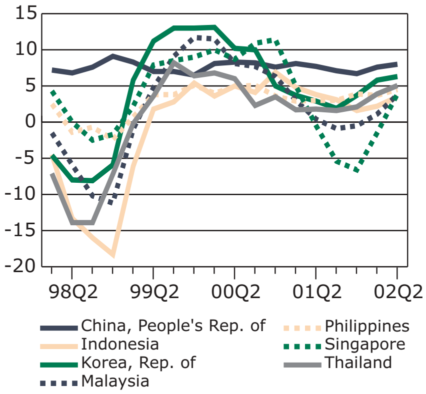
# East Asia's Growth, Recovery, and Restructuring—A Regional Overview

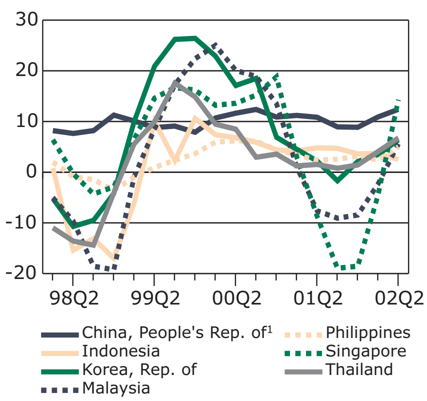
## Growth and Recovery in 2002

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%).

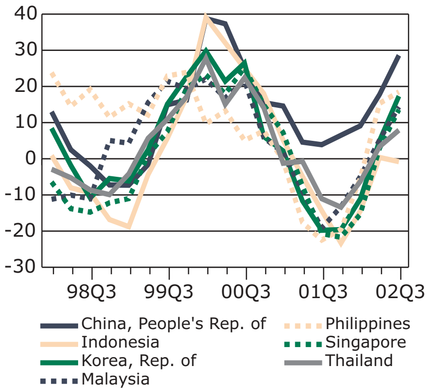
The region's economic rebound has been driven by both exports and domestic demand. The second quarter consolidated the turnaround in export growth that took place in the previous two quarters. All seven countries posted higher export growth in the second quarter compared to the two previous quarters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

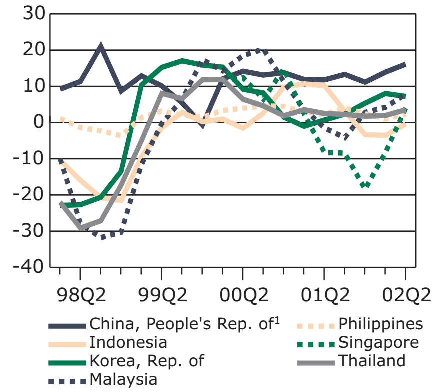
Estimates of GDP growth for the third quarter of this year are not yet available for East Asian countries, except for the PRC, where it came in at an impressive 8.1%, and Singapore, where it was 3.7%, the same rate as in the second quarter. However, trends in a few monthly economic indicators suggest 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, %)



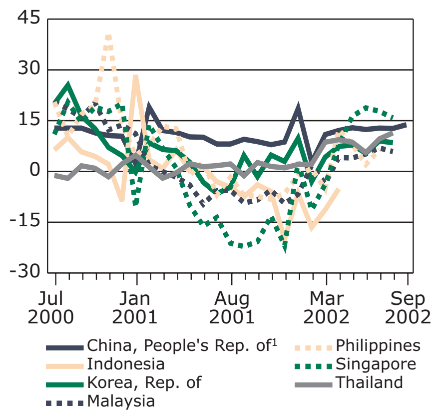

2002Q3 growth rates are based on two months of data (July and August) for all countries except Korea and PRC.
Source: ARIC Indicators.

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



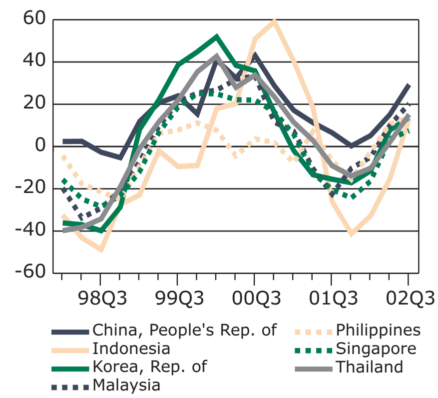

[1]Data refer to the growth of the sum of retail sales and fixed investment (1997=100).
Source: ARIC Indicators.

