ADB Asia Economic Monitor 2002

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The *Asia Economic Monitor* (AEM) is a quarterly review of East Asia's growth and recovery, financial and corporate sector reforms, and social developments. It covers the 10 Association of Southeast Asian Nations member countries plus the People's Republic of China and Republic of Korea. This October 2002 issue also features country updates on seven East Asian economies—People's Republic of China, Indonesia, Republic of Korea, Malaysia, Philippines, Singapore, and Thailand.

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Highlights

Growth and Recovery in 2002

- Driven by both exports and domestic demand, East Asia's economic rebound that started in the first quarter of this year continued in the second and third quarters.
- Fiscal and monetary policies have remained moderately expansionary, thus supporting domestic demand and growth. Most countries have also made progress in restructuring and reforming their financial and corporate sectors.
- The region's stock markets began to slide in the second quarter and the decline intensified in the third quarter. Nevertheless, their performance this year still compares favorably with stock markets in industrial countries as well as those in most other emerging markets around the world.

Prospects for East Asia's Growth and Recovery

- Since the release of the July 2002 *Asia Economic Monitor* (AEM), the external environment facing East Asia has turned less favorable. Growth forecasts for the major industrial economies for this year, and—more important—for next year, have been revised down. However, the global rebound is expected to continue, but at a more moderate pace than was foreseen only a few months ago.
- The main message of this report is that East Asia's modest economic rebound scenario for this year and the next remains intact, mainly because of the following factors:
  - In the face of slower-than-expected growth in industrial countries, East Asia's export growth may soften somewhat but will remain relatively healthy.
  - The progress made by East Asia in restructuring and reforms and the expansionary stance of monetary and fiscal policies should enhance the buoyancy of domestic demand.
  - Projections suggest an improvement in private capital flows to the region, especially next year.

Continued overleaf

Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AEM	Asia Economic Monitor
AMC	asset management company
ARIC	Asia Recovery Information Center
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
BOK	Bank of Korea
bp	basis point
CAR	capital adequacy ratio
CDRAC	Corporate Debt Restructuring Advisory Committee
CDRC	Corporate Debt Restructuring Committee
CPI	consumer price index
FRA	Financial Sector Restructuring Authority
GDP	gross domestic product
IBRA	Indonesian Bank Restructuring Agency
IIF	Institute of International Finance
IMF	International Monetary Fund
IPO	initial public offering
IT	information technology
JCI	Jakarta Composite Index
JITF	Jakarta Initiative Task Force
KAMCO	Korea Asset Management Corporation
KLCI	Kuala Lumpur Composite Index
KOSPI	Korean Stock Price Index
Lao PDR	Lao People's Democratic Republic
MAS	Monetary Authority of Singapore
NASDAQ	National Association of Securities Dealers Automated Quotation
NPL	nonperforming loan
PHISIX	Philippine Stock Exchange Composite Index
PRC	People's Republic of China
REMU	Regional Economic Monitoring Unit (ADB)
SCB	State commercial bank
SESALL	Singapore All Equities Index
SET	Stock Exchange of Thailand
SME	small and medium enterprise
SOCB	state-owned commercial bank
STI	Straits Times Index (Singapore)
TAMC	Thai Asset Management Corporation
WEO	World Economic Outlook
q-o-q	quarter-on-quarter
y-o-y	year-on-year

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

The *Asia Economic Monitor* October 2002 was prepared by the Regional Economic Monitoring Unit of the Asian Development Bank and does not necessarily reflect the views of ADB's Board of Governors or the countries they represent.

- The London-based Consensus Economics Inc.[1] now projects East Asia's gross domestic product (GDP) growth to reach 6% in 2002 (compared to 5.8% forecast at the time of the July AEM) and 5.9% in 2003 (marginally lower than the 6.2% forecast indicated in the July AEM).

- This scenario is, however, subject to a higher degree of uncertainty than before. There are two sets of risks that could undermine the current forecasts: (i) much lower growth among industrial countries than is expected, and (ii) any US-led military action against Iraq and the associated heightened uncertainty and increase in oil prices.

- Summing up, the emerging global environment appears to call for a two-pronged response by East Asian countries. First, they should closely monitor the emerging external environment, and remain ready to initiate appropriate fiscal and monetary responses should export prospects deteriorate sharply. Second, countries should push ahead with the remaining agenda of financial and corporate restructuring and reform, in order to improve resilience to external shocks.

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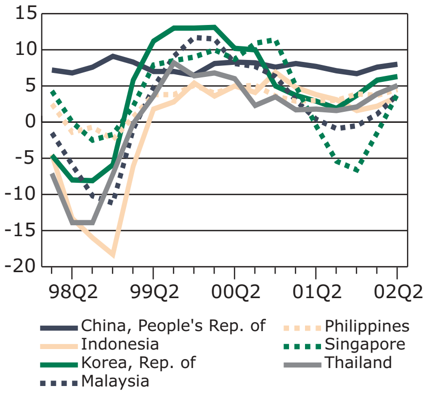
[1]A private institution that collates forecasts from about 200 economic and financial forecasters from more than 70 countries around the world.

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

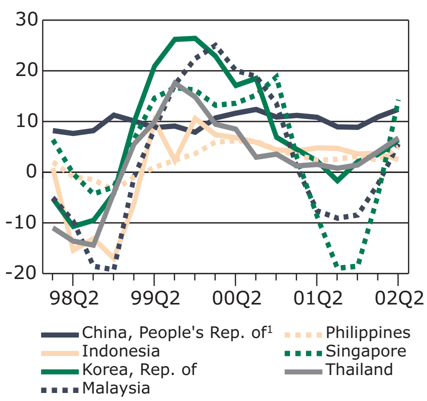
Growth and Recovery in 2002

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



Source: ARIC Indicators.

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



[1]Data for PRC refer to industrial production.
Source: ARIC indicators.

Real Sector Developments

The modest economic rebound in East Asia[1] that started in the first quarter of this year continued into the second quarter. In the seven economies in the region for which quarterly data are available—People's Republic of China (PRC), Indonesia, Republic of Korea (Korea), Malaysia, Philippines, Singapore, and Thailand—gross domestic product (GDP) growth accelerated in the second quarter (Figure 1), amounting collectively to 6.2% year-on-year (y-o-y).[2] This is an improvement on the 5.3% growth achieved in the first quarter and 4.3% for the whole of 2001. Individually, second quarter growth ranged from 3.5% in Indonesia (up from 2.2% in the first quarter) to 8% in the PRC (up from 7.6% in the first quarter), with Korea managing an impressive 6.3% growth (compared to 5.8% in the first quarter). The second quarter acceleration has been particularly marked for the more open economies such as Singapore (from -1.5% to 3.7%) and Malaysia (from 1.1% to 3.8%).

While it has cut across sectors, the second quarter growth acceleration was especially evident in manufacturing. The exception was Indonesia, where the manufacturing sector slowed down in the second quarter compared to the first (Figure 2). Once again, the acceleration was particularly pronounced in Singapore (from -4.5% to 14.3%) and Malaysia (from -2.3% to 5.6%).

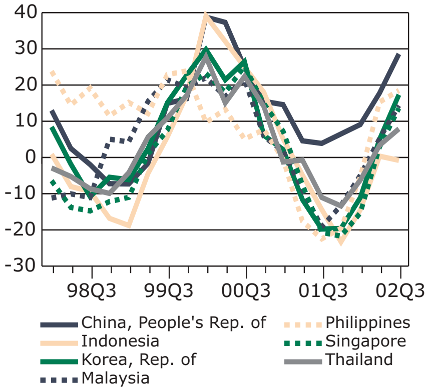
The region's economic rebound has been driven by both exports and domestic demand. The second quarter consolidated the turnaround in export growth that took place in the previous two quarters. All seven countries posted higher export growth in the second quarter compared to the two previous quarters (Figure 3).

Domestic demand, which has been picking up since the fourth quarter of last year across the region, has reinforced the economic rebound (Figure 4). The extent has, however, varied across countries, depending upon the pace of postcrisis economic reforms and use of fiscal stimulus measures. It appears to have played a particularly important role in supporting growth in Korea and Malaysia (see Box 1).

[1]Defined here as the 10 Association of Southeast Asian Nations countries (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China and Republic of Korea.
[2]Unless otherwise indicated, all growth rates are y-o-y.

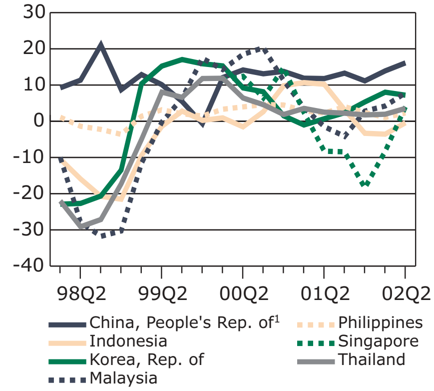
Estimates of GDP growth for the third quarter of this year are not yet available for East Asian countries, except for the PRC, where it came in at an impressive 8.1%, and Singapore, where it was 3.7%, the same rate as in the second quarter. However, trends in a few monthly economic indicators suggest that the economic rebound has continued elsewhere well into the third quarter. For example, in the first two months of the third quarter, industrial production continued to post robust growth rates (Figure 5). Except in Indonesia, the third quarter also witnessed robust export growth in the region. Import growth—another indicator of growth—has also been strong in the third quarter (Figure 6).

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



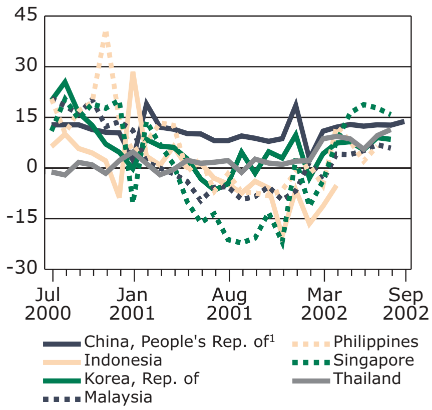
2002Q3 growth rates are based on two months of data (July and August) for all countries except Korea and PRC.
Source: ARIC Indicators.

Figure 4: **Growth of Domestic Demand** (y-o-y, %)



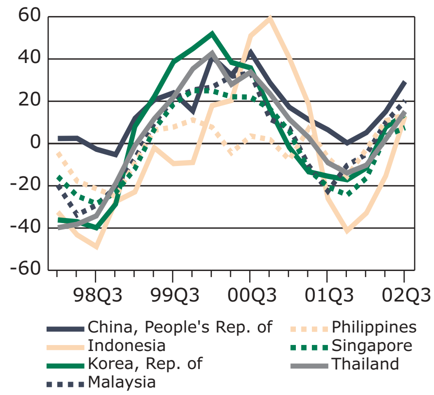
[1]Data refer to the growth of the sum of retail sales and fixed investment (1997=100).
Source: ARIC Indicators.

Figure 5: **Industrial Production Growth** (y-o-y, %)



[1]Growth rate of value added of industry.
Source: ARIC Indicators.

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



2002Q3 growth rates are y-o-y growth based on June data for the Philippines; July and August data for Indonesia, Malaysia, Singapore, and Thailand; and July, August, and September data for Korea and PRC.
Source: ARIC Indicators.

Box 1: **Domestic Demand: A Significant Role in East Asian Rebound?**

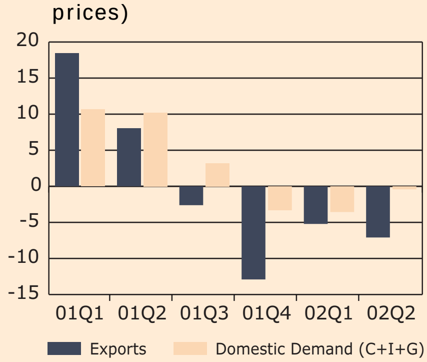
Helped by a combination of factors, including financial sector reforms and restructuring, moderately expansionary fiscal and monetary policies, and a turnaround in exports, domestic demand has posted a robust turnaround and played a significant role in East Asia's recent economic rebound. Even last year, when exports fell sharply, domestic demand held up well and provided a cushion to growth in the region (Figure 1.1a to 1.5a). Among the five crisis-affected countries, the contribution of domestic demand to the rebound is the most significant in Korea and Malaysia, followed by the Philippines and Thailand. However, in Indonesia domestic demand remains subdued. Outside the crisis-affected countries, judging by the strong growth in retail sales and fixed investment, domestic demand appears to have played a substantial role in the PRC's continued strong growth this year, while in Singapore, it has contributed moderately to the pickup in the country's GDP growth.

Across the region, private consumption has played a key role in driving domestic demand, although the other two components—domestic investment and public consumption—have also been significant in several countries (Figures 1.1b to 1.5b). In Korea, about three fourths of the growth in domestic demand since the third quarter of last year has been accounted for by private consumption,

Continued next page

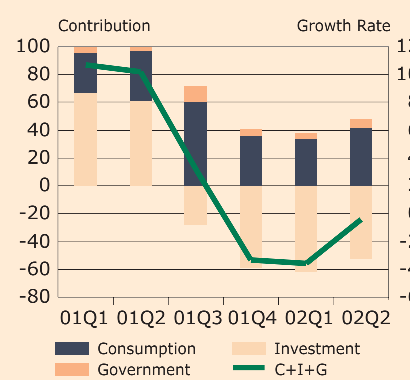
INDONESIA

Figure 1.1a: **Growth of Domestic Demand and Exports** (%, y-o-y, constant prices)



Note: Based on National Income Accounts.
Source: ARIC Indicators.

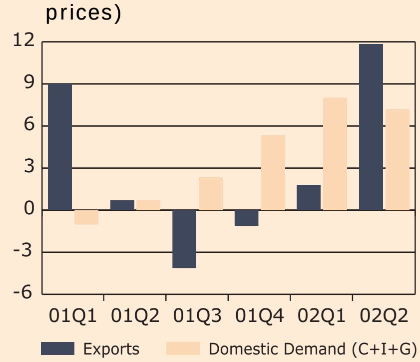
Figure 1.1b: **Domestic Demand: Growth Rate and Contribution of Components**



Note: Based on National Income Accounts.
Source: ARIC Indicators.

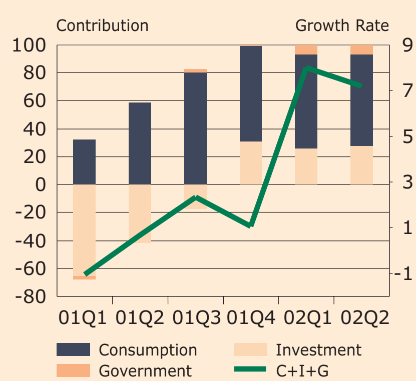
KOREA, REP. OF

Figure 1.2a: **Growth of Domestic Demand and Exports** (%, y-o-y, constant prices)



Note: Based on National Income Accounts.
Source: ARIC Indicators.

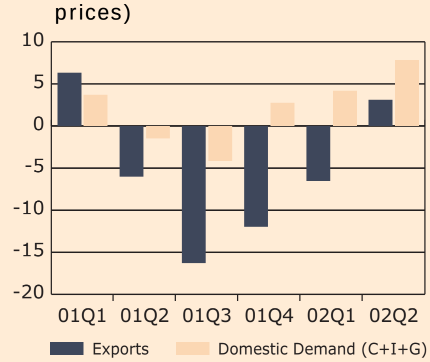
Figure 1.2b: **Domestic Demand: Growth Rate and Contribution of Components**



Note: Based on National Income Accounts.
Source: ARIC Indicators.

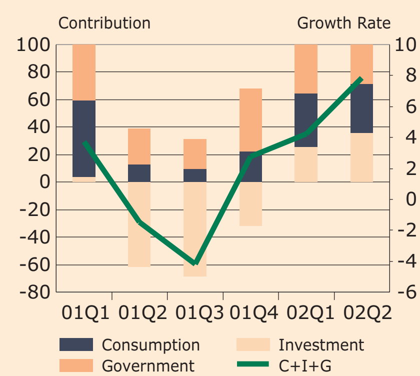
MALAYSIA

Figure 1.3a: **Growth of Domestic Demand and Exports** (%, y-o-y, constant prices)



Note: Based on National Income Accounts.
Source: ARIC Indicators.

Figure 1.3b: **Domestic Demand: Growth Rate and Contribution of Components**

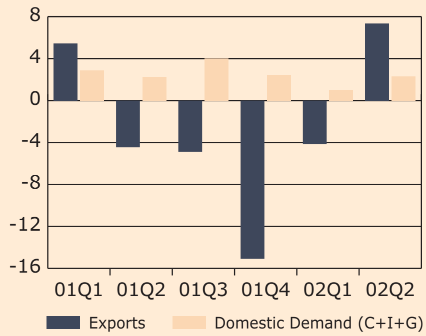


Note: Based on National Income Accounts.
Source: ARIC Indicators.

Box 1: **Domestic Demand: A Significant Role in East Asian Rebound? (Cont'd)**

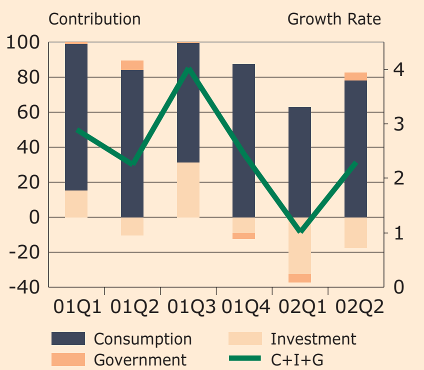
PHILIPPINES

Figure 1.4a: **Growth of Domestic Demand and Exports** (%, y-o-y, constant prices)



Note: Based on National Income Accounts.
Source: ARIC Indicators.

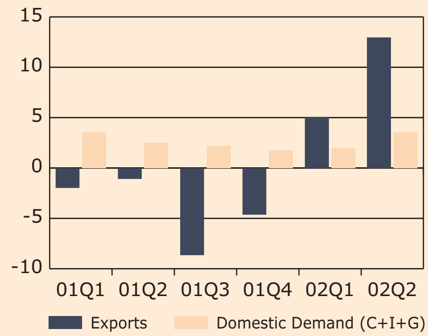
Figure 1.4b: **Domestic Demand: Growth Rate and Contribution of Components**



Note: Based on National Income Accounts.
Source: ARIC Indicators.

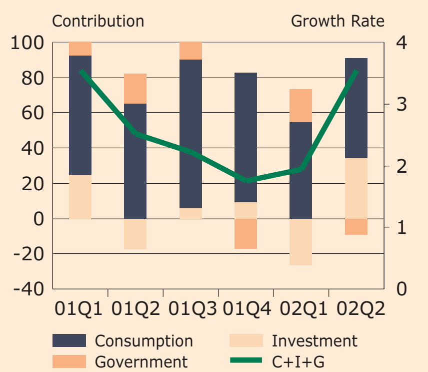
THAILAND

Figure 1.5a: **Growth of Domestic Demand and Exports** (%, y-o-y, constant prices)



Note: Based on National Income Accounts.
Source: ARIC Indicators.

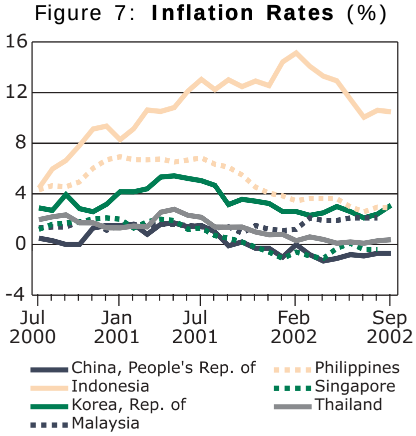
Figure 1.5b: **Domestic Demand: Growth Rate and Contribution of Components**



Note: Based on National Income Accounts.
Source: ARIC Indicators.

with most of the rest attributed to domestic investment. In comparison, Malaysia's growth in domestic demand since the beginning of this year has been more or less equally shared by all the three components—private consumption, public consumption, and domestic investment. In the Philippines and Thailand, private consumption has been the driving force behind growth in domestic demand in recent quarters, although beginning in the second quarter of this year, domestic investment also started playing a significant role in Thailand. In Indonesia, the contraction in domestic demand seen in recent quarters has been the result of a decline in domestic investment (caused mostly by a sharp drawdown of stocks), while the share of private consumption in domestic demand growth has held steady. In Singapore, the positive growth in domestic demand posted in the second quarter of this year (having declined for the previous four quarters) has been evenly shared by public consumption and domestic investment (largely due to change in stocks), with private consumption continuing to decline.

Figure 7: **Inflation Rates** (%)



Source: ARIC Indicators.

Meanwhile, inflation remains tame across the region (Figure 7). Except in Indonesia (where inflation is running at about 10%), inflation is now around 3% or below across the board. Prices have even been falling in the PRC (at an annual rate of about 1%) and Singapore (at an annual rate of about 0.4%), with Thailand not far behind. Korea, though, has experienced a slight uptick in inflation in more recent months. Yet, at about 3%, this is still not a major cause for concern.

Asset Market Developments

When the July 2002 AEM was issued, most regional stock markets, after posting strong gains in the first quarter of this year, were showing signs of weakening. Since then, the decline has intensified and has been particularly pronounced in the third quarter of the year. A combination of factors has contributed to the decline. These include a stock market slide in industrial countries, a decline in net foreign portfolio inflows to the region (see Box 2), and domestic economic problems in some of the regional economies (for example, the overshooting of the fiscal deficit target in the Philippines).

Box 2: **Private Capital Flows: Are They Bottoming Out?**

The Institute of International Finance (IIF) has noted that the prospects for capital flows to emerging markets have deteriorated since mid-year, as weaknesses in the global economy have resurfaced and political and economic uncertainty has increased. Net private capital flows to emerging markets, as a total, are forecast at $123 billion in 2002, against an annual average of $187 billion over the past 10 years.

But there are significant regional differences. Private flows to emerging markets in Latin America are expected to decline the sharpest to $29.1 billion in 2002 from $45.6 billion last year. But to emerging markets in Asia and Pacific (defined as the PRC, India, Indonesia, Korea, Malaysia, Philippines, and Thailand), they are projected to increase to $60.3 billion from 53.4 billion in 2001. In emerging markets of Europe, meanwhile, private capital flows are expected to increase from $16.4 billion in 2001 to $23.9 billion this year.

Net capital flows to the five crisis-affected countries are expected to increase slightly from $9.3 billion in 2001 to $10.2 billion this year, thanks mainly to improving stronger economic fundamentals, improving risk outlook, and relative attractiveness of Asian equities to other emerging stock markets. Net equity investment to crisis-affected countries is projected to decline to $11 billion this year, mainly as a result of declining portfolio investment in Korea. On the other hand, outflows of private lending are forecast to fall from $11.7 billion last year to $800 million in 2002 owing to improved ratings of several countries and a decline in repayments of external debt.

The compression in net equity investment is due to a fall in both direct equity and portfolio investment. Net direct equity investment is forecast to decline to $7.5 billion in 2002 from $9.9 billion in 2001—largely because of the drop in foreign direct investment in Korea. Several large deals were completed in 2001 and some asset sales have not taken place as expected. At the same time, net portfolio inflows are forecast to fall to $4 billion in 2002 from $11 billion in 2001, mainly because of the selloff of Korean stocks after they peaked earlier this year.

The improvement in the outflows of net private lending is largely due to an expected reversal in the trend of net flows to nonbank private creditors from an outflow of $6 billion in 2001 to an inflow of $1.1 billion in 2002. This has been helped by upgrades or improvements to the sovereign bonds outlook for Korea, Malaysia, and Thailand. Such flows include bond purchases, suppliers' credits, nonresident deposits in domestic banks, and nonresident purchases of local government securities. In 2002, Korea is expected to be the main contributor to 2002's net inflows into the five crisis-affected countries. Meanwhile, outflows in the form of debt repayments to commercial banks are expected to moderate to $2 billion in 2002 from $5.7 billion in 2001 as large repayments of external debt of the past several years have more or less run their course.

In 2003, net private flows to the five crisis-affected countries are expected to increase to $13.8 billion as the recovery progresses, driven by inflows of net equity investments. This figure, however, still represents a downward revision from $18.5 billion net private capital inflows estimated in July 2002.

Table 2.1: **Net Private Capital Flows to the Five Crisis-Affected Countries** ($ billion)

	1995	1996	1997	1998	1999	2000	2001	2002f	2003f
Net Private Flows	93.35	118.52	4.37	-37.33	-1.46	16.93	9.26	10.24	13.84
Equity Investment, net	16.13	19.95	6.16	16.60	35.04	25.38	20.99	11.05	15.25
Direct Equity Investment, net	4.14	4.77	6.81	13.29	16.12	13.79	9.89	7.50	8.40
Portfolio Investment, net	11.99	15.18	-0.66	3.32	18.92	11.59	11.11	3.55	6.85
Private Creditors, net	77.22	98.57	-1.79	-53.94	-36.51	-8.44	-11.74	-0.81	-1.41
Commercial Banks, credit flows, net	63.73	69.16	-17.57	-48.39	-32.33	-12.80	-5.71	-1.96	-2.51
Other Private Creditors, net	13.49	29.41	15.78	-5.54	-4.18	4.36	-6.03	1.14	1.10

f = forecast.
Source: Institute of International Finance.

Figure 8a: **Composite Stock Price Indexes**[1] (last week of 2001Dec=100, in local currency)

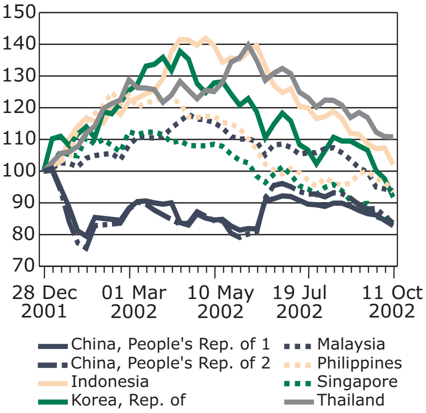
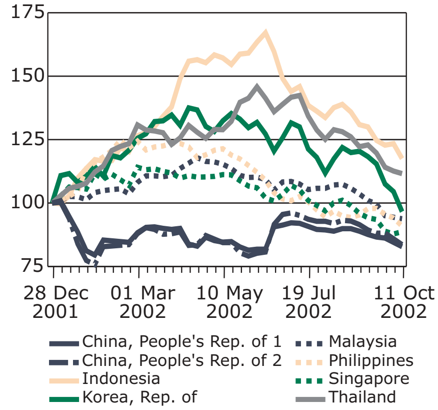
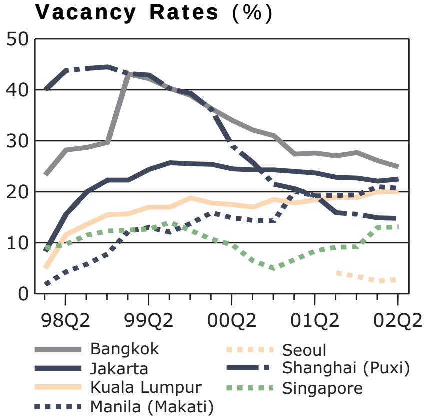


Figure 8b: **Composite Stock Price Indexes**[1] (last week of 2001Dec=100, $)



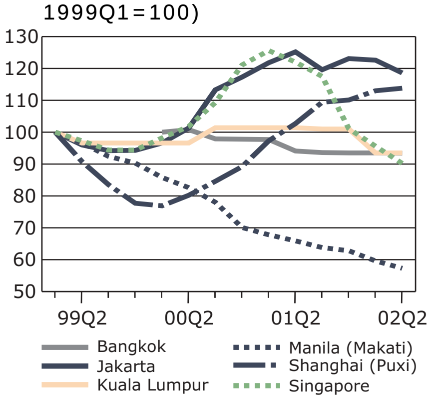
[1]Weekly averages of Shanghai-B (PRC 1), Shenzhen-B (PRC 2), JCI (Indonesia), KLCI (Malaysia), PHISIX (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand).
Source: REMU staff calculations derived from Bloomberg data.

Figure 9: **Office Property Vacancy Rates** (%)



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

Figure 10: **Rents** (per square meter per annum, local currency 1999Q1=100)



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

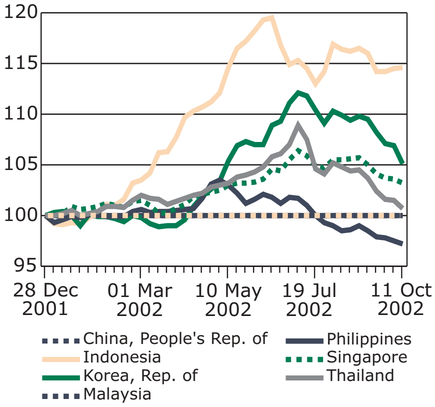
As a result, stock market indexes in several countries (PRC, Korea, Malaysia, Philippines, and Singapore), both in local currency and dollar values, are now back to or even below their levels seen at the beginning of the year (Figures 8a and 8b). In Indonesia and Thailand, despite the softening over recent months, stock prices have still managed positive gains this year.

Despite the recent slide, regional stock markets have turned in a resilient performance that compares favorably with global stock markets. For example, in the US, this year's stock market losses ranged from 22% in the case of the Dow Jones stock price index to 38% for NASDAQ. Losses in the other major industrial countries ranged from 19% in Japan's Nikkei 225 to 43% in Germany's Dax. Stock market losses in some of the emerging markets in Latin America were even larger, over 60% in Argentina and Brazil.

In the real estate sector, office vacancy rates in the first half of this year have remained stable in Malaysia; fallen mildly in PRC, Philippines, and Thailand; and increased somewhat in Indonesia, Korea, and Singapore (Figure 9). The mild decline for the PRC has been accompanied by an increase in office rentals, whereas the upward movement in office vacancy rates in Singapore put downward pressure on office rentals (Figure 10). In other countries, office rentals have either remained stable or have fallen.

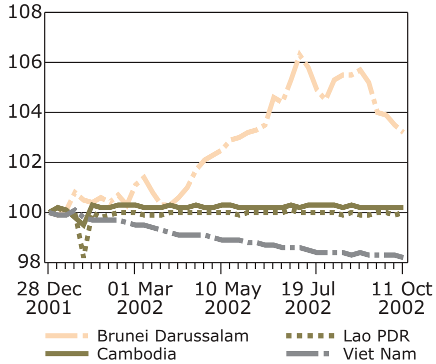
When the July 2002 AEM was published, most regional currencies were appreciating against the US dollar, which was showing general signs of weakness. This raised concerns that the regional rebound might be dampened by reduced export competitiveness. Since mid-July, however,

Figure 11: **Exchange Rate Indexes** (weekly average, last week of 2001Dec=100, $/local currency)



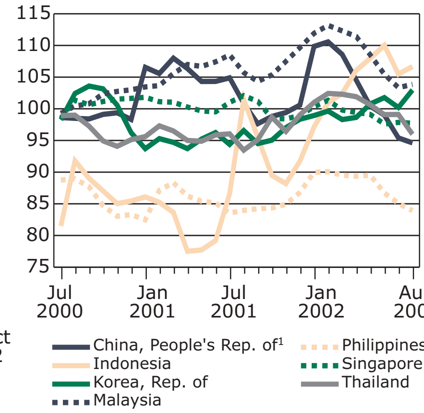
Source: REMU staff calculations derived from Bloomberg data.

Figure 12: **Exchange Rate Indexes—Other East Asian Countries** (weekly average, last week of 2001Dec=100, $/local currency)



Source: REMU staff calculations derived from Bloomberg data.

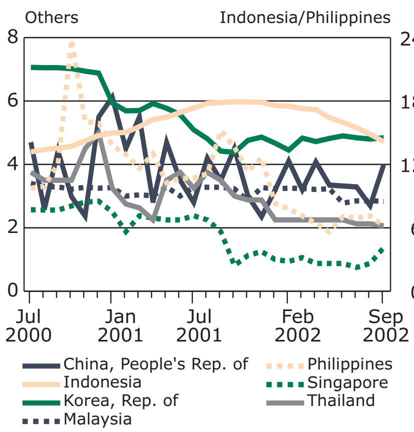
Figure 13: **Real Effective Exchange Rate** (2000=100)



Note: An increase is an appreciation. Trade weighted based on total trade with the European Union, Japan, and the US.
Source: REMU calculations.

most regional currencies (except the Malaysian ringgit and the PRC renminbi, both of which are pegged to the US dollar) have depreciated against the US dollar (Figures 11 and 12). These currency depreciations between mid-July and now range from 2% for the Brunei dollar and Singapore dollar to 6% for the Thai baht.

Figure 14: **Short-Term Interest Rates**[1] (nominal, %)



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

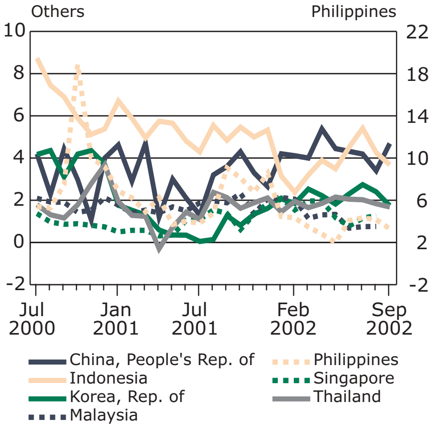
Coupled with low domestic inflation rates, the recent depreciation of the regional currencies against the US dollar has thus headed off any appreciation of the real effective exchange rates and loss of export competitiveness (Figure 13).

Fiscal and Monetary Policies

As the July AEM noted, most countries have responded to last year's external shock with modest fiscal stimulus measures and significant interest rate reductions. By the middle of this year, interest rates in many countries reached historically low levels. Since then, most have kept policy rates unchanged. With the exception of Indonesia, short-term nominal interest rates now range from 1.4% in Singapore to 6.2% in the Philippines and short-term real interest rates range from 0.8% in Malaysia to 4.7% in the PRC (Figures 14 and 15).

