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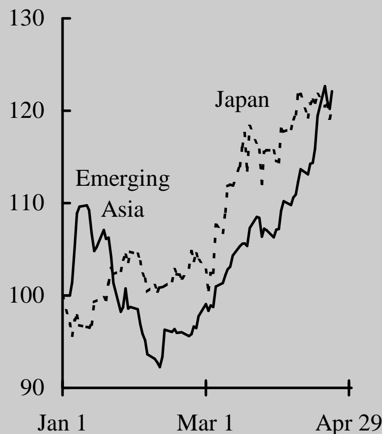
Asian Financial Markets

Second Quarter 1999

Stock markets
Jan 1, 1999=100, local currency terms



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Asia's recovery gathers some momentum

- The news from Asia over the last three months has been largely positive. Financial markets are up strongly and better economic activity reports have led to a number of forecast upgrades – notably for Malaysia, Singapore, and even Hong Kong. Most surprising, however, is the improvement in Japan following the monetary easing in February.

But not everyone will keep up to speed

- Looking ahead, there is good reason to be optimistic for continued recovery where monetary and fiscal stimulus is being combined with structural reform progress. Low and still-falling interest rates play an important role in this process but can also lead to complacency.

- The J.P. Morgan forecast assumes that most countries will stay on the path of reform, although at different speeds. Korea remains the leader (followed by Malaysia, the Philippines, and Thailand), but still must do much to change the behavior of its corporates and facilitate service-sector growth. China and India are destined to slow, but China seems committed to stay on the path of reform, while India has lost its way.

- There also are encouraging signs of restructuring in Japan – notably in the banking sector and among some large corporates. But there are no real signs of life in domestic private demand and the fiscal pump is bound to run out of fuel. Thus, pressure on the BoJ to act could reemerge soon and force it to buy more government debt.

Australia holds up well and New Zealand is having a comeback

- Booming domestic demand let Australia cruise at 5% GDP growth through the Asian meltdown, but its momentum this year will slow. In contrast, New Zealand suffered more from the Asian crisis and domestic policy tightening, but will see some recovery in 1999.

Interest rates to stay low for a long while to come

- On balance, Asia's recovery will be moderate. Thus, current account surpluses will narrow only slowly and inflation and interest rates will stay low for some time. Combined with reform progress, this is good news for equities and credit spreads. Government bond yields should also decline where people have faith that governments can service their debts.

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Executive Summary

The glass is half full, but still has some cracks

- **Signs of economic recovery continue to build in most parts of Asia**
- **Laggers are starting to catch up with leaders**
- **But hopes of recovery in Japan are premature**
- **Also China continues to face strong head winds**
- **Prospects of sustained low interest rates leaves investment opportunities still open despite rally**

Economic and financial conditions have improved in most parts of Asia over the last three months and investor sentiment is visibly on the rise.

- Countries that lagged the stabilization process at the end of 1998 – Malaysia, Singapore, and even Hong Kong – are now starting to catch up with the leaders – Korea and Thailand. Even Indonesia, which remains engulfed by political uncertainties, shows some signs of economic stabilization.

- China has avoided a hard landing, its WTO membership has come within reach, and fears of imminent renminbi devaluation are fading.

- Most eye-catching are the improvements in Japan, however. Financial markets, most notably stocks, have responded favorably to the BoJ easing in February and gains in several economic indicators have raised hopes of recovery.

- The main exception is India, which has fallen back under the burden of rising trade and budget deficits and acute political uncertainties.

To be sure, Asia's market euphoria is supported by Wall Street's continued rally and investors' reduced risk aversion following the benign outcome of Brazil's devaluation. Nevertheless, there is more to the market optimism than liquidity and a boost from Wall Street. Economic recovery on the whole will be moderate and uneven and there may be bumps still to come, but this is the real thing. The main outlier is Japan, whose recent signs of recovery are likely deceiving, while China will continue to face strong head winds as it slowly progresses on the path of structural reforms.

The power and temptation of low interest rates

Some of the output recovery in Emerging Asia is driven by rising export volumes, especially in countries where currencies have dropped sharply and exports have benefited from the upturn in the global semiconductor cycle. This rise in export volumes has led to inventory rebuilding and some new investments.

However, more important for the stabilization and recovery in financial and economic conditions has been the improvement of payments conditions following the shift of current account balances from deficit to surplus. This adjustment quickly removed pressure to cut spending further, stabilized output, and led to steep interest rate declines. Low interest rates are key for restoring financial health, as they reduce the marginal default rate and boost the earnings of both financial institutions and corporates.

Additional stimulus is coming from increasingly accommodative fiscal policies. The challenge is now to combine monetary and fiscal stimulus with restructuring progress, but most especially to avoid the complacency and restructuring paralysis that gripped Japan for so much of this decade. Bank reforms are making good progress, but corporate restructuring, especially asset sales and debt reduction, is slow.

Different methods lead to different results

Comparing reform progress across Emerging Asia shows that different approaches are leading to different results – notably as between Korea and Thailand.

- Korea has taken a hands-on approach, reflecting the extended role of banks in its economy. The government has bought a large chunk of the bad loans and forced many banks to merge or close. This approach, accompanied by stimulative monetary and

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fiscal policy, is already delivering tangible results. Reported nonperforming loans have dropped notably and banks have started to extend new loans. Still, Korea's problems extend far beyond the financial sector. The government seems committed to press ahead within the constraints of social and political stability, but failure to change the role and behavior of the conglomerates could limit overall reform progress and growth prospects.

- In contrast, Thailand has taken a less proactive role after the initial closure of many finance companies, instead leaving it more to the private sector to sort out the problems. This hands-off approach seems appropriate for the Thai case, where most of the country's bad assets are concentrated in the real estate sector, and could lead to more lasting changes. Still, the poor legal infrastructure has retarded progress so far. The recent passage of the foreclosure law and the government's decision to relax fiscal policy through tax cuts augur well for the reform and growth outlook, but more asset sales will be needed to clear and revive the market.

- Malaysia, which did not experience a balance of payments crisis, only started to set up bank restructuring agencies in the middle of last year. Its approach largely follows the Korean model and substantial progress has already been made. However, like in Korea, it remains to be seen whether the restructuring process will be extended to the corporate sector, which has been a key beneficiary of the government's preferential growth policy.