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?**

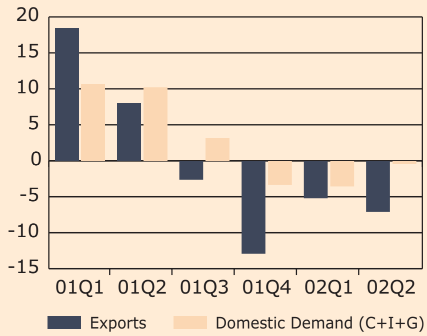
Helped by a combination of factors, including financial sector reforms and restructuring, moderately expansionary fiscal and monetary policies, and a turnaround in exports, domestic demand has posted a robust turnaround and played a significant role in East Asia's recent economic rebound. Even last year, 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**

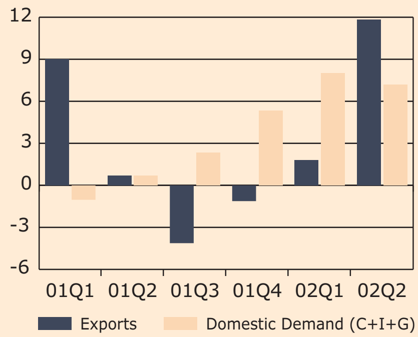
Figure 1.1a: **Growth of Domestic Demand and Exports** (%, y-o-y, constant prices)




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

**KOREA, REP. OF**

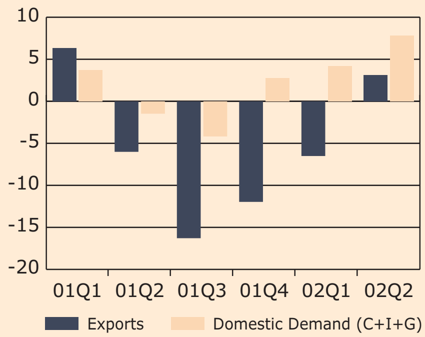
Figure 1.2a: **Growth of Domestic Demand and Exports** (%, y-o-y, constant prices)




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

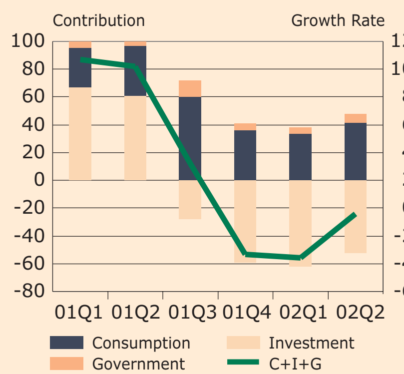
**MALAYSIA**

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



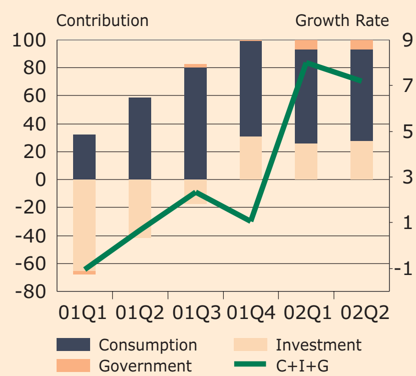

Note: Based on National Income Accounts.
Source: ARIC Indicators.

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



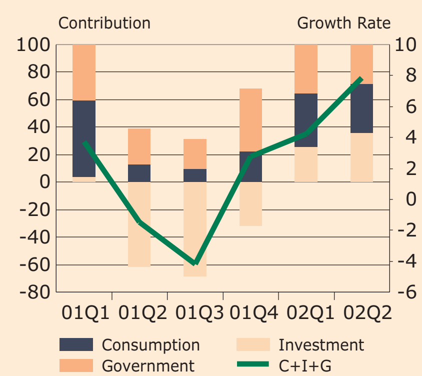

Note: Based on National Income Accounts.
Source: ARIC Indicators.

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




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

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

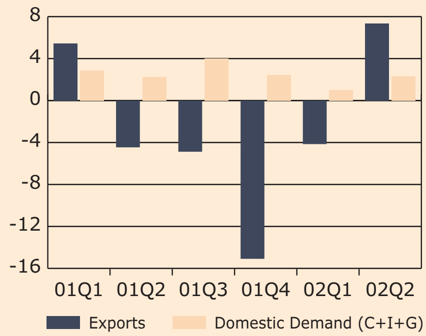



Note: Based on National Income Accounts.
Source: ARIC Indicators.