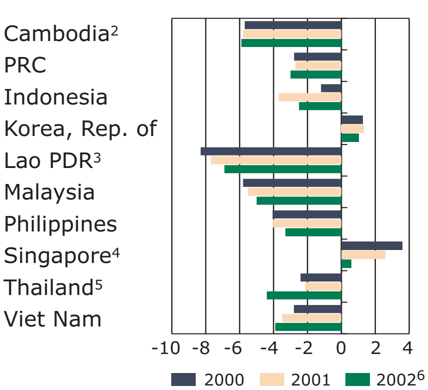
Except in Korea and Singapore, this year's fiscal policy stance has been moderately expansionary in several countries, most of which have budgeted for fiscal deficits (Figure 16). For instance, the PRC has maintained its moderately expansionary fiscal stance of recent years, with a budgeted fiscal deficit of 3% of GDP. Among the crisis-affected

Figure 15: **Short-Term Interest Rates**[1] (real, %)



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

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



[1]Data refer to central government for Cambodia, PRC, Indonesia, Korea, Myanmar, Philippines, Singapore, Thailand, and Viet Nam; general government for Lao PDR; and federal government for Malaysia.
[2]Excludes grants.
[3]Excludes grants and for fiscal year ending September.
[4]Data are for fiscal year April-March. Revenues include Net Investment Income Contribution and the surplus/deficit excludes special transfers.
[5]Data are for fiscal year October-September.
[6]Based on programmed budget.
Source: ARIC Indicators; IMF country reports (various issues).

countries excluding Korea, this year's budgeted fiscal deficits range from 2.5% of GDP in Indonesia to 5% in Malaysia. Budgeted fiscal deficits in other Association of Southeast Asian Nations (ASEAN) member countries, such as Lao PDR and Cambodia, are higher. Even in Singapore, where the Government programmed for a surplus in the budget, that planned for the fiscal year April 2002 to March 2003 was lower than last year's.

Coupled with lower interest rates, these moderate expansionary fiscal policies have supported robust growth in domestic demand, although the extent has varied across countries. This is not only due to the variations in the original fiscal stances but also because of the differences in the actual fiscal outturn during the course of the year compared to the original fiscal program.

In the first six to eight months of the fiscal year, actual fiscal developments were more or less on track in Malaysia (as well as in Singapore in the first three months of the fiscal year) in the sense that expenditures and revenues were moving roughly in line with budgeted levels for the year. But actual fiscal developments diverged significantly from their budgeted levels elsewhere. In the Philippines, for example, actual expenditures were more or less on track with budgeted levels but actual revenues fell significantly short of budgeted levels. As a result, the fiscal deficit in the first seven months has turned out to be greater than the full year target. The Philippines' fiscal position has, thus, turned out in the first eight months to be more expansionary than planned.

The opposite is the case in the PRC, Indonesia, and Thailand, while Korea has tended to be contractionary. In the first eight months of the year, revenues in Korea grew faster than originally planned (due to revenues from privatization and surplus budget transferred from the Bank of Korea), while expenditures grew slower than planned, resulting in a surplus (W23.3 trillion) that was about four times the full year target. In the PRC, expenditures and revenues both grew faster than planned. However, since revenues grew much faster than expenditures (compared to their expected rates of growth in the budget), in the first seven months of the year the budget, in fact, posted a surplus of CNY34 billion as compared to the full year deficit target of CNY310 billion. Thailand's experience was similar to that of the PRC: in the first 11 months of the fiscal year (running from October 2001 to September 2002), revenues and expenditures both grew faster than planned. But revenues grew faster than expenditures, mainly due to an improved economy and policies to enhance tax collection efficiency. The actual fiscal deficit amounted to about 2% of GDP, below the level planned in the budget. Meanwhile, in Indonesia, revenues and expenditures both increased at a slower pace than budgeted. But since the pace of expenditures was slower than that of revenues, the actual fiscal deficit in the first six months was less than one fifth the level planned for the full year.

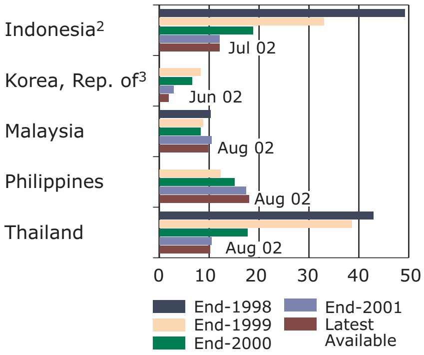
Progress in Financial and Corporate Restructuring and Reforms

Nonperforming Loans, Capital Adequacy, and Bank Profitability

In recent months, nonperforming loan (NPL) ratios in commercial banks' balance sheets have declined in Korea, Malaysia, Philippines, and Thailand, and increased marginally in Indonesia (Figure 17). The NPL ratios in the balance sheets of banks are now below 2% in Korea, about 10% in Malaysia and Thailand, 12% in Indonesia, and 18% in the Philippines.

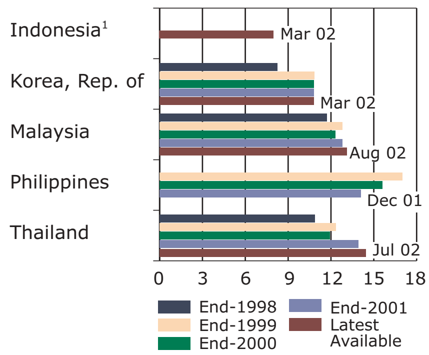
Capital adequacy ratios (CARs) have been maintained at or above the 8% Basel norm in all the five crisis-affected countries (Figure 18). CARs are now within the 10–15% range in Thailand, Philippines, Malaysia, and Korea. Indonesia, which has lagged behind the other four countries in re-capitalizing banks, has a CAR of about 8%. Between end-2001 and now, CARs have increased marginally in Malaysia and Thailand, but remained unchanged in Korea.

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



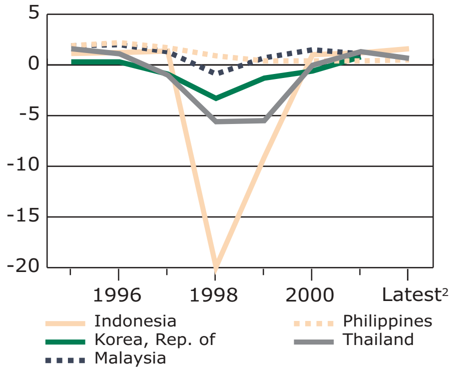
[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis in Malaysia, and three months or more in Korea and Thailand.
[2]Refer to NPLs in banking sector.
[3]NPL criteria were changed in December 1999, so no comparable data are available prior to that date.
Source: ARIC Indicators.

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



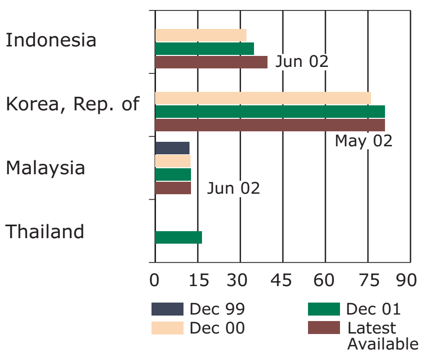
[1]Refers to CAR of the banking system.
Source: ARIC Indicators.

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



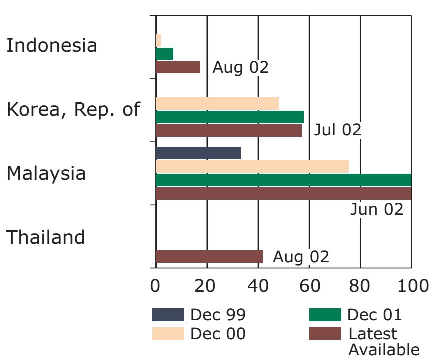
[1]Data refer to return on assets of commercial banks, with the exception of Malaysia, which refers to the banking/financial system.
[2]Latest data refer to annualized estimates: Indonesia (May 2002), Philippines (March 2002), Thailand (June 2002).
Source: Web sites of Bank Negara Malaysia, Bank of Indonesia, Bangko Sentral ng Pilipinas, Bank of Thailand, Financial Supervisory Service Korea.

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



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

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



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

Having recovered from their low, and often negative, levels during the crisis years, profitability of banks is now consolidating in all the five crisis-affected countries. Latest available data suggest that their bank profitability is now in the range of 0.5% to 1.6% (Figure 19).

Asset Disposal by Asset Management Companies

Centralized asset management companies (AMCs) have played a crucial role in reducing NPLs in bank balance sheets in four of the five crisis-affected countries—Indonesia, Korea, Malaysia, and Thailand. Backed by public funding, the AMCs purchased large amounts of bad loans from troubled financial institutions, often at substantial discounts. The Philippines has not established an AMC, which is reflected in the relatively high NPL ratios in its banking system. However, the Government is working on a bill to promote asset securitization and the creation of specially designed AMCs or special purpose vehicles to clean up the balance sheets of banks.

As of mid-2002, the volume of NPLs transferred from banks and other financial institutions to AMCs ranged from $12.6 billion in Malaysia to $81 billion in Indonesia (Figure 20). The progress in asset disposal by these AMCs has varied widely, with those in Malaysia and Korea the frontrunners (Figure 21). In Malaysia, Danaharta has either restructured or approved for restructuring all the assets that it acquired from banks. Danaharta is expected to turn in a profit by 2005 when it will be dissolved. As of May this year, the Korea Asset Management Corporation (KAMCO) had disposed of about 60% of the assets under its management at an average recovery rate of 46%. By the end of this year, KAMCO will stop purchasing NPLs. In Thailand, the percentage of assets resolved by the Thai Asset Management Corporation (TAMC) is somewhat lower. But considering that TAMC is only about a year old, the 41% asset resolution that it had achieved by August this year is impressive. Asset disposal by Indonesia's AMC—the Indonesian Bank Restructuring Agency (IBRA)—has progressed much slower than in other countries. By August this year, IBRA had disposed of only about 17% of the assets taken over from banks. However, the completion of a first major sale of NPLs, worth Rp82 trillion, which was sold for Rp23 trillion, in July this year suggests that Indonesia's pace of asset disposal is picking up.

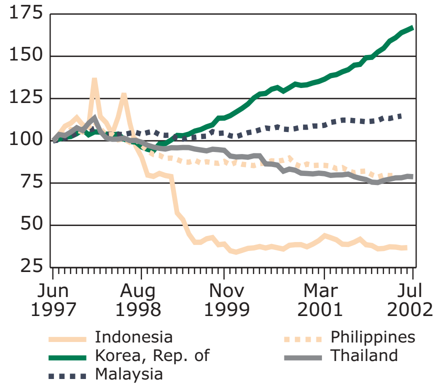
Bank Consolidation / Divestment

During the first three quarters of this year, bank consolidation and divestment have continued to progress in several countries. In Korea, the Public Fund Oversight Committee selected Hana Bank as purchaser of Seoul Bank on 13 September 2002. Accordingly, Hana Bank and Seoul Bank signed the merger contract on 27 September 2002 and are now in the process of merger. The Government and Hana Bank are negotiating the final contract signing details. The merger between Hana Bank, Korea's fifth largest bank, and Seoul Bank would create the country's third biggest bank, with assets of W84 trillion. In Indonesia, Parliament has cleared a plan submitted by the Government in early June for the disposal of the remaining banks held by IBRA. The plan provides for the selling of a 51% stake of Bank Danamon, 59% of Bank Lippo, 30% of Bank Mandiri, and completion of the merger of five small banks (Artamedia, Bali, Patriot, Prima Express, and Universal) in the second half of this year. In the Philippines, the central bank is continuing to impose a moratorium on licenses for new banks to encourage those considering expansion to buy into banks whose shareholders want to exit.

Voluntary Corporate Workout

Corporate restructuring under voluntary workout schemes has also made further progress. In Indonesia, the Jakarta Initiative Task Force (JITF), as of 6 September, had registered 126 corporate restructuring cases with debt value of $29.4 billion, and completed the mediation of 77 cases with debt totaling $16.9 billion. In Malaysia, since March, the Corporate Debt Restructuring Committee (CDRC) has completed an additional four restructuring cases and discharged two cases. A case was withdrawn and another is still pending lenders' approval and will be monitored by Danaharta. In the last few years, CDRC has successfully resolved 47 cases or 98% of those it accepted, with total value of RM43.97 billion. It officially ceased operations in August 2002. In Thailand, as of end-August 2002, the Corporate Debt Restructuring Advisory Committee (CDRAC) had approved 14,850 target debtors with outstanding credit of B2,625 billion to enter the voluntary workout process. Of these approved target debtors, 10,124 cases with credits outstanding of B1,298 billion had been successfully restructured, while 4,661 cases with outstanding credit of B1,162 billion remained unrestructured and subject to court litigation. From 1998 to end-June 2002, financial institutions successfully restructured 512,856 cases with credits outstanding of B2,573 billion. In Korea, a final joint venture agreement for the acquisition of Daewoo Motors by General Motors was reached and a Memorandum of Understanding was signed for the takeover of Hanbo Steel by AK Capital. The restructuring plan of Daewoo Motors, including debt rescheduling, debt conversion to equity, repayment measures, and the splitting of operations, was approved by a Korean court on 30 September, paving the way for General Motors to begin the joint venture and takeover of major operations by mid-October. In the case of Hynix Semiconductor Company, its sale to Micron has not been concluded yet. Hynix and its creditor banks are expected to devise a more detailed restructuring plan based on its due diligence outcome.

Figure 22: **Real Bank Credit[1]—Five Crisis-Affected Countries** (1997June=100), seasonally adjusted



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

Trends in Bank Credit

In Korea and Malaysia—the two countries that have made fastest progress in resolving financial sector NPLs—bank lending has picked up since end-1998. But the stock of bank credit is still below precrisis levels in the other countries (Figure 22). The pickup in bank credit has been particularly sharp in Korea, with real bank credit to private sector now about 70% higher than precrisis levels. In the year to July 2002, bank credit in Korea expanded at an annual rate of 19%. The expansion in bank lending in Korea has been accompanied by a shift in banks' strategy aimed at expanding retail activities, including household loans, and reducing exposure to the over-weighted corporate sector. In Malaysia, the stock of real bank credit to the private sector grew by 3.4% during the year to May 2002, and it is now about 15% higher than precrisis levels. In contrast to Korea and Malaysia, bank lending continues to be sluggish—although it seems to have stabilized in recent months—in Indonesia, Philippines, and Thailand, as banks are still cautious in lending. The stock of bank credit remains below precrisis levels in these countries, by more than 40% in Indonesia, and by about 20% in the Philippines and Thailand.

Recent Reforms in Supervision and Regulation

This year, measures were taken in the region to further strengthen supervision and regulation of the financial and corporate sectors. These included: (i) the adoption of 25 Basle Core Principles for Effective Banking Supervision in Indonesia, (ii) the establishment of a Task Force on Corporate Disclosure Best Practices in Malaysia, and (iii) the decision to adopt the Fair Disclosure Rule by November 2002 to significantly narrow or even eliminate information asymmetry among market participants and raise market transparency in Korea. The Financial Sector Restructuring Policy Committee in Indonesia is also taking measures to improve asset sales by IBRA, while the Korean Government is working on a comprehensive corporate liquidation and restructuring bill, which will consolidate the three existing bankruptcy laws, including those involving liquidation and court mediation. Several other countries in the region have also been pursuing the restructuring and reform of their financial sectors (see Box 3).

Box 3: **Financial and Corporate Restructuring in Other East Asian Countries**

Several of the other countries in the region have been pursuing reforms in the financial and corporate sectors. In Cambodia, bank restructuring has three main components: (i) relicensing of privately owned banks, (ii) reforming and eventually privatizing the government-owned Foreign Trade Bank (FTB), and (iii) improving bank supervision. The bank restructuring process has been completed, with 15 banks closed, 14 banks awarded a full banking license, and four banks granted a license to operate as specialized banks. The FTB reform is continuing and a draft reorganization plan is being put into operation. A public announcement to privatize the bank is expected by end-November 2002. To improve bank supervision, the Government adopted new prudential regulations on lending by connected parties in June 2002, and submitted the Law on Negotiable Instruments and Payment Transactions to the Council of Ministers also in June 2002. Other measures, including CAMEL and prompt corrective action systems, surveillance and inspection procedures, and prudential regulations on risk management and risk control have been adopted effective September 2002.

In the PRC, NPLs of four State-owned banks are declining slowly but steadily. From a peak of 29.2% of total loans at end-2000, the NPL ratio fell to 23.1% in June this year. Through end-2001, asset management companies have sold about 13% of the NPLs they acquired from the banks, with an average cash recovery rate of 21%. The Government requires the banks to reduce the NPL ratio to less than 15% by end-2004. To minimize the emergence of new NPLs, it adopted new measures to tighten bank credit and supervision. In early 2002, a new loan classification system and provisioning requirements consistent with international best practice were introduced, having been tried on a pilot basis earlier. The Government also introduced in early 2002 an official code of conduct for listed companies, which lays down the basic principles for corporate governance.

In Lao PDR, NPLs reported by State commercial banks (SCBs) are estimated at about 52% of total loans at end-2000. At end-2001, NPLs on new lending (since 1 January 2000) are calculated at 20–25% for Banque pour le Commerce Exterieur de Laos (BCEL) and Lang Xang Bank (LXB), and 70% for Lao May Bank (LMB). The three SCBs are technically insolvent by a wide margin. Financial restructuring plans for the banks include the consolidation of LXB and LMB into a new bank, and a recapitalization program for SCBs over four years starting in September 2002 through treasury instruments. The government-funded recapitalization will be limited to NPLs as of end-1999, which amount to $50 million or about 3% of GDP. The banks will build up their capital to eventually reach a capital adequacy ratio of 12%. NPL recovery will target large defaulters and will be accompanied by comprehensive restructuring programs for large State-owned enterprises.

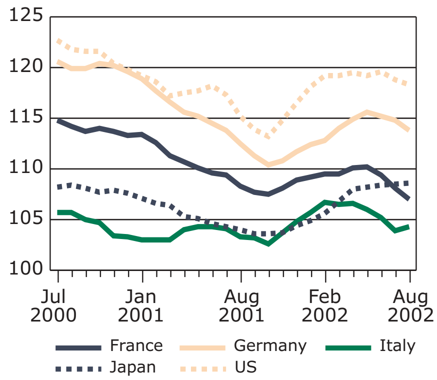
In Viet Nam, reforms are focusing on restoring the financial health of State-owned commercial banks (SOCB) by putting them on a commercial footing, strengthening credit risk management, and controlling NPLs. An overall SOCB restructuring framework, adopted in March 2001, provided for a phased and conditional recapitalization based on milestones in terms of quantitative NPL resolution and performance targets. To help assess the true size NPLs, external audits of the financial statements of the large SOCBs for 2000 are being undertaken, and will be followed by International Accounting Standards (IAS) audits of the 2001 financial statements. About D1.5 trillion of NPLs had been resolved at a discount rate of around 50% by end-March 2002. Banks are now required to resolve at least D3.5 trillion in NPLs on a cumulative basis by end-September 2002.

Prospects for East Asia's Growth and Recovery

External Economic Environment

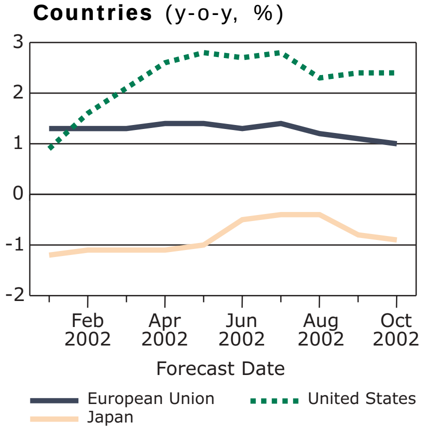
Since the release of the July 2002 AEM, the external environment facing East Asia has turned less favorable. With the exception of Japan, leading indicators for most industrial countries have trended downward in recent months, suggesting moderation in their growth prospects

Figure 23: **OECD Leading Indicators**



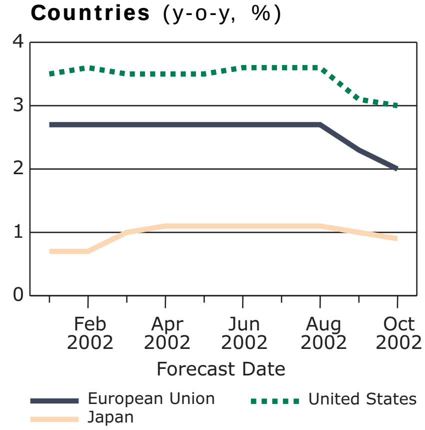
Source: OECD web site.

Figure 24: **Consensus Forecasts of 2002 GDP Growth—Industrialized Countries** (y-o-y, %)



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

Figure 25: **Consensus Forecasts of 2003 GDP Growth—Industrialized Countries** (y-o-y, %)



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

(Figure 23). Forecasts for most industrial countries for this year, and—more important—for next year, have been revised down as a result. The current global economic rebound is expected to continue, but at a more moderate pace than was foreseen a few months ago.

The optimism prompted by rapid first quarter growth in the US has subsided somewhat. This is partly because growth has fallen short of expectations in the second quarter. Also, there has been a host of less than encouraging signals from the US in recent months. Although US productivity growth remains strong, the stock market is continuing to slide, consumer confidence is deteriorating, business sentiment and investment are weakening, while industrial production is decelerating. Jobless claims are also increasing, and even new residential construction figures are starting to flag. Most forecasters have now revised down their US growth forecasts for both this year and the next. In its October 2002 survey, Consensus Economics placed the mean forecast of 2002 US GDP growth at 2.4%, down from the forecast of 2.7% in its June survey (Figure 24). The corresponding downward revision in the forecast of US 2003 GDP growth is from June's 3.6% to 3% in October (Figure 25). The International Monetary Fund (IMF) in its September 2002 *World Economic Outlook* (WEO) placed its US 2002 GDP growth forecast at 2.2%, marginally lower than its April 2002 figure of 2.3%. However, citing downward trends in several leading indicators of US economic activity, including the continued slide in the stock market and the weaknesses in consumer confidence and business investment, IMF made a larger downward revision to its 2003 GDP growth forecast, from 3.4% in April to 2.6% in September.

Exports have provided the impetus to European economic growth in recent quarters. As the US is a major export market for some of the big European economies such as Germany, France, Italy, and the United Kingdom, the downward revision of the US growth outlook has adverse implications for their growth prospects. Moreover, in Germany, the largest economy in Europe, domestic demand (both consumer spending and business investment) continues to be sluggish. The October 2002 survey of Consensus Economics forecasts GDP growth in the European Union of 1% in 2002 and 2% in 2003. These forecasts are lower than those of 1.3% and 2.7% in its June Survey. The IMF's September forecasts of European Union growth are similar: 1.1% for 2002 (down from the April forecast of 1.5%) and 2.3% for 2003 (down from the April forecast of 2.9%).

In the second quarter of this year, Japan's economy emerged from last year's recession. More recently, however, signals from the world's second largest economy have been mixed. For example, leading indicators of economic activity have trended up in recent months. However, in September 2002 there was a downward revision to the country's first quarter GDP growth (from the initial estimate of 1.4% to close to zero growth). In addition, a recent Tankan Survey shows only a marginal improvement in business among large manufacturers. These developments have raised concerns that economic performance continues to be weak. Moreover, with domestic demand subdued, whatever growth the country has achieved in recent quarters has been driven by exports. As in the case of Europe, the downward revisions of US growth prospects could thus impinge on growth in Japan. Reflecting some of these trends, in its October 2002 survey, Consensus Economics placed GDP growth forecasts for 2002 at –0.9% (lower than the June forecast of –0.4%) and for 2003 at 0.9% (marginally lower than the April forecast of 1.1%). IMF's September 2002 WEO places the GDP growth forecast for 2002 at –0.5% (compared to its April forecast of –1%) and the forecast for 2003 at 1.1% (higher than its April forecast of 0.8%).

IMF's September 2002 forecasts of average GDP growth (using purchasing power parity GDP weights for countries) for the major industrial countries (mainly US, Japan, and some European Union countries) (G3) work out to 1.4% for 2002 (almost the same as its April forecast) and 2.3% for 2003 (lower than its April forecast of 2.8%). The volume of world trade is now forecast to grow by 2.1% in 2002 (compared to the April forecast of 2.5%) and by 6.1% in 2003 (compared to the April forecast of 6.5%).

Regional Economic Outlook

The recent worsening of the external environment, including downward revisions to industrial country growth forecasts, raises concerns about the sustainability of the region's current economic rebound. This is especially so given that industrial countries constitute a major source of growth for the region. However, three sets of factors suggest that East Asia's modest rebound is likely to continue.

First, despite the sharp fall in industrial country stock markets, the recent downward revisions to forecasts of growth and imports are relatively modest, as seen in the IMF figures above. As for downward revisions by other forecasters, while October Consensus Economics forecasts of growth among G3 countries for this year are lower than those issued in June, they are still better than the corresponding March forecasts (except for the European Union) (Figures 24 and 25). Also, US information technology (IT) expenditure surveys point to slower growth in overall spending both this year and the next. However, spending on hardware products, which matter more for East Asia, is expected to continue to outperform spending on software and other IT products. Therefore, a slowdown in industrial country growth may soften East Asia's export growth somewhat, but it would remain relatively healthy.

Second, domestic demand has held up well and supported the economic rebound across the region. The progress made in financial and corporate sector reforms and restructuring leading to healthier banking sectors should support domestic demand. Moreover, macroeconomic conditions in several East Asian countries are such that there is reasonable scope for further easing of fiscal and monetary policies, if necessary.

There are significant excess production capacities across the region. Except for Indonesia, inflation remains tame. Most countries continue to run current account surpluses on their external balance of payments and hold sizable foreign exchange reserves. Asset prices, including stock price indexes, remain depressed following the bursting of the asset price bubble during the crisis years of 1997 and 1998. Nominal and real interest rates are still significantly above those in the US across the region. As for the fiscal response, except in Indonesia and the Philippines (and to a lesser extent Thailand), there is enough latitude to ease fiscal policy should the need arise. On all these counts, there is scope for supporting domestic demand by further easing of fiscal and monetary policies in most East Asian countries.

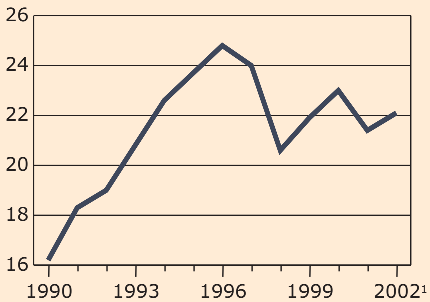
Third, current projections indicate an improvement in private capital inflows to the region, especially next year. For example, IIF is forecasting an increase in net private capital inflows to the five crisis-affected countries, from about $10 billion this year to $14 billion in 2003. All the major components of capital flows—direct equity investment, portfolio investment, and net private credit—are poised to increase (see Box 2).

In recent months, several analysts have also suggested that intra-regional trade could provide another cushion to any slowdown in the region's exports to the G3. Although the share of intra-regional trade in East Asia's total trade has been increasing slowly in recent years, it is still correlated with exports to G3 and is, therefore, expected to provide only a limited cushion to any sharp deterioration in the region's exports to the G3 (see Box 4).

Box 4: **Intra-Regional Trade: Can it Cushion an Export Slowdown to G3?**

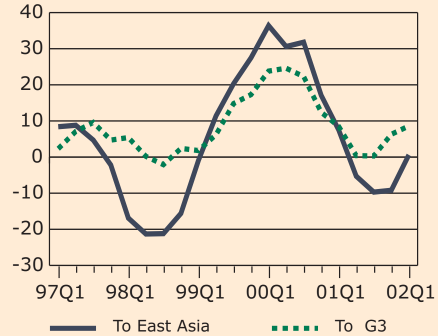
The share of intra-regional exports of East Asia increased from 16% in 1990 to 25% in 1996 (Figure 4.1). In the immediate aftermath of the 1997 crisis, it had dropped to 21% in 1998, but has slowly climbed again, reaching about 22% by the first quarter of this year. Intra-regional exports have now either regained lost ground or even exceeded precrisis levels in most major countries of the region. In the first quarter of this year, East Asia's intra-regional exports, including exports to Japan, stood at 36%, as compared to about 40% before the crisis and about 33% in 1998 at the height of the Asian crisis.

Figure 4.1: **Intra-regional Exports of East Asia** (% of total exports)



[1]As of 2002Q1.
Source: REMU staff calculations based on data from *Direction of Trade Statistics* (IMF, August 2002).

Figure 4.2: **Growth of East Asia's Exports** (y-o-y, %)



Source: REMU staff calculations based on data from *Direction of Trade Statistics* (IMF, August 2002).

At face value, these recent increases in intra-regional export shares appear encouraging, since they could provide a cushion against a drop in exports induced by a slowdown in growth in the G3 countries: US, Japan, and the European Union. For this to be true, most of this trade would have to be in final goods and not intermediate products. Various analysts have noted that a significant portion of intra-regional trade consists of intermediate and processed goods, which are exported intra-regionally for further processing or assembly before being re-exported to final destinations outside the region. If this is the case, then demand in G3 countries will continue to be the main driver of intra-regional trade. As a derived demand, intra-regional exports would not have their own momentum or be independent of the trends in exports to the G3. A close correlation between intra-regional exports of East Asia and its exports to the G3 suggests that this indeed is the case (Figure 4.2). Moreover, a regression of each country's intra-regional imports (from East Asia) on its exports to the G3 (covering the period 1997Q1 to 2002Q1) yielded statistically significant and positive (mostly unitary) coefficients for most major countries in the region.

Overall, although East Asia's intra-regional trade is rising slowly, it is still highly correlated with the region's exports to the G3. It is, therefore, expected to provide only a limited cushion to any sharp deterioration in the region's export prospects to the G3.

Overall, therefore, at this stage there are no compelling reasons to drastically revise growth forecasts across the region, although some downward revisions of growth forecasts for next year, especially for the more open economies in the region, are in order.

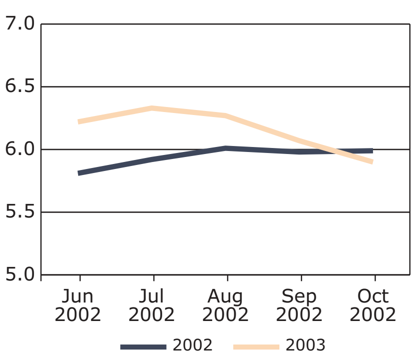
Consensus Economics, thus, forecasts East Asia's GDP growth to reach 6% in 2002 and 5.9% in 2003. Except for some minor country differences, these forecasts differ only slightly from its June forecast of 5.8% for this year and 6.2% for 2003 (Table 1 and Figure 26). Excluding the PRC, the region is now forecast to grow at 4.9% this year (compared to the 4.8% forecast of June) and the next (compared to the 5.3% forecast of June).

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

						October 2002 Forecasts				Difference[1]		Average	
	1997	1998	1999	2000	2001	2002		2003		2002	2003	1987–1996	1998-2002
						Mean	Low/High	Mean	Low/High				
Brunei Darussalam	3.6	-4.0	2.6	2.8	1.5	3-4	. . .	. . .	. . .	. . .	. . .	1.4	1.3
Cambodia	3.7	1.5	6.9	7.7	6.3	5.0		6.0		0.5	-0.1	6.2	5.4
China, People's Rep. of	8.8	7.8	7.1	8.0	7.3	7.7	7.5/8.0	7.5	7.0/8.3	0.3	-0.2	10.0	7.5
Indonesia	4.7	-13.1	0.8	4.9	3.3	3.5	2.5/3.9	4.0	3.4/4.8	0.1	-0.2	7.6	-0.1
Korea, Rep. of	5.0	-6.7	10.9	9.3	3.0	6.1	5.8/6.5	5.6	4.1/7.6	0.0	-0.4	8.1	4.5
Lao PDR	6.9	4.0	7.3	5.8	5.7	5.8	. . .	5.8	. . .	0.0	-0.3	5.2	5.7
Malaysia	7.3	-7.4	6.1	8.3	0.4	4.2	3.7/5.1	5.2	4.0/6.7	0.1	-0.5	9.1	2.3
Myanmar	5.7	5.8	10.9	6.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	2.7	. . .
Philippines	5.2	-0.6	3.4	4.4	3.2	4.0	. . .	3.8	. . .	0.2	-0.5	3.7	2.8
Singapore	8.5	-0.1	6.9	10.3	-2.0	3.8	3.0/4.8	4.7	2.5/6.0	-0.4	-1.1	9.1	3.9
Thailand	-1.4	-10.5	4.4	4.6	1.8	4.3	3.5/5.2	4.0	3.0/4.7	0.6	-0.2	9.5	0.8
Viet Nam	8.2	4.4	4.7	6.1	5.8	5.9	. . .	6.4	. . .	-0.1	-0.3	7.0	5.4
East Asia[2]	6.2	-1.4	6.9	7.6	4.3	6.0	. . .	5.9	. . .	0.2	-0.3	8.8	4.7
East Asia exc. PRC[2]	4.5	-7.3	6.8	7.4	2.4	4.9	. . .	4.9	. . .	0.1	-0.4	8.0	2.8
ASEAN[2]	4.2	-7.8	3.7	6.0	1.9	4.0	. . .	4.3	. . .	0.2	-0.4	8.0	1.5
Five Crisis-Affected	4.1	-8.2	6.8	7.2	2.7	5.0	. . .	4.8	. . .	0.1	-0.3	8.0	2.7

. . . = not available
[1]Difference from July 2002 AEM which uses June 2002 Consensus Economics forecasts.
[2]Exclude Brunei Darussalam and Myanmar.
Source: Asian Development Bank, *Asian Development Outlook Update 2002,* October 2002; official sources; Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* October 2002; Department of Economic Planning and Development, *Brunei Darussalam Statistical Yearbook 1999* and *Brunei Economic Bulletin*, January 2002.

Figure 26: **Consensus Forecasts[1] of 2002 and 2003 GDP Growth—East Asia[2]** (y-o-y, %)



[1]Based mainly on Consensus Economics forecasts, but for small countries, *Asian Development Outlook* and IMF country reports were used.
[2]East Asia includes ASEAN countries (except Brunei Darussalam and Myanmar) plus PRC and Korea.
Sources: Consensus Economics Inc., *Consensus Forecasts,* various issues; Asian Development Bank, *Asian Development Outlook Update 2002,* October 2002; IMF country reports (various issues).