- Indonesia also is trying to follow the Korean model, but is seriously handicapped by the government's limited fiscal means, the public's low faith in the government's credit standing, and the underlying political uncertainties.

Japan lags behind

Although far from complete, reform progress in Emerging Asia is impressive next to Japan's slim achievements. Structural adjustment in Japan is hampered both by a reluctance to shift jobs and write off bad assets and by a jungle of regulations and red tape that prevent the start-up of new companies, especially in the services sector. Bank reform has been kicked off, but has a long way to go to restore financial-sector health. Not surprisingly, large corporates remain pessimistic and look for even steeper cost cuts. Against this background, the government's pump-priming efforts lack any multiplier effect and boost sentiment only in areas that benefit directly from the fiscal handouts. With limited room to boost spending much further, however, the risk of another downturn is a clear and present danger and could force the BoJ to buy more government bonds against its better judgement.

China continues to muddle through

In contrast to Japan, China is using its stimulus policy effectively to keep the economy going and advance structural reforms. Fixing the financial sector and state industries seems nearly impossible and some of the current stimulus just papers over the cracks in the system. Still, China seems committed to continue on the path of reform. WTO membership, which appears to be closer than ever, will increase adjustment pain and could lead to a currency realignment down the road, but will also provide new growth opportunities.

Interest rates to stay low for a long time to come

All in all, while becoming a reality, Asia's recovery is uneven and moderate. This means that current account surpluses will narrow only slowly and inflation and short-term interest rates will stay low for an extended period, especially as central banks will try to keep their currencies competitive. In Korea and Thailand, interest rates have already dropped to historical lows, but there is room for rates to come further down in Malaysia, the Philippines, and even Indonesia.

Low interest rates are not only good news for liquidity but also help raise earnings and asset quality, which is constructive for stock markets and corporate credit spreads, especially in countries that have lagged the recent market rally. Finally, low funding rates should be instrumental in reducing long-term government bond yields, provided people have faith in their governments' policies and ability to service public debt. That faith seems to exist in most of Asia – certainly in Korea and Thailand – but has clearly been shaken in Japan and is currently nonexistent in Indonesia.

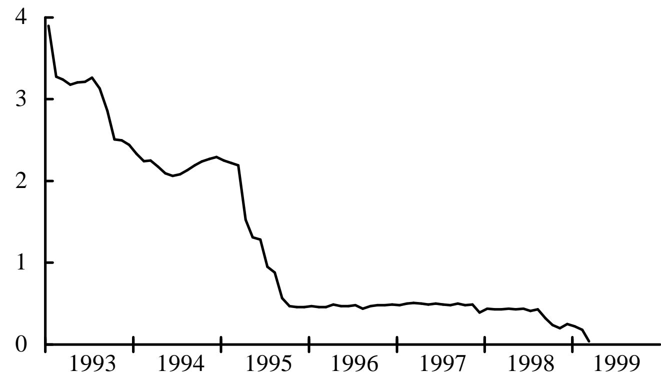
The BoJ's navigation at zero interest rates

- **February easing pushed BoJ into uncharted waters: operating at zero interest rates**
- **Banks' lending attitudes have not improved despite ample liquidity injection**
- **BoJ believes that monetary policy can not put right structural problems**
- **Still, further weakness or signs of deflation will probably force BoJ to buy more government debt**

The Bank of Japan's decision to ease policy on February 12 has opened a new chapter in Japanese monetary policy. With the overnight call rate falling to 0.03% in early March, the BoJ is essentially operating at zero interest rates. (With a brokerage fee of 0.02%, the actual offered rate is 0.01%.) This note describes the BoJ's operations at zero interest rates, the impact on the financial system and the economy, and the policy options still left should further easing be needed.

The BoJ believes that much of Japan's problems are structural and that it has done its utmost to promote recovery. The financial market's favorable response and signs of some recent improvement in the economy allow the BoJ to relax for now. However, renewed economic and financial weakness and sharp price declines remain a clear and present danger and would probably force the BoJ to buy more government debt.

Uncollateralized overnight call rate
percent per annum, average



Background of the latest easing

The minutes of the BoJ policy board meeting on February 12 and previous meetings show that the easing was prompted by growing concern over the weak state of the economy, continuing price declines, the rise of the yen, and the surge in long-term interest rates.

- By February, the economy did appear to be stabilizing, thanks to the surge in public work programs and some recovery in housing investment. However, the Bank's view was that firms would continue to cut costs and that rising unemployment and falling wages would induce households to reduce spending.
- All the main price indexes continued to decline, and the BoJ feared that this trend could even worsen against the background of a growing output gap, thus leading to higher real interest rates.
- Another concern was the strength of the yen, which had just reached a 18-month high against the dollar. This was bad news for profit margins in the export sector, particularly given the competitive gains of the Korean won. And it threatened to compound the deflationary pressures in the domestic economy.
- Finally, although not inclined to manipulate conditions in the government bond market, the BoJ was clearly worried over the impact of rising long-term interest rates on the economy.

The BoJ's decision to ease policy on February 12 was not a big surprise. But the statement – saying that the BoJ would not stop at pushing the overnight rate toward zero but would supplement the short-term rate target with more liquidity injections to expand money supply and stabilize financial markets – was exceptionally clear.

What has the BoJ easing achieved?

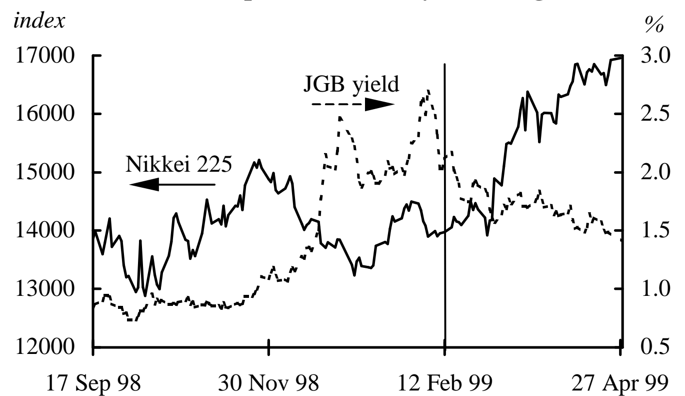
On balance, the BoJ is probably pleased with the result of the easing. However, there has been little impact on the financial system and the economy. And the favorable market response could be short-lived.

