, IBRA was able to recover about 70 percent of the loans' face value, implying a discount rate of 30 percent (Figure 14). In Korea, KAMCO has purchased NPLs at an average discount of 60 percent. To date, asset disposals have attracted a discount of about 46 percent, providing KAMCO with a gross operating surplus. Loan assets in Malaysia were acquired at an average discount of 55 percent. As of June 2000, assets sold by Danaharta had a recovery rate of 73 percent of their face value. This figure is impressive, and has doubtlessly been helped by Malaysia's accelerating economic growth. The surpluses raised from asset sales will be divided between Danaharta and the banks from which the NPLs were acquired. In Thailand, the FRA disposed of assets obtained from 56 suspended finance companies at a discount rate of a little more than 70 percent. In disposing of assets quickly—before economic recovery had really begun—values may have been depressed. Recent reports suggest that the asset management units of private banks have fared little better in recovering values in Thailand.

PROGRESS IN CORPORATE RESTRUCTURING. Corporate restructuring is also making some progress both in government-sponsored voluntary workout arrangements, similar to those of the London Approach, and outside this framework. The use of formal insolvency proceedings, however, is still limited.

In Korea, the restructuring of the top four *chaebols* is moving ahead. Hyundai, Samsung, LG, and SK have met the overall requirements of the Capital Structure Improvement Plans (CSIPs) for 1999. However, consolidated financial statements under the new reporting system show leverage ratios higher than the required 200 percent for some *chaebols*. By March 2000, the Fair Trade Commission had announced that cross-guarantees between *chaebol* affiliates had been eliminated. There has also been some progress in the restructuring of smaller *chaebols* and firms. As of March 2000, 76 firms were under the Corporate Restructuring Accord framework. In its June 2000 Report, FSS announced the early retirement of 32 firms from their workout programs, thereby allowing banks to reclassify W4.48 trillion of NPLs as normal loans.

Figure 15: **Progress in Government-Supervised Voluntary Workouts***



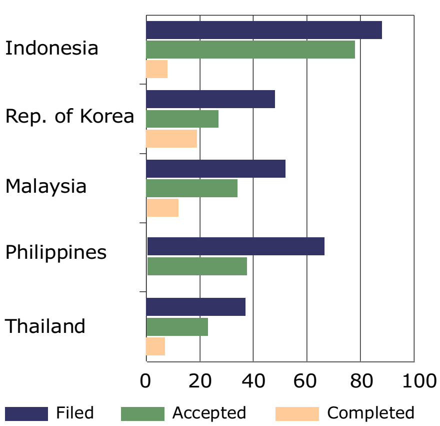
*Data refer to cases registered under CDRC (Malaysia) and CDRAC (Thailand).
Sources: Web sites of Bank Negara Malaysia; CDRAC; and the World Bank (*East Asia Quarterly Brief*, March and September 2000).

By the end of 1999, Malaysia's Corporate Debt Restructuring Committee (CDRC) had received applications amounting to about 12 percent of GDP. Additional applications of just under RM1 billion were received in 2000. By July 2000, 59 percent of the total debt received and accepted by CDRC had been resolved (Figure 15).

In Thailand, by end-September 2000, the Corporate Debt Restructuring Advisory Committee's (CDRAC's) participant debtors owed about B2.6 trillion in loans, of which B2.3 trillion were classified as large loans. About 43 percent of the loans referred to CDRAC had been resolved. However, 32 percent of the debts are in the process of legal action. Notwithstanding the new bankruptcy law, further progress in resolving corporate debts in Thailand is expected to be slow. Although many large loans have been voluntarily resolved, those that still have to be resolved outside of the voluntary process are larger still.

There has been encouraging progress in the government-supervised debt restructuring in Indonesia. In August 2000, the Jakarta Initiative Task Force (JITF) reported the completion of 24 debt restructuring cases out of 67 active cases. The completed cases involved $5.2 billion in debt, almost 40 percent of the total value of active cases handled. This is a substantial improvement on the less than $1 billion debt restructured as of February 2000. So far, JITF has been able to meet the targets specified in the Letter of Intent with IMF. Particularly helpful was the adoption of time bounds for mediation procedures and the improvement in regulatory incentives for corporate restructuring. JITF removed previously registered but inactive cases from its reported figures. Taking these into account, the task faced by JITF remains enormous. Also, its ability to pressure non-cooperative debtors into reaching debt restructuring agreements remains to be seen.

Figure 16: **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: Web sites of the World Bank (*Global Economic Prospects 2000* and Thailand Update, *East Asia Quarterly Brief*, March 2000) and the Philippine Institute for Development Studies (Lamberte, M., 2000, *The Philippines: Challenges for Sustaining the Economic Recovery*).

In the case of formal insolvency, recent data are not available. But earlier reports suggest that bankruptcy cases filed have been few and far between in the affected countries and the number completed is small (Figure 16). Gaps in bankruptcy legislation and weak institutional capacity in some countries suggest that formal resolution of debts may continue to be a slow process.

Social Sector Developments

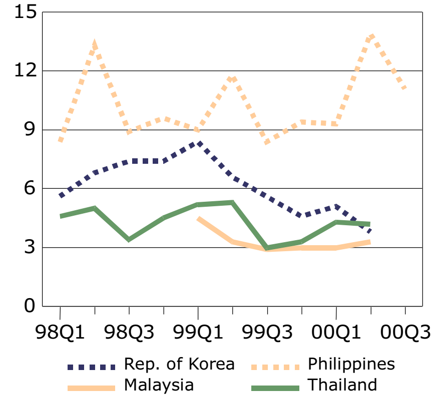
The social impacts of the crisis have turned out to be less serious than originally feared. This may be attributed to four factors: recovery was faster than anticipated; the agricultural sector absorbed unemployed urban dwellers; in some countries, public transfers were relatively effective; and, to some extent, the existence of informal safety nets helped too. However, social recovery still has a long way to go.

Unemployment trends have continued to vary across the countries (Figure 17), with unemployment rates being lowest in Malaysia. Korea's unemployment rate in the second quarter of 2000 recorded a significant drop compared to the same period in 1999, and stands now at 3.8 percent of the total workforce. On the other hand, there was a big jump in the unemployment rate in the second quarter of this year in the Philippines. This was partly due to a slowdown in the agricultural sector and peace and order problems in the south of the country. The rate has now fallen somewhat. In Thailand, meanwhile, the unemployment rate fell in the first half compared to the same period in 1999. More recent unemployment data are not available for Indonesia. Real wages fell in all the affected countries during the crisis. In Indonesia and Thailand, real wages remain below their precrisis levels (Figure 18). In Korea and Philippines, real wages have regained lost ground. Time series data on real wages are not available for Malaysia.

Perhaps because of its large subsistence component, real consumption per capita was least affected in Indonesia and Philippines (Figure 19), in the latter never falling below precrisis levels. It regained lost ground in Korea and Malaysia by the second quarter of 2000, in line with a strong recovery and improved consumer confidence in the two countries. In Indonesia and Thailand, however, per capita real consumption has remained below precrisis levels.

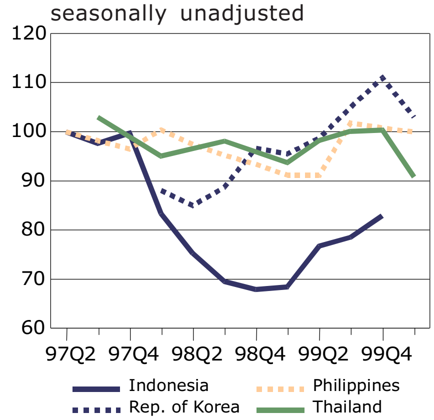
The crisis has increased levels of poverty in most of the affected countries (Figure 20). Although more recent data on poverty are not available, it is generally believed that poverty incidence has declined somewhat and this trend will continue in some of these countries as recovery gathers momentum. The outlook, however, is not so encouraging for Indonesia, where poverty incidence for 2001 is predicted to remain significantly above its 1996 level.

Figure 17: **Unemployment Rate** (%), seasonally unadjusted



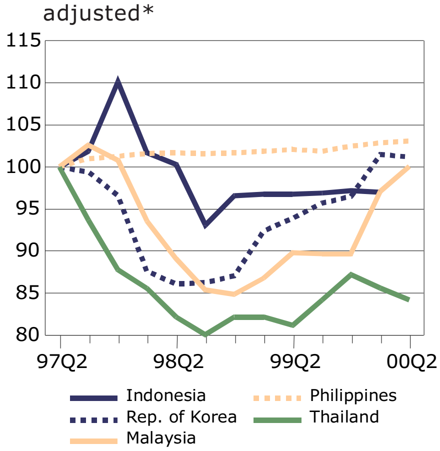
Source: ARIC Indicators.

Figure 18: **Real Wage Rate Index** (1997Q2=100*), seasonally unadjusted



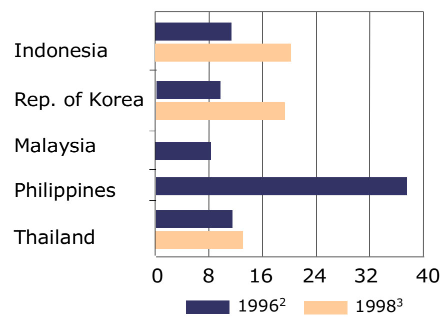
*For Korea, 1997=100; for Thailand, 1997Q1=100; prior to 1999, data for Thailand are available only for the first and third quarters.
Source: ARIC Indicators.

Figure 19: **Per Capita Real Private Consumption Index** (1997Q2=100), seasonally adjusted*



*Data for Indonesia are seasonally unadjusted.
Source: ARIC Indicators.

Figure 20: **Poverty Incidence**[1] (%)



[1]Derived using national poverty lines. Based on consumption for Indonesia and Korea and on income for Malaysia, Philippines, and Thailand. Data for Korea are for urban areas only.
[2]Data for Malaysia and Philippines are for 1997.
[3]Data for Indonesia are for February 1999.
Source: World Bank, *East Asia: Recovery and Beyond* (2000).

Quality of Recovery

As the recovery process deepens and consolidates, the quality of recovery is also improving. First, while net exports have generally led recovery, other drivers are now also kicking in (Box B). As outlined earlier, domestic demand is increasingly propelling growth on the expenditure side. On the supply side, a wide range of sectors, including services, is now contributing to recovery. Even the property sector is beginning to show signs of bottoming out in some countries.

Figures B-1 to 10 show a breakdown of the contribution of the components of demand and supply to overall GDP growth. Each bar in the charts is calculated as the product of the percentage change, measured year-on-year, 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.

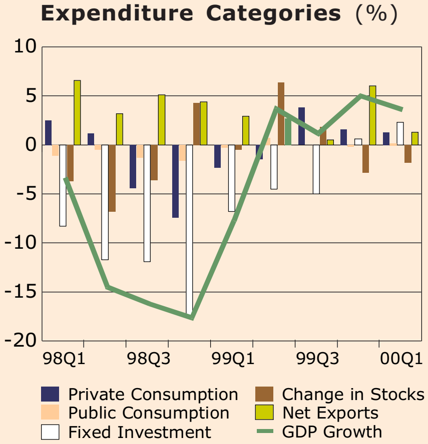
Figures B-1 to 5 clearly illustrate that on the demand side net exports led the recovery but now consumption and investment are also beginning to support growth. As private consumption and investment demands have expanded, so too has the demand for imports. In a context of continuing strong export performance this has had the effect of reducing the contribution of net exports to growth, as shown in the data for Indonesia, Korea, Malaysia, and Thailand. In the case of the Philippines, where recovery has not come so fast, net exports continue to make the dominant contribution to growth. In all economies, the collapse of investment that detracted from growth through 1998 until the first quarter of 1999 has just about run its course. In Korea, Malaysia, and Thailand, investment is now contributing positively to growth. More encouragingly, in Korea and Malaysia, the fixed investment component of domestic investment expenditure is gaining ground, while changes in stocks are taking a back seat. In this regard, Indonesia lags somewhat, but latest data for the second quarter of 2000 (not shown) suggest that there, too, investment may have turned the corner.

On the supply side (Figures B-6 to 10), the picture is a little more complex. In Korea, Malaysia, and Thailand, manufacturing clearly led the recovery process. Even in the first and second quarters of 2000, manufacturing was still making the largest overall contribution to growth in these economies. Services activity, which is dominant in terms of overall size, is also contributing positively in Malaysia and Thailand, but is growing much more slowly than manufacturing. Growth is more balanced in Korea.

In Indonesia, the contribution of manufacturing activity to the recovery process has not been as marked as that in Korea, Malaysia, and Thailand. Instead, services activity, possibly supported by private consumption, has played an important role since the middle of 1999. But the agricultural sector is shrinking and subtracting from overall growth.

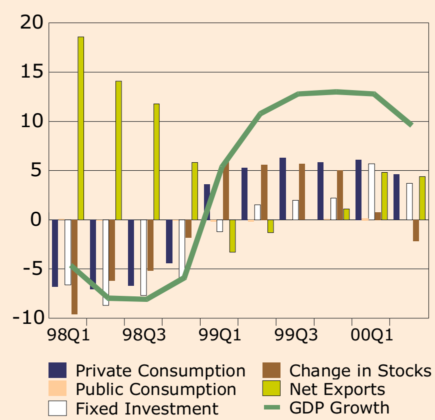
Manufacturing's contribution to recovery has also been secondary in the Philippines, where services activity has expanded throughout the period, and in many quarters has been the dominant source of growth. Agriculture also made an important contribution to recovery throughout 1999, though this effect has now faded.

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



Source: Statistics Indonesia (BPS) and Bank Indonesia.

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



Source: Ministry of Finance and Economy.

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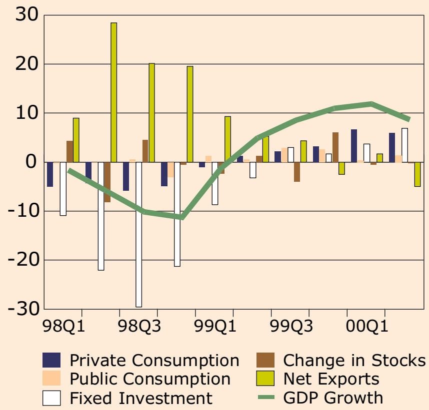
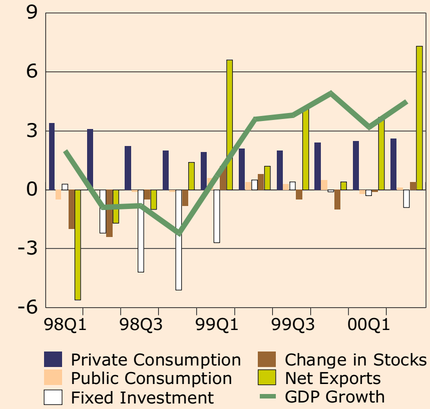
Figure B-3: **Malaysia**
Contribution to Growth by Expenditure Categories (%)



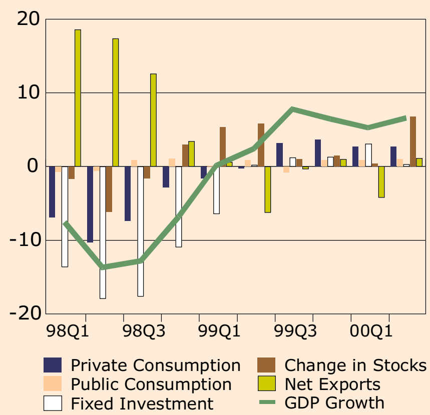
Source: Bank Negara Malaysia and Department of Statistics.

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



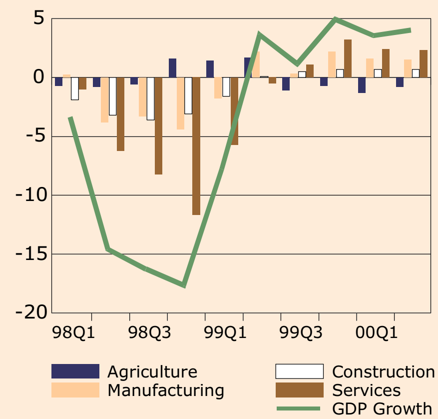
Source: National Statistical Coordination Board.

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



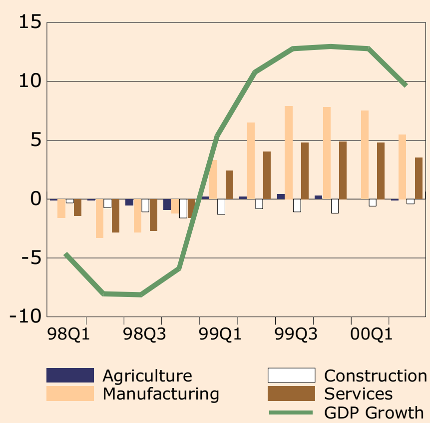
Source: National Economic and Social Development Board.

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



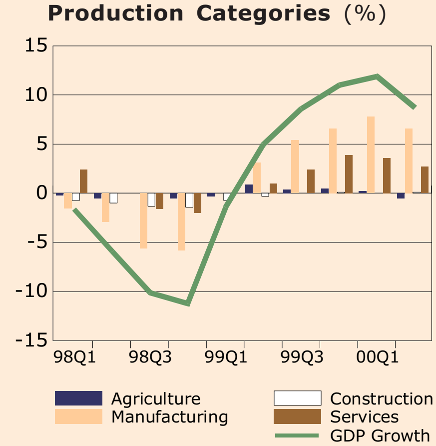
Source: Statistics Indonesia (BPS) and Bank Indonesia.

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



Source: Ministry of Finance and Economy.

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



Source: Bank Negara Malaysia and Department of Statistics.

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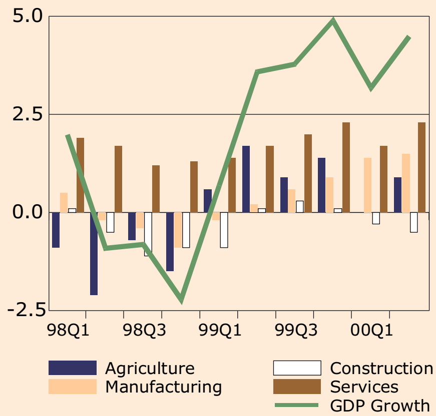
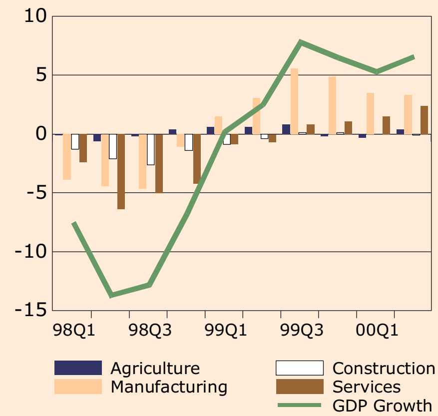
Box B: **Drivers of Asia's Recovery—Sources of GDP Growth** (Cont'd)

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



Source: National Statistical Coordination Board.

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

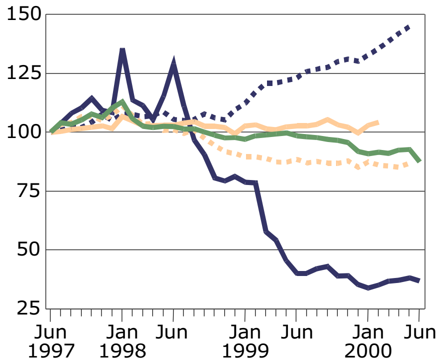


Source: National Economic and Social Development Board.

Second, with the region now in recovery mode and the US economy starting to show signs of slowing down, intraregional trade is starting to play an increasing role in propelling regional recovery. In 1998, intraregional exports (defined as exports to East and Southeast Asia and Japan) comprised 43.6 percent of total exports and this increased to 45 percent in 1999. With the region firmly in recovery mode, intraregional trade could have increased further in 2000. Consequently, on balance, recovery in Asia is becoming relatively less susceptible to the gyrations of external demand outside the region (see section on External Risks to Asia's Recovery starting on page 75). But still the US is the single largest export market for the affected countries (except Indonesia).

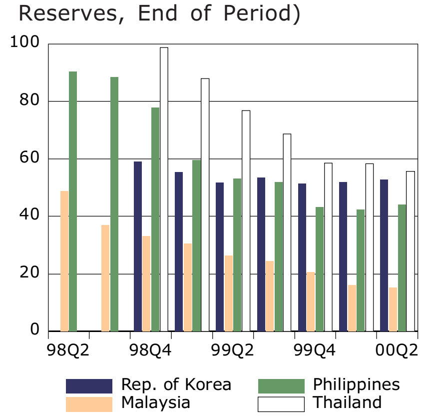
Third, not only is recovery occurring quickly and becoming more broad based, there is now greater clarity and coherence in macroeconomic policies in the affected countries. In particular, there have been significant changes in the conduct of monetary policy. The informal dollar pegs pursued before the crisis

Figure 21: **Real Bank Credit*** (1997June=100), seasonally adjusted



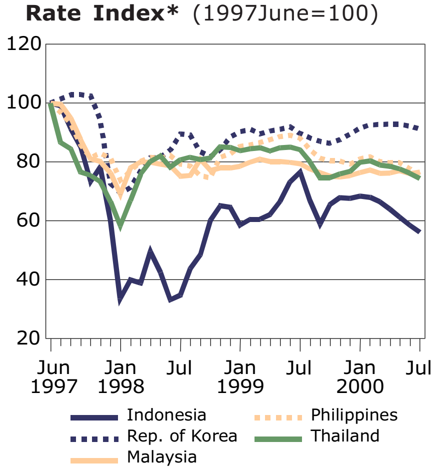
*Claims on the private sector: deposit money banks.
Source: ARIC Indicators.

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



*Data from national sources.
Source: ARIC Indicators.

Figure 23: **Real Effective Exchange Rate Index*** (1997June=100)



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

have been abandoned in Indonesia, Korea, Philippines, and Thailand. Only Malaysia has maintained a pegged exchange rate. Korea, Philippines, and Thailand have seen moves toward explicit inflation targeting frameworks, with Indonesia intending to follow the same path. Inflation targeting requires monetary authorities to use monetary policy to achieve an inflation target and is likely to promote greater transparency and independence in monetary policy. It will enhance policy credibility and may help lower inflation expectations, thereby reducing actual inflationary pressures and lowering interest rates.

Fourth, some headway is being made on structural rehabilitation. As previously described, NPL ratios are, in general, falling, while banks' capital positions have strengthened and they are slowly returning to profitability. Although corporate restructuring has generally lagged, a substantial proportion of debt that was referred for voluntary resolution in Korea, Malaysia, and Thailand has now been restructured. In Korea, the stock of real bank credit extended to the private sector continues to grow and now exceeds its precrisis level (Figure 21), while in Malaysia, data from national sources have shown signs of revival since the early part of this year. Meanwhile, in Indonesia, Philippines, and Thailand, the stock of private real bank credit is starting to stabilize. In all the affected countries, corporate reforms have been initiated to address structural weaknesses.

Fifth, external payments positions have been strengthened significantly in all the affected countries. Foreign exchange reserves now provide ample cover for short-term obligations (Figure 22), the maturity structure of external debt is improving, and real exchange rates are competitive (Figure 23).

Summing up, the more broad-based recovery, increased intraregional trade, improved macroeconomic management, reduced financial vulnerability, and strengthened external payment positions mean that the affected countries are now in a much stronger position to absorb shocks. This is supported by the fact that perceived credit risks of these countries are either declining or stable (Table 1). In the long run, the affected countries should also prove attractive to foreign investors. In particular, strengthened financial systems and more cohesive macroeconomic policies should result in greater predictability of capital flows and their more efficient use.