With an expected growth of 7.7% this year and 7.5% next year, the PRC will continue to be the fastest growing country in the region. This year's growth forecast is slightly higher (by 0.3 percentage point) than the June forecast, whereas next year's forecast is more or less unchanged. Growth is likely to be driven by a combination of strong export growth and continued strength in domestic demand. According to the latest Consensus Economics survey, the dollar value of the PRC's merchandise exports is forecast to grow at 15% this year and at 13% next year (compared to the 6.8% actual growth in 2001). These figures are an improvement on the June Consensus forecasts (11% for this year and 12% for next year). Underpinned by strong consumer confidence, nominal retail sales are expected to maintain a growth momentum of about 9% both this year and the next, while a stable business investment climate will help maintain robust growth in domestic investment. Domestic demand could get a further boost if the Government continues fiscal stimulus measures seen in recent years and the central bank eases monetary policy in the coming months. Neither of these developments can be ruled out with the country continuing to experience deflation.

Helped by strong domestic demand and export growth, Korea's GDP is likely to grow at 6.1% this year—a forecast unchanged from that of June. Forecasts of personal consumption growth for this year, however, have been revised up from June. But those of export growth have been marked down, while fixed investment remains largely unchanged. Personal consumption is expected to grow by about 7% this year. However, the 6.4% growth forecast for merchandise exports (dollar values) is marginally lower than the June forecast, although still substantially higher than the 14% decline last year. Meanwhile, exports are likely post 8% growth next year. However, a moderation in personal consumption and fixed investment is likely to lead to a slowdown in GDP growth to 5.6% next year. With core inflation remaining below 3% and only a modest public debt, Korea has ample scope for boosting domestic demand and growth by easing fiscal and monetary policies, should the need arise. At this stage, however, with a balanced budget target, the proposed budget for next year is taking a conservative stance.

Among the region's economies, Singapore was affected the most by last year's global slowdown, with GDP contracting by 2%. Following a turnaround in export growth (from –12% last year to about 4% this year) and modest help from better domestic demand conditions, Singapore's economy is forecast to grow at 3.8% this year. This is 0.4 percentage point lower than Consensus Economics' June forecast, mainly due to a downward revision of this year's export growth and fixed investment growth. Going forward, GDP growth should strengthen to 4.7% next year, with exports growing at about 9%, and private consumption and fixed investment moving more or less in tandem with improvements in export prospects. But as the most open economy in the region, Singapore would be more sensitive to worsening external economic conditions than other countries.

The 4.2% growth forecast for this year constitutes a significant improvement from last year's near-zero growth in Malaysia. It is also marginally higher than Consensus Economics' June forecast. This year's growth is being driven by a combination of pickup in exports and domestic demand. The dollar value of exports is expected to grow at more than 5% (up from a 10.6% contraction last year and Consensus Economics' June forecast of 4.7%). A modest rise in private consumption growth (from 2.8% last year to 4.3% this year) and fixed investment growth (from –2.8% to 1.7%) will complement the export-driven turnaround. Robust export growth (of about 9%) and improvements in private consumption (5.9%) and fixed investment (5.8%) are expected to underpin a modest acceleration of GDP growth to 5.2% next year. Like Singapore, Malaysia's economy is highly open to international trade, hence its growth prospects would be quite sensitive to any changes in the external economic environment over the coming months. However, with a comfortable fiscal situation and low inflation, Malaysia has enough leeway to support domestic demand and growth by easing fiscal and monetary policies in the immediate future.

GDP is forecast to grow at 4% this year in the Philippines. This is marginally better than the June forecast of 3.8%, and at the lower end of the Government's revised growth target of 4%–4.5%. Better-than-expected growth in the second quarter, the continued strength of exports, and a rise in private consumption underpin this upward revision. Growth is expected to be marginally lower next year. With inflation at historically low levels and the current account still in surplus, there is some scope for further easing of monetary policy to offset any moderate export slowdown. However, given this year's overshooting of the fiscal deficit target, any relaxation of fiscal policy could be perceived negatively by international investors and markets. Under the circumstances, Philippines is likely to be constrained in using fiscal policy to spur domestic demand and growth, should exports start slowing in the months ahead.

Consensus Economics is now forecasting this year's GDP growth in Thailand to be 4.3%, which is 0.6 percentage point higher than its June forecast. A pickup in exports and fixed investment and the continued strength in private consumption underpin this upward revision, along with the better-than expected growth outturn in the second quarter. For this year, forecasts of growth in the three key components of demand—exports, private consumption, and fixed investment—have now been revised up from the June forecasts. Exports are expected to grow at 4.3% (up from the 3.2% June forecast and the 7% contraction suffered last year), growth in fixed investment should be closer to 6% (improving on its less than 1% expansion last year), while private consumption is forecast to grow at 4% (slightly better than last year's 3.4% figure). Going into 2003, private consumption is projected to maintain this year's tempo, whereas export growth is likely to improve to about 7%. However, a moderation in fixed investment growth is expected to offset the effect on GDP of a better export growth. GDP next year is forecast to grow at the same pace as this year, as a result. With inflation remaining tame and the current account continuing to post a surplus, there is scope for easing fiscal and monetary policies to spur growth, although the rise in public debt in recent years might limit the extent to which fiscal policy can be eased for long.

At 3.5%, Indonesia's GDP growth forecast for this year is more or less unchanged from June. The main driver of this year's growth is likely to be private consumption, which is expected to grow at about 5%, while fixed investment is forecast to remain stagnant (compared to the 2.5% June forecast as well as last year's 4% actual expansion). Going into 2003, a pickup in fixed investment (forecast to grow at 5%) and exports (forecast to expand by more than 7%), and a mild deceleration in private consumption are expected, yielding a GDP growth forecast of 4%. Unlike several other countries in the region, Indonesia is constrained in using fiscal and monetary policy levers to spur growth, as the country has a public debt to GDP ratio of close to 100%, inflation is running above 10% per annum, and the fiscal burden of financial sector restructuring is sizable.

Among the other economies in the region, Viet Nam is expected to post robust GDP growth rates of 5.9% this year and 6.4% next year (both forecasts from Consensus Economics), while Cambodia is forecast to grow by 5% this year and by 6% next year. Meanwhile, Lao PDR is forecast to grow by 5.8% both this year and the next.

These Consensus Economics forecasts of GDP growth for this year as well as the next compare reasonably well with the September 2002 forecasts from the Asian Development Bank (ADB) as well as those from IMF, although some country-specific differences are noticeable (Figure 28).

Risks to Regional Growth and Recovery

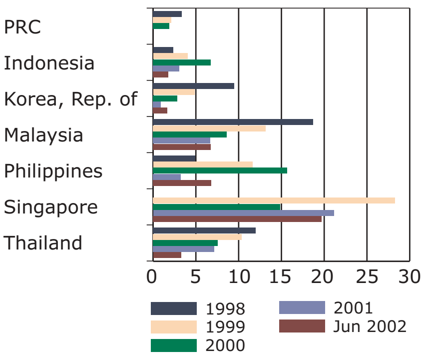
The modest rebound scenario for East Asia is, however, subject to a higher degree of uncertainty now than in July, with most of the external risks on the downside.

The July AEM had noted that with the maintenance of political stability and improvements in prudential indicators in most countries in the region, domestic risks to East Asia's current rebound have been

Figure 28: **Comparative 2002 and 2003 GDP Growth Forecasts for East Asian Countries** (%)

Note: For official estimates, the lower range of GDP forecasts is shown.
CE = Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* October 2002.
ADB = Asian Development Bank, *Asian Development Outlook 2002,* October 2002.
WB = World Bank, *East Asia Update,* April 2002.
IMF = International Monetary Fund, *World Economic Outlook,* September 2002.

Figure 29: **Current Account Balance** (% of GDP)

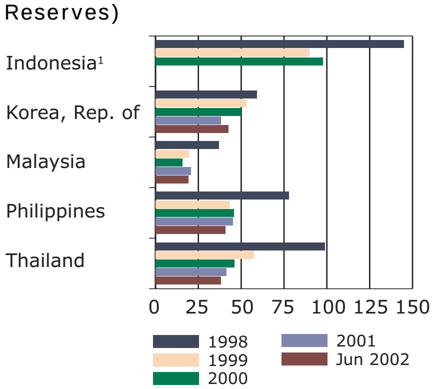


Source: ARIC Indicators.

receding. There have been increased risks in recent months, including the threat of adverse weather from an El Niño (for economies with a significant share of agriculture in GDP such as Indonesia, Lao PDR, Philippines, and Viet Nam) and aftermath from the bomb explosion in Bali. But the July assessment of domestic risks still largely holds good: (i) all the major countries in the region will continue to run current account surpluses Figure 29); (ii) foreign exchange reserves have improved significantly and more than cover the entire short-term external debt (Figure 30); (iii) the short-term to total external debt and total external debt to GDP ratios are lower than those at the height of the 1997 crisis (Figures 31 and 32); and (iv) banking sectors in the region are slowly returning to health, although there are still substantial remaining agenda of reforms in the financial and corporate sectors.

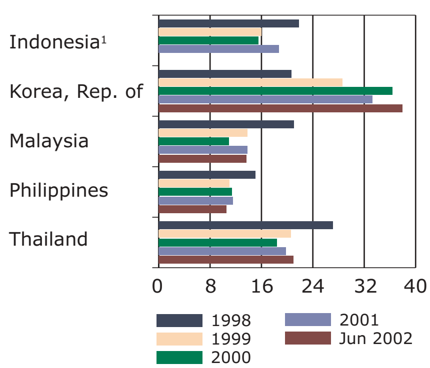
Reflecting many of these developments, international credit rating agencies have improved their assessments for several countries (Table 2). Following Moody's upgrade of Korea's long-term sovereign credit rating on 28 March 2002, Standard and Poor's upgraded Korea's sovereign rating to "A-" on 24 July 2002. This was followed by Fitch's upgrade of Indonesia to "B" on 1 August and Standard and Poor's upgrade to "CCC+" on 5 September. Also, all three international rating agencies upgraded their ratings of Malaysia: Fitch and Standard and Poor's to "BBB+" on 7 August and 20 August, respectively, and Moody's to "Baa1" on 24 September. Although Thailand's rating has not been upgraded, the outlook for the country was changed from "negative" to "positive" by Standard and Poor's on 20 August, and from "stable" to "positive" by Fitch on 10 October.

Figure 30: **Short-Term External Debt** (% of Gross International Reserves)



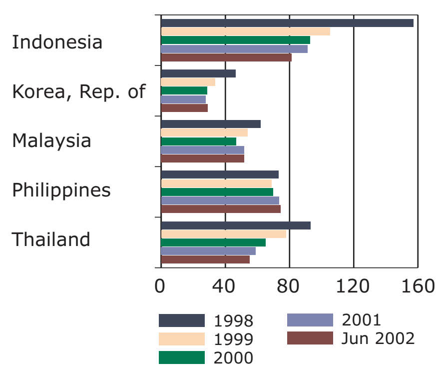
[1]Data for 2001 as of June 2001.
Source: ARIC Indicators, except for Indonesia which are taken from Nomura International and Bisnis Indonesia.

Figure 31: **Short-Term External Debt** (% of Total External Debt)



[1]Data for 2001 is as of June 2001.
Source: ARIC Indicators, except for Indonesia which are taken from Nomura International and Bisnis Indonesia.

Figure 32: **Total External Debt** (% of GDP)



Source: ARIC Indicators, except for Indonesia which are taken from Nomura International and Bisnis Indonesia.

Table 2: **Foreign Currency LT Sovereign Credit Ratings**[1]

	Item	PRC		Indonesia		Korea		Malaysia		Philippines		Singapore		Thailand		Viet Nam	
Moody's	Current Outlook	Stable	8-Aug-02	Positive	24-Apr-02	Stable	28-Mar-02	**Stable**	**24-Sep-02**	Stable	3-Feb-02	Stable	14-Jun-02	Stable	22-Jun-00	Positive	17-Jun-02
	Ratings	A3	10-Sep-93	B3	20-Mar-98	A3	28-Mar-02	**Baa1**	**24-Sep-02**	Ba1	18-May-97	Aaa	14-Jun-02	Baa3	22-Jun-00	B1	9-Jul-98
		Baa1	8-Nov-89	B2	9-Jan-98	Baa2	16-Dec-99	Baa2	17-Oct-00	Ba2	12-May-95	Aa1	18-Jan-96	Ba1	21-Dec-97	Ba3	17-Apr-97
		A3	18-May-88	Ba1	21-Dec-97	Baa3	12-Feb-99	Baa3	14-Sep-98	Ba3	1-Jul-93	Aa2	24-May-94	Baa3	27-Nov-97		
				Baa3	14-Mar-94	Ba1	21-Dec-97	Baa2	23-Jul-98			Aa3	20-Sep-89	Baa1	1-Oct-97		
						Baa2	10-Dec-97	A2	21-Dec-97					A3	8-Apr-97		
						A3	27-Nov-97	A1	15-Mar-95					A2	1-Aug-89		
						A1	4-Apr-90										
						A2	18-Nov-86										
Standard & Poor's	Current Outlook	Stable	20-Jul-99	**Stable**	**5-Sep-02**	**Stable**	**24-Jul-02**	**Stable**	**20-Aug-02**	Stable	4-Apr-02	Stable	16-Mar-01	**Positive**	**20-Aug-02**	Stable	28-May-02
	Ratings	BBB	20-Jul-99	**CCC+**	**5-Sep-02**	**A-**	**24-Jul-02**	**BBB+**	**20-Aug-02**	BB+	21-Feb-97	AAA	6-Mar-95	BBB-	8-Jan-98	BB-	28-May-02
		BBB+	14-May-97	SD	23-Apr-02	BBB+	13-Nov-01	BBB	11-Nov-99	BB-	2-Jul-93	AA+	6-Sep-91	BBB	24-Oct-97		
		BBB	20-Feb-92	CCC	2-Nov-01	BBB	11-Nov-99	BBB-	15-Sep-98			AA	24-May-89	A-	3-Sep-97		
				CCC+	21-May-01	BBB-	25-Jan-99	BBB+	24-Jul-98					A	29-Dec-94		
				B-	2-Oct-00	BB+	18-Feb-98	A-	17-Apr-97					A-	26-Jun-89		
				SD	17-Apr-00	B+	22-Dec-97	A	23-Dec-97								
				CCC+	31-Mar-99	BBB-	11-Dec-97	A+	29-Dec-94								
				SD	30-Mar-99	A-	25-Nov-97										
				CCC+	15-May-98	A+	24-Oct-97										
				B-	11-Mar-98	AA-	3-May-95										
				B	27-Jan-98	A+	1-Oct-88										
				BB	9-Jan-98												
				BB+	31-Dec-97												
				BBB-	10-Oct-97												
				BBB	18-Apr-95												
Fitch IBCA	Current Outlook	Stable	6-Dec-01	**Stable**	**01-Aug-02**	Stable	27-Jun-02	**Stable**	**7-Aug-02**	Stable	27-Jun-02	Stable	17-Jan-02	**Positive**	**10-Oct-02**	Positive	12-Jun-02
	Ratings	A-	11-Dec-97	**B**	**01-Aug-02**	A	27-Jun-02	**BBB+**	**7-Aug-02**	BB+	8-Jul-99	AA+	18-Nov-98	BBB-	24-Jun-99	BB-	12-Jun-02
				B-	16-Mar-98	BBB+	30-Mar-00	BBB	7-Dec-99					BB+	14-May-98		
				B+	21-Jan-98	BBB	24-Jun-99	BBB-	26-Apr-99								
				BB-	8-Jan-98	BBB-	19-Jan-99	BB	9-Sep-98								
				BB+	22-Dec-97	BB+	2-Feb-98	BBB-	13-Aug-98								
				BBB-	4-Jun-97	B-	23-Dec-97										

Notes: A positive/negative outlook suggests that a long/intermediate-term movement (i.e., an upgrade/downgrade) is likely. A stable outlook means that the rating is not currently subject to change. Those in bold refer to an improvement over a previous rating or outlook.
[1]Please refer to Annex in Regional Overview of the *Asia Recovery Report*, March 2001, for a description of ratings.
Sources: Web sites of Moody's, Standard and Poor's, and Fitch.

On the external front, however, there are two sets of risks that could undermine the current forecasts of a modest rebound in East Asia: (i) much lower growth among industrial countries than expected; and (ii) any US-led military action against Iraq and the associated increase in uncertainty and international prices of oil.

Although the current assessment is that the global economic rebound will be more muted than was earlier anticipated, the world economy is expected to maintain a modest pace of growth both this year and the next. However, risks to this outlook are primarily on the downside. The IMF has expressed concern that the global rebound continues to depend heavily on the outlook for the US, especially with the pickup in Europe not yet self-sustaining and domestic demand growth in Japan likely to remain constrained by banking and corporate difficulties for some time.

IMF has cautioned that the rebound among industrial countries could be much more subdued if: (i) their stock markets slide much further and/or the impact of the recent slide in their stock markets turns out to be greater than presently estimated; (ii) the US housing market, which has held up reasonably well until now, were to suddenly weaken; (iii) domestic demand in Germany, which has a strong influence on the rest of the euro area, weakens further; and (iv) Japan's tentative recovery gets derailed although plans to deal with the bad loan problem and stabilize the economy are expected to be announced by the end of October 2002. Being one of the most globally integrated subregions in the world, East Asia will be adversely affected if any of these downside risks to industrial country growth turns into reality. Not only will the region's export prospects be vastly diminished, but the regional equity markets, which until now have shown some resilience to the global stock market slide, will come under heightened pressure. This, in turn, will adversely affect domestic demand.

A second major risk to East Asia's economic rebound would arise if the US takes military action against Iraq. Apart from the uncertainty about the possible conflict and the damaging consequences for investors across the globe, the first reaction to such an event would be a sharp increase in international oil prices, as happened in 1990 when the Gulf War started. Higher oil prices would hit several East Asian economies in two ways. First, higher oil prices would work as a negative supply shock to net oil importers and, hence, would lead to lower growth, higher inflation, and smaller current account surpluses/higher current account deficits. Second, as higher oil prices lead to lower growth among industrial countries, exports from countries across the region would slow. As the bulk of East Asian exports go to net oil importing countries, this indirect effect of higher oil prices would be significant for the region. Hence, even the net oil exporting countries in the region would be adversely affected by any sharp increase in oil prices because of their reliance on external demand for their nonoil exports.

According to a December 2000 IMF study,[2] the combined effects of sharply higher oil prices on East Asia would be stagflationary—meaning lower growth and higher inflation. The results of the study indicate that for a $5 increase in oil prices per barrel, the combined effect on GDP growth would range from –0.1 percentage point for Indonesia to –0.9 percentage point for Korea and Thailand, with growth in the Philippines (–0.8 percentage point) and the PRC (-0.4 percentage point) also getting slashed significantly. Since such an increase in oil prices would also cause higher inflation (the effect would be to raise inflation rates by about 1 percentage point for some of the countries in the region) and a deterioration in current account balances, it would limit the scope of using fiscal and monetary policies to spur domestic demand and growth in these countries.

Summing up, the emerging global environment appears to call for a two-pronged response by the region's countries. First, they should closely monitor the emerging external environment, and remain ready to initiate appropriate fiscal and monetary responses should export prospects worsen sharply. Second, they should push ahead with the remaining agenda of financial and corporate sector restructuring and reforms, in order to improve resilience to external shocks. As noted earlier, given that inflation is tame almost across the region, there is scope for cutting interest rates in several countries, should the need arise. As for fiscal responses, except for Indonesia and the Philippines (and to a lesser extent Thailand), there appears to be reasonable scope for fiscal expansion in the immediate future. But it is also important to recognize that if the financial and corporate sectors do not return to health, the intended positive effects on the economy of fiscal, and—more important—monetary easing will be muted.

[2] "The Impact of Higher Oil Prices on the Global Economy," IMF, Research Department, December 2000.

People's Republic of China

Real Sector

Growth momentum remains strong.

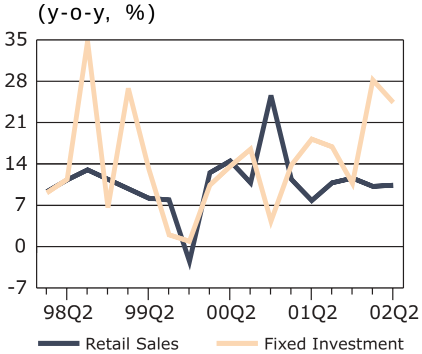
After weaker performance in the second half of 2001 due to a collapse in external demand, growth has bounced back strongly this year, driven by buoyant domestic demand and a rebound in exports. Real GDP grew by 7.8% year-on-year in the first half and 8.1% in the third quarter. The central bank in a recent report predicted that growth for 2002 could top 7.5%, which is half a percentage point higher than the Government's growth target set early this year (Table 1).

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

	1998	1999	2000	2001	2002	2003
Official[1]	7.8	7.1	8.0	7.3	7.0	—
ADB[2]	—	—	—	—	7.4	7.5
IMF[3]	—	—	—	—	7.5	7.2
World Bank[4]	—	—	—	—	7.0	7.0
Consensus Economics[5]	—	—	—	—	7.7	7.5

[1]National Bureau of Statistics.
[2]ADB, *Asian Development Outlook 2002 Update,* September 2002.
[3]IMF, *World Economic Outlook*, September 2002.
[4]World Bank, *East Asia Update Regional Overview,* April 2002.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, October 2002.

Figure 1: **Growth of Real Retail Sales and Public Sector Fixed Investment** (y-o-y, %)



Source: ARIC Indicators.

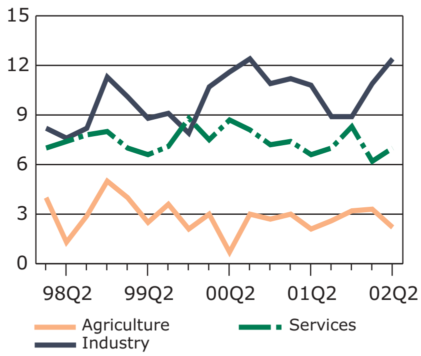
Strong fixed investment has fueled growth.

Buoyant domestic demand was underpinned by strong fixed investment, especially public sector fixed investment, which grew by 24.3% in the nine months to September (Figure 1). This was driven largely by the public sector as the Government continued its fiscal pump priming to contain adverse impacts of the global economic slowdown of last year. However, private investment is also picking up, registering 19.4% growth in the first half. While lower than the growth in public investment, its performance represents a significant improvement from the 12–13% annual growth recorded in the last two years. The pickup in private investment was partly attributable to increased bank lending to small and medium enterprises (SMEs), as the Government took measures to support them. Across sectors, investment in real estate was particularly buoyant, growing by 32.9% in the first half, as housing reform and cheap loans led to more homes being built and local governments increasing spending on urban development and modernization.

Consumer spending continues to grow steadily.

In the nine months to September, retail sales grew by 8.7% measured at current prices and 10.2% in real terms. The steady growth in consumer spending was to a large extent driven by urban households, which spent 9.8% more in the first nine months of this year than in the same period last year. However, rural residents registered only a 6.8% increase in the same period, illustrating the continued widening in the urban-rural income disparity. In the first nine months, per capita disposable incomes of urban households grew by 17.2% in real terms, while per capita real cash income of rural households increased by only 5.3%. The rapid increase in urban incomes is fueling a spending boom on private cars and houses. Automobile sales grew by 37.6% in the first half of 2002 and 61% in July. To further boost consumer spending, the Government granted a 10–15% pay increase to public employees and a 7% benefit increase to unemployed workers in major cities in July.

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



Source: ARIC Indicators.

Industrial production growth accelerated.

On the supply side, agricultural sector performance improved slightly compared to the same period in the last two years. But industry continued to be the top performing sector (Figure 2). After a dip in the second half of 2001, following the global slowdown, growth of value-added of the industrial sector regained momentum, reaching about 12.2% in the first nine months. Major drivers of industrial growth were producers of electronic communication equipment, transportation equipment, and steel products. The latest official statistics show that value added of the industrial sector grew by 12.7% in August and 13.8% in September, suggesting that growth momentum remains strong.

Fiscal and Monetary Developments

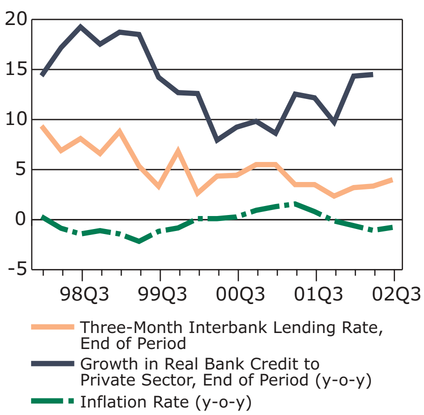
The fiscal stance remains expansionary.

The Government has maintained an expansionary fiscal policy this year to support growth. The programmed fiscal deficit for 2002 is CNY309.8 billion, which translates to around 3% of the country's GDP, 0.3 percentage points higher than recorded last year. Initially designed to contain the adverse effects of the Asian financial crisis, the Government's fiscal stimulus package is now crucial to keeping domestic demand strong. The Government plans to issue CNY593 billion ($71.6 billion) in Treasury bonds, up from CNY500 billion ($60.4 billion) in 2001, and CNY150 billion ($18.1 billion) in special bonds earmarked for public work to fund government spending this year. In view of strong growth of expenditure (18.7%) relative to revenue (10.6%) in the first seven months, the Government is taking steps to keep the budget deficit within the target. These include, on the revenue side, strengthening collection efforts and stricter compliance with audits of major commercial enterprises and high-income groups to prevent tax evasion. On the expenditure side, measures focus on tightening oversight in an effort to prevent excessive and unauthorized spending.

Key interest rates were slashed to bolster domestic demand.

The People's Bank of China, the country's central bank, cut key deposit interest rates by 27 basis points (bp) in February this year, the latest in a series of rate cuts since May 1996. As of September 2002, the demand deposit rate and one-year bank deposit rate stood at 0.72% and 1.98%, respectively. Benchmark lending rates of financial institutions were also reduced by an average of 50 bp from levels prevailing since June 1999, with the one-year lending rate now standing at 5.31%. The latest rate cuts were an attempt by the Government to encourage consumers to spend more. However, even with these cuts, household savings have continued to climb. Stock of urban and rural household savings reached CNY8.4 trillion at end-September, up by 12.4% from its level at the beginning of the year. In the meantime, outstanding broad money (M2) in September 2002 grew by 16.5%, which is higher than the target of about 13% set by the Government for 2002.

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Consumer prices continue to fall.

The consumer price index has recorded negative year-on-year growth in most months since October 2001 (Figure 3). The latest official statistics suggest that consumer prices were on average 0.7% lower in September 2002 than a year earlier. Prices continue to fall as enterprises cut prices to attract wary consumers who are deferring purchases due to expectations of further price declines. Continued declines of production costs due to sluggish raw material prices have also inhibited growth momentum of consumer prices. In addition, the reduction of import tariffs and quotas as a consequence of the country's accession to the World Trade Organization (WTO) has intensified downward pressures on prices.

Balance of Payments

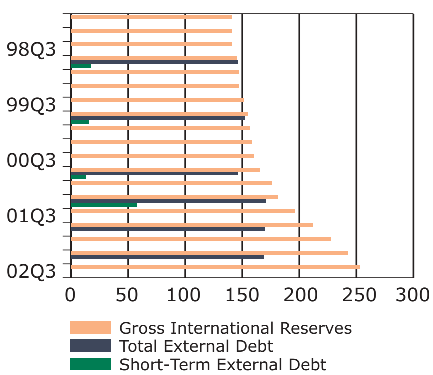
Exports rebound sharply.

Benefiting from improvements in the global economy and a weaker US dollar to which the renminbi is pegged, exports rebounded

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)

Source: ARIC Indicators.

Figure 5: **International Reserves[1] and External Debt** ($ billion)



[1]Data for 02Q3 as of August 2002.
Source: ARIC Indicators.

sharply in the first half after a disappointing performance for most of last year. Merchandise exports grew by 19.4% in the nine months to September (Figure 4). Exports of high-tech products grew even faster, by about 44% in the first six months. As more and more multinational companies engaged in production of technology-intensive goods move their manufacturing base to the PRC to take advantage of low production costs, exports of high-tech goods are accounting for a growing share of the country's total exports. Merchandise imports also grew, by 17.2% in the first three quarters. The latest data suggest that export growth maintained its momentum in the third quarter.

Trade surplus and foreign investment inflows are further boosting foreign reserves.

The trade surplus in the nine months to September reached $20 billion, equivalent to 3.6% of GDP. At the same time, foreign direct investment (FDI) continues to flow into the country. Contracted FDI reached $62.3 billion in the first eight months, growing by 42.2%. Actual FDI increased by 22% during the same period. With the large trade surplus and continued influx of FDI, foreign reserves reached a record high of $253 billion in August 2002 (Figure 5). Latest official data show the total external debt stood at $169.1 billion as of mid-2002. Short-term debt amounted to about 34% of total debt in June 2001.

Asset Markets

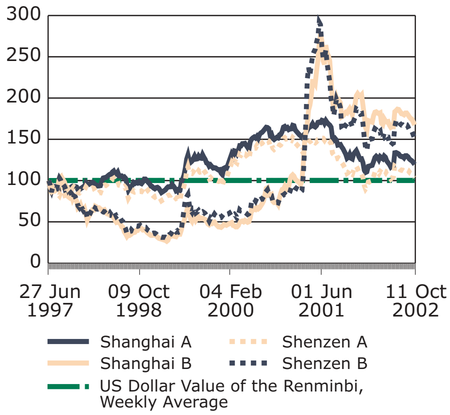
The yuan/dollar exchange rate remains stable.

Robust economic growth and a strong balance of payments position lent continued stability to the dollar value of the domestic currency. Since 1994, the country's central bank has adopted a "managed float" exchange rate regime, allowing the currency to fluctuate in a narrow band around CNY8.277 to the dollar. Since the last quarter of 2000, the central bank has managed to keep the exchange rate within this band. The eventual flotation of the currency remains a government policy goal, though the timing has yet to be set.

Stock prices are off their lows.

As of 11 October 2002, Shanghai and Shenzhen A-share indexes gained 12.3% and 20.3%, respectively, from their two-year lows of January 2002

Figure 6: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: ARIC Indicators.

(Figure 6). The rebound follows a dismal performance of the two indexes in the second half of last year, partly caused by the announcement of the state-share sale scheme. The Government suspended the planned share sales in October last year and scrapped the scheme altogether in June. That decision sparked an almost 10% surge in the two indexes on 24 June. Since then, the two price indexes have softened somewhat. The recent market weakness reflects a number of factors, including increased supply of equities because of initial public offerings (IPOs), poor corporate results, and a government crackdown on market irregularities. B-shares indexes have closely followed the movements of A-share indexes. As of 11 October, the Shanghai B-share index was up 9.8% and Shenzhen B-share index up 14.6% from their lows in 2002.

The office property market continues to improve.

The office property vacancy rate in Shanghai's Central Puxi business district has been in decline since 1999. The average vacancy rate of Grade A office space stood at 14.8% at end-June 2002, 4.4 percentage points lower than a year earlier (Table 2). The average net rental rose by 11% in the second quarter, reaching $312 per square meter per annum. In Beijing, after increasing for the last five consecutive quarters, the office property vacancy also declined in 2002. The average Grade A office vacancy rate stood at 16.3% at end-June, 1.4 percentage points lower than recorded at the end of 2001. In the Shanghai and Beijing office markets, leasing activity is being spurred by multinational companies expanding their business activities and new companies setting up their headquarters in the country.

Table 2: **Property Vacancy Rates** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2
Beijing	33.0	35.5	37.9	37.7	37.3	34.4	30.1	21.2	12.2	8.1	12.2	14.4	14.8	16.3	17.7	16.9	16.3
Shanghai*	43.8	44.2	44.5	43.2	42.9	40.2	39.3	36.1	31.0	25.7	21.5	20.6	19.2	17.5	15.6	14.9	14.8

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

Financial and Corporate Sector Developments

Commercial banks have been directed to disclose information on their financial positions.

In May 2002, the country's central bank issued a directive requiring commercial banks to disclose information on financial accounting, risk management, and major changes in their capital, shareholders, and other significant corporate matters. Such disclosures, especially on the status of balance sheets, are likely to improve the transparency of financial positions of domestic commercial banks. In compliance with the central bank's directive, the four wholly State-owned commercial banks disclosed that their nonperforming loans (NPLs) have continued to fall this year mainly due to improved risk management. It is reported that the average NPL ratio of the four banks stood at 23.1% as of June 2002. The four banks have been requested to reduce their NPL ratios to less than 15% by the end of 2004. A new, more stringent asset classification system was adopted early this year.

A new Bankruptcy Law was drafted.

To further strengthen the legal framework needed for market reforms, the PRC is revamping its bankruptcy system. A draft bankruptcy law was finalized early this year that will clarify and streamline bankruptcy procedures for State-owned and private enterprises. In addition, the new law contains provisions broadening the scope of bankruptcy application, improving court procedures for bankruptcy cases, and stepping up protection of creditors' interests. However, many analysts feel that the enactment of the new legislation may be deferred until after the passage of the Social Security Law, due to its potential impacts on unemployment.

The Law on the Promotion of Small- and Medium-sized Enterprises was enacted.

Despite its increasing importance in recent years, there are still many impediments to developing the SME sector in the PRC. One is the lack of finance, as commercial banks are reluctant to lend to SMEs. In June 2002, the Government enacted a Law on the Promotion of Small- and Medium-sized Enterprises. The Law includes provision for an SME guarantee fund, the regulations for which are being developed. In August 2002, the Government through its central bank issued guidelines directing commercial banks to strengthen their credit support to SMEs. These measures are likely to boost the development of SMEs and the country's private sector.

Social Sector Developments

Urban unemployment remains high.

The continued layoffs by SOEs as they attempt to streamline business operations and improve efficiency have led to significant increases in urban unemployment over the past few years. Official statistics show that the registered number of unemployed workers in urban areas was 7 million as of the end of June 2002, about equal to the number at the beginning of the year; and the unemployment rate remained below 4%. The Government's target is to limit urban unemployment rate to below 4.5% this year. But many analysts believe that the actual urban unemployment rate could be higher already. In response to the growing discontent among laid-off workers, the Government indicated in a recent white paper that it would help promote the development of labor-intensive enterprises with market potential to absorb the unemployed. Measures are also being taken to help the unemployed seek new jobs.

