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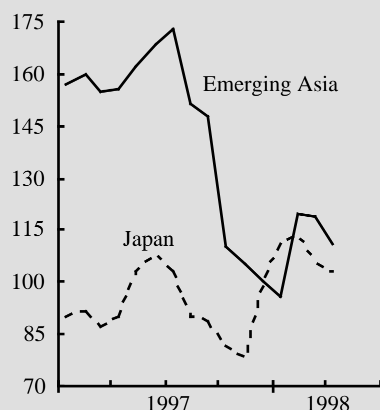

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The financial meltdown is over and another crash is unlikely

- Most Asian currency and stock markets have performed better than expected over the last three months, putting an end to the region's financial meltdown. There are still risk factors, notably in Indonesia and through the potentially negative impact of Japan's recession and yen weakness on the rest of the region. But another region-wide meltdown seems unlikely, as current account corrections and debt adjustments are removing the risk of another balance of payments crisis. Also stabilizing is the increasingly evident lack of runaway inflation.

But the economic downturn continues...

- The economic downturn, however, has only started. 1998 GDP growth forecasts have been marked down substantially since the last issue of *Asian Financial Markets*, with recessions not only occurring in Indonesia, Korea, and Thailand, but also in Hong Kong, Japan, and Malaysia. The downturn has squeezed imports, while the lack of working capital has so far limited a positive export response. Meanwhile, China is slowing, India is struggling, and only Taiwan still enjoys robust growth.

...and lasting recovery will hinge on financial reform

- Ultimately, though, exports are set to accelerate, given the sharp real currency depreciations in most countries. But trade adjustment alone is not sufficient for a sustained recovery. On the domestic front, Japan's new fiscal boost is set to fade after a few quarters. Thus for both Japan and the rest of Asia, financial reform and, in particular, recapitalization of banking systems will be key to restoring lasting dynamism. So far, only Thailand has demonstrated enough political will to pull through with reforms, while Indonesia and Malaysia are notable laggards.

Markets will struggle to climb higher

- As the state of panic fades from Asia, market correlations within the region are starting to break down and focus returns to each country's relative market performance. Given the sheer size of funds needed to recapitalize the region's insolvent banks and the limited domestic resources, foreign participation will be crucial and so too will be investors' perception of reform progress. Here, Thailand and the Philippines are likely to score well, but Indonesia, Malaysia, and even Korea are apt to struggle. Japan's new fiscal package is not expected to reverse the yen's trend decline, which could somewhat undermine markets in the rest of the region. Yet, another crash is unlikely.

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Review and outlook

The crash is over, but the cleanup takes time

- **The financial meltdown has come to an end and no further crash is likely to follow soon**
- **However, the economic downturn is in full swing**
- **Prospects for recovery depend on the speed of reforms and efforts to recapitalize the banks**
- **Financial markets will struggle to move higher, depending on concrete signs of reform progress**

Developments over the last three months have brought an end to Asia's financial meltdown. Many factors contributed to the change in market sentiment, but most important were the encouraging initiatives taken by the Korean and Thai governments in coordination with the IMF. Especially, the announcement of the Korean bank deal in late January marked a turning point. Also important but less acknowledged was China's decision not to devalue the renminbi. Even so, not all developments have been positive. Indonesia's repeated failure to abide by the second letter of intent with the IMF and prolonged struggle to come to a new agreement long kept the market on edge. Also, Japan's fall back into recession and its implications for the rest of Asia have recently undermined market sentiment.

Nevertheless, the risk of a second region-wide market crash seems increasingly remote. The huge current account corrections and private-sector debt adjustments now under way in Korea, Thailand, and even Indonesia have eased the balance of payments crisis. Moreover, China is unlikely to devalue its currency as long as this could lead to financial turmoil in the rest of the region and, in particular, have a negative effect on the HK$ peg. Finally, the increasingly evident lack of runaway inflation also has a stabilizing effect, as it reduces the need for nominal interest rate increases and keeps most of the region's currencies extremely low in real terms. But even as the state of panic disappears from the region as a whole, some countries are still vulnerable to a severe market downturn. Here, Indonesia is the most at risk, reflecting social and political uncertainties, the potential for a renewed conflict with the IMF, and substantial inflation risks.

The economic downturn is only unfolding now...

Despite the mostly positive market developments, the situation in the real economies has sharply deteriorated. Recessions are now unfolding across the region. Indonesia, Korea, and Thailand are hit the worst, with real GDP in 1998 expected to decline between 4% in Korea and Thailand and 10% in Indonesia. Malaysia, despite government efforts to prevent a meltdown, is now also expected to fall into recession and the Philippines is staying just above zero. The crisis is also hitting the economies of Hong Kong and Singapore harder than expected, with Hong Kong likely to slip into its first post World War II recession. Even China seems unlikely to meet its 8% growth target for this year, as the contribution from external trade declines and domestic demand fails to pick up the slack.

The regional gloom is further compounded by the recent contraction in the Japanese economy. The only bright spots are India and Taiwan, which have been spared the Asian flu. Australia and New Zealand have also escaped the financial turmoil, but their trade performances are suffering more than expected from the Asian downturn, undermining their growth outlooks.

... leading to a shift of resources to the trade sector

No matter how grim, though, the downturn in economic activity is a prerequisite for the recovery, as it will shift resources from the domestic side to the trade sector. The first wave of this adjustment is already underway, visible in the sharp plunge in imports. But little has happened so far on the export side, despite the large real currency devaluations in many countries.

The slow export response is primarily the result of the liquidity crunch and the lack of working capital, but also highlights the downside of Asian countries' past ambition to shift into high value-added exports. The now unfolding current account adjustment and improvement in financial market conditions will gradually ease the lack of working capital, but this may involve yet more domestic demand weakness and switching of resources into the trade sector.

Another concern for the export outlook are the developments in Japan, especially if the new fiscal package fails to lead to a convincing recovery in the second half of this year. A weak Japanese economy and a weak yen are a multiple blow for the rest of Asia, since Japan is one of its major export destinations and also the home of key competitors and investors.

Ultimately, however, exports of countries with sharp real currency devaluations – notably Indonesia, Korea, the Philippines, and Thailand – are set to accelerate and the question is what this means for countries that have not devalued, foremost China. While China's productivity gains will offset some of the loss in currency competitiveness, and its trade accounts have felt little pressure so far, this will change. But by the time the pressure gets real, probably not before the end of this year or early 1999, a renminbi devaluation would be far less damaging for financial markets in the rest of the region and will become politically more acceptable to the Chinese authorities, especially if domestic demand remains sluggish. In fact, a depreciation of the renminbi in 1999 could be seen as positive for growth in greater China and, thus, be a plus for the HK$ peg.

Banking reform is key for Japan and rest of Asia

For the deeply distressed economies in the region, trade adjustment alone is not a sufficient condition for sustained recovery. Whether economies will return to robust growth over the next few years or just limp along will depend mostly on efforts and results in recapitalizing their banking systems. Japan's long period of economic stagnation and recent fall back into recession highlight that a sustained recovery is unattainable if the financial system lacks the capital to extend its balance sheets. Indeed, without far-reaching financial restructuring, Japan's new fiscal package will boost growth only for a few quarters, as was previously the case in 1995/96.

Unfortunately, developing the political will to tackle the banking problems is a tough hurdle, given the inevitable wealth and income distribution consequences. Instead, maintaining the *status quo* often seems more convenient, especially if, as in the case of Japan and more recently Malaysia, low interest rates and other funds can be used to prevent a meltdown. So far, only Thailand appears to have broken out of deadlock, following the change in government. In contrast, Indonesia and Malaysia are clear laggards and even Korea is behind, as the new government struggles under pressures from big *chaebols* and the labor movement. In addition to political considerations, practical constraints, such as expertise, regulatory and supervisory standards, legal infrastructure, and limited fiscal resources are likely to prolong the reform process.

Besides Japan and the most distressed economies in the rest of Asia, China is also in need of substantial financial reform. Contrary to market wisdom, however, the existing nonperforming loan problem of the state banks is not so worrying, being really a fiscal issue that has already been covered by past central bank liquidity injections. The authorities have also realized the need for banking reform and their measures so far, while not sufficient, do warrant applause. More radical reforms would conflict with the government's other objectives, especially to maintain robust growth. As a result, the government will avoid a "Big Bang" and continue its policy of gradual change.

Financial markets will struggle to climb higher

Banks' huge recapitalization requirements – estimates range from 20% of GDP in Indonesia, Japan, and Malaysia to 30% of GDP in Korea and Thailand – are an important factor in the outlook for regional financial markets. With fiscal and private domestic resources severely squeezed, a large part of the capital will have to come from foreign investors. However, with many bargains now gone after the first-quarter rally, foreign participation will increasingly depend on signs of reform progress. Accordingly, only Thailand and the Philippines – the latter for its lack of severe banking problems – appear attractive so far.

Asian governments' efforts to revive growth and recapitalize banks will also affect currency and interest rate markets. Given the lack of runaway inflation, the bias for currencies will be to appreciate, especially if supported by positive reform news. But central banks are likely to take advantage of low inflation to cut interest rates in response to significant exchange rate gains. Note too that further Nikkei weakness and yen decline on the back of a fading fiscal boost and Japan's persistent structural problems will constrain markets in the rest of Asia. Still, another crash is unlikely

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Financial restructuring is key to Asia's future

- **Markets have stabilized, but real recovery unlikely without bank recapitalization and reform**
- **Japan's experience shows that failure to address banking problems will prolong any slump**
- **Thailand has made the most progress to date**
- **Politics still a key obstacle to resolving banking issues in most other countries, including Japan**

The worst of Asia's financial and balance of payments crisis is over. Market conditions have improved a bit since the turn of the year and current accounts have shifted into surplus, two developments that are starting to ease the liquidity crunch. The real economic downturn is anything but over, however. Indeed, it probably has gained momentum with the recession now unfolding in Japan. Indonesia, South Korea, and Thailand are in deep recession and real GDP in Hong Kong and Malaysia is on the verge of contraction. However grim, though, the downturn in economic activity is a prerequisite of recovery, as it will shift resources from the domestic side to the trade sector. The liquidity crunch is still holding back exports, but this is bound to change as balance of payments conditions normalize and corporate debt rescheduling makes progress.

Nevertheless, trade adjustment is not a sufficient condition for recovery. Whether economies will return to robust growth over the next few years or just limp along will depend largely on efforts and results in recapitalizing and restructuring their banking systems. Japan's long period of economic stagnation and recent fallback into recession highlight that a sustained recovery is unattainable – even with fiscal stimulus and super-low interest rates – if the financial system lacks the capital to expand its balance sheet. Worse, failure to address banking troubles, especially banks' large nonperforming loan (NPL) problems, will not only prolong the credit crunch but also prevent necessary corrections of asset prices, as banks will be reluctant to foreclose and sell distressed assets. Moreover, with little or no capital left and therefore facing limited conventional business opportunities, banks that have increasingly bet on high risk ventures to make a living could well continue doing so.

Still, Japan's case also shows that despite the obvious and pressing need for financial reform, developing the political will to tackle the problems can be a long and painful process. Reforms inevitably redistribute income and wealth, which often meets resistance from political interest groups – shareholders fearful of losing their wealth; unions worried about their members' jobs; businesses wanting to protect their franchises from domestic or foreign competition. Such complications exist both in Japan and the rest of Asia. So far, only Thailand appears to have fully broken the deadlock, but even its reform process is set to last at least two years thanks to practical constraints such as the sheer size of the recapitalization and reform need, the poor shape of accounting, legal, and supervisory standards, and the government's limited fiscal resources.

Finally, fixing the problems of the past is not all that is required. Ultimately, the goal of financial reform should be a more robust and efficient financial system, which means more financial disintermediation.

Banking risks

	Hong Kong	Indonesia	Japan	Malaysia	Philippines	Singapore	South Korea	Thailand
Property sector risks	moderate	high	high	high	moderate	moderate	moderate	high
Exposure (% of total loans)	40-55	25-30	20-22	30-40	15-20	30-40	10-15	30-40
Loans/collateral (%)	50-70	80-100	80-120	80-100	70-80	70-80	60-100	80-100
Corporate risks	low	high	mod/high	high	moderate	low	very high	high
Share lending/investment risks	low	moderate	high	very high	moderate	low	high	high
Overseas investment risks	moderate	low	high	low	low	moderate	high	low
Fx risks of foreign liabilities	low	high	moderate	moderate	moderate	low	high	high
Asset/liability mismatches	low	high	low	high	mod/high	low	high	high

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Where banks are in trouble

While it is true that almost all banking systems in Asia have problems, not all are in acute trouble. The most obviously troubled are those of the three countries now under IMF supervision – Indonesia, South Korea, and Thailand – as well as Malaysia and Japan. One country repeatedly mentioned for its banking and, especially, NPL problems but missing in this discussion is China. This is not to belittle China's NPL problems, however, but reflects their different nature which are discussed in the subsequent essay.

The problems now facing Asia's distressed banks are a legacy of past business practices. In essence, banks have taken on too much risk, which has been the result of bad management and lending practices, poor accounting, regulatory, and supervisory standards, hasty or inappropriate financial liberalization, and a growing overestimation of sustainable long-term economic growth potentials.

The most prominent area of banking troubles is the property sector (see table, previous page). However, it is not simply the size of banks' exposure to the property sector, but the basis on which these loans have been extended. Banks have much too often judged the creditworthiness of a property loan by the perceived value of its collateral rather than the economic viability of the project. Moreover, the valuation of collateral has often been too optimistic and the loan too generous given the downside risk to the collateral's value. On this score, banks in Indonesia, Japan (dating back to the late 1980s), Malaysia, and Thailand are clearly in most trouble, while those in Hong Kong, Singapore and even the Philippines have been relatively prudent.

With the big exceptions of South Korea and to a lesser degree Indonesia, Malaysia, and Thailand, banks' exposures to the nonproperty corporate sector are less troublesome. In South Korea, however, where the government and the *chaebols* have used the banks to fund their industrial expansion drive, exposure to the corporate sector is at the core of the banking problem.

Commercial banks' loan exposure to emerging markets
US$ billion, % of banks capital in italics, end 1997

	Europe		Japan		United States	
Emerging Asia	353.3	*48.5*	271.4	*109.5*	43.3	*12.4*
5 crisis countries*	98.1	*13.5*	97.1	*39.2*	23.8	*6.8*
Emerging Europe	92.6	*12.7*	6.0	*2.4*	14.9	*4.3*
Latin America	125.7	*17.3*	14.5	*4.9*	60.3	*17.3*
Total	571.6	*78.5*	291.9	*117.8*	118.5	*34.0*

* Indonesia, Malaysia, Philippines, South Korea, Thailand.

Another area of widespread trouble has been lending to individuals and corporates against stocks as collateral as well as banks' own equity investments. Here again, banks in Japan, Malaysia, South Korea, and Thailand are hardest hit. In Japan, where equity is the second largest asset class in banks' portfolios after loans, an additional problem is the market risk to hidden reserves in the form of cross shareholdings.

Overseas investments, although still small compared to domestic assets, are another problem area for Japanese banks, reflecting their willingness to take more risks in response to declining conventional business opportunities. Japanese and European banks, for example, invested in aggregate roughly the same dollar amount in the 5 Asian crisis countries, but that amount is three times greater relative to capital for Japanese banks than for their European counterparts. Korean banks, if on a much smaller scale, engaged in similarly risky overseas investments in 1996/97, following liberalization of overseas investment rules.

Recapitalization needs of Asia's banking sectors
1998 estimates

	Hong Kong	Indonesia	Japan	Malaysia	Philippines	Singapore	South Korea	Thailand
Domestic credit (% of GDP)	175	75	170	165	60	115	165	155
Nonperforming loans (NPL, % of total loans)	6-10	30-35	15-20	15-25	8-10	6-10	25-30	25-30
Capital asset ratio (CAR, %)	15-20	8-10	6-10	8-14	15-18	18-22	6-10	6-10
CAR after NPL write-off (%)	14	-17	-4	-4	10	16	-10	-11
Recapitalization need (% of GDP)	none	19	20	20	none	none	30	30

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Other – but often damaging – trouble spots on banks' balance sheets are the unhedged foreign exchange risks of their overseas liabilities – notably those of banks in Indonesia, South Korea, and Thailand – plus maturity mismatches between assets and liabilities.

Who needs to recapitalize?

Given the various risk profiles and the different degrees of financial turmoil, banks' resulting nonperforming loan problems vary across the region (see table at bottom of facing page). By J.P. Morgan estimates, banks in Indonesia, South Korea, and Thailand have been hit hardest here, followed immediately by those in Malaysia and Japan – note, however, that Japan's NPL problem is not just the result of the current crisis but largely dates back to the late 1980s and early 1990s. Nonperforming loans of banks in Hong Kong, the Philippines, and Singapore are also likely to rise but to remain low and manageable by comparison.

Asia's banks have done little hitherto to provide against potential loan losses, which leaves them now poorly capitalized given the amount of their estimated NPLs. Indeed, after writing off their NPLs, only banks in Hong Kong, Singapore, and perhaps the Philippines will on average meet the 8% BIS capital-asset ratio (CAR) requirement, with the rest including Japanese banks exhibiting negative net equity.

Building back to the 8% BIS CAR level creates a recapitalization need for distressed banking systems that will range from 20% of GDP in Indonesia, Japan, and Malaysia to 30% of GDP in South Korea and Thailand (percentages depending partly on the size of the banking system as a share of GDP). By comparison, the recapitalization need of the U.S. banking system was roughly 4%-to-5% of GDP in 1984-91 and Mexico's some 12%-to-15% in 1995-97. This makes Asia's banking crisis one of the worst in modern history.

Goals of financial reform: to avoid Japan's mistakes

Given the poor shape of many banking systems and the sheer size of recapitalization needs, the case for financial reform is well established for Indonesia, Malaysia, South Korea, Thailand, and even Japan. For guidelines, there are plenty of case studies of financial restructuring, ranging from the United States and Mexico to Sweden and Chile (just to name a few), but the most important principle is to avoid Japan's mistakes. The key goals of financial reform are to:

- Restore depositor confidence and the payment system to prevent a run on the banking system;
- Force banks to acknowledge and write off nonperforming loans;
- Restructure and recapitalize the banking system (through mergers, acquisitions, and liquidations);
- Ensure equitable loss distribution and prevent moral hazard problems;
- Minimize fiscal cost;
- Build a stronger financial system (by regulation, supervision, deposit insurance, and disintermediation).

Unfortunately, as the experience of Japan clearly shows, there are substantial real-life obstacles that make it difficult to achieve the goals of financial reform swiftly (see table below).

Lack of political will is usually the first obstacle

The political willingness to push through with financial reforms is a key factor determining the speed and success of the reform process. Finding a political consensus always takes time, even under favorable circumstances. Experience from other reform efforts suggests

Obstacles to the financial reform process

	Indonesia	Japan	Malaysia	South Korea	Thailand
Political considerations	high	high	high	high	declining
Expertise and manpower	weak	weak	weak	weak	weak
Legal infrastructure	poor	weak	fair	weak	improving
Regulatory and supervisory standards	poor	weak	fair	weak	weak
Fragmentation of the banking system	high	very high	moderate	mod/high	mod/high
Fiscal and foreign borrowing limits	tight	limited	fair	limited	limited

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that several months if not a year or more of political maneuvering and possibly even political change are likely to pass before a broad consensus is reached. The difficulty in doing so reflects the conflict of interests that results from the income and wealth redistributions inherent in almost any reform process. In Japan, these conflicts of interests seem particularly strong, and have paralyzed the government for years. Moreover, although political considerations are sometimes different, the risk of policy paralysis also hangs over the rest of Asia. Only Thailand seems to have broken the deadlock so far, but this has followed more than a year of frustrating political maneuvers and a change of government.

As in Thailand until the end of last year, resistance to financial reform in Indonesia comes largely from the banks' majority shareholders and related business groups with political connections who are set to lose both wealth and economic control. In contrast to Thailand, however, this resistance in Indonesia is unlikely to be broken by political change, but will require the current government's recognition that pushing through with financial reform is in the best interest of the country and its own survival. The outline of the financial reform program negotiated with the IMF and the first implementation steps taken are encouraging. But the big push – allowing the closure or merger of more than half the banks and large-scale majority acquisitions by foreign investors – is still pending.

Also weak is the Malaysian government's willingness to push through far-reaching financial reforms, despite tough public statements. Its interest is to protect the so-called "Bumiputra" (ethnic Malay) businesses, which have been an important priority group in the government's industrialization policy. In addition and in contrast to the three countries under IMF supervision, Malaysia is not facing a balance of payments crisis, which gives the government the ability to at least delay any adjustments by providing banks and corporates with cheap liquidity and funds from resource-rich state entities. But while this policy may prevent large-scale bankruptcies and restructurings, it risks leading to a prolonged credit crunch such as continues to cripple Japan.

Unlike in Indonesia and Malaysia, political change in South Korea has let the government play tough with the banks and *chaebols*. Indeed, the new government under Kim Dae-Young is anything but friendly to big business. In Korea, however, radical financial and corporate reforms will generate much larger employment redundancies than elsewhere in Asia (apart from China), which is a big concern for the labor-friendly Kim Dae-Young government.

There are also major practical reform constraints

Yet even if there is enough political will to push through financial reforms, as seems to be the case in

Accounting and prudential standards
latest survey

	Indonesia	Japan	Malaysia	South Korea	Thailand
Nonperforming loan definition	3 mos. overdue by 2001	6 mos. overdue	3 mos. overdue	6 mos. overdue, to move to 3 mos.	3 mos. overdue by 2000
General provision (% of loans)	1.0%	0.3%	1.5%	0.5%	1.0%
Loss provision (% of NPL)	15% 3-6 mos. 50% 6-9 mos. 100% for more		20% 3-12 mos. 50% 12-24 mos. 100% for more	20% w/ coll. 75% w/o coll. 100% for loss	20% 3-6 mos. 50% 6-12 mos. 100% for more
Collateral valuation: securities	Market value	Market value	Market value	70% of average value	Market value
all other	Book value	Book value	Book value	70% of book value	95-100% of market value otherwise 50% of book value
Minimum capital	IDR250 bil by end 1998		Com bks: MYR1 bil Fin cos: MYR600 mil Mer bks: MYR500 mil	KRW100 bil for national bks, KRW25 for regional bks	
Capital asset ratio	9%, 12% by 2001	8%	8%, 10% by 1999	8%	8.5%

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Thailand, practical constraints ranging from a lack of expertise and qualified manpower to weak legal, accounting, and supervisory standards along with limited fiscal resources are likely to impede reform.

Among the IMF's clients in the region, Fund pressure has prompted recent formal improvement of accounting and prudential standards to meet international standards (see table, facing page), but the reality of the improvement is in some question.

- Many rules, such as NPL definitions, do not apply immediately (Indonesia and Thailand) or are only slowly to be enforced, allowing banks to understate their loan problems.

- Most accounting standards, especially for the valuation of nonsecurity collateral, are not based on the mark-to-market principle and so let banks hide their losses. Only Thailand is now forcing its banks to mark their assets to market or else write off 50% of the book value. Japan was also planning to extend the mark-to-market principle as part of the so-called *Prompt Corrective Action* program this year. Late in 1997, however, it delayed this aspect of the program for one year, following concerns that an earlier date could precipitate more high-profile bank failures and jeopardize economic growth.