- On the financial market side, the response has been better than what the BoJ was probably expecting. Interest rate markets rallied and the yield curve flattened: the JGB 10-year benchmark yield falling from 2.1% to less than 1.5%, and the spreads of Tibor rates over the overnight rate falling 6, 31, and 18 basis points, respectively. The stock market rallied, rising 22% to a 12-month high. And the yen weakened to a more comfortable 118-123 ¥/$ range.

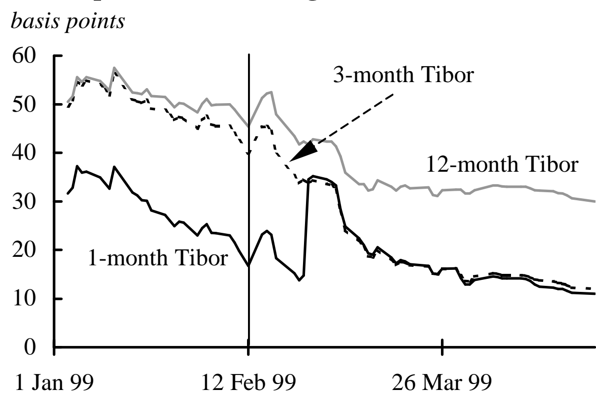
- On the operational side, the BoJ provided ample liquidity to the interbank market. During the February reserve maintenance period, which ended on March 15, banks' average daily excess reserves at the BoJ rose to ¥148 billion from ¥44 billion in the previous period. Including nonbank deposits at the BoJ, excess funds averaged ¥375 billion in the February period, up from ¥100 billion in the January period. During the March reserve maintenance period, the BoJ boosted average daily excess reserves to ¥350 billion and total excess funds including nonbank deposits to ¥843 billion, far exceeding the previous highs seen during the bank failure periods in November 1997 and October 1998.

- In contrast to the increased liquidity operations, the BoJ's balance sheet continued to contract compared to the highs seen a year earlier. However, this was not a sign of tightening or sterilization. Rather, it simply reflects the normalization of financial conditions following the earlier bank failures. Less concerned about default risks, people have reduced their cash holdings, while commercial banks have been able to raise funds more easily in the market and have relied less on BoJ loans. As a result, the BoJ reduced the amount of bills outstanding on its liability side, and JGBs and CPs on its asset side. Despite the shrinkage of the balance sheet, the BoJ is committed to supply as much funding as banks need at near zero interest rates. Thus, there is no balance sheet constraint on liquidity.

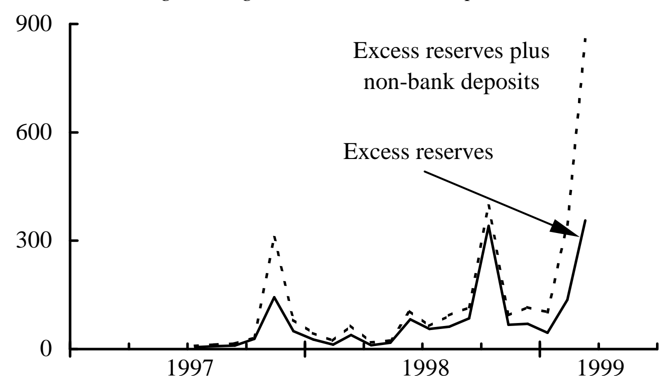
Financial market impact of February 12 easing



Tibor spreads over overnight rate



Excess reserves and non-bank deposits at BoJ



Banks' attitudes have not improved

Nevertheless, except for keeping the overnight rate comfortably around zero, the liquidity injections failed to have broader ramifications for the financial system and, thus, the real economy.

- The pace of decline in outstanding bank loans moderated slightly in February and March, but this was entirely due to new loans by regional and second-

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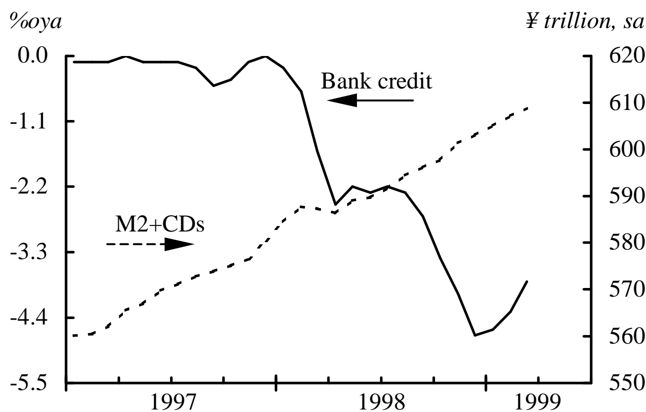
BoJ monthly balance sheet changes
¥ bil, nsa, ch from previous period, previous year in italics

	98Q4	Jan 99	Feb 99	Mar 99
	97Q4	*Jan 98*	*Feb 98*	*Mar 98*
Assets:				
Government debt	1,018	-4,665	828	1,304
	587	*-6,312*	*3,685*	*8,088*
Bills purchased	1,144	-4,113	-4,156	-279
	1,575	*1,115*	*-242*	*225*
Loans	1,909	-788	-947	-219
	1,267	*-328*	*1,096*	*-160*
JGBs in custody	200	-1,144	-20	35
	771	*1,412*	*2,001*	*401*
Total	4,206	-10,132	-4,104	3,480
	4,121	*-3,475*	*6,763*	*12,472*
Liabilities:				
Bank notes	2,396	-5,222	610	34
	3,391	*-6,303*	*596*	*38*
Current deposits	-452	-5	257	1,537
	155	*16*	*611*	*1,685*
Bills sold	2,248	-5,076	-5,008	498
	984	*2,963*	*5,666*	*6,516*

M2+CDs and bank credit



Contribution to M2+CDs' growth
%oya, nsa

	M2+CDs	Claims on public sector	Claims on private sector	Misc. inflow
97Q1	2.73	1.29	0.84	0.60
97Q2	3.00	1.55	0.58	0.86
97Q3	2.78	0.94	-0.46	2.29
97Q4	3.47	0.96	0.45	2.06
98Q1	5.13	0.17	0.46	4.50
98Q2	3.87	0.54	0.72	2.61
98Q3	3.57	0.85	1.27	1.45
98Q4	3.90	1.21	-0.21	2.90
Jan-99	3.56	1.86	-0.23	1.94

tier regional banks under the government's credit guarantee scheme. In fact, with ¥14 trillion of credit guarantees approved between last October and March (2.5% of outstanding loans), bank lending should have grown more. This suggests that many guarantees were used to refinance bad loans, while major banks continued to call in existing loans.