Table 1: **Foreign Currency Long-Term Sovereign Credit Ratings***

	Item	Indonesia	Rep. of Korea	Malaysia	Philippines	Thailand
Moody's	Current Outlook	Positive	Stable	Positive	Stable	Stable
	Ratings	B3 19 Mar 98	Baa2 16 Dec 99	Baa3 14 Sep 98	Ba1 18 May 97	Baa3 21 Jun 00
		B2 9 Jan 98	Baa3 12 Feb 99	Baa2 23 Jul 98	Ba2 23 Jan 97	Ba1 21 Dec 97
		Ba1 21-Dec 97	Ba1 21 Dec 97			Baa3 27 Nov 97
			Baa2 12 Oct 97			Baa1 1 Oct 97
			A3 27 Nov 97			A3 25 Jun 97
Standard & Poor's	Current Outlook	Stable	Positive	Positive	Stable	Stable
	Ratings	B- 2 Oct 00	BBB 11 Nov 99	BBB 10 Nov 99	BB+ 21 Feb 97	BBB- 8 Jan 98
		SD 17 Apr 00	BBB- 25 Jan 99	BBB- 15 Sep 98	BB- 2 Jul 93	BBB 24 Oct 97
		CCC+ 31 Mar 99	BB+ 18 Feb 98	BBB+ 24 Jul 98		A- 3 Sep 97
		SD 30 Mar 99	B+ 22 Dec 97	A- 17 Apr 97		
		CCC+ 15 May 98	BBB- 11 Dec 97	A 23 Dec 97		
		B- 11 Mar 98	A- 25 Nov 97	A+ 18 Aug 97		
		B 27 Jan 98	A+ 24 Oct 97			
		BB 9 Jan 98				
		BB+ 31 Dec 97				
		BBB- 10 Oct 97				
Fitch IBCA	Current Outlook	Stable		Positive		
	Ratings	B- 16 Mar 98	BBB+ 30 Mar 00	BBB 7 Dec 99	BB+ 8 Jul 99	BBB- 24 Jun 99
		B+ 21 Jan 98	BBB 24 Jun 99	BBB- 26 Apr 99		BB+ 14 May 98
		BB- 8 Jan 98	BBB- 19 Jan 99	BB 9 Sep 98		
		BB+ 22 Dec 97	BB+ 2 Feb 98	BBB- 13 Aug 98		
		BBB- 4 Jun 97	B- 23 Dec 97			
			BBB- 11 Dec 97			
			A 26 Nov 97			
			A+ 18 Nov 97			
Thomson Financial Bankwatch	Current Outlook		Stable	Stable	Stable	Stable
	Ratings	CCC 27 Aug 98	BBB 10 Dec 97	BBB 28 Mar 00	BB 16 Oct 96	BBB- 3 Dec 97
		C 18 May 98	A- 3 Dec 97	BBB- 21 Sep 99		BBB 24 Sep 97
		B- 13 Mar 98	A 11 Nov 97	BB+ 22 Sep 98		
		B+ 9 Jan 98	A+ 14 Apr 97	BBB 5 Aug 98		
		BB 18 Dec 97		A- 22 Dec 97		
		BBB- 1 Apr 97		A+ 1 Apr 97		

*See Annex for ratings descriptions.
Sources: Bloomberg, Fitch IBCA, Moody's, and Standard & Poor's.

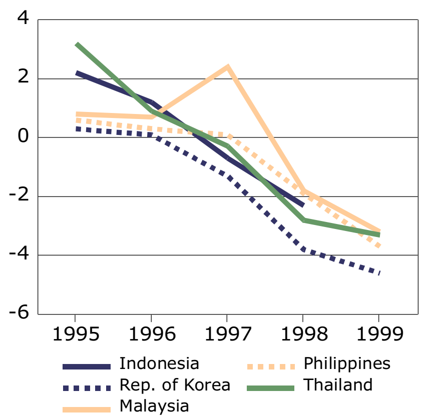
Remaining Weak Spots

Although the recovery has consolidated further and its quality is improving, weak spots remain. Tackling these effectively will have a decisive influence on the sustainability and quality of recovery in the coming months.

Fiscal positions are a cause for concern in some countries.

In Indonesia, Philippines and, to a lesser extent, Thailand, the room for fiscal maneuverability is narrowing. Large deficits and growing public sector debt in these countries (Figures 24 and 25) have greatly reduced the scope for offsetting any future negative demand shocks through deficit spending measures. Indeed, robust growth and low interest rates will soon be needed to reassert stable fiscal dynamics. If fiscal positions were to deteriorate further, future pressures on interest rates stemming from rising public debt could hamper investment.

Figure 24: **Central Government Fiscal Balance** (% of GDP)

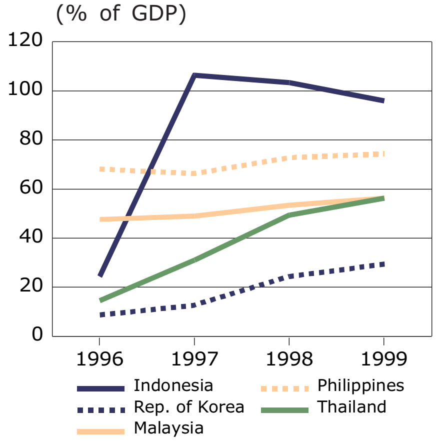


Source: ARIC Indicators.

Restructuring still has a long way to go.

On the structural front, too, there are problems remaining. While there has been progress on debt resolution, the most difficult cases have yet to be tackled. Bankruptcy courts, particularly in Indonesia and Thailand, may have difficulty coping with the backlog of cases that is likely to build up. If institutions prove to be ineffective in resolving the debt overhang, this will bode badly for international investment and could again threaten bank capital. The recently announced reductions in weight of some markets in the Morgan Stanley Capital International (MSCI) indexes were induced, in part, by concerns over the pace of reforms and restructuring, and registered strongly in equity markets.

Figure 25: **Gross Public Debt*** (% of GDP)



*Includes public sector debt and costs of financial restructuring. These numbers should be interpreted with caution as coverage is not uniform across the countries.
Source: IMF, *World Economic Outlook*, April 2000.

While financial workouts are taking place, doubts exist about their durability. Following restructuring, some debtors have run into difficulties anew. It would seem that the needed operational reforms do not always accompany balance sheet restructuring. Capacity utilization rates are, in general, on the rise, but substantial excess capacity remains in some sectors. Resistance to the painful changes that are required will ultimately have an adverse effect on competitiveness and foreign investor sentiment.

Political uncertainties are hampering reform and recovery.

There is growing concern about the future path of reforms, despite the considerable progress that has been made. In all the affected countries, bank and corporate governance reforms still have a long way to go. Powerful vested interests have already shown their ability to thwart and delay needed changes. The political business cycle has also now moved to a stage where it may work against the required changes in some countries. For instance, political uncertainty remains a feature of the landscape in Indonesia, undermining the credibility of economic managers and policies. Further reforms are likely to be delayed in Thailand until after the general election. In the Philippines, perceptions of political risk are also increasing, despite some headway being made with a difficult reform agenda.

Social recovery needs to be accelerated.

Despite mixed progress, social recovery remains slow and lags behind economic recovery. Real wages are still well below their precrisis levels in most affected countries. In the Philippines, unemployment remains high; while in Thailand and Indonesia, per capita real consumption has still not made up lost ground. In some countries, the shares of government budgets allocated to education and health care have been reduced because of fiscal difficulties, leading to possible adverse consequences in the long term. In most countries, social safety nets are either lacking or rudimentary, and governments face enormous challenges in fighting against poverty.

Prospects and Risks

The recovery has been consolidated in 2000. Over the first half, actual growth in Korea and Malaysia once again exceeded earlier projections. Growth outturn in 2000 in both countries is likely to exceed 8 percent (Table 2).

In the Philippines, growth of between 3 to 4 percent is widely expected in 2000. However, prospects have been dented by the unrest in Mindanao, heightened perceptions of political risk, budgetary difficulties, and concerns over governance problems in both the public and private sectors. Nevertheless, important

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

	Indonesia		Rep. of Korea		Malaysia		Philippines		Thailand	
	2000	2001	2000	2001	2000	2001	2000	2001	2000	2001
Official[1]	3.0-4.0	4.0-5.0	8.0-8.5	—	5.8	—	4.0	4.0-4.5	4.5-5.5	4.0-6.0
ADB[2]	3.5	5.0	8.3	6.0	7.8	7.0	3.8	4.3	4.5	4.6
IMF[3]	4.0	5.0	8.8	6.5	6.0	6.0	4.0	4.5	5.0	5.0
World Bank[4]	4.0	4.0	8.5	6.5	8.0	6.0	4.0	4.5	4.5	4.5
Consensus Economics[5]	3.8	4.3	8.7	6.0	8.6	6.7	3.6	3.7	5.1	4.7

[1]Indonesia - Letter of Intent of the Government of Indonesia, 31 July 2000; IMF Public Information Notice No. 00/82, 25 September 2000; Korea - Letter of Intent of the Government of the Republic of Korea, 12 July 2000; Malaysia - Ministry of Finance, 1 April 2000; Philippines - National Statistical Coordination Board, National Accounts of the Philippines; National Economic Development Authority; Thailand - Bank of Thailand, *Inflation Report,* July 2000.
[2]ADB, *Asian Development Outlook 2000 Update,* September 2000.
[3]IMF, *World Economic Outlook,* September 2000.
[4]World Bank, *East Asia's Recovery: Gathering Force—An Update,* 18 September 2000.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* September 2000.

reforms have now been legislated and measures are planned to plug budgetary shortfalls.

Indonesia, too, should enjoy faster growth this year. Consensus Economics projections (September 2000) suggest full year growth of about 4 percent. The real economy is displaying some resilience, but political risks remain and investor confidence is still lacking. Continuity in the direction of key policies remains an issue, while progress on debt resolution has yet to pick up speed.

Meanwhile, Thailand's full year growth is likely to be in the range of 5 to 6 percent. Signs of improvement include a decline in the banking sector's NPLs, the restructuring of a significant portion of problem debt, and rapid export growth. Nevertheless, difficulties remain and pending parliamentary elections leave the future of the reform process in doubt.

In 2001, recovery in Korea and Malaysia is expected to slow to a more sustainable pace. Provided global conditions remain favorable and domestic reform agenda do not stall, there is scope for faster growth in Indonesia, Philippines, and Thailand. Although Consensus Economics projections (September 2000) suggest that growth in these economies in 2001 will be little changed on outcomes in 2000, there are reasons for guarded optimism.

Besides the internal weaknesses already discussed, there are also external risks that could jeopardize future growth and the reform process.

In the first quarter of this year, there were concerns that US growth could slow abruptly, with damaging consequences for the East Asian recovery. Recent economic data suggest that this is increasingly unlikely and that the US will slow more gradually and in an orderly way. Nevertheless, this is still by no means assured, and there are significant risks on the horizon. If the US were to slow quickly, this would have adverse effects for the region. While intraregional trade ties strengthened in 1999 compared to 1998, and Europe and Japan are now important markets for many regional economies, trade with the US remains significant. In fact, the US is the single largest export market for all countries except Indonesia. If domestic demand in the US were to slow sharply, imports to the country would reduce even more quickly. This would also hurt Europe and Japan, which in turn could further adversely affect demand for the region's exports. A harder than expected landing of the US economy would not derail the region's recovery process, but could slow it down somewhat (see section on External Risks to Asia's Recovery starting on page 75).

Another external threat is the recent increase in oil prices, which have tripled in little more than a year. To net oil exporters (Indonesia and Malaysia), some benefits may arise from this, but for other countries there will be problems (see section on External Risks to Asia's Recovery). Compared to the oil crises of 1973-1974 and 1979-1980, the size of the recent oil shock is small. If there were no further rises in oil prices and the present levels were maintained only until the first quarter of next year, the adverse impact on most countries would be manageable and recovery would still be on track. However, if the present level of oil prices were to be maintained for a longer period, or if they increased further, there could be significant disruptions to the region's recovery.

There have been some welcome developments, such as OPEC's decision to pump more oil, and the announced release by the US of some of its reserves and Japan of its gas and oil stockpiles. But oil supply and demand balances are such that prices will probably continue to remain high at least until the first quarter of next year. Political tensions in the Middle East are complicating the situation further. The futures market for oil, therefore, suggests that prices will continue to remain over $30 a barrel until the first quarter of 2001. Korea, Philippines, and Thailand are particularly vulnerable to oil price shocks. They are heavily reliant on oil imports, unlike many developed countries, which have successfully weaned themselves away from petroleum dependence, and Indonesia and Malaysia, which are net exporters of oil. The switch away from oil has not been a policy priority; some governments have even subsidized its use because of the politically sensitive cost of energy. Economic progress in these countries, while driving up per capita consumption of energy, has not been accompanied by a decline in the amount of energy used to produce a dollar of output. Net oil import dependency remains high, implying a failure to either diversify to other energy sources or tap new local supplies.

The threat posed by high oil prices is fourfold. First, high oil prices will ignite inflationary pressures. This in turn could lead to further currency depreciations in oil importing countries and to rising interest rates. Second, in the three net oil importers, high oil prices could begin to undermine their balance-of-payments positions. Third, where fuel attracts government subsidies, increases in oil prices will weaken fiscal positions. And last, by raising costs and reducing profitability, high oil prices will, in general, impact negatively on economic activity and income.

To sum up, the recovery process should make further headway during the rest of 2000 and in 2001. There is, however, no room for complacency. Domestic debt problems are still far from resolved, and structural weaknesses remain in other areas including governance. On balance, it is likely that global economic conditions will remain propitious in 2001, but rising oil prices and the possibility—although receding—of a hard landing of the US economy provide grounds for caution. The remaining weaknesses need to be addressed and reforms completed if Asia is to be put on track toward a new era of high economic growth and reduced vulnerability to external shocks.

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)

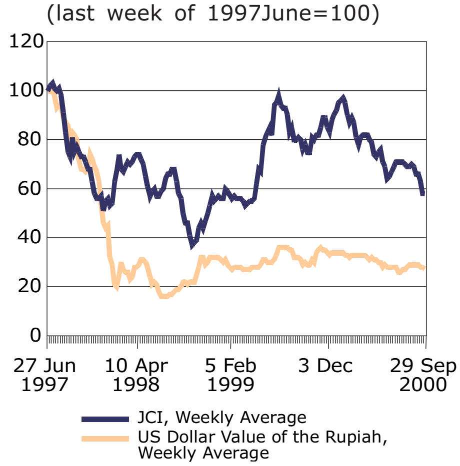
Fitch IBCA	
Investment Grade Ratings	
AAA	Highest credit quality. Denotes the lowest expectation of credit risk. They are assigned only in cases of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
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.

Thomson Financial Bankwatch	
Investment Grade Ratings	
AA+ / AA / AA-	This rating indicates a very strong ability to repay principal and interest on a timely basis, with limited incremental rise compared to issues rated in the highest category.
A+ / A / A-	This indicates that ability to repay principal and interest is strong. Issues rated A could be more vulnerable to adverse developments than obligation with higher ratings.
BBB+ / BBB / BBB-	Lowest investment grade category: indicates acceptable capacity to repay principal and interest. BBB issues are more vulnerable to adverse developments than obligations with higher ratings.
Noninvestment Grade Ratings	
BB+ / BB / BB-	Bonds that may be speculative in the likelihood of timely repayment of interest. There are significant uncertainties that could affect the ability to adequately service debt obligations.
B+ / B / B-	Bonds that show a high degree of uncertainty and therefore greater likelihood of default than higher rated issues. Adverse developments could negatively affect the payment of interest and principal on a timely basis.
CCC+ / CCC / CCC-	Issues that have a high likelihood of default, with little capacity to address further adverse changes in financial circumstances.
CC+ / CC / CC-	Applied to issues that are subordinate to other obligations rated CCC and are afforded less protection in the event of bankruptcy or reorganization.

Indonesia Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

External factors and domestic political problems combined to weaken the rupiah.

Private capital continued to leave Indonesia in the first quarter of 2000, driven away mainly by rising US interest rates and uncertainties over economic recovery. The capital outflow, combined with domestic political problems, put pressure on the rupiah. Despite some recovery in late July and early August, by end-September, the Indonesian currency had depreciated by 19 percent since the start of the year (Figure 1). Exchange rate volatility had revived public discussions on a currency board system or Malaysian-style capital controls. However, the official policy is to adopt inflation targeting as a monetary tool.

The stock market has taken a beating.

After approaching its precrisis level early this year, the Jakarta Composite Index (JCI) has slumped anew, declining by 39 percent in the first nine months of 2000. Higher US interest rates, uncertain regional economic prospects, communal unrest, and political uncertainty prompted investors to unload Indonesian equities.

The property market remains weak.

Office vacancy rates in the prime business districts of Jakarta declined slightly in the first half of 2000. There were also significant improvements in the retail vacancy rates between the second quarters of 1999 and 2000. Nevertheless, vacancy rates in general remain high (Table 1), while property prices and rents are not likely to recover any time soon.

Table 1: **Property Vacancy Rates in Jakarta** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Office Property	15.6	20.0	22.3	22.3	24.3	25.7	25.5	25.4	24.5
Retail Property	. . .	. . .	. . .	. . .	16.4	. . .	11.8	. . .	9.3

. . . = not available.
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Real Sector

Economic recovery consolidated in the first half of 2000.

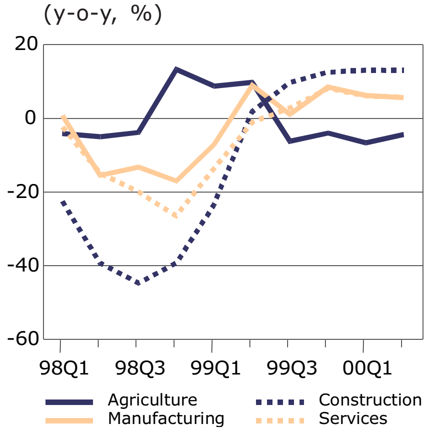
Economic recovery consolidated in the first half of 2000, with GDP expanding by 3.9 percent, a pace consistent with the government target of 3-4 percent for the whole year (Table 2). However, the gap between real per capita GDP and its peak value—attained in 1997—is still wide.

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

	1997	1998	1999	2000	2001
Official[1]	4.7	-13.0	0.3	3.0-4.0	4.0-5.0
ADB[2]	—	—	—	3.5	5.0
IMF[3]	—	—	—	4.0	5.0
World Bank[4]	—	—	—	4.0	4.0
Consensus Economics[5]	—	—	—	3.8	4.3

[1]Letter of Intent of the Government of Indonesia, 31 July 2000; IMF Public Information Notice No. 00/82, 25 September 2000.
[2]ADB, *Asian Development Outlook 2000 Update*, September 2000.
[3]IMF, *World Economic Outlook*, September 2000.
[4]World Bank, *East Asia's Recovery: Gathering Force—An Update*, 18 September 2000.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* September 2000.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)

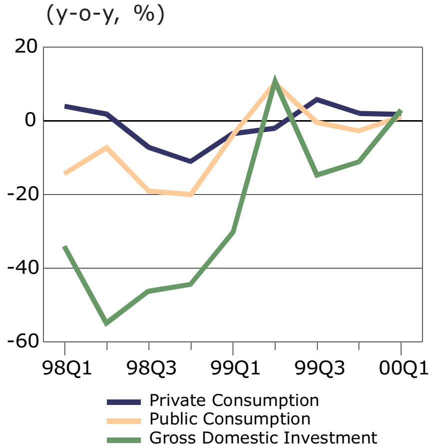


Source: ARIC Indicators.

Expansion in manufacturing, construction, and services offset the contraction in agriculture.

After experiencing a strong weather-related rebound in the first half of 1999, agricultural output contracted over the next four quarters (Figure 2). Its poor performance is partly a result of credit shortages and communal unrest in several provinces. However, manufacturing, which benefited from a surge in nonoil exports, grew, as did construction, in response to the fiscal stimulus. Services output also expanded on the back of a turnaround in the financial sector. The expansion of these three sectors in the first half of 2000, plus the recovery in oil prices, offset the decline in agricultural activity.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

Consumption expenditure tailed off but investment finally posted a turnaround.

The recovery in consumption spending tailed off in the first quarter of 2000, growing by only 1.8 percent (Figure 3). Sharp falls in real wages, uncertain job prospects, and the drying up of consumer credit continued to dampen consumer confidence. However, fixed investment finally posted a turnaround after declining since mid-1997. While the positive growth rate is more a reflection of a depressed base period, it does signal an improvement in capacity utilization and a mild response to bank and corporate restructuring efforts. Export expansion, and not import compression, was the reason this time behind the positive contribution of net exports to output.

Fiscal and Monetary Developments

The budget deficit for fiscal year 1999/2000 was narrower than expected.

According to official sources, the budget deficit for fiscal year 1999/2000 was 1.5 percent of GDP, well below the 5 percent initially projected. A windfall in oil and gas revenue, delays in project implementation, and the slow progress of bank recapitalizations were the main reasons for the reduced deficit. But in the context of a weaker rupiah, rising debt repayments, and, hopefully, more rapid progress in bank restructuring, a wider deficit is expected in the next fiscal year. If growth falters, or IBRA does not speed up asset disposal, the deficit could be larger still.

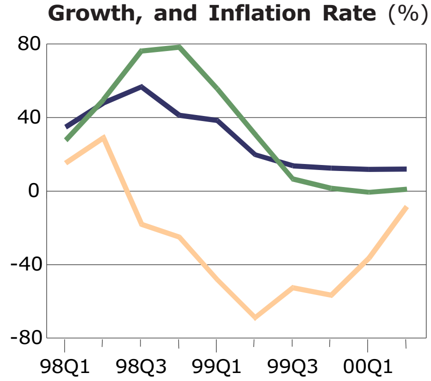
But government debt increased.

Because much of the widening budget deficit has been financed through bond issues, central Government debt is estimated to have reached $76 billion at the end of June 2000, compared to $54 billion when the crisis began and $70 billion just a year ago. A substantial proportion of domestic bond issues was used to recapitalize banks and repay Bank Indonesia's liquidity support to the banking system after the crisis. With the deficit projected to be higher in the next fiscal year, privatization programs and asset sales by IBRA are expected to receive greater priority.

Inflation remains under control but is expected to rise in the second half of 2000.

The consumer price index increased in the first quarter of 2000 after declining in the previous three quarters. Nevertheless, measured year-on-year, inflation was still negative (–0.6 percent) in the first quarter of 2000 (Figure 4), reflecting weak domestic demand. However, lower agricultural output, faster growth in money supply, and the recent depreciation of the rupiah are expected to lead to an upswing in prices. Inflation in

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Three-Month Interbank Lending Rate, End of Period
Growth in Real Bank Credit to Private Sector, End of Period (y-o-y)
Inflation Rate (y-o-y)

Source: ARIC Indicators.

the second quarter was 1.1 percent and reached 6.8 percent in September on a year-on-year basis. An anticipated reduction in fuel price subsidies and a scheduled increase in government workers' wages will also exert upward pressures on prices.

Tightening of monetary policy has led to a slight increase in interest rates.

Interest rates continued to fall in the first quarter of 2000. Monetary policy was, however, subsequently tightened in response to the rise in US interest rates, higher-than-targeted growth in base money, and looming inflationary threats. The yield on the benchmark, one-month, Bank Indonesia Certificates stood at 13.5 percent in early August compared to 10.9 percent in early May. Overnight lending rates are now about 154 basis points higher than at the start of the year.

Although real bank credit to the private sector has continued to contract, the pace is slowing down.

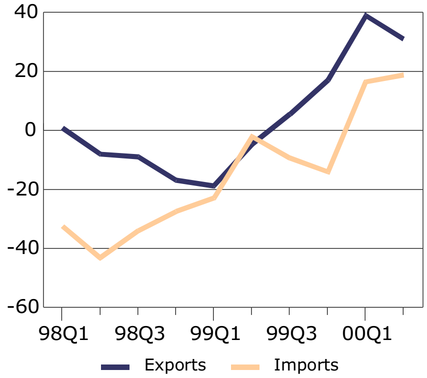
Real interest rates remain high in Indonesia. Up to the first quarter of 2000, declines in nominal rates were outpaced by the slowdown in inflation. Subsequently, interest rates were raised at a faster pace than inflation. The rapid rise in bond-financed government debt has also kept real interest rates high. Reflecting weak bank balance sheets, high lending costs, and weak demand, bank credit extended to the private sector has continued to contract in real terms. However, the pace of contraction is slowing down. Recovery of lending is likely to be slow until real interest rates decline, debt-ridden banks have been sufficiently recapitalized, and satisfactory progress has been made in corporate debt restructuring.

Balance of Payments

The surge in nonoil exports contributed to a large increase in the trade surplus.

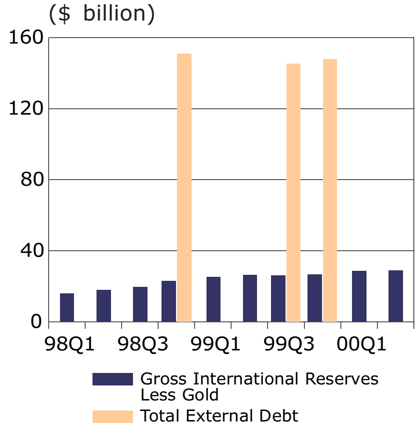
Exports rose sharply in the first six months of 2000 (Figure 5). An encouraging sign was the strong performance of nonoil exports, indicating that Indonesia has recovered sufficiently to participate in an expanding global market. Imports also increased, although at a more modest pace, particularly in the case of nonoil imports. As a result, the trade surplus posted a 53.2 percent increase in the first half of 2000.