Poor legal standards impede repossession of NPLs

A key motive for banks to hide NPLs as much as possible is the poor state of local legal systems, which make the foreclosure of collateral very difficult if not impossible. Here, the problem is not so much the lack of comprehensive bankruptcy and foreclosure laws – in Malaysia and even Indonesia, the law body has already been reasonably adequate or, as in the case of

Legal infrastructure
latest survey

	Bankruptcy and foreclosure laws	Court system and law enforcement
Indonesia	Revised Apr 22, 1998: adequate	Poor, special bankruptcy court installed on Apr 22, 1998
Japan	Adequate, but debtor friendly	Inefficient, but fair
Malaysia	Adequate	Efficient, but politically biased
South Korea	Revised in 1997: debtor friendly	Inefficient, biased to favor stronger party
Thailand	Bankruptcy law revised March 1998: adequate, creditor friendly; Foreclosure law to be revised by Oct 1998	Weak, but being improved under international guidance

Thailand, has recently improved – but the inefficiency and lopsidedness of the judicial system (see table above). Work is now underway, especially in Indonesia and Thailand, to improve the legal infrastructure, but while laws can be changed relatively quickly, improving the judicial system will take longer, even with outside help. Meanwhile, poor legal infrastructure relieve insolvent debtors of pressure to sell their assets. That keeps asset prices, especially in the real estate sector, artificially high and prevents the market clearing needed to revive investment and economic growth.

There are too many banks, especially in Japan

From a practical viewpoint, banking system fragmentation and the sheer number of often small and undercapitalized financial institutions is another obstacle to speedy reform (see table below). Interestingly though, while Indonesia is widely seen as having banks that are too many and too small, its total number of 240

Fragmentation of banking system
number of financial institutions, June 1997

	Indonesia	Japan	Malaysia	South Korea	Thailand
Private domestic commercial banks	223	990	23	26	15
State banks	7	12	none	8	2
Merchant banks	none	none	12	30	none
Financial institutions for the primary sector	none	3,506	none	none	none
Finance/security companies	none	247	40	53	104
Foreign financial institutions	10	156	14	52	11
Total	240	4,911	89	169	132

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appears more manageable than the nearly 5,000 financial institutions (excluding insurance companies) in Japan. The problem in Japan is not just the huge number of small financial institutions besides the 19 top-tier banks and the postal savings bank, but the degree of specialization – often backed by legislation – that gives every institution no matter how small a "right" to exist.

Fiscal constraints are real

The huge recapitalization needs and the central role of the government in the reform process imply an enormous burden on the public purse. This raises the question of whether there are enough fiscal resources available. To be sure, governments should not bear (on moral hazard grounds) and are unlikely to bear (on practical grounds) the full cost of the recapitalization process. But public help is at least needed as a catalyst to get the recapitalization process started. Ideally, fiscal outlays should be recovered at a later time through the sale of nationalized banks or other acquired financial assets such as nonperforming loans. However, even if governments can recover most of their outlays, the up-front funding needs remain huge – ranging from 7% to 15% of GDP in Indonesia, Japan, and Malaysia to 10% to 20% of GDP in South Korea and Thailand.

The bad news is that the sharp deterioration of cyclical conditions has pushed fiscal accounts from what used to be surplus or balance into deficit (see top table). And although gross public debt levels in Asia are low by international standards (except in Japan), the ability to run larger deficits is limited. The three countries under IMF supervision are subject to strict deficit targets. In Japan, there is a growing political concern that continued deficit spending will create an insurmountable debt burden for future generations. Furthermore, except in Japan, government bond markets are underdeveloped or even nonexistent. Indonesia, for example, has announced that it plans to issue rupiah 155 trillion worth of bonds, which seems nearly impossible not only because of the proposed issue's size but especially because of the country's lack of a developed government bond market. On the external side, the downgrades to noninvestment ratings and the foreign borrowing limits imposed by the IMF are additional constraints on Indonesia, South Korea, and Thailand. Room for spending cuts and tax increases is also limited, given the poor cyclical conditions, and has already been largely exhausted.

General government fiscal position
% of GDP

	Expected 1998 balance	1997 gross debt
Indonesia	-3.0	28.0
Japan	-2.7	83.6
Malaysia	-2.0	38.0
South Korea	-3.8	20.0
Thailand	-2.5	16.0

Privatization is one alternative for governments to improve their funding. Indeed, there is no lack of state enterprises and other assets that could be sold. Indonesia, South Korea, and Thailand all have started privatization campaigns, but except for a few jewels – usually in the telecom sector – the obstacle is often the state enterprises' own poor financial condition and restructuring needs. Thus, privatization proceeds are likely to be low this year and increase at best in 1999.

Foreign participation will be key

With government's fiscal resources limited and private domestic resources largely depressed, foreign capital will have to play a key role in funding the re-

Reform steps and progress

	Indonesia	Japan	Malaysia	South Korea	Thailand
1. Recognition: severity of impairment	slow	very slow	slow	improving	completing
2. Emergency measures: deposit and payment guarantees, lender of last resort	in place	in place	in place	in place	in place
3. Strengthening of infrastructure: accounting and prudential standards, supervision and legal infrastructure, foreign entry rules	slow	slow	slow	slow	progressing
4. Restructuring: NPL write-off and buyout, nationalization, liquidations, recapitalization, mergers, foreign acquisitions	little	little	little	little	some
5. Refinancing: disposition of foreclosed or nationalized assets, privatization of state assets	none	none	none	none	little

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capitalization of banks and buying distressed assets. In Indonesia, South Korea, and Thailand, governments have recognized the need for foreign participation and – partly under pressure of the IMF – have removed or sharply reduced most foreign ownership restrictions (see top table at right). In contrast, foreign entry rules in Malaysia remain relatively restrictive. In practice, though, there is often substantial grass-roots resistance, especially in Indonesia, Malaysia, and South Korea. In Japan, foreign access has been unrestricted for many years, but the peculiar rules and customs of its banking system have often deterred potential foreign investors. In general, the poor disclosure and transparency of information and financial statements often discourage potential foreign investors.

Thailand is ahead so far

Despite all the difficulties and obstacles, there are some signs of progress as well as divergence across the region (see table, bottom of facing page). Thailand seems ahead of the pack, both in terms of recognition as well as actual implementation. But while the process of political recognition has been slow in most countries, governments have been quick to put emergency measures into place to prevent a further meltdown and restore depositor confidence. The Bank of Japan has been supporting its banks for years through low funding rates and generous liquidity injections. In the rest of the region, governments have provided guarantees for depositors (Indonesia, South Korea, and Thailand) and central banks have undertaken huge liquidity injections, boosting their net claims on the financial sector (see second table at right). In fact, the concern is that large lender-of-last-resort activities could lead to a surge in base money and subsequent inflation. In response, the IMF has required Indonesia, South Korea, and Thailand to reduce their interventions in the money market.

Foreign ownership limits
latest survey

	General	Financial sector
Indonesia	Restrictions sharply reduced, except a few	No limits
Japan	No limits	No limits
Malaysia	30% of total equity, 49% for telecoms	30% of total equity
South Korea	55% for stocks, to be lifted by end 1998	10%, 25%-33% with special permission
Thailand	100% for 10 years, but land excluded	100% for 10 years

Central banks' net claims on the financial sector
local currency terms

	Dec 96	Dec 97	latest	month
Indonesia (IDR trillion)	-5.5	43.1	47.3	Feb 98
Malaysia (MYR billion)	-50.5	-37.5	-31.5	Feb 98
South Korea (KRW trillion)	-3.1	35.5	n.a.	
Thailand (THB billion)	-0.6	582.6	n.a.	

Beyond the first emergency measures, though, action has mostly been slow. Besides the previously mentioned difficulties in strengthening the reform infrastructure (accounting, supervision, legal, etc.), little has actually happened by way of restructuring (see table below). The number of banks put under supervision in Indonesia seems large, but this simply reflects the fact that their liquidity support from the central bank exceeds more than five times their capital; nothing has happened in terms of actual restructuring.

The number of financial institutions in Malaysia involved in merger plans is also impressive, but progress on the ground is slow and little is being done to improve the financial conditions of the merged entities, while the system remains on the life support of low interest rates from the central bank.

Consolidation progress
number of financial institutions, latest estimates

	Indonesia	Japan	Malaysia	South Korea	Thailand
Original number of financial institutions	240	4,911	89	169	132
Closed/suspended	23	4	none	16	56
Nationalized/under supervision	47	7	none	2	4
To be merged	none	none	61	none	none
Bought by foreigners, joint ventures	none	4	none	none	4

In Korea too, restructuring progress is slow. Of the won20 trillion earmarked to buy nonperforming loans from banks, more than half has been spent, but after the closure of 16 merchant banks and the nationalization of two commercial banks at the end of last year, little has followed and no mergers or foreign acquisitions seem in sight.

In contrast, restructuring in Thailand is more advanced. Not only has the government closed 56 finance companies and taken over four commercial banks after writing off shareholders' equity, but there have also been encouraging cases of foreign participation. Moreover, the government is making progress in seizing the assets of closed financial institutions and the prospect of large-scale auctions, especially of property, has started to squeeze asset prices, which is a key prerequisite to bringing in new investors.

Toward a stronger financial system

Besides the badly needed recapitalization of the banks, the main goal of Asia's financial reform efforts should ultimately be to build stronger financial systems. First, the financial crises in both Japan and the rest of the region highlight anew the need for stronger accounting, prudential, supervisory, and legal standards. Second, there is a clear need for efficient and well-secured depositor insurance schemes. Third, foreign participation is not only required to help recapitalize banking systems, but also to bring in know-how and enforce better practices through competition.

Finally, financial reform and greater foreign participation should increase disintermediation away from traditional banking in favor of securitized funding. The often undisputed dominance of the banks – bank loans in most Asian countries account for 50% to 80% of total financial assets versus just 20% in the United States – and their poor risk management capabilities have been a key weakness of Asia's financial systems.

Disintermediation is clearly a target of Japan's "Big Bang" financial reform plan (see box) and the reality already shows a clear shift toward more securitization (see chart). However, putting liberalization of the market place ahead of banking reform (especially the recapitalization of banks) can be dangerous. With their traditional lending business declining but without capital to move into new business areas, banks will be cornered and are more likely to pursue high-risk opportunities. This has already been a trend for banks in Japan and more recently has been seen in Korea. Indeed, it could easily happen somewhere else in the region as well.

Principles and timetable of Japan's "Big Bang"

- Toward a free market: liberalize entry, products, and prices
- Toward a transparent and credible market: enhance transparency, and protect investors' interests
- Toward a global market: establish legal, accounting, and supervisory standards consistent with international norms.

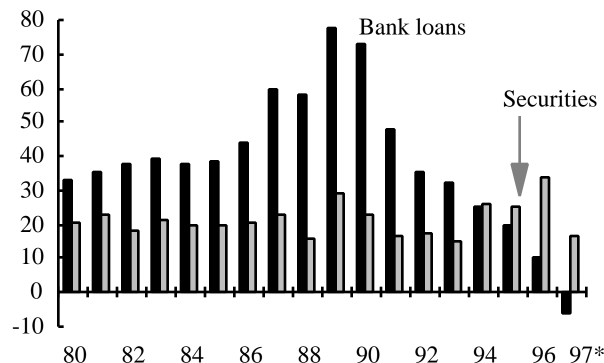
From April 1997:
- Introduction of asset management accounts at security firms
- Introduction of holding companies
- Introduction of trading in unlisted companies
- Introduction of individual stock option trading

From April 1998
- Banks allowed to sell investment trusts
- Brokerage commissions deregulated
- Restrictions on derivative instruments entirely removed
- Foreign exchange operations and cross-border transaction settlements liberalized
- Issuance of commercial paper and straight bonds deregulated
- *Corrective Action Program* introduced (but partly delayed by one year) to tighten prudential and accounting standards

From April 1999
- Brokerage commissions to be fully liberalized
- Corporate accounting to shift to consolidated basis
- Banks to be allowed to issue straight bonds

From April 2001
- Banks to be allowed to enter life insurance business

Japan: fund-raising by nonfinancial sector
¥ trillion



* January through September 1997

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China’s balancing act on financial reforms

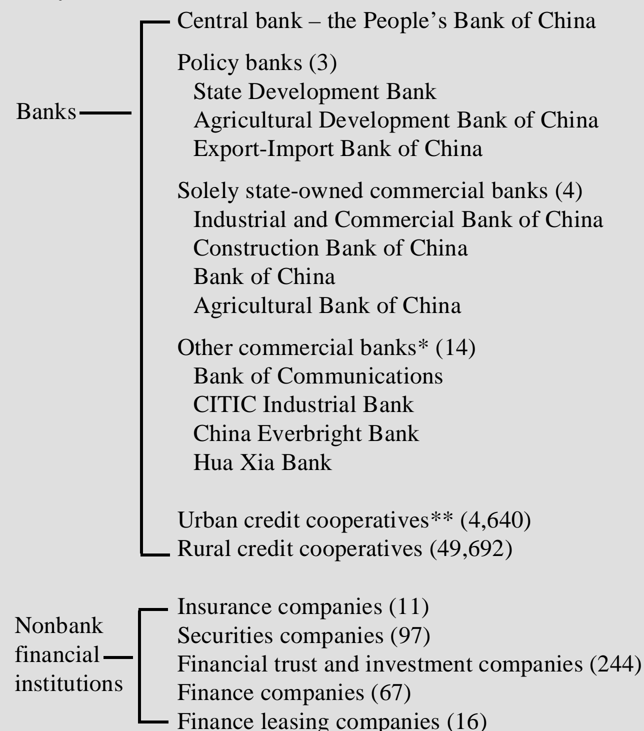
- **Contrary to market wisdom, existing non-performing loans are not so worrying**
- **What will determine Chinese banks’ fate in the long term are sound reforms**
- **Proactive reform measures so far warrant applause, but are not sufficient**
- **China is likely to strike a balance among its multiple objectives and so to muddle through**

By any standards, China’s banking sector is in terrible shape. The weakest players of all are the four largest and solely state-owned banks (referred to as state banks), whose nonperforming loans (NPLs) probably reach 40% of total loans if international accounting standards are applied. Although the current economic slowdown is bound to worsen asset quality problems, China’s banking sector problems are not the result of a sudden downturn in economic activity. They are instead the result of a “covert” fiscal policy followed over many years, whereby loss-making state enterprises have been financed through bank loans.

Scary as the figure appears, the existing NPL stock is not so worrying, as it has already been offset by liquidity injections from the central bank in the past few years. And a swap of the central bank’s loans to the state banks into shares held by the government could not only fill the negative capital base, but also push the capital asset ratio above 8%. Such a bailout is logical, as the NPLs result from what is tantamount to an ongoing but unacknowledged fiscal problem. Moreover, helping the state banks reinforces the government’s implicit guarantee, which in turn has bolstered depositor confidence. Indeed, the banking sector in general, and state banks in particular, have experienced few liquidity problems, despite their extremely poor asset quality. Nor should they be dragged down by the increasingly insolvent state of nonbank financial institutions, thanks to the latter’s limited market significance.

Still, there should be no complacency. Any newly injected capital could be quickly whittled away by fresh bad loans, if banks continue to be reckless in lending.

China’s financial system – local institutions
end of 1996



* Including two housing banks. ** Including urban cooperative banks.
Note: Figures in brackets indicate number of institutions in category.

True, China has been taking steps to strengthen banks’ control over credit risk. But the measures taken so far are not sufficient and payoff has been limited, not only by banks’ minimal autonomy and, hence, their lack of financial discipline, transparency, and expertise but also by the country’s lack of an enforceable legal infrastructure. All this leaves the system vulnerable to a financial crisis as the economy opens up.

Having recognized the risk, the Chinese government will continue to push ahead with reforms to strengthen its financial sector. Yet, a “big bang” approach, which would require draconian budget constraints on the state enterprises and boost unemployment, is neither politically feasible nor needed as an emergency response to a dire external situation (as in Korea). In turn, financial liberalization and globalization will be managed at a pace consistent with the step-by-step reforms in the banking sector.

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State banks have negative capital...

It is common knowledge that state banks in China have extremely low asset quality and probably negative capital, were bad loans to be written off. In January, central bank governor Dai Xiang Long acknowledged that NPLs totaled more than 20%, and bad loans, 5%-6%, of the state banks' outstanding loans. But international accounting standards would probably double these figures, to an estimated yuan670 billion (see table). Meanwhile, bad-loan provisioning amounts to only 1% of total outstanding loans (up, however, from 0.6% in 1996). Worse, bad loans continue to climb due to banks' past reckless lending, the current economic downturn, and, especially, corporate borrowers' disrespect for loan contracts.

The estimated yuan670 billion of bad loans, if written off, plus sufficient provisioning for NPLs, would push the state banks' capital into a negative of yuan820 billion. This black hole reflects not only the NPL problem, but also the government's failure to increase the equity stock. Worse, until 1997, the government viewed the state banks as milk cows, levying on them a profit tax of over 50% even after unifying standard profit taxes on other firms at 30%. Alarmed by reality, the government has belatedly let banks write off some bad loans: yuan30 billion in 1997, rising to yuan50 billion in 1999. But even yuan50 billion is reckoned to fall short of the loans newly going bad every year.

...but adequate recapitalization not that daunting

To meet the targeted 8% capital asset ratio (net of bad loan and sufficient loan provisioning), China's state banks would need yuan1.1 trillion. Of this, yuan820 billion would fill the current negative capital base and an extra yuan324 billion would push the capital asset ratio to 8%. Interestingly, recapitalization may prove less daunting than might appear. Indeed, all the bad loans of these banks have already been covered in past decades, insofar as the central bank's lending to these banks amounted to yuan1.4 trillion as of end-1997.

In detail, the central bank could, in its balance sheet, simply reclassify its lending to the four state banks as claims on the government. At the same time, these banks could turn their current borrowing from the central bank into capital held by the government. Such a debt-equity swap could easily push the four largest

Loan classification in China (standardized in 1995)

- Overdue loans: not repaid when due or not repaid after due date has been extended
- Doubtful loans: past due for two years or longer or made to borrowers who have suspended production or projects
- Bad loans: not repaid after borrower has declared bankruptcy and gone through liquidation

Loan classification is much more lenient than in the Guidelines of the Basle Committee for Bank Supervision, which require banks to classify any loan on which either an interest or principal payment is past due for 90 or 180 days. Not only is the past due period allowed for nonperforming loans (NPL) much longer in China, but loan classification is usually based on past due principal, not interest. Many loans do not call for principal payment until maturity and hence fall outside the classification scheme. More importantly, only the portion of the particular loan that is past due is classified as nonperforming, not the entirety of outstanding loans to the borrower concerned.

Solely state-owned banks' negative capital base and recapitalization requirement
yuan billion, eop

	1997
Total loans to nongovernment	5,586
Nonperforming loans (NPL) - 40% of total loans	2,234
Bad loans - 30% of NPL	670
Loan provisioning - 25% of NPL (net of bad loans)	390
Paid-in capital+1-year's earnings pre-tax	240
Net of bad loans	-430
Net of NPL provisioning	-820
Required capital to reach 8% capital asset ratio after NPL provision*	324
Total recapitalization need	1,144
(% of GDP)	13.9
Memo	
Nominal GDP	8,250

* Risk-weighted assets of solely state-owned banks = 40%*(453+150) + 0%*(1092+6+76) + 80%*(5437-670 bad loan write-off) = yuan4,055 billion. This indicates that an 8% capital asset ratio requires another yuan324 billion capital injection.

Assets of solely state-owned banks
yuan billion, eop

	1997	% of total
Total assets	7,214	100.0
Foreign assets	453	6.3
Reserves at central bank (plus cash in vault)	1,092	15.1
Bonds issued by central bank	6	0.1
Claims on government	76	1.1
Claims on nonfinancial sector	5,437	75.4
Claims on nonmonetary FIs	150	2.1

banks' capital adequacy ratios, risk-weighted, to 8%, with little implication for the current monetary base or inflation. Nor, thanks to its foreign exchange and other liquid assets, would the central bank hit a liquidity problem when commercial banks draw down their excess reserves. The only obstacle is that the 1994 central bank law banned central bank lending to the government. But this problem could be circumvented, as the lending at issue existed prior to 1994. More importantly, the bailout is justified insofar as the government itself was largely responsible for these banks' NPLs. And moral hazard concerns should be outweighed by increased accountability as state banks could no longer use the inherited burden to excuse poor performance.

In fact, a similar proposal has been circulating in Beijing for some months. It would have the Ministry of Finance issue yuan270 billion of special 30-year government bonds, and inject the proceeds into the four state banks. At the same time, to limit the bond issue's liquidity impact on the banks, the central bank would cut the basic reserve requirement from 13% to 8%. The second part of the proposal has just been carried out, together with a slashing of interest rates on bank loans. But, even if successful, the proposal would boost these banks' capital by only yuan270 billion – not enough to cover all the bad loans, both recognized and hidden.

Troubled nonbank financial institutions

Besides the state banks, what is worrying, yet little noticed, is the ongoing slide into insolvency of nonbank financial institutions due to their reckless lending in the early 1990s and the subsequent asset bubble burst. Among the most problematic are trust and investment companies and credit cooperatives. Alarmed by the sector's woes, the central bank decided, in late 1997, to restructure or even close most of the over 300 trust and investment companies and finance companies.

The demise of these entities has at least two implications for the banking sector. First, it tends to increase banks' liabilities and drag down their average asset quality, as state banks are often ordered by the government to take control of their failed cousins. For example, in late 1997, the Hainan Development Bank – a regional commercial bank – was told to take over insolvent credit cooperatives in Hainan province. Second, and more importantly, the banks will inevitably find that more of their loans have gone definitively sour. Exact figures are not available, but it is known that the banks, up to late 1993, lent heavily through the interbank markets to nonbank financial institutions, which in turn lent aggressively, especially to the real estate sector, to earn a windfall interest margin. Worried by the risks, the authorities banned banks in late 1993 from lending to nonbank financial institutions, but the seeds of trouble had already been sown.

Assets of People's Bank of China
yuan billion, eop

	1997
Total assets	3,141
Net foreign assets	1,323
Claims on government	158
Claims on deposit money banks*	1,435
Claims on nonmonetary financial institutions	207
Claims on nonfinancial sector	17

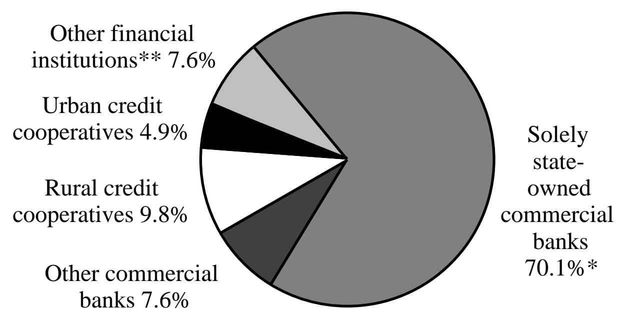
* Mainly the four solely state-owned banks.

Liabilities of solely state-owned banks *
yuan billion, eop

	1997	% of total
Total liabilities	7,185	100.0
Foreign liabilities	391	5.4
Loans from central bank	*1,389*	*19.3*
Bonds issued	28	0.4
Deposits	5191	72.3
Due to nonmonetary fin. institutions	101	1.4
Capital (yuan211 billion paid-in)	203	2.8
Other	-118	-1.6

* Policy banks are excluded from this analysis: They are not commercial banks and should not be judged on commercial terms. Moreover, their asset quality problem is not significant, as they are new and small.