- M2+CDs money supply growth rate picked up slightly in March to 3.7%oya. But this was largely due to a lower comparison base a year ago, and money growth failed to accelerate over the month.

- With bank lending actually subtracting from the money supply stock, the main contribution to growth is banks' purchases of government debt and the inflow of funds from other financial assets such as bank debentures and money in trusts.

- Moreover, banks clearly were not willing to hold all the extra liquidity provided by the BoJ. This is reflected in the sharp increase in nonbank reserves at the BoJ during the March reserve maintenance period, which even exceeded the amount of excess bank reserves.

The surge in nonbank deposits at the BoJ is largely due to deposits by *Tanshi* (money) brokers, which borrowed excess funds from banks at 0.01% interest and redeposited them at zero interest with the BoJ. Since playing an intermediary role in the money market is the *Tanshi* brokers' *raison d'être*, they accepted a loss on these transactions for the sake of maintaining good will with the central bank and the commercial banks. Over time, however, *Tanshi* brokers are unlikely to sustain such losses and will probably become a casualty of the BoJ's zero interest rate policy.

Another side effect of the BoJ's zero interest rate policy has been the decline of call money-market activity, which shrank from ¥35 trillion in the first half of February to ¥26 trillion in the first half of April. Large investors such as life insurance companies are withdrawing from the call market, leaving their excess funds in ordinary bank accounts – which provide 0.05% interest, slightly better than the 0.01% call rate. Continuation of this trend could damage the efficiency of the call market as a main financial intermediary.

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Monetary targeting not considered an option

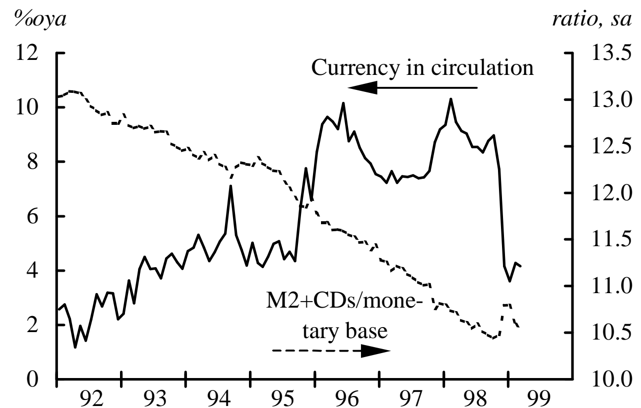
Despite the aggressive injection of liquidity, the BoJ has shied away from announcing explicit monetary growth targets. There is a lively debate within the Bank, but public statements and the minutes of previous board meetings show that the majority of policy board members views a move to an explicit monetary target as both not feasible and not desirable. The BoJ's main concern is the lack of control over monetary aggregates and their unstable relationship with broad economic activity figures.

- The monetary base, which consists approximately of 95% cash and only 5% bank reserves (the latter is unusually low compared to other major OECD countries), is highly volatile. This is due to frequent shifts in the public's demand for cash, which in the short term is beyond the control of the BoJ. Thus, targeting the monetary base would require forecasting the public's cash demand, which is nearly impossible. Moreover, even if the BoJ were able to anticipate all changes in public cash demand, maintaining a stable monetary base growth target would require frequent and disproportionately large swings in bank reserves.

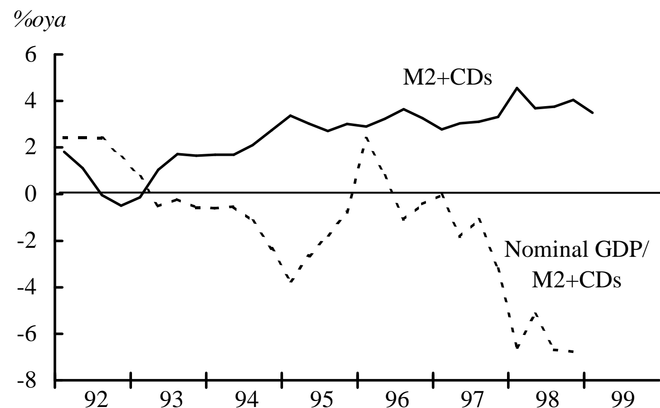
- On a broader scale, the BoJ has had a long tradition of projecting the quarterly growth rate of M2+CDs (with mixed success), but has always refused to announce any targets. M2+CDs is even further beyond the BoJ's direct control than the base, with the difficulties of controlling base money growth compounded by an unstable relationship between base money and M2+CDs. The money multiplier has been declining for a long time, but not always at a constant or predictable pace. Moreover, there is a growing deterioration in the relationship between M2+CDs and nominal GDP, seen in the rising volatility of the rate of velocity decline.

To be sure, the growing volatility of monetary aggregates and the increasingly unstable relationship between money supply and broad economic indicators is a global phenomenon that has led many OECD central banks to drop explicit monetary growth targets. In the case of Japan, however, these distortions are compounded by the unresolved problems in the banking sector as well as the painfully slow structural adjustment of the economy at large. Given this background, it is not surprising that the BoJ feels that it is already doing what it can to halt the economic downturn but cannot put right the overwhelming problems on the supply side of the economy.

Currency in circulation and base money multiplier



M2+CDs and money velocity



Term-rate targeting possible but not likely

Despite its reluctance to announce monetary targets, public statements and the minutes of the policy board meetings show that the BoJ continues to look for alternative ways to extend the reach of monetary easing. One such option is to target the term structure of interest rates with the objective to flatten the yield curve. This would be a natural extension of the current policy to target the overnight rate. In fact, one-to-six month

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interest rates have already moved close to the overnight rate. Moreover, with financing bills now being auctioned in the market, the BoJ has sufficient tools to set short-term interest rates up to the one-year maturity. However, the majority of policy board members feels that the BoJ cannot and should not determine the shape of the yield curve beyond one year. Note that the BoJ actually did target the entire yield curve until November 1988 and getting free of that objective was viewed as a major advance.

- First, the BoJ is uneasy about manipulating (demand) conditions in the JGB market. Underwriting or buying large amounts of JGBs could be seen as a violation of the BoJ's independence. Moreover, with the stock of JGBs outstanding at more than ¥250 trillion and rising rapidly, manipulating yields would require buying a huge amount of bonds, which would bloat the BoJ's balance sheet and compromise the effectiveness of its other operations.