Figure 5: **Growth of Merchandise Exports and Imports** (y-o-y, %)



Source: ARIC Indicators.

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

Net private capital flows remain negative.

Since the crisis began, there has been an outflow of short-term and long-term private capital from Indonesia. This trend continued in the first quarter of 2000. Higher US interest rates and domestic political problems fueled an outflow of portfolio investment. Meanwhile, the level of official flows in the first quarter of 2000 was lower than in the same period last year.

Foreign reserves continue to rise.

The trade surplus in the first four months of 2000 has contributed to an accumulation of international reserves, which have been rising since the second quarter of 1998. Capital inflows from official sources, which were given a boost by IMF's acceptance of the Government's letter of intent in May and July 2000, have also contributed. Gross reserves were estimated to be $28 billion as of September 2000 (Figure 6).

External debt in 1999 was lower than in 1998.

External debt at the end of 1999 was $148.1 billion. This is about $30 billion higher than at the start of the crisis in 1997 but $2.8 billion lower than that recorded in 1998. The external debt to GDP ratio has escalated sharply, as a result of the depreciation of the rupiah and the contraction of real income. The ratio reached 103 percent at the end of 1999. The debt-service ratio, meanwhile, fell from 58 percent in 1998 to 56.7 percent in 1999.

Financial Sector Developments

There has been little progress in bank restructuring.

IBRA has resumed its multibillion-dollar rehabilitation program after a brief interruption following the outbreak of the Bank Bali scandal. However, the debt restructuring process continues to be slow. Part of the problem has been the ineffectiveness of the bankruptcy courts. In the March and July economic program reviews with IMF, the Government detailed a substantial agenda to resolve faster the NPLs held by IBRA and the JITF. Finishing this task is essential if the momentum of the economic recovery is to be maintained.

The cost of bank restructuring has been escalating.

Financing banking sector recapitalization is one of the main challenges faced by the Indonesian authorities. In June 1999, the cost of bank recapitalization was estimated at Rp570 trillion but, by the end of 1999, restructuring bonds worth Rp599 trillion had been issued. Current estimates indicate that, by the end of 2000, a total of Rp648 trillion worth of bonds—52 percent of GDP—will have been issued for this purpose.

Prospects and Policy Issues

The economy is on firmer ground but the recovery remains fragile.

Resurgences in investment and nonoil exports have put the Indonesian economy on firmer ground. Nevertheless, the recovery remains fragile, with Indonesia still vulnerable to external shocks and domestic political problems creating an uncertain investment climate for domestic and foreign investors alike. Consensus Economics' latest forecast (September 2000) is for a GDP growth rate of 3.8 percent in 2000—significantly lower than the 4.5 percent forecast just four months ago. However, second quarter data were more encouraging and showed that the economy had expanded by 4.1 percent. The official forecast for GDP growth in 2001 is higher at 4-5 percent, while Consensus Economics projects a growth rate of 4.3 percent. The average inflation rate in 2000 is likely to be below 10 percent but the year-end figure may be higher than the government target of 5-7 percent.

Bank restructuring is starting to make an impact but higher interest rates may slow its progress.

Speeding up and sustaining the recovery process depends crucially on the rejuvenation of the moribund banking system. Reducing NPLs and recapitalizing banks are essential steps to restoring credit flows. Recent reports indicate that several banks that have benefited from the official recapitalization program have begun to extend fresh loans. However, progress may be hampered by the rise in domestic interest rates. Given the sheer magnitude of the needed financial commitment, it is unlikely that banking sector restructuring can be successfully completed without drawing on foreign capital and expertise.

The decentralization process must be worked out carefully.

The budget for fiscal year 2001 will be the first one to reflect the 1999 decentralization laws. Several sensitive issues will have to be addressed, including the transfer of civil servants and spending functions, amounts of shared revenues and transfers, borrowing authority, and accountability. The devolution process must be worked out carefully in order not to disrupt government services or put additional pressure on the budget. Meanwhile, some foreign investors are concerned about the manner in which the Government's decentralization program will affect their operations, particularly in the provinces (Box C).

Box C: **Decentralization in Indonesia—Process and Issues**

The land size, large population, and diversity of its people provide sufficient reasons for Indonesia to be a decentralized state. Yet, despite previous attempts, it is only now that Indonesia has embarked on a process of decentralization, with the timetable calling for some elements to be incorporated in the 2001 budget. However, such a short timescale, plus concerns about provisions of the decentralization laws, suggest that some adjustments in implementing the scheme might be warranted. Two laws were passed by the Indonesian parliament at the end of April 1999 to pave the way for decentralization. The Regional Governance Law focuses on enhanced administrative and political decentralization, particularly at the district level, by eliminating the hierarchical relationship between the provincial and district governments. After decades of highly centralized and authoritarian rule, the movement toward multiparty elections at all levels should lay the foundations for greater accountability in government operations and improved efficiency in the delivery of public services.

Meanwhile, the Fiscal Balance Law delegates expenditure functions to the local governments and at the same time outlines a revenue-sharing scheme. Although the law specifies that 25 percent of central Government domestic revenues are to be transferred to regions through the general allocation fund, there is no explicit formula for allocating the funds to specific districts. For the laws to be effective, several issues have to be addressed. First, there is only broad reference to the devolution of expenditure responsibilities. Goals, as well as guidelines, are not well defined. For example, there are few allowances made for the districts' differing capacities to handle expenditure functions. Moreover, the role of the central Government in determining minimum standards for education, health, and other services is not specified.

Second, the proper sequencing of the decentralization process has to be taken into account. The main concern is that the revenue devolution provisions will be enacted before there has been an effective decentralization of expenditure. This may lead to serious macroeconomic imbalances, especially at the central Government level.

Third, despite enactment of revenue sharing, the laws do not give local governments any new, meaningful, or locally controlled tax instruments. This may constrain the fiscal flexibility of the districts.

And fourth, the proposed sharing of revenue, especially that from oil and gas, may widen regional disparities. In addition, sharing of the land and property tax may undercut the potential for local accountability. Given that the fiscal 2001 budget has already been unveiled, the central Government must move quickly to draft regulations that would ensure a smooth and effective devolution of expenditure functions. Proper sequencing should be the priority. While it is an advantage that the revenue-sharing formula is not permanent, when put into operation, it should be transparent and equitable. Last, the basis for own revenue generation must be established at the district level.

Sources: E. Ahmad and B. Hofman. 2000. Indonesia: Decentralization—Opportunities and Risks (from the web site: http://www.imf.org/external/pubs/ft/seminar/2000/idn/oprisk.pdf); J. Alm and R. Bahl. 1999. Decentralization in Indonesia: Prospects and Problems (from the web site: http://www.gsu.edu/~prprwb/IndonesiaReport.pdf).

Fiscal consolidation must also be given priority.

Fiscal difficulties have resulted in inadequate funding for basic government services such as education and law and order. Meanwhile, debt service has escalated to more than 50 percent of tax revenues. To ease the pressure on the budget, the Government must make rapid progress with privatization programs and state enterprise reform. Priority should also be given to effective debt management practices and development of a domestic bond market.

Indonesia: Selected ARIC Indicators

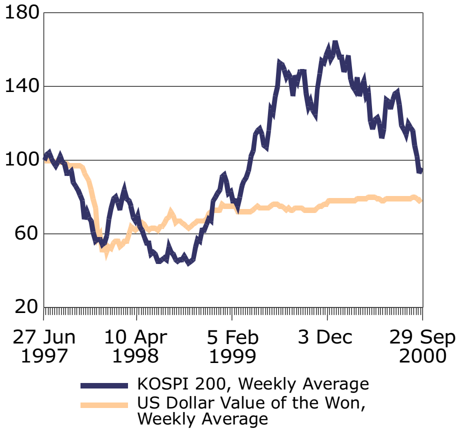
	1996	1997	1998	1999	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Output and Prices														
GDP Growth (%)	7.8	4.7	-13.0	0.3	-3.3	-14.5	-16.2	-17.6	-7.7	3.7	1.2	5.0	3.6	4.1
Private Consumption Expenditure Growth (%)	10.9	6.7	-3.3	0.5	4.0	1.9	-7.2	-11.0	-3.4	-2.0	5.7	2.1	1.8	. . .
Public Consumption Expenditure Growth (%)	2.6	0.0	-15.4	0.7	-14.3	-7.3	-19.0	-19.9	-3.9	10.2	-0.4	-2.7	1.1	. . .
Gross Domestic Investment Growth (%)	. . .	6.3	-44.8	-13.6	-34.0	-54.9	-46.1	-44.4	-30.3	10.7	-14.9	-11.1	2.9	. . .
Agricultural Sector Growth (%)	. . .	1.0	-0.7	2.1	-4.1	-5.0	-3.8	13.3	8.8	9.8	-6.2	-4.0	-6.6	-4.3
Manufacturing Sector Growth (%)	11.7	5.2	-11.4	2.6	0.8	-15.4	-13.2	-17.0	-7.1	9.0	1.1	8.5	6.2	5.7
Construction Sector Growth (%)	12.8	7.4	-36.5	-1.6	-22.5	-39.3	-44.7	-39.3	-23.4	1.8	9.7	12.5	13.2	13.0
Services Sector Growth (%)	6.8	5.6	-16.3	-1.5	-2.3	-15.0	-19.9	-26.4	-13.7	-1.1	2.8	8.1	6.1	5.8
Exports of Goods and Services Growth (%)	7.6	7.8	11.2	-31.6	57.5	21.8	22.7	-40.4	-43.7	-37.3	-38.2	12.4	9.1	. . .
Imports of Goods and Services Growth (%)	6.9	14.8	-5.4	-40.7	23.4	8.7	4.4	-46.4	-51.6	-43.1	-43.6	-12.8	4.0	. . .
Inflation Rate (%)	8.0	6.2	58.5	20.5	27.7	49.7	76.3	78.4	55.8	30.9	6.7	1.7	-0.6	1.1
Unemployment Rate (%)	4.9	4.7	5.5	6.4	5.5	. . .	. . .	. . .	6.4	. . .	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts														
Growth of Broad Money, M2 (%)[1]	27.2	25.2	63.5	12.5	52.6	81.5	67.4	63.5	34.3	9.2	19.1	12.5	10.3	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	25.8	41.3	12.6	34.8	47.9	56.7	41.3	38.6	19.9	13.7	12.6	12.0	12.2
Growth in Real Bank Credit to Private Sector (%)[1]	14.5	17.2	-25.0	-56.5	15.3	29.0	-17.9	-25.0	-48.1	-68.8	-52.5	-56.5	-36.3	-8.2
NPL Ratio of the Banking System[1]	. . .	. . .	49.2	. . .	. . .	. . .	. . .	49.2	. . .	. . .	. . .	. . .	. . .	. . .
Average Stock Price Index	585.9	607.1	418.3	543.1	474.7	449.2	392.0	357.4	402.0	566.0	590.4	614.0	620.3	513.9
Central Government Fiscal Balance as % of GDP	1.2	-0.7	-2.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Central Government Debt as % of GDP[1]	24.3	24.2	66.5	52.9	29.3	37.8	53.4	66.5	62.0	57.1	54.2	52.9	49.5	49.6
Government Expenditure on Education (% of Total)	. . .	. . .	5.0	6.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	. . .	1.4	1.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates														
Growth of Merchandise Exports ($ fob, %)	9.7	7.3	-8.6	-0.4	0.9	-8.4	-9.1	-16.8	-18.8	-4.4	5.6	17.1	39.0	31.0
Growth of Merchandise Imports ($ cif, %)	5.7	-2.9	-34.4	-12.5	-32.5	-43.2	-34.0	-27.5	-22.9	-2.0	-9.4	-14.1	16.6	18.8
Current Account Balance as % of GDP	-3.4	-2.2	4.0	4.0	4.3	3.0	7.5	2.2	4.7	2.4	5.1	3.9	4.7	. . .
Net Foreign Direct Investment ($ Billion)	5.6	4.5	-0.4	-2.8	-0.5	0.4	-0.2	-0.1	-0.2	-0.9	-0.7	-0.9	-1.5	. . .
Net Portfolio Investment ($ Billion)	5.0	-2.6	-1.9	-1.8	-3.5	1.8	0.1	-0.3	-2.0	0.8	-0.6	0.0	-0.0	. . .
Gross International Reserves Less Gold ($ Billion)[1]	18.3	16.6	22.7	26.4	15.8	17.9	19.6	22.7	25.2	26.3	26.0	26.4	28.5	28.7
Total External Debt as % of GDP[1]	49.7	62.0	149.0	103.4	. . .	. . .	. . .	149.0	. . .	. . .	105.3	103.4	. . .	. . .
Real Effective Exchange Rate (1995=100)[2]	109.5	104.6	52.7	74.5	42.7	47.5	48.3	72.2	68.2	76.7	76.8	76.4	77.1	69.8
Average Exchange Rate (Local Currency to $)	2,342.3	2,909.4	10,013.6	7,854.9	9,433.4	10,460.8	12,252.1	7,908.3	8,730.5	7,977.5	7,501.3	7,210.5	7,412.0	8,324.3

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratio of the banking system, central government debt, total external debt, and government expenditure on education and health are from national sources. Data on M2, real bank credit to private sector, central government fiscal balance, net foreign direct and portfolio investments, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics*. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on ARIC calculations.

Republic of Korea Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: ARIC Indicators.

Strong growth continues to support a stable won.

Supported by strong growth and the return of foreign capital, the won appreciated slightly against the dollar in the first quarter of 2000 and remained stable in the second and third quarters (Figure 1). This is a noteworthy performance given the weakening of other Asian currencies in recent months. The reluctance of the Bank of Korea, the country's central bank, to bow to inflationary pressures and increase interest rates until recently suggests that it is trying to head off any further appreciation of the won. Still, as of end-September 2000, the dollar value of the won remains about 20 percent below its June 1997 level.

But the stock market performed poorly.

Stock prices have been declining for most of 2000. While there have been a few short rallies, these have proved to be short-lived. The poor performance of Korean equities has in part been caused by downward adjustments in global asset markets, sparked in turn by increases in US interest rates. But domestic concerns have also played an important role. The slow progress of corporate restructuring, the reported troubles of the largest *chaebol*, Hyundai, and liquidity problems of investment trust companies (ITCs), all have had negative impacts on investor confidence. Compounding these factors are fears that the economy might overheat and require an increase in domestic interest rates.

Prospects for the property market are mixed.

On the positive side, housing prices continued their upward trend and have substantially exceeded precrisis levels. There has also been an increase in land acquisition by foreign investors, signaling rising confidence in the market. But there have been few positive developments in commercial property transactions. Intensified competition among shopping malls has led to oversupply. Consequently, the rate of unsold shopping mall units increased in the second quarter of 2000.

Real Sector

Growth in the first half of 2000 exceeded expectations.

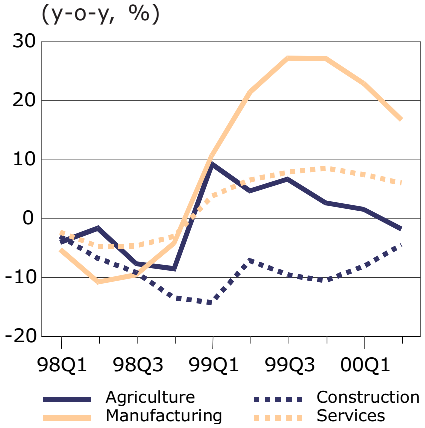
The strong economic rebound that began early in 1999 continued in 2000. GDP grew by 12.8 and 9.6 percent in the first and second quarters, respectively. In July 2000, the Government accordingly revised its growth target from 6 to 8-8.5 percent. This positive outlook is also echoed by Consensus Economics, which has raised its forecast to 8.7 percent for 2000 (Table 1).

Table 1: **GDP Growth and Projections** (%)

	1997	1998	1999	2000	2001
Official[1]	5.0	-6.7	10.7	8.0-8.5	—
ADB[2]	—	—	—	8.3	6.0
IMF[3]	—	—	—	8.8	6.5
World Bank[4]	—	—	—	8.5	6.5
Consensus Economics[5]	—	—	—	8.7	6.0

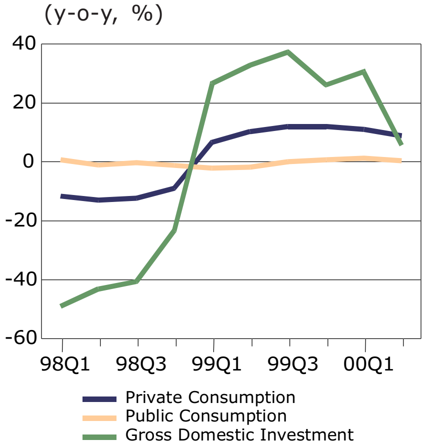
[1]Letter of Intent of the Government of the Republic of Korea, 12 July 2000.
[2]ADB, *Asian Development Outlook 2000 Update*, September 2000.
[3]IMF, *World Economic Outlook*, September 2000.
[4]World Bank, *East Asia's Recovery: Gathering Force—An Update*, 18 September 2000.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, September 2000.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

Growth was driven by manufacturing.

While the services sector is growing strongly, the manufacturing sector continues to be the principal driving force behind Korea's economic recovery (Figure 2). Manufacturing output expanded by 19.7 percent in the first half of 2000. The tapering of growth from its exceptional level in 1999 was partly because it is now measured from a higher base. Capacity utilization of the manufacturing sector improved further, from an average of 76.5 percent in 1999 to 81.5 percent in July 2000. Recent manufacturing production surveys indicate an upsurge in the production of semiconductors, mainly for overseas markets.

Investment in machinery and equipment soared.

On the demand side, exports and domestic demand both fueled growth. Supported by continued global economic expansion and the IT boom, export growth remained strong through the first half of 2000. Private consumption also grew steadily (Figure 3). Gross domestic investment rose by more than 30 percent in the first quarter of 2000, but slowed down to only 5.7 percent growth in the second quarter. Investment in machinery and equipment performed more consistently, growing by 63.6 and 41.3 percent in the first and second quarters of the year, respectively.

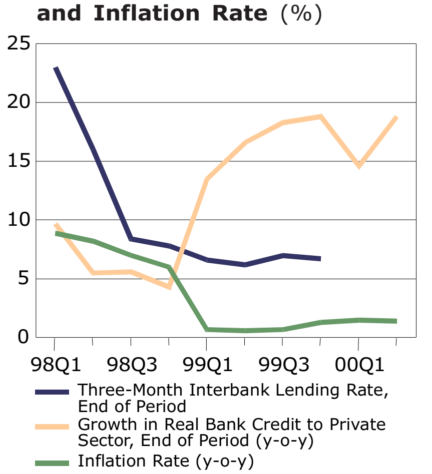
Fiscal and Monetary Developments

Fiscal position improved.

After running deficits for three years, Korea posted a fiscal surplus of W17.5 trillion in the first eight months of 2000, equivalent to 3.3 percent of GDP. Tax collection in the first eight months was also up by 29 percent compared to the same period last year. This made it possible for the Government to achieve a surplus without making substantial cuts in expenditure. Even if the Government proceeds with an additional W20 trillion in public spending for financial sector restructuring, a W10 trillion to W12 trillion deficit target for 2000 is still within reach.

Inflation is edging up.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth,* and Inflation Rate** (%)



*Growth in real bank credit in the second quarter of 2000 is only up to May.
Source: ARIC Indicators.

Inflation started to rise in the fourth quarter of 1999 (Figure 4), by September 2000 reaching 3.9 percent. The inflationary surge has been partly caused by increases in prices of agricultural goods and services, with high world oil prices also contributing. As the output gap is closed, further pressure on domestic prices can be expected.

Monetary policy remained broadly accommodating.

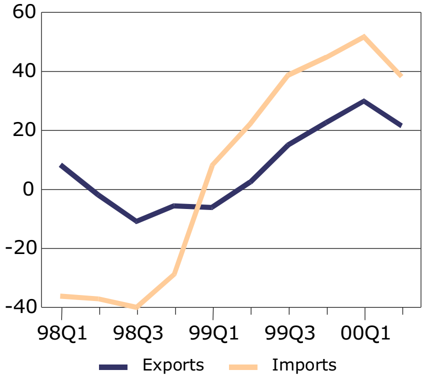
To curb rising inflationary pressures, the Bank of Korea raised the overnight call rate by 0.25 percentage point in early October 2000. This is the second time this year that the monetary authority hiked the call rate. Despite the rate increase, the Bank of Korea has indicated that it will maintain its stance close to neutral. One of its concerns is that higher interest rates may worsen difficulties in the banking sector. Real bank credit growth slowed in the first quarter of 2000, but bounced back in May 2000.

Balance of Payments

Global demand has supported strong exports, while economic recovery has spurred imports.

Despite the slight erosion of international competitiveness due to the real appreciation of the won, exports continued to grow

Figure 5: **Growth of Merchandise Exports and Imports** (y-o-y, %)



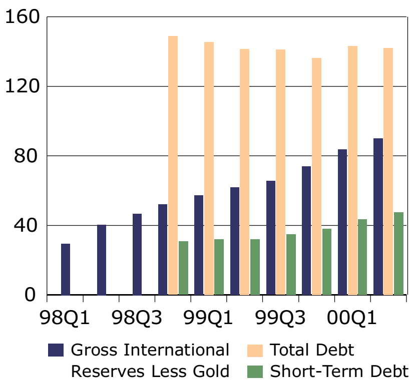
Source: ARIC Indicators.

in 2000 (Figure 5). Computer exports were particularly strong, increasing by 96 percent in the first half, supported by the boom in global IT demand. Economic recovery is also spurring import growth, which rose by 45 percent in the first six months, led by raw materials and capital goods imports. The import growth has resulted in lower trade and current account surpluses compared to last year.

Foreign direct investment inflow is steady.

Strong economic performance has led to a resurgence of capital flows into Korea. FDI has performed well since the third quarter of 1999, with July 2000 FDI inflows reportedly reaching $2.1 billion. Good economic news also attracted a large amount of foreign portfolio capital in the first quarter of 2000, with net inflows amounting to $6.7 billion. But gyrations in the stock market, triggered by unfavorable corporate news, caused inflows of foreign portfolio capital to abate in the second quarter of 2000.

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

The share of short-term debt is rising, but external payments are still manageable.

Total external debt has been declining since 1998. Short-term external debt, however, rose in recent quarters (Figure 6). Therefore, the share of short-term to total external debt increased to 33.5 percent in August 2000, compared to 22.7 percent in June 1999. Partly, this is due to increases in trade-related credits. But with a rapid buildup of international reserves, spurred by large current account surpluses, the external payments position is still manageable. The ratio of short-term external debt to foreign reserves stood at 52.9 percent as of end-July 2000.

Financial and Corporate Sector Developments

Financial restructuring enters its second phase.

NPLs of the financial system fell to W60.9 trillion (10 percent of total loan portfolio) in June 2000 from W112 trillion in March 1998.[1] Likewise, the NPL ratio of commercial banks fell to

[1]Based on new and tighter criteria for classifying NPLs introduced by FSS in December 1999.

7.7 percent in June 2000 from 8.3 percent in December 1999. The transfer of NPLs from troubled banks to KAMCO was responsible for much of the reduction. As of July 2000, KAMCO had acquired about W74.6 trillion in NPLs, measured at their book value, and disposed of 40 percent of them at an average recovery rate of 54 percent. Early this year, the Government announced the start of the second phase of its financial restructuring, signaling a policy shift from a government-led approach toward one that is more market-oriented. The second phase is expected to focus on developing the institutional infrastructure to support reforms, in order to enhance financial stability, improve competitiveness of the financial industry, and strengthen prudential regulations of the capital markets.

Additional public funds are needed to complete financial restructuring.

The Government had earlier estimated that an additional W30 trillion in public funds would be needed to complete its financial restructuring program. Of that, W20 trillion was expected to be raised this year through loans from KAMCO, sales of assets owned by the Korea Deposit Insurance Corporation (KDIC), and the issuance of asset-backed securities and exchangeable bonds. The remaining W10 trillion was to be raised in 2001 through the sales of NPLs by KAMCO and of other impaired assets being managed by KAMCO and KDIC. It has been reported recently that the Government has raised its estimate of the additional public fund needed to complete its financial restructuring program from W30 trillion to about W50 trillion (about $45 billion).

Corporate restructuring continues, but the task remains formidable.