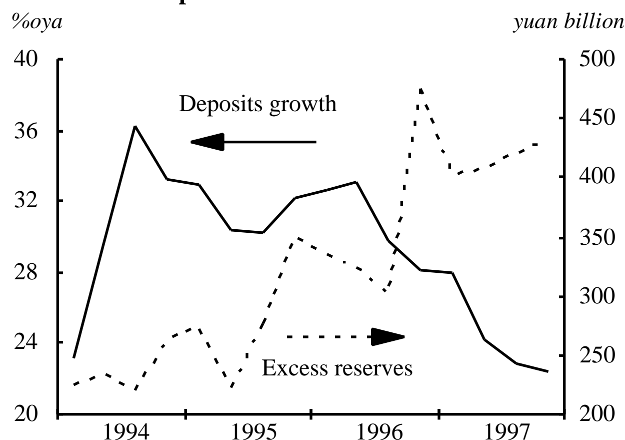
Financial institutions by size of assets held
% of total charted, end-1997



* Industrial and Commercial Bank of China (ICBC), 27.1%; Construction Bank of China (CBC), 16%; Bank of China (BoC), 15.9%; Agriculture Bank of China (ABC), 11.1%.
** Including policy banks, which are small.

Fortunately, with just 7% of the assets of the entire financial sector, these nonbank institutions pose no systemic risk to the banking sector. So far, banks in general, and state banks in particular, have had few liquidity problems. To the contrary, their liquidity improved in 1997 and they hold more reserves in the central bank than the basic reserve requirement and liquidity management mandate. Nor does depositor confidence seem to be waning. Indeed, a recent official survey found that Shanghai households still prefer bank savings to other types of investment, although the expansion of the stock and bond markets, together with smaller income gains, has slowed deposit growth.

State banks' deposits and excess reserves



State banks' long-term survival hinges on prudence

The above analysis of bank liquidity and potential recapitalization indicates that the risk of a financial crisis in China remains limited in the near term. But down the road, the banks' survival will depend on their lending prudence. As demonstrated by Asia's financial crises, what determines the fate of the banking sector and hence the whole economy is banks' ability to control credit risk. It is banks' unchecked appetite for risk that engenders their own overreliance on foreign debt, and the entire economy's overinvestment.

Admittedly, the Chinese authorities have been taking steps to discipline lending. As early as 1994, they sought to reduce risks arising from bank loan concentration by capping lending to any one borrower. The loan approval process has been altered to allow cross checks and balances; and existing portfolios have been examined and reshuffled, if necessary, to limit risk exposure. Also, appointment of bank heads has been depoliticized. Moreover, since Mexico's currency crisis, China has made real efforts to improve its prudential supervision of the banking sector, to enforce accountability and transparency in the lending process. And to minimize interference from various levels of government, the central bank has decided to reorganize branches within broader regions rather than by province; and the four largest banks have withdrawn lending authority from their county branches.

The pressure to improve loan quality is now so high that credit officers are loath to increase their loan portfolios. For example, the largest commercial bank – the Industrial and Commercial Bank of China (ICBC) – has been trying to boost profits by paying back loans and thereby shaving its costs of borrowing from the central bank, instead of expanding its lending. Downside overshooting of bank willingness to lend was also a factor in the 1997 drop in Bank of China's profit and the liquidity squeeze in the nonfinancial sector.

Transparency still lacking

Still, there should be no complacency. The caution that the banks are showing during the current economic slowdown may not last during some new economic boom. And it is their boom-time behavior that is arguably more crucial. International experience demonstrates that the most effective way to enforce and maintain bank prudence is transparency: by international standards of asset classification, well-defined financial responsibilities, and clear administrative hierarchies. China's recent announcement that it will introduce international standards of asset classification this year is one step in the right direction. But more effort has to be made in the other areas. Reducing administrative hierarchies, in particular, will remain challenging, as it requires closure of duplicative offices or divisions in an environment of fast-rising unemployment. For example, the ICBC employs 566,000 staff and has a complicated structure (see table). Supervision and monitoring have to filter through many layers before reaching the rank and file. In many ways, privatization of the state banks may be the ultimate solution to the lack of financial accountability. But this option has been ruled out by the Chinese government for the coming five years at least.

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Also lacking are expertise and legal structure

Also limiting improvement in credit risk control are a lack of banking autonomy, though this is improving; a lack of expertise, whether it be among regulators, supervisors, or grassroots credit officers; and a lack of legal infrastructure, which makes it very hard for banks to enforce loan contracts.

- *Lack of banking autonomy.* Although government intervention has been diminishing over the past decade and, officially, new policy lending obligations have been shifted to the three policy banks established in 1995, state banks are unlikely to enjoy full autonomy anytime soon: Since it will take time for China to establish a market-based mechanism to transmit policy signals to the micro end of the economy, the government will continue to put pressure on state banks, either via administrative measures or moral suasion, to support its growth objectives, for higher or lower. Worse, at times when unemployment surges out of control, it may even temporarily sideline its reform drive, instead favoring easier lending over prudence.

- *Lack of banking expertise.* The knowledge vacuum created by China's decades-long closed-door policy and "command regime" are starting to hurt the financial sector and indeed the whole economy. Many credit officers still measure credit risk by the size of their corporate borrowers. In their eyes, "large" is identical to "safe." Few of them have the ability to distinguish "sunrise" from "sunset" industries, since they are not even aware of technology advances overseas. Even regulators and supervisors are still learning by doing. True, hard knocks in the financial markets can make experts of many newcomers almost overnight. What has made fast-track learning possible is the effective and ruthless elimination system imposed by the market, or the labor mobility granted by a new activity such as the securities industry. But neither elimination nor mobility exists in the old and traditional banking sector.

- *Lack of legal infrastructure.* Equally worrying is that decades of communism have wiped out society's respect for contract. Many state enterprises still hold the view that there is nothing wrong in defaulting on state bank loans, since both sides are wholly owned by the state. Admittedly, the public's awareness of contractual consequences is rising, thanks to the government's efforts to improve the legal framework. Still, economic liberalization has created more hurdles for banks to jump to enforce loan contracts. Many borrowers, for example, declare bankruptcy just to escape servicing bank debt, egged on by the difficulties of asset liquidation.

Structure of solely state-owned banks
end-1996

	ICBC	BOC	CBC	ABC
Staff	565,955	198,555	383,593	538,780
Offices	38,219	13,863	35,117	65,870
Provincial branches	29	30	30	30
City branches	14	15	14	14
County branches	362	253	325	324
District branches	1,981	1,522	2,002	2,391
Other*	35,833	12,043	32,746	63,111

* Primarily deposit-taking offices.

Can China fix its banks before it's too late?

These challenges suggests that the official steps taken so far to improve the health of the financial sector may not be sufficient to defuse the risk of a bank liquidity or insolvency crisis, even if the banks' capital ratios are raised to 8%. As demonstrated during Asia's currency and financial crisis, in an environment of rising globalization and international fund flows, the banking sector has to become stronger than ever to survive all internal and external shocks. And specifically in China, ongoing financial liberalization and innovation, while bringing long-term benefit, are only too capable of triggering a financial crisis, unless implemented at a proper pace and in well-judged sequence.

- *Competition from new domestic or foreign banks, or from new forms of financial intermediation such as the stock and bond markets, could make the weakness of the state banks so plain as to engender a confidence crisis that would push them to the edge (or over).* Already, the introduction of new investment options for households, for example, has limited banks' ability to pass onto depositors the burden of NPLs. Indeed, despite the current deflation rate and the resulting very high real interest rates, the government has been very cautious about cutting nominal interest rates on deposits, lest more funds switch from banks to the stock market or from local to foreign currencies or markets.

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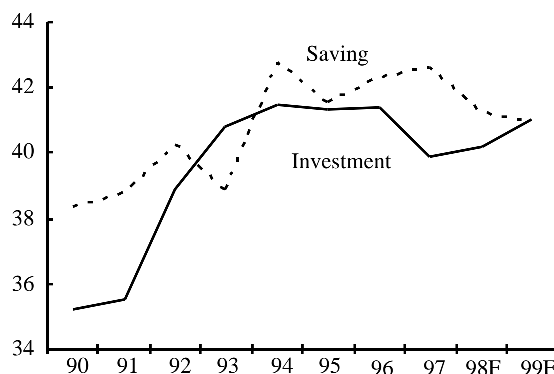
- *Given the corporate sector's risk appetite and the fact that domestic interest rates exceed international rates by a margin likely big enough to cover perceived exchange rate risk, easier access to international financial markets would almost certainly lead to overreliance on foreign borrowing and to overexposure to innovative derivative products over which domestic prudential supervision constantly lags.* A souring of international sentiment could sink the local corporate sector and, in turn, the local banking sector. In the case of China, economic and financial integration with Hong Kong has made official control over foreign borrowing less effective.

The Chinese government is fully aware of these risks and hence is trying to strike a delicate balance among its multiple objectives in order to muddle through.

- *It will continue to balance the pace of financial liberalization and that of banking sector reforms.* On the one hand, the government continues to strengthen the banking sector and remove legal obstacles to enforcing loan contracts. On the other, it will continue to go slowly in withdrawing its protection from the banks, especially since it cannot yet relieve these institutions of their customary obligations, both social and toward state-owned enterprises. In turn, stock and bond market development, the currency's full convertibility, and the banking sector's further opening-up to foreign banks will all be held hostage to banking and hence to state sector reforms; and the banking sector will consequently continue to be insulated from external and even internal shocks. More importantly, the government will maintain an implicit guarantee for the four largest state banks, limiting the risk of a public confidence collapse from some internal or external shock.

- *To keep the country from overreliance on foreign debt and overexposure to derivative products, China has so far maintained a rigid quota system and has banned most nonfinancial corporations from accessing international financial markets (either cash or derivative).* Obviously, there are loopholes in the foreign debt control system, especially given the rising economic and financial integration between China and Hong Kong. This is why the Chinese government has recently stepped up its surveillance of funds flows between the two economies. More importantly, the current control system will probably be replaced by a new one based on credit ratings by international credit rating agencies. Of course, how well that will work will depend on the competence of those agencies.

Investment and savings rates
% of GDP



- *Fundamentally, what will limit any overborrowing from overseas is the likely absence of any chronic and substantial trade deficit, since investment is not excessive relative to the high national savings rate.* (Note that the trade deficit is simply excess of the investment rate over the savings rate.) In coming years, national saving should not drop sharply from the current 40%-of-GDP level, as consumption growth will continue to be capped by rising unemployment. Besides, banks' increasing prudence and official controls over capital outflows should prevent savings from leaving the country on any large scale. In addition, banking and corporate restructuring should put a leash on investment growth.

The banking sector's significance will diminish

Interestingly, increasing prudence will eventually diminish the importance of the banks in China's financial intermediation sector. Since the corporate sector will probably not gain financial discipline any time soon, its demand for credit will remain relatively strong. But increasing prudence will drive banks to demand a wider interest margin. That will push their depositors, for higher return, and their corporate borrowers, for cheaper funding, to capital markets such as the stock market. Consequently, over time, there will be a shift of financial intermediation from the banking sector to capital markets.

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IMF-3 external debt: a case of déjà vu?

- **Indonesia, Korea, and Thailand are taking different paths to tackle their foreign debt problems**
- **Korea has given explicit guarantees to facilitate rescheduling of bank debts**
- **Indonesia is considering giving fx guarantees to ease debt burdens on corporates**
- **Thailand's market approach features improved legal recourse for creditors in case of default**

A major concern about Indonesia, South Korea, and Thailand (the "IMF-3") is the impact of the currency crisis on their ability, and more importantly, their willingness to make good on their foreign debt obligations. The policy paths taken by these countries differ. In Korea, the public sector has made clear that it will stand by the banks to guarantee some of their external obligations. Thailand has opted not to support debtors, but has instead put in place a series of structural reforms to allow foreigners greater participation in the domestic economy and give foreign creditors recourse to the legal system if need be.

Moreover, both Korea and Thailand have demonstrated to the international community that their will to abide by their IMF macro-stabilization and reform packages is genuine. The manifest turnaround in sentiment that has followed, generating growing investor inflows, especially into Korea, suggests that the first hurdle to winning investors' trust has been overcome.

In contrast, Indonesia, while making the right noises has failed to take the right steps. Uncertainty has kept creditors from even beginning to trust the intentions of the authorities there. Indeed, whatever attempts have been made to resolve debt issues have been overshadowed by the plethora of breaches in the country's previous agreements with the Fund. In such cases, trust between creditors and debtors runs thin, much as it did with the Philippines in the 1980s. For Indonesia this time, it will be credible progress in tackling some of the broader reform issues facing the country that will begin to pave the way for constructive debt discussions in the months ahead.

IMF-3: structure of external debt
US$ billion, end-1997

	Indonesia	Korea	Thailand
Public sector	67.8	11.0	27.2
Long term	66.0	11.0	27.2
Short term	1.8	0.0	0.0
Private sector	68.7	143.4	75.2
Long term	33.3	75.0	43.3
Short term	35.0	68.4	31.9
Financial sector	9.8	94.2	41.1*
Long term	n.a.	50.4	18.5
Short term	n.a.	43.8	26.0
Nonfinancial	58.9	42.7	30.7
Long term	n.a.	18.0	24.8
Short term	n.a.	24.7	5.9
Total	137.4	154.4	102.4
% of GDP†	159.1	34.0	63.3
% of exports	215.0	87.6	127.4
Debt service, % of exports	32.7	10.6	17.8

* Includes Bangkok International Banking Facility (BIBF) loans.
† GDP figures are calculated using 1997 year-end exchange rates, which are substantially weaker than average 1997 exchange rates.

Different debt profiles

Debt stocks of the IMF-3 differ markedly (top table). In plain dollar terms, Korea has the highest debt burden of the three, although Indonesia is not far behind. Relative to GDP or exports, however, Korea's foreign debt exposure is the lowest, followed by Thailand's. Korea also scores best in terms of the debt service burden (annual payments of interest and principal), which is less than 11% of exports. Thailand pays nearly 18% of its exports to service its debts, but that seems still manageable compared to Indonesia, which needs 33% of its export revenues for this purpose.

Korea's more favorable debt ratios highlight the importance of a country's trade orientation in its ability to service debts. In the early 1980s, Korea experienced a debt crisis brought on by overinvestment in the tradable sector and a severe terms-of-trade shock as oil prices shot up in 1980-1983. Despite the external shock, Korea was able to export its way out of the problem since the bulk of the debt was in fact self-financing through exports. This time, liquidity problems

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have kept the sharp depreciation of the won from spurring an export boom so far, but a similar pattern is likely to unfold in due course. The key difference is that much of the country's private debt today has been borrowed through capital markets, whereas in the 1980s it was to an extent easier to make payment arrangements with the foreign banks and official creditors who dominated at the time.

In Thailand and, more especially, Indonesia where tradable sectors are smaller and more foreign loans have been used in the nontradable sectors, the adjustment will be more painful and require a larger shift of resources from the domestic economy.

High short-term debt left Korea vulnerable

Despite its more favorable debt ratios, Korea suffered a balance of payments crisis last year that put it in desperate need of international help. What went wrong was its huge short-term debt exposure, which was to a large extent refinanced day-by-day in the overnight market. This is not a problem under normal circumstances when investor confidence is stable, but became a death trap in the volatile circumstances of the Asian financial crisis and investors' growing concerns over the health of Korea's banks and big *chaebols*.

Public debt manageable for Korea and Thailand...

The IMF-3 countries also differ in their levels of public sector debt. In Korea and Thailand, external borrowing by the public sector has been limited, which argues that the ability of the sovereign to service its external obligations should not be unduly impaired.

... but less so for Indonesia

However, in the case of Indonesia, the public sector owes some US$68 billion abroad. No doubt the bulk of this total is longer term in nature but the associated principal and interest servicing costs still run high, at some US$9 billion a year. In the current circumstances of severely straitened domestic tax revenues and a highly uncertain volume of foreign inflows, the financing position of the sovereign looks uneasy.

Most likely, the bulk of the public sector's fx-related liabilities will be paid but the US$3.2 billion to

Indonesia: fx-related fiscal revenue and expenditure
J.P. Morgan estimates for FY1998/99

Scenario 1: IDR/$10,000 and oil price at $14/barrel	
Fx revenue (all from oil and gas)	US$5.3 bil
Revenue from oil	US$3.5 bil
Revenue from gas	US$1.8 bil
Interest and principal expense	US$9.0 bil
Fx shortfall	US$3.7 bil
Shortfall in rupiah terms (at IDR10,000/US$)	IDR37 tril
Shortfall as % of domestic revenues*	46.0%
Scenario 2: IDR/$5,000 and oil price at $16/barrel	
Fx revenue (all from oil and gas)	US$5.8 bil
Revenue from oil (at US$16/barrel)	US$4.0 bil
Revenue from gas	US$1.8 bil
Interest and principal expense	US$9.0 bil
Fx shortfall	US$3.2 bil
Shortfall in rupiah terms (at IDR5,000/US$)	IDR16 tril
Shortfall as % of domestic revenues†	19.9%

Note: Both scenarios assume oil production of 550 million barrels a year and that gas revenue is unaffected by the oil price.

* Assumes official projection of rupiah80.4 trillion in domestic non-oil revenue. This expenditure items has historically accounted for some 8-9% of domestic non-oil revenue.

IMF-3: financial sector liquidity support
net claims on financial sector, end -Dec 1997

	Indonesia	Korea	Thailand
Liquidity support	IDR52.8 tril	KRW38.6 tril	THB583 bil
% of GDP	8.6%	10.0%	10.9%

US$3.7 billion annual amount that has to be paid out of rupiah revenues creates what is potentially a heavy fiscal burden (see top table). Consequently, it is uncertain whether Indonesia will be able and willing to make good on its sovereign obligations.

Financial sector intervention adds to fiscal burdens

A related concern is the cost of public sector interventions to support domestic banking sectors. The volume of liquidity injection undertaken by the IMF-3 has been substantial (see second table) and its cost will fall largely on their public sectors. No doubt, some outlays will be covered by the later sale of seized assets but this still leaves a substantial up front funding need.

For example, the Thai authorities have already said that the bonds issued by the Financial Institutions De-

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velopment Fund (FIDF) to support their liquidity operations will be converted into longer-term government bonds. That could cost the Thai fiscal balance up to 2%-3% of GDP annually for 10 years. Fortunately, the volume of new support of this kind began to slow quite significantly by this past January. Furthermore, the bulk of the banking sector's recapitalization needs appears to have been met by willing foreign participants, enthused by the recently lucid moves by the Thai authorities to restructure the sector.

In contrast, the Indonesians have not made much headway. Indeed, the central bank's balance sheet suggests no real slowing in the volume of liquidity support, at least through to February. Combined with the hitherto opaque nationalization of much of the banking sector through the Indonesian Bank Restructuring Agency (IBRA), this suggests that the public sector may have to recapitalize the banking system at a cost provisionally estimated at 7%-15% of GDP against an estimated total cost of 20% of GDP (see *Financial restructuring is key to Asia's future,* page 5).

In Korea too, the degree of liquidity injection undertaken by the Korean authorities has been relatively large. This intervention, along with their subsequent commitment to reschedule commercial bank debt, may exert some pressure on Korea's fiscal accounts.

Lessons from Mexico and the Philippines

In all three countries, however, the real problem has been and continues to be the level and structure of private sector debt. The biggest issues here are the poor financial conditions of the debtors, the large numbers of participants (both creditors and debtor), and the degree of legal uncertainty. Sensible lessons on what best to do can be drawn from past debt crises. In the present context, two examples come to mind: Mexico's crisis of the early 1980s (which was the genesis of the FICORCA program) and the Philippines deal of the mid-1980s (a cautionary tale of poor handling). These examples are presented in some detail in the appendix on pages 25-26. Suffice it here to draw their major lessons for today:

- Large-scale and widespread private sector debt problems remain intrinsically messy, but public sector facilitation can provide some help;
- Public guarantees should generally be avoided because it risks creating moral hazard and incurring higher fiscal burdens;
- FICORCA-like schemes are workable but depend crucially on prudent assumptions to avoid unplanned future public subsidies to debtors;
- Legal reforms are key to forcing debt rescheduling and minimizing "free-rider" problems;
- Mistrust between creditors and debtors should be avoided. It had much to do with the delay in rescheduling Filipino debt in the mid-1980s and owed principally to uncertainty spawned by breaches of commitments made by the national authorities;
- A debt program needs to be undertaken as part of a larger macroeconomic stabilization package in order to boost sentiment as well as to reduce the economy's net external deficit.

The Korean workout

In addressing private-sector debt issues, Korea has been the most proactive so far, having offered to convert some US$24 billion in short-term nontrade-related debt of commercial banks into new loans with maturities between one to three years. The ability and willingness of the authorities to intermediate actively in this way on behalf of these banks were heightened by the fact that the debt was contracted by relatively few debtors vis-à-vis a quite limited number of creditors.

Steps taken by Korea to resolve external debt problems

- Korean banks have offered to convert US$24 billion in nontrade-related short-term debt into new loans with maturities of one, two, or three years, guaranteed by the Korean government and bearing interest of 225, 250, and 275 basis points over 6-month LIBOR.
- Each bank is permitted to swap up to 20% of its eligible loans for the new 1-year loans, and the new 2- and 3-year loans will carry call options permitting penalty-free repayments at six-month intervals.
- The new loans will be in the form of transferable loan certificates for which a secondary market will likely emerge from April onward. Voluntary conversion by international creditors may not occur until the latter part of 1998.
- The conversion, already carried out, will effectively limit Korea's debt-servicing burden (including long-term maturities) to US$45.2 billion in 1998.

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One motivation for public intervention was the fact that Korea's commercial banks form a large portion of the domestic payments system and any failure would have been highly disruptive, especially for the export sector which has been suffering from a severe dearth of working capital, and if left unattended, would have likely exacerbated other systemic problems. It should also be noted that for decades past the government has, through moral suasion, directed these banks to lend heavily to government-targeted industries. Consequently, the public sector's hitherto hefty support to these banks has left a legacy, and sense of implicit responsibility, that should not be underestimated.

This year's short-term bank debt conversion, already accomplished for some US$21.8 billion, will effectively limit Korea's debt-servicing burden (including long-term maturities) to about US$45.2 billion in the remainder of 1998 (see table). This figure is manageable, helped by a combination of trade adjustment, foreign aid, and further bond issues, and so should not lead to a renewed crisis. One caveat, however: The official statistics on Korea's foreign debt should be viewed with some reserve, given the country's poor accounting practices, and may well prove to be larger than the stated figures, especially if borrowing by Korean offshore subsidiaries is included. Even so, the authorities's engagement has achieved real progress and should pave the way for additional debt rollovers as confidence builds further in the government's ability and will to implement its reform plans.

However, Korea's corporate sector debt has yet to be resolved. It appears likely that further reschedulings will occur, probably without government intervention. Consequently, while the efforts of the authorities should be applauded, much work remains to be done, including to address the looming capital shortage facing the banking sector. Moreover, South Korea, like Thailand, is making much effort to open its economy further to foreign participation, to which end more micro-level reforms are needed to catalyze requisite restructuring and to improve corporate transparency.

Projected fx supply/demand for Korea to end-1998
US$ billion

Usable reserves on hand, end-Mar 1998	24.2
Amount to be disbursed from IMF package	4.2
Current account contribution, Apr to Dec 1998	11.4
Korean bond issue†	9.0
Contribution by G-7 countries	8.0
Total fx available through end-1998	**56.8**
Maturing short- and long-term debt	67.0
Less debt conversion	21.8
Total fx liabilities to pay down through end-1998	**45.2**

* US$21.8 billion out of the US$24 billion deal has been converted.
† Amount to be raised through capital markets depends on actual funds received from the G-7, currently expected to be US$8.0 billion.