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

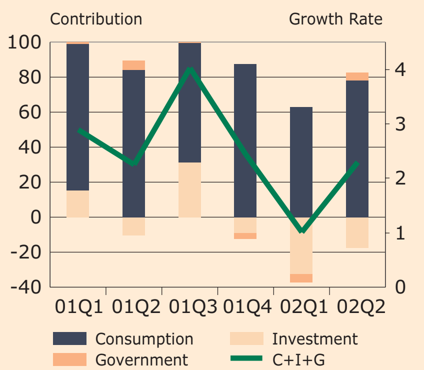
**PHILIPPINES**

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




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

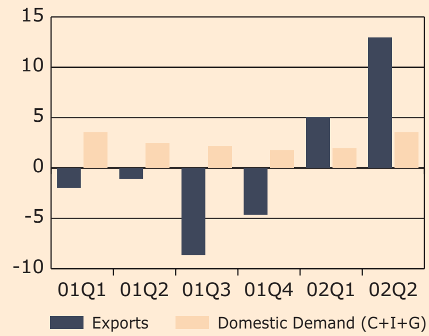
Figure 1.4b: **Domestic Demand: Growth Rate and Contribution of Components**




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

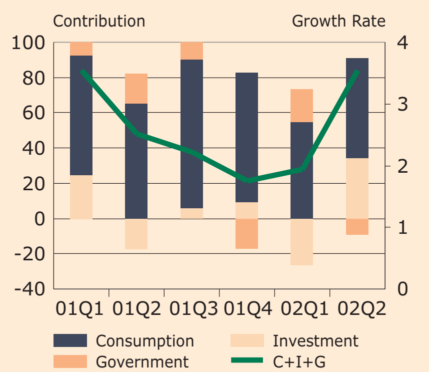
**THAILAND**

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




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

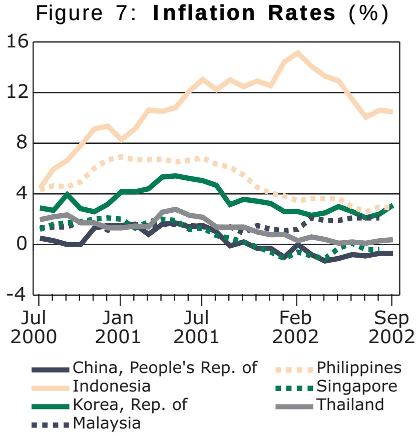
Figure 1.5b: **Domestic Demand: Growth Rate and Contribution of Components**




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)

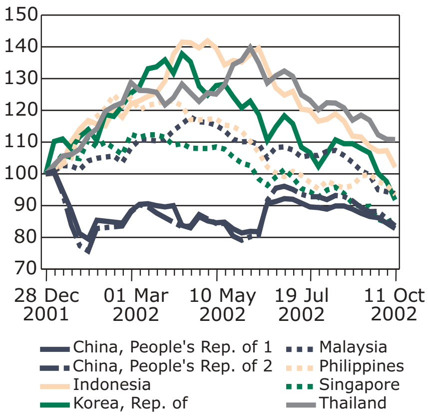
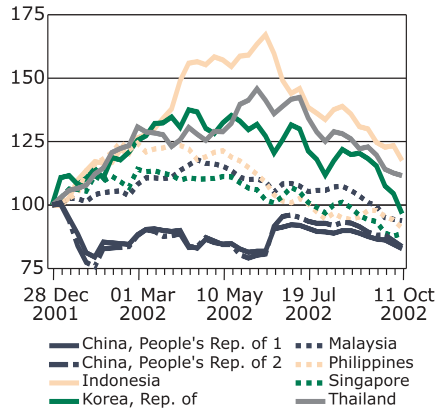
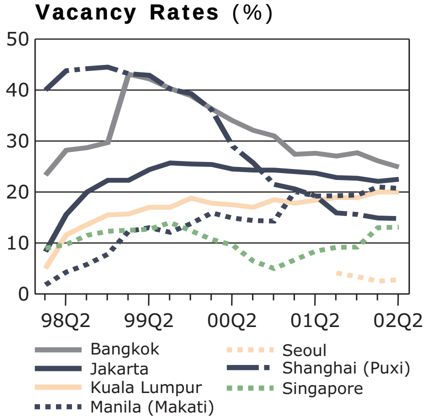