Restructuring of the top four *chaebols* is making progress. Hyundai, Samsung, LG, and SK have met the overall requirements of the CSIPs for 1999. Targets in asset disposal, raising new capital, removing cross-guarantees, separating affiliates, and improving corporate governance were exceeded. In March 2000, the Fair Trade Commission announced that cross-guarantees between *chaebol* affiliates had been completely eliminated. There has also been a breakthrough in the debt overhang of Daewoo. In its June 2000 report, FSS announced the early retirement of 32 firms from their workout programs, thereby allowing banks to reclassify W4.5 trillion of NPLs as normal loans.

Despite these welcome developments, the task of corporate restructuring remains formidable. The nervousness triggered recently by the leadership struggle within Hyundai signifies that the mechanisms set in place for proper corporate governance are far from complete. The continued heavy indebtedness of financial subsidiaries of *chaebols* still puts the conglomerates at risk, as highlighted by the recent case of Hyundai Investment Trust & Securities Co. (HITS), whose debt exposure was believed to be large enough to cause market difficulties for the entire group (Box D). With the recently instituted consolidated financial statement reporting system for *chaebols*, fresh questions may arise about their financial health. For instance, consolidated statements show leverage ratios of some *chaebols* higher than the targeted 200 percent due to substantial discrepancies in accounting for capital.

Prospects and Policy Issues

Prospects for Korea look bright.

Korea remains on track toward a sustainable recovery. The Government has shown an ability to avert fiscal difficulties, while a series of upward revisions to growth forecasts reflect increased confidence in the country's macroeconomic fundamentals. The latest Consensus Economics (September 2000) forecast puts GDP growth for the whole of 2000 at 8.7 percent. The increase in facilities investments indicates that more productive capacity is forthcoming. But while prospects for Korea are bright, there are still risks to be faced.

The export boom may not be sustainable.

Exports have been one of the main engines of growth in the recovery process, but there are indications that the boom may not be sustainable. First, real currency appreciation suggests that the international competitiveness achieved by the sharp devaluation of the won is gradually being eroded. Second, Korea's terms of trade have been deteriorating. As of June 2000, they were nearly 20 percent below their June 1997 level. Third, a slowdown in the US economy, Korea's top export market, would dampen export demand.

Inflation could become a problem in the near future.

The recent rise in inflation could spell difficulties ahead, while further increases in world oil prices could put more pressure on inflation in the coming months. Latent inflationary pressures sug-

Box D: **Debt, Politics, and Family Feuds—The Case of Korea's Largest *Chaebol***

The family drama unwinding in Hyundai's headquarters may have real—and serious—consequences for the recovery of the Korean economy. Three years after the regional financial crisis, domestic and international investors alike perceive little change on the *chaebol* front. Corporate governance, despite pleas for reform, has not yet markedly improved. There are well-founded fears that profitable affiliates of certain *chaebols* have to subsidize loss-making units. Complicated layering and pyramidal ownership structures form the essence of Korea's *chaebols*, and have increasingly come under attack from reformers. Yet Hyundai, like other mostly family-run *chaebols*, appears to remain reluctant to change. The lack of transparency could well lead to a withdrawal of foreign involvement and alliances with Korean firms, and increase their reluctance to participate in large recapitalization programs.

Since the beginning of this year, the loss of investor confidence, reinforced by market intransigence and family infighting within Hyundai, has destabilized Korea's stock market. A government bailout of Korea's biggest ailing ITCs, announced in April 2000, did not include the troubled HITS. The restructuring and indeed rescue of these trusts is crucial for Korea's corporate recovery. It was reported that, in 1999, HITS, along with two other Korean ITCs, accounted for 80 percent of total ITC holdings of $150 billion in corporate bonds. HITS alone estimated its losses at about W400 billion at the end of the financial year in March, which amounts to half of its capital of W800 billion. Panic struck investors and creditors alike, thinking that the *chaebol* was in serious financial trouble.

Consequently, when Hyundai's short-term notes came up for a routine rolling over in May, its creditors refused to do so. The conglomerate had to seek emergency liquidity loans from the *chaebol's* main creditor, the Korea Exchange Bank. The exclusion from the bailout, some speculated, was meant to pressurize the *chaebol* into accepting a restructuring plan proposed by the Government. But the outcome, a drop in the stock exchange index of some 6 percent in two days, and general fear of a financial collapse of Korea's largest *chaebol*, was not what the then Finance Minister had expected.

In the run-up to Hyundai's latest liquidity crisis in May, the Government had been pushing all first-tier *chaebols* to reduce their debt-equity ratio to 200 percent. Hyundai sought to comply by predominantly increasing capital, rather than reducing debt, and its current debt-equity ratio is estimated at higher than 200 percent. Following the new and stricter guidelines, the picture looks even less rosy with a debt-equity ratio estimated at an even higher level. However, some of the Hyundai companies are profitable and at the forefront of Korea's industrial production. Thus, the government plan involved the spinning off of healthy units to restore at least the partial health of this powerful *chaebol* whose total debts are estimated at W52 trillion at the end of 1999. It also involved the demand that family members of Chung Ju-yung, Hyundai's founder, resign from their management positions.

After clashes between the Government and the Chung family, and intra-family power struggles, the Government pushed through a restructuring plan in August 2000. Hyundai Motor and Hyundai Heavy Industries, the two affiliates with the strongest cash flow, will be separated from the *chaebol* and thus cease to subsidize loss-making units. They will then also be safe from a potential debt crisis. Part of the deal, observers speculated, was that the Government retracted its demand for Chung Ju-yung to resign from his honorary chairmanship.

In addition, Chung Ju-yung finally agreed to reduce his 9.1 percent share of Hyundai Motors to 3 percent, a crucial prerequisite for the spinning off of this affiliate.

Sources: Bloomberg, 27 April and 14 August 2000; *Far Eastern Economic Review*, 11 May and 21 September 2000; *Financial Times*, 29 May and 14 August 2000; JP Morgan, *Asia Credit Monthly,* 30 August 2000, p. 27; *Oxford Analytica Daily Brief*, 5 June and 4 August 2000.

gest the need to tighten monetary policy. But problems in the corporate sector are constraining credit growth. This limits the monetary authorities' scope in taking tough anti-inflationary measures. Therefore, it is imperative for financial and corporate restructuring, and reforms to be completed as quickly as possible.

Corporate restructuring and reforms remain the biggest challenges.

Incomplete restructuring and reforms remain a possibility. One fear is that strong economic growth may spawn complacency over reforms. Another is that the mechanisms set in place since the onset of the crisis are not in themselves sufficient to nurture a healthy corporate sector. Recent events at Hyundai suggest that the regulatory framework to guarantee sound corporate governance is still incomplete. Also, the "Big Deal" for the top *chaebols* may have allowed them to hide the true debt exposures of their nonbank financial affiliates. Large but hidden debts could yet knock recovery and reforms off course.

Republic of Korea: Selected ARIC Indicators

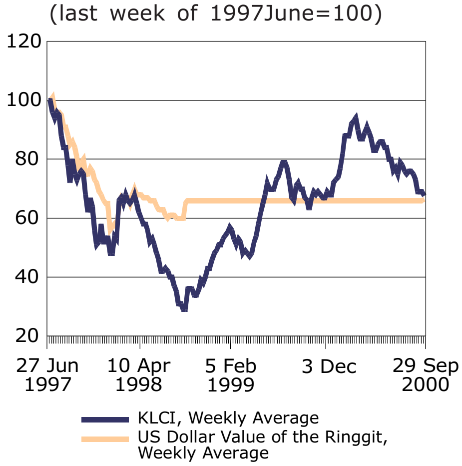
	1996	1997	1998	1999	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Output and Prices														
GDP Growth (%)	6.8	5.0	-6.7	10.7	-4.6	-8.0	-8.1	-5.9	5.4	10.8	12.8	13.0	12.8	9.6
Private Consumption Expenditure Growth (%)	7.1	3.5	-11.4	10.3	-11.6	-13.0	-12.3	-8.9	6.7	10.3	12.1	12.1	11.1	9.0
Public Consumption Expenditure Growth (%)	8.2	1.5	-0.4	-0.6	0.8	-1.0	-0.2	-1.1	-2.0	-1.7	0.1	0.8	1.3	0.5
Gross Domestic Investment Growth (%)	8.7	-7.5	-38.4	30.4	-49.0	-43.1	-40.6	-23.3	26.6	32.8	37.3	26.1	30.6	5.7
Agricultural Sector Growth (%)	3.3	4.6	-6.6	4.7	-4.0	-1.6	-7.6	-8.5	9.3	4.7	6.7	2.7	1.6	-1.7
Manufacturing Sector Growth (%)	6.8	6.6	-7.4	21.8	-5.2	-10.7	-9.5	-4.2	10.7	21.5	27.3	27.2	23.0	16.8
Construction Sector Growth (%)	6.9	1.4	-8.6	-10.1	-2.9	-6.7	-9.1	-13.4	-14.2	-7.1	-9.5	-10.5	-8.1	-4.4
Services Sector Growth (%)	6.2	5.2	-3.7	6.7	-2.3	-4.7	-4.6	-3.0	3.8	6.6	7.9	8.6	7.5	6.1
Exports of Goods and Services Growth (%)	11.2	21.4	13.2	16.3	25.8	13.6	8.5	7.6	9.2	14.6	20.0	21.0	32.9	22.9
Imports of Goods and Services Growth (%)	14.2	3.2	-22.4	28.9	-27.3	-25.7	-26.1	-10.1	27.3	28.3	32.3	28.0	31.9	19.8
Inflation Rate (%)	4.9	4.4	7.5	0.8	8.9	8.2	7.0	6.0	0.7	0.6	0.7	1.3	1.5	1.4
Unemployment Rate (%)	2.0	2.6	6.8	6.3	5.6	6.8	7.4	7.4	8.4	6.6	5.6	4.6	5.1	3.8
Monetary and Fiscal Accounts														
Growth of Broad Money, M2 (%)[1]	15.8	14.1	27.0	27.4	12.1	16.3	24.8	27.0	36.3	26.4	24.1	27.4	26.0	37.7
Three-Month Interbank Lending Rate (%)[1]	. . .	. . .	7.8	6.7	23.0	16.0	8.4	7.8	6.6	6.2	7.0	6.7	. . .	. . .
Growth in Real Bank Credit to Private Sector (%)[1]	14.4	14.4	4.3	18.8	9.7	5.5	5.6	4.3	13.5	16.6	18.3	18.8	14.6	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	. . .	11.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	11.3	10.8	10.0
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	. . .	8.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	8.3	8.0	7.7
Average Stock Price Index	90.6	67.8	47.1	95.4	58.3	43.0	36.5	50.6	65.8	90.1	113.1	112.6	114.3	96.9
Central Government Fiscal Balance as % of GDP	0.1	-1.3	-3.8	-4.6	4.1	-2.4	-4.2	-8.7	-0.2	-4.9	0.1	-7.1	1.5	. . .
Central Government Debt as % of GDP[1]	. . .	11.1	16.1	18.5	. . .	. . .	. . .	16.1	17.9	. . .	18.2	18.5	18.7	. . .
Government Expenditure on Education (% of Total)	. . .	. . .	23.1	19.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	. . .	. . .	1.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates														
Growth of Merchandise Exports ($ fob, %)	4.3	4.8	-2.8	8.6	8.4	-1.8	-10.8	-5.5	-6.1	2.5	15.1	22.7	30.0	21.6
Growth of Merchandise Imports ($ cif, %)	12.3	-2.2	-34.2	28.4	-36.1	-37.0	-39.9	-28.7	8.1	22.2	38.7	44.8	51.8	38.3
Current Account Balance as % of GDP	-4.4	-1.7	12.7	6.1	16.3	14.4	12.0	9.2	6.8	6.5	6.6	4.9	1.5	2.4
Net Foreign Direct Investment ($ Billion)	-2.3	-1.6	0.7	5.1	-0.0	0.6	0.7	-0.5	0.1	1.2	2.1	1.7	0.3	1.8
Net Portfolio Investment ($ Billion)	15.2	14.3	-1.9	8.7	3.8	0.6	-3.9	-2.4	0.9	4.0	-1.2	4.9	6.7	1.6
Gross International Reserves Less Gold ($ Billion)[1]	34.0	20.4	52.0	74.0	29.7	40.8	46.9	52.0	57.4	61.9	65.4	74.0	83.6	90.1
Total External Debt as % of GDP[1]	30.3	33.3	46.4	33.5	. . .	. . .	. . .	46.4	42.4	38.9	36.7	33.5	33.7	32.3
Short-Term Debt as % of Gross International Reserves[1]	. . .	312.3	59.1	51.5	. . .	. . .	. . .	59.1	55.5	51.8	53.5	51.5	51.9	52.7
Short-Term Debt as % of Total Debt[1]	. . .	. . .	20.6	27.9	. . .	. . .	. . .	20.6	21.9	22.7	24.8	27.9	30.3	33.5
Real Effective Exchange Rate (1995=100)[2]	104.5	100.3	83.1	90.8	73.8	83.7	88.8	86.1	91.7	92.6	89.7	89.2	93.8	94.1
Average Exchange Rate (Local Currency to $)	804.5	951.3	1,401.4	1,188.2	1,605.7	1,394.6	1,326.1	1,279.3	1,196.3	1,188.9	1,195.0	1,172.5	1,126.1	1,119.6

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the financial and commercial banking system, central government debt, total and short-term external debts, net foreign direct and portfolio investments, and government expenditure on education and health are from national sources. Data on M2, real bank credit to private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics*. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on ARIC calculations.

Malaysia Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: ARIC Indicators.

The KLCI has declined, but not fared as badly as other markets

The Kuala Lumpur Composite Index (KLCI) has performed poorly in 2000, in line with weaknesses in other regional equity markets (Figure 1). Despite low domestic interest rates; easier liquidity, helped in part by strong balance-of-payments surpluses; reinstatement of Malaysian equities in the MSCI indexes; and a powerful recovery in the real sector, the KLCI's decline, which started from the second quarter of this year, has continued. Investors' concerns over the implications of the staggered release of shares formerly traded on Singapore's Central Limit Order Book has also adversely affected market sentiment. However, the KLCI has not fared as badly as other markets in the region. As of end-September 2000, the KLCI was 33 percent in local currency terms and 56 percent in dollar terms below its end-June 1997 precrisis level.

Consolidation is still taking place in the property market.

The property market in Malaysia is still in difficulty, but the worst may be over. Office vacancy rates in the central business district of Kuala Lumpur have probably peaked. In June 2000, the vacancy rate fell to 17.5 percent from 18.8 percent two quarters earlier (Table 1). In line with this, rentals have halted their decline (measured quarter-on-quarter). In the first quarter of 2000, capital values also steadied on a quarter-on-quarter basis, but are still lower than a year ago. The picture is similar in the residential market, with vacancy rates beginning to fall and rentals holding steady. In the first quarter of 2000, residential capital values stabilized, but are still down on a year-on-year basis.

Table 1: **Property Vacancy Rates in Kuala Lumpur** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Office Property	11.6	13.6	15.5	15.7	17.0	17.0	18.8	17.8	17.5
Retail Property	. . .	. . .	. . .	. . .	12.8	. . .	15.2	. . .	13.2

. . . = not available.
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Real Sector

First half GDP growth exceeded 10 percent.

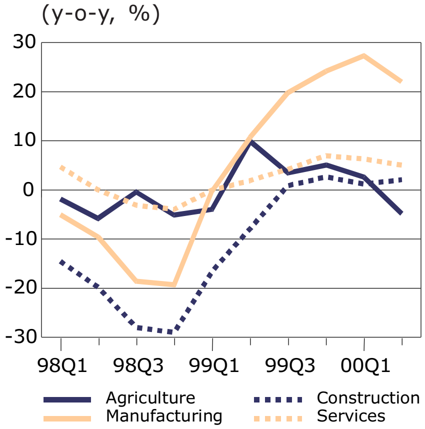
Real GDP grew by 10.3 percent in the first half of the year, with second quarter growth moderating to 8.8 percent from 11.9 percent in the first quarter. Against this backdrop, the official projection of 5.8 percent for the full year now seems overly conservative. Consensus Economics (September 2000) projections suggest that the growth rate will be about 8.6 percent—itself a significant upward revision of earlier estimates. The Malaysian economy, it would seem, is continuing to surprise on the upside (Table 2).

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

	1997	1998	1999	2000	2001
Official[1]	7.5	-7.6	5.6	5.8	—
ADB[2]	—	—	—	7.8	7.0
IMF[3]	—	—	—	6.0	6.0
World Bank[4]	—	—	—	8.0	6.0
Consensus Economics[5]	—	—	—	8.6	6.7

[1]Ministry of Finance, 1 April 2000.
[2]ADB, *Asian Development Outlook 2000 Update*, September 2000.
[3]IMF, *World Economic Outlook*, September 2000.
[4]World Bank, *East Asia's Recovery: Gathering Force—An Update*, 18 September 2000.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* September 2000.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

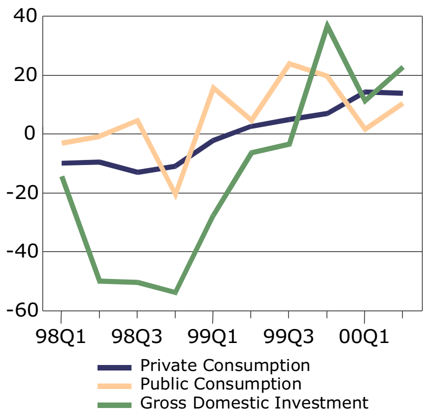
The recovery is becoming more broad based.

Malaysia's manufacturing sector continues to power ahead, but recovery is also becoming increasingly broad based. All major sectors of the economy, except agriculture, are posting positive growth (Figure 2). Even the mining and construction sectors, which until recently lagged, are contributing to growth. Moreover, while exports, aided by a competitive exchange rate and strong demand for electronics, are still driving growth on the demand side, local investment and consumption are increasingly supporting domestic demand. Earlier concerns about an undervalued ringgit compared to other regional currencies have been mitigated to some degree by the appreciation of the US dollar.

Manufacturing output continues to soar.

In the second quarter of 2000, manufacturing production grew by 22 percent (year-on-year), down from 27.3 percent in the previous quarter. Spearheading this growth are the electronics and electrical sectors, which are being spurred by the upswing in the global electronics cycle. Taken together, export-oriented manufacturing sectors grew by 30 percent on average over the second quarter. Significantly, output of the domestic-oriented manufacturing sectors is also on the rise, with growth averaging at about 20 percent in the second quarter of 2000.

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

Private consumption has recovered.

In 1999, private consumption lagged broader GDP growth, with public expenditure providing the main support for total consumption. In the first quarter of 2000, this situation has been reversed. Public consumption posted a marginal 1.7 percent growth while private consumption grew at 14.4 percent (Figure 3). Public consumption rebounded in the second quarter, to post a 10.5 percent increase, while private consumption remained robust, rising by 13.9 percent. Rising incomes and falling unemployment have supported the acceleration of private consumption expenditure.

Investment is contributing to growth.

Investment demand also perked up in the first quarter and then led domestic demand in the second quarter. Total fixed investment expanded in the second quarter by 25.8 percent (y-o-y). Much of this expansion is likely to have been due to investment by the public sector and State-related enterprises. FDI continues to be low relative to precrisis levels (Box E). In many private sector companies, there is probably still some excess capacity, though capacity utilization rates are now increasing.

Fiscal and Monetary Developments

Deficit spending is again planned in 2000.

The Malaysian Government remains committed to an expansionary fiscal stance to support the recovery of private demand. The target deficit for 2000 is 4.5 percent of GDP. Although the Government posted a surplus in the first quarter of 2000, there was a deficit in the second quarter, leaving the half-year figures in overall deficit. Nevertheless, with strong growth, the actual

Box E: **The Slump in FDI—Cause for Concern?**

Before the economic crisis struck in 1997, Malaysia's success in attracting FDI was spectacular, providing an engine of growth to the country's economy. FDI to Malaysia started shooting upwards in the mid-1980s, increasing by almost tenfold between 1987 and 1991—faster than experienced by other Association of Southeast Asian Nations (ASEAN) countries. From 1991 to 1997, Malaysia also outshone the rest of ASEAN in the volume of FDI inflows.

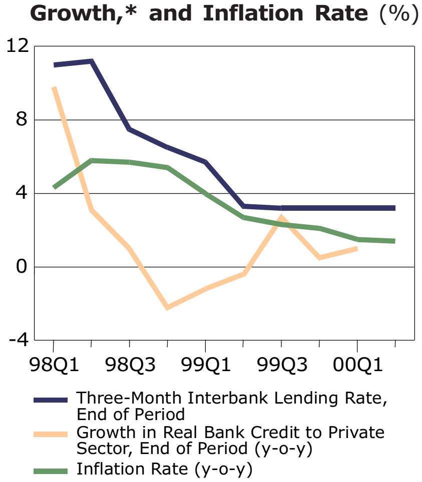
Having received a high share of the region's FDI before the crisis, Malaysia now receives a disproportionately low share (see Table A-2 in Tracking Asia's Recovery—A Regional Overview). Japanese investment in particular has tailed off sharply, having been one of the largest investors in Malaysia before the crisis. In 1999, Malaysia ranked a lowly fifth when it came to yen investments in Southeast Asia. The situation appears not to be getting any better even as Malaysia's recovery from the crisis gathers pace. Excluding one large approval that was backdated, total investment approvals in the first seven months of 2000 declined 50 percent year-on-year to only RM4.7 billion.

What could be behind Malaysia's dismal record in reattracting FDI? Some point to the slowdown as an unintended consequence of capital controls and the negative perceptions that they generated (unintended in that they were designed to curb short-term flows, not FDI). The gradual easing of these controls has failed to stem the decline in FDI, however. Others say foreign investors are being scared off by unpredictable policies and political uncertainty, when once certainty and stability in these areas were hailed as major attractions. The optimists, or less-alarmists, suggest that the slowdown may just reflect the early phase of recovery in countries such as Korea, as well as Taipei,China, which were large investors in Malaysia just before the crisis.

Furthermore, unlike Korea and Thailand, Malaysia did not promote takeovers by foreign companies as part of the corporate and banking restructuring process. A significant portion of FDI to the region has been associated with acquisition activities, and Malaysia has not been part of this trend. Another view is that, in sectors such as electronics where there is still excess capacity despite recent rapid increases in exports, there is still no need for new investment, and so the slowdown is nothing unusual. It may also be that new investments are being financed in some sectors from the retained earnings of foreign firms, and thus do not show up in the FDI statistics.

On the demand side, the increasing importance of the People's Republic of China (PRC) as an FDI destination must have affected flows to Malaysia and the ASEAN countries; Korea too is now a big recipient, but was not before the crisis. Whether taking an alarmist or optimistic view, the slowdown in FDI in Malaysia will be a cause for concern if it continues for much longer, particularly if foreign and domestic investment in manufacturing continue to fall in tandem.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth,* and Inflation Rate** (%)



*Growth in real bank credit in the first quarter of 2000 is only up to February.
Source: ARIC Indicators.

deficit may prove to be substantially lower than the amount originally programmed. Although tax revenues performed poorly in the first quarter, they are likely to show considerable elasticity as incomes track upward. The first quarter's low collections were associated with problems in implementing the move to tax assessment on a current year basis.

Monetary policy remains broadly accommodating.

Interest rates fell steadily in 1999, and have shown little movement over the first half of 2000 (Figure 4). In a benign inflationary environment, Bank Negara Malaysia (BNM) is following a broadly accommodating monetary policy and maintaining stable liquidity. In the second quarter, the commercial banks' base lending rates remained at historic lows. Low interbank interest rates are a reflection of this policy. However, interest rates did begin to edge up in August.

There are early signs of renewed credit growth.

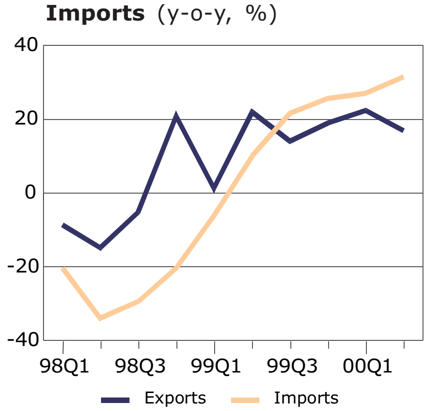
In recent months, overnight rates have risen in response to inflationary pressures prompted, in part, by the high cost of fuel and the likely removal of fuel subsidies. Despite ample liquidity, there was no increase in the stock of loans over the first quarter of 2000. However, more recent monthly data suggest that banking system loans are on the rise to accommodate increased residential property and manufacturing sector demand. After declining further during the first quarter, the loan-to-deposit ratio is now beginning to track up. Nevertheless, banks are still using cash to buy government securities as they seek to further strengthen their balance sheets.

Inflation remains tame.