Thailand: no public bailout seen

In contrast to the proactive approach adopted by the Korean authorities, the attitude of the Thais seems to be one of letting debtors and creditors negotiate obligations through market mechanisms. The Thai authorities have made commendable efforts in both closing failed financial institutions and reforming the legal structure. These reforms have led to a marked improvement in market sentiment toward the country.

Banking sector restructuring aids debt workout

The Thai financial sector's debt structure is skewed predominantly to the side of commercial bank loans along with loans booked through the Bangkok International Banking Facility (BIBF). Together, these totaled some US$41.06 billion at the end of the third quarter of 1997, with a large portion of the BIBF loans on-lent by domestic banks to the finance companies.

In this area, efforts have already been made to resolve problems. The efforts have yielded the closure of 56 finance companies plus initiatives by the authorities to restructure elements of the banking system. The restructuring process so far differs by type of financial institution: for insolvent finance companies, closure and disposal of their assets; for severely troubled banks, nationalization and eventual privatization.

The seized assets of the closed finance companies are estimated to be worth baht860 billion, from which the FRA estimates a recovery rate of 40%-67%. They have been divided into high- and low-quality groups that will be auctioned separately. Two newly created government institutions will participate in the auctions. The Radhanasin Bank (RAB) will bid on high-quality assets and the Asset Management Corporation (AMC) will act as "buyer of last resort" for low-qual-

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ity assets that fail to be liquidated after the initial auction. Still not clear is how the claims of the creditors of the foreclosed finance companies on the auctioned assets will be resolved nor how "good" and "bad" assets will be differentiated and, more importantly, priced. Nonetheless, both debtors and creditors are apt to take a haircut, especially as there is to be no subsidy to facilitate the payments process – a politically difficult abnegation but one that amply demonstrates the willingness of the new government to deal with the problems in the "correct" way. Still, with the government taking an active stance in brokering the assets of the insolvent finance companies, creditors stand a better chance of retrieving a higher amount than they would have had on a stand-alone basis.

For the corporate sector, the government has explicitly said that no public support will be rendered concerning the bulk of the obligations (with some 50% due to Japanese creditors). It seems that a *de facto* (often involuntary) rollover of the debt of illiquid corporates will likely come to pass. Deals are being signed that suggest that some progress is being made, especially for manufacturers (see box at right). Creditors facing insolvent debtors may also find some comfort through the recently revamped bankruptcy law (see box below), although much will depend on efforts to strengthen the judicial system at the micro level.

The other legal reform on the timetable includes modification of the foreclosure law that provides a mechanism, separate from bankruptcy, to enforce creditors' claims against a debtor's assets. Discussion of this reform is only beginning, with a working deadline of October 31 for passage of amendments. Separately, the process of reviewing restrictions on foreign ownership of property remains unresolved. Uncertainties over these issues will doubtless linger, but the proven track record of implementing these reforms provides some buffer of credibility for the Thai authorities.

Thailand's Wongpaitoon finds an innovative solution

Wongpaitoon Group, a large Thai footwear exporter, recently struck an innovative deal to borrow US$100 million from Daiwa Securities America Inc. which it will repay over the next five years using its future export earnings. The transaction is a form of securitization, with the assets packaged in this case being the company's future cash flows. While securitization deals were done in Thailand with auto loans prior to the economic crisis last year, the Wongpaitoon deal appears to be the first in Thailand to securitize export earnings.

The agreement calls for Daiwa to give Wongpaitoon $100 million now in return for a portion of Wongpaitoon's future export earnings that will be paid over the next five years into a trustee-held account. Such "future flow" securitization transactions have been widely used in Latin America.

Indonesia: still an uncertain path ahead

The corporate sector in Indonesia at the current exchange rate is insolvent. Only at 4000 to 5000 rupiah/US$ will some of the companies be viable. To resolve this problem, the public sector looks intent on

Amendments to Thai bankruptcy law

Advantages to creditors

- Permits creditors to appoint a planner and plan administrator who assume powers and duties.
- Creditors who provide funds to the planner, plan administrator, or the official receiver for the purpose of reorganizing the debtor's business are not subject to Section 94(2) of the Bankruptcy act.
- Creditors who extend loans to the planner, plan administrator, or the official receiver receive priority in distribution of the debtor's assets .
- Following acceptance of petition by the court, the debtor is protected from revocation of existing licenses by regulatory authorities.
- A petitioning creditor is not required to bear costs of reorganization proceedings.
- The new law does not prevent enforcement of pledges of shares of the debtor company or guarantees provided by shareholders or directors of the debtor company.

Disadvantages to creditors

- The new law permits a debtor unilaterally to file a petition for reorganization proceedings.
- Petitions relating to debtors regulated by authorities require prior approval of the relevant authority.
- Following acceptance of petition by the court, the debtor is protected from any action that may adversely affect the business, including commencement of proceedings.
- Secured creditors have no special status at creditor meetings.
- Creditors failing to file a claim for payment within the prescribed time limit will lose rights to receive payments.
- Resolution to approve reorganization plan must be passed by affirmative vote of creditors whose claims equal or exceed 75% of the total claims of creditors.
- Reorganization proceedings may last for five years (plus two court-approved extensions of one year each).
- The current court administration will not reduce the time required for bankruptcy-related matters.

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Potential fiscal cost of an Indonesian "FICORCA"*
J.P. Morgan estimates, US$ billion, excluding interest

Assumed exchange rate for debt conversion	IDR/$5,000
Total private sector debt	68.3
Corporates viable at IDR/$5000	40% of total
Debt needing FICORCA coverage	27.3
Public subsidy if IDR sustained at 8000/$	10.2
Public subsidy if IDR sustained at 6000/$	4.6

* See appendix opposite for the workings of the Mexican original.

setting up a system, similar to the Mexican FICORCA program of the 1980s, that would effectively subsidize the corporates by offering a below-market exchange rate. Indonesia's plan remains vague so far, but early statements suggest that the government will guarantee a fixed exchange rate, calculated by taking the best of a series of 20-day moving averages of the rupiah's value during a window of time leading up to the program's implementation, which is expected to begin in 1999. The actual debt restructuring, however, is to be left to individual companies and their creditors to work out. Options are likely to include some debt extension, grace periods on payments, and outright forgiveness.

The risk here, apart from lack of commitment, remains the potential fiscal cost of the exchange fund and possible subsidy of nonviable firms (see table). Furthermore, the plan will not solve the issues surrounding defaulted obligations and further micro-level creditor/debtor discussions will be needed. Nor can it be said that historical experience in resolving Indonesian corporate debt problems truly bodes well for the present discussions (see box).

The by now seven-year-old Bentoel case painfully underscores the point that it is not so much legal statutes that need to change in Indonesia but rather the attitude of the judicial and political powers that be. The case conveys a sense that foreign creditors remain at the mercy of the legal system, unlike in Thailand whose unwillingness to deal with private sector problems has been more than compensated by its resolve to reform the legal system (and thereby permit foreign creditors fairer representation). Unfortunately, legal administration uncertainties still weigh heavily in Indonesia and are by no means allayed by the government's third letter of intent to the IMF. That letter failed to address clearly the authorities' consistent track record of policy slippage up until now. Present conditions thus make it difficult to judge whether Indonesia will repeat the costly mistakes made by the Philippines in the mid-1980s. The signs right now are not encouraging.

Bentoel: a case of Javanese judicial shadow play?

This is not the first time that Indonesian corporate insolvency has forced foreign creditors to seek protection through the courts. A discouraging example is Bentoel, a large cigarette company run by Budiwijaya (Tjioe Jan Hwie, a second-generation descendant of the founder). In June 1991, Citicorp withdrew a planned US$50 million refinancing facility for Bentoel and the firm subsequently declared itself insolvent. It emerged that the company had debts totaling some US$350 million, giving the firm a net worth of around negative US$200 million.

Bentoel's debts were equally divided between Indonesian and foreign banks, with Bank Rakyat Indonesia and Bank Bumi Daya owed US$150 million between them. Together, 27 foreign banks formed a committee to represent their interests as creditors but the Indonesian banks (being also better collateralized) refused to join. In September 1991, Peter Sondakh, through his Rajawali group, was interested in picking up Bentoel and through Budiwijaya had persuaded the firm's shareholders (many of whom personally guaranteed the company's debt) to back his bid in return for release from their personal guarantees. In November of 1991, the company was taken over by the Rajawali group.

In statements to the foreign creditors, Bentoel offered to convert its U.S. dollar debts into rupiah at the rate prevailing when the loans were first taken, without taking into account subsequent rupiah devaluation of about 15% since 1990. By early 1992, the smaller foreign creditors (including the Bank of Tokyo), were frustrated by the proceedings and pushed to take a hard line with the new owners. Most other foreign creditors based in Indonesia realized that there was little comfort to be had from the judicial system and began to negotiate with the company.

However, in June 1992 Bentoel's creditors were offered a deal. They could cash out immediately if they were prepared to write off 90% of their exposure or they could accept a combination of senior Bentoel debt and ten-year convertible bonds. Frustrated, the creditors proceeded to see the Senior Economics Minister, then Mr. Radius Prawiro (currently the debt restructuring adviser), who replied that "it was a private matter."

The foreign banks responded by filing a bankruptcy petition with the Malang City Court against a Bentoel shareholder who had guaranteed some of Bentoel's debt. In November 1992, the court ruled that the banks had no grounds for enforcing a personal guarantee until Bentoel had itself entered liquidation proceedings. Later the court ruled there were no grounds for putting Bentoel into liquidation. The case continues and the foreign creditors will likely agree to reschedule the company's debts.

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Appendix: Two previous episodes of private sector debt resolution

Episode 1: Mexico's FICORCA plan

Mexico in the early 1980s suffered a severe capital flight provoked by a crisis of confidence brought on by declining global oil prices and an unsustainable debt service burden. This led eventually to a balance of payments crisis.

In August 1982, the Minister of Finance called for a payment freeze on public debt. Subsequently, some 1,000 of the 1,400 creditor banks participated in talks leading to an arrangement that called for rescheduling of some US$20 billion in public sector capital payments originally due between August 1982 and December 1984.

A key issue facing Mexico was the sheer scale of its private sector debt (see table), the bulk having been contracted by local corporates working through Mexican banks who had borrowed from offshore banks. Making matters worse, massive devaluations accompanied the crisis, which led to serious cash flow problems for companies indebted in U.S. dollars but without natural dollar income.

Mexico: private sector long-term debt
US$ billion

		Owed to		
	Total	FICORCA	Paris club	Other
1978	5.5	-	-	5.5
1979	7.2	-	-	7.2
1980	11.0	-	-	11.0
1981	14.9	-	-	14.9
1982	20.0	-	-	20.0
1983	20.6	11.5	-	9.1
1984	18.8	11.9	0.1	6.8
1985	17.6	11.0	0.3	6.3
1986	17.0	10.6	0.3	6.2

The FICORCA plan unveiled

To aid such firms, a financial scheme known as FICORCA (Fideicomiso Para la Cobertura de Riesgo Cambiaros) was created in 1983 (and ended in 1992) to provide coverage of foreign exchange risk. FICORCA enabled the restructuring of US$12-15 billion in short-term debt (out of a US$20 billion total corporate debt). Slightly over 1500 firms were helped by means of some 5000 credit contracts. The firms eligible for FICORCA assistance had to be viable, and had to pay all of their credits without public assistance. The intention was to give no official subsidy.

Problems with FICORCA

To work well, the FICORCA program needed accurate exchange rate and interest rate assumptions so that the trust would have enough funds to meet the dollar obligations of

Intricacies of the FICORCA plan

1. Any private sector company having foreign-currency-denominated debt could participate, provided it registered with the Bank of Mexico, remained solvent, and had already rescheduled its obligations to its creditors.
2. At the borrower's option and based on the terms agreed with the creditor, FICORCA guaranteed foreign exchange protection for either principal or principal and interest payments at rates up to LIBOR+2%. Mostly it covered both, with loans rescheduled on "FICORCA terms" – usually eight years maturity, four years grace, and an interest rate up to LIBOR+2%.
3. The foreign exchange cover was achieved by a program of contracts between FICORCA and the corporates. The contracts effectively let corporates swap their foreign debt due to creditors for peso loans due to FICORCA. FICORCA essentially assumed responsibility for providing the corporate with the U.S. dollars needed to service its foreign loans, thereby relieving the company of exposure to the markets.
4. For their part, the corporates made peso payments to FICORCA with the peso equivalent of the dollar principal calculated at one of several exchange rates preestablished from the start. As the peso debt had no grace period, peso-denominated principal payments to FICORCA preceded the dollar-denominated payments to the Mexican company. Payments of interest by these corporates to FICORCA were based on the average of prime and CD rates, which were usually considerably cheaper to these companies than alternative types of Mexican funding at the time.
5. FICORCA then reinvested its receipts from the corporates at the prevailing domestic rate, though this was set artificially low in a deliberate policy to mitigate the ongoing recession – indeed, it turned out lower than the initially assumed rate of return.
6. In addition, the preestablished exchange rates were determined by complicated formulae that staggered debt payments in such a way that the present value of each payment was the same. In this way, interest and principal payments due in earlier periods were much smaller than those due later. This eased a corporate's debt burden in the early years of a FICORCA contract by deferring interest costs to later years.
7. The authorities' zeal to cap domestic interest rates spilled over as greater-than-expected devaluation of the exchange rate. The difference was picked up by the government as a subsidy.

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the corporates. However, the government ended up setting domestic interest rates artificially low in the mid-1980s to mitigate the country's recession and this accommodative stance also wound up weakening the exchange rate to lower-than-expected levels.

Also, the government had a dual exchange rate policy at the time and converted corporate external debt at the lower official exchange rate. Consequently, the dollar value of peso interest payments into FICORCA and reinvested by the trust lagged behind the amount needed for the trust to meet its obligations – a problem worsened by continuing peso devaluation and ensuing inflation that led to miscalculations of the parity exchange rate. Eventually, the public sector picked up the tab for the mistaken assumptions.

Example 2: Philippines in 1983

As in Mexico in 1982, capital flight engendered by a crisis of political and economic confidence sparked a balance of payments crisis in the Philippines in 1983. The IMF quickly stepped in and, together with a bank advisory committee, called for the rescheduling of US$9.1 billion in commercial and official loans. However, despite positive developments, the Philippines debt negotiations proved to be the most prolonged and drawn out of the 1980s debt crises, dragging on for some 19 months after the initial declaration of debt moratorium (see table).

Philippines: commercial bank financing program
US$ billion, rescheduling terms agreed in May 1985

Rescheduling class	Amount	Maturity (grace), years	%-point spread over LIBOR
Total debt	5.89		
Public sector debt	3.24		
Medium/long term	2.06	10 (5)	1 5/8
Short term	1.18	10 (5)	1 5/8
Private financial debt	1.61		
Medium/long term	0.02	10 (5)	1 5/8
Short term	1.59	4 (4)	<2
Private corporate debt	1.03		
Medium/long term	0.45	10 (5)	1 5/8
Short term	0.59	10 (5)	1 5/8

Delays and doubts on debt restructuring

Delays in the negotiations came about for several reasons. The main one was that the Philippines had difficulty in reaching an agreement with the IMF due to the growing mistrust that developed between the Fund and the Filipino authorities. Essentially, the latter had overstated the reserves by some US$600 million, while money supply had already jumped by a substantial 38% in just one year. Also, huge fiscal expenditure to the tune of pesos5 billion (2-3% of GDP) was used to quell potential political unrest. Another unfortunate incident occurred in June 1984, when the biggest savings bank, Banco Filipino, faced serious liquidity problems. The Marcos administration, instead of allowing the monetary authorities to impose monetary discipline, forced the central bank governor to bail out the bank.

The Philippines' breaches of its IMF agreements were not the only problem. Another was that the major creditor banks became reluctant to participate in the negotiation effort, reflecting to a large degree their own differences. Finally, these differences were resolved and the Philippines government signed its restructuring agreement with the banks in May 1985.

Private sector debt workout

Creditors and their corporate debtors were left to work out repayment of existing loans largely on their own. However, the central bank did offer an option for foreign exchange cover of restructured private corporate debt. Another option, similar to the FICORCA plan, offered forward exchange protection and credit assistance for corporate borrowers in financial distress. Under all options, counterpart payments were made to the central bank on an agreed schedule and the central bank assumed the corresponding external obligation, payable on the same schedule as the restructured public sector debt. In each case, the commercial risk of the loans was borne by the original lender.

Subsequently, a second agreement was made in 1986 under the aegis of the Aquino government. This deal proved more resilient, thanks primarily to the new authorities' increasingly credible efforts to implement reforms and to adhere to macroeconomic stabilization measures.

Regional economic outlook themes

Japan

The recession continues through the first half of 1998. The new fiscal package plus renewed stock building will boost growth in the second half, but the economy will again lose momentum in 1999. **Meanwhile, deflation remains the theme:** Excess capacity and unemployment will rise, while prices, especially in the real estate sector, will fall. **Page 28**

Only trade contributes to growth and will continue over the next 12-15 months. However, the rising current account surplus is driven by domestic demand weakness, while exports are suffering from the demand implosion in the rest of Asia. **32**

Monetary policy will stay hostage to the fragile financial system. Deteriorating asset quality, insufficient capital, and competitive pressure from “Big Bang” are squeezing the banks. In response, the authorities will keep interest rates low, but this will not ease the credit crunch. **33**

Emerging Asia

The regional financial meltdown has ended, but the economic downturn is only now starting. 1998 real GDP forecasts have been significantly marked down for Hong Kong, Indonesia, and Malaysia. **34**

Current account balances have staged a dramatic U-turn, but the correction is basically driven by import compression. Exports are held back by a lack of working capital, but should accelerate in the second half as the liquidity crisis abates. **35**

Inflation continues to rise, but the risk of runaway inflation is fading except in Indonesia. Food prices and prices of currency-linked goods are surging, while growing domestic slack is putting downward pressure on many other prices. **36**

China is trying to push ahead with reform, while the economy continues to slow. **37**

Indonesia’s reform program is finally starting to take shape, but there are still implementation risks and the country is suffering its worst downturn since the mid 1960s. **39**

India’s markets have accorded a friendly reception to the new government, despite its fragility. Monetary policy has been easing, but the big macro policy challenge will be to frame a budget in the next month or so that pares the deficit while spurring a stagnant economy dogged by an overvalued rupee. **41**

Australia/New Zealand

Australia and New Zealand both feel the pain from Asia. The decline in exports to Asia is partly offset by increased exports to Europe and North America. **42**

Domestic demand in Australia has been strong, but the boost from the 1996/97 interest rate cuts is starting to fade. Though the RBA tries to steer a steady course, more signs of demand weakness are likely to trigger another rate cut. **44**

New Zealand has both the room and the need to cut interest rates more aggressively. **45**

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Japan: dancing up and down around zero

- **Economy again on roller-coaster ride: recession through 98H1, up through policy boost in 98H2**
- **Risks high that 1999 will bring reversion toward zero growth and disinflation trauma**
- **Temporary fiscal pump-priming is not enough to engender lasting reinvigoration of economy**
- **Permanent restructuring, especially of financial sector's capital base, is key corrective needed**

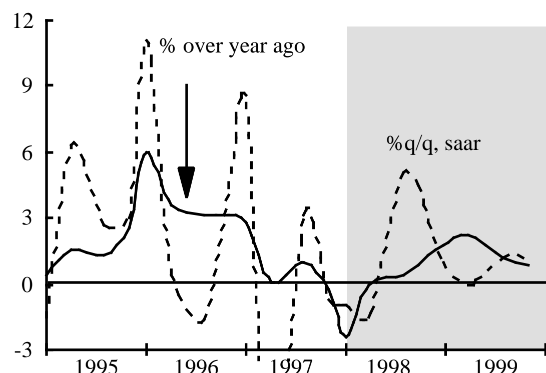
Key forecasts
calendar years

	1997	1998	1999
Real GDP (%oya)	0.9	-0.2	1.5
Consumer prices (%oya)	1.7	0.1	-0.4
Current account (US$ bil)	97.4	106.0	119.4
3-mo. Eurodeposit rate (% p.a.)*	0.5	0.6	0.6
10-year bond yield (% p.a.)*	1.7	1.5	2.0
Yen/US$*	130	150	122

* Year end.

GDP growth to stay volatile: down in first half, up in second half, and back down from early 1999

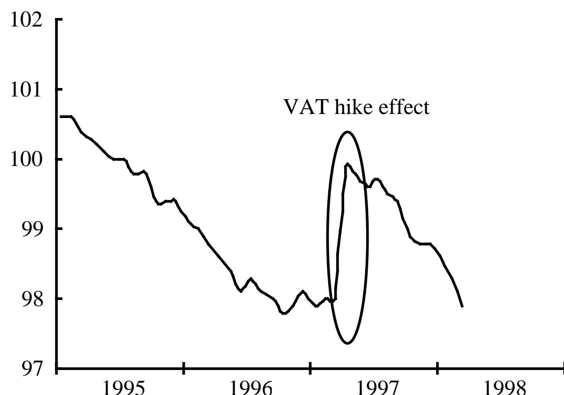
Real GDP growth
percent



- Real GDP has followed a distinctly roller-coaster path over the past three years. 1998/99 promises to be no different.
- The recession leg of the cycle is presently firmly entrenched, having begun in fourth-quarter 1997 and lasting through the current quarter.
- From this summer, the recent about-turn in fiscal policy will force another sharp move up, with GDP rising as much as 5% q/q saar in the third quarter.
- Subsequently, the economy will probably not stay airborne when the fiscal engines are cut off. J.P. Morgan expects subpar growth of 1.5% for 1999.

Deflation, not inflation, remains the principal risk

Domestic wholesale prices
1995=100, nsa



- Deflation worries are still justified. Resource utilization continues to decline, with excess capacity rising and unemployment surging. In addition, asset prices – for real estate, equities, and the currency – have continued to slide in spite of the near-zero interest rate policy now in place for over two years.
- Traditional price indicators will highlight deflation momentum in coming months: From May/June, once the base effects of 1997's VAT hike drop out, wholesale prices will dropping about 2% on a year ago, and core consumer prices about 1%.

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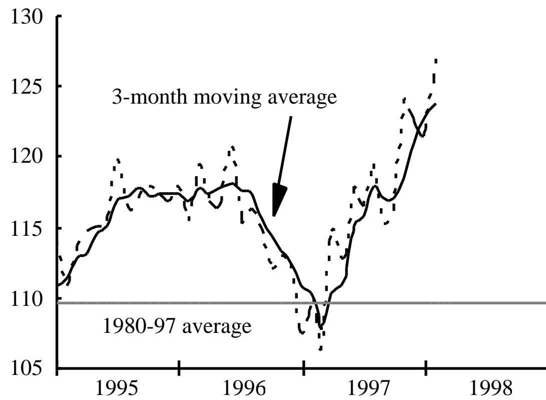
Large inventory overhang to dictate output cuts in coming six to nine months

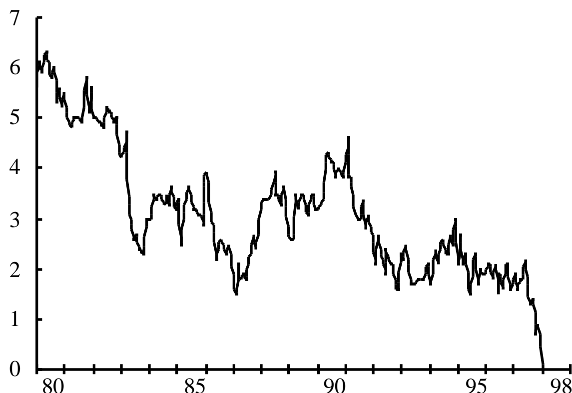
Inventory to shipment ratio
1990=100, sa



- The inventory overhang has worsened in recent months, despite sharp cutbacks in production. From here forward, producers will be forced to cut production even more. Typically, such downward adjustment takes at least six to nine months.
- Last year, the buildup of involuntary inventories occurred initially and mainly in consumer goods, for which demand plummeted after the VAT hike. But since last October/November, capital goods have become the principal source of ongoing buildup because the domestic capital cycle and Asian capital goods demand are both careening downhill.