- Second, as stressed by Governor Hayami, the BoJ fears that buying large amounts of JGBs could undermine the government's fiscal discipline and lead to the inefficient use of public funds.

- Third, a flattening in the yield curve would only be constructive for the ultimate purpose of reviving economic growth if it was driven by a decline in real interest rates. The majority of BoJ policy board members, however, supports the conventional view that monetary policy has little impact on real long-term interest rates. On the other hand, there is the concern that large bond-buying operations would only boost inflation fears and long-term yields without promoting recovery.

The third point also relates to the issue of inflation targeting, which was repeatedly raised by BoJ policy board member Nakahara, but rejected by the rest of the board. Most policy board members agree that maintaining a low and stable rate of inflation should be a key policy objective, but argue that the BoJ currently lacks efficient tools to target an explicit rate of inflation due to the prevailing structural problems, while an aggressive monetization policy could backfire and only result in stagflation.

Pressure to act could reemerge soon, ...

In sum, the BoJ is strongly committed to providing ample liquidity to keep the overnight rate at roughly zero, but it has no clear concept how to further extend monetary easing. With financial markets up and the economy showing some signs of improvement, there is no immediate need to act. But pressure could reemerge from several directions.

- The economic stabilization remains extremely fragile, relying largely on short-term public stimulus programs. Indeed, the boost from the November supplementary budget – especially the credit guarantee scheme, housing loan programs, and the public work programs – will soon run out of steam. Most likely, the government will implement another supplementary budget later in the year, but it is not clear that it will be timely and large enough to keep the momentum going. Without a supplementary budget, base line spending in the current budget will drop from last fiscal year's supplemented budget.

- On the other hand, any increase in public spending and the fiscal deficit could renew supply fears in the bond market and boost long-term yields.

- Japan's current account surplus remains stubbornly high, while the U.S. current account deficit is also surging. This could quickly lead to yen strength if the current absence of large capital outflows from Japan persists.

- The foreign-capital-inflow-driven rally of the stock market could also give way to weakness, triggered by much weaker-than-expected earnings reports for the fiscal year that ended in March.

- Probably most concerning for the BoJ, however, would be signs of increased deflationary pressures, coming from the labor market and household income reports. So far, evidence of actual deflation and deflationary expectations has been surprisingly modest, given the size and continued expansion of the output gap. Still, any pickup of deflationary pressures would lead to higher real interest rates, especially since there is little room even for long-term interest rates to fall much further.

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...prompting the BoJ to buy government securities

If pressures are limited to the currency, the BoJ will probably get away with some *ad hoc* foreign exchange market interventions. In the event of a broad deterioration in economic and financial conditions, however, the BoJ will come under pressure to respond in a more visible and credible way.

In that case, and with the overnight rate already at zero, the BoJ will have to announce specific quantitative easing measures to persuade market participants that it has expanded its arsenal. To be sure, the BoJ most likely will resist setting explicit monetary growth targets, but it could announce a detailed program to buy a certain amount of government debt over a specific period of time. Theoretically, the BoJ could also buy private sector debt, but both liquidity and credit concerns favor the purchase of government debt.

Within the range of government securities, comments by governor Hayami have already suggested that the BoJ would prefer to buy Finance Bills and Treasury Bills, to keep its balance sheet as liquid as possible and leave the size of its regular JGB operations unchanged. No matter what, the BoJ would most likely resist directly underwriting JGBs.

Such a move to target a specified amount of securities purchase would clearly be a compromise. And its effectiveness would depend largely on the size and duration of the operation and its impact on public sentiment. A small and short-lived program is bound to have little impact. On the other hand, a large and long-dated (or even open-ended) program would risk fueling inflation fears without boosting growth. In addition, much will depend on whether the government's own fiscal and reform policies are seen to advance the structural adjustment process and establish the preconditions for a sustained recovery.

Depending on the exchange rate conditions, a government securities purchase program could also be complemented by foreign exchange interventions, which would add a little bit to the liquidity expansion. However, such policy would probably have to be flexible and avoid setting specific intervention targets and time frames, given the more volatile nature of the currency market and bilateral sensitivities, especially in the United States.

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China's outlook hinges on pace of reforms

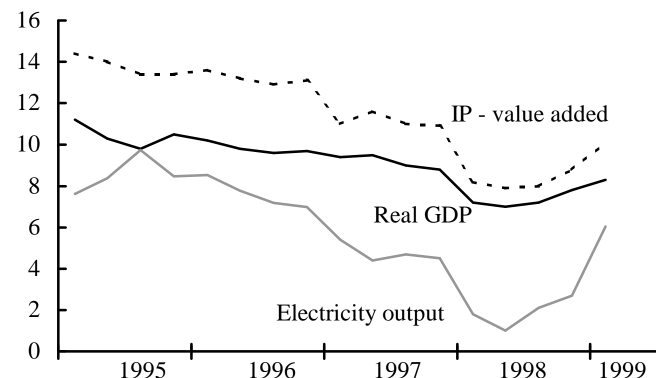
- **Public investment makes GDP recovery a reality**
- **But economic reforms limit second-round gains**
- **The government cannot quit its pump-priming, since it intends to push reforms ahead**
- **Financial constraints should not prove binding**
- **Currency depreciation may be sought, but hardly before China's WTO entry**

China is in true economic recovery, led by state fixed investment. But the recovery is still narrowly based, with no pickup visible in non-state investment and retail sales. Limiting second-round gains from public investment has been official and market pressure on all sectors to improve efficiency. This makes existing excesses of production capacity, inventories, and workers more of a GDP growth drag than ever before.

Still, Beijing appears determined to push economic reforms ahead, a task made more urgent by its recent bold offer on opening its market to foreign competition. Not only would this hurt short-term growth, for long-term benefit, but tougher investment criteria (and a high base effect) may make public investment less of a prop for GDP growth in the second half of this year.

The reach for efficiency, however, will continue to be balanced against the need to maintain social stability. The latter, with the social welfare system still infant, requires that economic growth not slip too much. In this tough balancing act, the government may wind up fine-tuning its policy stance frequently and pushing mutually contradictory measures. But to shore up economic growth, Beijing can always resort to fast, high-dose fiscal stimulus and even to indirect public debt monetization. China has no lack of investment opportunities and, with domestic saving above 40% of GDP, should have no trouble funding them at least for some years ahead. Down the road, its debt could always be serviced by selling the assets it is nationalizing now. In addition, China could try to boost exports by cheapening its currency. But that option will not be taken soon for fear of complicating China's WTO entry.