Despite a vigorous expansion in economic activity, consumer price inflation has remained subdued, on a year-on-year basis, registering just 1.4 percent in the second quarter of 2000 compared to 1.5 percent in the first quarter. Stable food, and transport and communications service prices contributed to this decline. Producer price inflation also moderated. But there are indications that inflation could begin to edge up as transport prices and fuel subsidies come under review, in a context of high oil prices. As of August 2000, inflation was 1.5 percent.

Balance of Payments

Figure 5: **Growth of Merchandise Exports and Imports** (y-o-y, %)



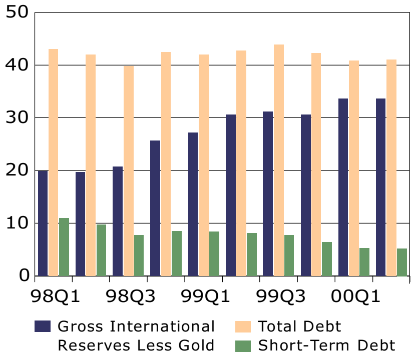
Source: ARIC Indicators.

The trade account remains in surplus.

Malaysia posted its 12th consecutive trade surplus in the second quarter of 2000. The surplus is, however, now beginning to narrow. Import growth in the second quarter surged to 31.5 percent (Figure 5). Intermediate goods imports accounted for nearly three fourths of the total increase, comprising largely of components for the electronics industry and crude petroleum. However, capital and consumption goods imports also picked up.

Exports, particularly manufacturing exports, continued to perform strongly. Commodity export revenues also performed well in the second quarter—expanding by 8.4 percent (y-o-y)—

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

although at a slower pace compared to the first quarter (34.5 percent).

Foreign exchange reserves strengthened further.

Malaysia's large trade surplus in the first quarter helped to further boost foreign exchange reserves. As of end-August 2000, BNM reported foreign exchange reserves of $33 billion, which is 6.4 times the short-term external debt. With a net inflow of foreign loans, Malaysia's total external debt slightly increased in the second quarter of 2000 (Figure 6).

Financial and Corporate Sector Developments

Banking system capital strength is maintained.

The core capital and risk-weighted capital ratios confirm an increase in the capital strength of the Malaysian banking system over the past two years. The risk-weighted capital ratio reported in August 2000 was 13.1 percent, well above the 8 percent Basle norm. The core capital adequacy ratio has tracked up too.

Nonperforming loans are broadly stable.

As of end-August 2000, Danaharta has already carved out a large portion (42.6 percent) of the NPL portfolio from the balance sheet of the Malaysian banking system. Banks, however, have still been left to work out a significant portion of problem loans, many of which are comparatively small. The NPL ratio, measured on a three-month accrual basis, is lower than in 1999, with the latest data for July 2000 showing a ratio of 10.6 percent.

Danaharta's operations continue at a steady pace.

Danaharta's mandate is to rehabilitate and restructure viable loans. In the first quarter, Danaharta held a second open tender for properties and second restricted tender for foreign loan assets. The recovery rates on assets showed a reassuring improvement. As of June 2000, a total of RM28.7 billion of loans or assets have been restructured or disposed of with an average recovery rate of 73 percent.

CDRC has resolved nearly half of referred cases.

As of end-July 2000, the CDRC had received applications amounting to RM45.9 billion. Of these, 29 applications with a value of RM23.9 billion have been resolved, and 20 applications with a value amounting to RM16.3 billion are outstanding. The remaining cases have either been transferred to Danaharta, withdrawn, or rejected.

Prospects and Policy Issues

Malaysia's growth in 2000 could still surprise on the upside.

The latest Consensus Economics (September 2000) projections suggest that the Malaysian economy is likely to grow by 8.6 percent in 2000. Increasingly, private consumption and investment demand will contribute to growth, but net exports will also continue to make a positive impact. For 2001, growth is expected to slow. By then, the gap to potential output in Malaysia will have been substantially closed, and interest rates may eventually have to increase as burgeoning demand feeds through to consumer prices.

Ringgit peg will remain for now.

Against a background of subdued inflation and currency depreciation elsewhere in the region, a revaluation of the ringgit looks unlikely any time soon. However, as constraints on banks' balance sheets are eased, and the private sector worries less about leverage in a context of solid growth, increasing amounts of liquidity could soon find their way into equity and other assets. These trends would be magnified if significant capital inflows occurred in response to improving conditions. If liquidity expanded too quickly, nontradable prices could begin to perk up and eventually upward pressure on either domestic interest rates or the exchange rate would emerge.

Bank and corporate restructuring is making progress.

The year-end will see consolidation of the Malaysian banking sector. But while the amalgamated entities' compositions are now known, little information has yet emerged about how the consolidated entities will function. Consolidation is, however, taking place against the backdrop of a significant improvement in banking system balance sheets. Danamodal's activities are likely to cease once the consolidated entities are formed.

Danaharta and CDRC continue to make progress on debt restructuring, with nearly half of reported cases now being resolved. One concern, however, is that there has, in some cases, been a reluctance to allow foreign equity to fully participate in the restructuring process. Also, to the extent that unrestructured enterprises are once again being permitted to borrow aggressively to shore up their finances, difficulties are perhaps being deferred rather than resolved.

Malaysia: Selected ARIC Indicators

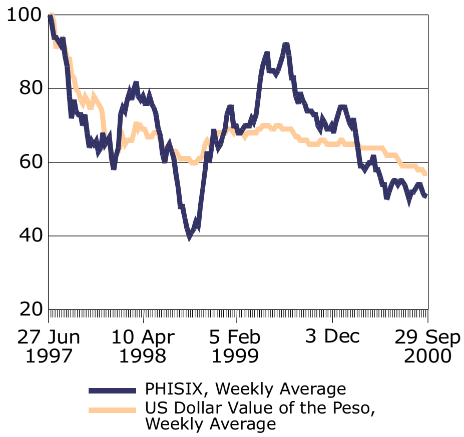
	1996	1997	1998	1999	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Output and Prices														
GDP Growth (%)	10.0	7.3	-7.4	5.8	-1.6	-5.9	-10.1	-11.2	-1.4	5.0	8.6	11.0	11.9	8.8
Private Consumption Expenditure Growth (%)	6.9	4.3	-10.8	3.1	-9.8	-9.5	-12.9	-10.9	-2.1	2.7	5.0	7.0	14.4	13.9
Public Consumption Expenditure Growth (%)	0.7	5.7	-6.7	16.3	-3.0	-0.7	4.6	-20.4	15.7	4.7	23.9	19.6	1.7	10.5
Gross Domestic Investment Growth (%)	4.7	11.2	-43.0	-5.1	-14.3	-49.8	-50.3	-53.7	-27.6	-6.3	-3.4	36.8	11.4	22.9
Agricultural Sector Growth (%)	4.5	0.4	-3.0	3.8	-1.8	-5.8	-0.4	-5.1	-3.9	9.9	3.5	5.1	2.6	-4.8
Manufacturing Sector Growth (%)	18.2	10.1	-13.4	13.5	-5.0	-9.6	-18.6	-19.3	-0.2	10.7	19.8	24.2	27.3	22.0
Construction Sector Growth (%)	16.2	10.6	-23.0	-5.6	-14.5	-19.8	-28.0	-29.0	-16.6	-7.9	0.9	2.7	1.2	2.1
Services Sector Growth (%)	8.9	9.9	-0.7	3.3	4.7	0.0	-3.1	-3.9	0.0	1.9	4.2	7.0	6.3	5.1
Exports of Goods and Services Growth (%)	9.2	5.5	0.5	13.4	-0.9	1.6	-2.5	3.8	1.9	13.0	19.5	18.4	20.2	15.5
Imports of Goods and Services Growth (%)	4.9	5.7	-18.7	10.8	-9.7	-24.7	-22.4	-16.9	-7.9	8.8	18.1	25.6	21.8	24.0
Inflation Rate (%)	3.5	2.7	5.3	2.7	4.3	5.8	5.7	5.4	4.0	2.7	2.3	2.1	1.5	1.4
Unemployment Rate (%)	2.5	2.6	3.2	3.4	. . .	. . .	. . .	. . .	4.5	3.3	2.9	3.0	3.0	3.3
Monetary and Fiscal Accounts														
Growth of Broad Money, M2 (%)[1]	24.3	17.4	-1.4	16.9	10.0	6.8	2.8	-1.4	3.6	13.2	17.1	16.9	22.5	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	. . .	6.5	3.2	. . .	11.2	7.5	6.5	5.7	3.3	3.2	3.2	3.2	3.2
Growth in Real Bank Credit to Private Sector (%)[1]	16.9	19.9	-2.2	0.5	9.8	3.1	1.0	-2.2	-1.2	-0.4	2.7	0.5	. . .	. . .
NPL Ratio of the Banking System[1]	. . .	. . .	13.4	11.2	. . .	. . .	12.8	13.4	14.5	12.4	12.0	11.2	10.8	10.4
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	9.7	9.0	. . .	. . .	10.5	9.7	11.4	9.5	9.6	9.0	9.1	8.6
Average Stock Price Index	1,134.1	978.9	517.7	692.0	657.7	565.3	381.1	466.7	556.0	706.9	763.2	741.8	950.1	892.8
Central Government Fiscal Balance as % of GDP	0.7	2.4	-1.8	-3.2	5.9	-0.5	2.1	-14.6	1.8	0.2	-7.3	-6.5	. . .	. . .
Central Government Debt as % of GDP[1]	35.3	31.9	36.2	37.3	30.5	31.3	30.7	36.2	36.8	38.3	37.8	37.3	36.7	. . .
Government Expenditure on Education (% of Total)	21.4	21.3	21.4	22.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	5.9	6.2	6.5	6.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates														
Growth of Merchandise Exports ($ fob, %)	0.4	-2.5	-2.9	14.1	-8.6	-14.8	-5.1	20.9	1.3	22.0	14.1	19.0	22.4	16.9
Growth of Merchandise Imports ($ cif, %)	1.4	1.8	-21.5	12.6	-20.3	-34.0	-29.4	-20.3	-6.1	10.1	21.6	25.7	27.1	31.5
Current Account Balance as % of GDP	-4.6	-4.7	13.0	15.8	6.4	11.4	17.3	16.6	13.7	16.1	17.7	15.3	. . .	. . .
Private Long-Term Capital ($ Billion)[2]	5.1	5.1	2.2	1.6	1.1	0.7	-0.2	0.6	0.3	1.0	0.0	0.2	0.7	. . .
Private Short-Term Capital ($ Billion)[2]	4.1	-4.6	-5.6	-9.9	-2.3	-1.2	-1.1	-0.6	-1.8	-0.7	-4.2	-3.3	0.9	. . .
Gross International Reserves Less Gold ($ Billion)[1]	27.0	20.8	25.6	30.6	19.8	19.7	20.7	25.6	27.1	30.6	31.1	30.6	33.6	33.7
Total External Debt as % of GDP[1]	38.3	43.4	58.5	53.4	46.3	49.9	52.3	58.5	57.8	57.9	57.3	53.4	49.6	48.2
Short-Term Debt as % of Gross International Reserves[1]	. . .	53.5	33.1	20.7	54.9	48.9	37.0	33.1	30.7	26.3	24.5	20.7	16.2	15.3
Short-Term Debt as % of Total Debt[1]	. . .	. . .	20.0	15.0	25.3	23.0	19.2	20.0	19.8	18.8	17.4	15.0	13.4	12.6
Real Effective Exchange Rate (1995=100)[3]	106.5	105.5	86.8	87.6	84.8	88.9	86.5	87.1	89.4	89.7	87.2	84.2	85.8	85.6
Average Exchange Rate (Local Currency to $)	2.5	2.8	3.9	3.8	4.0	3.8	4.1	3.8	3.8	3.8	3.8	3.8	3.8	3.8

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Quarterly figures were converted to dollars from ringgit using the quarterly average exchange rate.
[3] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the banking and commercial banking system, central government debt, total and short-term external debts, private long-term and short-term capital, and government expenditure on education and health are from national sources. Data on M2, real bank credit to private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics*. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on ARIC calculations.

Philippines Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

The peso hit an all-time low in October 2000.

After staying broadly stable through most of the first quarter of 2000, the peso has since been depreciating steadily against the US dollar and, in October 2000, its value reached an all-time low. The peso's weakness can be attributed to a number of factors, including the hike in US interest rates, rising world oil prices, the faltering pace of economic recovery, the separatist conflict in Mindanao, and political uncertainty. Better-than-expected GDP growth for the second quarter failed to provide a boost. As of end-September 2000, the dollar value of the peso was more than 40 percent off its June 1997 level.

Equity prices continue to decline.

Philippine equity prices continued to decline in 2000 (Figure 1). This is largely a reflection of downward adjustments in global asset markets, triggered by US interest rate hikes, and domestic economic and political uncertainties. In the wake of an alleged insider trading scandal early this year, the Philippine Stock Exchange (PSE) was stripped of its self-regulatory status, but this was later restored in September. The Philippine Stock Exchange Composite Index (PHISIX) was 49 percent below its end-June 1997 level in peso terms and 71 percent below in dollar terms as of end-September 2000.

Although improving slightly, the property market remains weak.

The property market remains depressed. Although the office vacancy rate in prime business districts improved in the second quarter of 2000 (Table 1), it remains high compared to precrisis levels. The absence of takers led to a fall in office rents by 24.9 percent in dollar terms on a year-on-year basis during the same period. The demand for retail property also remains weak as the vacancy rate reached 13 percent in the second quarter of 2000, its highest level since June 1997, putting pressure on rental rates.

Table 1: **Property Vacancy Rates in Prime Business District of Manila (Makati)** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Office Property	4.3	5.8	7.8	12.3	13.0	12.1	13.8	15.9	14.9
Retail Property	. . .	. . .	. . .	9.3	11.0	12.9	12.6	. . .	13.0

. . . = not available.
Source: Jones Lang LaSalle, *Asia Pacific Property Digest,* various issues.

Real Sector

Output grew by 3.9 percent in the first half of 2000.

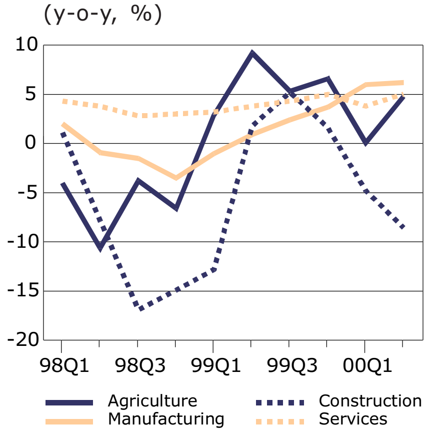
After a lower-than-expected growth of 3.2 percent in the first quarter of 2000, GDP expanded by 4.5 percent in the second quarter, bringing first half output growth to 3.9 percent. Consensus Economics had scaled down its projection of GDP growth for 2000 from 4 percent early this year to 3.4 percent in May, reflecting concerns over the country's political and economic uncertainties and poor first quarter performance. However, the projection was later raised by 0.2 percentage point (September 2000), based on the stronger than expected second quarter GDP growth (Table 2).

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

	1997	1998	1999	2000	2001
Official[1]	5.2	-0.6	3.3	4.0	4.0-4.5
ADB[2]	—	—	—	3.8	4.3
IMF[3]	—	—	—	4.0	4.5
World Bank[4]	—	—	—	4.0	4.5
Consensus Economics[5]	—	—	—	3.6	3.7

[1]National Statistical Coordination Board, National Accounts of the Philippines, various issues; National Economic and Development Authority.
[2]ADB, *Asian Development Outlook 2000 Update*, September 2000.
[3]IMF, *World Economic Outlook*, September 2000.
[4]World Bank, *East Asia's Recovery: Gathering Force—An Update*, 18 September 2000.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* September 2000.

Figure 2: **Sectoral GDP Growth** (y-o-y, %)

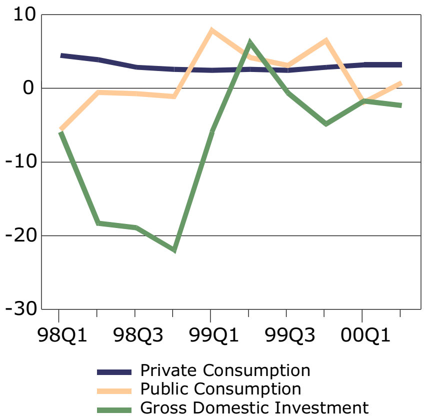


Source: ARIC Indicators.

Manufacturing production improved.

After a weak performance in 1999, manufacturing production grew by more than 6 percent in the first half of 2000 (Figure 2), led by strong electrical machinery manufactures. Agriculture got off to a disappointing start in the first quarter of 2000, but perked up by nearly 5 percent in the second quarter as the country entered its harvest seasons. The communications industry posted an exceptional performance, boosting the services sec-

Figure 3: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

tor, which grew by 5 percent in the second quarter. However, construction continues to perform poorly, with the sector contracting by 7 percent in the first half of 2000.

Exports continued to lead the recovery.

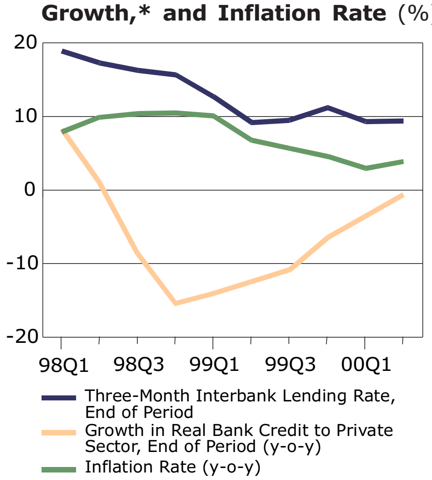
On the demand side, exports continued to dominate. Merchandise exports, in real peso terms, grew by 16 percent year-on-year in the first half of 2000. Private consumption also improved in 2000 compared to 1999, as household expenditures on food, transportation, and communications increased. However, investment remains sluggish. While durable equipment investments expanded in the first half of 2000, this was more than offset by a decline in construction investment, resulting in a contraction of overall investment. Public consumption also declined by 0.5 percent year-on-year in the first half of 2000, after expanding by more than 5 percent in 1999 (Figure 3).

Fiscal and Monetary Developments

Fiscal position remains fragile.

The fiscal position remains a matter for serious concern. As of end-August 2000, the national Government deficit was 65 percent higher than what was programmed for the first eight months. Recent official reports indicate difficulties in achieving fiscal targets for this year. This was mainly due to shortfalls in revenues, caused by poor collection and disappointing privatization proceeds. Expenditure also fell short of targets but the difference was small. The national Government debt stock rose as a result of deficit financing. As of March 2000, it was P2.3 trillion, which was more than 70 percent of GDP.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth,* and Inflation Rate** (%)



*Growth in real bank credit in the second quarter of 2000 is only up to May.
Source: ARIC Indicators.

Inflation is edging up.

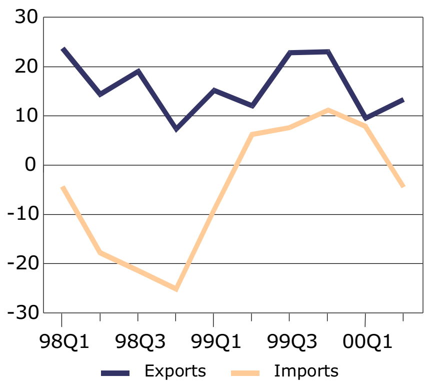
Inflation fell to an all-time low in January 2000. It has since edged up (Figure 4), reaching 4.6 percent in August in the wake of fuel price increases and the weakening of the peso—factors that are expected to continue to exert inflationary pressures. The monetary authorities are targeting an average inflation rate of 5-6 percent for the whole of 2000, lower than the average rate in 1999.

Further monetary tightening may be forthcoming.

Subdued inflation enabled the monetary authorities to reduce interest rates in early 2000. But monetary policy was tightened in May 2000 in response to the peso depreciation, a rise in US interest rates, and emerging inflationary pressures. As the peso fell in September 2000, the central bank responded with another round of overnight rate increases. More recently, in response to the continued slide of the peso, the central bank raised overnight rates by 400 basis points. It also increased liquidity reserves twice.[1] Further monetary tightening may follow if world oil price increases put further pressure on inflation, and political and economic uncertainties continue to overshadow the peso.

Balance of Payments

Figure 5: **Growth of Merchandise Exports and Imports** (y-o-y, %)



Source: ARIC Indicators.

Trade surplus increased in the first half of 2000 due to a slowdown in imports.

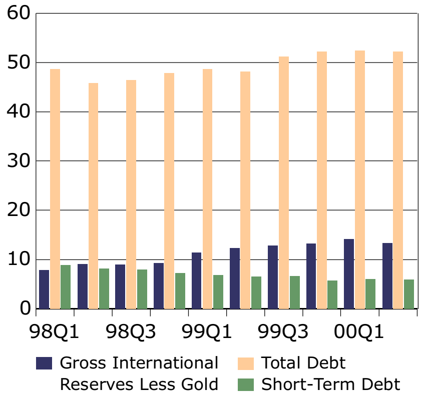
Export growth slowed significantly in the first quarter of this year (Figure 5) due possibly to increased competition from other recovering countries in the region, but it recovered somewhat in the second quarter. Exports have benefited from strong overseas demand for electronic products, fueled by the global IT boom, and improved competitiveness arising from the real currency depreciation. Merchandise imports, meanwhile, contracted by more than 4 percent in the second quarter. Increased import costs caused by the peso's depreciation weakened demand for consumer products, raw materials, and intermediate goods imports. Demand for capital goods imports, though, continued to grow. Following the cutbacks in imports, the trade balance for the first six months of 2000 posted a surplus of $2.4 billion, 112 percent higher than for the same period last year. This, together with the lower deficit for trade in services, resulted in a higher current account surplus from January to June 2000 compared to the same period last year.

But the capital account weakened significantly.

In the first four months of 2000, a surplus of $287 million was recorded in the capital account, compared to $1.7 billion in the same period last year.[2] This was partly caused by a reversal of

[1] Liquidity reserves refer to the portion of required reserves that earns interest at market rate.
[2] These figures are based on the old balance-of-payments (BOP) definitions. Using the new BOP definitions, which the central bank has introduced recently, the capital account registered a deficit of $1.5 billion during January-June 2000.

Figure 6: **International Reserves and External Debt**
($ billion)



Source: ARIC Indicators.

portfolio capital, from a net inflow of $290 million during January-April 1999 to a net outflow of $398 million in the same period this year. There was also a marked weakening of foreign direct investment and other capital inflows in 2000 compared to the same period last year. Weak investor interest reflects, in part, the uncertainties arising from the Mindanao conflict and problems in the domestic stock market.

External debt remains high, but the external payments position is manageable.

Total external debt was $52.2 billion in June 2000, $4 billion higher than a year earlier, but $250 million lower than in March 2000 (Figure 6). However, the external payments position remains manageable. The share of short-term debt to total debt has been kept low, at less than 12 percent. Meanwhile, the ratio of short-term debt to international reserves fell from 78 percent at the end of 1998 to 44 percent in June 2000.

Financial and Corporate Sector Developments

The NPL ratio has been on the rise.

The Philippine banking sector was the least affected by the crisis among the five affected countries. However, against a trend of declining NPLs in the other countries, the NPL ratio of Philippine commercial banks has been rising in recent months. This is mainly due to some technicalities, namely, the reclassification of certain loans after the merger of two large banks, and the fall in interbank loans, which caused total gross loans—the denominator in the ratio—to decline. After reaching a low of 12.3 percent in December 1999, it increased to 14.1 percent in March 2000 and further to 15.3 percent in July. This, together with the closure of a major commercial bank in April, raised concerns about the health of the banking sector. On the positive side, the CAR of commercial banks, at 17.2 percent in March 2000, remained well above the international norm.

A new banking law was enacted.

After being in the legislative mill for some time, the General Banking Law of 2000 was finally enacted in May. The law aims to strengthen and modernize the regulatory and supervisory

Box F: **General Banking Law of 2000—Gearing up for the Future**

One of the lessons learned from the Asian financial turmoil is that the banking sector plays a key role in both preventing economic crises and spurring economic growth. With weak and inadequately supervised banks, sharp adjustments in the financial markets could lead to deep economic crises. As part of the financial sector reform program, a new general banking framework, known as the General Banking Law of 2000, was passed in May 2000, replacing the General Banking Act enacted more than half a century ago.