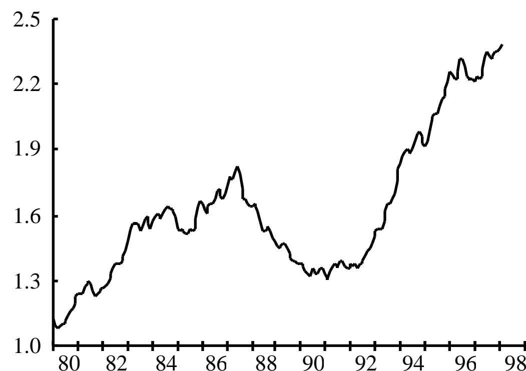
Labor market staging a full-fledged adjustment downward

Contractual nominal wage growth
%oya, companies with over 30 employees

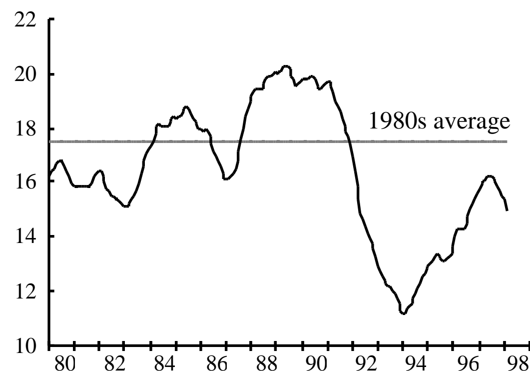


- On the demand side, the labor market is now in the midst of a hard landing – unemployment is rising and wages are declining.
- Here, the adjustment is driven not just by cyclical considerations but also by corporate managers now seeking to cut structurally excess employment and wage costs. The latter is done by introducing merit-based pay systems, replacing the still dominant, and costly, pay-by-seniority structure.
- All said, nominal income growth is apt to stagnate at best this year, after a rise of about 1.8% last year. In contrast, the ¥4 trillion tax rebates now planned for 1998 will be worth about 1.1% of incomes.

Unemployment
millions of people, sa, 3-month moving average



Overtime hours – manufacturing
hours, sa, 3-month moving average



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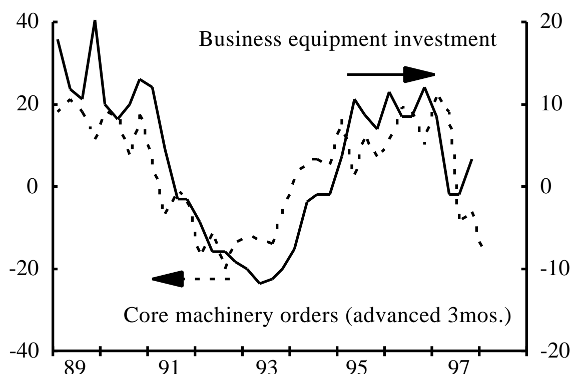
Downturn in business investment still deepening

Machinery orders and equipment spending
%q/q, saar, 2-quarter moving average



- Business investment will be a steady drag on growth throughout the coming 12-15 months. For 1998 it should subtract almost 1% off GDP.
- The visibility of the downturn continues to increase. On top of the downturn in the monthly machinery orders series – it leads GDP-based capital spending by about six months – survey data now suggest that nominal business expenditures will fall about 4% (see March Tankan and March LTCB surveys).
- Driving the downturn are several factors. First, the cyclical drop in domestic demand since last summer highlights a general excess capacity overhang. Utilization rates had barely climbed back to previous mid-cycle averages in the 1996 economic boom and have now fallen back to about 10% below long-term averages. Global excess capacity in key industries, such as cars, semiconductors, and electronic components, adds to downsizing pressures.
- Second, the downturn in corporate profits is squeezing investment plans. For 1998, corporate profits could be down as much as 25% from 1997.

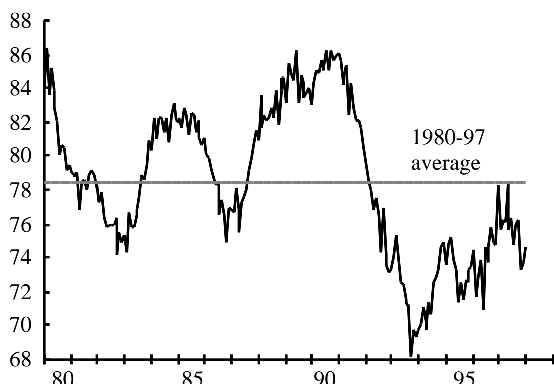
Investment plans of large firms
% increase in nominal yen

		FY97	FY98
NCB (Jan 98)	All	2.9	-1.4
	Manufacturing	6.1	-5.8
	Nonmanufacturing	1.8	0.1
Nikkei (Feb 98)	All	3.3	-4.6
	Manufacturing	7.1	-7.1
	Nonmanufacturing	1.0	-3.0
JDB (Feb 98)	All	2.8	-4.0
	Manufacturing	7.5	-6.7
	Nonmanufacturing	0.7	-2.7
LTCB (Mar 98)	All	3.3	-3.9
	Manufacturing	6.5	-8.2
	Nonmanufacturing	2.0	-2.2
IBJ (Feb 98)	All	2.9	-1.6
	Manufacturing	7.3	-6.4
	Nonmanufacturing	1.3	0.3

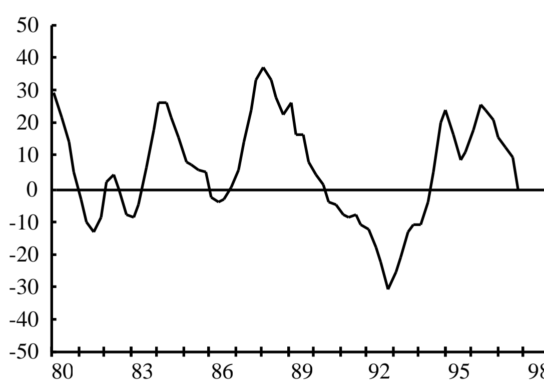
		FY97	FY98
LTCB (Mar 98)	All	3.3	-3.9
	Manufacturing	6.5	-8.2
	Nonmanufacturing	2.0	-2.2
BoJ Tankan (Mar 98)	All	2.0	-4.3
	Manufacturing	9.1	-7.2
	Nonmanufacturing	-1.4	-2.7

* NCB is Nippon Credit Bank; LTCB is Long-term Credit Bank; JDB is Japan Development Bank; IBJ is Industrial Bank of Japan.

Capacity utilization
%, sa



Corporate profits
%oya, 3-quarter moving average



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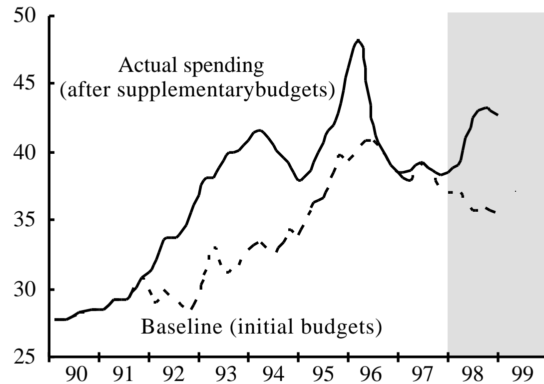
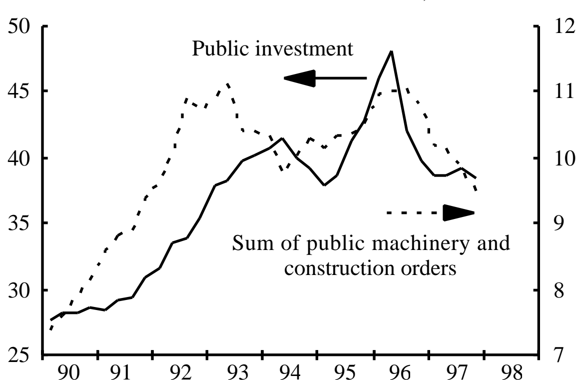
Temporary good news: Sizable fiscal stimulus to boost demand from the summer

Public investment
¥ trillion, 1990 prices, GDP accounts basis

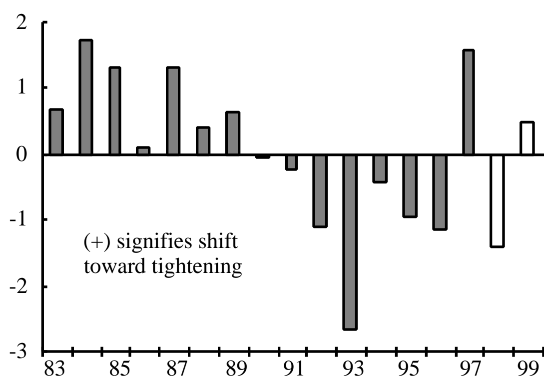


- With key components of domestic demand weakening markedly, countercyclical policy stimulus is now on its way. The supplementary budget for 1998 will deliver a fiscal boost worth about 1.4% of GDP this year. Compared to the 0.3%-of-GDP drag implied in the original budget, this is a sizable turnaround.
- About one-third of 1998's fiscal boost comes from tax cuts and two-thirds from extra public spending. The latter especially will kick in over the summer. Morgan expects third quarter GDP to jump more than 5%q/q saar, with public investment up 35%.
- After the fiscal engines are cut, the economy will face adjustment down to lower, normal public spending levels and higher, normal tax rates.

Public sector investment and orders
¥ tril., 1995 prices, saar *¥ tril., latest 12 months*

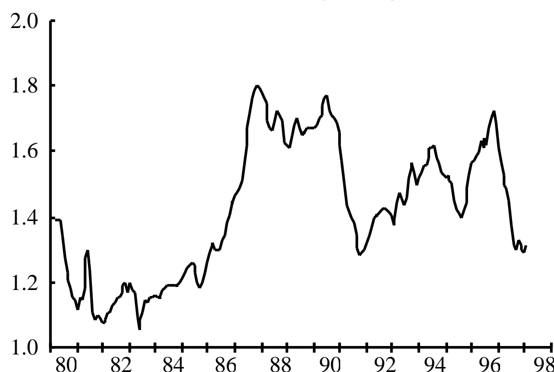


Fiscal thrust
% of GDP



More lasting good news: Housing starts to kick in from the autumn

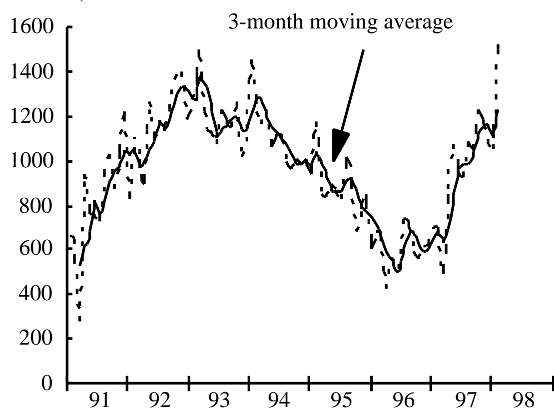
Housing starts
million units, saar, 3-month moving average



- On the private demand side, a turn in the housing cycle should be the lead indicator for the bottom of the recession. Cyclically, prospects for a turn are increasing: After the sharp fall last year, signs that starts are stabilizing are beginning to emerge.
- Added support for housing comes from innovative tax measures: Capital losses on individual houses became tax deductible as of April 1 for individuals who bought a house more than five years ago, sell it, and buy a new one. This scheme will be in place for the next three years.

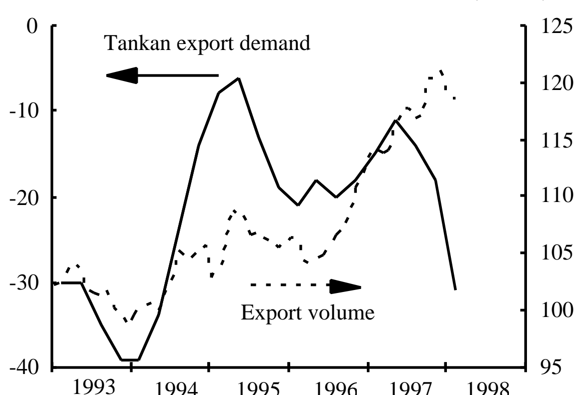
Steady boost from net exports to last throughout the next 12-15 months

Current account surplus
¥ trillion, sa

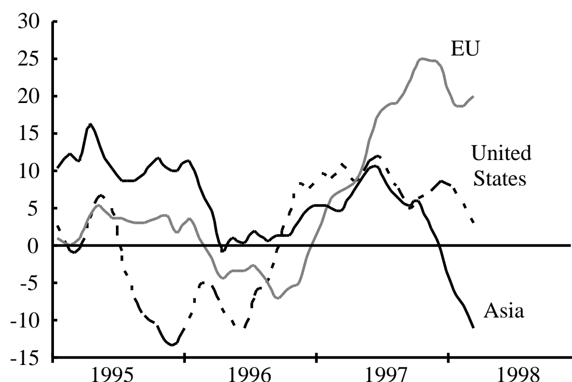


- The current account surplus has been the single bright spot in the economy since early last year. This is set to persist, with the surplus rising from ¥11.8 trillion in 1997 to ¥14 trillion in 1998.
- Driving this rise is the domestic demand weakness and compression of imports that will last until this summer. In contrast, export growth is suffering from the demand implosion in Asia and, from the summer onward, the expected moderation in U.S. demand will take added toll. Only Europe will remain a steady market for Japanese exports.
- In spite of yen weakness against the dollar, Japan's terms of trade have actually improved, thanks to the drop in world commodity prices and the yen's appreciation against other Asian currencies.

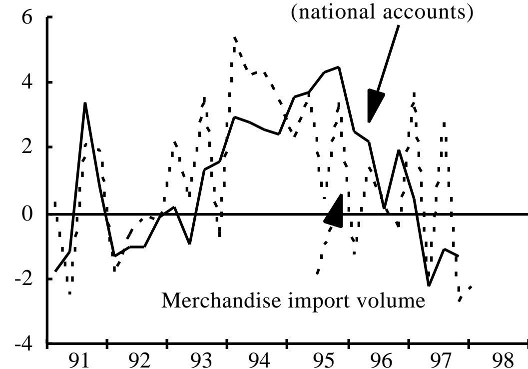
Export demand and volume
diffusion index, "tight"-"loose" *1990=100, 3mma, sa*



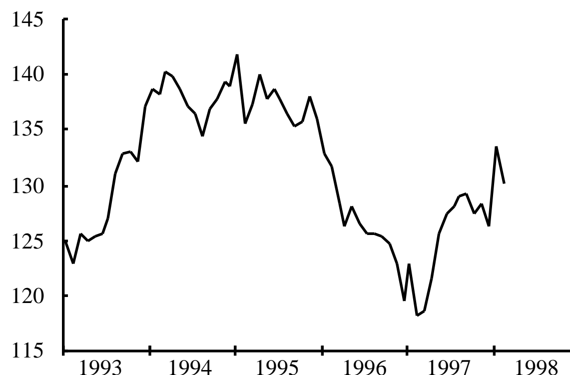
Export volume growth
%oya, 3-month moving average



Import volume
%q/q, sa



Terms of trade
1990=100



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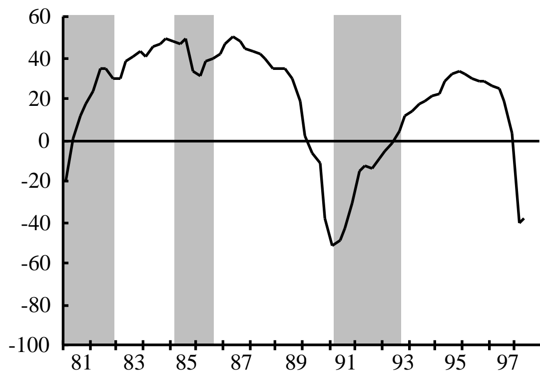
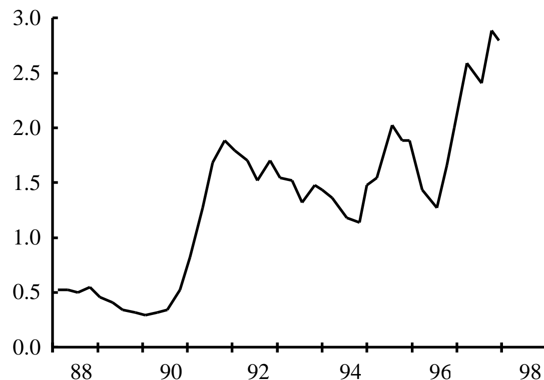
Monetary policy to stay hostage to the still-fragile financial system – no rate hike in sights

Banks' willingness to lend
diffusion index, "easy"-"tight"

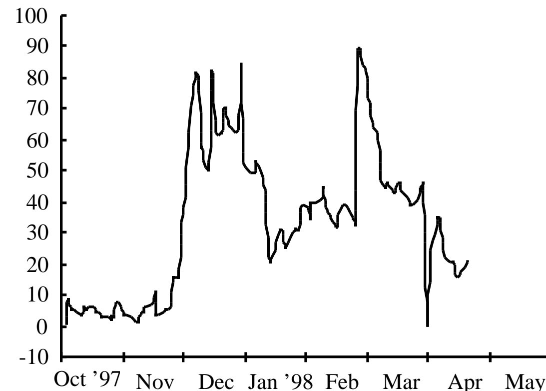


- The "credit crunch" remains a reality, with corporate views of banks' willingness to lend still in free fall.
- Driving the crunch are several forces that are likely to persist. First, "Big Bang" deregulation is raising competition in financial services. This means erosion of the banks' franchise value and lending margins, so they scrutinize credit decisions more closely than ever. Second, the banks' asset quality is still deteriorating, with bankruptcy debt now rising again. Third, the banks' domestic funding costs remain high.
- For the BoJ, this dictates further monetary accommodation. Other monetary aggregates have grown far less rapidly than its own balance sheet, indicating that the latter's expansion is mainly funding financial system assets, rather than feeding a new credit cycle.

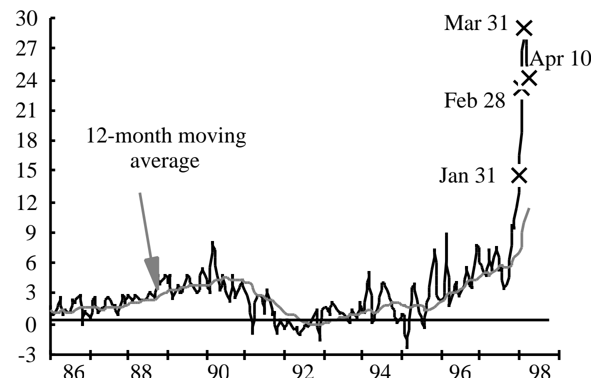
Bankruptcy debt
% of GDP, 3-quarter, debts of ¥10 million or more



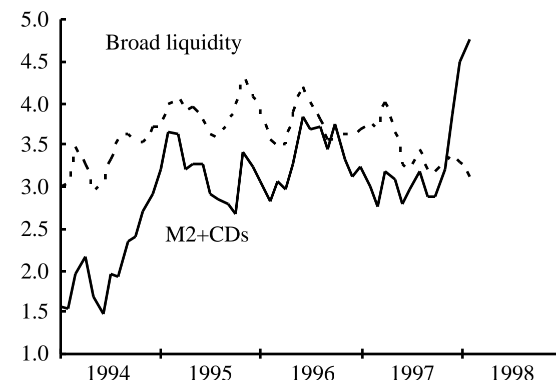
Spread: 1-month TIBOR – overnight call
basis points



BoJ's assets
¥ trillion, change over a year ago



Money supply
%oya



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Emerging Asia: throwing it into reverse

- **Financial conditions have recovered sharply in the past three months**
- **But 1998 GDP growth forecasts have generally been marked down**
- **Import collapse drives trade balance gains**
- **ASEAN and Korean inflation speeds up**
- **Thailand and Korea continue down their long hard roads, Indonesia's trip is just starting**

Real GDP growth forecasts

%oya, calendar years

	1996	1997e	1998f	1999f
Emerging Asia (10)	7.5	6.4	1.4	4.9
China	9.7	8.8	6.5	6.9
Hong Kong	4.9	5.2	-0.6	2.2
India*	6.8	5.0	5.5	6.5
Indonesia	7.8	7.0	-10.0	3.5
Korea	7.1	5.5	-3.6	3.5
Malaysia	8.2	8.0	-0.5	1.2
Philippines	5.7	5.1	1.0	4.7
Singapore	7.0	7.5	2.0	3.7
Taiwan	5.7	6.8	5.5	5.8
Thailand	6.7	0.5	-4.2	3.0

* Fiscal year beginning Apr 1.

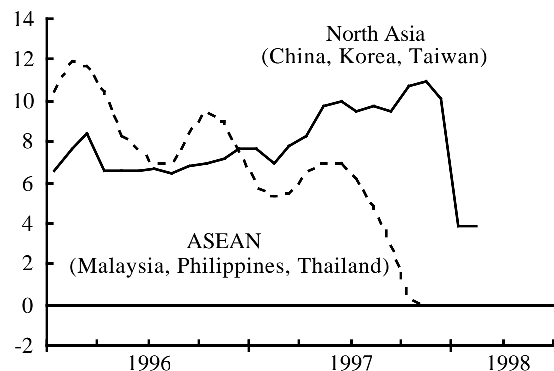
Financial and economic conditions

Financial indicators

	US$ fx rate (Jun 97=100)		Interest rates (% p.a.)		Stock prices (Jun 97=100)	
	Dec-97	Apr-98	Dec-97	Apr-98	Dec-97	Apr-98
North Asia						
China	100	100	8.8	6.8	78	70
Hong Kong	100	100	9.4	6.3	71	74
South Korea	52	64	18.6	20.0	50	63
Taiwan	85	84	6.8	7.3	91	97
ASEAN						
Indonesia	44	30	28.5	47.0	55	70
Malaysia	65	66	9.1	11.0	55	58
Philippines	66	69	18.1	15.1	67	79
Singapore	85	89	6.3	5.1	77	76
Thailand	53	63	27.0	24.0	71	83
India	91	90	7.2	7.3	86	99

Industrial production

%oya, 3-month moving average



- Across Emerging Asia, the currencies that suffered massive depreciations last year have regained some ground since the beginning of 1998. The lone exception is the Indonesian rupiah which continued to slide in January, but even it has retraced significantly in the past month. The nominal pegs against the dollar in China and Hong Kong remain in place and are not likely to be moved in the near future.
- Likewise, stock markets started the year strong, recouping some of their losses. The leaders so far are the Korean and Thai markets, whose gains are significantly higher when translated into U.S. dollar terms (though January's KOPSI gain now looks more like a one-off). Conversely, the rise in local currency terms in the Jakarta market is actually a drop in dollar terms.
- Interest rates remain above their precrisis levels in Korea and ASEAN (but less so in the Philippines).
- Mirroring the timing of the currency crashes, the economies of North Asia (driven by Korea and partly by Lunar New Year effects) began deteriorating five months after the ASEAN slowdown. J.P. Morgan's forecasts for 1998 GDP growth in Hong Kong, Indonesia, and Malaysia were significantly marked down in March, with lesser downward revisions in many other Emerging Asian economies. These painful recessions should be mercifully short, with regional growth in 1999 forecast at 4.9%.