Figure 8b: **Composite Stock Price Indexes**[1] (last week of 2001Dec=100, $)



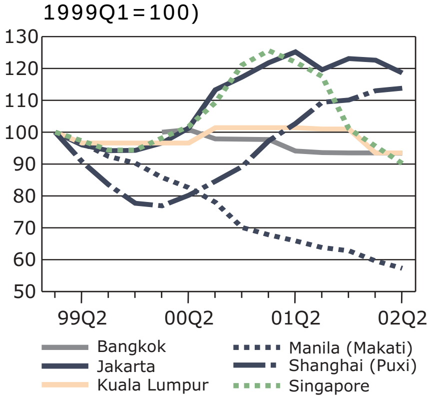

[1]Weekly averages of Shanghai-B (PRC 1), Shenzhen-B (PRC 2), JCI (Indonesia), KLCI (Malaysia), PHISIX (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand).
Source: REMU staff calculations derived from Bloomberg data.

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.

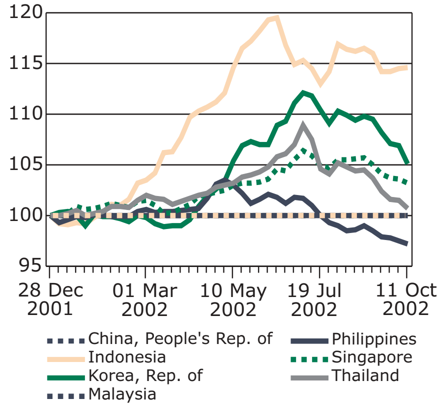
As a result, stock market indexes in several countries (PRC, Korea, Malaysia, Philippines, and Singapore), both in local currency and dollar values, are now back to or even below their levels seen at the beginning of the year (Figures 8a and 8b). In Indonesia and Thailand, despite the softening over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

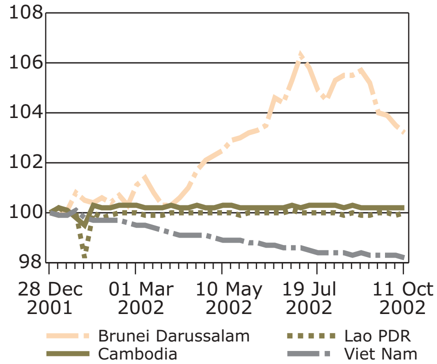
When the July 2002 AEM was published, most regional currencies were appreciating against the US dollar, which was showing general signs of weakness. This raised concerns that the regional rebound might be dampened by reduced export competitiveness. Since mid-July, however,

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



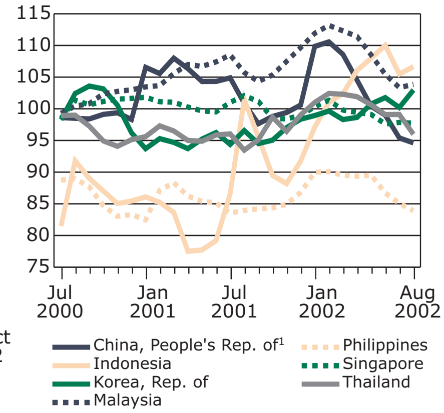

Source: REMU staff calculations derived from Bloomberg data.

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)

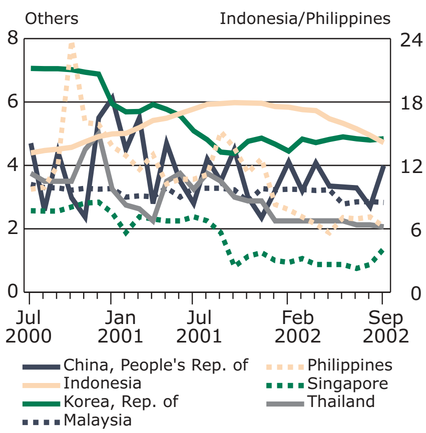



Note: An increase is an appreciation. Trade weighted based on total trade with the European Union, Japan, and the US.
Source: REMU calculations.

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.

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).