The new law introduces changes to the Philippine banking sector by overhauling the regulatory and supervisory framework of the central bank, Bangko Sentral ng Pilipinas. It updates the classification system of banks to include universal, cooperative, and Islamic banks and, at the same time, sets limits on the regulatory scope of the central bank over nonbank financial institutions. This permits monetary authorities to focus on a specific set of financial institutions that are normally under the ambit of a central bank. The supervisory functions of the central bank are also rationalized and made more explicit, in order to enhance its supervisory capability. Changes include the enforcement of prompt corrective action, introduction of a fit and proper rule for bank directors and officers, and the alignment of prudential regulations with internationally accepted standards. Rules on bank lending to directors, officers, stockholders, and related interests are also tightened. Greater financial transparency is encouraged through more explicit disclosure requirements for banks.

The law is also designed to restructure the banking system. For one, it further liberalizes the entry of foreign banks in the Philippines, in order to foster competition within the sector. Foreign ownership of domestic banks is raised to 40 percent of voting stock. In addition, within seven years after enactment of the law, the central bank can allow a foreign bank to own 100 percent of a domestic bank. However, the central bank will ensure that 70 percent of the resources or assets of the banking system are held by banks that are majority-owned by Filipinos. Also, as a response to more foreign competition, the new law tries to encourage more domestic bank mergers and consolidation by prohibiting the establishment of new banks within three years after enactment of the law. A summary of major changes in the banking law is given in Table F-1.

The General Banking Law of 2000 is expected to strengthen the Philippine banking industry and make it better able to withstand internal and external shocks. It is also expected that, under the new framework, the Philippine banking system will better cope with increasingly internationalized and competitive financial markets.

Table F-1: **Major Differences Between the 1949 and 2000 Banking Laws**

Item	General Banking Act (1949)	General Banking Law (2000)
Supervisory functions	• General statement of supervisory powers	• Supervisory powers are explicitly enumerated • Enforces prompt corrective action
Prudential measures and regulations	• Central bank prescribes its own prudential measures and regulations • Risk-based capital: 10 percent of risk assets	• Central bank prescribes its own prudential measures and regulations, aligned with international standards • Risk-based capital: conforms with internationally accepted standards (including those of the Bank for International Settlements)
Fit and proper rule	• No provision	• Monetary Board reviews the qualifications of bank directors and officers and determines their fitness to hold a position
Foreign ownership	• 30 percent of voting stock	• 40 percent of voting stock • Within seven years after the law is made effective, the Monetary Board may allow a foreign bank to acquire 100 percent of voting stock of a domestic bank • The Monetary Board must ensure that at least 70 percent of resources or assets of the entire banking system are held by banks that are majority-owned by Filipinos
Transparency	• No provision	• Submission of financial statement to the central bank • Quarterly publication of financial statements
Lending to directors, officers, stockholders, and related interests (DOSRI)	• Lending is limited to an amount equal to the outstanding deposit and book value of paid-in capital contributions to the bank • Excluded are loans granted to officers in the form of fringe benefits	• Lending is limited to an amount equal to unencumbered deposits and book value of their paid-in capital contributions to the bank • Excluded are (1) loans considered as nonrisk by the Monetary Board, and (2) loans granted to officers in the form of fringe benefits • Dealings with DOSRI shall be upon terms not less favorable to the bank than those offered by others • Definition of DOSRI lending is expanded to include investments of the bank in enterprises owned or controlled by DOSRI

framework governing the banking system by adopting prudential regulations consistent with international norms (Box F). The liberalization of foreign equity participation in banks is expected to increase foreign presence in the banking sector and, thereby, foster competition. The new banking law is also expected to improve transparency with regard to banks' financial conditions.

The new securities code is expected to facilitate corporate sector reform.

The reform process in the corporate sector was boosted in July 2000 with the passage into law of the Securities Regulation Code. The measure is intended to increase corporate transparency, afford better protection of investors' interests, and strengthen regulation. Under the law, the Securities and Exchange Commission (SEC) is to be reorganized to function as an effective market regulator. One of the major changes is that SEC's quasi-judicial functions—such as the resolution of intracorporate disputes, suspension of payments, and private damage actions—are to be removed and transferred to courts. This will enable SEC to focus on securities regulation. However, to speed up the corporate debt restructuring process, the bias against creditors in the legal framework for insolvency needs to be addressed.

Prospects and Policy Issues

GDP growth is likely to fall short of Government targets.

Even with the better-than-expected performance in the second quarter of 2000, GDP growth is likely to fall short of the Government target of 4 percent. One of the downside risks is that export-led growth in the first half of 2000 is highly dependent on trade with the United States. Although the continued real currency depreciation has worked in favor of the Philippines, a slowdown in the US economy could hurt Philippine exports, and hence adversely affect the growth of the manufacturing sector. On the demand side, the need for fiscal consolidation, higher inflationary expectations, and the peso depreciation rule out a further stimulus from either fiscal or monetary policy. Investment spending is thus likely to remain restrained. Beyond 2000, the country faces serious challenges to ensuring a sustainable recovery and achieving a higher growth path. Weak corporate investment and tight credit markets could further hamper manufacturing growth. Meanwhile, the expected recurrence of the *El Niño* phenomenon in 2001 will reduce agricultural output. Prospects could be further dampened if political uncertainties continue.

To consolidate the gains from reforms, investor concerns must be addressed.

The recent enactment of two economic laws, the General Banking Law of 2000 and the Securities Regulation Code, is a positive step toward addressing structural weaknesses in the financial system. These laws are expected to raise regulatory standards of the banking sector and securities market and bring them closer to internationally acceptable norms. Other economic laws enacted recently include the Retail Trade Liberalization Act, which opens retail trade to foreign equity investment; the E-commerce law, which provides a basis for transactions made over the Internet; and the Regional Headquarters law, which grants additional incentives to multinational corporations establishing regional headquarters in the Philippines. They are intended either to promote competition, or create a business climate conducive to domestic and foreign investment, and will go a long way toward improving investor confidence. Their efficacy, however, will diminish if nagging investor concerns are not addressed effectively—for instance, the budget deficit, which is likely to exceed targets again this year. Another is the Mindanao conflict, into which the administration has been channeling a great deal of resources and effort. The issue of public sector governance also needs to be addressed. Further, the laws need to be effectively implemented.

Effective tax administration is a key to improving fiscal position.

One immediate remedy to offset fiscal deterioration is to put the privatization program back on track, including the Omnibus Power bill, which will govern the privatization of the National Power Corporation. Privatization proceeds, however, are only a temporary solution. Effective tax administration is a more permanent option. There are leaks in the system, either through legal loopholes or outright tax evasion, which send out the wrong signals. The broader context shows the need for improved public sector governance at all levels. Progress in this area, however, requires political and social reforms and a great deal of political will.

The Government needs to address adverse social impacts of the crisis.

The rise in the unemployment rate in the second quarter of 2000—the highest level in nine years—suggests that the full impact of the Asian financial crisis is still working itself through the economy. The precise effect on poverty, health, and education will not be known for years to come, both because of the drawn-out process and data constraints. These limitations should not preclude an effective Government program to mitigate the worst effects of the crisis. Unfortunately, the widening budget deficit has reduced fiscal flexibility in addressing these social concerns. This provides another important reason to strive for an immediate consolidation of the Government fiscal position.

Philippines: Selected ARIC Indicators

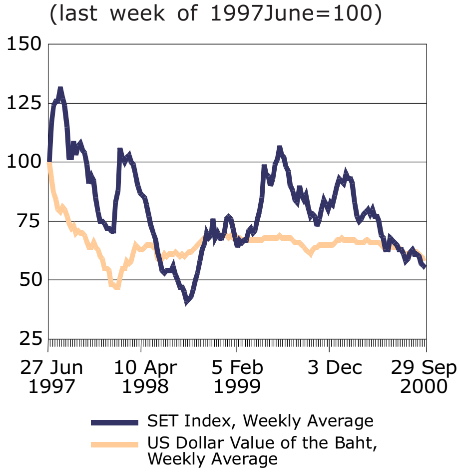
	1996	1997	1998	1999	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Output and Prices														
GDP Growth (%)	5.8	5.2	-0.6	3.3	2.0	-0.9	-0.8	-2.2	0.7	3.6	3.8	4.9	3.2	4.5
Private Consumption Expenditure Growth (%)	4.6	5.0	3.4	2.6	4.5	3.9	2.9	2.6	2.5	2.6	2.5	2.9	3.2	3.2
Public Consumption Expenditure Growth (%)	4.1	4.6	-1.9	5.3	-5.6	-0.5	-0.7	-1.1	7.9	4.2	3.1	6.5	-1.9	0.8
Gross Domestic Investment Growth (%)	12.5	11.7	-16.3	-1.7	-5.9	-18.3	-18.9	-21.9	-5.9	6.2	-0.6	-4.8	-1.7	-2.3
Agricultural Sector Growth (%)	4.6	3.2	-6.3	6.0	-4.0	-10.6	-3.8	-6.6	2.9	9.2	5.3	6.6	0.1	4.8
Manufacturing Sector Growth (%)	5.6	4.2	-1.1	1.6	2.0	-0.9	-1.5	-3.5	-1.0	0.9	2.4	3.7	6.0	6.2
Construction Sector Growth (%)	10.9	16.2	-9.6	-1.6	1.1	-7.9	-16.9	-14.9	-12.8	1.8	5.2	1.6	-4.8	-8.6
Services Sector Growth (%)	6.4	5.4	3.5	4.1	4.3	3.8	2.8	3.0	3.2	3.8	4.3	5.0	3.8	5.0
Exports of Goods and Services Growth (%)	15.4	17.2	-21.0	3.6	-4.5	-19.4	-21.4	-34.8	-8.4	3.3	11.5	8.9	10.7	13.9
Imports of Goods and Services Growth (%)	16.7	13.5	-14.7	-2.7	5.8	-12.5	-15.7	-32.8	-16.8	0.1	1.5	6.6	1.4	-3.3
Inflation Rate (%)	9.0	5.9	9.7	6.7	7.9	9.9	10.4	10.5	10.1	6.8	5.7	4.6	3.0	3.9
Unemployment Rate (%)	7.4	7.9	9.6	9.4	8.4	13.3	8.9	9.6	9.0	11.8	8.4	9.4	9.3	13.9
Monetary and Fiscal Accounts														
Growth of Broad Money, M2 (%)[1]	23.2	26.1	8.5	16.1	18.0	19.3	15.0	8.5	10.8	9.6	10.2	16.1	12.3	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	31.4	15.7	11.2	18.9	17.3	16.3	15.7	12.7	9.2	9.5	11.2	9.3	9.4
Growth in Real Bank Credit to Private Sector (%)[1]	38.8	20.1	-15.4	-6.4	8.3	1.0	-8.6	-15.4	-14.0	-12.4	-10.8	-6.4	-3.5	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	11.0	. . .	. . .	9.7	11.6	11.0	13.6	. . .	. . .	. . .	. . .	. . .
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	10.4	12.3	7.4	8.9	11.0	10.4	13.2	13.1	13.4	12.3	14.1	14.7
Average Stock Price Index	3,054.2	2,595.2	1,799.0	2,168.7	2,029.2	2,044.0	1,431.3	1,691.7	2,003.4	2,381.5	2,285.4	2,004.6	1,882.3	1,574.6
Central Government Fiscal Balance as % of GDP	0.3	0.1	-1.9	-3.7	-1.9	-1.9	-0.3	-3.2	-4.9	-2.6	-4.7	-2.8	-3.0	-3.2
Central Government Debt as % of GDP[1]	53.2	55.8	53.1	57.6	. . .	. . .	. . .	53.1	. . .	. . .	. . .	57.6	73.9	. . .
Government Expenditure on Education (% of Total)	17.9	19.3	19.9	19.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	2.7	2.9	2.5	2.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates														
Growth of Merchandise Exports ($ fob, %)	17.7	24.3	15.7	18.6	23.8	14.4	19.1	7.4	15.2	12.1	22.9	23.1	9.6	13.4
Growth of Merchandise Imports ($ cif, %)	20.8	12.7	-17.5	3.6	-4.3	-17.8	-21.4	-25.1	-9.1	6.3	7.7	11.2	7.8	-4.4
Current Account Balance as % of GDP	-4.8	-5.3	2.4	10.3	-0.2	1.1	3.1	4.9	8.8	7.0	13.8	11.5	8.3	10.8
Net Foreign Direct Investment ($ Billion)[2]	1.3	1.1	1.6	0.8	0.2	0.2	0.2	1.0	0.4	0.1	0.1	0.1	0.2	. . .
Net Portfolio Investment ($ Billion)[2]	2.2	-0.4	0.1	0.3	0.3	-0.0	-0.3	0.1	0.1	0.4	-0.2	0.0	-0.4	. . .
Gross International Reserves Less Gold ($ Billion)[1]	10.0	7.3	9.2	13.2	7.8	9.0	9.0	9.2	11.4	12.3	12.7	13.2	14.2	13.4
Total External Debt as % of GDP[1]	50.5	55.0	72.9	68.2	63.5	64.5	69.8	72.9	71.5	68.1	69.0	68.2	67.8	67.5
Short-Term Debt as % of Gross International Reserves[1]	. . .	116.1	77.9	43.4	113.1	90.4	88.5	77.9	59.6	53.1	52.1	43.4	42.3	44.0
Short-Term Debt as % of Total Debt[1]	. . .	. . .	15.0	11.0	18.2	17.8	17.2	15.0	14.0	13.6	13.0	11.0	11.5	11.3
Real Effective Exchange Rate (1995=100)[3]	110.4	111.0	94.0	100.8	91.5	97.2	92.6	94.7	102.2	105.1	100.5	95.2	96.4	94.1
Average Exchange Rate (Local Currency to $)	26.2	29.5	40.9	39.1	40.7	39.4	42.9	40.6	38.7	38.0	39.3	40.4	40.7	42.2

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Based on old balance of payments definitions.
[3] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the financial and commercial banking system, central government debt, total and short-term external debts, net foreign direct and portfolio investments, and government expenditure on education and health are from national sources. Data on M2, real bank credit to private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics*. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on ARIC calculations.

Thailand Update

Asset Markets

Figure 1: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

The baht has depreciated significantly.

As of end-September 2000, the baht had depreciated by 11 percent since the beginning of the year (Figure 1). The baht's weakness can be attributed mainly to the rise in US interest rates and uncertainties about the pace of economic recovery in the region. Concerns about the timing and outcome of the forthcoming general election, including worries that reforms may be delayed or cancelled, may have also contributed to the decline.

The stock market has also posted substantial losses this year.

Equity values have fallen steadily in 2000. By end-September 2000, the Stock Exchange of Thailand (SET) Index had declined by 42 percent since the beginning of the year. Also the turnover has been relatively thin. The major factors that adversely affected the stock market were the hike in US interest rates, reduced investment weight for Thailand in the MSCI Indexes, continuing concerns over the performance of financial institutions (despite a return to profitability by some), the pace of corporate restructuring, and political uncertainties.

But a better sovereign credit rating by Moody's should help boost investors' confidence.

On 21 June, Moody's raised its rating of Thailand's foreign currency long-term bonds and notes (to Baa3 from Ba1) and foreign-currency bank deposits (to Ba1 from B1), citing an improved balance-of-payments performance. An upgraded credit rating should somewhat help restore confidence among foreign investors.

The worst is over in property markets, but oversupply remains.

Bangkok's office property market remains sluggish due to the supply overhang. But the worst is probably over. The office vacancy rate has declined for five consecutive quarters since early

1999 (Table 1), with many businesses still looking to relocate into newer and better offices in the central business districts. Rentals of Grade A office space have started picking up due to the strong take-up in this segment of the market. However, office vacancy rates are still high compared to other crisis-affected countries. The rate stood at 34 percent in the second quarter of 2000.

Table 1: **Office Property Vacancy Rates in Bangkok** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Office Property	28.2	28.7	29.7	43.1	42.2	40.3	38.9	36.3	34.0

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

Real Sector

Economic recovery is continuing.

Thailand's rebound from its worst recession in 30 years has continued in 2000. First half GDP growth was 5.9 percent year-on-year. The Government's growth target of 4.5-5.5 percent for the whole of 2000 appears now within easy reach.

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

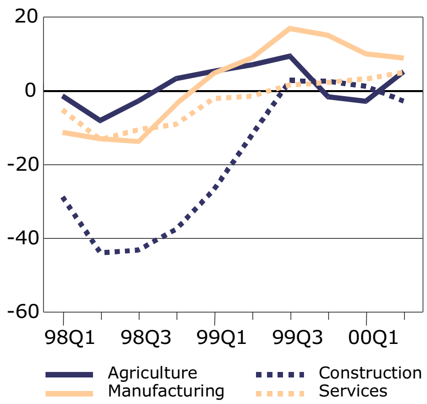
	1997	1998	1999	2000	2001
Official[1]	-1.7	-10.2	4.2	4.5-5.5	4.0-6.0
ADB[2]	—	—	—	4.5	4.6
IMF[3]	—	—	—	5.0	5.0
World Bank[4]	—	—	—	4.5	4.5
Consensus Economics[5]	—	—	—	5.1	4.7

[1]Bank of Thailand, *Inflation Report*, July 2000.
[2]ADB, *Asian Development Outlook 2000 Update*, September 2000.
[3]IMF, *World Economic Outlook*, September 2000.
[4]World Bank, *East Asia's Recovery: Gathering Force—An Update*, 18 September 2000.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* September 2000.

The manufacturing sector is still leading GDP growth.

Manufacturing continues to drive output growth, although this has taken place at a slower rate than during the second half of 1999, partly because it is measured from a higher base (Figure 2). The recovery of manufacturing production has been broad based. Output of vehicles, related parts and accessories, elec-

Figure 2: **Sectoral GDP Growth**
(y-o-y, %)

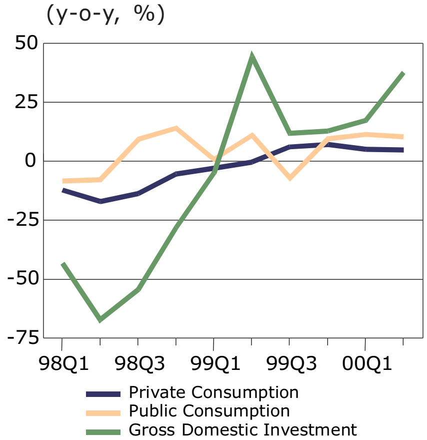


Source: ARIC Indicators.

tronics, and iron and steel production have all expanded in response to the increased demand in the export sector and related industries. Nevertheless, capacity utilization rates have remained below normal levels. After a sizable contraction in the first quarter, the agricultural sector rebounded strongly in the second quarter as weather conditions improved and higher crop prices induced farmers to produce more. To help revive the property market, the Government from 1999 introduced a series of measures, including a reduction in real estate transfer fees, provision of long-term fixed rate credit, and an expanded role for the National Housing Authority in purchasing and completing unfinished housing projects. These have had some impact on the construction sector, which stopped contracting from the third quarter of 1999 and posted modest growth until the first quarter of 2000. In the second quarter, however, the sector contracted again, reflecting underlying conditions in the property market.

Domestic demand has turned.

Figure 3: **Growth of GDP Expenditure Components**
(y-o-y, %)



Source: ARIC Indicators.

Domestic demand has turned in 2000. Public consumption expanded by more than 10 percent in the first two quarters (Figure 3), as the Government continued with its measures to stimulate growth. Private consumption grew at a more moderate pace—at 5.1 percent in the first quarter and 4.8 percent in the second quarter. Despite the Government's measures—including a reduction in value-added and personal income tax rates, and cuts in taxes on petroleum products—declining farm income and cautious consumer sentiment have kept private consumption growth in check. In contrast, gross domestic investment continued to expand strongly, especially in the second quarter of 2000. Investment growth, due mainly to changes in stocks rather than increased fixed investment, has been propelled by strong exports and a recovery in domestic demand.

Fiscal and Monetary Developments

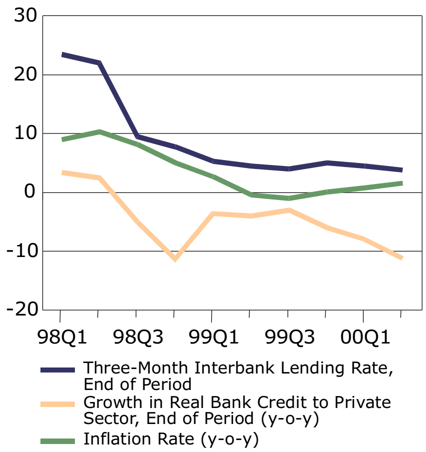
Fiscal deficits continue to support recovery.

In 1999, fiscal policy played an important role in stimulating the economy. Many of the deficit spending measures were directed at stimulating private demand and helping to alleviate the adverse social effects of the crisis. A projected budget deficit of about 4.1 percent of GDP in fiscal year 2000 is expected to further stimulate domestic demand and support economic growth.

But central Government debt has climbed.

Central Government debt has increased sharply in the past three years, from 6.3 percent of GDP in 1997 to 14.5 percent in 1998, 21.1 percent in 1999, and 21.4 percent in the second quarter of 2000. While Government debt has increased and will need to be carefully managed, Thailand's public debt dynamics are currently sustainable.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Inflation remains subdued.

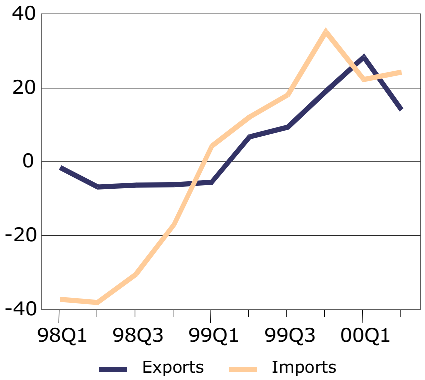
In 1999, consumer price inflation averaged only 0.3 percent, the lowest rate since Thailand started compiling the index more than 50 years ago. Low inflation has allowed nominal interest rates to remain well below their precrisis levels. However, in the second quarter of this year, inflation rose to 1.6 percent, measured year-on-year (Figure 4). Increases in oil prices and the depreciation of the baht contributed to the rise. Baht interest rates have now come off their earlier lows following increases in US dollar interest rates and potential inflationary threats. The Bank of Thailand has recently adopted an explicit inflation targeting system, setting the initial core inflation target quite wide at 0-3.5 percent. The 14-day repo rate will be used to manage variations in liquidity.

Balance of Payments

Although import growth is outpacing export growth, the current account remains in surplus.

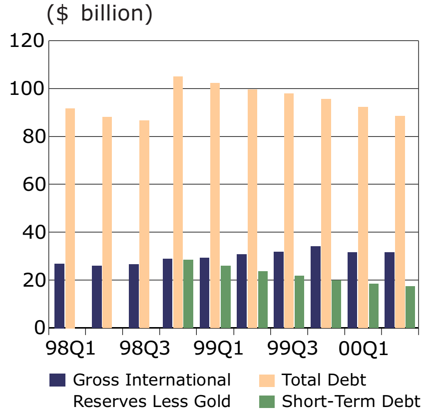
Merchandise exports (in dollars) grew by 20.9 percent (y-o-y) in the first half of 2000 (Figure 5). Meanwhile, import values rose at a higher rate of 23.4 percent, boosted by a recovery in domestic demand and higher international oil prices. The country's trade surplus in the second quarter narrowed slightly over its corresponding figure in 1999. The trade surplus, combined with rising revenues from tourism in the service and transfer account, led to a current account surplus of $4.7 billion in the first half of 2000.

Figure 5: **Growth of Merchandise Exports and Imports** (y-o-y, %)



Source: ARIC Indicators.

Figure 6: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

Capital outflows offset a larger current account surplus.

Net capital outflows remain sizable. External debt repayments of commercial banks, especially by the Bangkok International Banking Facility, underpinned the capital account deficit. As a result, the balance of payments registered a deficit of $2.5 billion in the first half of 2000. International reserves, meanwhile, declined by $2.85 billion in the first seven months of 2000 to $31.9 billion (Figure 6). Nevertheless, they remain at a comfortable level (about 5.9 months of imports), and provide ample cover for short-term debt.

Total external debt declined and its profile improved.

The private sector's repayment of short-term foreign loans led to an improvement in the maturity structure of the country's external debt. The ratio of short-term debt to total debt fell to 19 percent at end-July 2000, compared to 20.9 percent and 27.1 percent at the end of 1999 and 1998, respectively. Despite an increase in public sector external debt, total external debt continued to decline, decreasing from $95.6 billion at the end of 1999 to $86.1 billion at end-July 2000.

Financial and Corporate Sector Developments

Financial conditions are slowly improving.