Real GDP, industrial production, and electricity output
%oya, year-to-date



The true pace of China's real GDP growth

Chinese statistics are of questionable quality, often manipulated or distorted. To be fair, the central government no longer keeps two sets of records: one for external consumption, the other for internal reference. In fact, it has itself been increasingly frustrated by the poor quality of national statistics. The problem is that regional governments and state agencies continue to twist statistics – economic growth in most years and in late 1998 in particular – to flatter their own performance and thereby to correlate with the central government's objectives. Not surprisingly, real GDP growth has been exaggerated, but by how much?

Some analysts point to the marginal growth in electricity output or freight as evidence that the economy is on the verge of recession. But those data overstate China's economic weakness.

- First, the industrial sector is shifting away from electricity-intensive activities such as steel and petrochemicals to energy-efficient ones such as electronics.
- Second, while industrial growth has always been exaggerated, services growth may have been understated. Much of it (including transportation) is run by non-state entities lacking sound books and apt to understate output for tax benefit. And lately, services occupy an increasing share of the economy.
- Finally, were growth so low, the labor market would be worsening more than the government could cope with.

To improve data quality, the State Statistics Bureau is now to conduct more surveys. But it is unclear how it will make its new data historically consistent with the old or survey samples representative, given regional discrepancies and the fast-changing economic and incentive structure.

For this reason and also because of the wide gap between the quantity and quality of growth, it is almost meaningless to debate the true growth of China's real GDP. Instead, J.P. Morgan focuses on the financial performance of the corporate sector. This is a better leading indicator of possible deterioration in the labor market or in the asset quality of the financial sector. More importantly, its authenticity can be cross-checked against survey data and the performance of listed companies.

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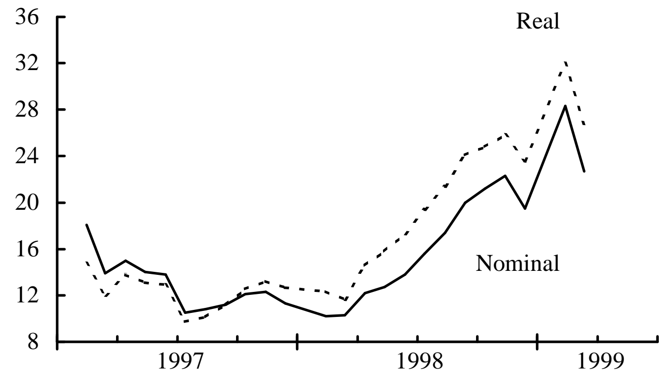
Economic recovery led by fiscal investment...

On the official statistics, real GDP grew 8.3% from a year earlier in the first quarter, up from 7.8% growth over the whole of 1998 and marking the first time that first-quarter growth has been recorded as outpacing that of the previous full year. The recovery was engineered by the government via public investment: State fixed investment growth has been going from strength to strength since mid-1998, skyrocketing this past quarter by 26.8% in real and 22.7% in nominal terms, the highest since September 1993. Inevitably, some of the investment is inefficient, whether measured in economic or social returns, especially since much was done hastily in late 1998 in the bid to meet the 8% GDP growth target. But at least at the central government level, efforts have since been made to avoid project repetition in industry. Indeed, most state investment is going into the fast-growing services sector. And most of the yuan100 billion proceeds of the central government's special bond issue has gone to building grain storage facilities, rural electricity distribution, and agriculture infrastructure.

...but still narrowly based

Still, it would be wrong to take the past quarter's 11% surge in imports as signaling a sharp turnaround of domestic demand. The import jump was much exaggerated by the official crackdown on smuggling, by the appreciation of regional currencies which diminishes the incentive to import illegally, and in March especially by the import of lumpy items. The economy's recovery is narrowly based, with the multiplier effect of pubic investment still disappointing: There has been no visible recovery in non-state investment or retail sales growth. Non-state fixed investment, for example, grew a mere 1.2%oya in 1998, even as state fixed investment ballooned 19%. Unfortunately, only annual data are available for this non-state indicator, so it is hard to judge the more recent trend. Utilized foreign direct investment (FDI) dropped 14.6% in January-March, its worst showing in history. Also confirming the fiscal stimulus' lack of multiplier effect is the renewed moderation in retail sales growth, to about 6-7% in March from 8% in the previous five months. Worse, even the jump in state fixed investment has been aided by a low comparison base last year.

State fixed asset investment
%oya, year-to-date



State fixed investment by funding and sector
%oya, year-to-date

	1997	1998	Feb 99
State investment	4.1	19.5	22.7 (Q1)
By source of funding			
State budgetary appropriation	10.8	63.6	104.1
Domestic loans	5.6	22.9	34.6
Foreign investment	-18.2	-4.8	-27.8
Self-raised funds	13.0	15.8	17.4
Investment by sector			
Primary sector	40.0	47.8	102.0
Industry	6.1	3.0	2.0
Tertiary	13.0	29.8	44.0
Transportation and telecoms	14.8	53.4	61.4
Real estate services	3.7	21.5	29.6
Recreation and education	32.5	15.5	29.7

Fixed investment by investor type

	1994	1995	1996	1997	1998
Total (billion yuan)	1,637	2,002	2,297	2,494	2,846
%oya	30.4	22.3	14.8	8.6	14.1
State, % of total	73.7	72.7	73.8	70.8	74.1
%oya	21.3	20.7	16.6	4.1	19.5
Non-state , % of total	26.3	27.3	26.2	29.2	259
%oya	...	26.9	9.9	21.0	1.1
FDI, % of total	17.7	15.6	15.1	15.1	13.3
%oya	83.5	7.9	10.9	8.4	0.5

Reforms show up growth burden of past excesses

Limiting the public investment multiplier has been administrative and market pressure on all sectors to improve efficiency. Beijing's frequent policy shifts have caused much confusion on whether China's reforms have stalled. In reality, most reforms are being carried out, but at varying speeds in different times or sectors.