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



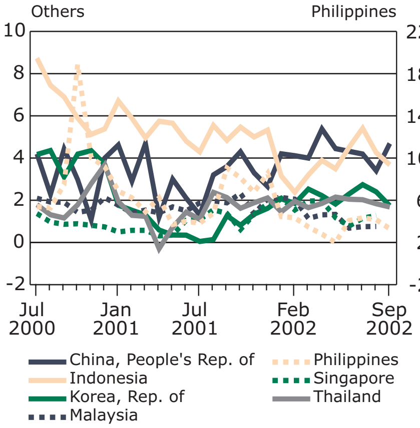

Source: ARIC Indicators.
[1]Three-month interbank lending rates—
PRC: Average trading rate in interbank borrowing and lending market (People's Bank of China); Indonesia: Weighted average of banks' interbank lending rates (Bank Indonesia); Korea: Certificate of deposit (3 months); Malaysia: Average of 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).

## 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).

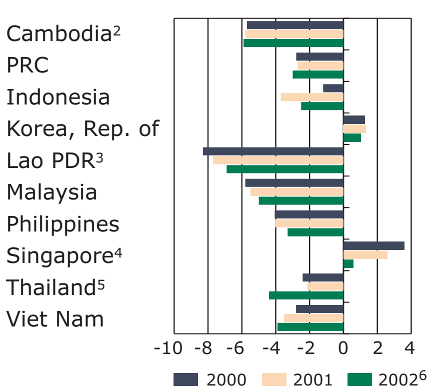
Except in Korea and Singapore, this year's fiscal policy stance has been moderately expansionary in several countries, most of which have budgeted for fiscal deficits (Figure 16). For instance, the PRC has maintained its moderately expansionary fiscal stance of recent years, with a budgeted fiscal deficit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

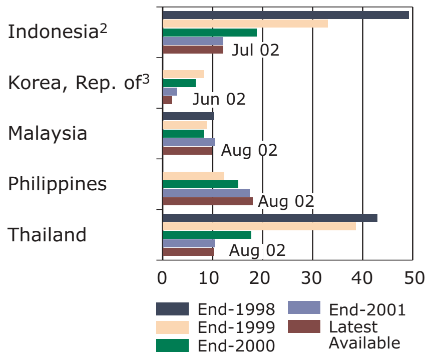
# Progress in Financial and Corporate Restructuring and Reforms

## 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.

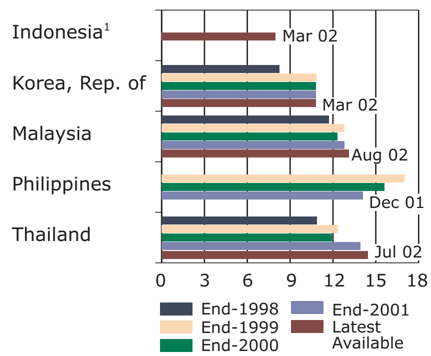
Capital adequacy ratios (CARs) have been maintained at or above the 8% Basel norm in all the five crisis-affected countries (Figure 18). CARs are now within the 10–15% range in Thailand, Philippines, Malaysia, and Korea. Indonesia, which has lagged behind the other four countries in re-capitalizing banks,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



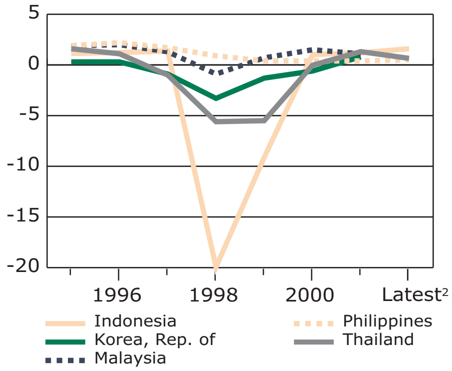

[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis in Malaysia, and three months or more in Korea and Thailand.
[2]Refer to NPLs in banking sector.
[3]NPL criteria were changed in December 1999, so no comparable data are available prior to that date.
Source: ARIC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

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



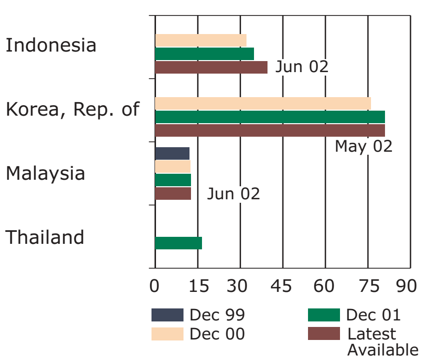

[1]Refers to CAR of the banking system.
Source: ARIC Indicators.