Prospects and Policy Issues

The PRC is likely to surpass its official growth target for 2002.

Driven by continued fiscal pump priming and a rebound in exports, GDP growth of 7.9% in the first three quarters exceeded the Government’s 7.0% target for 2002. Despite increased uncertainty over the pace of the global and US recovery in recent months, the latest trade statistics suggest that exports remain strong. Fiscal stimulus measures, including pay hikes for civil servants and increases in unemployment benefits, are likely to boost consumer spending, which could offset some of the slack as a result of a likely softening in public sector investment in the last quarter. Therefore, the official growth target of 7.0% for 2002 is likely to be surpassed. The latest Consensus Economics (October 2002) projection for GDP growth is 7.7% for 2002 and 7.5% for 2003.

The Government’s efforts to increase rural incomes will help stimulate consumer spending and sustain growth.

Given the huge size of the PRC economy and continued uncertainty over global economic prospects, keeping domestic demand strong is key to sustaining growth. Growth of rural consumption has been lagging behind urban consumption in recent years. Consumption by rural households, which largely make up the country’s populace, could become a major source of growth for many years if rural incomes could be accelerated. But growth of rural incomes has been slow and could be further hampered by potential adverse impacts on farmers as the Government follows through with its WTO commitments to reduce tariffs and quotas on various agricultural products. The Government is taking steps to contain such adverse impacts, and to increase rural incomes and reduce the urban-rural income disparity. The initiatives—reforming systems of rural taxes and administrative charges, improving grain and cotton distribution, increasing investment in agricultural and rural infrastructure, and improving the access to finance by rural households—should improve rural incomes. It is imperative that such efforts be continued and measures successfully implemented.

The Government's contingent liabilities warrant serious attention.

The PRC's public debt has increased significantly in recent years as a result of continued fiscal pump priming. The official estimate indicates that public debt as a percentage of GDP remains below 20%, which is low in comparison with other countries in the region. But independent estimates suggest that the actual figure is substantially higher, especially if the Government's contingent liabilities are included. Many believe that the country's public debt is sustainable over the medium and long term given its large stock of assets. But the contingent liabilities could constrain the Government's fiscal maneuverability and, therefore, deserve serious attention. Contingent liabilities are largely in the form of government guarantees of the banking sector's indebtedness and commitments to fund the country's pension and other social safety net requirements. With high levels of NPLs among State-owned banks; demand for increased contributions to the country's pension system in the coming years to support urban retirees; and an expected increase in the number of unemployed workers, resulting in demands for increased funding for social safety nets such as unemployment insurance, the Government's contingent liabilities are large. The Government is moving to reform the country's taxation system to broaden and strengthen its revenue base. Divesting State-owned assets would also generate funding that will likely be needed to meet potentially large payments stemming from the Government's contingent liability obligations.

People's Republic of China: Selected ARIC Indicators

	1996	1997	1998	1999	2000	2001	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2	02Q3
Output and Prices																									
GDP Growth (%)	. . .	. . .	7.8	7.1	8.0	7.3	7.2	6.8	7.6	9.1	8.3	7.0	7.0	6.5	8.1	8.3	8.2	7.6	8.1	7.7	7.1	6.7	7.6	8.0	8.1
Agricultural Sector Growth (%)	. . .	. . .	3.5	2.8	2.4	2.8	4.0	1.3	2.9	5.0	4.0	2.5	3.6	2.1	3.0	0.7	3.0	2.7	3.0	2.1	2.6	3.2	3.3	2.2	. . .
Value-Added of Industry Growth (%)	. . .	. . .	7.6	7.5	7.8	7.4	8.2	7.6	8.2	11.3	10.1	8.8	9.1	7.9	10.7	11.6	12.4	10.9	11.2	10.8	8.9	8.9	10.9	12.4	13.2
Services Sector Growth (%)	. . .	. . .	7.6	7.5	7.8	7.4	7.0	7.4	7.8	8.0	7.0	6.6	7.1	8.8	7.5	8.7	8.1	7.2	7.4	6.6	7.0	8.3	6.2	7.0	. . .
Inflation Rate (%)	8.3	2.9	-0.8	-1.4	0.3	0.9	0.3	-0.9	-1.4	-1.1	-1.4	-2.2	-1.2	-0.8	0.1	0.1	0.3	0.9	1.3	1.6	0.8	-0.1	-0.6	-1.1	-0.8
Unemployment Rate (%)	3.0	3.1	3.1	3.1	3.1	3.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts																									
Growth of Broad Money, M2 (%)[1]	. . .	19.6	14.8	14.7	12.3	14.4	15.4	14.3	16.2	14.8	17.8	17.6	15.3	14.7	13.0	13.7	13.4	12.3	13.2	14.3	13.6	14.4	14.4	14.7	16.5
Three-Month Interbank Lending Rate (%)[1]	. . .	8.3	6.6	6.8	5.5	2.4	9.4	6.9	8.1	6.6	8.8	5.3	3.3	6.8	2.6	4.4	4.4	5.5	5.5	3.5	3.5	2.4	3.2	3.3	4.0
Growth in Real Bank Credit to Private Sector (%)[1]	16.5	20.5	17.5	12.7	9.8	9.7	14.4	17.2	19.3	17.5	18.7	18.5	14.2	12.7	12.6	7.9	9.2	9.8	8.6	12.5	12.2	9.7	14.3	14.5	. . .
Average Stock Price Index	236.6	409.3	412.4	438.1	623.7	612.9	405.3	446.6	400.0	398.4	365.5	399.6	506.9	461.8	532.7	615.0	660.8	669.9	655.3	682.6	610.7	509.8	461.6	493.2	514.2
Central Government Fiscal Balance as % of GDP	-0.8	-0.7	-1.2	-2.1	-2.8	-2.6	. . .	. . .	. . .	. . .	2.9	0.8	-2.2	-7.6	2.8	-0.6	-1.2	-9.5	4.3	-0.1	-1.8	-10.4	1.4	0.02	. . .
External Account, Debt, and Exchange Rates																									
Growth of Merchandise Exports ($ fob, %)	1.6	20.9	0.5	6.2	27.7	7.0	13.0	2.5	-2.0	-7.2	-7.3	-1.6	14.9	16.2	38.8	37.3	25.0	15.5	14.6	4.6	3.9	6.5	9.1	17.8	28.6
Growth of Merchandise Imports ($ cif, %)	5.2	2.3	-1.2	18.1	35.8	8.2	2.4	2.5	-2.7	-5.3	11.9	20.6	24.0	15.4	41.0	32.4	43.1	28.8	17.2	11.3	6.5	0.3	5.2	15.1	29.3
Current Account Balance as % of GDP	0.9	3.3	3.3	2.1	1.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Net Foreign Direct Investment ($ Billion)	. . .	45.3	45.5	40.3	40.8	46.8	8.60	11.9	10.9	14.1	7.3	11.2	10.6	11.1	7.1	10.0	9.5	14.1	8.0	12.6	11.5	14.7	10.1	14.5	. . .
Net Portfolio Investment ($ Billion)	1.7	6.9	-3.7	-11.2	-4.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Gross International Reserves ($ Billion)[1]	105.0	139.9	145.0	154.7	165.6	212.2	140.6	140.5	141.1	145.0	146.6	147.1	151.5	154.7	156.8	158.6	160.1	165.6	175.8	180.8	195.8	212.2	227.6	242.8	. . .
Total External Debt as % of GDP[1]	. . .	14.5	15.2	15.3	13.5	14.7	. . .	. . .	. . .	15.2	. . .	. . .	. . .	15.3	. . .	. . .	. . .	13.5	. . .	15.2	. . .	14.7	. . .	14.2	. . .
Short-Term Debt as % of Gross International Reserves[1]	13.4	13.0	12.0	9.8	7.9	. . .	. . .	. . .	. . .	12.0	. . .	. . .	. . .	9.8	. . .	. . .	. . .	7.9	. . .	31.8	. . .	. . .	. . .	. . .	. . .
Short-Term Debt as % of Total Debt[1]	12.1	13.9	11.9	10.0	9.0	. . .	. . .	. . .	. . .	11.9	. . .	. . .	. . .	10.0	. . .	. . .	. . .	9.0	. . .	33.8	. . .	. . .	. . .	. . .	. . .
Real Effective Exchange Rate (1995=100)[2]	112.2	121.3	131.5	124.2	122.3	131.1	138.3	133.3	131.7	122.6	131.2	126.6	122.1	116.7	127.0	121.1	120.0	121.1	134.1	131.7	129.5	129.3	142.8	133.0	. . .
Average Exchange Rate (Local Currency to $)	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3	8.3

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, M2, central government fiscal balance, government expenditure on education and health, merchandise exports and imports, current account balance, net foreign direct investment, gross international reserves, and total and short-term external debts are from national sources. Data on real bank credit to private sector and net portfolio investment 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 REMU staff calculations.

Indonesia

Real Sector

GDP growth picked up in the second quarter.

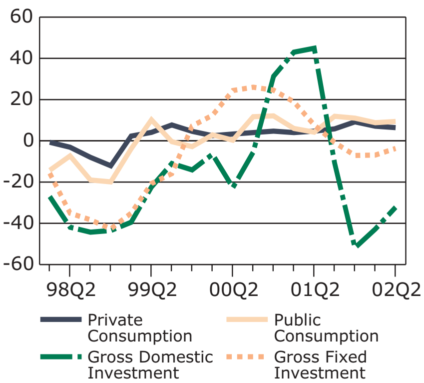
The Indonesian economy has begun to recover from last year's slowdown that reached its low point in the fourth quarter. GDP growth at 3.5% (y-o-y) in the second quarter surpassed the 2.2% gain in the first to bring growth in the first half of 2002 to 2.9%. Some analysts believe that the upturn in economic activity may actually be higher, given the recent strong growth in sales of electricity. Bank Indonesia forecasts place GDP growth for the full year 2002 at 3.3–3.8% (Table 1).

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

	1997	1998	1999	2000	2001	2002	2003
Official[1]	4.7	-13.1	0.8	4.9	3.3	3.3-3.8	—
ADB[2]	—	—	—	—	—	3.2	4.4
IMF[3]	—	—	—	—	—	3.5	4.5
World Bank[4]	—	—	—	—	—	3.5	4.0
Consensus Economics[5]	—	—	—	—	—	3.5	4.0

[1]Bank Indonesia, *The Development of Economy, Monetary, Banking and Payment System in the Second Quarter 2002, and Future Policy Direction*, July 2002.
[2]ADB, *Asian Development Outlook 2002 Update*, September 2002.
[3]IMF, *World Economic Outlook*, September 2002.
[4]World Bank, *East Asia Update Regional Overview*, April 2002.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, October 2002.

Figure 1: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

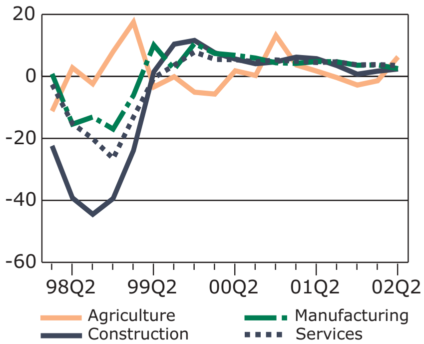
Public and private consumption expenditures underpinned growth.

The economic growth seen in the first half of the year was mainly attributable to high levels of consumer and government spending. Private consumption spending grew by 7.1% and 6.4% in the first and second quarters, respectively, underpinned by public sector salary increases and a sharp increase in the minimum wage at the beginning of the year (Figure 1). Growth in government consumption spending also has been high, averaging more than 9% above the level seen in the first half of last year. Fixed investment, however, depressed since the second half of last year, continued to fall in the first half of 2002—by about 5%. Meanwhile, the reduction in stocks has continued to be large this year, depressing growth. An improvement in the foreign balance supplemented consumption expenditure in supporting growth, as reduced real imports offset a fall in real exports.

The consumer confidence index rose from 86.8 in January to 101.4 in June. Increased confidence was also mirrored in the Business Sentiment

Index, which reached 111.3 in the April–May survey. This confidence reflected the new Government's accomplishments in restoring political calm and achieving greater control over the direction of economic policy, in part evidenced early in the year by resumed IMF lending and a successful Paris Club rescheduling.

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



Source: ARIC Indicators.

Agriculture rebounded while manufacturing continued to slow.

On the supply side, agriculture output (around 23% of Indonesia's GDP) rebounded by 6.3% (y-o-y) in the second quarter, after three consecutive quarters of contraction (Figure 2). Continued consumer spending has helped to sustain services sector output that expanded by 3.6% in the first half of the year. The construction sector also continued to grow (by 2%), although much more slowly than before the downturn in business investment. Notably, growth in the manufacturing sector continued to slow in the second quarter, dipping to only 2.5% compared to 3.7% in the first. Several problems have affected the sector in recent years, including labor disputes, higher wage demands, and transport and regulation issues. These pressures have led to some corporate downsizing, particularly in the export oriented textile and shoe industries. Manufacturing capacity utilization was recorded at 60%, against 70% in early 2001.

Fiscal and Monetary Development

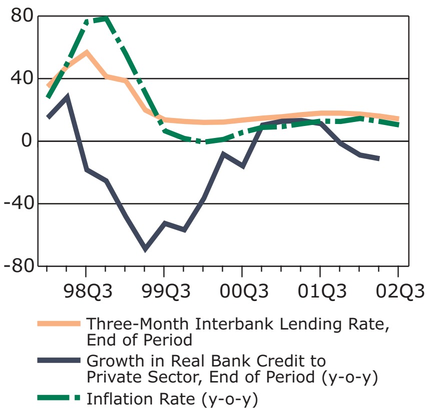
The fiscal deficit is within targets.

The Government's target for the 2002 budget deficit is set at Rp42.1 trillion or 2.5% of GDP, a reduction from last year's 3.6% level. Fiscal policy is oriented toward reducing the large public debt burden (total public sector debt stands at about 100% of GDP) and achieving fiscal sustainability. As of June, the deficit stood at Rp8 trillion, about 0.5% of GDP—well below the targeted deficit, but higher than last year's first half outcome of 0.1% of GDP.

Measures were taken to strengthen the budget.

The Government aimed to reduce the budget deficit this year through a 0.7% increase in revenue to Rp301.9 trillion (17.9% of projected GDP) and a 2.6% decline in expenditures to Rp344 trillion (20.4% of GDP). The major adjustment was the politically sensitive oil subsidies that were cut by about 56% to Rp30.4 trillion, allowing some increase in other expenditure items while reducing total expenditure enough to

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

allow deficit reduction. Because the first quarter deficit was larger than expected, the Government took a number of initiatives to strengthen the budget outlook. The measures included elimination of the VAT exemption on capital goods, securing higher dividends and other nontax revenues owed by State-owned enterprises, establishing a large taxpayers office to administer collection from the 200 largest corporations, and formulating a more comprehensive collection system for tax arrears owed by SMEs. These actions are expected to keep the budget deficit on target, even though interest costs and subsidy payments may exceed budgeted expectations.

Inflation rate is falling.

Inflation averaged nearly 12% last year and in the first quarter of 2002 peaked at 14.5% (y-o-y), amid price increases for petroleum products, electricity, and telephone charges (Figure 3). However, it was pushed back to 12.6% over the second quarter and by September had fallen to 10.5%. The reduction in inflation reflected better monetary control this year, a strengthening in the exchange rate, and more stable political and financial environment. The Government's economic program objective is to bring inflation down to 9–10% by the end of the year.

Improved monetary control has allowed the benchmark interest rate to fall.

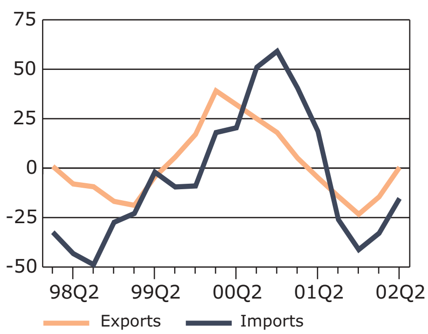
Improvements in monetary and inflationary conditions have enabled Bank Indonesia to reduce its benchmark interest rate. The three-month interest rate on Bank Indonesia certificates (SBIs) was brought down to 15.18% by end-June and to 13.12% in early October 2002 from 17.63% at end-2001. While this decline in the SBI rate has improved public perceptions that economic conditions are improving, it has not yet worked to reduce bank lending rates. In June, interest rates on working capital loans were 19.08% and investment loans 18.11%, essentially unchanged from end-2001 levels. The three-month deposit rate, however, has fallen to 15.85%, a drop of about 140 bp from end-2001.

Bank lending appears to be improving.

Total commercial banks' claims on the private sector recorded an increase of only 0.7% to Rp310.0 trillion in June 2002 from end-2001. This outcome, however, is affected by valuation changes of bank lending denominated in foreign currency and the sizeable appreciation of the rupiah over this period. Making an approximate adjustment for this, private credit outstanding would show a larger gain, perhaps in the order of 5–7%. While bank intermediation is improving, greater lending has been limited by bank risk aversion, the limited number of creditworthy clients, and uncertainties with regard to future economic developments. On the other hand, government efforts to rehabilitate lending to SMEs are progressing.

Balance of Payments

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

Nonoil/gas exports fell in August after a pick-up in the second quarter.

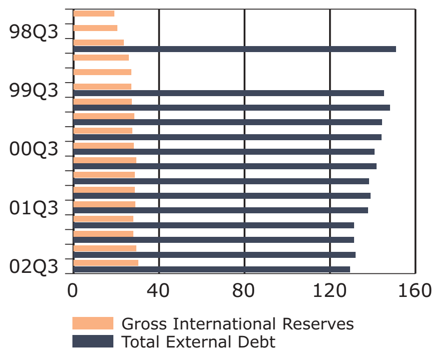
Nonoil/gas exports picked up in the second quarter, growing by 3.6%, after three consecutive quarterly declines. The rebound reflected better global and domestic economic circumstances. More recent data show that nonoil/gas exports continued to grow in July, by 6.6%, but fell in August, by 5.6 %. While global demand conditions were better, nonoil/gas exports have been adversely affected by greater competition from other regional countries, substantial appreciation of the rupiah, and labor issues affecting production. Net oil/gas export earnings of $3.8 billion in the first eight months of the year were about $1.5 billion below the comparable figure last year, mostly owing to lower prices and reduction in shipments. Taking together, merchandise exports declined by 7.1% in the first six months (Figure 4), grew by 3% in July, but fell again in August, by 4.4%. Nonoil/gas imports fell by 17% in the first half. While imports in all categories fell, the bulk of the reduction was accounted for by lower imports of capital goods and raw materials for manufacturing industries during the first quarter. The latest trade data, however, show that nonoil/gas imports recovered in July and August, growing by 10.8% and 21.5%, respectively.

With little change in the net services deficit for the first half ($8.4 billion) from a year ago, the current account surplus amounted to $2.4 billion in the six months to June, compared to $3.4 billion for the same period last year. For full year 2002, Consensus Economics (October 2002) forecasts a current account surplus of $6 billion, compared to $6.9 billion in 2001.

The capital account shows substantial improvement.

The capital account improved substantially in the first half of 2002, as net capital outflows were reduced to $1.9 billion, compared to $6 billion in the same period last year. The bulk of the $4.1 billion reduction in net outflow was due to a $3.7 billion slowdown in private capital outflows, mostly owing to a reduction in private debt repayments, but also to sizeable inflows from the sale of an interest in an IBRA-intervened bank as well as proceeds from the privatization program.

Figure 5: **International Reserves and External Debt**[1] ($ billion)



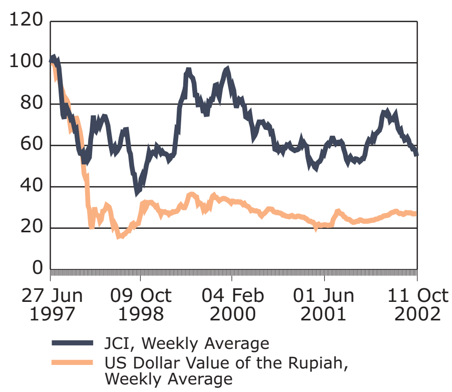
[1]Data for 02Q3 as of July 2002.
Source: ARIC Indicators.

Foreign exchange reserves are up and foreign debt is falling.

As of end-September, foreign exchange reserves rose to $30.2 billion, from $28 billion at end-2001 (Figure 5). As of end-July 2002, preliminary data indicate that total external debt amounted to $129.4 billion, reduced from the $133.1 billion (90.3% of GDP) reported for the end of last year. At end-2001, short-term debt was reported to be $6.7 billion on an original maturity basis and $18.5 billion on a remaining maturity basis. Government foreign debt is $73.5 billion, about 57% of total foreign debt. To reduce its heavy debt service burden, the Government sought and obtained a third round of debt rescheduling. In April, the Paris Club agreed to reschedule $5.4 billion in debt service payments, while in June, the London Club agreed to reschedule $1.3 billion.

Asset Markets

Figure 6: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

The rupiah strengthened amid greater political stability.

The rupiah strengthened from Rp10,320 to the dollar (weekly average data) at end-2001 to Rp8,638 at end-June, an appreciation of about 19% (Figure 6). Subsequently, the rate moved backward to Rp9,006 per dollar by mid-October to hold the appreciation in 2002 to 14.5%. While most regional currencies recorded gains in this period as the dollar weakened, other key factors affecting the volatile rupiah rate were greater political stability and the improved economic outlook.

The stock market lost all its early gains.

The Jakarta stock market was one of the best performing markets in Asia this year. The Jakarta Composite Index (JCI) rose from this year's low of 392.0 (3 January 2002) to a high of 551.6 (16 April 2002) before sliding to 376.5 (11 October 2002). The upward trend to April/May 2002 was due to confidence building news, bargain hunting, and some improvements in corporate fundamentals. Since June onwards, however, the stock market has declined considerably—underperforming even the MSCI Far East ex-Japan. This reflected adverse developments such as the worldwide bearish sentiment in the wake of US accounting and corporate scandals, and erratic court handling of a case in Indonesia involving a foreign invested company that focused attention on problems in the investment climate.

Property markets remain soft.

The office vacancy rate in the second quarter edged down to 22.5%, from 23.7% in the same period of 2001 (Table 2). At the same time, office property rents in rupiah have remained stable. The retail property vacancy rate stood at 7.3% in the second quarter; the market is relatively strong, as there is a lack of premium shopping space.

Table 2: **Property Vacancy Rates in Jakarta** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2
Office	15.6	20.0	22.1	22.3	24.3	25.7	25.5	25.4	24.5	24.3	24.3	24.0	23.7	23.3	22.7	22.1	22.5
Retail	. . .	. . .	. . .	. . .	16.4	. . .	11.8	. . .	9.3	. . .	6.5	. . .	5.3	9.8	7.9	7.2	7.3

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

Financial and Corporate Sector Developments

Privatization of SOEs lags behind target, but sale of IBRA's assets has progressed.

In the first eight months of the year, only Rp2.26 trillion or 35% of the Rp6.5 trillion ($722 million) budgeted privatization target for 2002 was collected. In the past two years, the Government has failed to meet its privatization goals, mainly owing to strong political and employee resistance. To speed up the disposition of State enterprises, the Government has agreed with parliament guidelines for more effective privatization. These include the sale of companies operating in highly competitive sectors, where the Government holds a minority equity holding, and where technological change is rapid unless government capital is necessary; but retaining companies with public service obligations such as transport.

IBRA is on course to achieving its budgeted target of raising Rp38.5 trillion ($4.3 billion) in 2002, with total proceeds in the first half reaching Rp16.5 trillion ($1.8 billion). The first half result included sale of a controlling stake in Bank Central Asia ($600 million). A program for sale of other intervened banks and further sale of NPLs has been agreed with IMF in the economic program. In July, IBRA made its first major sale of NPLs, putting up for auction NPLs with an original value of Rp135.5 trillion. Some Rp81.6 trillion in NPLs was sold for Rp23.1 trillion, with a recovery rate of 28.3%.

The asset quality of the banking system is improving.

NPLs as a share of total loans declined by almost 4 percentage points to 12.1% in July 2002 from 15.8% in July 2001. Nevertheless, the NPL rate is well above the 5% target set for end-2002. The average CAR was 23.4% during the second quarter of 2002. A number of banks (smaller private banks), however, are reported to be close to the 8% limit.

Social Sector Developments

Social problems weigh heavily as the poverty rate remains high.

Using the $2-a-day measure, the World Bank estimates poverty to be running at 56.4% of the population in 2002, down from a peak of 65.1% in 1999. This means that about 122 million people are living under the poverty line. The United Nations' Human Development Index (HDI), which measures quality of life in terms of life expectancy, education, and per capita income, ranked Indonesia 110th out of 173 countries. These data highlight the enormous social problems faced by the country in the aftermath of the 1997 crisis.

Current levels of growth are inadequate to absorb the growing numbers of unemployed.

The number of unemployed is officially estimated at 8.4 million. However, the real figure could be several times above this level. Moreover, the labor market will need to absorb an estimated 400,000 illegal Indonesian workers that are now being returned to the country. To reduce the number of unemployed and absorb the 2.5 million new entrants to the labor force each year, local economists estimate that the economy must grow by 6–7% annually, matching its precrisis performance.

Prospects and Policy Issues

The Government's growth target for 2002 is within reach.

The agreement reached with IMF on an economic program and resumed government lending were important steps in rebuilding confidence that the economy is on the mend. The Government's stabilization measures and its more cooperative relationship with parliament than the previous administration have steadily improved economic prospects. While Indonesia is benefiting from the higher oil prices that now prevail due to uncertainties in the Middle East, it would be adversely affected by any substantial slowing in global growth. The Government's growth forecast of 3.3–3.8% should be attainable and is consistent with the forecast by Consensus Economics (3.5%) and other agencies. A moderate pickup in growth to 4–4.5% next year is generally expected.

The drying up of investment is a serious concern.

Although there has been progress on several economic fronts, the sustainability of growth hinges on the country's ability to generate a sufficient level of investment to support demand-led growth that would more fully employ the growing labor force. Unfortunately, investments in the country have been dwindling. Foreign investment approvals in the first half of 2002 fell by 40% to $2.5 billion from $4.2 billion in the same period in 2001. Domestic investment also plunged by 70.6% to Rp11.1 trillion from Rp37.8 trillion. The four main impediments to higher investment remain unresolved. First, the weak legal system has prevented investors from making new investments in the country. Second, increasing labor unrest, including strikes and demands for higher wages, combined with regulatory uncertainties has increased business costs and scared away investors. Third, the new regional autonomy law has also left investors wary, especially in the wake of a surge of levies and taxes charged to them. Changes in local regulations also add to their frustration. Finally, security concerns (including the recent bombing in Bali) continue to weigh on certain investors, both domestic and foreign, especially on investment in outlying provinces and in the mining industry. Unless these concerns are addressed systematically, investment may not pick up, to the detriment of longer-term economic growth and poverty reduction.

Indonesia: Selected ARIC Indicators

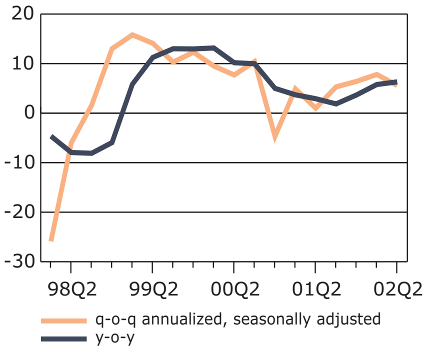
	1996	1997	1998	1999	2000	2001	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2	02Q3
Output and Prices																									
GDP Growth (%)	7.8	4.7	-13.1	0.8	4.9	3.3	-4.5	-13.3	-16.0	-18.3	-6.1	1.8	2.8	5.4	3.6	5.0	4.1	6.9	4.8	3.8	3.1	1.6	2.2	3.5	. . .
Private Consumption Expenditure Growth (%)	9.7	7.8	-6.2	4.6	3.6	5.9	-0.7	-3.1	-8.0	-12.1	2.3	4.1	7.7	4.6	2.5	3.3	4.0	4.7	4.0	4.7	5.8	9.2	7.1	6.4	. . .
Public Consumption Expenditure Growth (%)	2.7	0.1	-15.4	0.7	6.5	8.2	-14.3	-7.3	-19.0	-19.9	-3.9	10.2	-0.4	-2.8	2.9	0.3	11.7	12.1	6.0	4.2	11.9	11.0	8.8	9.4	. . .
Gross Domestic Investment Growth (%)	4.9	6.3	-39.0	-23.2	-1.2	-0.7	-27.0	-41.9	-44.3	-43.5	-39.5	-22.4	-11.0	-14.1	-6.5	-22.7	-5.5	31.3	43.0	44.9	-10.7	-51.9	-42.8	-32.2	. . .
Gross Fixed Investment Growth (%)	14.5	8.6	-33.0	-18.2	21.9	4.0	-15.7	-35.1	-38.3	-42.7	-35.1	-20.7	-15.9	7.2	12.4	24.4	26.0	24.6	18.9	7.7	-0.8	-7.1	-6.9	-3.7	. . .
Agricultural Sector Growth (%)	3.1	1.0	-1.3	2.2	1.7	0.6	-11.2	2.8	-2.4	8.0	17.5	-3.4	-0.1	-5.1	-5.7	1.8	0.3	13.2	3.7	1.7	-0.4	-2.8	-1.4	6.3	. . .
Manufacturing Sector Growth (%)	11.6	5.3	-11.4	3.9	6.1	4.3	0.8	-15.4	-13.1	-17.0	-6.1	10.1	2.3	10.6	7.4	6.8	5.9	4.4	4.2	4.8	4.7	3.6	3.7	2.5	. . .
Construction Sector Growth (%)	12.8	7.4	-36.4	-1.9	5.5	4.0	-22.4	-39.2	-44.5	-39.4	-23.9	1.5	10.4	11.6	7.6	5.6	4.1	4.7	6.2	5.7	3.5	0.7	1.7	2.4	. . .
Services Sector Growth (%)	6.8	5.6	-16.5	-1.0	5.2	4.4	-2.6	-15.2	-20.1	-26.5	-13.1	-0.5	3.6	7.9	5.5	5.4	4.7	5.3	4.9	4.5	4.7	3.7	3.8	3.5	. . .
Exports of Goods and Services Growth (%)	7.6	7.8	11.2	-31.8	26.5	1.9	57.6	21.8	22.7	-40.4	-43.7	-37.5	-38.6	12.3	15.3	32.1	25.9	32.3	18.4	8.0	-2.6	-12.9	-5.2	-7.1	. . .
Imports of Goods and Services Growth (%)	6.9	14.7	-5.3	-40.7	21.1	8.1	23.4	8.7	4.4	-46.4	-52.6	-44.8	-43.1	-9.0	4.3	5.2	23.3	50.1	50.7	37.2	-3.7	-29.8	-25.7	-21.6	. . .
Inflation Rate (%)	8.0	6.2	58.5	20.5	3.7	11.5	27.7	49.7	76.3	78.4	55.8	30.9	6.6	1.7	-0.6	1.1	5.7	8.8	9.3	11.1	12.8	12.6	14.5	12.6	10.4
Unemployment Rate (%)	4.9	4.7	5.5	6.4	6.1	. . .	5.5	. . .	. . .	. . .	6.4	. . .	6.4	. . .	4.1	. . .	6.1	. . .	8.1	. . .	8.1	. . .	. . .	. . .	. . .
Monetary and Fiscal Accounts																									
Growth of Broad Money, M2 (%)[1]	29.6	23.2	62.3	11.9	15.6	13.0	52.7	80.9	67.3	62.3	34.1	8.8	18.5	11.9	8.8	11.2	5.2	15.6	16.8	16.4	14.1	13.0	8.4	5.3	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	25.8	41.3	12.6	14.7	17.9	34.8	47.9	56.7	41.3	38.6	19.9	13.6	12.6	12.0	12.2	13.5	14.7	15.6	16.9	17.9	17.9	17.3	16.0	14.2
Growth in Real Bank Credit to Private Sector (%)[1]	14.0	17.1	-25.4	-56.7	10.2	-1.4	14.9	28.1	-18.3	-25.4	-48.2	-68.8	-52.6	-56.7	-36.6	-8.4	-15.9	10.2	12.7	13.2	11.2	-1.4	-8.9	-11.2	. . .
NPL Ratio of the Banking System[1]	. . .	. . .	49.2	33.0	18.8	12.1	. . .	. . .	. . .	49.2	. . .	. . .	. . .	33.0	. . .	30.0	26.9	18.8	18.1	16.6	14.7	12.1	12.8	11.8	. . .
Average Stock Price Index	585.1	606.7	416.8	547.3	507.4	404.4	474.7	449.2	392.0	357.4	402.0	566.0	590.4	614.0	620.3	513.9	478.5	420.9	414.2	386.1	435.3	379.2	446.9	526.4	448.9
Central Government Fiscal Balance as % of GDP	1.2	-0.7	-2.9	-1.1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	-4.0	-1.8	. . .
Central Government Debt as % of GDP[2]	25.8	25.7	74.4	57.3	52.3	50.5	31.2	40.7	58.5	74.4	69.0	62.9	58.6	57.3	53.6	53.3	52.2	52.3	51.9	52.3	53.2	50.5	. . .	. . .	. . .
Government Expenditure on Education (% of Total)	1.4	1.4	1.3	1.3	0.9	0.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	0.4	0.5	0.6	0.6	0.3	0.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																									
Growth of Merchandise Exports ($ fob, %)	9.7	7.3	-8.6	-0.4	27.7	-9.9	0.9	-8.0	-9.4	-16.8	-18.8	-4.4	5.6	17.1	39.1	32.1	25.0	18.0	5.1	-4.8	-14.3	-23.3	-14.5	0.4	. . .
Growth of Merchandise Imports ($ cif, %)	5.7	4.1	-38.8	-11.2	38.1	-8.1	-32.4	-43.2	-48.8	-27.4	-22.9	-2.0	-9.5	-9.0	18.0	20.4	51.0	59.1	40.5	18.6	-26.0	-41.2	-32.9	-15.3	. . .
Current Account Balance as % of GDP	-3.4	-2.3	4.4	4.1	5.2	4.7	4.5	3.2	8.0	2.3	4.8	2.5	5.1	4.0	4.7	3.6	5.9	6.7	5.7	4.1	6.1	3.0	3.2	1.8	. . .
Net Foreign Direct Investment ($ Billion)	6.2	4.7	-0.4	-2.7	-4.6	-5.9	-0.5	0.4	-0.1	-0.1	-0.2	-0.9	-0.7	-0.9	-1.5	-0.4	-0.9	-1.7	-2.2	-1.9	-1.1	-0.6	-2.2	. . .	. . .
Net Portfolio Investment ($ Billion)	5.3	-5.0	-13.5	-7.2	-5.4	-2.4	-6.6	-1.4	-3.5	-2.0	-2.6	-1.2	-2.0	-1.4	-0.5	-2.4	-1.8	-0.8	-0.9	-0.6	-1.4	0.4	1.2	. . .	. . .
Gross International Reserves ($ Billion)[1]	. . .	. . .	23.6	27.3	29.4	28.0	. . .	19.0	20.5	23.6	25.8	26.9	26.9	27.3	28.3	27.5	28.1	29.4	28.7	28.6	29.0	28.0	28.0	29.3	30.2
Total External Debt as % of GDP[1]	. . .	61.4	157.1	105.2	92.7	91.3	. . .	. . .	. . .	157.1	. . .	. . .	108.0	105.2	96.7	94.2	91.5	92.7	92.8	96.2	94.8	91.3	87.8	81.2	. . .
Real Effective Exchange Rate (1995=100)[3]	109.5	104.6	52.7	74.5	70.3	69.5	42.7	47.5	48.3	72.2	68.2	76.7	76.8	76.4	77.1	69.8	67.5	66.8	67.3	63.3	74.3	73.0	80.3	72.1	. . .
Average Exchange Rate (Local Currency to $)	2,327	2,890	10,224	7,848	8,405	10,257	9,435	10,747	12,565	8,068	8,731	7,978	7,501	7,211	7,391	8,243	8,740	9,241	9,779	11,226	9,717	10,303	10,177	9,105	8,951

Note: All growth rates are on a year-on-year basis.
. . . = not available.
[1]End of period.
[2]Central government debt refers only to government's and state enterprises' outstanding external debt.
[3]Trade weighted using wholesale price index for trading partners and consumer price index for the home country.
Sources: Data on output and prices, real bank credit to private sector, nonperforming loan ratios of the banking system, central government debt, government expenditure on education and health, merchandise exports and imports, current account balance, net foreign direct and portfolio investment, and total external debt are from national sources. Data on M2, central government fiscal 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 REMU staff calculations.