The Thai economy has rebounded from the economic crisis but sustaining recovery still depends on continued progress in financial and corporate restructuring. NPLs in the financial system fell to 31.2 percent of total outstanding loans[1] or B1.59 trillion ($39.5 billion) in August 2000 from 39 percent at the end of 1999. The reduction in NPLs largely reflects the progress of corporate debt restructuring and their removal and transfer to newly established AMCs. Profitability is now

[1] 30.9 percent if new international banking facilities and credit foncier companies are included.

returning to some commercial banks. The private sector raised B52.6 billion in the first quarter of 2000 through direct financing from the domestic bond market. In the first quarter of 2000, private bond issuance registered a total of B75.3 billion, of which B55.4 billion were nonfinancial corporate bonds.

Despite these improvements, credit from the banking sector remains tight, with the overall stock of the private sector declining. In part, this reflects provisioning, and the transfer of NPLs to AMCs. But, in part, it also reflects a reluctance to lend in a context of weak bank balance sheets. Credit availability from other sources does, however, seem to be improving. As loans are restructured, firms are more willing to extend trade credit to their customers. This has helped small- and medium-sized enterprises (SMEs). For larger corporates, the debt market is now providing an important source of finance.

Measures were introduced to promote stock market development.

To buoy up the Thai stock market and improve its competitive edge, the Securities and Exchange Commission and SET have introduced measures to increase both the demand for and supply of quality stocks. These measures include (i) expediting public offerings of listed and nonlisted stocks of large state-owned enterprises (SOEs), (ii) expediting the launch of derivatives as risk management instruments, (iii) reducing the trading cost of Internet-related securities and listing fees for listed companies, and (iv) introducing new hedging instruments. In addition, to attract international investors who are unable to invest in the Thai Trust Funds, the issuance of Non-Voting Depository Receipts has been allowed as an option. These measures will contribute to the development of the Thai stock market in the medium and long term. Some intermediate impacts will also be felt, especially as the result of large-size SOE listings and share offerings, promotion of Internet trading, and reductions in commission fees.

Prospects and Policy Issues

GDP growth is back on track and likely to grow more than 5 percent this year.

The latest Consensus Economics (September 2000) projections suggest that GDP could grow by 5.1 percent in 2000. The generally positive outlook is based on the presumption of continued growth of exports, recovery of investment, and further progress in financial and corporate restructuring. However, risks remain. A high level of public debt, recalcitrant debtors, rising oil prices, slower than anticipated privatization, and the uncertainty created over the timing and outcome of the pending election could all blunt growth. Concerns are increasing that further reforms may be delayed or cancelled and that the most difficult restructuring cases are yet to come. Nevertheless, 2000 should see further consolidation of the recovery process. Consensus Economics projects a slowdown in growth to 4.7 percent in 2001.

Growth may help fiscal balances.

Deficit spending measures have helped to kick-start recovery in Thailand. A substantial deficit is again programmed for 2000-2001 to sustain economic growth until private investment and consumption have gathered more momentum. It is anticipated that, as growth accelerates, fiscal revenues will grow. In a low interest rate environment, this will help the Government reduce the budget deficit and bring down debt.

Slow financial restructuring could hamper recovery.

Even though the Thai economy has shown overall improvement, the recovery is not yet broad based. Farm incomes are falling, many SMEs are struggling, and there is still a substantial amount of debt to be resolved. The pace of bank and corporate restructuring will have a crucial influence on getting credit flowing again and putting growth on a faster track. Although NPLs have of late shown an encouraging decline, they remain high. A 25 percent NPL ratio has been set as the target for year-end 2000. One concern is that the most problematic cases are yet to be resolved. There is also a growing number of cases that will be referred by CDRAC for legal settlement.

Confidence in the legal framework for insolvency is vital for speedy corporate restructuring.

Although there has been some progress in corporate debt restructuring, settlements are concentrated on large firms. Medium and small loans and their underlying assets are being restructured slowly, and markets for distressed assets are not clearing. The corporate restructuring completion ratio is high for services and export sectors and relatively low for the real estate (including construction) and manufacturing sectors.

Despite new bankruptcy laws and promised further legal reforms, creditors appear to be not yet sufficiently empowered. The framework for insolvency is still biased in favor of debtors and the costs of pursuing bankruptcy actions are high. Nevertheless, the headline ruling on the case of Thai Petrochemical Industry in mid-March 2000 signals the bankruptcy courts' willingness to back creditors (Box G). Debtors and creditors now have a better understanding of the bankruptcy law and are more confident about legal protection. More debtors are filing petitions to protect their businesses. Steps are needed to ease congestion in bankruptcy courts and to redress the features of the bankruptcy law that still seem to work against creditors.

Box G: **Bankruptcy Law Reform—The Landmark TPI Insolvency Case**

The financial crisis has highlighted the need for an overhaul of Thailand's insolvency framework; to this end, the Government has designated reform of bankruptcy laws a priority.

Thailand's old insolvency framework allowed only for "liquidation" when resolving credit disputes through the courts. The revised bankruptcy law, enacted in 1999, introduces a second mechanism, "reorganization," modeled on the US's Chapter 11.

The purpose of the new mechanism is to prevent viable businesses that suffer liquidity problems from being driven to bankruptcy. Under this framework, either a creditor or debtor can petition for protection under reorganization supervised by the courts. The petition will activate a moratorium to prevent secured and unsecured creditors from pursuing their claims or filing a bankruptcy petition. If the court is satisfied that the debtor is insolvent but has the potential to be rehabilitated, it may order reorganization. If the reorganization fails to help the business, the court could then declare the business bankrupt and order liquidation under the bankruptcy law.

The revised law provides weak protection for creditors, as the test for insolvency uses the balance sheet criteria, namely, "liabilities exceed assets," as opposed to the more appropriate criteria of "ability to pay when the debt falls due." If a company can prove that the value of its assets exceeds liabilities, even if its cash flow cannot service current debts, it may not be ruled to be insolvent. The bias against creditors under the existing insolvency system has often been cited as one of the reasons for the slow progress of bank and corporate restructuring in Thailand.

However, a ruling on the Thai Petrochemical Industry (TPI) Plc insolvency case in March this year was hailed as a landmark in financial and corporate reform in Thailand. TPI had been negotiating with creditors, led by Bangkok Bank, to restructure outstanding debt of about B120 billion ($3 billion). In January 2000, Bangkok Bank filed a reorganization petition at the Central Bankruptcy Court, which TPI contested the following month, arguing that it was not insolvent because the value of its assets exceeded liabilities. The court, however, ruled in favor of the petitioning creditors that as TPI could not service its debts, it was, in effect, insolvent.

This positive development is expected to encourage more insolvent companies to proceed with formal insolvency and help create the kind of business culture that is needed in corporate Thailand. However, the insolvency test is still at the court's discretion and the TPI case should not be regarded as a legal precedent for defining insolvency under the more appropriate "ability to pay" criteria. Further reforms to the insolvency system will be required.

Sources: *Thailand Economic Monitor*, World Bank, June 2000; and Comment: Thai Bankruptcy Court Decision on TPI—Implication for Thai Banks, Fitch IBCA Ratings, 15 March 2000.

Thailand: Selected ARIC Indicators

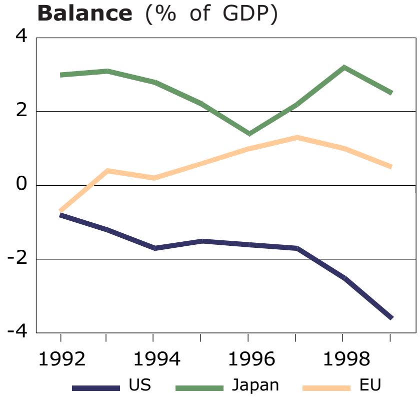
	1996	1997	1998	1999	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2
Output and Prices														
GDP Growth (%)	5.9	-1.7	-10.2	4.2	-7.5	-13.7	-12.8	-6.8	0.2	2.5	7.8	6.5	5.3	6.6
Private Consumption Expenditure Growth (%)	6.8	-1.1	-12.3	2.4	-12.3	-17.1	-13.7	-5.4	-2.9	-0.3	6.1	7.1	5.1	4.8
Public Consumption Expenditure Growth (%)	9.5	-0.9	1.9	2.8	-8.4	-7.8	9.2	14.0	0.8	11.0	-7.1	9.6	11.4	10.4
Gross Domestic Investment Growth (%)	6.8	-23.1	-49.3	12.6	-43.2	-67.3	-54.3	-28.0	-4.9	44.3	11.9	12.9	17.3	37.6
Agricultural Sector Growth (%)	3.8	0.6	-1.3	4.0	-1.3	-8.0	-2.7	3.4	5.4	7.1	9.4	-1.6	-2.8	5.2
Manufacturing Sector Growth (%)	6.7	0.8	-10.5	11.3	-11.2	-13.0	-13.7	-3.6	4.7	9.0	16.9	15.1	10.1	9.0
Construction Sector Growth (%)	7.2	-26.7	-38.8	-8.7	-28.7	-43.9	-43.1	-37.4	-26.7	-11.8	2.8	2.6	1.3	-2.8
Services Sector Growth (%)	5.3	-1.4	-9.5	0.1	-5.2	-13.1	-10.5	-9.0	-2.0	-1.4	1.6	2.4	3.3	5.0
Exports of Goods and Services Growth (%)	-5.5	8.4	6.7	9.6	15.0	8.9	5.7	-1.2	-0.6	4.5	13.9	20.4	21.1	15.2
Imports of Goods and Services Growth (%)	-0.5	-11.4	-22.3	16.7	-27.1	-28.4	-21.9	-10.1	-2.8	22.0	20.1	26.3	45.1	16.0
Inflation Rate (%)	5.8	5.6	8.1	0.3	9.0	10.3	8.1	5.0	2.7	-0.4	-1.0	0.1	0.8	1.6
Unemployment Rate (%)	1.1	0.9	4.4	4.2	4.6	5.0	3.4	4.5	5.2	5.3	3.0	3.3	4.3	4.2
Monetary and Fiscal Accounts														
Growth of Broad Money, M2 (%)[1]	12.6	16.5	9.7	5.4	15.7	13.8	12.7	9.7	8.6	6.2	3.4	5.4	4.1	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	26.0	7.8	5.0	23.5	22.0	9.5	7.8	5.3	4.5	4.0	5.0	4.5	3.8
Growth in Real Bank Credit to Private Sector (%)[1]	9.4	13.6	-11.3	-6.0	3.4	2.5	-5.0	-11.3	-3.6	-4.0	-3.0	-6.0	-8.0	-11.2
NPL Ratio of the Financial System[1]	. . .	. . .	45.0	38.9	. . .	32.7	39.7	45.0	47.0	47.4	44.7	38.9	37.3	32.0
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	42.9	38.6	. . .	31.0	37.9	42.9	46.2	46.5	43.9	38.6	36.9	31.8
Average Stock Price Index	1,167.9	597.8	353.9	421.1	473.1	361.5	246.0	335.0	357.1	461.8	450.5	415.0	432.7	358.2
Central Government Fiscal Balance as % of GDP	0.9	-0.3	-2.8	-3.3	0.0	0.6	-8.5	-3.4	0.0	-4.2	-4.1	-4.9	-1.5	. . .
Central Government Debt as % of GDP[1]	. . .	6.3	14.5	21.1	5.4	9.1	10.2	14.5	18.5	19.6	20.6	21.1	20.7	21.4
Government Expenditure on Education (% of Total)	22.2	23.9	25.2	25.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	6.9	7.3	7.8	7.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates														
Growth of Merchandise Exports ($ fob, %)	-1.3	3.4	-5.7	7.7	-1.5	-6.8	-6.3	-6.2	-5.5	6.8	9.4	19.1	28.4	14.0
Growth of Merchandise Imports ($ cif, %)	2.2	-15.2	-30.1	17.5	-37.3	-38.1	-30.5	-17.1	4.2	12.1	18.2	35.3	22.3	24.4
Current Account Balance as % of GDP	-8.1	-1.9	12.5	8.9	16.0	10.1	12.3	11.8	10.4	8.5	8.9	7.7	. . .	. . .
Net Foreign Direct Investment ($ Billion)	. . .	3.3	7.4	5.9	2.2	2.5	1.4	1.2	1.0	1.9	1.2	1.8	0.8	0.7
Net Portfolio Investment ($ Billion)	. . .	4.4	0.4	0.4	0.5	-0.1	-0.1	0.0	-0.1	0.1	0.2	0.2	0.3	0.2
Gross International Reserves Less Gold ($ Billion)[1]	37.7	26.2	28.8	34.1	26.9	25.8	26.6	28.8	29.2	30.7	31.6	34.1	31.6	31.5
Total External Debt as % of GDP[1]	59.8	70.3	93.1	76.9	67.3	73.9	78.3	93.1	85.9	82.1	78.6	76.9	73.6	69.6
Short-Term Debt as % of Gross International Reserves[1]	. . .	146.3	98.7	58.6	. . .	. . .	. . .	98.7	88.0	76.8	68.7	58.6	58.4	55.7
Short-Term Debt as % of Total Debt[1]	. . .	. . .	27.1	20.9	. . .	. . .	. . .	27.1	25.1	23.7	22.2	20.9	20.0	19.8
Real Effective Exchange Rate (1995=100)[2]	109.2	102.4	90.0	93.5	77.3	92.5	93.5	96.8	97.3	97.5	91.9	87.4	92.0	89.3
Average Exchange Rate (Local Currency to $)	25.3	31.4	41.4	37.8	47.1	40.3	41.1	37.0	37.1	37.2	38.3	38.8	37.7	38.7

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1] End of period.
[2] Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, merchandise exports and imports, nonperforming loan ratios of the financial and commercial banking system, central government debt, total and short-term external debts, net foreign direct and portfolio investments, and government expenditure on education and health are from national sources. Data on M2, real bank credit to private sector, central government fiscal balance, current account balance, and gross international reserves are from the International Monetary Fund, *International Financial Statistics*. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on ARIC calculations.

External Risks to Asia's Recovery

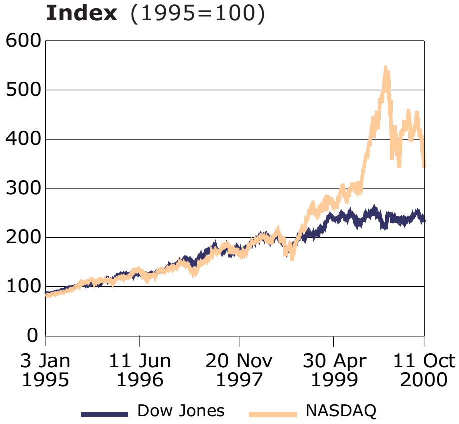
Introduction

Figure 1: **Current Account Balance** (% of GDP)



Source: IMF, *World Economic Outlook*, September 2000.

Figure 2: **US Stock Market Index** (1995=100)



Source: ADB calculations based on data from Bloomberg.

There is an increasing concern that recent renewed depreciation of Asian currencies and equity losses could herald a slowdown or even a reversal of the Asian recovery. The fear is that if growth of domestic demand slows and the external environment deteriorates significantly, then the recovery could be in jeopardy.

While the prognosis for the global economy is generally favorable, worrisome imbalances exist. In particular, the US is running an unprecedented current account deficit that is being financed by equally unprecedented capital inflows (Figure 1). These inflows are helping to support what many continue to believe, despite recent volatility, are grossly inflated US domestic asset prices (Figure 2). If imbalances in the US economy were to unwind in a disorderly manner, other countries—in Asia and elsewhere—would feel the impact in a number of ways.

Another concern is that world oil prices may escalate further. High oil prices have heightened inflationary fears in industrialized economies and could yet be the trigger for a "hard landing" in the US. They also pose a direct threat to the net oil importing countries of the region through their likely impact on inflation and on economic growth.

This section begins by describing briefly the ways in which shocks in the global economy can be transmitted across countries. Next, it considers the downside risks to the US and global economic outlook, and examines the possible implications for the recovery in Asia. Finally, the section outlines the likely impacts of high oil prices on Asian countries and reviews policy options to mitigate these.

External Shocks and their Transmission

Globalization manifests itself in a variety of ways, one of which is through tighter economic links between countries. Countries are increasingly bound together through trade, investment, and financial flows, and in some places through the movement of workers and their associated income remittances. Together, these influence asset prices, including domestic interest rates and exchange rates, and real economic activity.

The way in which a small economy responds to global economic events depends on its degree of openness to trade, investment, and financial flows, as well as on the geographical pattern of these flows. It also depends on the nature of any shock that occurs. For example, a decline in output of the major industrial countries is likely to lead to an even sharper decline in world demand for exports. At given output prices, this will reduce the demand for goods and services produced in a small open economy. The likely outcome is slower growth and slower inflation. In a flexible exchange rate regime, and in the absence of any offsetting policy response, there will be pressure for the nominal exchange rate to depreciate and for domestic interest rates to fall.

On the other hand, a shock emanating from the supply side, such as a sharp rise in the price of an imported input for which demand and supply are relatively inelastic (e.g., energy), will raise costs for given output prices and will be associated with slower growth but accelerating inflation. Again, this stagflationary situation will have repercussions for domestic interest rates, the nominal exchange rate, and other asset prices.

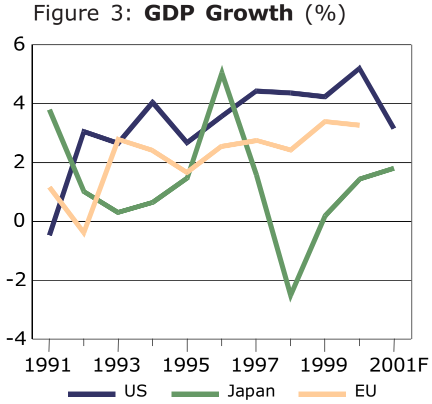
The Asian crisis has also demonstrated the significant influence that international investors can have on an economy. In the presence of an open capital account, the perceptions and expectations of international investors can play a crucial role in both initiating a shock and in propagating its effect across borders. For example, a withdrawal of financial capital from a country would initially constitute a demand side shock. This could happen because global interest rates rise and the balance of risks and rewards then move in favor of investments overseas. But it could also occur for other reasons, including a perceived reduction in the domestic economy's creditworthiness, or for reasons that are quite unrelated to fundamentals. Whatever the underlying cause, net exports would have to increase to fill the financing gap left by the withdrawal of capital. Normally, this would result in the compression of domestic demand and of imports.

But this may not be the end of the story. Induced asset price changes (including the nominal exchange rate) may alter the structure of domestic balance sheets and in adverse circumstances put the solvency of businesses or banks at risk. If this occurs, the initial demand side shock can have supply side repercussions, as working and fixed capital are withdrawn. Moreover, if investors perceive asset returns and risks to be correlated across neighboring economies, the movement of capital out of one economy can precipitate a movement out of others. If neighboring economies are also linked through trade and investment flows, a self-reinforcing spiral of declining output and demand can then ensue.

In practice, disentangling these effects is not easy. They occur in parallel, have complicated dynamics, and provoke responses by key actors, including policymakers. Complicated models of the global economy are often used to try to work out what the impacts of given shocks might be on particular countries and regions. Even then, differences in assumptions about how economies work, the information on which decisions are made, and the policy responses to the shocks can make important differences to conclusions. These qualifications should be borne in mind in the discussion that follows.

A US Hard Landing

Figure 3: **GDP Growth** (%)

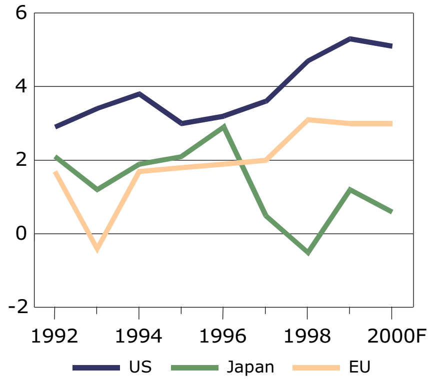


F = forecast.
Source: IMF, *World Economic Outlook,* September 2000.

The US has now enjoyed 115 consecutive months of expansion (Figure 3), propelled by personal consumption (Figure 4) and investment expenditures (Figure 5). Unemployment has fallen to below 4 percent, a level that was thought might provoke an acceleration of inflation. Despite this, inflationary pressures seem to be remarkably subdued (Figure 6). While there is some disagreement about how inflation ought to be measured, and there have been suggestions that headline inflation rates are understated in the US, substantial productivity gains (Figure 7) and interest rate tightening have undoubtedly helped contain inflation.

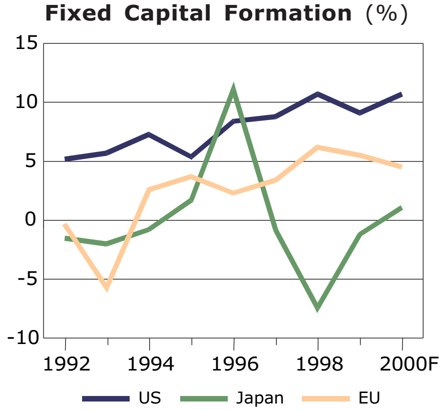
The consensus outlook for the US economy is that over the next 12 to 24 months, economic growth will gradually slow in a benign inflationary environment. This is the essence of the "soft

Figure 4: **Growth of Private Consumption Expenditure** (%)



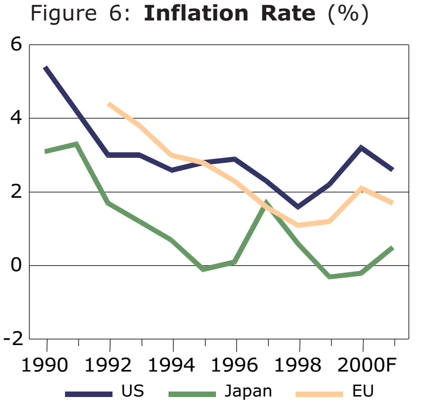
F = forecast.
Source: IMF, *World Economic Outlook,* September 2000.

Figure 5: **Growth of Gross Fixed Capital Formation** (%)



F = forecast.
Source: IMF, *World Economic Outlook,* September 2000.

Figure 6: **Inflation Rate** (%)



F = forecast.
Source: IMF, *World Economic Outlook,* September 2000.

landing." As the US economy cools, personal savings, which are now negative and at a historic low, are likely to increase, and the current account deficit should start to close. A variety of data (e.g., housing starts and manufactured production) released over the third quarter of 2000 support the likelihood of a soft landing, although it is difficult to assign a probability.

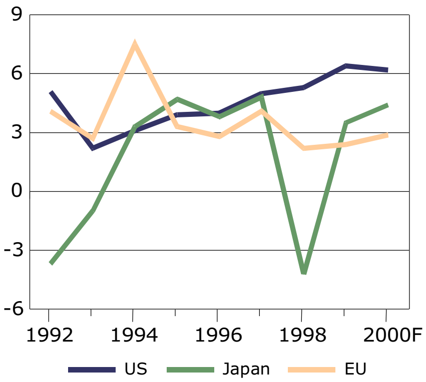
Despite this optimistic outlook, asset price volatility continues in US markets. Historically, increased volatility has often presaged a fall in asset prices. As of mid-October, US equity markets were close to their lowest point for the year, as lackluster earnings projections and high oil prices have combined to unnerve investors.

Essentially there are two ways in which US growth could slow more quickly than is now generally anticipated: through a negative supply shock or through a negative demand shock. On the supply side, a slowdown in productivity growth or a further escalation in world oil prices could trigger a hard landing. In these circumstances, the Fed might raise interest rates to combat the associated inflationary pressures. On the demand side, an unexpected withdrawal of foreign capital from US asset markets would slow demand growth, as could a loss of confidence by domestic investors. While the impact of either scenario would be to slow inflation, it could also lead to a sharp depreciation of the dollar. In such an event, the Fed might also tighten monetary policy to ward off further dollar declines.

The secondary ramifications of these shocks could be complicated. For example, if domestic debt has been incurred in acquiring US equity assets, highly leveraged US institutions could come under pressure in the event of a rapid decline in asset values. Equally, an unexpected fall in productivity growth might lead investors to revise expectations of earnings growth, and precipitate a fall in real investment. One concern is that if one sector of the economy were to take a turn for the worse, this could spill over into other sectors and unhinge the virtuous circle of low inflation and high growth.

The effects of a US slowdown would inevitably spill over to other industrialized economies. They would be transmitted both through trade and investment channels and possibly also through coincident falls in asset prices across major markets. In particular, a depreciation of the dollar against the yen would

Figure 7: **Growth of Labor Productivity** (%)



F = forecast.
Source: IMF, *World Economic Outlook,* September 2000.

hinder Japan's, as yet, fragile recovery, given that the scope for fiscal maneuver has been greatly reduced. In Europe, export growth, which has underpinned the present cyclical upswing, would also likely suffer. European inflation targets would limit latitude for a more accommodating monetary policy, and tight fiscal requirements would preclude an expansionary fiscal response.