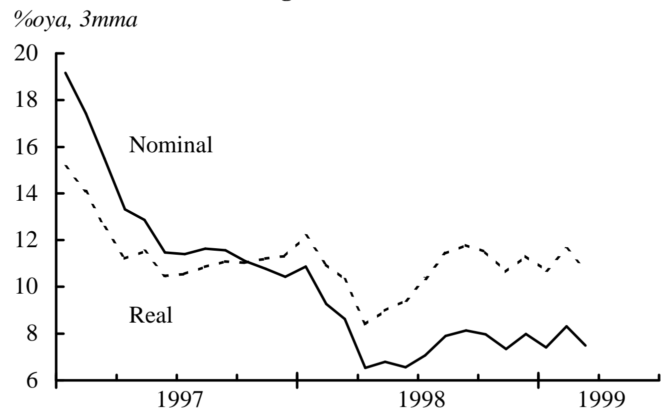
- *Policy focus on asset quality has made banks reluctant to take credit risk.* A few years ago, the government started to link asset quality to the merit assess-

ment of bank managers. It put this aside briefly in mid-1998 in its drive to hit the GDP growth target, but the practice was firmly put back in place after the closure of GITIC last October, which aroused a sense of financial crisis within China. Never before have bank officials' jobs been so stressful. To make their own life easier, they are shunning new credit risk in favor of buying safe government bonds or paying down borrowings from the central bank. More importantly, banks have been trying to enhance their internal control of credit risk. (Also see *China's balancing act on financial reforms*, AFM, Apr 24, 1998). Just this month, for example, the Industrial and Commercial Bank of China (ICBC) – the largest bank in the country– decided to centralize approval of fixed investment loans. True, state banks continue to support loss-making state companies, but much less than in the past. Indeed, bank loan growth is sluggish by China's standards, and the loan/deposit ratio continues to fall (see chart).

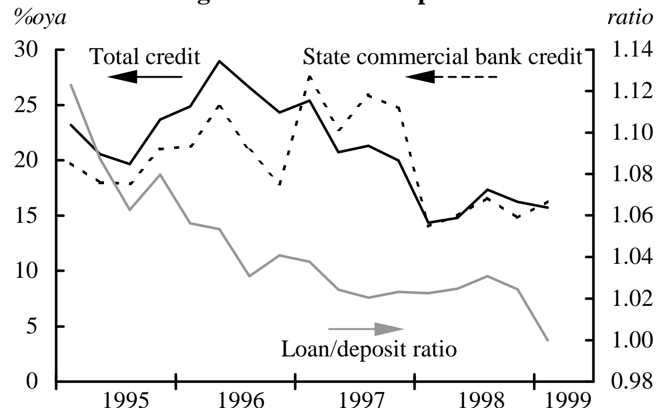
Banks' reluctance to lend diminishes the effectiveness of monetary stimulus. Other than by buying up surplus foreign exchange at the current exchange rate, the central bank is pushing on a string when it tries to enlarge base money, as increased liquidity often recycles back to the monetary authority. The base money expansion in the final quarter of 1998 owed largely to central bank lending to earmarked projects, such as state grain procurement for which state commercial banks bear no credit risk.

Meanwhile, in allocating credit, banks tend to favor state-sponsored investment projects, so that they can blame the government for related credit risk. This bias has hit non-state companies harder than ever. In past years, they could get renminbi funding by selling foreign exchange revenues to banks or obtain loans from small regional financial institutions. But since 1998, export revenue has been flat and now declining. At the same time, small financial institutions have been battling with their own financial difficulties – 45 have failed since 1997, automatically cutting off customer credit lines. Consequently, non-state companies are starved for funds, though they are more efficient in investment and job creation, whereas their state counterparts, large ones in particular, are awash in new liquidity.

Retail sales - consumer goods
%oya, 3mma



Domestic credit growth and loan/deposit ratio
%oya *ratio*



- *Banks' prudence and the tough market environment are forcing corporates to trim excess capacity, inventories, and workers – another negative for headline GDP growth in the short term.* Nowadays, enterprises are being squeezed from all directions: Access to bank credit has narrowed, yet competition has become fierce and price deflation persists. State-owned enterprises now face additional government pressure. Early this year, Premier Zhu Rongji issued an ultimatum to state company managers: Shape up or ship out. All this is gradually reshaping the culture of corporate China, shifting managers' focus, albeit slowly, away from output toward profitability. But in the short term, the shift makes existing excesses more of a drag on headline GDP growth than in the past, as companies hold back output to limit inventory accumulation; take over assets of other companies, instead of making fresh investment; or lay off workers to cut costs. In industry, the effort to limit inventories shows through in a rising sales/output ratio, partly explaining why industrial output

growth actually moderated in March, even as aggregate demand gained some strength.

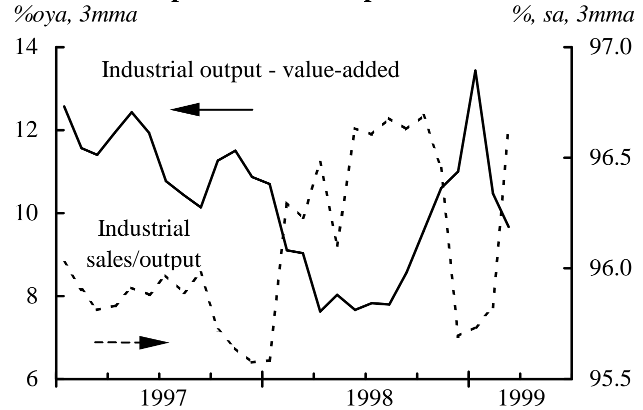
Still, the cutback in existing excesses has not been significant. Production overcapacity, for example, has been trimmed mainly by merger and acquisition, in an effort to limit the social impact. Some inefficient firms have been closed, but many others continue to live on bank credit. The fact that price deflation shows no sign of easing indicates that China still has far to go to digest existing excesses, net of what has and will become obsolete. Since price deflation has outpaced the fall in operating costs, it is not surprising that state industrial firms remain in the red. This will in turn maintain the pressure on corporate China to improve efficiency.

- *Worker layoffs by the corporate, financial, and public sectors have bred a growing sense of job insecurity. This, together with the shift of social welfare burdens from firms to households, has eroded consumer confidence.* Officially, the urban unemployment rate was 3.1% at the end of 1998. In reality, it probably exceeded 9% of the urban *workforce*. Last year, even the central government itself moved to slash its workforce quite significantly. Though most of the redundant public servants have been redeployed, sometimes just administratively, the sense of job insecurity stirred up is unprecedented. And this year, the government is implementing a second phase of downsizing, this time affecting regional governments, albeit more slowly. Consistent with the sharp deterioration in the labor market, household income growth has plunged from 1997's double-digit pace into negative territory early this year.