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



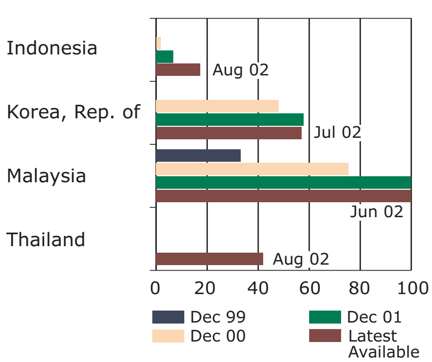

[1]Data refer to return on assets of commercial banks, with the exception of Malaysia, which refers to the banking/financial system.
[2]Latest data refer to annualized estimates: Indonesia (May 2002), Philippines (March 2002), Thailand (June 2002).
Source: Web sites of Bank Negara Malaysia, Bank of Indonesia,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

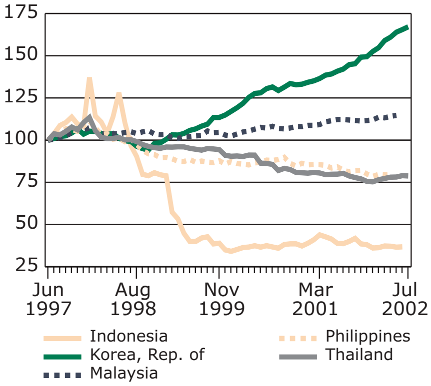
## Bank Consolidation / Divestment

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.

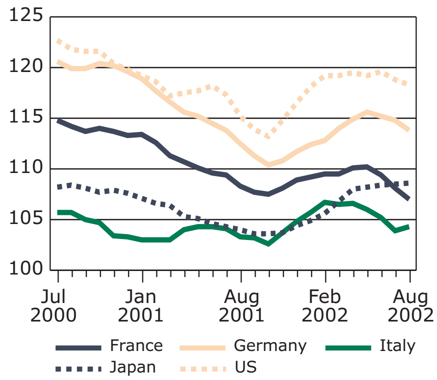
In Viet Nam, reforms are focusing on restoring the financial health of State-owned commercial banks (SOCB) by putting them on a commercial footing, strengthening credit risk management, and controlling NPLs. An overall SOCB restructuring framework, adopted in March 2001, provided for a phased and conditional 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

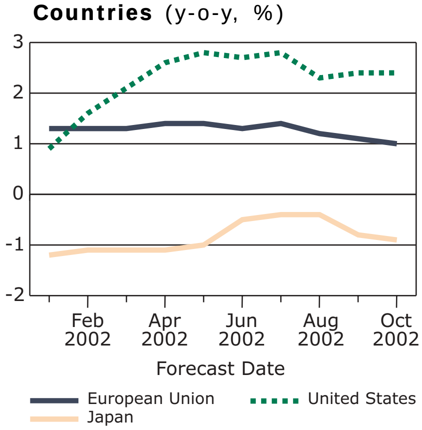
Since the release of the July 2002 AEM, the external environment facing East Asia has turned less favorable. With the exception of Japan, leading indicators for most industrial countries have trended downward in recent months, suggesting moderation in their growth prospects

Figure 23: **OECD Leading Indicators**



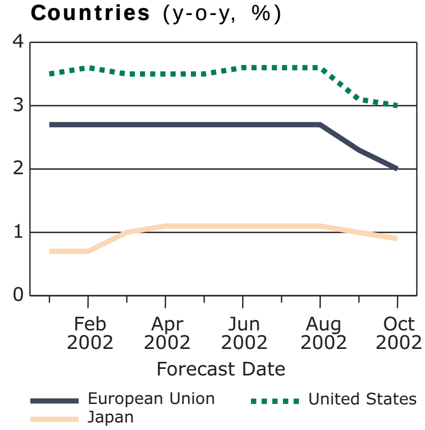

Source: OECD web site.

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.

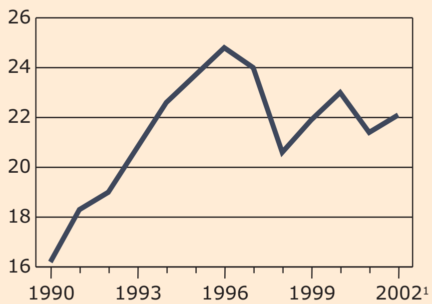
Third, current projections indicate an improvement in private capital inflows to the region, especially next year. For example, IIF is forecasting an increase in net private capital inflows to the five crisis-affected countries, from about $10 billion this year to $14 billion in 2003. All the major components 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.