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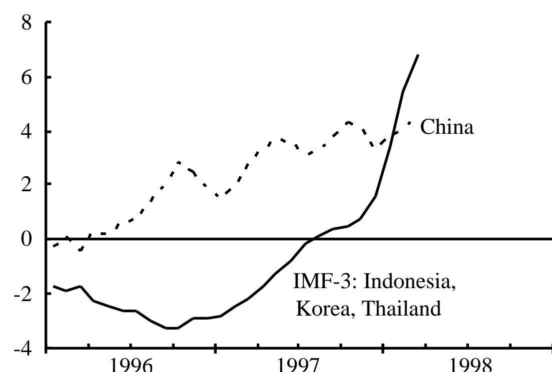
Trade adjustment is basically import adjustment

China and IMF-3 trade balance
US$ billion, sa, 3-month moving average



U.S. dollar-denominated merchandise exports
Jun 97=100, sa, 3-month moving average

	Sep 97	Dec 97	Latest	Month
China	103.4	100.4	114.3	Mar 98
Hong Kong (domestic)	103.0	100.1	93.5	Feb 98
India	103.6	99.1	94.8	Feb 98
Indonesia (non-oil)	104.3	97.9	101.1	Jan 98
South Korea	103.1	98.5	103.6	Mar 98
Malaysia	99.3	94.8	95.1	Feb 98
Philippines	101.2	107.0	109.9	Feb 98
Singapore (domestic non-oil)	98.8	98.4	94.6	Feb 98
Taiwan	105.0	103.9	97.0	Mar 98
Thailand	98.5	102.7	98.3	Mar 98

U.S. dollar-denominated merchandise imports
Jun 97=100, sa, 3-month moving average

	Sep 97	Dec 97	latest	month
China	102.8	103.1	109.5	Mar 98
Hong Kong (domestic)	104.3	105.2	99.2	Feb 98
India	95.4	100.4	109.1	Feb 98
Indonesia (non-oil)	96.0	93.1	82.0	Jan 98
South Korea	99.7	92.6	66.7	Mar 98
Malaysia	90.2	86.1	78.9	Feb 98
Philippines	103.9	104.1	100.3	Feb 98
Singapore (domestic non-oil)	103.6	95.9	86.9	Feb 98
Taiwan	108.6	110.6	102.7	Mar 98
Thailand	89.3	78.0	62.8	Mar 98

- The rapid turnaround in the trade balances of the countries that sought IMF aid (the “IMF-3” of Indonesia, Korea, and Thailand) continues to plow ahead. Despite expectations that the renminbi peg would quickly eat into Chinese competitiveness, China’s first-quarter 1998 trade surplus was $10.5 billion, up from $6.7 billion in 1997.
- The IMF-3 adjustment story continues as before: import compression now, export expansion later. The concern is that the “later” for exports may never materialize. Prospects for a Korean export boom are clouded by the weakness of the Japanese yen, while the worsening of demand conditions in Japan and the rest of Asia severely constrain exports from Indonesia and Thailand. Indonesia has great export growth potential, not only because of the real depreciation of its currency, but because of its abundance of natural resources and its focus on labor-intensive, primary goods to power its export engine.
- Elsewhere, China and the Philippines stand out for their strong export performances since last June, which really extend longer-term trends. China’s export growth in the face of depressed regional demand and a strong currency points to the fact that great leaps in productivity are still possible in China. It further stands in glowing contrast with dismal export showings by Hong Kong and India, whose currencies also have been relatively strong, even rigid.
- The Philippines has benefited because only about 40% of its exports stay within Asia and because recent capital investments in high-end electronics have upgraded its export capability.
- Such exposure to volatile electronics demand starts to put the Philippines in the same boat as the region’s more developed economies like Hong Kong, Malaysia, Singapore, and Taiwan. J.P. Morgan is forecasting a U.S. slowdown in the second half of 1998, so global demand for Emerging Asia’s electronics could be in further peril down the road.
- Imports remain very weak across ASEAN, again excepting the Philippines, and are basically flat in North Asia (save China). By contrast, India’s imports have been quite strong, despite low oil prices.

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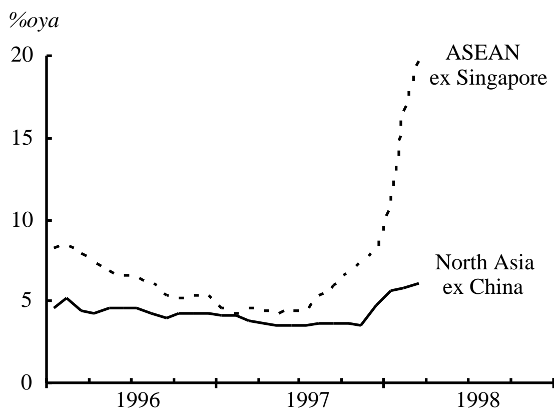
Inflation heads north in Southeast Asia

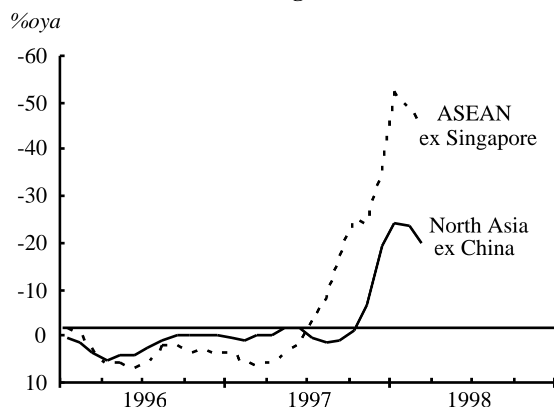
Consumer prices

%oya



Nominal effective exchange rates

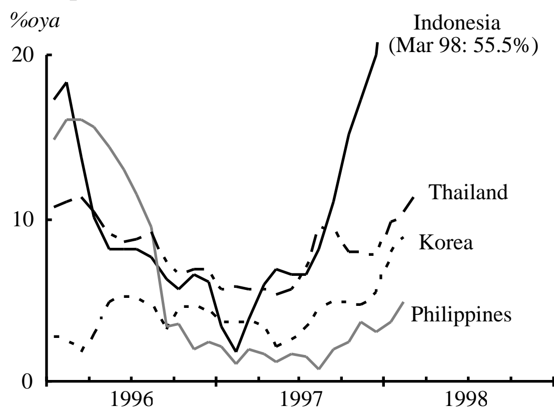
%oya



- ASEAN inflation continues to trend higher, led by sharp increases in Indonesia. However, March inflation data for Thailand (9.5% on a year ago), the Philippines (7.3%), and Malaysia (5.1%) show the trend is region-wide. In contrast, inflation is relatively mild in North Asia, though Korean prices rose over 9% on a year ago in the first quarter of 1998.
- However, given the acute depreciations of most Emerging Asian currencies, the inflation seen so far has, in fact, been relatively muted.
- Indonesia, plainly, is the biggest concern. Skyrocketing food prices, driven by drought, distribution bottlenecks, and the savaged rupiah, hold the potential to spark social unrest. Concessions in the latest IMF program that allow continued subsidization of rice and other foods should help ease the pressures.
- The acceleration of Thai food prices is exacerbated by healthy world demand for Thai rice. Meanwhile, food prices in the Philippines remain suspiciously quiet, especially given their historical volatility and tightening supply conditions.
- Nonfood prices in Korea, especially for imports, jumped in the first quarter of the year, but gains by the won, labor concessions, and weak domestic demand should help to attenuate inflationary pressure. Strong service sector price increases drove nonfood prices in the Philippines higher throughout 1997 and, along with the effects of oil price deregulation, will keep inflation there a concern.

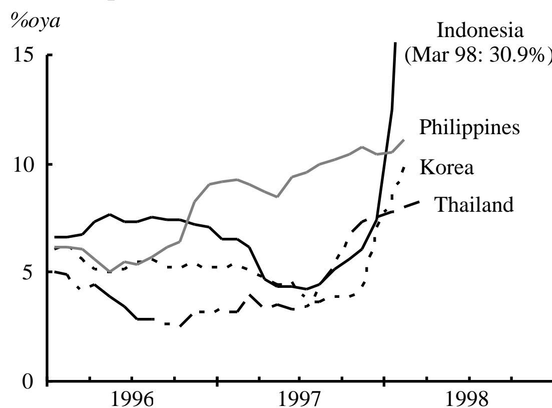
Food prices

%oya



Nonfood prices

%oya



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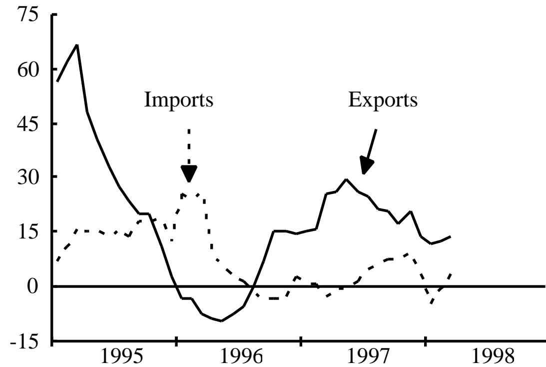
China is pushing reforms, while trying to stimulate domestic demand

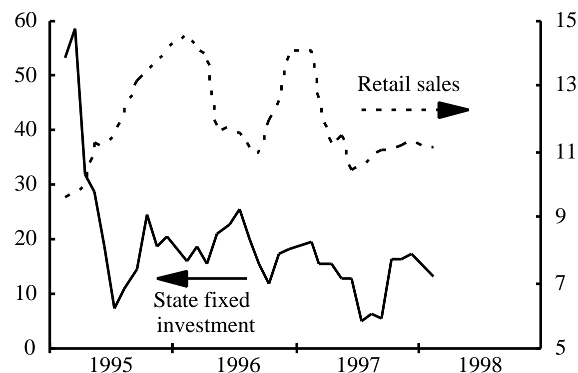
China: trade performance

%oya, US$ terms, 3-mo. mov. avg.



China: real domestic demand

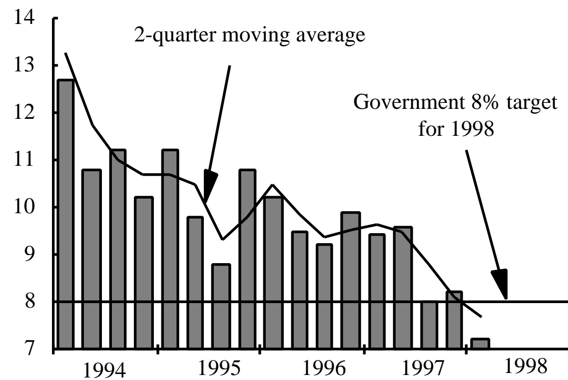
%oya, 3-month moving average



- China has learned a lesson from its crisis-ridden neighbors: Reforms are the best way to avoid a future economic crisis. Its resolve to push ahead with reforms shows in the lineup of the new leadership.
- Still, the challenges should not be underestimated. China is feeling competitive pressure from its Asian neighbors already and will feel it harder in the coming months. Meanwhile, the domestic demand boost from interest rate cuts is fading.
- Even so, China has ruled out currency devaluation for now, opting instead to encourage investment in infrastructure and mass residential housing. This thrust, while cushioning the ongoing economic downturn, may not be sufficient to boost growth to the 8% pace promised by Premier Zhu Rongji.

China: real GDP growth

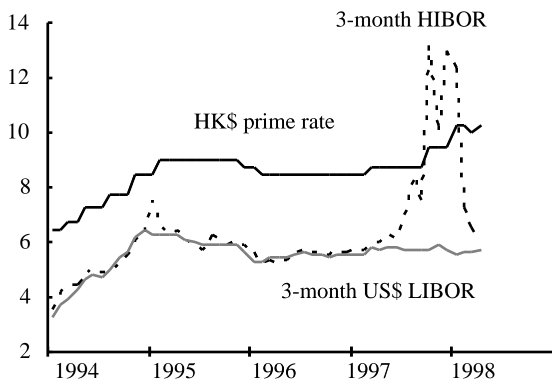
%oya, quarterly



Hong Kong's economic adjustment to continue

Interest rates

% p.a.



- HIBOR has eased significantly. But it has not converged to U.S. LIBOR, as a result of regional uncertainties and market concerns about the peg's vulnerability to either a renminbi depreciation or underperformance by the mainland economy. And the risk premium may not disappear any time soon.
- And the pain of the liquidity squeeze is showing up: financial activities have dried up, the property market remains in the doldrums after prices plunged 30% and retail sales are on a nose-dive. Indeed, the economic adjustment may be more severe than the market has recognized and lead to a recession.

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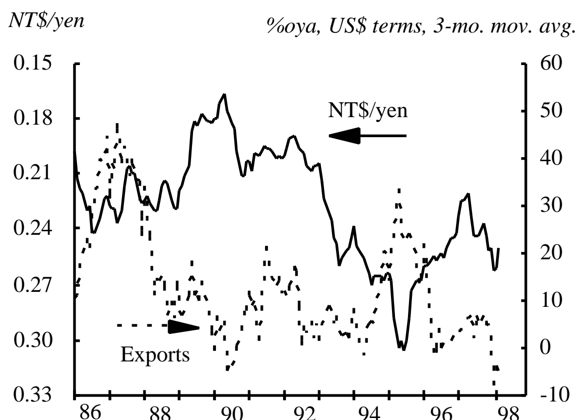
Taiwan starts to feel the impact of the harsh times elsewhere in the region

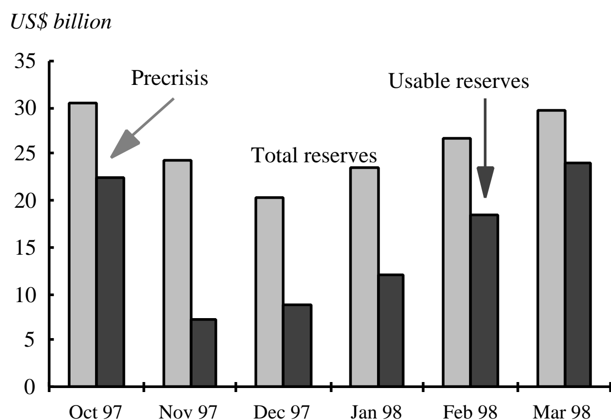
Taiwan: exports and NT$/yen rate



- The weakness of the Japanese yen is putting new competitive pressure on the Taiwanese economy whose exports have not performed well lately. Their poor showing, together with possible capital outflows, may tilt the NT$ further downward against the greenback in the coming months.
- The consolation for the overall economy is that growth has been led by domestic demand for quite some time already.
- Fortunately too, there is little risk of a financial crisis, spawned by a market bubble or cross-straits relations, such as would undermine domestic demand.

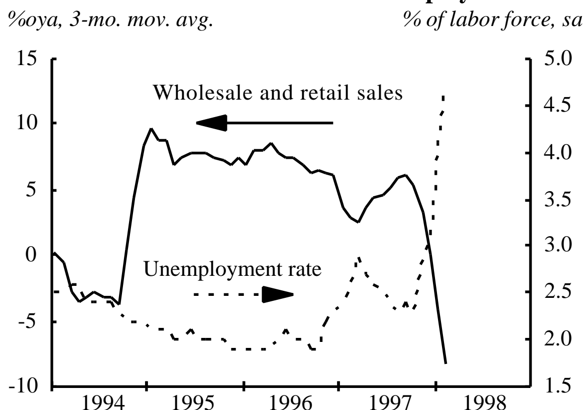
South Korea: pain of adjustment to intensify

South Korea: foreign exchange reserves

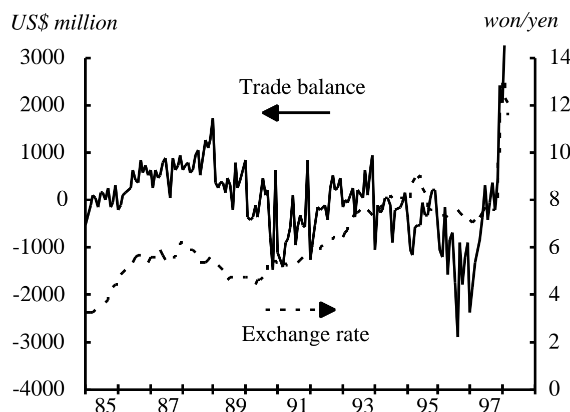


- Korea's external position continues to improve: Usable reserves have risen to US$24 billion (and likely higher after the US$4 billion bond issue) from the crisis low of US$6 billion, thanks to IMF-bailout disbursements and the US$8.6 billion trade surplus recorded in the first three months of this year.
- Still, economic prospects remain dim, especially near term: More and more small and medium-sized firms are falling over the edge, creating 10,000 new jobless every day and depressing sentiment. And the *chaebols*, which have done little to restructure as yet, will have to face the music down the road.
- The corporate sector's restructuring will be even more painful if the Japanese yen weakens sharply from the current level.

South Korea: domestic sales and unemployment

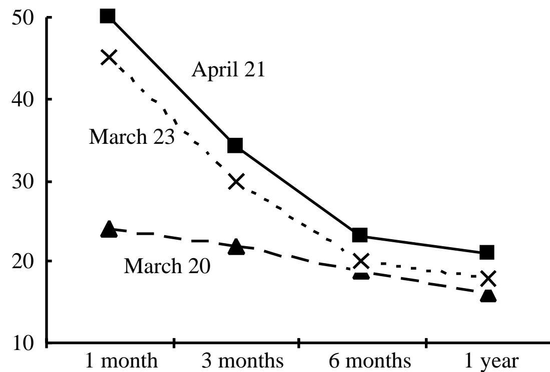


South Korea: trade balance and won/yen rate

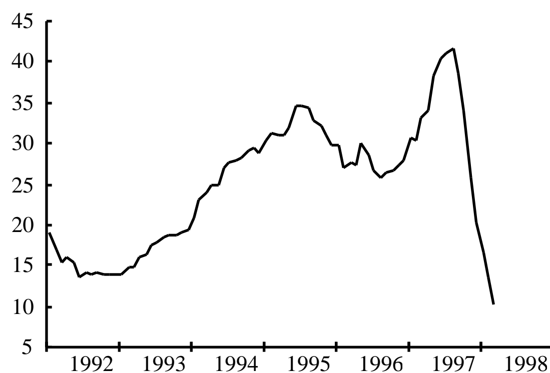


Indonesia: reform program finally starts to take shape, while the economy deteriorates

Indonesia: SBI yield curve
percent p.a.



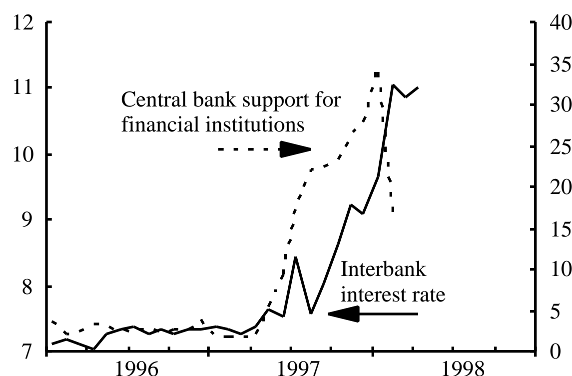
Indonesia: car sales
'000 units, sa, 3-month moving average



- President Suharto's reelection and the announcement of a third iteration of the IMF program helped rally the rupiah beyond the IDR/$8,000 level – but supported too by sharp increases in interest rates, and speculation that even higher rates are coming.
- The third IMF-supported policy program builds on the January 15 letter of intent, and adds a vague framework for tackling the foreign-currency debts of Indonesia's corporate sector. That framework, refined in talks between foreign banks and a contact group of creditors, could let Indonesian companies swap dollar debts for rupiah debt, based on a specified exchange rate and interest rate. Details of this voluntary hedging mechanism have yet to be worked out, so concerns will persist about how the US$60 billion plus external debt problem will be resolved.
- Generally, the president and policy team have made the right noises about the reform agenda ahead. This week's hike in interbank interest rates and the spate of policy announcements covering everything from lifting of the palm oil export ban to progress on privatization plans are encouraging. However, a market made skeptical by past reversals will monitor the next months of the reform process closely.
- Meanwhile, the devastating economic impact of the crisis continues. Indicators like car sales give a sense of the collapse of domestic demand, while inflation (led by food prices) has soared to the 40% level.

Malaysia: piecemeal reform dogs sentiment

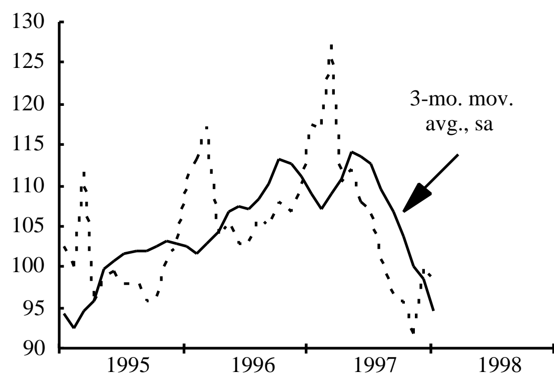
Malaysia: interbank conditions
percent p.a *RM billion, eop*



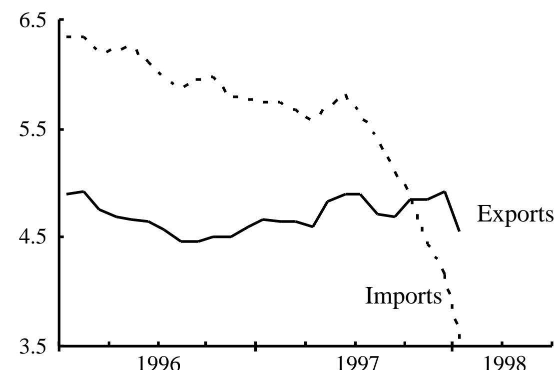
- For Malaysia, external trade continues to slow on both the export and import sides of the ledger. The country's exports are particularly vulnerable to regional weakness (28% of exports stay within ASEAN), while the slowdown in imports reflects worsening domestic demand conditions.
- Despite the central bank's initial reluctance to raise interest rates, troubles in the banking sector (due to asset deterioration) and a chronically tight interbank market have prompted it to step up liquidity injections.