The small open economies of Asia could feel the impact of a sharp slowing of global growth through trade, investment, or asset market linkages. But the main impact, at least over the first 12 to 18 months, is likely to be felt through trade linkages, given the already distressed asset markets and investment levels that are still far short of their precrisis levels.

The fallout in regional asset markets and on regional balance sheets of a sharp slowing of global growth and a downturn in global asset markets is not easy to predict. The effect on Asian equities should, to some degree, be moderated by the fact that they are already heavily discounted relative to both precrisis levels and underlying fundamentals. Even if regional markets were to fall further, as might happen if the risk premium on global equities rises, this is unlikely to have much of an effect on private sector demand or on balance sheets. The possibility even exists that once global markets settle, investors in pursuit of international diversification opportunities would help support a recovery within the region.

The substantial erosion of equity values since 1997 has been reflected in equally large reductions in the degree of market capitalization within the region. This limits the marginal effects that further reductions in equity wealth might have on demand and income. Also, equity issuance is already at a low ebb so that further reductions would, at the margin, be unlikely to encumber investment. Of more concern is the possibility that a hard landing in the US, and knock-on effects in other parts of the industrialized world, would further delay the recovery of FDI, which has been slow to return to countries such as Indonesia, Malaysia, and Philippines.

How would the dollar value of Asian currencies other than the yen be affected by a hard landing? The potential weakening of export growth (see below) and a likely shift of current accounts toward deficit would exert pressures for a depreciation of local currencies. But the currencies' response to a hard landing would also depend on what happens to capital account flows. While direct equity inflows would be unlikely to benefit, outflows of portfolio capital or debt capital could not occur on the same scale as was seen in the crisis years. Indeed, in some countries, capital outflows have already occurred and are factored into exchange rates. In the short term, capital account balances might not be much affected by an unanticipated global slowdown. If this were the case, overall balance-of-payments positions might deteriorate slightly, exerting, at most, modest pressure for a depreciation of nominal exchange rates vis-à-vis the dollar.

In Malaysia where the nominal exchange rate is still pegged to the dollar, a sharp slowdown in global growth and rising US interest rates would put upward pressure on its domestic interest rates. The required increase in domestic interest rates to support the peg would depend on the level of foreign exchange reserves, the evolving current account situation, and the ease with which substitution could take place from the domestic currency into dollars.

Elsewhere in the region, monetary policy has increasingly become keyed on inflation. Since the initial impact of a global slowdown would be to dampen inflationary expectations, this would, other things equal, provide some latitude for monetary easing. But in those economies where fiscal balances are under pressure (Indonesia, Philippines, and Thailand) there might be little scope for countervailing fiscal measures to boost domestic demand.

While domestic interest rates, equity values, and exchange rates would respond to sharply slower global growth, the major impacts on the real economy and on recovery would most likely be felt through trade. The dependence of some economies on electronics exports could be crucial. If an investment slowdown were to occur, particularly in the US, this could be reflected in a disproportionately large drop in the demand for electronics and related products. This would impact adversely on export volumes and the terms of trade. An unexpected slowing in the growth of orders for computers in the US has already registered in a sharp decline in DRAM (Dynamic Random Access Memory) chip prices for regional producers.

At an aggregate level, the region's economies vary in terms of the strength of their trading ties with the United States and other major world economies. In fact, trade dependence on major industrialized economies has been trending downwards over the past decade. For example, the share of intraregional exports[1] (excluding Japan) of the five affected countries increased from 22.7 percent in 1990 to 36 percent in 1997 (Table 1). Partly, this increase was a reflection of comparatively fast growth within the region. During the crisis, as growth slowed, the intraregional trade share dipped to 31.4 percent in 1998, but with recovery it has subsequently edged back up. Although intraregional trade has lent the recovery a welcome self-sustaining quality, the region is not completely insulated from outside disturbances.

Table 1: **Interregional and Intraregional Trade of the Five Affected Countries***

Year	Total ($ Million)		% of Total							
			US		EU		Japan		East and Southeast Asia[1]	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1990	151,394	167,437	23.9	18.0	16.1	15.0	22.2	26.1	22.7	21.6
1995	318,606	355,548	19.5	17.3	13.8	14.7	15.7	25.8	33.6	21.3
1996	334,899	376,862	17.9	17.5	13.3	14.7	15.7	23.0	35.8	23.3
1997	351,149	367,242	18.4	17.9	13.7	13.0	14.4	21.8	36.0	26.5
1998	338,559	253,439	20.6	18.7	16.1	12.1	12.2	19.6	31.4	30.5
1999	370,806	295,188	22.0	17.3	15.1	10.9	13.2	22.4	31.8	32.3

*Export and import values are in current prices.
[1]People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. Trade shares of Taipei,China reported in International Center for the Study of East Asian Development, *East Asian Economic Perspectives*, Vol. 11, March 2000 were used for 1998 and 1999 calculations of intraregional trade values.
Source: IMF, *Direction of Trade Statistics Yearbook,* 1997, 1998, December 1999, and June 2000 issues.

The US, in particular, continues to be a major destination for exports from the affected countries as a group as well as individually, with the share of exports increasing since 1996. The US is the single largest market for exports from the five countries, and absorbs more than one fifth of their combined exports. Individually, Indonesia is least exposed to the US market as its trade and exports are directed more to Japan (receiving 20 percent), compared to the US, which gets 15 percent (Table 2). At the other end of the spectrum, the Philippines is the most heavily dependent on the US market, with more than

[1]Defined to include the PRC; Hong Kong, China; Indonesia; Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

one third of its exports directed there (Table 5). Korea, Malaysia, and Thailand, meanwhile, all ship more than one fifth of their exports to the US (Tables 3, 4, and 6).

Table 2: **Indonesia—Interregional and Intraregional Trade***

			% of Total							
	Total ($ Million)		US		EU		Japan		East and Southeast Asia[1]	
Year	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1990	25,681	22,008	13.1	11.5	12.0	20.4	42.5	24.8	24.1	23.3
1995	44,948	40,807	14.4	11.2	15.0	19.6	27.5	24.2	29.5	25.1
1996	49,873	42,959	13.6	11.8	15.5	21.5	25.8	19.8	32.3	25.7
1997	53,444	41,680	14.1	13.1	14.6	20.5	23.8	22.0	31.7	27.3
1998	48,848	27,337	17.6	9.2	18.2	17.4	19.7	17.3	35.8	39.8
1999	56,683	29,981	16.3	7.1	15.4	12.9	20.2	18.0	32.9	41.4

*Export and import values are in current prices.
[1]People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. Trade shares of Taipei,China reported in International Center for the Study of East Asian Development, *East Asian Economic Perspectives*, Vol. 11, March 2000 were used for 1998 and 1999 calculations of intraregional trade values.
Source: IMF, *Direction of Trade Statistics Yearbook,* 1997, 1998, December 1999, and June 2000 issues.

Table 3: **Rep. of Korea—Interregional and Intraregional Trade***

			% of Total							
	Total ($ Million)		US		EU		Japan		East and Southeast Asia[1]	
Year	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1990	65,027	69,858	29.9	23.6	15.4	13.0	19.4	26.6	15.5	14.7
1995	125,365	135,153	19.3	22.5	12.2	13.4	13.6	24.1	33.2	15.0
1996	130,526	150,370	16.7	22.1	10.8	14.1	12.3	20.9	35.9	15.8
1997	136,008	144,580	15.9	20.7	11.2	9.0	10.9	19.3	36.8	17.3
1998	132,256	93,282	17.4	21.9	13.8	11.7	9.3	18.1	28.8	21.4
1999	136,730	111,967	21.2	21.8	13.3	10.9	10.7	22.7	28.9	23.5

*Export and import values are in current prices.
[1]People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. Trade shares of Taipei,China reported in International Center for the Study of East Asian Development, *East Asian Economic Perspectives*, Vol. 11, March 2000 were used for 1998 and 1999 calculations of intraregional trade values.
Source: IMF, *Direction of Trade Statistics Yearbook,* 1997, 1998, December 1999, and June 2000 issues.

Table 4: **Malaysia—Interregional and Intraregional Trade***

			% of Total							
	Total ($ Million)		US		EU		Japan		East and Southeast Asia[1]	
Year	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
1990	29,420	29,170	16.9	16.9	15.4	15.9	15.3	24.2	41.1	30.9
1995	73,722	77,614	20.8	16.3	14.2	15.2	12.5	27.3	40.5	25.8
1996	78,214	78,441	18.2	15.5	13.7	14.4	13.4	24.5	43.2	34.6
1997	78,909	79,047	18.5	16.8	14.4	13.9	12.5	22.0	42.4	37.2
1998	73,470	58,319	21.6	19.6	16.2	11.8	10.5	19.7	37.3	39.2
1999	84,550	65,491	21.9	17.4	15.7	11.6	11.6	20.8	38.1	39.6

*Export and import values are in current prices.
[1]People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. Trade shares of Taipei,China reported in International Center for the Study of East Asian Development, *East Asian Economic Perspectives*, Vol. 11, March 2000 were used for 1998 and 1999 calculations of intraregional trade values.
Source: IMF, *Direction of Trade Statistics Yearbook,* 1997, 1998, December 1999, and June 2000 issues.

Table 5: **Philippines—Interregional and Intraregional Trade***

Year	Total ($ Million) Exports	Total ($ Million) Imports	% of Total: US Exports	US Imports	EU Exports	EU Imports	Japan Exports	Japan Imports	East and Southeast Asia[1] Exports	East and Southeast Asia[1] Imports
1990	8,194	12,993	37.9	19.5	18.5	11.8	19.8	18.4	17.4	25.8
1995	17,371	28,282	35.8	18.5	17.6	10.7	11.6	22.3	25.3	28.2
1996	20,543	31,756	33.9	19.7	15.9	9.4	17.9	21.8	23.9	26.1
1997	25,228	39,131	38.9	20.9	18.2	16.0	18.1	24.4	26.8	39.5
1998	29,496	31,393	34.4	21.9	20.3	9.1	14.4	20.3	26.0	34.3
1999	33,623	37,369	33.8	20.5	16.4	7.8	14.6	24.5	30.8	35.7

*Export and import values are in current prices.
[1]People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. Trade shares of Taipei,China reported in International Center for the Study of East Asian Development, *East Asian Economic Perspectives*, Vol. 11, March 2000 were used for 1998 and 1999 calculations of intraregional trade values.
Source: IMF, *Direction of Trade Statistics Yearbook,* 1997, 1998, December 1999, and June 2000 issues.

Table 6: **Thailand—Interregional and Intraregional Trade***

Year	Total ($ Million) Exports	Total ($ Million) Imports	% of Total: US Exports	US Imports	EU Exports	EU Imports	Japan Exports	Japan Imports	East and Southeast Asia[1] Exports	East and Southeast Asia[1] Imports
1990	23,072	33,408	22.7	10.8	22.7	16.2	17.2	30.4	20.1	24.9
1995	57,200	73,692	17.6	11.5	14.9	15.2	16.6	29.3	31.3	23.7
1996	55,743	73,336	18.0	12.6	16.0	14.6	16.8	27.9	32.8	24.0
1997	57,560	62,804	19.4	13.8	15.9	14.2	15.2	25.7	33.4	25.4
1998	54,489	43,108	22.3	14.0	17.8	12.4	13.7	23.6	28.9	29.4
1999	59,220	50,380	23.1	10.8	17.0	11.2	13.6	24.8	28.9	34.7

*Export and import values are in current prices.
[1]People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. Trade shares of Taipei,China reported in International Center for the Study of East Asian Development, *East Asian Economic Perspectives*, Vol. 11, March 2000 were used for 1998 and 1999 calculations of intraregional trade values.
Source: IMF, *Direction of Trade Statistics Yearbook,* 1997, 1998, December 1999, and June 2000 issues.

A rough indication of the potential vulnerability of regional economies to a downturn in the industrialized countries is shown in Table 7. In the table, demand impact multipliers are calculated for the affected countries for a percentage point reduction in US, EU, and Japanese growth. We use the national income identity and, to simplify the calculations, assume that private consumption and import demand components respond equi-proportionately to income changes both within the region and elsewhere in the world. In the calculations, trade shares for 1999 are used. This may lend an upward bias to the estimated multipliers, because in that year exports were an unusually large percentage of GDP in most regional economies. Biases work in the other direction in that global demand for regional output changes more than in proportion to global income. The numbers are, therefore, intended to be suggestive. They do not include the induced impacts of relative prices and other changes on domestic growth.

Table 7: **Estimated Demand Impact Multipliers for a One Percentage Point Reduction in Growth in Export Markets**

	US	EU	Japan	Combined US, EU and Japan
Indonesia	-0.080	-0.076	-0.099	-0.255
Rep. of Korea	-0.121	-0.076	-0.061	-0.259
Malaysia	-0.161	-0.116	-0.086	-0.363
Philippines	-0.195	-0.095	-0.084	-0.373
Thailand	-0.149	-0.109	-0.088	-0.346

Sources: ADB calculations based on data from web sites of the national statistics offices of Indonesia, Korea, Malaysia, Philippines, Thailand, and IMF, *Direction of Trade Statistics Yearbook*, 1997, 1998, December 1999 and June 2000.

The estimated multipliers suggest that, in the short run, the Philippines would be most susceptible to a slowdown in US growth. A percentage point reduction in the US growth rate could reduce growth in the Philippines by just under 0.2 percentage point. Malaysia is the next most exposed, with a percentage point reduction in US growth slowing Malaysian growth by 0.16 percent. Not surprisingly, given its geographical trade pattern, the Indonesian economy would be least affected.

The effects of a coincident slowing of growth on the global economy can be pieced together using the individual multipliers (because they are additive). For example, although the assumed distribution is somewhat improbable, a combined percentage point reduction of growth in US, EU, and Japan suggests that Malaysia, Philippines, and Thailand would be most affected. In each, their growth would be reduced by about 0.35 percentage point. The impacts on Indonesia and Korea would be substantially less at about 0.26 percentage point.

To the extent that trade did indeed transpire to be the most significant route through which impacts from the global economy are transmitted to the region, the estimated multipliers suggest that an unexpected slowing of global growth would impair but not derail recovery. Indeed, continued recovery of domestic investment demand, which will be closely related to progress in corporate and banking restructuring, could do much to support regional growth in a context of a faster than anticipated slowdown of global growth. In this event, domestic macroeconomic responses would also depend on initial fiscal conditions and on the structure of monetary regimes. There would not be a "one size fits all" response.

Impact of Recent Oil Price Increases

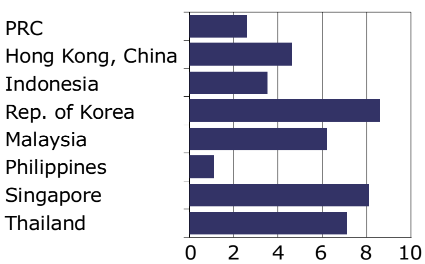
Oil prices have risen by more than 300 percent since December 1998 (the last trough in prices). As of mid-October 2000, spot market prices had climbed to $37 a barrel. There have been some welcome developments recently, with OPEC's decision to pump more oil, the US's intended release of some of its strategic supplies, and Japan's announcement to release part of its stockpile of gas oil. But oil supply and demand balances are such that prices will probably continue to remain high at least until the first quarter of next year. A recent report from the International Energy Agency notes that global oil supplies remain "stretched" and "forcing more crude into a capacity constrained system will not correct the situation overnight." Refineries in key markets such as the US were working close to capacity, pipelines were full, and world fleet tankers were in high demand. On the demand side, the emerging signs of a harsh winter in the Northern Hemisphere are starting to add to the mounting pressure, while tensions in the Middle East are complicating the situation further. The futures markets are, therefore, anticipating that the price of crude will remain above $30 a barrel until the first quarter of 2001.

When examining how high oil prices threaten Asia's recovery, it is important to differentiate between nominal and real prices. Clearly, nominal oil prices have risen sharply in recent months but, in real terms, oil prices are still far off earlier peaks reached during the first (1973-1974) and second (1979-1980) oil crises. In these two periods, real oil prices quadrupled and tripled, respectively. Today, the real price of oil is 50 percent higher than the average during the second half of the 1990s. In short, the size of the shock this time around is much smaller than in either the 1970s or 1980s.

Nevertheless, a sharp increase in oil prices has potentially serious macroeconomic consequences for countries that are net importers of oil. Most immediately, higher oil prices add to inflationary pressures. By raising producer costs they can also slow output growth (see below). Net oil importers also experience income losses as their terms of trade deteriorate, and their balance of payments may move toward deficit. Last, higher fuel prices can create fiscal strains where fuel attracts subsidies.

The degree to which a country might be vulnerable to oil price increases depends on various factors. At the time of the first oil shock, the demand for energy generally rose more quickly than income. Output was also quite energy intensive. For these reasons, it was difficult for countries to quickly reduce their dependency on fuel and net fuel importers were badly hit when prices rocketed. But by the mid-1980s, many industrialized countries had invested in technologies that lessened oil dependency and had sought to contain energy demand through increased fuel taxes. As a consequence, subsequent oil price increases did not have the devastating effects seen in the 1970s. But in developing Asia there has been less success in reducing oil dependency. Indeed, the low oil and energy prices that prevailed following conservation measures in the industrialized economies could have induced Asian developing countries to place even less emphasis on energy conservation. This has now left some more vulnerable to rising fuel prices.

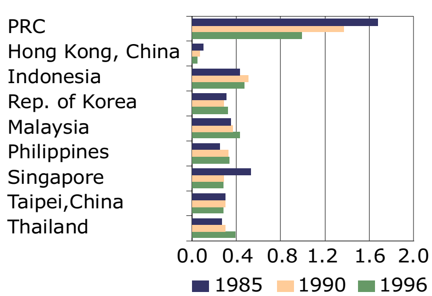
Figure 8: **Commercial Energy Use Per Capita, 1980-1997**
(average annual growth, %)



Source: World Bank, *World Development Indicators 2000*.

Partly as a result of fast income growth, there has been a big increase in per capita consumption of commercial energy in Asia (Figure 8). In Korea and Singapore, it grew at an annual rate of more than 8 percent between 1980 and 1997, and by more than 7 percent in Thailand. In the Philippines, where economic growth has been weaker, per capita consumption growth averaged only 1 percent. Meanwhile, per capita consumption of commercial energy grew by 2.6 percent per annum in the PRC and by 4.6 percent in Hong Kong, China. No discernable differences in patterns of energy consumption can be detected in Asia's net oil exporting countries. Over the same period, per capita consumption rose by 5.4 percent per annum in Indonesia and 9.1 percent in Malaysia.

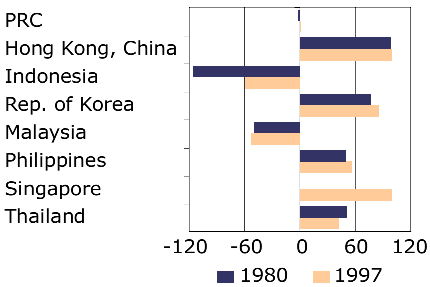
Figure 9: **Energy Consumption Per Unit of Economic Output**
(tons of energy equivalent per thousand 1993 $)



Source: ADB, *Key Indicators of Developing Asian and Pacific Countries 2000*.

Despite fast per capita consumption growth, energy consumption per unit of GDP (measured at constant prices in dollars) declined or energy efficiency increased over the period 1985 to 1996 in some countries: notably, the PRC; Hong Kong, China; Singapore; and Taipei,China. But in others (Indonesia, Korea, Malaysia, Philippines, and Thailand), energy efficiency seems to have fallen (Figure 9). Moreover, Asia has become more dependent on imported energy. For example, the PRC switched from being a net exporter of energy in the 1980s to becoming a net importer in recent years. Imported energy accounts for 100 percent of commercial energy use in Hong Kong, China and Singapore, and a rising share in Korea (86 percent in 1997) and

Figure 10: **Net Energy Imports**
(% of commercial energy use)



Source: World Bank, *World Development Indicators 2000*.

Philippines (57 percent) (World Bank, *World Development Indicators 2000*).

Oil import dependency, measured as the ratio of net oil imports to commercial energy use, between 1980 and 1997 increased in all oil importing countries except Thailand (Figure 10). In part, this reflects the sharp growth of vehicle ownership and associated increases in demand for refined petroleum products. In some countries, governments have also subsidized petroleum products particularly for transportation and household uses. However, most of the countries have drastically reduced their reliance on oil in electric power generation, by substituting coal, natural gas, or nuclear power.

Declining energy efficiency coupled with increasing oil import dependency make Korea and Philippines most vulnerable to higher oil prices. Although energy efficiency has increased in Hong Kong, China; Singapore; and Taipei,China, these economies remain vulnerable because of their increased oil import dependency. In Thailand, energy efficiency has fallen, while dependency on imported oil continues to be high. Hence, all of the oil importing countries are vulnerable to increased oil prices and their external payments positions are likely to deteriorate. Moreover, inflationary pressures may compel central banks to tighten monetary policies and put a brake on demand growth. As production costs rise, this would act as a double squeeze on domestic output in oil importing economies.

Estimates of the precise impacts of increasing oil prices on growth and inflation depend on baseline assumptions. For example, the IMF (WEO, September 2000) estimated that a sustained $5 rise in the price of a barrel of oil from a baseline figure of $26.50 would lead to a 0.2 percent drop in output of the major industrial countries in the space of a year, while inflation would rise by 0.2 to 0.4 percentage point. The IMF estimates that output in Asia would decline by 0.4 percent, exceeding that of industrial countries and other developing countries, because of the region's continued high dependence on imported oil. These rough estimates suggest that the adverse impacts of recent increases in oil prices on Asia's recovery would be moderate and manageable. The situation would, however, be different should oil prices remain high beyond the first quarter of 2001, or if they rise much higher than present levels.

The question also arises as to how the region's economies might respond to high oil prices. Given their growing dependency on imported fuel, it would make sense for countries to move toward becoming more fuel-efficient. The current structure of taxes and subsidies in some countries encourages waste and may also be environmentally damaging. Moreover, although fuel subsidies are frequently presented as benefiting the poor, their effects are usually quite regressive. In countries where restrictions on importing fuel-efficient technologies exist, these should also be reconsidered. In general, it would be better to induce fuel conservation through the price mechanism than through command and control mechanisms.

The recent increases in oil prices should act as a wakeup call for the recovering Asian countries. Steps that must be taken include energy conservation, diversification of energy supplies, reduction in dependence on oil in favor of alternative sources, and investments to promote greater efficiency in consumption of electric power and fuel. Information and communications technology can be applied to improve the efficiency of household and industrial use of energy and to streamline transportation systems so that less energy is consumed per unit of GDP.

The appropriate macroeconomic response to fuel price increases will depend on whether the country is a net fuel exporter or an importer. In importing economies, a rise in the cost of imported fuel constrains supply, adds to inflation, and reduces income through terms of trade effects. If monetary policy is conducted within an inflation targeting framework, an approach that is increasingly favored within the region, the authorities must respond by tightening monetary policy—most likely through an increase in interest rates. This will have the effect of further dampening demand. To offset this, a more expansionary fiscal policy could be considered. But where fuel is subsidized, maneuverability on the fiscal side would be simultaneously reduced. In oil importing countries that have a pegged exchange rate regime, inflationary pressures are likely to require sterilized intervention to support the chosen parity, and domestic interest rates would increase through this channel.

For net exporters of fuel, an increase in price is still inflationary, and in adding to costs it has negative supply side repercussions. However, the present increase in price has positive terms of trade effects, and will move the payments situation toward surplus. It may also improve fiscal balances to the extent that the production of fuel is taxed. The net effect of these changes is that, for a given price hike and in the absence of fuel subsidies, inflationary pressures are likely to be even stronger in fuel exporting than in fuel importing economies, and may require a stronger monetary response. Finally, while the scope for expansionary fiscal policy may be greater (if fuel production is taxed), the need for it is likely to be less as demand is supported through terms of trade gains.

Summary and Conclusions

Asia's recovery was initially propelled by the rapid net export growth made possible by favorable conditions in the global economy. Although the drivers of recovery are now broader, external developments will still exert an important influence on the path of recovery over the next few years. While the global economic outlook is widely regarded as favorable, a harder than expected landing of the US economy or prolonged high oil prices could cast a shadow over recovery prospects in the short to medium term. Although these events would slow regional growth, they would in themselves be insufficient to derail the recovery process. Coherent and credible macroeconomic policies, together with a continued commitment to structural reforms, can help rebuild the internal dynamism and resilience to external shocks that once allowed the region to weather global shocks so effectively.

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