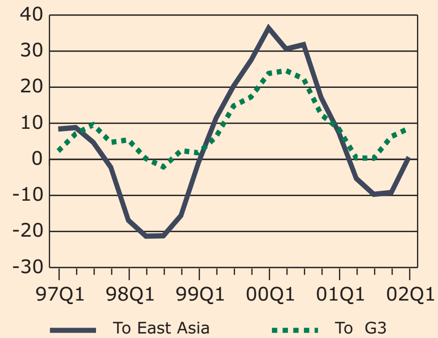
Figure 4.1: **Intra-regional Exports of East Asia** (% of total exports)




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

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.

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).

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.

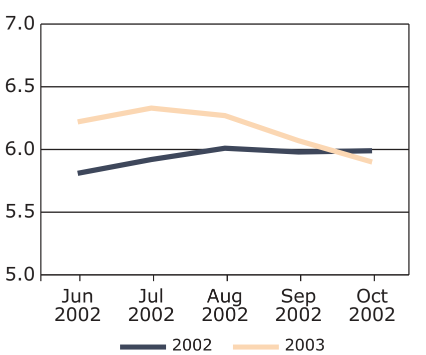
Consensus Economics, thus, forecasts East Asia's GDP growth to reach 6% in 2002 and 5.9% in 2003. Except for some minor country differences, these forecasts differ only slightly from its June forecast of 5.8% for this year and 6.2% for 2003 (Table 1 and Figure 26). Excluding the PRC, the region is now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

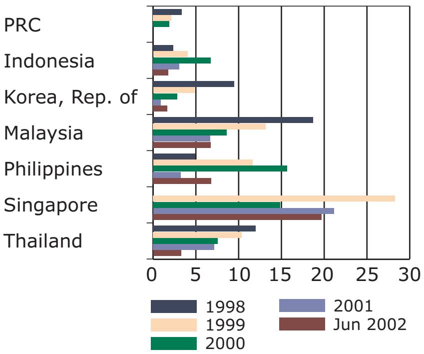
The modest rebound scenario for East Asia is, however, subject to a higher degree of uncertainty now than in July, with most of the external risks on the downside.

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)

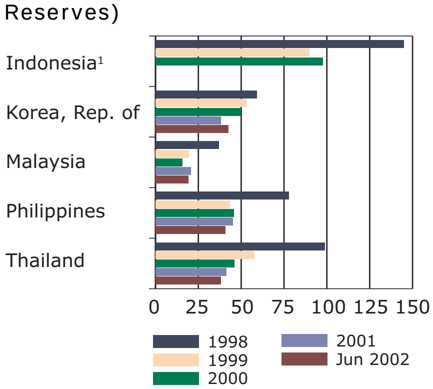



Source: ARIC Indicators.

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.

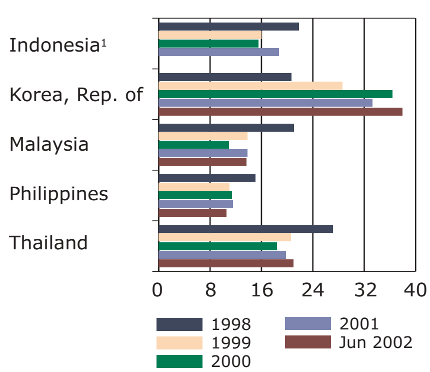
Reflecting many of these developments, international credit rating agencies have improved their assessments for several countries (Table 2). Following Moody's upgrade of Korea's long-term sovereign credit rating on 28 March 2002, Standard and Poor's upgraded Korea's sovereign rating to "A-" on 24 July 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)



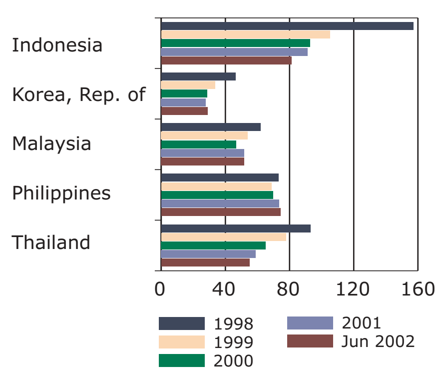

[1]Data for 2001 as of June 2001.
Source: ARIC Indicators, except for Indonesia which are taken from Nomura International and Bisnis Indonesia.

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.