Republic of Korea

Real Sector

Figure 1: **GDP Growth Rates**
(%)



Source: ARIC Indicators.

The economy is growing at an encouraging pace.

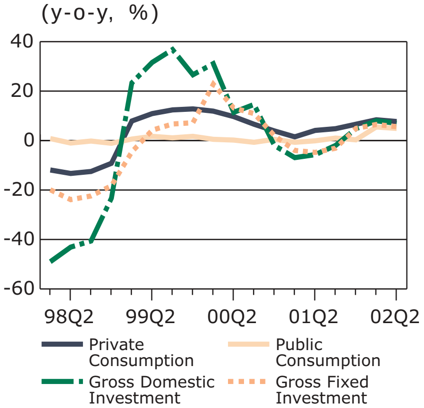
After slackening to 3% growth during last year's global slowdown, real GDP grew by 6.1% (y-o-y) in the first half of 2002. The pickup was led by a resurgence in consumer spending and construction investment that began in the second half of 2001 and was then supplemented in the second quarter by strengthened export demand. Growth accelerated from 5.8% in the first quarter to 6.3% in the second; however, on a quarter-on-quarter annualized basis, growth slowed to 5.6% in the second quarter from 7.8% in the first (Figure 1). The recovery's changing pattern can be seen in that domestic demand accounted for 87% of the increase in total demand in the first quarter, but only 50% in the second. As a result of improving economic performance, growth forecasts for 2002 have been upgraded during the year. The Korean Development Institute's current forecast is for 6% (Table 1).

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

	1997	1998	1999	2000	2001	2002	2003
Official[1]	5.0	-6.7	10.9	9.3	3.0	6.0	—
ADB[2]	—	—	—	—	—	6.0	5.8
IMF[3]	—	—	—	—	—	6.3	5.9
World Bank[4]	—	—	—	—	—	4.2	5.6
Consensus Economics[5]	—	—	—	—	—	6.1	5.6

[1]Korea Development Institute, July 2002.
[2]ADB, *Asian Development Outlook 2002 Update*, September 2002.
[3]IMF, *World Economic Outlook*, September 2002.
[4]World Bank, *East Asia Update Regional Overview*, April 2002.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, October 2002.

Figure 2: **Growth of GDP Expenditure Components**
(y-o-y, %)



Source: ARIC Indicators.

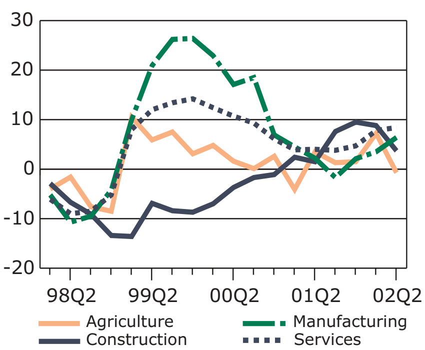
After a sharp rise, consumption expenditures may moderate.

The upward trend in private consumption that began in mid-2001 swelled to 8.4% growth in the first quarter before moderating slightly to 7.7% in the second (Figure 2). This trend has been driven by several factors, including falling unemployment, rising wages, improving consumer expectations, a temporary cut in certain sales taxes during the first half of 2002 (especially for automobiles), low interest rates, and the increased availability of credit. Banks have been highly active in promoting credit cards (mostly used through cash advances) over the past two years and the authorities have begun instituting regulations to restrain their use to within prudent bounds. The sharp uptick in government consumption expenditure growth to 5.2% in the first half of the year reflected planned fiscal stimulus.

Domestic investment is on the rise.

Gross fixed investment rose by 6% in the first half of 2002, against a 4.4% decline in the comparable period last year. The first half outturn reflected roughly equal substantial increases in both construction investment and purchase of equipment. However, growth in construction investment slowed in the second quarter, due to completion of infrastructure for the (June) World Cup, as equipment purchases rose. Improved business confidence and a recovery in real estate development have fostered investment recovery. More fundamentally, the recovery rests on the success of structural reforms that have strengthened the banking system and improved operations and profit performance in many parts of the corporate sector. The 5.7% growth in fixed investment forecast for the year by Consensus Economics in October is, thus, broadly achievable.

Figure 3: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

Manufacturing output is registering gains.

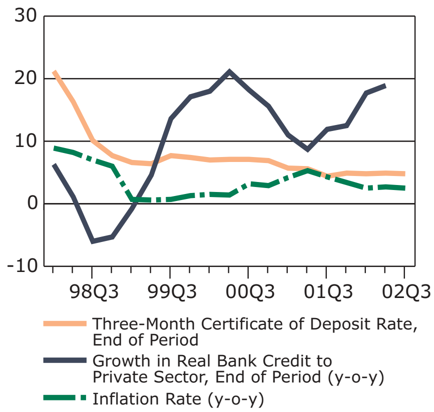
The changing pattern of demand during the recovery has been reflected in output variations. With the recent dominance of domestic demand in total demand, expansion in the service sector has been especially evident: growing by 7.8% and 8.4% in the first and second quarters, respectively (Figure 3). Growth in the construction sector in the last half of 2001 and first quarter of 2002, averaging about 8.5%, was exceptional, in part reflecting a housing boom and public works. However, growth moderated to 3.7% in the second quarter. Growth in manufacturing output has been rising since the last quarter of 2001, with a marked stepup in the second quarter to 6.4% as export demand began to recover. Expansion in the quarter mainly reflected increased production of semiconductors, communications equipment, electrical equipment for household use, and industrial machinery. A step up in growth of output was recorded in April and May; however, in June it lost steam owing to strikes at major automakers and World Cup fever. But the index of manufacturing output fully recovered in July and August, recording even larger year-on-year gains of 8.7%. The average operating capacity ratio in manufacturing was 77.1% in August, up about 5 percentage points from the end of last year.

Fiscal and Monetary Developments

The expansionary fiscal policy is fostering economic growth.

To boost domestic demand, the government budget for 2002 provided various tax benefits, including cuts in income and corporate

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



Source: ARIC Indicators.

tax rates and a planned 8.5% rise in expenditures. Much of the increase was intended for disbursement in the first half of the year. The budget surplus was to be reduced to 1% of GDP, compared to 1.3% in 2001. Despite the expansionary fiscal policy stance, the consolidated budget surplus for the first semester rose to W16.1 trillion, compared to W13 trillion in the same period last year. Overperformance on the revenue side including public-purpose funds—especially social security funds—accounted for much of the enlarged surplus. With the economic recovery stronger than expected, the budget surplus may be higher than planned, without creating a drag on the economy.

Inflation is moderate despite boosted domestic demand.

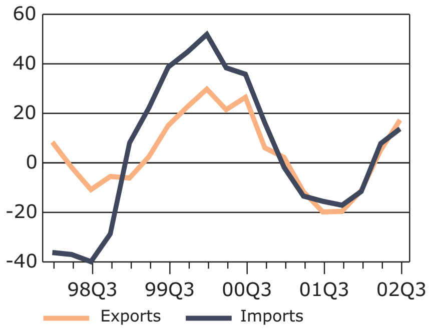
Inflation had trended lower since the second quarter of 2001 (Figure 4). In September 2002, the CPI rose 3.1% from a year earlier mainly due to typhoon damage that raised agricultural prices. But from January through September, consumer price increases averaged only 2.6%. Core inflation (excluding agricultural and petroleum products) averaged 2.9% during the first nine months of the year, compared to 3.6% a year earlier, an outturn within the core target range of 2–4% set by Bank of Korea (BOK).

Monetary policy remains accommodative but with a tightening bias.

BOK cut its target overnight call rate by 100 bp in the third quarter of 2001, including 50 bp shortly after the 11 September 2001 attacks on the US, to bring the rate to a historic low of 4%. Given the buoyancy of the economic recovery and concerns that inflationary pressures may emerge, the bank in early May raised the target call rate by 25 bp to 4.25%. This indication of tightening appears to have been appropriate. Subsequently through August, loan and deposit rates were little changed and the yield on three-year corporate bonds declined, with the market indicating confidence that inflation would be kept in check. Developments in money and credit aggregates demonstrate the supporting nature of monetary policy, as credit to the private sector and money supply grew by 9.8% and 7.4%, respectively, in the first half of the year. At its September policy review, BOK left the target overnight rate unchanged because of increased uncertainties in the international economy. However, it expressed concern that sharply rising housing prices in parts of Seoul and the upturn in international oil prices combined with continued strong domestic demand could accelerate inflation.

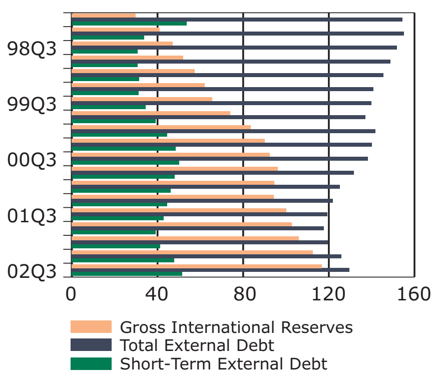
Balance of Payments

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



Source: ARIC Indicators.

Figure 6: **International Reserves and External Debt**[1] ($ billion)



[1]Data for 02Q3 as of August 2002.
Source: ARIC Indicators.

Exports and imports begin to recover.

Exports and imports began to register year-on-year growth starting in April. Exports grew by 5.1% in the second quarter with growth increasing to 17.3% in the third (Figure 5). Notable gains were achieved in electronic products—especially telephones—and in automobiles. In addition, the PRC emerged as the second largest export destination after the US. Preliminary balance-of-payments data for the first eight months show a trade surplus of $9.5 billion, only about $214 million less than a year ago. There was, however, a substantial increase in the net services deficit in the period of nearly $2.8 billion from a year ago, in good part owing to much larger Korean expenditures on tourism. Largely as a result of this, the current account surplus fell to $3.7 billion for the eight-month period, from about $6.8 billion in the comparable period a year earlier. For the full year 2002, Consensus Economics in October forecasts a current account surplus of $4.4 billion, compared to $8.6 billion in 2001.

The capital account and external reserves strengthened substantially.

Estimates for the financial and capital account balance for the first eight months show a surplus of $4.3 billion, in marked contrast to a $5 billion deficit over the same period last year. The bulk of the turnaround was accounted for by reduced amortization, in part reflecting full IMF repayment ($5.7 billion) in 2001, and a return to net inflows of trade, and commercial and bank credits. The balance of payments estimates show official reserves increased by $9.2 billion in the first eight months, more than three times the $2.6 billion gain during the comparable period last year. Gross reserves amounted to $116.7 billion at end-September, up $13.9 billion from end-2001, reflecting balance of payments and valuation gains over the period.

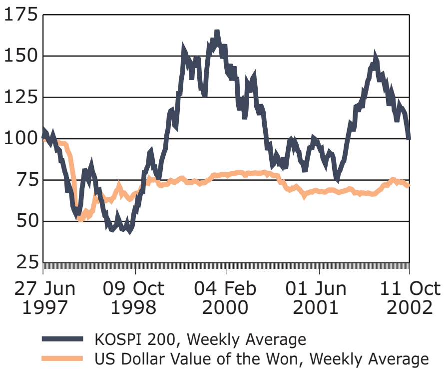
At end-August 2002 Korea's external debt amounted to $129.6 billion, up by about $12 billion from end-2001 (Figure 6). The ratio of external debt to GDP is about 29%, making Korea one of the "less-indebted" countries. Short-term liabilities amounted to $51.5 billion, up by $12.4 billion from end-2001; June external reserves were equivalent to 2.3 times short-term debt.

Asset Markets

The rising won is causing concerns among exporters.

The weakness in the US dollar and strengthening of Korea's balance of payments have combined to put upward pressure on the exchange rate, especially from April through mid-July when appreciation for the year peaked at about 12%. In mid-October the won/dollar rate stood at W1,249.8 (weekly average data), an appreciation of 5.1% since end-2001 (Figure 7). Exporters have been concerned about the rise, which appears to have attracted limited market intervention as reflected by the marked rise in official reserves. The real effective exchange rate is estimated to have appreciated by about 4–5% over the year through August.

Figure 7: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

After peaking in April, the stock market has softened.

Starting in October 2001, stocks rallied strongly through April on expectations of a faster-than-expected economic recovery. Upward momentum, however, was derailed and the market trended downward through September owing to subsequent concerns of overheating in the economy, the rapid appreciation of the won, and fears that exports would lose steam. It also coincided with the downturn in global equity markets influenced by US corporate accounting scandals and growing concerns over its tepid economic recovery. The KOSPI index (weekly average data) rose 38% from end-2001 through its peak in April, but retreated to 8.2% decline for 2002 by mid-October as a result of the selloff.

The commercial property market is stable.

The office vacancy rate in the Seoul central business district fell to 5.5% in the second quarter of 2002 from 7.3% in the third quarter of 2001, the starting point of the economy's ongoing recovery, according to data from a private property company. Net effective rents were reported to be stable. Partly as a result of a rapid increase in mortgage lending, housing prices in certain parts of Seoul have risen sharply and the Government is seeking administrative measures to avoid a bubble market developing.

Financial and Corporate Sector Developments

Financial and corporate reforms underpin the recovery.

Korea has made the most progress among the crisis countries in bank and corporate restructuring. The banking sector has been substantially consolidated and largely restored to financial health, and the industrial corporate landscape has changed dramatically, if not completely. The sale of Seoul Bank to Hana Bank to create Korea's third largest bank and the GM-Daewoo auto agreement were landmarks in restructuring this year in the continuing effort to reform Korea's extensive industrial base. Nevertheless, the Government's restructuring agenda still faces important issues, including resolving the multi-billion dollar Hynix Semiconductor reorganization that failed this year. Other outstanding matters include completing restructurings of other companies remaining in workout programs; enacting the comprehensive corporate liquidation and restructuring bill that consolidates and improves existing bankruptcy laws to strengthen means to force the exit of nonviable firms; and completing the Government's privatization program, including that for the important energy sector.

Banks' bad loan ratio is low.

The ratio of bank loans, graded substandard or below, to total outstanding loans dipped to a record low of 2.4% in June, down 3.3 percentage points from a year ago and 1 percentage point from a semester ago.

A plan for funding financial restructuring costs was announced.

In July, the Government announced a long-term plan for funding the W156 trillion spent (through March 2002) on rescuing the financial system. About W87 trillion is expected to be retrievable from the sale of assets acquired in the operation. Of the unrecoverable balance of W69 trillion, W20 trillion would be financed by higher deposit insurance payments by financial institutions (over 20 years) and the remaining W49 trillion would be met by the budget. Since losses to date have largely been financed by issuance of KDIC and KAMCO bonds, the Government would convert these into Treasury bonds (to be amortized over the next 25 years). As a result, government debt would increase from about 22% of GDP to 30%, still low by any standard.

Social Sector Developments

The unemployment rate is falling.

After falling for four consecutive months, the unemployment rate in June reached 2.7%, the lowest rate since November 1997. Meanwhile, the seasonally adjusted rate was 3%. In August, the rate, affected by unusually heavy typhoon rain, increased to 2.9% or to 3.1% after seasonal adjustment. Real wages (including overtime and bonuses) increased by 6.9% for the first half of 2002, whereas during last year's economic slowdown the real wage increase over the comparable period was only 1.5%.

Prospects and Policy Issues

The growth target for 2002 is attainable but fiscal policy implementation needs strengthening.

Despite increased uncertainty over the momentum of the US economic recovery and international conditions—worries that have caused some recent softening in Korean consumer and business expectations—the economy is likely to grow by about 6% this year. Since a heightened sense of uncertainty may well prevail into 2003, at issue is how Korea can sustain economic growth in the period immediately ahead. Notwithstanding this year's progress, a substantial output gap remains to be eliminated. With relatively low external debt and a sizable current account surplus, the balance of payments will not constrain a continuation of recent macro policies to foster growth in domestic demand. Fiscal policy, however, has been hampered by an inability to reliably achieve expenditure and revenue targets. Achieving real time treasury management would make fiscal policy a more effective tool in carrying out demand management objectives.

The Action Plan for a Northeast Asian Business Hub should be market driven.

In July, the Government announced action plans for transforming Korea into a regional hub for Northeast Asian business that will shape longer-term growth prospects. The plan focused on an air traffic logistics center, a knowledge-based business center, an international financial center, an IT and digital media hub, and supporting policies. Korea has gone a long way toward enhancing the competitiveness of its industrial and financial corporations by adopting structural reforms to ensure that operations are responsive to market forces. This free market orientation should also underpin the strategy and operations of the action plan.

Republic of Korea: Selected ARIC Indicators

	1996	1997	1998	1999	2000	2001	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2	02Q3
Output and Prices																									
GDP Growth (%)	6.8	5.0	-6.7	10.9	9.3	3.0	-4.6	-8.0	-8.1	-5.9	5.8	11.2	13.0	13.0	13.1	10.2	10.0	5.0	3.7	2.9	1.9	3.7	5.8	6.3	. . .
Private Consumption Expenditure Growth (%)	7.1	3.5	-11.7	11.0	7.9	4.2	-11.9	-13.3	-12.5	-9.2	7.9	10.9	12.4	12.8	11.9	9.7	6.6	3.9	1.5	4.1	4.8	6.6	8.4	7.7	. . .
Public Consumption Expenditure Growth (%)	8.2	1.5	-0.4	1.3	0.1	0.2	0.8	-1.0	-0.2	-1.1	0.6	1.7	1.1	1.7	0.5	0.2	-0.7	0.5	-0.7	-0.1	1.0	0.3	5.5	4.9	. . .
Gross Domestic Investment Growth (%)	8.7	-7.5	-38.4	29.5	11.2	-1.9	-49.0	-43.1	-40.6	-23.3	23.3	31.6	36.8	26.6	31.1	11.4	14.6	-2.0	-6.9	-5.7	-2.0	4.8	8.0	7.0	. . .
Gross Fixed Investment Growth (%)	7.3	-2.2	-21.2	3.7	11.4	-1.7	-19.9	-23.9	-22.4	-18.3	-4.6	4.2	6.7	7.2	22.8	13.2	10.9	2.0	-4.0	-4.8	-3.1	4.9	6.5	5.6	. . .
Agricultural Sector Growth (%)	3.3	4.6	-6.6	5.4	2.0	1.4	-4.0	-1.6	-7.6	-8.5	10.5	5.9	7.5	3.1	4.8	1.6	0.1	2.6	-4.1	3.5	1.3	1.5	7.2	-0.7	. . .
Manufacturing Sector Growth (%)	6.8	6.6	-7.4	21.0	15.9	1.7	-5.2	-10.7	-9.5	-4.2	10.0	20.9	26.2	26.4	22.9	17.1	18.5	6.9	4.5	2.2	-1.7	2.1	3.5	6.4	. . .
Construction Sector Growth (%)	6.9	1.4	-8.6	-9.1	-3.1	5.6	-2.9	-6.7	-9.1	-13.4	-13.6	-6.9	-8.4	-8.7	-7.0	-3.7	-1.7	-1.1	2.4	1.5	7.6	9.5	8.8	3.7	. . .
Services Sector Growth (%)	7.8	5.4	-7.2	11.9	9.5	4.1	-6.1	-9.0	-8.5	-5.2	8.0	12.0	13.4	14.2	12.4	10.7	9.3	6.1	3.9	4.0	3.8	4.7	7.8	8.4	. . .
Exports of Goods and Services Growth (%)	11.2	21.4	14.1	15.8	20.5	1.0	26.7	14.4	9.3	8.6	9.1	14.4	20.0	19.5	26.9	20.2	21.9	14.3	9.0	0.7	-4.1	-1.1	1.8	11.8	. . .
Imports of Goods and Services Growth (%)	14.2	3.2	-22.1	28.8	20.0	-2.8	-27.0	-25.4	-25.8	-9.7	27.1	28.1	32.2	28.0	31.6	20.5	22.4	8.0	0.2	-7.2	-5.5	1.1	6.2	19.2	. . .
Inflation Rate (%)	4.9	4.4	7.5	0.8	2.3	4.3	8.9	8.2	7.0	6.0	0.7	0.6	0.7	1.3	1.5	1.4	3.2	2.9	4.2	5.3	4.3	3.4	2.5	2.7	2.5
Unemployment Rate (%)	2.0	2.6	6.8	6.3	4.1	3.7	5.6	6.8	7.4	7.4	8.4	6.6	5.6	4.6	5.1	3.8	3.6	3.7	4.8	3.5	3.3	3.2	3.6	2.9	. . .
Monetary and Fiscal Accounts																									
Growth of Broad Money, M2 (%)[1]	15.8	14.1	27.0	27.4	25.4	13.2	12.1	16.3	24.8	27.0	36.3	26.4	24.2	27.4	26.0	37.7	28.3	25.4	17.9	14.5	16.5	13.2	17.5	13.5	. . .
Three-Month Certificate of Deposit Rate (%)[1]	13.3	25.0	7.7	7.4	6.9	4.9	21.2	16.3	10.1	7.7	6.6	6.4	7.7	7.4	7.0	7.1	7.1	6.9	5.7	5.6	4.4	4.9	4.8	4.9	4.8
Growth in Real Bank Credit to Private Sector (%)[1]	13.9	11.2	-5.3	17.1	15.6	12.5	6.3	1.1	-6.0	-5.3	-0.8	4.6	13.6	17.1	18.0	21.1	18.2	15.6	11.0	8.7	11.9	12.5	17.7	18.9	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	. . .	11.3	8.1	4.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	11.3	10.8	10.7	9.7	8.1	7.2	6.4	6.0	4.9	4.6	3.8	. . .
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	. . .	8.3	6.6	2.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	8.3	8.0	8.7	7.9	6.6	5.4	4.1	3.8	2.9	2.5	1.9	. . .
Average Stock Price Index	90.5	67.9	46.8	96.1	92.3	71.2	58.3	43.0	36.5	50.6	65.8	90.1	113.1	112.6	114.3	96.9	89.8	67.2	72.0	71.9	66.9	74.3	99.1	105.6	90.9
Central Government Fiscal Balance as % of GDP	. . .	. . .	-4.2	-2.7	1.3	1.3	. . .	. . .	. . .	-15.6	-3.1	-2.3	-2.1	-3.3	9.3	3.4	2.2	-8.4	9.6	0.6	-1.9	-2.1	6.0	5.5	. . .
Central Government Debt as % of GDP[1]	. . .	11.1	16.1	18.6	19.3	20.8	. . .	. . .	. . .	16.1	17.9	. . .	18.3	18.6	18.7	18.9	19.1	19.3	19.4	19.9	20.2	20.8	21.3	21.1	. . .
Government Expenditure on Education (% of Total)	3.4	3.6	3.8	3.7	3.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	0.2	0.2	0.2	0.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																									
Growth of Merchandise Exports ($ fob, %)	3.7	5.0	-2.8	8.6	19.9	-12.7	8.4	-1.8	-10.8	-5.5	-6.1	2.5	15.1	22.7	29.8	21.5	26.5	6.1	2.2	-11.6	-19.8	-19.6	-11.1	5.1	17.3
Growth of Merchandise Imports ($ cif, %)	11.3	-3.8	-35.5	28.4	34.0	-12.1	-36.2	-37.0	-39.9	-28.7	8.1	22.2	38.7	44.8	51.9	38.4	35.8	16.2	-1.8	-13.4	-15.5	-17.1	-11.5	7.8	13.8
Current Account Balance as % of GDP	-4.4	-1.7	12.7	6.0	2.7	2.0	15.9	14.2	11.9	9.5	6.7	6.3	6.5	4.8	1.5	2.6	3.6	2.9	2.8	3.6	1.0	0.9	1.7	1.6	. . .
Net Foreign Direct Investment ($ Billion)	-2.3	-1.6	0.7	5.1	4.3	0.6	-0.03	0.6	0.7	-0.5	0.1	1.2	2.1	1.7	0.4	1.9	-0.1	2.0	0.5	0.2	0.2	-0.3	-0.1	-0.6	. . .
Net Portfolio Investment ($ Billion)	15.2	14.3	-1.9	8.7	12.0	6.3	3.8	0.6	-3.9	-2.4	0.9	4.0	-1.2	4.9	7.1	1.9	2.1	1.0	0.8	2.8	-0.7	3.4	-1.5	-3.8	. . .
Gross International Reserves ($ Billion)[1]	33.2	20.4	52.0	74.1	96.2	102.8	29.7	40.9	47.0	52.0	57.5	62.0	65.5	74.1	83.6	90.2	92.5	96.2	94.4	94.3	100.1	102.8	106.1	112.4	116.7
Total External Debt as % of GDP[1]	. . .	33.2	46.4	33.7	28.6	27.8	35.9	40.4	44.7	46.4	42.4	38.8	36.5	33.7	33.4	31.8	30.3	28.6	27.6	27.6	27.7	27.8	28.1	28.9	. . .
Short-Term Debt as % of Gross International Reserves[1]	280.8	311.5	59.0	53.0	49.8	38.1	179.9	82.7	65.3	59.0	54.6	50.4	52.8	53.0	53.2	53.8	54.1	49.8	48.9	47.1	42.9	38.1	38.8	42.4	. . .
Short-Term Debt as % of Total Debt[1]	57.1	39.9	20.6	28.6	36.4	33.3	34.7	21.8	20.2	20.6	21.6	22.2	24.7	28.6	31.4	34.6	36.2	36.4	36.9	36.4	35.9	33.3	34.5	37.9	. . .
Real Effective Exchange Rate (1995=100)[2]	104.5	100.3	83.1	90.8	94.1	91.5	73.8	83.7	88.8	86.1	91.7	92.6	89.7	89.2	93.7	94.2	94.9	93.5	90.4	90.6	91.3	93.8	95.4	97.0	. . .
Average Exchange Rate (Local Currency to $)	802	949	1,396	1,188	1,131	1,290	1,597	1,393	1,324	1,280	1,196	1,189	1,195	1,173	1,127	1,116	1,115	1,168	1,272	1,306	1,291	1,290	1,318	1,266	1,197

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, M2, real bank credit to private sector, nonperforming loan ratios of the financial and commercial banking system, central government fiscal balance, central government debt, government expenditure on education and health, merchandise exports and imports, current account balance, net foreign direct and portfolio investments, gross international reserves, and total and short-term external debts are from national sources. Data on three-month certificate of deposit rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on REMU staff calculations.

Malaysia

Real Sector

Economic recovery is underway.

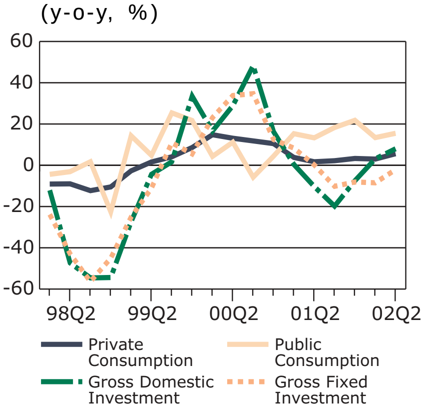
After posting near-zero growth in 2001, the Malaysian economy began to show signs of a rebound in the first quarter of 2002 when it grew by 1.1% (y-o-y). Recovery continued in the second quarter when much stronger growth of 3.8% was recorded to bring the overall expansion in the first half of 2002 to 2.5%. Early in the year, the central bank had forecast GDP growth for 2002 to be 3.5%. However, the Economic Report 2002/2003, accompanying the 2003 budget presented in September, has upgraded this to the 4–5% range (Table 1).

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

	1997	1998	1999	2000	2001	2002	2003
Official[1]	7.3	-7.4	6.1	8.3	0.4	4.0-5.0	—
ADB[2]	—	—	—	—	—	4.5	5.0
IMF[3]	—	—	—	—	—	3.5	5.3
World Bank[4]	—	—	—	—	—	3.0	6.0
Consensus Economics[5]	—	—	—	—	—	4.2	5.2

[1]Ministry of Finance, Economic Report 2002/2003.
[2]ADB, *Asian Development Outlook 2002 Update,* September 2002.
[3]IMF, *World Economic Outlook*, September 2002.
[4]World Bank, *East Asia Update Regional Overview*, April 2002.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* October 2002.

Figure 1: **Growth of GDP Expenditure Components** (y-o-y, %)

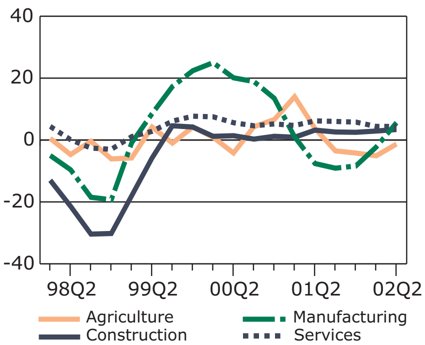


Source: ARIC Indicators.

Growth in consumption remains strong.

During the economic slowdown, Malaysian policymakers used expansionary fiscal policies to pump prime the economy. In 2002, the Government continued with its efforts to stimulate domestic demand. Government consumption expenditure grew by 14.5% (Figure 1) in the first half of the year, accounting for about 1.5 percentage points of GDP growth. An accommodative monetary policy has also been in place to assist the recovery and boost private demand. Growth in private consumption increased from 3% in the first quarter to 5.6% in the second. Gross fixed investment continued to decline in the second quarter, but only by 2%, substantially less than the 8–10% range of the previous three quarters. Moreover, the improving outlook in the manufacturing sector has prompted restocking with inventories beginning to rise in the first quarter of 2002. To maintain investment momentum in the medium term, however, it will be necessary to overcome the recent slowing in applications for new investment in manufacturing. Investment applications were only RM6 billion ($1.6 billion) during the first half of 2002, compared to RM16.1 billion ($4.2 billion) last year and RM46.2 billion ($12.2 billion) in 2000. Moreover, foreign investors accounted for only one third of applications this year (RM2.1 billion), whereas they usually account for two thirds of such applications.

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



Source: ARIC Indicators.

Manufacturing growth rebounded strongly and services remain strong.

After consecutive declines since the first quarter of 2001, manufacturing output grew by an impressive 5.6% in the second quarter of 2002, bringing growth for the first half to 1.6% (Figure 2). The improved manufacturing performance was supported by a turnaround in manufacturing exports and stronger domestic demand. Average manufacturing capacity utilization in the second quarter was 82%, compared to 79% in the fourth quarter of last year (for electronics, 85% versus 78%). The services sector continued to underpin overall growth. Strong domestic demand has allowed the services sector to maintain robust growth of about 4.5% in both the first and second quarters, accounting for 2.5 percentage points of output growth in the first half of 2002. Construction output grew by 3.1% in the first half. Increased government spending on public projects and improved demand for low cost housing accounted for the steady expansion in the sector over the course of the economic slowdown. On the other hand, growth in agricultural output continued to be negative in the second quarter, although reduced to –1.3%. The weakness in agriculture was mainly due to a drop in palm oil production and fishing output. As part of its diversification campaign, the Government is committed to revitalizing the agricultural sector.

Fiscal and Monetary Developments

The budget deficit is forecast to fall in 2002 with a further decline planned for 2003.