Thailand continues to feel the pain, but policymakers remain determined

Thailand: manufacturing production
1995=100



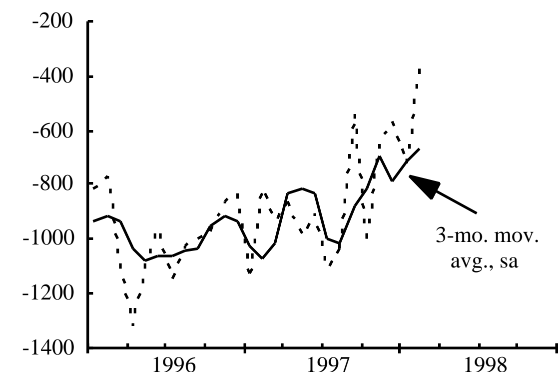
Thailand: merchandise trade
US$ billion, 3-month moving average



- Macroeconomic data releases continue, relentlessly, to reveal the real economic aftermath of the currency and financial crisis. Manufacturing production continues to trend down, though there are signs that declines in the level of output may slowing.
- The trade accounts keep building on the remarkable improvements begun soon after the baht devaluation. Unfortunately, exports have yet to show any significant gains. Instead, collapsing imports, reflecting domestic demand conditions, remain the driving force behind the trade adjustment story. The unknown here is the degree to which trade financing difficulties are depriving key export industries (like electronics and textiles) of imported inputs. Beyond this, with close to 50% of exports shipped within Asia, the export outlook remains cloudy.
- Importantly, Thai policymakers continue to impress with their commitment to the reform process. Recently, two more items were crossed off its financial restructuring timetable. First, the 1940 Bankruptcy Law was amended in a generally “creditor friendly” way. Second, a new set of bank rules for loan-loss provisioning and the accounting treatment of interest income significantly tighten banking standards. The next items on the timetable include continuing to recapitalize healthy banks and auctioning the core assets of the 56 closed finance companies.

Philippines: export strength and lower interest rates heading into the elections

Philippines: trade balance
US$ million



- The trend toward balance in merchandise trade is distinctive in the Philippines because, unlike those of other ASEAN economies, its exports grew robustly throughout 1997.
- Upward pressure on agricultural prices (related to weather vagaries) and energy prices (due to recent oil price deregulation), plus pass-through from the peso’s depreciation, keep inflation a rising concern.
- Nevertheless, the authorities have brought interest rates down almost to their precrisis levels (and just in time for the May 11 presidential elections).

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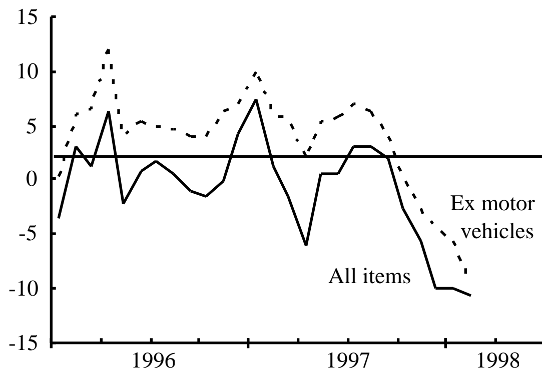
Singapore: the slowdown has arrived

Singapore: retail sales

%oya, 3-month moving average

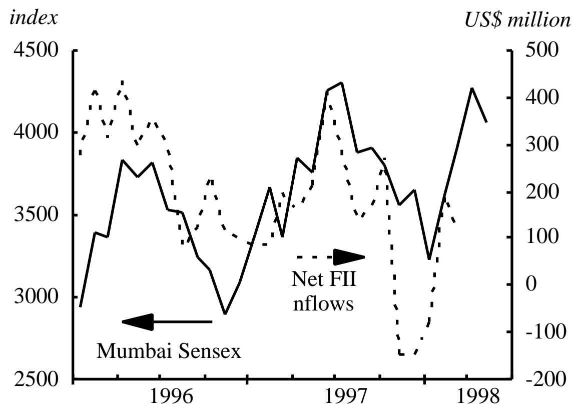


- Data released in the past quarter show that the chill from the region's misfortunes has given Singapore's real economy a cold. Retail sales have been contracting at an alarming rate since October 1997.
- Export growth has also been sluggish, primarily due to Singapore's large exposure to the region.
- Monetary policy should stay accommodative to moderate sharp asset price deflation. Consequently, it is quite likely that the monetary authority will intervene to keep interest rates from rising too fast.

India: economy encumbered by strong rupee, huge fiscal deficit, and weak government

India: stock market and portfolio inflows

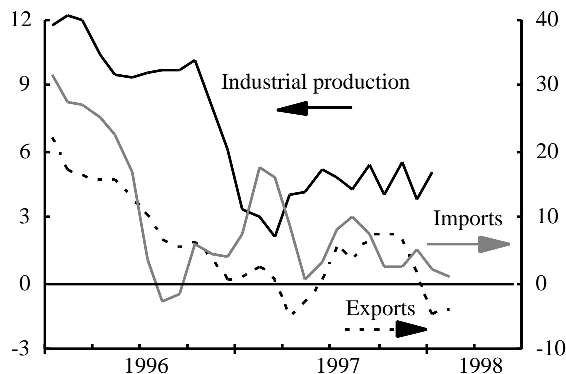
index *US$ million*



- The equity market has soared in anticipation and since the advent of the new national government, which is seen mostly as business-friendly.
- The ruling coalition, however, may be too fractious and bent on survival to mount a coherent and forceful economic program.
- The economy continues to struggle against the burden of an overvalued rupee. Hopes for better growth this year hinge on some correction on that front along with easier monetary policy.
- The dilemma for the government is how to conjure a budget next month that convincingly narrows the deficit (6% of GDP at the center last fiscal year) without derailing the economy anew.

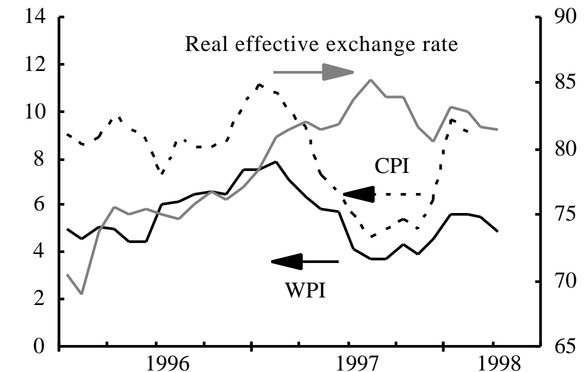
India: industrial production and external trade

%oya, 3-mo., mov. avg. *%oya, US$ terms, 3-mo. mov. avg.*



India: inflation and real exchange rate

%oya *1990=100*



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Australia and New Zealand feel Asia's pain

- **The Asian crisis is moderating growth**
- **In Australia, low interest rates are partly cushioning the external drag**
- **New Zealand is saddled with high interest rates due to its substantial current account deficit**
- **An easing in domestic demand and benign inflation could allow interest rates to fall**

Key forecasts

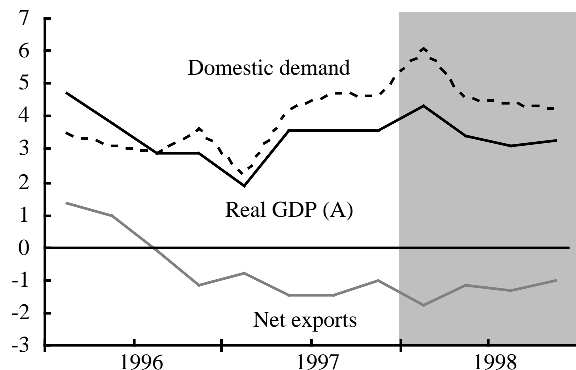
calendar years, except government balance: years ending June 30

	1997	1998f	1999f
Australia			
Real GDP (%oya)	3.1	3.5	2.9
Consumer prices (%oya)	0.3	1.0	2.2
Current account balance, % of GDP	-3.4	-5.0	-4.1
Government balance, % of GDP	0.5	2.1	1.5
New Zealand			
Real GDP (%oya)	2.8	2.7	3.0
Consumer prices (%oya)	1.2	1.4	1.5
Current account balance, % of GDP	-7.5	-7.1	-5.8
Government balance, % of GDP	2.0	1.5	1.8

Economic growth will slow...

Contributions to real GDP growth

percentage points over year ago



- Tight fiscal policy, a poor international environment for exports, and a muted housing upswing appear to be offsetting the boost from low interest rates.
- Moreover, domestic demand will slow as the boost fades from last year's interest rate cuts.
- Exports will be a drag, although the A$'s depreciation will cushion the blow somewhat. To the extent that volumes hold up, export prices will be lower.
- Deteriorating business and consumer sentiment will hurt spending, investment, and hiring.
- J.P. Morgan forecasts the pace of GDP growth to ease during the course of 1998 – from over 4%oya in the first quarter, to around 3%oya in the fourth.

...and the inflation outlook is improving

Private sector wage settlements

percent average annualized wage increase

- Inflation will remain surprisingly low.
- Wage settlements under enterprise agreements, which cover one-third of the workforce, are moderating in response to low inflation expectations and moderate demand for labor.
- The wage cost index, recently introduced, reported a modest rise of 0.8%q/q in fourth quarter 1997. This points to no boost to inflation from wages.
- The pass-through to consumer prices of the near 8% rise in import prices to-date will be restrained by intense competitive pressures.

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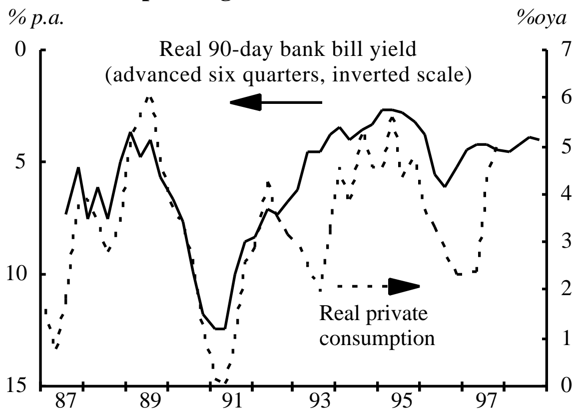
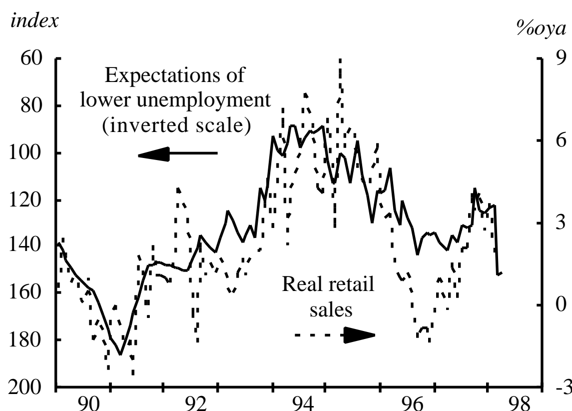
Consumer spending is the key to growth

Consumer spending and interest rates

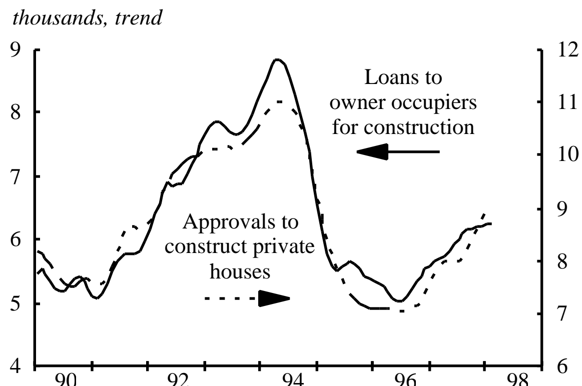


- The consumer's contribution to growth will provide a partial offset to the external drag. Interest rates remain supportive but a slower job gains and plunging confidence could derail private consumption.
- Demutualization of AMP – Australia's largest insurer – around midyear will give households windfall gains which could lift private consumption by up to 0.5%.
- Despite record affordability, the upswing in residential construction is likely to remain modest by past cyclical standards, adding little to construction jobs, spending on household goods, or purchases of building materials. Significantly lower immigration has cut underlying demand for housing.

Retail sales and unemployment sentiment

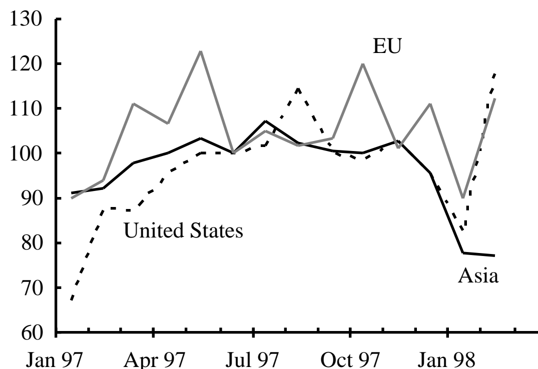


Indicators of residential construction



Decline in exports to Asia is offset by gains to Europe and United States

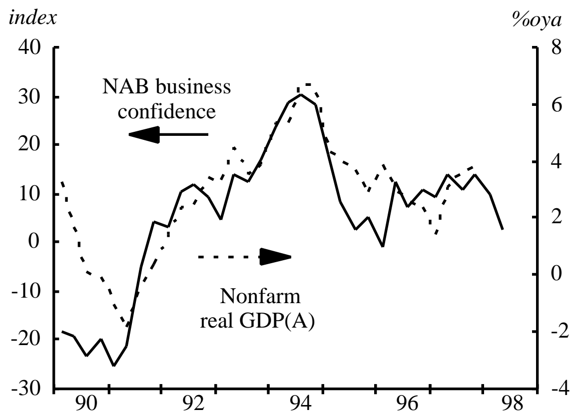
Merchandise exports



- Exports to Asia have declined but a boom in exports to Europe and the United States are providing a partial offset, assisted by the lower A$.
- Inbound tourism is down 14% on a year ago, mainly because Asians have slashed discretionary spending.
- So far, exports of nonrural commodities remain at a high level, likely buoyed by increased sales to Asia.
- However, business surveys report a plunge in export orders for manufactured goods, alternative markets for which will be difficult to find.

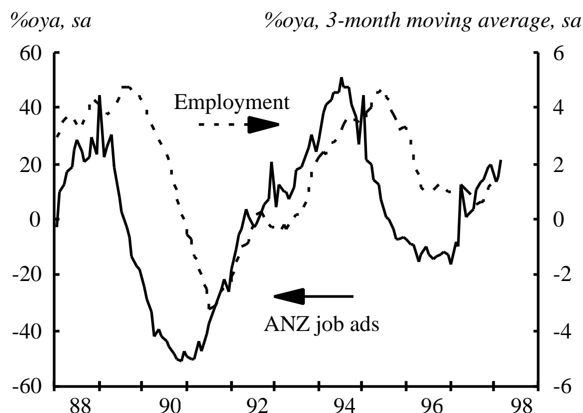
Business conditions moderate and employment stalls

NAB business confidence

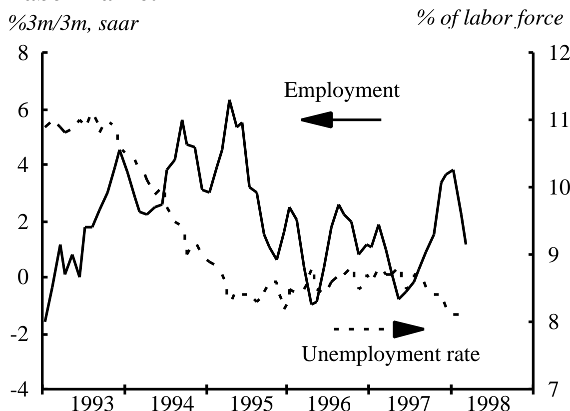


- Business conditions moderated in the first quarter. While interest-rate-sensitive sectors like retailing were relatively resilient, activity weakened in mining, manufacturing, and recreational services.
- Business confidence about future conditions plummeted due to rising concern that the Asian crisis will significantly hurt sales.
- Job vacancies remain high and consistent with employment gains sufficient to reduce unemployment modestly further. Yet actual job gains have stalled, suggesting that poor business confidence is affecting hiring or that the pace of economic growth likely stepped down a few gears.

Leading indicator of jobs

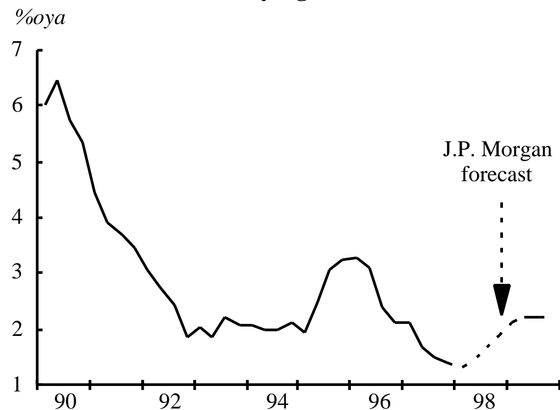


Labor market



RBA has flexibility to cut rates if demand stagnates

CPI inflation – underlying



- The RBA is likely to steer a steady course on monetary policy, allowing the lower A$ to bear the brunt of the hit from Asia.
- However, the likelihood of inflation projections remaining below 2%oya provides the RBA with a great deal of flexibility to cut interest rates should domestic demand stall and unemployment rise.
- The case for another rate cut would be enhanced by a “tight” Federal budget in May and a Fed ease in the United States.

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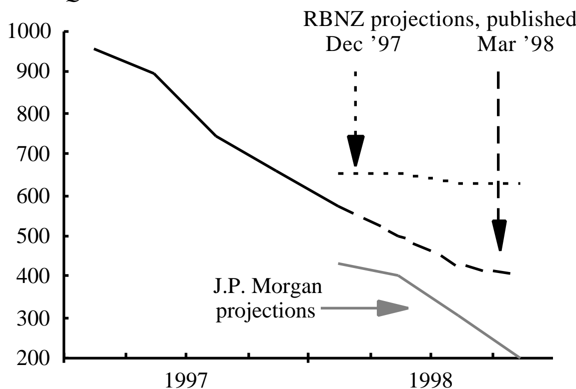
New Zealand's growth prospects are hurt by Asia and high interest rates

New Zealand: output gap

% of GDP

New Zealand: monetary conditions

1996 Q4= 1000



- The outlook for growth in 1998 has deteriorated following intensifying headwinds from Asia and sustained high interest rates.
- International demand prospects for New Zealand's exports have worsened in view of the sharp and ongoing contraction in Asian imports.
- Signs are emerging that domestic demand is beginning to slacken due to high interest rates and the slide in confidence.
- Residential construction is likely to dip, and house prices are expected to come under pressure – indeed some regions may experience outright declines. With household debt at an all-time high, interest rates recently having risen, and house prices possibly to fall, consumer spending will likely weaken.
- Apart from some temporary and limited boost from higher import prices, inflation will remain benign so long as economic growth remains below trend.
- The driver of the NZ$'s sharp fall is the rising current account deficit, which exceeds 7.5% of GDP. Still, while the figures will remain bleak for some time longer, the deficit should top out before long.
- True, exports will continue to weaken as Asian demand contracts, but import volumes should ease as business and household spending moderates. In turn, the worst news on the current account deficit may be history by second half 1998.

RBNZ will need to ease monetary conditions more aggressively

Monetary conditions index (MCI)

J.P. Morgan projections

	Bank bills, 90-day, % p.a.	NZ$ units/US$	Trade-wtd.	MCI
Apr 23,1998	8.8	0.56	59.9	420
June 1998	9.5	0.53	58.8	402
Sep 1998	8.5	0.53	58.8	302
Dec 1998	7.5	0.52	58.8	202
Mar 1999	7.5	0.53	59.4	253
Jun 1999	7.5	0.54	60.0	304
Sep 1999	7.5	0.55	60.5	346
Dec 1999	7.5	0.56	61.4	420

- The central bank's Monetary Policy Statement on May 26 is likely to sanction a further easing in monetary conditions.
- J.P. Morgan expects the monetary conditions index to fall a further 200 basis points by year end.
- The NZ$ is likely to provide most of the easing initially, but a topping out of the current account deficit will eventually allow interest rates to decline.
- Moderating domestic demand and household borrowing is the key to lower interest rates.

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Financial market implications

The going gets tougher after the first bounce

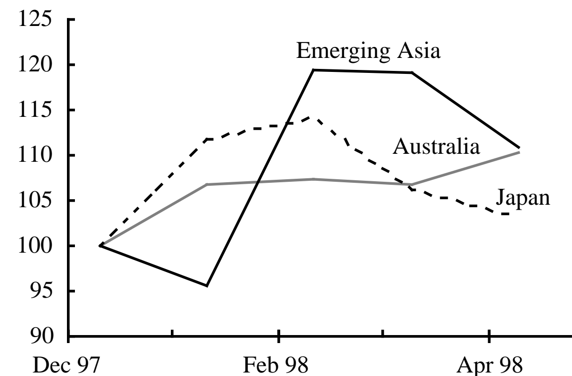
- **Fresh capital inflows in late January and February caused many markets to surge**
- **But the next moves up will be a bigger struggle, depending on concrete signs of reform progress**
- **The Philippines and Thailand are set to do best**
- **Interest rates in Japan will stay low or fall even further, but that will not help the stock market**

Most Asian currency and stock markets have performed better than expected over the last three months. Two factors have driven the turnaround: positive policy announcements, especially the "Korean bank deal," and bargain hunting by foreign investors at the start of the New Year. In the equity markets, Southeast Asia and Hong Kong were the clear leaders (see also page 50), while Korea followed by Thailand performed best in the credit markets. Although strong, the rally was not long-lived and market conditions have started to weaken again. Key factors here are the poor showings of the Japanese economy and stock market and the growing concern over the implications of a Japanese recession and a weaker yen for the rest of the region.

Still, Japan is not the whole story. To be sure, current account and private-sector debt adjustments and the absence of runaway inflation will prevent new financial meltdowns, with only Indonesia still at risk. Nevertheless, markets will feel the huge funding burden of recapitalizing the region's insolvent banks (see also page 5). Given the sheer size of recapitalization needs and the limited domestic resources, foreign participation will be key and hence too will be investors' perception of reform progress. Here, Thailand is likely to score the best, while Indonesia, Malaysia, and even South Korea are well behind. Well placed also is the Philippines due to its lack of severe banking problems. And although the economic impact of the regional crisis on Hong Kong and Singapore has become larger than expected, the market outlook for both city states is also brighter, thanks to their stronger fundamentals and banking systems.

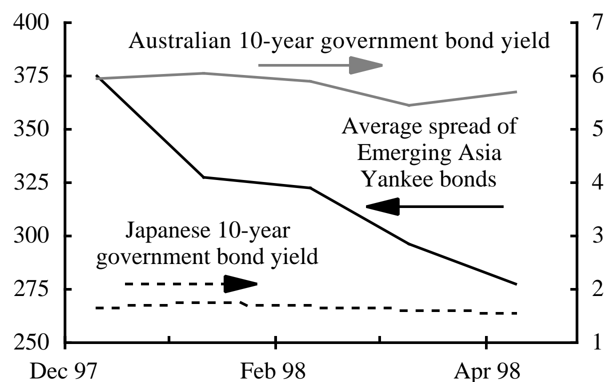
Stock markets

Dec-97=100, US$ terms, eop



Bond yields and spreads

basis points over 10-year U.S. Treasuries *% p.a.*



But what applies for most markets in the rest of Asia is also true for Japan. The new fiscal boost will lift growth in the second half but do little for Japan's structural problems, especially in the banking sector, and the recovery is set to wither again in 1999. Thus, growth, inflation, and interest rates will continue to dance around zero, undermining both the Nikkei and the yen. In contrast, Australia continues to offer better prospects. In its case too, the hit from Asia is likely to be stronger than originally expected and may trigger another rate cut. But the economy is otherwise in good shape and inflation remains under control, which bodes well for both bonds and stocks.