The 2002 central Government budget was designed to support growth momentum but also aimed at limited fiscal consolidation by targeting a lower deficit of 5.1% of GDP, compared to the 5.5% outturn in 2001. In implementing the budget, additional spending allocations were made. The 2002 budget included a 10% salary revision for civil servants and several tax measures, including a reduction in personal income tax rates, lower import duties on certain intermediate goods, and adjustments in investment allowances and depreciation and tax holiday coverage for enterprises. The focus of fiscal policy was on sustaining aggregate demand and for the medium and long term increasing productivity and competitiveness through spending on education, human resource development, and improvements in infrastructure. Despite the additional spending allocations, recent estimates of the budget outcome indicate that due to strong revenue performance during the year, the fiscal deficit for 2002 will be about 4.7% of GDP, less than that originally budgeted. Nonetheless, public sector consumption and investment expenditure is expected to contribute 1.3 percentage points to GDP growth of 4–5% expected for the year.

The budget for 2003, based on expectations of more robust growth prospects, globally and domestically, plans further fiscal consolidation in line with the goal of achieving a balanced budget by the end of the Eighth Malaysian Plan (2001–2005). The budget deficit for 2003 is to be reduced to 3.9% of GDP. The policy thrust of budget is to be supportive of the private sector as the driver of growth through improving competitiveness and diversification. Expenditure emphasis is on human resource development, research and development, SMEs, agriculture, and services. No major tax measures will be taken, although the corporate rate is to be reduced by 8 percentage points to 20% for SMEs.

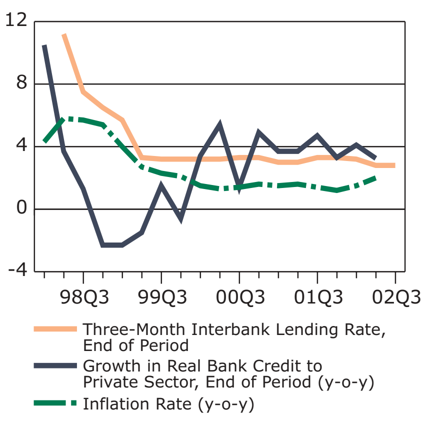
Interest rates remain low.

An accommodative monetary policy stance has been maintained during 2002 with ample liquidity and low interest rates supporting economic growth. The average bank lending rate fell from 6.67% at end-2001 to 6.49% at mid-year. Bank lending in the first half of the year has focused mainly on residential mortgage loans and consumer credit, mainly for the purchase of passenger cars. Outstanding bank credit increased by 3.6% in the year ending in August. With continued economic recovery, particularly in the manufacturing sector, demand for funds by the production sector will likely increase in the second half of the year. The broad money supply (M3) grew by 6.2% in the year ending in August.

Inflation was kept in check.

The consumer price index (CPI) rose by 2.1% in August (Figure 3). For the first eight months of 2002, the CPI averaged 1.8% above the period a year ago. The producer price index (PPI) increased by 3.8% (y-o-y) in July, largely reflecting better (though still relatively low) prices for crude palm oil and rubber. Excluding commodity-related products, the PPI was down 0.1%. As in the past, prudent monetary policy is expected to maintain price stability.

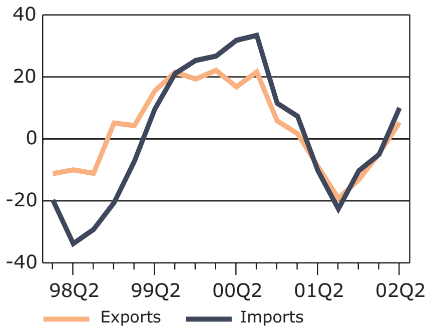
Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

Balance of Payments

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)

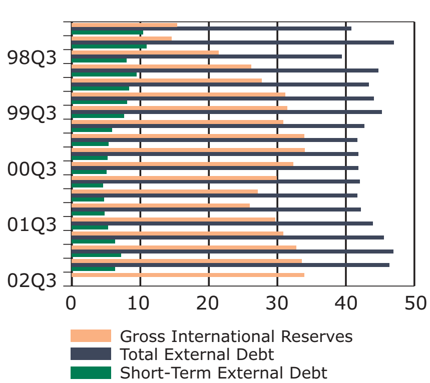


Source: ARIC Indicators.

The trade surplus shrunk but the current account surplus is little changed.

Malaysia's trade account (BOP basis) recorded a surplus of $8.3 billion in the first half of 2002, compared to $9.8 billion a year ago, as last year's import compression and drawdown of inventories were reversed this year. Exports grew by 5.2% (y-o-y) in the second quarter of 2002 after a decline of 4.3% in the first (Figure 4). The recovery in exports mainly reflected a 7% expansion in electronics and electrical products (about 70% of total exports), with the electronics sub category (about 50% of total exports) growing by 16.6% and offsetting weakness in certain electrical components. Imports also turned up in the second quarter by nearly 10% (down 3.9% in the first quarter), as the economy started to recover. Import growth was led by a recovery in the imports of intermediate goods brought about by improved manufacturing and export sector performance. A reduction in the services deficit this year, in part owing to the Government's promotion efforts, and lower net payments in the income and transfer accounts, offset most of the lower trade surplus. This resulted in a current account surplus of $3.4 billion for the first half of 2002, compared to $3.6 billion last year. Consensus Economics (October) forecast a $6.2 billion current account surplus for 2002, while the (September) Economic Report for the budget estimated it to be $6.1 billion (6.5% of GDP), compared to $7.3 billion (8.3% of GDP) last year.

Figure 5: **International Reserves and External Debt** ($ billion)



Source: ARIC Indicators.

The overall balance of payments records a surplus.

The overall balance of payments recorded a surplus of $2.8 billion for the first half of 2002. The financial account moved from surplus to deficit between the first and second quarters to record a $780 million deficit for the half year. While various factors were at work, the reversal was largely due to a change from net portfolio investment inflow to outflow between quarters. This turnaround coincided with the change in the direction of stock market prices, and outflows likely continued in the third quarter as part of the worldwide flight from equities. Foreign net direct investment in Malaysia increased to $1.5 billion in the first half of 2002, compared to $1.1 billion in the same period a year ago.

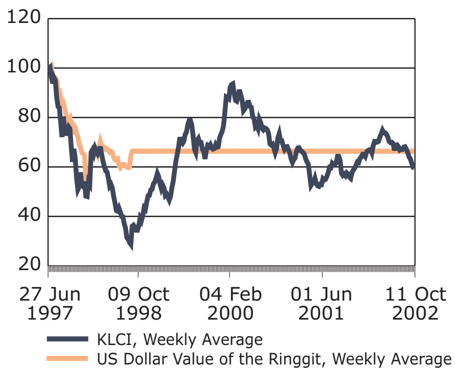
The reserve position is strong and external debt is little changed.

Malaysia's international reserve position remains strong. Gross international reserves stood at $34 billion as of end-September 2002, up from $30.8 billion as of end-2001. Reserves are equivalent to about

5.5 months of retained imports. As at end June 2002, total external debt amounted to $46.4 billion, compared to $45.6 billion (51.8% of GDP) outstanding at end-2001. Short-term debt was $6.3 billion (13.7% of total external debt) and unchanged from the end-2001 level. Reserves provide ample cover (a multiple of 5.3) for short-term external debt.

Asset Markets

Figure 6: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)



Source: ARIC Indicators.

The ringgit depreciated against other currencies.

With the weakening of the US dollar, the ringgit has depreciated against the other major currencies of the world. Between December 2001 and mid-October 2002, the ringgit depreciated by about 10.2% against the euro and 5.2% against the yen. From end-2001 through August, Malaysia's effective exchange rate depreciated by 6.5% in nominal terms and 5.3% in real terms.

The KLCI remains volatile.

Volatility in the stock market continued for most of 2002. The Kuala Lumpur Composite Index (KLCI) increased through the last week of April by 18% (Figure 6) on end-December 2001 levels (weekly average data). Subsequently, the KLCI weakened through early October, wiping out all of the gains made in the early months of the year. The downturn occurred in the context of a general weakening in the stock markets of industrial countries, especially the United States.

Office vacancy rates continues to rise.

The office vacancy rate during the first and second quarters of 2002 was 20%, compared with 18.9% in the fourth quarter of last year (Table 2). Due to continued weak demand in this period, rental values fell by 5–10% for most office buildings. Three new retail projects were completed in the second quarter. With a large proportion of space in these projects still being readied for occupancy, the vacancy rate in the retail property sector has increased to 14.2% in the second quarter from 12.3% in the first.

Table 2: **Property Vacancy Rates in Kuala Lumpur** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2
Office	11.6	13.6	15.5	15.7	17.0	17.0	18.8	17.8	17.5	17.0	18.5	17.8	18.4	18.7	18.9	20.0	20.0
Retail	. . .	. . .	. . .	. . .	12.8	. . .	15.2	. . .	13.2	. . .	13.4	. . .	12.5	12.4	12.4	12.3	14.2

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

Financial and Corporate Sector Developments

Bank capitalization is high and steps are being taken to strengthen credit risk evaluation.

The risk-weighted capital ratio (RWCR) stood at 13.1% in August 2002, improved from 13.0% at end-2001, and well above the BIS minimum ratio of 8%. To assist in credit evaluation, a Central Credit Reference Information System was inaugurated to enable banks to have real-time, online access to a comprehensive up-to-date database on all borrowers from the banking system. In addition, a standard of Best Practices for Management of Credit Risk was issued, stipulating minimum requirements to be observed by banks in all aspects of credit activities.

The NPL ratio is improving.

The NPL ratio (three-month basis) of commercial banks fell to 9.8% in August 2002 from 10.5% at end-2001. The NPL ratio had risen in the wake of the economic slowdown last year, increasing from 8.3% at end-2000 to 10.9% in October 2001, before moderating.

Asset disposal continues to progress.

Danaharta has initiated recovery action on essentially all of the RM47.76 billion of loans it had acquired and expects a recovery of 57%. By mid-2002, RM9.6 billion of recoveries had been distributed to banking institutions. In December 2001, Danaharta made Malaysia's first asset backed security issue of RM310 million of four-year notes at a coupon of 3.875%.

CDRC has been closed.

The Corporate Debt Restructuring Committee (CDRC) was closed effective 15 August 2002. Of the 50 cases accepted, only three remain unresolved and one case is still pending lender's approval; Danaharta will oversee the pending case. CDRC resolved 47 cases with debts valued at RM43.97 billion with recovery of 61% in the form of cash and redeemable instruments, and 22% in rescheduled debts.

Social Sector Developments

The labor market has perked up.

Retrenchment peaked in September 2001 at 5,830 workers but fell to 1,440 workers by June 2002. The unemployment rate rose from 3.1%

in 2000 to 3.7% in 2001. While unemployment remained at this level in the first quarter of 2002, it is expected to moderate to 3.5% for the year. Thus, while the economy has experienced a marked slowdown it continued to operate at close to full employment.

Prospects and Policy Issues

Economic outlook is favorable.

The economic recovery that began in the first quarter 2002 is expected to continue, as reflected for instance in the recent increases in the Malaysian Institute of Economic Research (MIER) consumer and business sentiment indexes. The October 2002 issue of Consensus Economics puts GDP growth at 4.2% in 2002. Although much slower than the growth rates posted immediately after the 1997 Asian crisis, this is an improvement from the near-zero growth last year. Recovery in fixed investment is seen in the second half of the year when the economy is expected to begin operating closer to capacity. A further rebound in growth is expected in 2003 with the pickup in investment. Consensus Economics forecasts 2003 GDP growth to be 5.2%, in line with other agency forecasts such as the September IMF WEO projection of 5.3%.

Diversification to a knowledge-based economy is a top priority.

Malaysia is taking steps to diversify its economy. These include fostering growth in the rapidly expanding services sector by promoting tourism and developing the country into a transport and logistical hub through the new Kuala Lumpur International Airport and the large, rapidly expanding Tanjung Pelepas Port in Johor.

To speed up the transformation, the Government is carrying out the Knowledge-based Economy Master Plan that outlines strategies to accelerate movement to a knowledge-based economy. The Multimedia Super Corridor (MSC), which has already attracted 53 world-class companies, will provide infrastructural support for the strategies. In this connection, biotechnology in Malaysia is to be further developed by the Bio Valley initiative that will cluster three new research institutions, universities, and specialized companies within the MSC (renamed the Biotechnology and Information Technology Super Corridor).

While growth in the global demand for electronics will most certainly revive and again grow rapidly, substantially reduced IT industry margins and the emergence of low cost regional competitors underline the need to transform the economy and reduce Malaysia's high exposure to the electronics sector.

Government expenditure kept the Malaysian economy growing during the global economic and IT slowdown last year, while also maintaining high levels of development expenditure oriented to transforming the growth process. While the decline in the central government deficit in the 2003 budget represents prudent fiscal consolidation, the budget plans were formulated when the global outlook appeared brighter than it does now. Moreover, because of lower investment expenditure by nonfinancial public enterprises, the overall public sector balance in 2003 is expected to move toward a surplus. Accordingly, if the global economy substantially weakens, Malaysia would again need to decide whether additional expansionary fiscal measures would be required to maintain adequate growth and diversification momentum.

Malaysia: Selected ARIC Indicators

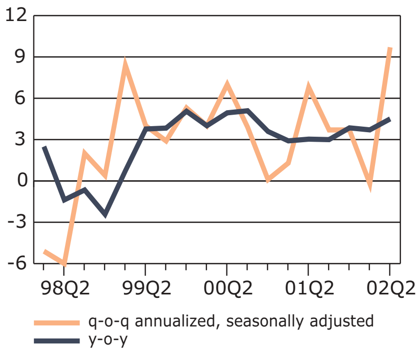
	1996	1997	1998	1999	2000	2001	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2	02Q3
Output and Prices																									
GDP Growth (%)	10.0	7.3	-7.4	6.1	8.3	0.4	-1.5	-5.9	-10.2	-11.2	-1.0	4.8	9.1	11.7	11.5	8.1	7.7	6.3	3.0	0.4	-0.9	-0.5	1.1	3.8	. . .
Private Consumption Expenditure Growth (%)	6.9	4.3	-10.2	2.9	12.5	2.8	-9.1	-9.0	-12.3	-10.5	-2.7	1.6	4.1	8.6	14.8	13.1	11.8	10.5	3.8	1.7	2.2	3.3	3.0	5.6	. . .
Public Consumption Expenditure Growth (%)	0.7	5.7	-8.9	17.1	3.0	17.6	-4.4	-3.1	1.7	-22.6	14.3	4.8	25.4	21.7	4.3	11.2	-5.8	4.4	15.3	13.3	18.3	21.8	13.4	15.5	. . .
Gross Domestic Investment Growth (%)	. . .	12.2	-43.5	-3.9	27.4	-9.9	-12.1	-47.3	-54.6	-54.4	-27.4	-4.4	1.7	33.5	16.6	28.9	48.3	16.3	0.4	-10.3	-19.8	-7.5	3.1	8.0	. . .
Gross Fixed Investment Growth (%)	. . .	9.2	-43.0	-6.5	25.7	-2.8	-23.8	-42.9	-56.4	-45.0	-25.1	-11.1	10.9	5.5	23.1	33.8	34.7	12.5	8.3	0.2	-10.2	-8.1	-8.5	-2.1	. . .
Agricultural Sector Growth (%)	4.5	0.7	-2.8	0.5	2.0	1.8	0.5	-4.7	-0.4	-6.1	-5.8	4.2	-1.0	4.2	0.9	-4.2	4.3	6.6	14.0	3.7	-3.5	-4.2	-5.1	-1.3	. . .
Manufacturing Sector Growth (%)	18.2	10.1	-13.4	11.7	19.1	-6.2	-5.0	-9.6	-18.5	-19.3	-0.9	8.5	17.3	22.4	25.0	20.1	18.9	13.5	1.0	-7.6	-9.1	-8.4	-2.3	5.6	. . .
Construction Sector Growth (%)	16.2	10.6	-24.0	-4.4	1.0	2.3	-13.0	-21.4	-30.4	-30.2	-18.0	-5.8	4.6	4.2	1.2	1.4	0.3	1.2	0.9	3.2	2.6	2.5	2.9	3.4	. . .
Services Sector Growth (%)	8.9	9.9	-0.4	4.5	5.7	5.7	4.4	0.1	-2.6	-3.0	1.1	2.8	6.1	7.7	7.5	5.6	4.6	5.2	4.7	6.2	6.0	5.8	4.4	4.4	. . .
Exports of Goods and Services Growth (%)	9.2	5.0	0.9	13.2	16.1	-7.5	-0.9	-1.5	2.3	3.7	2.1	12.7	18.5	18.6	21.4	16.8	19.2	8.3	6.4	-6.0	-16.3	-12.0	-6.5	3.1	. . .
Imports of Goods and Services Growth (%)	4.9	5.8	-18.8	10.6	24.4	-8.6	-9.5	-24.9	-22.5	-17.1	-8.4	8.9	17.7	25.4	25.8	27.9	32.3	12.9	7.5	-8.1	-20.1	-10.5	-4.8	6.7	. . .
Inflation Rate (%)	3.5	2.7	5.3	2.7	1.4	1.4	4.3	5.8	5.7	5.4	4.0	2.7	2.3	2.1	1.5	1.3	1.4	1.6	1.5	1.6	1.4	1.2	1.5	2.0	. . .
Unemployment Rate (%)	2.5	2.6	3.2	3.4	3.1	3.7	. . .	. . .	. . .	. . .	4.5	3.3	2.9	3.0	3.0	3.3	3.1	3.0	4.0	3.7	3.3	3.7	3.7	3.8	. . .
Monetary and Fiscal Accounts																									
Growth of Broad Money, M2 (%)[1]	24.3	17.4	-1.4	16.9	9.9	2.5	10.0	6.8	2.8	-1.4	3.6	13.2	17.1	16.9	18.5	11.9	7.2	9.9	7.3	4.6	5.9	2.5	4.2	4.5	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	. . .	6.5	3.2	3.3	3.3	. . .	11.2	7.5	6.5	5.7	3.3	3.2	3.2	3.2	3.2	3.3	3.3	3.0	3.0	3.3	3.3	3.2	2.8	2.8
Growth in Real Bank Credit to Private Sector (%)[1]	22.3	20.2	-2.3	-0.6	4.9	3.3	10.5	3.7	1.3	-2.3	-2.3	-1.5	1.5	-0.6	3.4	5.4	1.4	4.9	3.7	3.7	4.7	3.3	4.1	3.3	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	13.6	11.0	9.7	11.5	. . .	. . .	12.8	13.6	14.2	12.4	12.0	11.0	10.7	10.4	10.1	9.7	10.6	11.4	11.7	11.5	11.5	11.0	. . .
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	10.3	8.8	8.3	10.5	. . .	. . .	10.5	10.3	11.1	9.4	9.6	8.8	8.9	8.6	8.5	8.3	9.3	10.3	10.7	10.5	10.6	10.0	. . .
Average Stock Price Index	1,134.8	972.6	515.9	696.3	841.4	636.7	657.7	565.3	381.1	466.7	556.0	706.9	763.2	741.8	950.1	892.8	792.0	734.8	694.7	579.2	646.7	632.7	720.2	767.5	712.0
Central Government Fiscal Balance as % of GDP	0.7	2.4	-1.8	-3.2	-5.8	-5.5	5.9	-0.5	2.1	-14.7	1.8	0.2	-7.2	-6.4	1.2	-1.9	-5.2	-16.5	-2.0	2.2	-3.6	-18.6	-1.5	-4.6	. . .
Central Government Debt as % of GDP[1]	35.3	31.9	36.4	37.3	36.7	43.6	30.5	31.4	30.8	36.4	37.0	38.5	37.9	37.3	36.4	37.1	36.9	36.7	37.5	37.8	40.9	43.6	43.5	44.0	. . .
Government Expenditure on Education (% of Total)	4.9	4.6	4.7	5.1	5.9	7.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	4.3	3.8	4.0	4.1	4.1	4.8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																									
Growth of Merchandise Exports ($ fob, %)	9.0	0.7	-7.0	15.3	16.1	-10.4	-11.2	-10.0	-11.1	5.1	4.3	15.5	21.5	19.3	22.1	16.8	21.6	5.8	1.7	-8.9	-19.2	-13.2	-4.9	5.3	. . .
Growth of Merchandise Imports ($ cif, %)	1.0	0.7	-26.1	12.0	25.3	-9.9	-19.7	-33.8	-29.2	-20.6	-7.2	9.6	21.1	25.3	26.7	31.8	33.4	11.5	7.3	-10.3	-22.6	-10.3	-5.0	11.3	. . .
Current Account Balance as % of GDP	-4.8	-5.2	13.5	15.9	9.3	8.0	6.4	11.4	17.4	18.7	16.0	16.7	18.0	13.2	12.9	7.8	8.3	8.6	8.5	8.0	8.7	6.7	8.7	6.7	. . .
Net Foreign Direct Investment ($ Billion)[2]	5.1	5.6	2.2	2.3	1.8	0.3	1.10	0.7	-0.2	0.6	0.3	1.0	0.2	0.8	0.5	0.2	0.4	0.6	0.3	0.3	0.6	-0.9	0.6	0.04	. . .
Net Portfolio Investment ($ Billion)[2]	4.1	-4.4	-6.9	-3.9	-2.5	-0.6	-2.3	-1.2	-1.1	-2.2	-1.8	-0.7	-0.7	-0.7	1.4	-1.7	-1.2	-0.9	-0.6	-0.2	0.6	-0.4	0.8	-1.3	. . .
Gross International Reserves ($ Billion)[1]	27.8	15.7	26.2	30.9	29.9	30.8	15.4	14.6	21.4	26.2	27.7	31.2	31.4	30.9	34.0	34.0	32.3	29.9	27.2	26.0	29.7	30.8	32.7	33.6	34.0
Total External Debt as % of GDP[1]	. . .	48.5	61.9	54.0	46.7	51.8	44.0	55.9	51.9	61.9	60.0	60.1	59.4	54.0	50.4	48.8	47.4	46.7	46.1	46.9	49.3	51.8	53.2	51.8	. . .
Short-Term Debt as % of Gross International Reserves[1]	36.0	79.2	36.0	19.1	15.4	20.5	67.4	74.7	37.3	36.0	30.2	25.8	24.3	19.1	15.8	15.4	15.8	15.4	17.3	18.3	17.9	20.5	22.0	18.8	. . .
Short-Term Debt as % of Total Debt[1]	25.7	25.3	21.1	13.8	10.9	13.8	25.4	23.2	20.3	21.1	19.3	18.2	16.9	13.8	12.8	12.5	12.2	10.9	11.3	11.3	12.1	13.8	15.3	13.7	. . .
Real Effective Exchange Rate (1995=100)[3]	106.5	105.5	86.8	87.6	86.2	92.9	84.8	88.9	86.5	87.1	89.4	89.7	87.2	84.2	85.8	85.7	85.8	87.4	91.0	92.8	92.7	95.1	99.0	95.8	. . .
Average Exchange Rate (Local Currency to $)	2.5	2.8	3.9	3.8	3.8	3.8	4.0	3.8	4.1	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	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, nonperforming loan ratios of the financial and commercial banking system, central government fiscal balance, central government debt, government expenditure on education and health, merchandise exports and imports, current account balance, net foreign direct and portfolio investments, gross international reserves, and total and short-term external debts are from national sources. Data on M2 and real bank credit to private sector 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 REMU staff calculations.

Philippines

Real Sector

Figure 1: **GDP Growth Rates** (%)



Source: ARIC Indicators.

Growth in the second quarter has surprised on the upside.

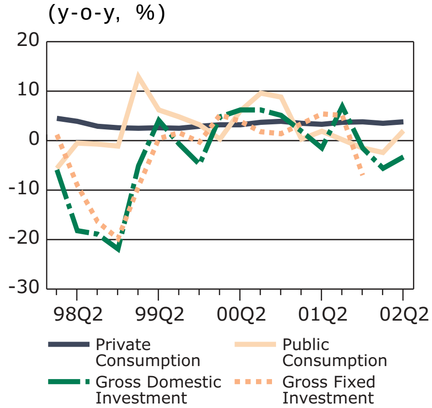
In the face of the global slowdown last year, the Philippine economy has performed well compared to some of its neighbors, growing by 4.1% year-on-year in the first half of 2002. Second quarter growth was particularly buoyant at 4.5%, exceeding both the government forecast and market expectations. The quarter-on-quarter annualized growth accelerated to 9.7% in the April–June period after a decline of 0.2% in the first quarter, suggesting the economy is picking up momentum (Figure 1). The official growth target for 2002 is 4% to 4.5% (Table 1).

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

	1997	1998	1999	2000	2001	2002	2003
Official[1]	5.2	-0.6	3.4	4.4	3.2	4.0-4.5	—
ADB[2]	—	—	—	—	—	4.0	4.5
IMF[3]	—	—	—	—	—	4.0	3.8
World Bank[4]	—	—	—	—	—	4.0	4.5
Consensus Economics[5]	—	—	—	—	—	4.0	3.8

[1]NEDA, Director-General Speech, August 2002.
[2]ADB, *Asian Development Outlook 2002 Update*, September 2002.
[3]IMF, *World Economic Outlook*, September 2002.
[4]World Bank, *East Asia Update Regional Overview*, April 2002.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, October 2002.

Figure 2: **Growth of GDP Expenditure Components** (y-o-y, %)



Source: ARIC Indicators.

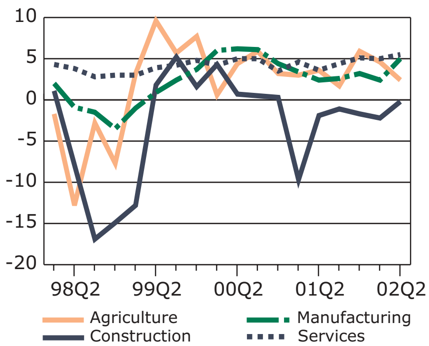
A rebound in exports and strong consumer spending have driven growth.

Growth was largely driven by a rebound in net exports and steady domestic consumption. On the back of a modest recovery in the global IT market earlier this year, exports of goods and services (in real terms) grew by 7.3% (y-o-y) in the second quarter, compared to a contraction of 4.1% in the first. Steady domestic consumption was underpinned by buoyant consumer spending, growing by 3.6% in the six months to June and 3.8% in the second quarter (Figure 2). Public consumption, on the other hand, contracted by 2.4% in the first quarter, as the Government tightened its expenditure in an attempt to keep fiscal deficits under control. But it recovered in the second quarter, resulting in zero growth for the first half of this year.

But investment continues to be weak.

Fixed investment declined by 0.4% in the six months to June. This was largely a result of shrinking investment in public construction and durable equipment. However, there have been signs of a revival of private investment in recent months. Particularly in construction, this made a modest recovery from its depressed performance of the past several years, registering positive growth in the first half. Underpinning the recovery was renewed activity in private real estate development and construction of new factories, lifting private construction outlays by 4.2% in the first six months of 2002, compared with a contraction of 2% in the same period last year.

Figure 3: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

Manufacturing picked up, while the service sector remains strong.

On the supply side, growth was underpinned by a continuously buoyant service sector and a pickup in manufacturing production. Owing to a strong rebound in exports, particularly of electronic products, manufacturing growth rose from 2.4% in the first quarter to 5% in the second (Figure 3), pushing the sector's first half growth to 3.7%. Fueled by activity in communications, trade, and financial services, the service sector also turned in a stronger performance, growing by 5.3% in the first half. After a robust performance of 4.6% in the first quarter, agriculture growth dipped to 2.4% in the second quarter due to a contraction in corn and coconut production. The construction sector output, on the other hand, contracted by 1.2% in the six months to June, although this represents an improvement from the sharp contraction of 5.8% in the first half of last year.

Fiscal and Monetary Developments

Fiscal deficit breached targets.

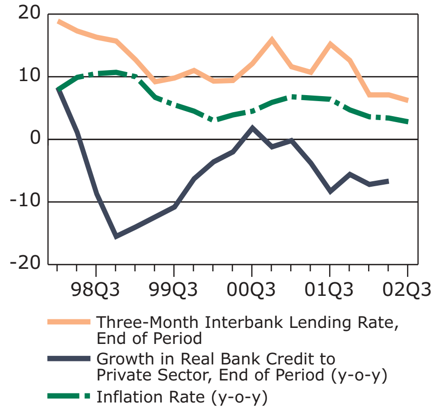
The accumulated fiscal deficit in the eight months to August reached P144 billion, equivalent to 111% of the full-year target (P130 billion or 3.3% of GDP). The significant fiscal slippage, which had a negative impact on the stock market, was caused mainly by a 15% shortfall in revenues from the programmed level, due to poor collection. To keep the deficit under control, the Government through the Bureau of Internal Revenue is stepping up its efforts to improve revenue collection, including stricter monitoring, auditing, and enforcement; intensifying the tax awareness campaign; and waging a war against smuggling. Through these and other fiscal reform measures, as well as expected interest savings owing to lower interest rates, the Government hopes to keep the deficit within 4% of GDP.

Public debt continues to climb.

As of mid-2002, the national government debt stood at P2.65 trillion, with domestic debt accounting for 53% of this. The figure represents a

17% surge from its level a year earlier and a 6% increase from the level at the beginning of this year. The increase was largely due to the issuance of Retail Treasury Bonds that were oversubscribed. National government debt stood at 67% of GDP as of mid-2002, a ratio higher than in most of the other crisis-affected countries.

Figure 4: **Short-Term Interest Rate, Real Bank Credit Growth[1], and Inflation Rate** (%)



[1]Data for 02Q2 as of May 2002.
Source: ARIC Indicators.

The Government's inflation target was revised downward.

After a significant deceleration in the last quarter of 2001, inflation remains low this year despite increases in domestic oil prices (Figure 4). Inflation averaged 3.6% in the first quarter, 3.4% in the second, and fell further to 2.6% in July before rising to 2.9% in August and September. The low figures were partly a result of subdued food prices due to improved supply and a broadly stable exchange rate. High unemployment and excess capacity in many sectors have also helped to mute inflationary pressures. The Government has scaled down its inflation target from 5–6% to 4.5–5.5% for this year. Bangko Sentral ng Pilipinas (BSP), the country's central bank, formally adopted the inflation targeting policy framework in January 2002.

The monetary stance has become cautious.

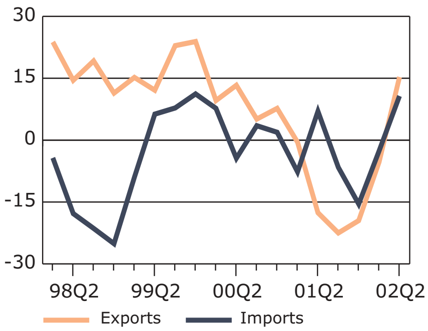
Following an easing in the last quarter of 2001 and the first quarter of 2002, monetary policy has moved to a neutral stance owing to perceived inflationary risks. In the last quarter of 2001, key policy rates were lowered four times by a total of 125 bp. Further easing occurred in mid-March 2002 when rates were lowered by 75 bp to bring the overnight borrowing rate to 7% and the overnight lending rate to 9.25%. These rates have been maintained subsequently through September, as has the reserve requirement after it was reduced from 18% to 16% in January 2002.

Balance of Payments

The trade and current account surplus widens.

After five consecutive quarters of decline, merchandise exports rebounded strongly in the second quarter of this year, growing by 15.3%. The rebound was largely driven by increased shipments of semiconductors and finished electrical machinery. The latest trade data show that export growth accelerated to 23% in July but tapered off to 14.1% in August, bringing the first eight months' growth to 7.8%. Merchandise imports also recovered, growing by 10.7% in the second quarter and 13.6% in July after three consecutive quarters of contraction, boosted by strong demand for intermediate inputs by

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



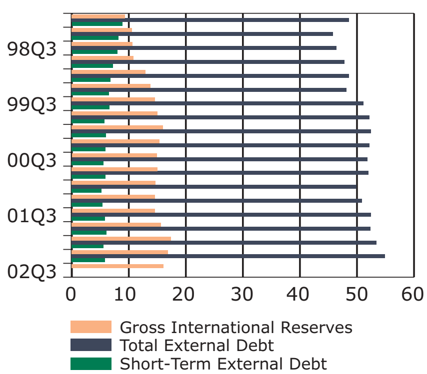
Source: ARIC Indicators.

export-orientated industries (Figure 5). In the seven months to July, the trade surplus was recorded at $913.6 million, 36.8% higher than the level for the same period last year. This, together with remittance of overseas Filipino workers, led to a current account surplus of $3.4 billion in the first half of 2002, more than double the $1.6 billion recorded in the comparable period last year.

The capital account deficit narrows.

Meanwhile, the deficit in the capital and financial account in the first half of 2002 dropped to $1.5 billion from $2.2 billion in the comparable period last year. This positive development resulted from net inflows registered in the portfolio and direct investment accounts, which offset the increase in the net outflow in the “other investments” account. The significant increase in portfolio investments was achieved on the strength of increased non-residents’ investments in foreign currency denominated debt securities and equity capital. The net outflow in the “other investments” account was due to higher resident banks’ net deposits abroad.

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



Source: ARIC Indicators.

The improved balance of payments position has boosted foreign exchange reserves.

The increase in the current account surplus and reduction in the capital and financial account deficit have resulted in an overall balance of payments surplus of $1.7 billion in the first half of 2002. This is a substantial reversal of the $606 million deficit recorded for the same period last year. Consequently, gross international reserves increased to $16.1 billion as of end-September 2002 (Figure 6), up by 2.6% from the end of last year. This level of reserves could cover 9.3 months of imports of goods and services. In the meantime, total external debt as of end-June 2002 stood at $54.9 billion, with the maturity profile biased toward long-term debt, accounting for more than 90% of the total based on original maturity and 80% based on residual maturity.

Asset Markets

The dollar value of the peso remains broadly stable.

The dollar value of the peso has varied only slightly during 2002. The currency appreciated slightly against the dollar during the first half of this year, helped by increased inflows of foreign portfolio

Figure 7: **Exchange Rate and Stock Price Indexes** (last week of 1997June=100)

Source: ARIC Indicators.

investments and remittances of overseas Filipino workers. The appreciation also coincided with the general rise in regional currencies against the dollar led by the yen. More recently, however, there has been some weakening in dollar value of the peso, partly due to seasonal demand by corporations for servicing foreign currency obligations. Investor concerns over the ballooning fiscal deficit have also contributed to the peso's slide against the dollar. The peso stood at 52.74 to the US dollar (weekly average data) as of mid-October 2002, representing a depreciation of 2.8% from its level at end-2001 (Figure 7).

The stock market remains weak.

After a strong rebound in the first quarter of this year, driven mainly by investors' bargain hunting for sound stocks that had become attractively priced due to the dramatic downturn last year, the stock market has been on the decline for the last few months. This reflected global and regional trends, but also investors' concerns over the country's economic and political situation. The absence of positive local corporate news has further weakened investors' appetite for local equities. As of mid-October 2002, the Philippine Stock Exchange Composite Index (PHISIX) was down by 25% from its peak of 1440 at end-February (weekly average data) and down 6.5% from end-2001.

The property market remains depressed.

The property market continues to be sluggish. The office vacancy rate in the prime business district of Manila (Makati City) rose to 20.7% in the second quarter, up 1.5 percentage points from a year earlier (Table 2). During the same period, rents were down by 12%. The growth in the number of new housing projects in the first six months of the year has slowed to 15%, substantially lower than the 34% growth in the comparable period a year ago. The increase in new projects was confined largely to low cost housing. However, there are signs of an improvement in the property market, as the first quarter saw a significant increase in the value of construction permits and number of building permits. Despite this, a full recovery in the property market may take several years to achieve.

Table 2: **Property Vacancy Rates in Prime Business District of Manila (Makati)** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2
Office	4.3	5.8	7.8	12.3	13.3	12.1	13.8	15.9	14.9	14.4	14.3	20.1	19.2	18.8	19.4	21.0	20.7
Retail	. . .	. . .	. . .	9.3	11.0	12.9	12.6	. . .	13.0	. . .	11.2	. . .	10.5	10.4	11.2	11.0	11.3

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

Financial and Corporate Sector Developments

The NPL ratio remains high.

The NPL ratio of the country's 44 commercial banks dropped slightly from 18.3% in January 2002 to 17.6% in August. The reduction was caused by a fall in NPL volume brought about by the sale of bad loans by one of the major banks. However, the current NPL ratio represents an 8 percentage point hike from its level in the immediate aftermath of the 1997 financial crisis. Although the Philippine banking sector was less affected by the crisis, hence its bad loans were substantially lower than those of other affected countries at the height of the crisis, the NPL ratio has been steadily rising over the past few years. The higher NPL levels have made banks more cautious in extending new loans. With restrained lending, partly also due to weak corporate demand for credit, banks have channeled their excess funds into government securities and placements with BSP. However, the country's banking sector has remained strong in terms of capital. The risk-weighted capital adequacy ratio (CAR) was 14.1% as of end-December 2001, much higher than BSP's statutory requirement of 10% and the 8% BIS standard.

Proposed legislation on AMCs is still pending.

Unlike many of the crisis-affected countries, the Philippine Government did not set up a centralized AMC to take over problem loans from troubled banks in the aftermath of the crisis, as the banking sector was relatively unscathed. Banks instead were required to resolve their NPLs through their own initiatives. In response to the rising NPL ratio, the Government is working on new legislation—the Special Purpose Asset Vehicle bill, which seeks to promote asset securitization and the creation of specially designed AMCs or special purpose vehicles designed to clean up the balance sheet of the country's banking sector. The bill has been seen as key to getting commercial banks to start lending to their corporate borrowers. A House bill was approved as early as May 2002 but the counterpart bill is still pending for consideration by the Senate.

Social Sector Developments

The unemployment rate continues to edge up.

Despite strong growth momentum, there is no indication of an improvement in the labor market. The unemployment rate was estimated at 11.2% in July 2002, a jump of 0.9 percentage point from its level in January 2002. The increase was partly a result of seasonal factors, such as new graduates joining the labor force. Compared to the same period last year, unemployment has edged up by 1.1 percentage points. The persistent high unemployment rate in the country reflects both slow job creation and a fast growing labor force associated with the continued high population growth. This could have serious adverse implications for the country's poverty reduction efforts. According to World Bank estimates, in 2002, the incidence of $2-a-day poverty in the Philippines stood as high as 44%.

Prospects and Policy Issues

The Government's growth target is likely to be achieved.

With the stronger-than-expected growth in the first half, the Government is hoping to achieve a growth rate towards the higher end of its 4.0–4.5% target for 2002. But there are significant downside risks to this scenario. Although the latest trade data indicate that export growth remained strong, mixed signs of the global and US economic rebound suggest that there are uncertainties over whether export growth can carry its current momentum into late this year. Another risk to growth is the possibility of another El Niño. In the second half, agricultural output is likely to be affected by this adverse weather condition. The possibility of a significant hike in world oil prices is a further risk, which has increased recently because of events in the Middle East. Given the country's heavy reliance on oil imports, an escalation of oil prices could adversely affect growth performance. Last, the ballooning fiscal deficits also pose a risk to growth, as the Government's efforts to keep deficits under control may lead to reductions in public consumption and investment. Reflecting these concerns, the latest Consensus Economics (October 2002) projection is for GDP growth of 4% for 2002 and 3.8% for 2003.

Strong private investment is the key to sustaining growth.

With continued uncertainties over global and US economic prospects, keeping domestic demand strong is key to sustaining growth. Growth of public consumption and investment are likely to be constrained by the Government's revenue problem. Personal consumption has been growing at a robust pace in recent years, but is unlikely to grow any faster. On the other hand, private investment has so far been weak, and could be a source of growth. Despite recent signs of a pickup in private investment, its full recovery is yet to be seen and needs to be supported by government policies. The low interest rates bode well for a private investment recovery. But the rising NPL ratio could constrain bank lending and needs to be addressed. More fundamentally, it is essential that the Government continues to improve the business environment, including maintaining macro stability, keeping fiscal deficits under control, tackling the peace and order situation, fighting corruption, and upgrading the country's infrastructure.

Improving tax collection is a must to restore fiscal balance.

The ballooning fiscal deficit in the first eight months of this year was largely caused by a significant shortfall in revenue collection. But this problem is not new. The Government has introduced several reforms to improve revenue collection, including stricter monitoring, auditing, and enforcement; intensifying the tax awareness campaign; and waging a war against smuggling. It is essential that such efforts be continued and stepped up.

Philippines: Selected ARIC Indicators

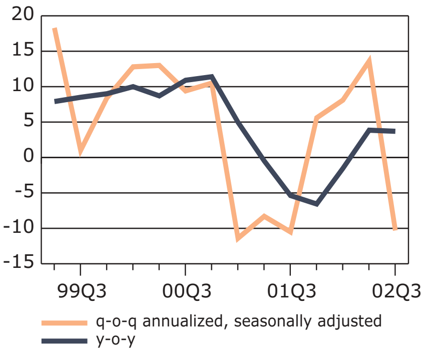
	1996	1997	1998	1999	2000	2001	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2	02Q3
Output and Prices																									
GDP Growth (%)	5.8	5.2	-0.6	3.4	4.4	3.2	2.5	-1.4	-0.7	-2.4	0.7	3.8	3.8	5.1	4.0	4.9	5.1	3.6	2.9	3.0	3.0	3.9	3.7	4.5	. . .
Private Consumption Expenditure Growth (%)	4.6	5.0	3.4	2.6	3.5	3.6	4.5	3.9	2.9	2.6	2.5	2.6	2.5	2.9	3.2	3.2	3.7	3.9	3.5	3.3	3.7	3.8	3.5	3.8	. . .
Public Consumption Expenditure Growth (%)	4.1	4.6	-1.9	6.7	6.1	0.3	-5.6	-0.5	-0.7	-1.1	12.9	6.2	4.8	3.2	0.3	6.0	9.6	8.8	0.3	1.9	0.2	-1.5	-2.4	2.0	. . .
Gross Domestic Investment Growth (%)	13.3	11.7	-16.3	-2.0	5.5	1.3	-5.9	-18.2	-18.9	-21.9	-5.1	4.1	-0.7	-4.8	4.8	6.2	6.2	5.1	1.9	-1.5	6.9	-1.5	-5.6	-3.3	. . .
Gross Fixed Investment Growth (%)	12.0	11.5	-11.2	-2.3	3.1	-26.2	1.2	-9.0	-16.4	-19.8	-9.3	0.4	1.6	-0.3	5.2	3.9	1.8	1.4	-3.3	-1.3	-0.2	-3.9	-1.1	0.4	. . .
Agricultural Sector Growth (%)	3.8	3.1	-6.4	6.5	3.4	-27.5	-1.7	-12.8	-2.8	-7.7	3.2	9.6	5.7	7.7	0.6	4.4	5.9	3.2	3.0	3.6	1.7	5.9	4.6	2.4	. . .
Manufacturing Sector Growth (%)	5.6	4.2	-1.1	1.6	5.6	-25.4	2.0	-0.9	-1.5	-3.5	-1.0	0.9	2.4	3.7	6.0	6.2	6.1	4.4	3.4	2.4	2.6	3.2	2.4	5.0	. . .
Construction Sector Growth (%)	10.9	16.2	-9.6	-1.6	1.4	-26.9	1.1	-7.9	-16.9	-14.9	-12.8	1.8	5.2	1.6	4.3	0.7	0.5	0.3	-9.7	-1.9	-1.1	-1.7	-2.2	-0.2	. . .
Services Sector Growth (%)	6.4	5.4	3.5	4.0	4.4	-24.0	4.3	3.8	2.8	3.0	3.0	3.9	4.2	4.8	4.2	5.0	5.0	3.5	4.6	3.6	4.4	5.1	5.0	5.5	. . .
Exports of Goods and Services Growth (%)	15.4	17.2	-21.0	3.6	17.7	-5.2	-4.5	-19.4	-21.4	-34.8	-8.4	3.3	11.5	8.9	11.7	16.0	17.4	25.2	5.4	-4.5	-4.9	-15.1	-4.1	7.3	. . .
Imports of Goods and Services Growth (%)	16.7	13.5	-14.7	-2.8	4.0	-24.7	5.8	-12.5	-15.7	-32.8	-16.8	0.1	1.5	6.6	1.4	-3.7	-1.8	22.2	1.8	9.2	-0.8	-11.9	-8.0	3.9	. . .
Inflation Rate (%)	9.0	5.9	9.8	6.6	4.3	6.1	7.9	9.9	10.5	10.7	10.0	6.7	5.5	4.5	3.0	3.9	4.5	5.9	6.8	6.6	6.4	4.7	3.6	3.4	2.8
Unemployment Rate (%)	7.4	7.9	9.6	9.6	10.1	9.8	8.4	13.3	8.9	9.6	9.2	11.9	8.5	9.6	9.5	13.9	11.2	10.1	11.3	13.3	10.1	9.8	10.3	13.9	. . .
Monetary and Fiscal Accounts																									
Growth of Broad Money, M2 (%)[1]	15.8	20.5	8.0	19.3	4.8	6.9	16.9	16.9	8.0	8.0	4.2	9.0	13.7	19.3	17.4	11.5	9.1	4.8	12.2	13.4	10.7	6.9	8.6	5.1	. . .
Three-Month Interbank Lending Rate (%)[1]	11.3	31.4	15.7	11.0	15.9	12.6	18.9	17.3	16.3	15.7	12.7	9.2	9.8	11.0	9.3	9.4	12.1	15.9	11.6	10.7	15.2	12.6	7.1	7.1	6.2
Growth in Real Bank Credit to Private Sector (%)[1]	38.8	20.2	-15.5	-6.3	-1.2	-5.6	8.3	1.1	-8.7	-15.5	-14.0	-12.4	-10.8	-6.3	-3.6	-2.0	1.8	-1.2	-0.2	-2.3	-8.3	-5.6	-7.2	. . .	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	11.0	12.7	14.9	16.9	. . .	9.7	11.6	11.0	13.6	. . .	. . .	12.7	. . .	. . .	. . .	14.9	16.6	17.0	17.4	16.9	17.6	. . .	. . .
NPL Ratio of the Commercial Banking System[1]	2.8	4.7	10.4	12.3	15.1	17.3	7.4	8.9	11.0	10.4	13.2	13.1	13.4	12.3	14.1	14.6	15.7	15.1	16.6	17.0	17.9	17.3	18.0	18.1	. . .
Average Stock Price Index	3,053	2,591	1,792	2,170	1,584	1,347	2,029	2,044	1,431	1,692	2,003	2,382	2,285	2,005	1,882	1,575	1,487	1,399	1,582	1,435	1,300	1,065	1,350	1,326	1131
Central Government Fiscal Balance as % of GDP	0.3	0.1	-1.9	-3.8	-4.1	-4.0	-1.9	-1.9	-0.3	-3.2	-4.9	-2.7	-4.8	-2.9	-2.9	-3.2	-4.3	-5.5	-4.6	-4.6	-4.9	-2.4	-6.8	-6.1	. . .
Central Government Debt as % of GDP[1]	53.2	55.7	56.1	59.6	65.5	65.5	. . .	. . .	. . .	56.1	. . .	. . .	. . .	59.6	61.9	62.5	63.3	65.5	64.4	65.3	65.4	65.5	67.4	69.8	. . .
Government Expenditure on Education (% of Total)	3.4	3.9	4.0	3.7	3.7	3.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	0.5	0.6	0.5	0.5	0.4	0.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	
External Account, Debt, and Exchange Rates																									
Growth of Merchandise Exports ($ fob, %)	17.8	22.8	16.9	18.8	8.7	-15.6	23.8	14.5	19.2	11.4	15.2	12.1	22.9	23.9	9.6	13.3	5.1	7.7	-0.5	-17.6	-22.5	-19.5	-5.3	15.3	. . .
Growth of Merchandise Imports ($ cif, %)	22.2	10.8	-17.5	3.7	2.1	-5.9	-4.3	-17.8	-21.4	-25.1	-9.0	6.3	7.8	11.2	7.7	-4.4	3.5	1.9	-7.7	7.0	-6.6	-15.5	-2.6	10.7	. . .
Current Account Balance as % of GDP	-4.8	-5.3	2.4	9.7	12.4	3.9	-0.2	1.1	3.1	4.9	8.7	7.1	14.0	11.6	8.1	11.3	14.6	15.7	9.6	0.0	2.8	3.2	12.2	6.8	. . .
Net Foreign Direct Investment ($ Billion)	. . .	. . .	. . .	. . .	1.3	2.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	0.4	0.4	0.5	0.1	0.6	0.8	0.4	0.2	1.2	-0.5	. . .
Net Portfolio Investment ($ Billion)	. . .	. . .	. . .	. . .	-0.11	1.4	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	0.5	-0.4	-0.07	-0.2	-0.6	0.3	0.5	1.2	1.6	-0.4	. . .
Gross International Reserves ($ Billion)[1]	11.7	8.8	10.8	15.0	15.0	15.7	9.4	10.6	10.6	10.8	13.0	13.8	14.6	15.0	16.0	15.4	14.9	15.0	14.7	14.6	14.5	15.7	17.4	16.9	16.1
Total External Debt as % of GDP[1]	. . .	55.0	73.1	68.6	69.7	73.4	63.5	64.6	70.0	73.1	71.7	68.3	69.3	68.6	68.0	67.6	67.6	69.7	68.4	71.4	74.4	73.4	74.1	74.3	. . .
Short-Term Debt as % of Gross International Reserves[1]	61.4	96.3	66.5	38.2	39.6	38.6	94.7	77.3	75.0	66.5	52.4	47.3	45.5	38.2	37.5	38.4	37.6	39.6	35.6	36.9	40.0	38.6	32.1	34.3	. . .
Short-Term Debt as % of Total Debt[1]	17.2	18.6	15.0	11.0	11.4	11.6	18.2	17.8	17.2	15.0	14.0	13.6	13.0	11.0	11.5	11.3	10.8	11.4	10.5	10.6	11.1	11.6	10.4	10.6	. . .
Real Effective Exchange Rate (1995=100)[2]	110.4	111.0	94.0	100.8	91.0	88.2	91.5	97.2	92.6	94.7	102.2	105.1	100.5	95.2	96.4	94.2	89.2	84.4	88.4	87.9	87.1	89.3	93.9	92.7	. . .
Average Exchange Rate (Local Currency to $)	26.2	29.6	40.8	39.1	44.3	51.0	40.5	39.3	42.8	40.4	38.7	38.0	39.3	40.4	40.7	41.9	45.1	49.4	49.2	50.8	52.1	51.8	51.2	50.4	51.5

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, M2, real bank credit to private sector, nonperforming loan ratios of the financial and commercial banking system, central government fiscal balance, central government debt, government expenditure on education and health, merchandise epxorts and imports, current account balance, net foreign direct and portfolio investments, gross international reserves, and total and short-term external debts are from national sources. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on REMU staff calculations.

Singapore

Real Sector

Figure 1: **GDP Growth Rates**
(%)



Source: ARIC Indicators.

Growth rebounded in the second quarter.

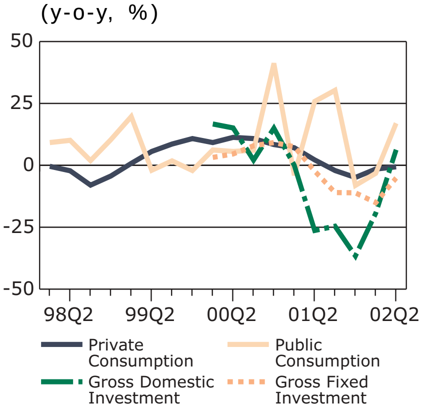
Following a 1.5% (y-o-y) contraction in GDP growth in the first quarter of 2002, Singapore's economy rebounded strongly in the second quarter to post growth of 3.9%, the first such expansion in five quarters. These rates were slightly revised down to –1.6% and 3.7% at the time the third quarter GDP advance estimate was released in October. The third quarter estimate, thus, fell well short of the general market expectation of about 6.5%. On a quarter-on-quarter annualized basis (seasonally adjusted), growth picked up to 13.6% in the second quarter, from 8.1% in the first but fell to 10.3% in the third quarter (Figure 1). The fall back in the third quarter was attributed to moderation in activity in the chemicals sector after an exceptional surge in the second quarter. Overall for 2002, the Government forecasts GDP growth to be in the 3–4% range (Table 1).

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

	1997	1998	1999	2000	2001	2002	2003
Official[1]	8.5	-0.1	6.9	10.3	-2.0	3.0-4.0	—
ADB[2]	—	—	—	—	—	3.9	5.6
IMF[3]	—	—	—	—	—	3.6	4.2
World Bank[4]	—	—	—	—	—	3.8	5.8
Consensus Economics[5]	—	—	—	—	—	3.8	4.7

[1]Ministry of Trade and Industry, *Economic Survey of Singapore,* Second Quarter 2002.
[2]ADB, *Asian Development Outlook 2002 Update,* September 2002.
[3]IMF, *World Economic Outlook*, September 2002.
[4]World Bank, *East Asia Update Regional Overview,* April 2002.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* October 2002.

Figure 2: **Growth of GDP Expenditure Components**
(y-o-y, %)

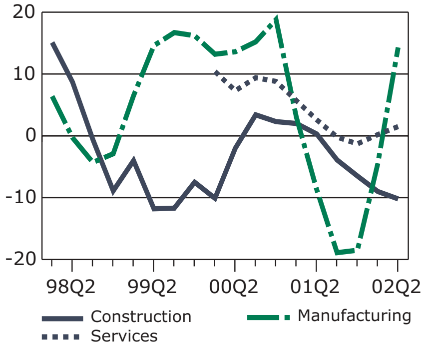


Source: ARIC Indicators.

Both domestic and external demand showed upturn.

Domestic demand rose by 4% in the second quarter, following an 8.3% decline in the previous quarter. This was mainly due to a slowdown in inventory cutbacks arising from better business conditions and a more moderate decline in fixed investment (–5.1% versus -15.1% in the first quarter). The better performance in fixed investment reflected growth in the transportation component and a slower rate of decline in machinery and plant investment (Figure 2). Private consumption expenditure continued to contract in the second quarter but at only 0.6%, which had a marginal negative impact on GDP growth. Public consumption expenditure, which is relatively volatile, grew by 17% in the second quarter and accounted for 1.6 percentage points of overall growth. Meanwhile, external demand (in real terms) rose by 4.5% in the second quarter, in marked contrast to the 8.5% fall in the first, as economic conditions improved in global and regional trading partners. With some recovery in imports, the contribution of the net foreign balance to growth was reduced in the second quarter.

Figure 3: **Sectoral GDP Growth** (y-o-y, %)



Source: ARIC Indicators.

The manufacturing sector saw the biggest improvement.

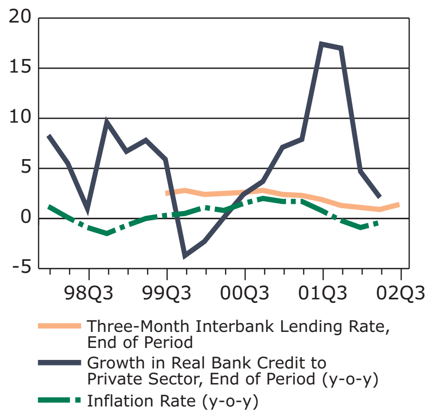
At the sectoral level, the upturn in economic activity in the second quarter was driven by a large improvement in manufacturing, accounting for nearly 90% of GDP growth. The sector rebounded from a 4.5% decline in the first quarter to grow by 14.3% in the second (Figure 3). This performance was essentially due to sharply increased output in the chemical/pharmaceuticals industry resulting from capacity expansion and greater production of higher value-added products. The electronics industry saw a moderate recovery (up 1.8%) in tandem with some improvement in the global electronics market. But construction further declined in the second quarter by 10.2% compared to 9% in the first, due to the sluggish property market. Overall services sector output posted positive growth of 1.5% but performance among its components was mixed. Wholesale and retail trade and transport and communications registered growth in the second quarter, driven by a recovery in entrepot trade activity. But financial services worsened (down 7.3%) due to sluggish activity in most financial markets.

Fiscal and Monetary Developments

The fiscal stance remains expansionary and tax cuts will enhance competitiveness.

Recovery in the economy was supported by an expansionary fiscal policy stance. In the 2002 Budget (FY April–March), several fiscal policy changes were introduced. There was a comprehensive set of personal and corporate tax changes to help position Singapore as a business hub and support the growth of local enterprises. From the year of assessment 2003, the corporate and personal tax rates of 24.5% and 26%, respectively, will be cut in stages to bring both down to 20% in three years. Other reforms announced include replacing the full-imputation corporate tax system with a more efficient one-tier system; selective improvements and simplification of tax incentive schemes; and more liberal treatment of foreign business income remitted to Singapore. To offset the loss of revenue from the tax cuts, the Goods and Services Tax (GST) will be increased to 5%, up by 2 percentage points beginning 1 January 2003. Because of a higher GST, an assistance package for all low-income households will be offered.

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



Source: ARIC Indicators.

Domestic interest rates remain low.

Low domestic interest rates reflect the soft global interest rate environment and easy liquidity conditions in the domestic money market. The domestic three-month interbank rate eased from 1.3% at end-2001 to 0.9% at the end of second quarter 2002 (Figure 4). This decline partly reflects lackluster interbank credit demand among resident banks, which in turn was a result of sluggish lending and increased inflows of deposits from individual customers. By end-September 2002, however, this rate had climbed back up to 1.375%.

Monetary policy is centered on the exchange rate.

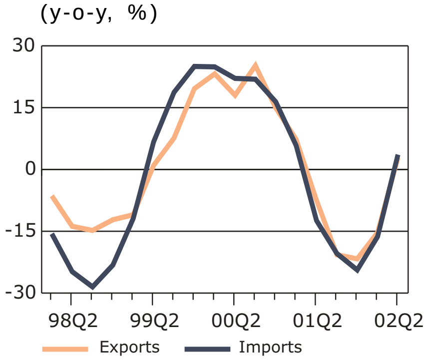
Monetary policy of the Monetary Authority of Singapore (MAS), reviewed in a semi-annual Monetary Policy Statement, is focused on the exchange rate. At the beginning of 2002, MAS announced that it would maintain a zero percent appreciation path within a policy band centered on the trade-weighted dollar nominal effective exchange rate (S$NEER) then prevailing. Since then, the S$NEER has fluctuated within a narrow range, with bilateral rates displaying variation.

Inflation rate has been negative this year.

Inflation registered a negative rate of 0.4% at the end of the second quarter, compared to –0.9% in the first quarter, mostly reflecting higher transport and communication costs. Weakness in consumer demand, especially housing, has put downward pressure on prices.

Balance of Payments

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



Source: ARIC Indicators.

Following four quarters of decline, imports and exports showed signs of recovery.

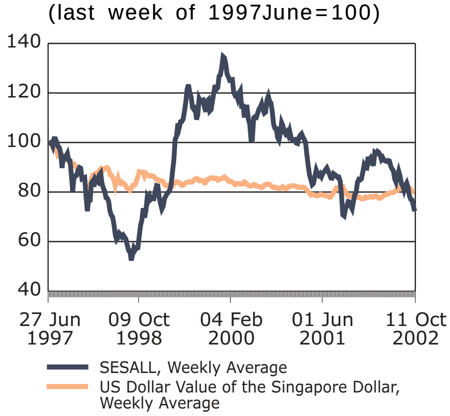
Exports and imports both showed signs of recovery in the second quarter recording their first year-on-year expansion after four quarters of decline. Total exports (S$56.9 billion) rose by 2.4%, a significant turnaround from the first quarter's contraction of 10.9% (Figure 5). The upturn, however, was due to growth in re-exports. Nonoil exports, the key component, recorded a small 0.4% decline, though this was much improved from the 15% fall in the first quarter. Trade data for July and August, however, did show a substantial recovery in nonoil exports, bringing them to 15% and 17%, respectively, above the levels of a year ago. Total imports (S$50.7 billion), a short-term indicator of the degree of activity in manufacturing, expanded by 2.7% in the second quarter, after a 12.8% contraction in the previous quarter. The trade surplus of S$6.2 billion in the second quarter was little different from that recorded a year earlier and in the first quarter. Owing to increased transportation charges and income payments, the current account posted a smaller surplus of S$7.7 billion in the second quarter of 2002, compared to S$8.4 billion of the previous quarter, but nevertheless still amounted to about 20% of GDP.

But the overall balance of payments surplus was reduced.

The overall balance of payments registered a small surplus of S$200 million in the second quarter of 2002, compared to S$1.6 billion in the previous quarter. The decline reflected large private sector portfolio capital outflows owing to heightened global risk aversion and uncertainty over the strength of the global economic recovery and substantially reduced net direct investment inflows. Official reserves were S$143.4 billion (US$80.4 billion) at end-September (equivalent to 8.4 months of imports), compared to S$139.9 billion (US$75.8 billion) at end-2001.

Asset Markets

Figure 6: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

The Singapore dollar varied against major currencies.

From end-2001, the Singapore dollar appreciated against the US dollar by 3.2% to mid-October. Against the euro and yen, however, the currency fell by 8.1% and 2.3%, respectively, over the same period. Among other regional currencies, the Singapore dollar appreciated against the ringgit, the baht, and the New Taiwan dollar.

Sluggish trading activity sent stock prices falling.

Stock market activity grew substantially over the first quarter of 2002 as the All-SingEquities index (SESALL) rose by about 12% (weekly average data) in tandem with the release of several positive US macroeconomic indicators and signs of an emerging domestic economic recovery (Figure 6). However, the upward momentum was not sustained, mainly owing to investor concerns over US corporate scandals and accounting practices that resulted in a worldwide flight from equities. As a result, the SESALL fell through mid-October with a loss of about 14% over the year. These developments were reflected in portfolio investment outflows and deterred potential listings. IPOs dwindled to 11 in the first half of 2002, compared with 35 for the whole of last year.

Overall, the property market remains soft.

The office vacancy rate reached 13.1% in the second quarter, compared to 8.4% a year ago (Table 2). The vacancy rate has trended upward over the previous 18 months due to continued corporate downsizing and closures during the global economic slowdown. Overall office rentals declined by 5.7% in the second quarter. Meanwhile, retail rentals remained stable, although there have been upward pressures on rents in some of the high-end shopping malls. Private residential property prices have further declined in the second quarter of 2002, the eighth consecutive quarterly decline. The weakness in private housing prices has largely been the result of sluggish market demand and a persistent overhang of unsold units.

Table 2: **Property Vacancy Rates in Singapore** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2
Office	9.7	11.5	12.3	12.5	12.7	11.8	11.5	10.7	9.6	6.4	5	6.7	8.4	8.8	10.4	13.0	13.1
Retail	. . .	. . .	4.0	. . .	2.9	. . .	1.8	. . .	1.0	. . .	0.7	. . .	1.2	0.3	1.0	0.9	0.6

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

Financial and Corporate Sector Developments

There was a move from regulation to risk-focused supervision.

MAS embarked on a series of regulatory initiatives that resulted in the Securities and Futures Act (SFA) and the Financial Advisors Act (FAA) aimed at protecting investors. The SFA and FAA will fully come into force by the third quarter of 2002. MAS also took steps to introduce a risk-sensitive supervisory framework for the financial industry. It explored ways to enhance integrated supervision of the financial sector and to harmonize regulations and enhance supervisory processes. There was continued consolidation in financial institutions, in line with global trends, with five local banking groups merging into three.

Capital markets were further liberalized.

Several currency controls on the Singapore dollar were eased in March 2002, aimed at providing more room for the capital market to grow. There are now two basic limits on use of the Singapore dollar: (i) nonresidents that tap Singapore financial sources must convert proceeds into foreign currency when they are used offshore, and (ii) loans by financial institutions are limited if the proceeds are believed to be used for speculation against the currency. These limits are consistent with the longstanding policy of not encouraging the internationalization of the currency.

Additional corporate governance and accounting standards have been adopted.

Corporate governance and financial disclosure standards for financial institutions have been improved. From 2006 onwards, MAS will require banks to change auditing firms every five years, in order to boost the independence and effectiveness of external auditors. Banks will also be required to take more stringent corporate governance measures from 1 January 2003. These measures include strengthening the independence of bank boards, as well as the nominating, audit, and compensation committees. In particular, the independence of directors will be assessed not just in terms of the business relationship element stated in the Code of Corporate Governance, but also by their independence from executives and substantial shareholders. In terms of accounting standards, International Accounting Standards will be fully adopted by January next year. Listed companies were also required to report earnings on a quarterly basis rather than half-yearly.

Social Sector Developments

Unemployment rate eased but new skills are needed in a knowledge-based economy.

Preliminary estimates show that the seasonally adjusted unemployment rate moderated to 4.1% in June 2002, from 4.5% in March 2002. But these were well above the 2.7% figure seen in the same period last year. Data indicate that around 3,800 workers were retrenched in the second quarter, lower than 4,857 in the previous quarter.

An important issue facing Singapore is the growing mismatch between the skills of those workers losing their jobs from the traditional manufacturing sectors and those needed for the new jobs in the high technology, knowledge-based sectors. The Government is investing in retraining programs to upgrade labor skills of workers. Typical of the projects is the S$200 million Manpower Development Assistance Scheme to finance the further education of low-skilled workers. Strategies were adopted to boost the number of “infocomm” workers in the light of the Government’s concern about the lack of the necessary labor force skills to promote the development of a knowledge-based economy. As part of this, schools are upgrading educational standards through IT. It is expected that by the end of 2002, 30% of the school curriculum will be IT-based.

Prospects and Policy Issues

Recovery is underway, but risks remain.

Singapore's economy has improved as the external environment has shown signs of an economic pickup. Supported by sound domestic macroeconomic policies, the recovery is expected to continue. Nevertheless, if the lower-than-expected advance estimate of GDP growth in the third quarter (3.7% y-o-y) is confirmed by complete data for the quarter, it would then require a substantial pickup in the fourth quarter growth (about 6-10%, y-o-y) to reach the official forecast for GDP growth of 3–4% for 2002. The Consensus Economics (October 2002) growth forecast is 3.8% for 2002 and 4.7% for next year. As Singapore is a small and highly open economy, the pace of recovery is heavily dependent on the external environment, particularly the global demand for electronics products that dominates Singapore's industry and exports. The September IMF WEO, thus, projected 4.2% growth for 2003 (revised down from a 5.1% forecast in April), in light of its assessment that recovery in industrial countries would be slower than expected.

Building a "new economy" remains top priority.

Singapore appears to be losing ground in certain traditional industries to Malaysia and, increasingly, to the PRC. It has the potential to develop high value-added industries such as health care, education, telecommunications, and biotechnology and to enhance its role as a regional transportation and financial services hub. Over the medium to long term, the tax reforms and educational and training projects to address the skills mismatch introduced in the 2002 Budget will play key roles in helping to boost Singapore's international competitive position and maintain full employment. They should have an expansionary impact on the economy, with private investment as the key driver of economic growth. Nevertheless, the Government will need to continue to adapt its policies to develop and attract the top talent and investment needed to transform the economy to one where high value-added, knowledge-based industries are the focal point for continued rapid economic development.