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Foreign exchange and interest rates

- **Yen may stabilize into June but still trend down**
- **As crisis recedes, local fundamentals become key to direction of Asian markets**
- **Pace of central bank easing is key to the outlook for the A$ and NZ$**

Japan

The dollar's uptrend against the yen reflects the weak state of Japan's domestic economy and lack of value in domestic asset prices. The Asian crisis has added to the already large bad loan book of the Japanese financial houses, and their failure to mark loan losses to market makes it difficult to determine firm value properly. The exporting sector is enjoying a foreign order boom but the bottom-line benefit has been muted by weak domestic demand. Despite the Nikkei's slump, it is still not clear that a bottom is in place. Poor capital gains potential and low yields remain a strong incentive for Japanese investors to continue investing offshore. The widening current account surplus alone will not suffice to shore up the yen.

Although Japan's fiscal package does not begin to address the structural problems in the economy, the yen downtrend should temporarily abate into mid-May. Japanese investors have been an important source of dollar demand and they are likely to become inactive during Japan's "Golden Week" holidays. The rangebound market is expected to continue through the mid-May G-7 summit as concern of concerted official action to cap the dollar will temper the bulls.

However, no shift in the G-7 indifference to the dollar is expected. The Clinton Administration is not likely to shift away from its strong dollar bias until the U.S. unemployment rate starts trending up – that is, not until late in the year. Hence, the yen downtrend is expected to reemerge by late May and continue well into the second half of the year. A true reversal of the yen downtrend can only occur if expectations of a sustained Japanese recovery get priced into the market. But, this should become apparent in a Nikkei rally and a steepening of the front end of the yield curve before it begins to help the yen (chart on top of next page).

Exchange rate and interest rate forecasts

	Actual	Forecasts	
	Apr 23	3 month	12 month
US$ exchange rate			
Germany	1.79	1.78	1.65
Japan	130	140	142
Australia	1.53	1.56	1.45
New Zealand	1.79	1.89	1.85
China	8.28	8.30	8.32
Hong Kong	7.75	7.75	7.76
India	39.7	42.1	44.0
Indonesia	7970	8000	8500
Malaysia	3.78	3.83	4.00
Philippines	38.4	34.0	32.0
Singapore	1.59	1.60	1.55
South Korea	1368	1400	1300
Taiwan	33.0	34.0	30.0
Thailand	39.1	38.0	37.0
3-month interest rate*			
United States	5.79	5.62	5.40
Japan	0.68	0.55	0.65
Australia	4.80	4.85	5.20
New Zealand	8.37	6.75	6.50
China	7.70	9.00	9.00
Hong Kong	5.75	6.30	6.15
India	14.68	19.50	18.00
Indonesia	39.80	35.00	40.00
Malaysia	12.75	13.50	14.50
Philippines	18.67	16.50	16.00
Singapore	5.87	5.90	5.40
South Korea	28.76	24.00	18.00
Taiwan	7.45	7.85	7.00
Thailand	18.12	17.50	13.00
10-year government bond**			
United States	5.71	5.55	5.25
Japan	1.53	1.70	1.50
Australia	5.71	5.55	6.00
New Zealand	6.80	6.75	6.50

* % p.a., United States, Japan, Australia, and New Zealand are deposit offer rates, all others are midlevel offshore money market rates.
** % p.a., based on local convention.

Morgan sees little chance of a Bank of Japan rate hike this year. Indeed, the credit-risk premium being priced into short-term interbank rates is an additional incentive for the Bank to keep the discount rate low. Bonds, like the yen, should enter a directionless period over the next month and yields are likely to move up while the fiscal package temporarily boosts the activity indicators. But, the rally should resume over the summer as the limited impact of the stimulus becomes apparent and inflation continues negative. By year end, 10-year JGBs are expected to be retesting the 1.5% low.

Emerging Asia

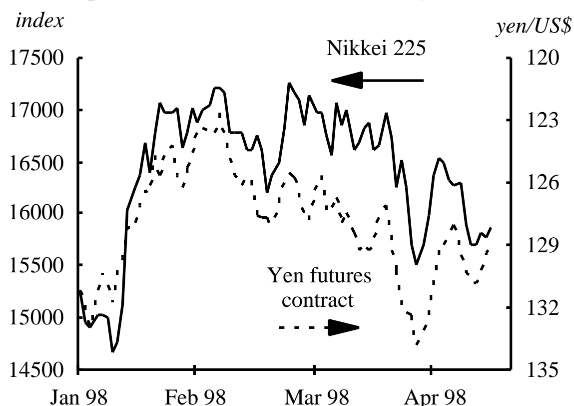
Some common themes prevail across the Asian emerging markets. On the positive side, IMF programs are being implemented and inflation remains well behaved. On the negative side, insolvency and default are universal and financial restructuring is, at best, in its early stages. Exports have responded only marginally to the currency devaluations so the constraints on current account performance continue to force governments to clamp hard on domestic demand and growth.

The absence of a sustained recovery in Japan is not good news for Asia since Japanese demand is a key driver of regional trade volume. Indeed, concern is building that the downtrend of the yen will spread to the region's other currencies. Still, the risks of an "Asia wave II" are fading. Low inflation has kept the depreciations from evaporating in real terms. Global monetary conditions are easier than a year ago and no rate hikes from the Fed, Bank of Japan, or Bundesbank are expected until at least the third quarter. And the huge long positions in local currencies created during the fixed-rate era are now largely gone, eliminating the key source of selling in last year's crisis.

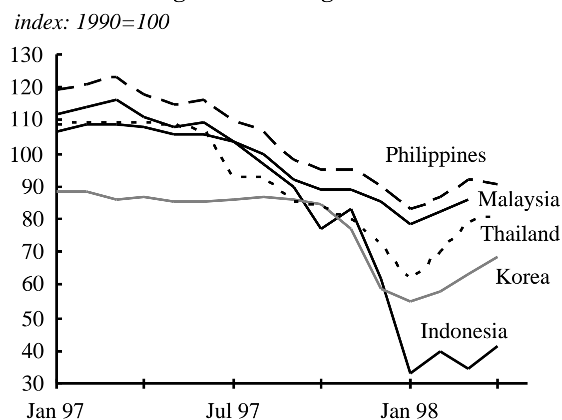
One crucial fundamental is that, even after nominal rebounds from earlier troughs, most of the region's currencies stand extremely low in real terms (second chart). Given the improved inflation outlook, this suggests that the bias will be for the currencies to remain stable to stronger. But the potential for appreciation will be limited by the severe contraction of local demand and the pervasive solvency problems. Tight monetary policy has helped to stabilize exchange rates but at the expense of high short-term interest rates and inverted yield curves (bottom chart). As high interest rates are exacerbating debt insolvencies, central banks will probably take advantage of low inflation to cut rates in response to any significant exchange rate gains. This points to a general condition of stable exchange rates and flattening yield curves.

As the state of panic fades from Asia, correlations are breaking down within the region. So while Morgan expects the general pattern of firm currency and flatter curves to prevail, performance will not be uniform. Thailand has made the greatest strides at addressing

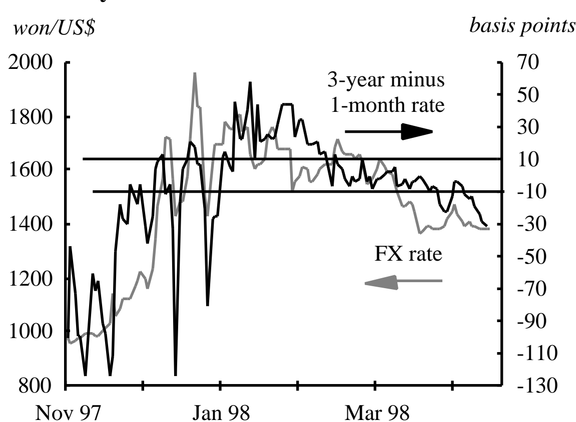
The Japanese stock market and the yen



Real trade-weighted exchange rates



Korean yield curve and the won



structural problems – indeed, it is becoming the paragon – and the general pattern is apt to be particularly pronounced in its markets. The baht's rebound has eroded a substantial portion of its previous real decline

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and the central bank appears to prefer to hold the currency to the weak side of the 38-39 area. So, it should continue cutting short-term interest rates whenever the baht pushes this sensitive region.

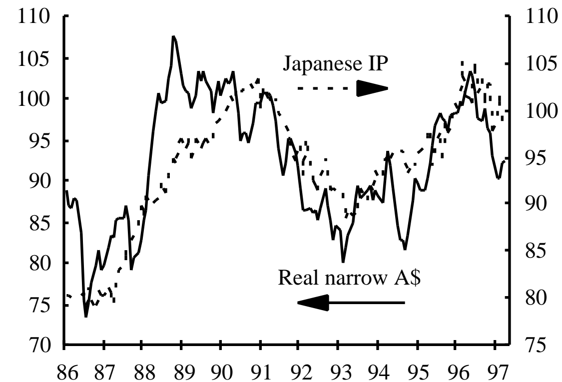
While the Philippines' prospects also look positive, short-term interest rates and the peso are likely to remain under pressure into the May 11 national election. But the market is exaggerating the risk that the likely winner, Mr. Estrada, will abandon the policies of reform. Hence, a sharp drop in rates and a surge in the peso will probably occur shortly after the election.

Korea, while moving in the same direction, is far behind Thailand in restructuring and deregulating financial markets. Moreover, Korea and Taiwan are the two countries most vulnerable to yen weakness. Hence, the prospects for the won are more mixed – it could well move back toward 1450 if the dollar breaks above ¥150. However, once the yen downtrend abates, the won should gradually recover and Korean short-term interest rates likely would drop sharply.

Indonesia and Malaysia are the regional laggards in the reform process. Indonesia's abandonment of the currency board concept and recent willingness to cooperate with the IMF are positive signs. However, the process of restructuring insolvent corporates and local banks is just beginning. And, the proposed "ficorca" may prove to be a dodge to delay reform and subtly funnel government support to favored projects. The rupiah remains severely undervalued even if inflation achieves Morgan's forecasted 55%, so the rupiah is likely to have a firming bias over the next few months and to dramatically outperform the forward curve. However, short-term interest rates will be relatively slow to come down. Malaysia is even earlier in the restructuring process and has used price controls to suppress headline inflation. Since the government appears reluctant to accept the domestic consequences of higher interest rates, the ringgit is the most vulnerable to decline of the main Emerging Asian currencies.

There is little risk of a Chinese devaluation even if the yen moves sharply lower. China's foreign exchange reserves and bilateral surplus with the United States continue to grow. A devaluation ahead of Clinton's June visit would be confrontational and would jeopardize China's pending WTO membership. Absent a yuan plunge, there is little risk of the HK$ peg breaking, although sporadic speculative pressure on the long end is expected, especially if the dollar moves sharply higher against the yen. Finally, the S$ is vulnerable to weakness because of both its attractiveness as a funding vehicle within the region and Singapore's close economic links to Malaysia and Indonesia.

Japanese industrial production and the A$
index: 1990=100



Australia and New Zealand

A global environment of disinflation does not bode well for currencies that historically have had a strong link to commodity prices. Like those of their Asian neighbors, Australian and New Zealand exports are very sensitive to the Japanese economy. So, the prospect of prolonged weak Japanese growth also does not bode well for these currencies.

Though both the A$ and NZ$ are likely to trend lower, as will the yen, it appears that a period of consolidation and retracement is emerging. The fact that both currencies are nearing decade lows should slow their declines and any reversal of the yen would also be constructive – especially if it reflected optimism on Japan's economy. In addition, the gold price rebound above $310 should also be a temporary source of support. However, in parallel with the general Asian pattern, weak domestic demand, labor strife – particularly in Australia – and low inflation imply that the Reserve Banks in both countries will be quick to take advantage of currency strength to cut rates.

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Equities

- **Markets have outperformed expectations over the last three months, but their upside is limited**
- **1998 earnings outlook has further deteriorated and valuations are not always attractive**
- **Banks' recapitalization need is another burden**
- **The Philippines and Thailand, followed by Hong Kong and Singapore, are set to perform best**

The outlook for Asian equity markets for the next 12 month is mixed, especially following the bounce at the beginning of the year. Markets have performed much better than expected since the mid-January publication of the last issue of *Asian Financial Markets*, but exhibit a clear divergence in performance. Southeast Asia and Hong Kong clearly outperformed the rest of North Asia and Japan, both in local currency as well as in U.S. dollar terms.

The rally was mostly driven by foreign investors, who have been heavily underweight in the Asian markets and were looking for cheap opportunities at the beginning of a new investment year. Indeed, investors have been very selective, looking for companies with strong franchise values that were trading below replacement values. Also contributing to the market rally has been the turnaround in the currency and interest rate markets, following positive policy announcements.

Equity market moves since mid-January
% change since last Asian Financial Markets, *Jan 15 to Apr 23*

	Local currency	US$ terms
Hong Kong	27.3	27.1
Indonesia	27.1	41.9
Malaysia	19.5	36.9
Philippines	26.8	37.7
Singapore	21.3	34.1
South Korea	-17.6	-3.4
Taiwan	10.9	14.3
Thailand	17.3	55.2
Japan	4.2	5.0
United States	18.9	18.9

The climb from here will get tougher

Since the rally in late January and early February, however, markets have lost momentum and have started to soften again over the last few weeks – most notably in Malaysia and South Korea. Some of this reflects the poor performance of the Nikkei and concerns over the implications of a Japanese recession for the rest of the region. Still, developments in Japan are only one of many drivers.

Estimates of earnings growth have been revised down across the board. With the possible exception of Taiwan, levels of earnings are expected to drop this year. In Indonesia, the risk is even for aggregate net losses. Malaysia aside, where the government is still trying to resist the economic adjustment, earnings are expected to rebound in 1999. But for most countries that recovery is unlikely to offset earlier declines, leaving earn-

Top-down earnings and valuation fundamentals

	Hong Kong	Indonesia	Malaysia	Philippines	Singapore	South Korea	Taiwan	Thailand
Earnings growth* (%)								
1997e	3	0	0	1	5	-34	7	-36
1998f	-14	-86	-36	-7	-9	-69	1	-48
1999f	17	151	-3	21	7	92	9	93
Implied P/E								
1997e	12.0	11.5	10.7	12.1	15.2	20.0	26.4	9.5
1998f**	14.3	103.5	17.7	15.0	14.7	71.1	27.4	20.7
1999f**	12.2	41.2	18.3	12.4	13.8	37.0	25.2	10.8
7-year average P/E	13.0	18.3	21.1	20.4	20.1	21.8	24.2	17.3
Fair-value P/E* **	13.1	18.2	16.3	18.2	15.1	13.9	17.0	15.3

* Top down earnings are defined as: (nominal GDP times operating margins) minus (domestic interest rates times private domestic credit) minus (foreign currency interest rates times exchange rate times private foreign debt) minus (depreciation rate times capital stock).
** Current index over expected earnings.
*** Based on discounted value of long-term earnings potential (see *Asian Financial Markets*, Jan 16, page 42).

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ings levels still depressed. Given current prices, P/E valuations for 1998 are attractive only for the Philippines and Singapore, with Hong Kong and Thailand joining the club in 1999. In contrast, valuations for the rest of the region seem very unattractive for both 1998 and 1999.

Besides earnings and valuation fundamentals, supply and liquidity conditions will be two important drivers of the region's equity markets. On the supply side, the main factor will be banks' recapitalization requirements. Here, the figures range from 20% of GDP in Indonesia and Malaysia to 30% of GDP in South Korea and Thailand (see *Financial restructuring is key to Asia's future*, page 5). And with fiscal and private domestic resources largely depressed, a large part of the necessary liquidity will have to be attracted from foreign investors.

With many earlier bargains now gone, however, foreign participation will increasingly depend on signs of reform progress. Here, Thailand is clearly ahead, while Indonesia, Malaysia, and even South Korea continue to struggle. Investors are also likely to look favorably on the Philippines, which has far fewer banking problems but enjoys one of the region's strongest export growth rates. Moreover, although the outcome of the presidential election in May remains open, the election process has been orderly so far and investor concerns that the economic reform process could be derailed after Ramos are likely to fade.

The 12-month outlook

Based on market fundamentals and expected liquidity conditions, the Philippines and Thailand should produce the strongest returns over the next 12 months. In the case of the Philippines, the expected market returns are even likely to exceed the cost of equity. Hong Kong and Singapore are next in line, with Hong Kong also having a chance to exceed its cost of equity. Both city states have been more adversely affected by the regional downturn than originally expected. Nevertheless, both have strong banking systems and payment fundamentals, which remain a key advantage compared to the more distressed economies in the region.

Market returns in Indonesia, Malaysia, South Korea, and Taiwan, by contrast, are likely to be in the low single digits, which probably implies negative excess returns after subtracting the cost of equity. For Indonesia, Malaysia, and South Korea, a better market performance will hinge primarily on visible signs of reform progress. In Malaysia, public liquidity injections could also help lift the market, but this is likely to be temporary and could actually hurt sentiment if seen by the market as a government effort to bail out existing majority shareholders. Finally, although Taiwan does not suffer the ills of most of its neighbors and has staged a remarkable performance over the last twelve months, its safe-haven status is likely to fade, while its earnings and valuation fundamentals look increasingly stretched.

Market outlook for 12-month horizon

	Hong Kong	Indonesia	Malaysia	Philippines	Singapore	South Korea	Taiwan	Thailand
Index (Apr 23, 1998)	10,919	492	628	2,164	411	417	8,614	427
Earnings growth* (%)	-4.8	-71.2	-28.0	-2.2	-3.9	-47.1	3.8	-18.5
Implied P/E	13.5	68.8	17.9	14.0	14.4	54.4	26.6	15.8
Fair-value P/E**	13.1	18.2	16.3	18.2	15.1	13.9	17.1	15.3
P/E target***	15.7	70.2	18.0	18.2	15.1	56.5	26.0	19.6
Rate of return (%)	14.6	5.6	4.9	29.7	10.7	5.1	2.6	20.9
Discount rate (%)****	12.8	43.1	18.1	23.1	11.2	28.5	12.4	21.1
Excess return (%)	**1.8**	**-37.5**	**-13.2**	**6.6**	**-0.5**	**-23.4**	**-9.8**	**-0.2**

* Top-down estimates.
** Based on discounted value of long-term earnings potential (see *Asian Financial Markets*, Jan 16, page 42).
*** Based on fair-value P/E estimates and expected liquidity conditions. The P/E target is used to derive the rate of return, given current prices and expected earnings.
**** 1-year forward rate plus 5% equity risk premium.

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The regional economic outlook in summary

	Nominal GDP in US$ (1997)			Real GDP % year-on-year				Consumer prices % year-on-year			
	total billion	% of region	per capita 000s	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f
Japan	4193		33.5	4.1	0.9	-0.2	1.5	0.1	1.7	0.1	-0.4
Australia	388		21.2	3.6	3.1	3.5	2.9	2.6	0.3	1.0	2.2
New Zealand	66		18.5	2.6	2.8	2.7	3.0	2.3	1.2	1.4	1.5
Emerging Asia	2846	100.0	1.1	7.5	6.4	1.4	4.9	6.5	4.2	11.1	6.9
China	923	32.4	0.7	9.7	8.8	6.5	6.9	8.3	2.8	0.8	3.0
Hong Kong	172	6.0	26.4	5.0	5.2	-0.6	2.2	6.0	5.7	3.4	3.1
India	373	13.1	0.7	6.8	5.0	5.5	6.5	9.0	7.2	10.0	9.0
Indonesia	212	7.4	1.1	7.8	7.0	-10.0	3.5	7.9	6.6	60.0	25.0
Korea	442	15.5	9.6	7.1	5.5	-3.6	3.5	5.0	4.4	12.5	7.0
Malaysia	101	3.6	4.7	8.6	8.0	-0.5	1.2	3.5	2.7	10.0	6.0
Philippines	83	2.9	1.1	5.7	5.1	1.0	4.7	8.4	5.1	15.0	7.0
Singapore	98	3.5	31.8	7.0	7.5	2.0	3.7	1.4	2.0	3.0	2.8
Taiwan	283	10.0	13.0	5.7	6.8	5.5	5.8	3.1	0.9	3.0	2.8
Thailand	158	5.6	2.6	6.7	0.5	-4.2	3.0	5.8	5.6	15.0	9.0

	Current account balance US$ billion				Current account balance % of GDP				Foreign reserves US$ billion			
	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f
Japan	65.5	97.4	106.0	119.4	1.4	2.3	2.8	3.0				
Australia	-15.8	-13.5	-18.4	-17.2	-4.0	-3.4	-5.0	-4.1				
New Zealand	-2.6	-5.0	-4.0	-3.5	-3.9	-7.5	-7.1	-5.8				
Emerging Asia	-23.8	5.6	60.7	41.5	-0.9	0.2	2.3	1.4	490.9	501.6	538.8	573.2
China	7.2	25.7	10.2	-0.8	0.9	2.8	1.0	-0.1	107.0	140.4	148.9	141.0
Hong Kong	3.0	1.4	2.8	3.1	1.9	0.8	1.6	1.7	63.8	75.1	74.1	77.3
India	-3.7	-4.7	-4.7	-6.1	-1.1	-1.3	-1.3	-1.5	22.4	24.5	26.6	28.7
Indonesia	-8.9	-10.6	6.9	6.2	-3.9	-5.0	7.3	4.3	24.0	20.5	20.5	26.5
Korea	-23.0	-8.6	22.2	13.1	-4.7	-1.9	6.9	3.4	34.0	21.1	41.6	52.6
Malaysia	-5.1	-7.5	-1.9	3.1	-5.1	-7.4	-2.3	3.5	27.0	21.7	17.2	20.2
Philippines	-3.9	-3.4	1.8	-2.2	-4.7	-4.1	2.5	-2.4	10.0	7.3	10.3	12.3
Singapore	14.3	13.7	7.3	9.5	15.2	14.0	7.7	8.9	76.9	82.9	84.9	90.4
Taiwan	11.0	5.1	4.7	6.1	4.0	1.8	1.7	2.0	88.0	81.2	85.7	89.2
Thailand	-14.7	-5.5	11.4	9.4	-7.9	-3.5	7.9	5.6	37.7	27.0	29.0	35.0

	External debt % of GDP, end of period				Short-term foreign debt US$ billion, end of period				Headline government balance % of GDP, end of period			
	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f
Japan									-4.4	-4.2	-4.4	-4.3
Australia									-1.0	0.5	2.1	1.5
New Zealand									3.0	2.0	1.5	1.8
China	17.5	16.9	17.0	17.3	35.2	41.7	48.4	55.5	-0.9	-0.7	-1.1	-1.4
Hong Kong									1.3	4.5	-0.9	-1.6
India	27.8	26.0	26.3	24.5	16.8	17.5	18.3	19.6	-5.0	-6.1	-5.5	-5.0
Indonesia	55.4	63.8	148.2	96.1	41.3	36.8	33.8	33.8	1.0	1.2	-3.0	-2.0
Korea	26.2	33.5	48.9	40.7	75.6	68.4	44.9	46.4	-1.1	-2.3	-3.8	-3.2
Malaysia	40.3	42.8	54.7	47.8	11.2	12.8	11.3	11.3	3.9	2.7	-2.0	-1.5
Philippines	56.6	61.5	72.2	60.1	12.6	12.6	12.6	13.3	-0.1	-1.0	-2.5	-0.5
Singapore									7.0	6.0	2.5	5.2
Taiwan	15.2	15.3	16.5	15.9	28.7	29.2	29.7	30.1	-8.7	-6.9	-6.5	-5.0
Thailand	50.4	63.3	70.3	59.1	37.9	31.9	19.9	20.9	1.5	-1.0	-2.5	-1.0

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