Singapore: Selected ARIC Indicators

	1996	1997	1998	1999	2000	2001	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2	02Q3
Output and Prices																									
GDP Growth (%)	. . .	8.5	-0.1	6.9	10.3	-2.0	4.3	0.0	-2.5	-1.7	2.2	7.9	8.5	9.0	10.0	8.7	10.9	11.4	5.0	-0.5	-5.4	-6.6	-1.5	3.9	3.7
Private Consumption Expenditure Growth (%)	. . .	5.5	-3.8	6.4	9.9	0.5	-0.4	-2.2	-8.0	-4.3	0.8	5.6	8.6	10.8	9.2	11.3	10.8	8.4	7.1	2.2	-2.1	-4.9	-1.5	-0.6	. . .
Public Consumption Expenditure Growth (%)		7.1	8.0	6.1	14.0	6.6	9.2	10.1	1.9	10.4	19.7	-2.0	1.8	-2.1	6.2	5.6	6.1	41.2	-4.0	25.8	30.3	-8.1	-3.2	17.0	. . .
Gross Domestic Investment Growth (%)	. . .	. . .	-13.3	2.5	2.9	-15.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	16.7	15.1	2.1	15.0	0.0	-26.3	-24.6	-36.6	-19.3	6.3	. . .
Gross Fixed Investment Growth (%)	. . .	. . .	. . .	. . .	6.3	-27.2	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	3.2	4.6	7.9	9.2	7.5	-2.3	-11.0	-11.1	-15.1	-5.1	. . .
Manufacturing Sector Growth (%)	. . .	4.5	-0.6	13.6	15.3	-11.6	6.4	-0.3	-4.3	-2.9	6.5	14.6	16.7	16.2	13.2	13.6	15.2	18.8	3.0	-8.7	-18.9	-18.5	-4.5	14.3	. . .
Construction Sector Growth (%)	. . .	16.3	2.8	-8.8	-1.7	-2.1	15.1	8.7	-0.6	-8.9	-4.0	-11.8	-11.7	-7.5	-10.1	-2.0	3.4	2.3	2.0	0.3	-3.9	-6.5	-9.0	-10.2	. . .
Services Sector Growth (%)	. . .	9.6	-0.6	6.1	9.0	1.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	10.4	7.3	9.4	8.8	5.7	2.6	-0.2	-1.3	0.2	1.5	. . .
Net Exports of Goods and Services Growth (%)	. . .	. . .	. . .	19.3	2.7	31.8	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	24.3	37.9	13.5	50.6	38.9	3.1	. . .
Inflation Rate (%)	1.4	2.0	-0.3	0.03	1.4	1.0	1.2	0.1	-0.9	-1.5	-0.7	-0.03	0.3	0.5	1.1	0.8	1.5	2.0	1.7	1.7	0.8	-0.2	-0.9	-0.4	. . .
Unemployment Rate (%)	2.0	1.8	3.2	3.5	3.1	3.3	1.9	3.2	3.2	4.6	3.3	4.6	2.9	3.1	2.8	4.4	2.1	3.0	2.0	3.4	3.0	4.9	3.7	5.2	. . .
Monetary and Fiscal Accounts																									
Growth of Broad Money, M2 (%)[1]	9.8	10.3	30.2	8.5	-2.0	5.9	9.4	8.1	10.0	30.2	27.8	30.4	28.4	8.5	5.6	2.3	-2.2	-2.0	2.2	1.9	5.0	5.9	3.5	2.4	. . .
Three-Month Interbank Lending Rate (%)[1]	. . .	. . .	. . .	2.8	2.8	1.3	. . .	. . .	. . .	. . .	. . .	. . .	2.5	2.8	2.4	2.5	2.6	2.8	2.4	2.3	1.9	1.3	1.1	0.9	1.4
Growth in Real Bank Credit to Private Sector (%)[1]	13.6	10.4	9.6	-3.7	3.7	17.0	8.3	5.5	1.0	9.6	6.7	7.8	5.9	-3.7	-2.3	0.1	2.4	3.7	7.1	7.9	17.5	17.0	4.8	2.1	. . .
Average Stock Price Index	557.7	488.9	348.8	523.6	557.0	428.0	404.7	353.0	289.5	351.8	387.5	525.5	569.6	598.5	612.6	542.9	559.4	512.4	487.8	428.3	410.1	388.8	458.1	448.1	401.5
Central Government Fiscal Balance as % of GDP	. . .	2.1	0.7	0.5	1.9	1.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	-5.9	7.4	11.5	-5.5	-4.5	5.3	7.2	-1.6	-8.0	2.8	. . .
Central Government Debt as % of GDP[1]	. . .	. . .	. . .	89.8	84.0	95.8	. . .	. . .	. . .	. . .	371.7	182.7	120.1	89.8	88.8	87.9	86.0	84.0	85.8	86.5	90.2	95.8	99.4	98.7	. . .
Government Expenditure on Education (% of Total)	3.2	3.2	3.6	3.7	4.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	1.2	1.1	1.4	1.3	1.0	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																									
Growth of Merchandise Exports ($ fob, %)	5.7	-0.1	-11.9	4.2	20.1	-11.6	-6.4	-13.8	-14.8	-12.2	-11.0	1.0	7.6	19.6	23.2	18.0	25.2	14.9	7.3	-7.5	-20.7	-21.7	-15.3	2.9	. . .
Growth of Merchandise Imports ($ cif, %)	5.5	0.8	-23.2	9.2	21.1	-13.8	-15.6	-24.8	-28.5	-23.2	-11.9	6.7	18.7	25.0	24.9	22.1	21.9	16.4	5.8	-12.4	-20.4	-24.4	-16.3	3.6	. . .
Current Account Balance as % of GDP	16.2	15.7	23.3	26.3	17.2	20.9	0.0	0.0	0.0	0.0	24.9	27.2	24.8	28.3	17.8	16.8	19.4	14.8	18.9	23.9	19.6	21.1	23.4	19.7	. . .
Net Foreign Direct Investment ($ Billion)[2]	5.0	1.3	5.6	7.5	0.4	-1.7	0.63	1.4	1.5	2.1	3.7	0.2	0.1	3.6	0.6	-0.1	-0.1	0.1	0.8	0.9	-5.4	2.0	1.5	0.2	. . .
Net Portfolio Investment ($ Billion)[2]	-16.5	-15.0	-9.9	-5.6	-9.9	-4.6	-1.9	-2.8	-2.7	-2.5	-1.3	-1.4	-0.9	-2.1	-3.6	-2.5	-1.9	-2.0	-1.8	-1.2	-1.0	-0.6	-0.6	-2.2	. . .
Gross International Reserves ($ Billion)[1]	77.0	71.4	75.0	77.2	80.4	75.8	74.7	71.0	72.4	75.0	71.8	73.9	76.4	77.2	74.8	77.7	78.1	80.4	77.7	74.7	75.5	75.8	75.9	80.4	80.7
Real Effective Exchange Rate (1995=100)[3]	104.0	107.6	106.5	102.8	101.2	103.9	108.7	108.3	104.7	104.2	102.0	103.5	103.7	102.1	101.3	99.8	100.9	102.8	104.7	102.5	105.0	103.6	103.8	102.3	. . .
Average Exchange Rate (Local Currency to $)	1.4	1.5	1.7	1.7	1.7	1.8	1.7	1.6	1.7	1.6	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.8

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 Singapore dollars 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, M2, real bank credit to private sector, central government fiscal balance, central government debt, government expenditure on education and health, merchandise exports and imports, current account balance, net foreign direct and portfolio investments, and gross international reserves are from national sources. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg, LP. Real effective exchange rates are based on REMU staff calculations.

Thailand

Real Sector

Economic growth is picking up.

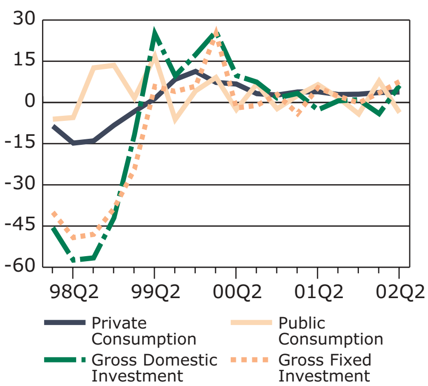
Real GDP growth picked up to 4.5% (year-on-year) in the first half of 2002, having slipped to only 1.8% in 2001. The gain mainly reflected strengthened private consumption expenditure, construction investment, and export demand. GDP exceeded expectations, growing by 3.9% in the first quarter but rising to 5.1% in the second. Having released GDP estimates in September, the Government's National Economic and Social Development Board raised its 2002 growth forecast to 4–4.5% from 3.5–4% (Table 1).

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

	1997	1998	1999	2000	2001	2002	2003
Official[1]	-1.4	-10.5	4.4	4.6	1.8	4.0-4.5	—
ADB[2]	—	—	—	—	—	3.8	4.0
IMF[3]	—	—	—	—	—	3.5	3.5
World Bank[4]	—	—	—	—	—	3.0	3.5
Consensus Economics[5]	—	—	—	—	—	4.3	4.0

[1]National Economic and Social Development Board, Press Release, September 2002.
[2]ADB, *Asian Development Outlook 2002 Update,* September 2002.
[3]IMF, *World Economic Outlook*, September 2002.
[4]World Bank, *East Asia Update Regional Overview,* April 2002.
[5]Consensus Economics Inc., *Asia Pacific Consensus Forecasts*, October 2002.

Figure 1: **Growth of GDP Expenditure Components** (y-o-y, %)

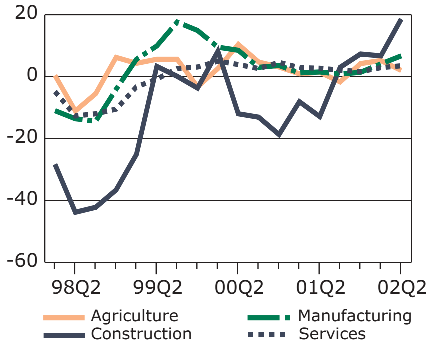


Source: ARIC Indicators.

Private consumption and investment are strengthening.

Improved consumer and business confidence supported by expansionary fiscal and accommodative monetary policies have raised domestic demand to bring GDP growth to 4.5% in the first half of the year. The change in net export balance accounted for about one half (2.1 percentage points) of the GDP growth, compared to 1.6 percentage points or nearly all of last year's first half growth. Personal consumption expenditure has revived, increasing by 3.6% and 3.8%, respectively, in the first and second quarters, compared with 2.9% growth during the trough. Public consumption expenditure growth increased sharply by 7.8% in the first quarter, reflecting planned stimulus, but fell in the second quarter. Growth in fixed investment more than doubled in the second quarter to 7.6% to bring growth in the first half of the year to 5.5%, mainly owing to increased residential and commercial construction investment as low mortgage rates, housing tax incentives, and better business promotion took effect. Investment in inventories was much lower this year than 12 months ago, reducing its contribution to GDP growth by about 1 percentage point and causing gross capital formation to show negative growth in the first quarter.

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



Source: ARIC Indicators.

Manufacturing production has accelerated.

The manufacturing sector grew by 5.4% (y-o-y) in the first half of 2002, compared to only a 1.2% expansion in 2001 (Figure 2). Output growth accelerated from 4.1% in the first quarter to 6.7% in the second, with recovery evident in domestic- and export-oriented industries. Greater growth in the second quarter largely reflected gains in the high-tech and capital goods sectors, especially motor vehicles and integrated circuits. Overall capacity utilization of the sector, while still low, increased to 58% in June from 54% at end-2001. Construction sector growth, meanwhile, jumped to 18.6% from a year ago in the second quarter (6.7% in the first quarter), as increased public works added to the uptrend in private construction. These two sectors were the main sources of output recovery, accounting for about 50% of GDP growth in the first half of the year. Agricultural output expanded by 5.2% in the first quarter but fell to 2% in the second, mainly owing to a drop in fisheries output caused by food safety concerns in export markets that subsequently were resolved. Tourist arrivals (expenditures account for about 5% of GDP) have rebounded from the bleak level reached immediately after the 11 September 2001 attacks and should achieve targeted growth of 8%. Reflecting higher Thai and tourist expenditures, growth in the services sector has recovered to more than 3%, compared to only 2.3% during 2001.

Fiscal and Monetary Developments

Fiscal policy is moving from stimulus to consolidation.

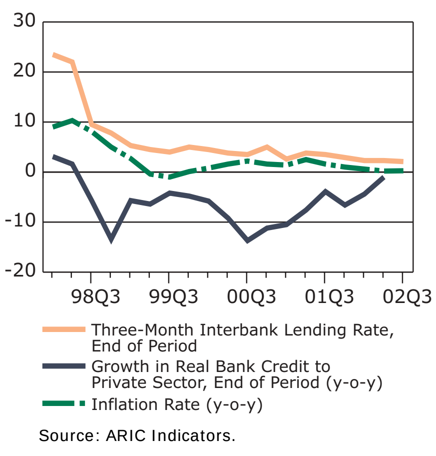
To counter the economic downturn, public sector spending was stepped up in the FY2001/2002 budget; however, a retrenchment is planned for the fiscal year beginning October 2002 to help reduce the high level of public debt. The public sector deficit is targeted to increase to 6% of GDP this year (4.4% for the central Government), substantially above the 3.5% deficit outcome in FY 2000/01. Buoyant tax collections, however, may bring the planned overall deficit lower. The increased fiscal stimulus is largely accounted for by special spending schemes for the rural and small enterprise sectors and a package of tax cuts to encourage corporate stock exchange listing, business startups, and home buying. Expenditures were "front loaded" to hasten the economic recovery and the special programs were generally "one-off" expenditures. For FY2002/03 the public sector deficit is slated to fall to 4.2% of GDP (3.3% for the central Government) with the improvement owing to expenditure reduction. In formulating the new budget, the Government deferred, for a third year, hiking Value Added Tax (VAT) from 7% to 10%, the pre-crisis rate. The policy to begin fiscal consolidation reflects the ongoing economic recovery and the need to focus on a debt management strategy. Public sector debt has escalated from 14.5% of GDP in 1996 to nearly 58% in 2001, as a result of the cumulative buildup of the fiscal stimulus since the 1997 crisis and the financial costs of financial system restructuring that have yet to be fully realized.

Monetary policy remains accommodative.

After cutting the benchmark 14-day repurchase rate by 50 bp in two steps in December 2001 and January 2002, the Bank of Thailand (BOT) has since maintained the rate at 2%. Bank rates responded to the change: between Q4 2001 and Q2 2002 average deposit rates fell by 50 bp to 2% while the average lending rate declined by 17 bp to 7%. The continued wide spread of about 500 bp for deposit and loan rates has sparked calls for regulation. Powers for BOT to control maximum spreads were included in the draft Financial Institutions Act that is pending in Parliament. Also, to encourage greater bank lending, BOT has eased loan provisioning and classification requirements, broadened norms for appraisal of collateral, and relaxed its requirements for banks on issuing credit cards.

Bank lending shows signs of improvement.

Figure 3: **Short-Term Interest Rate, Real Bank Credit Growth, and Inflation Rate** (%)



Source: ARIC Indicators.

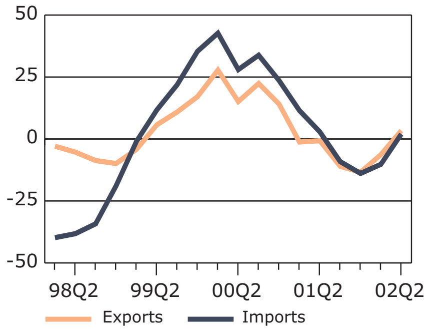
Commercial bank credit outstanding declined by 0.8% at end-June from its level a year earlier. However, when debt write-offs and net transfers to AMCs are added back, credit outstanding increased by 1.9%. While this development indicates that retrenchment in bank lending to the private sector has ended, banks remain weak and highly risk adverse. Their activities have focused more on diversifying their loan portfolios with emphasis on home mortgage and credit card operations, rather than business lending, and on increasing fee-based activity.

Inflation is subdued.

Consumer prices and the core CPI increased by only 0.4% and 0.3%, respectively, in September 2002 from a year ago (Figure 3). The benign inflationary environment reflects the absence of excessive demand pressures, low capacity utilization, a competitive business environment, and favorable oil prices, as well as the appreciation of the baht. While economic recovery is under way and world oil prices are trending up, BOT is expected to continue to contain inflation within its target range of 0–3.5%.

Balance of Payments

Figure 4: **Growth of Merchandise Exports and Imports, Dollar Value** (y-o-y, %)



Source: ARIC Indicators.

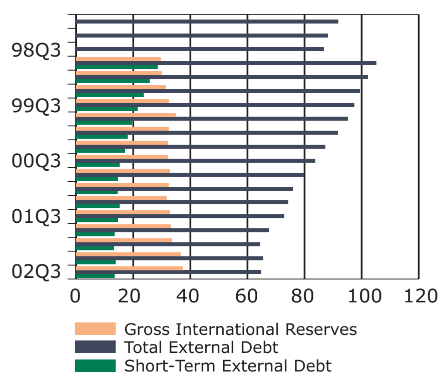
Export growth resumes.

The export sector experienced a welcome turnaround in the second quarter of 2002, as receipts rose by 3.4% on a year-on-year basis after five previous quarterly declines (Figure 4). The recovery largely resulted from an upturn in exports of manufactured products, especially high-tech products. Exports continued to recover in July and August, growing by 7.7% and 8.2%, respectively. Imports also turned up, growing by 2% in the second quarter after three previous quarterly declines. The latest trade data show that imports grew by 11.2% in July and 19.4% in August. The trade surplus rose to $1.37 billion in the first eight months of this year, compared to $1.2 billion a year earlier.

The balance of payments improves.

The current account surplus rose moderately to $2.8 billion in the first half of 2002, compared to $2.4 billion a year earlier. Despite increased tourism receipts (9%), the net services surplus of $2.3 billion was essentially unchanged from a year earlier while net income payments rose by about $0.5 billion. The capital account strengthened substantially in the period as net capital outflow was reduced to $747 million, compared to an outflow of $3 billion a year earlier. While direct investment inflows were smaller and portfolio investment recorded a larger net outflow, the other investment account substantially improved owing to lower repayments of liabilities and a reflow of banks' offshore assets acquired in the first half of 2001. For the period the overall balance posted a surplus of $2.8 billion, compared to a deficit of $0.2 billion in the first half of 2001.

Figure 5: **International Reserves and External Debt**[1] ($ billion)



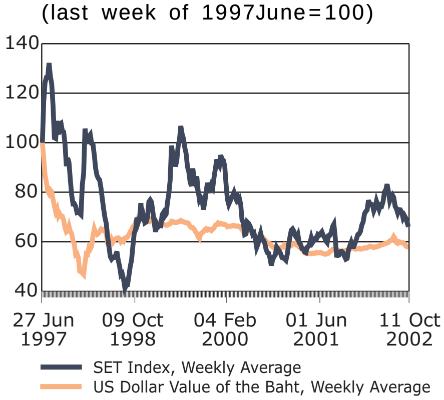
[1]Data for 02Q3 as of July 2002.
Source: ARIC Indicators.

The external position strengthens.

Total external debt amounted to $65.4 billion (about 55% of GDP) at the end of June 2002, down from $67.5 billion at the end of 2002 (Figure 5). Short-term debt, substantially reduced in recent years, was little changed over the period and was $13.8 billion (21% of total debt), with foreign exchange reserves equivalent to 2.7 times short-term debt. At end-September 2002, foreign exchange reserves reached $37.5 billion, an increase of $4.5 billion from end-2001.

Asset Markets

Figure 6: **Exchange Rate and Stock Price Indexes**
(last week of 1997June=100)



Source: ARIC Indicators.

After an appreciation, the baht/dollar exchange rate fell back to its end-2001 level.

From end 2001 through mid-July, the baht appreciated against the US dollar by about 9% with about one half of the gain occurring between mid-June and mid-July (Figure 6). The improving current account surplus, strengthening of the capital account, and weakening of the dollar fueled the gain. Subsequently, there was a steady fallback in the rate and by early October the baht/dollar rate was back to near its end-2001 level. Growing uncertainties in the global economy outlook largely account for the reversal in market direction.

After strong gains, the stock market has softened.

Better global conditions, improved corporate profitability, and rising expectations of economic recovery boosted the Stock Exchange of Thailand (SET) index to a high of 423 (weekly average data) in mid-June, up nearly 46% in dollar terms from the end of 2001. Subsequently, the SET was adversely affected by the worldwide slump in equities, especially in the US market. Nevertheless, through mid-October the market remained up for the year by about 12% in dollar terms and about 11% in baht terms.

The property market is improving.

Faced with rising demand, the Bangkok property market improved in the first half of 2002, with moderate increases in prices and rents seen in most sectors. The office property market overall vacancy rate fell to 24.9% in the second quarter from 27.7% in the fourth quarter of 2001 (Table 2). With no new grade-A projects under construction or recommencing, tighter supply is expected to raise occupancy levels in the period ahead. The residential sector is expected to continue to dominate the property market as sales of newly-built detached houses, townhouses, and condominiums have been brisk and new projects are being launched.

Table 2: **Property Vacancy Rates in Bangkok** (%)

	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2
Office	28.2	28.7	29.7	43.1	42.2	40.3	38.9	36.6	34.0	32.1	31.0	27.4	27.6	25.3	27.7	26.1	24.9

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

Social Sector Developments

Employment conditions have improved.

The unemployment rate fell to a five-year low of 1.9% in June 2002, compared to 2.4% a year earlier. Employment increased by nearly 2%, with the majority of jobs created in the wholesale and retail trade, construction, and hotels and restaurants.

Poverty incidence has declined.

World Bank estimates of poverty based on consumption of $2 per day increased from 28.2% of the population in 1996 to 35.6% in 2000, but has declined to 32.3% in 2002. The Government has produced a substantial package of farm, village, and small enterprise-oriented programs designed to expand productive opportunities for low-income groups as part of its fiscal program to raise economic growth. Additionally, a low-cost (B30/visit) universal health scheme has been brought in to cover the uninsured.

Financial and Corporate Sector Developments

NPL ratios remain high.

TAMC has completed the bulk of its purchases of NPLs from the banking system. It acquired B717 billion (about 13% of GDP or $17 billion) in NPLs from banks and their AMCs at an average price of 33.3% of face value. About 80% of purchases were from State-owned banks. Through August, 41% of acquired loans had been resolved. TAMC has set ambitious targets to restructure B500 billion of NPLs by end-2002 and reach resolution on all loans by the end of 2003.

Private banks benefited only marginally from NPL transfers to TAMC and their burden continues to inhibit lending activities. The NPL ratio of commercial banks at end-August was 10.2%, little changed from end-2001. The bulk of NPLs are at private banks; an overburdened legal system and a high re-entry rate of previously restructured loans inhibit their reduction.

In June 2002, the Ministry of Finance (MOF) and BOT announced a plan to fiscalize the losses of the Financial Institutions Development Fund

(FIDF), the BOT entity that has financed restructuring of the financial system. The plan aims to remove uncertainties concerning the transparent funding of the estimated losses of B1.4 trillion (about 26% of GDP) and reassure that they would not adversely affect monetary policy. Under the plan, losses would be fully funded by additional government bond issues replacing all FIDF nongovernment funding. Interest payments on bonds will be met in the budget by the MOF, while principal would be amortized by BOT using its annual profits and would likely be accomplished over 20 to 30 years.

Prospects and Policy Issues

Recovery will likely accelerate in 2002.

Economic performance in the first half of 2002 has been encouraging and the latest Consensus Economics Survey (October 2002) forecast of 4.3% for growth this year is likely to be achieved. The survey forecasts 2003 GDP growth to a moderate 4%. Nevertheless, with exports of goods and services amounting to two thirds of GDP, Thailand remains vulnerable to any adverse developments in the world economy. Policies pursued to stimulate domestic demand have been beneficial in speeding economic recovery and widening the basis for growth. But strengthening the fiscal position, continuing structural reforms, and enhancing transparency remain essential to ensuring sustainable growth.

Bank and corporate restructuring process remains unfinished and is holding back growth.

While the 2002 economic recovery was heartening, it will have taken six years for real GDP to reach precrisis (1996) levels. Thailand's economic rebound has thus been slower than most of the other crisis-hit countries. While various factors have inhibited progress, the main stumbling block is the limited success in dealing with the corporate debt overhang problem. Banks are burdened by excessive NPLs that inhibit new lending and a significant portion of the corporate sector remains highly leveraged and is operating well below capacity. Policy issues to be addressed include:

- Assuring that TAMC operations are perceived as transparent, with debt restructuring provided only to viable companies;
- Enacting reforms to the bankruptcy and foreclosure process needed by creditors to deal with obstructionist debtors;

- Assisting private banks in resolving their bad debt overhang that inhibits new lending, while avoiding any regulation of interest rate spreads that would undermine market-oriented risk assessment; and
- Speeding the stalled government privatization program, with emphasis on the quick sale of State-owned banks that are now financially sound and fully competitive institutions after the TAMC cleanup.

Thailand: Selected ARIC Indicators

	1996	1997	1998	1999	2000	2001	98Q1	98Q2	98Q3	98Q4	99Q1	99Q2	99Q3	99Q4	00Q1	00Q2	00Q3	00Q4	01Q1	01Q2	01Q3	01Q4	02Q1	02Q2	02Q3
Output and Prices																									
GDP Growth (%)	5.9	-1.4	-10.5	4.4	4.6	1.8	-7.1	-13.9	-13.9	-7.2	-0.2	3.6	8.2	6.4	6.8	6.0	2.3	3.5	1.7	1.8	1.6	2.1	3.9	5.1	. . .
Private Consumption Expenditure Growth (%)	5.8	-1.4	-11.5	4.3	4.9	3.4	-8.6	-14.8	-14.0	-8.3	-3.3	1.4	8.4	11.3	7.3	6.7	3.2	2.7	3.8	3.9	2.9	3.0	3.6	3.8	. . .
Public Consumption Expenditure Growth (%)	12.1	-2.8	3.9	3.2	2.6	1.6	-6.1	-5.5	12.6	13.5	1.6	16.8	-6.2	4.2	9.1	-2.6	6.7	-2.3	2.5	6.5	1.7	-4.2	7.8	-3.7	. . .
Gross Domestic Investment Growth (%)	5.2	-21.9	-50.9	8.7	10.9	0.6	-45.6	-57.4	-56.6	-42.0	-11.8	25.1	9.7	17.4	25.8	9.8	7.4	1.6	3.3	-2.7	0.6	1.0	-4.1	6.2	. . .
Gross Fixed Investment Growth (%)	7.0	-20.5	-44.3	-3.2	5.5	-22.8	-40.0	-49.2	-48.0	-38.6	-24.3	5.8	4.0	5.9	25.1	-2.0	-1.1	2.9	-4.1	5.4	2.3	-0.2	3.5	7.6	. . .
Agricultural Sector Growth (%)	4.4	-0.7	-1.5	2.2	4.8	1.6	0.4	-11.1	-5.5	6.2	4.3	5.6	5.6	-3.3	2.6	10.4	4.7	3.1	0.9	1.4	-1.7	4.2	5.2	2.0	. . .
Manufacturing Sector Growth (%)	6.6	1.4	-10.9	11.9	6.0	1.2	-11.0	-13.6	-14.4	-4.1	5.6	9.9	17.6	14.9	9.5	8.5	3.0	3.6	1.2	1.5	0.8	1.4	4.1	6.7	. . .
Construction Sector Growth (%)	7.0	-25.6	-38.3	-6.8	-9.4	-3.0	-28.3	-43.8	-42.2	-36.6	-25.1	3.3	0.1	-3.7	8.2	-12.0	-13.1	-18.7	-8.1	-12.9	3.0	7.3	6.7	18.6	. . .
Services Sector Growth (%)	5.3	-1.1	-10.0	0.4	4.0	2.3	-4.8	-12.7	-12.0	-10.5	-3.3	-0.8	2.6	3.1	5.0	3.9	2.6	4.6	2.9	2.7	2.1	1.6	2.9	3.5	. . .
Exports of Goods and Services Growth (%)	-5.5	7.2	8.2	9.0	17.6	-4.2	16.7	10.4	7.2	0.2	-1.3	3.9	13.4	19.8	22.1	17.5	21.1	10.7	-2.0	-1.1	-8.7	-4.6	5.1	12.9	. . .
Imports of Goods and Services Growth (%)	-0.6	-11.3	-21.6	10.5	27.3	-8.3	-26.4	-27.8	-21.4	-9.4	-8.1	15.6	13.8	19.6	51.0	21.6	29.1	14.0	-3.5	-7.1	-12.7	-9.4	1.5	12.7	. . .
Inflation Rate (%)	5.8	5.6	8.1	0.3	1.5	1.7	9.0	10.3	8.1	5.0	2.7	-0.4	-1.0	0.1	0.8	1.6	2.2	1.6	1.4	2.5	1.6	1.0	0.6	0.2	0.3
Unemployment Rate (%)	1.1	0.9	4.4	4.2	3.6	3.4	4.6	5.0	3.4	4.4	5.2	5.3	3.0	3.3	4.3	4.1	2.4	3.6	4.2	4.2	2.6	2.4	3.2	2.9	. . .
Monetary and Fiscal Accounts																									
Growth of Broad Money, M2 (%)[1]	12.6	16.4	9.5	2.1	3.7	4.2	15.8	13.8	12.6	9.5	8.6	5.8	2.1	2.1	0.7	0.8	2.5	3.7	6.0	6.7	5.3	4.2	5.0	5.1	. . .
Three-Month Interbank Lending Rate (%)[1]	13.0	26.0	7.8	5.0	5.0	2.9	23.5	22.0	9.5	7.8	5.3	4.5	4.0	5.0	4.5	3.8	3.5	5.0	2.6	3.8	3.5	2.9	2.3	2.3	2.1
Growth in Real Bank Credit to Private Sector (%)[1]	9.0	14.7	-13.4	-4.8	-11.2	-6.6	3.1	1.6	-5.7	-13.4	-5.7	-6.4	-4.2	-4.8	-5.8	-9.2	-13.7	-11.2	-10.5	-7.6	-3.9	-6.6	-4.4	-1.0	. . .
NPL Ratio of the Financial System[1]	. . .	. . .	45.0	38.9	17.9	10.5	. . .	32.7	39.7	45.0	47.1	47.4	44.8	38.9	37.4	32.1	22.9	17.9	17.6	12.7	12.9	10.5	10.3	10.2	. . .
NPL Ratio of the Commercial Banking System[1]	. . .	. . .	42.9	38.6	17.7	10.5	. . .	31.0	37.9	42.9	46.2	46.5	44.0	38.6	37.0	31.8	22.4	17.7	17.4	12.6	12.9	10.5	10.4	10.2	. . .
Average Stock Price Index	1,165.7	596.9	351.6	421.0	341.5	303.5	473.1	361.5	246.0	335.0	357.1	461.8	450.5	415.0	432.7	358.2	304.0	275.0	309.8	305.0	312.3	287.1	355.3	390.1	369.6
Central Government Fiscal Balance as % of GDP	0.9	-1.5	-2.8	-3.3	-2.2	-2.4	0.01	0.6	-8.6	-3.4	-0.01	-4.1	-4.2	-5.0	-1.5	-1.1	-2.0	-4.2	-2.8	0.5	-2.0	-5.3	-5.3	2.7	. . .
Central Government Debt as % of GDP	. . .	6.9	15.0	21.4	23.6	25.0	5.9	9.6	10.7	15.0	18.6	19.7	20.8	21.4	21.0	21.8	23.0	23.6	24.1	24.0	24.9	25.0	25.4	25.7	. . .
Government Expenditure on Education (% of Total)	3.8	4.2	4.8	4.7	4.5	4.3	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Government Expenditure on Health (% of Total)	1.3	1.5	1.5	1.4	1.3	1.7	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
External Account, Debt, and Exchange Rates																									
Growth of Merchandise Exports ($ fob, %)	-1.9	3.8	-6.8	7.4	19.5	-6.9	-2.9	-5.3	-8.7	-9.9	-4.2	5.7	10.9	17.1	27.8	15.1	22.4	14.1	-1.2	-0.7	-11.0	-13.4	-6.3	3.4	. . .
Growth of Merchandise Imports ($ cif, %)	0.6	-13.4	-33.8	16.9	31.3	-2.8	-39.8	-38.2	-34.2	-18.9	-1.0	11.7	21.9	35.4	42.7	28.0	33.8	23.6	11.5	2.9	-9.1	-13.9	-10.2	2.0	. . .
Current Account Balance as % of GDP	-7.9	-2.0	12.7	10.2	7.7	5.4	16.2	10.1	12.6	12.0	12.7	7.4	10.1	10.4	10.1	5.4	7.4	7.6	4.7	3.7	6.0	7.2	5.8	3.3	. . .
Net Foreign Direct Investment ($ Billion)	1.5	3.3	7.4	5.9	3.4	3.7	2.2	2.5	1.4	1.2	1.0	1.9	1.2	1.8	0.7	0.7	0.7	1.2	0.7	1.1	0.7	1.2	0.1	0.2	. . .
Net Portfolio Investment ($ Billion)	3.5	4.4	0.4	0.4	-0.1	-0.9	0.5	-0.1	-0.1	0.02	-0.1	0.1	0.2	0.2	0.3	0.1	-0.4	-0.1	0.0	-0.7	-0.4	0.2	-0.6	-0.1	. . .
Gross International Reserves ($ Billion)[1]	. . .	27.0	29.5	34.8	32.7	33.0	. . .	. . .	. . .	29.5	29.9	31.4	32.4	34.8	32.3	32.1	32.2	32.7	32.3	31.6	32.6	33.0	33.6	36.8	37.5
Total External Debt as % of GDP[1]	. . .	69.4	93.1	77.7	65.2	58.9	66.1	73.1	77.9	93.1	86.5	82.6	79.0	77.7	74.0	69.9	67.5	65.2	63.6	64.0	63.5	58.9	55.7	55.0	. . .
Short-Term Debt as % of Gross International Reserves[1]	. . .	142.0	96.3	56.2	45.0	40.5	. . .	. . .	. . .	96.3	85.5	74.9	66.4	56.2	55.6	53.1	47.3	45.0	45.0	48.0	44.8	40.5	39.4	37.4	. . .
Short-Term Debt as % of Total Debt[1]	43.9	35.0	27.1	20.6	18.4	19.8	. . .	. . .	. . .	27.1	25.1	23.7	22.0	20.6	19.6	19.6	18.2	18.4	19.2	20.4	20.1	19.8	20.5	21.0	. . .
Real Effective Exchange Rate (1995=100)[2]	109.2	102.4	90.0	93.5	86.9	85.3	77.3	92.5	93.5	96.8	97.3	97.5	91.9	87.4	92.0	89.3	84.9	81.4	85.2	83.7	84.2	88.3	91.6	90.8	. . .
Average Exchange Rate (Local Currency to US$)	25.3	31.1	41.2	37.9	40.2	44.5	46.6	40.3	41.1	36.9	37.1	37.2	38.4	38.8	37.7	38.7	41.0	43.4	43.3	45.4	44.9	44.3	43.7	42.8	42.1

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, M2, real bank credit to private sector, nonperforming loan ratios of the financial and commercial banking system, central government fiscal balance, central government debt, government expenditure on education and health, merchandise exports and imports, current account balance, net foreign direct and portfolio investments, gross international reserves, and total and short-term external debts are from national sources. Data on interbank lending rate, average stock price index, and average exchange rate are from Bloomberg LP. Real effective exchange rates are based on REMU staff calculations.