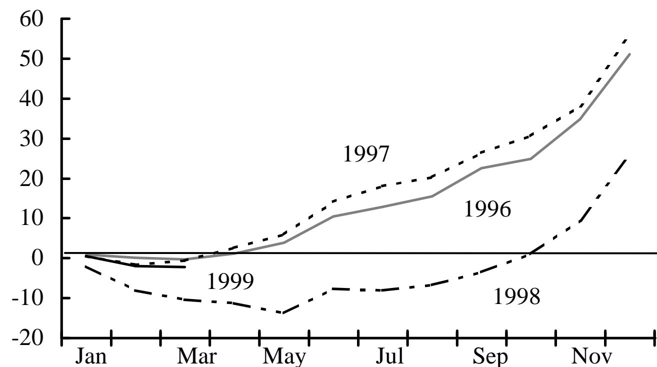
Just when households face uncertain job and income prospects, they are having to shoulder a growing portion of the social welfare burden, such as medical care, unemployment insurance, and housing. Not surprisingly, their marginal propensity to consume continues to decline, and bank deposits have continued to surge, despite the plunge in interest rates.

All this explains why retail sales growth has been not been very responsive to the sharp decline in interest rates and the surge in public investment. To be fair, the government has been taking measures to kick-start consumer spending, but has met limited success so far. The promotion of mortgage and consumer loans, for example, has and will continue to be hindered by the society's lack of respect for property rights. And mortgage lending in particular is further handicapped by the lack of progress in commercializing public housing and the huge gap between household income and housing prices.

Industrial output and sales/output ratio
%oya, 3mma *%, sa, 3mma*



Total profit of state industrial firms
yuan billion, year-to-date



The true unemployment rate

Officially, the urban unemployment rate was 3.1% at end-1998, unchanged from its 1997 level. But this rate is too narrow a measure of Chinese labor market conditions. In reality, the number of jobless workers has probably surpassed 10% of the urban *workforce*. Notice that China does not have the concept of labor force.

- 3.4 million jobs were cut in the first nine months of last year.
- Another 7 million or so became jobless but are still on the payrolls of SOEs, net of those redeployed.
- 5.7 million were officially unemployed at end-1997.
- About 10 million were added to the labor force last year.

Adding all this up, and on the generous assumption that 7 million urban jobs were created in 1998, the jobless rate should have risen to 9.2% of the urban *workforce*.

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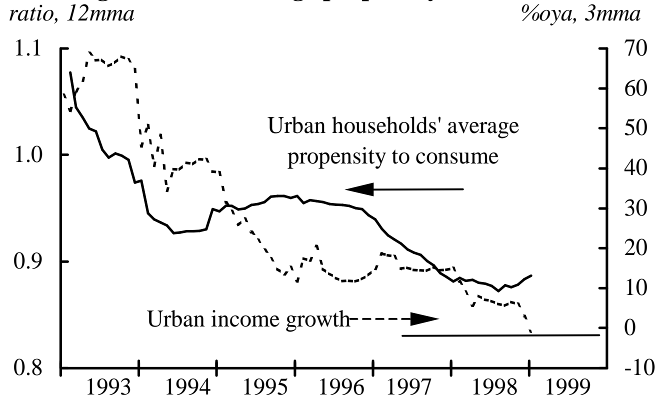
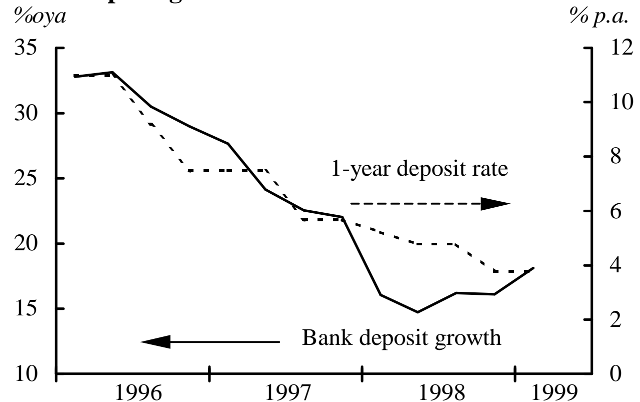
Income growth and average propensity to consume
ratio, 12mma *%oya, 3mma*



Bank deposit growth and interest rates
%oya *% p.a.*

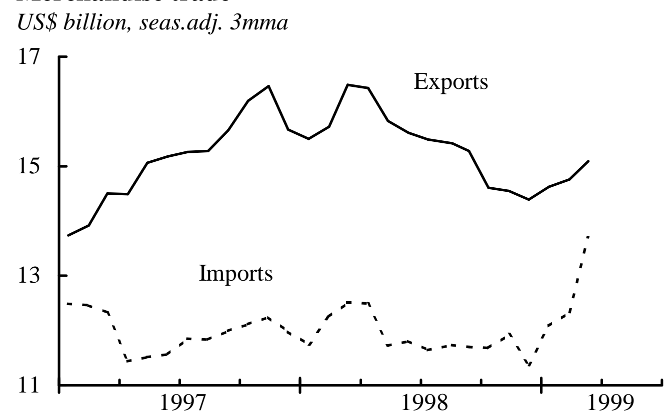


Trade surplus narrowing less ominous than it looks

Meanwhile, the trade surplus trended down to US$0.5 billion in March from US$4.7 billion last August. At first, this owed to declining exports. But into 1999, exports have been recovering gradually in month-on-month, seasonally adjusted terms. Now, it is surging imports that are eroding the trade surplus. True, higher imports reflect the jump in state fixed investment, but they also in recent months have been exaggerated by lumpy purchases, the antismuggling campaign, and the strengthening of regional currencies which also deters illegal importing (government tariff revenue leaped 147% in the first quarter). Clearly, the falling trade surplus is less damaging to overall economic growth than the figures suggest. Nor, thanks to rigid enforcement of capital controls, has it hurt official reserves, despite a sharp drop in FDI and foreign credit inflows.

Worryingly, though, are the continually worsening terms of trade and Chinese exporters' heavy reliance on the U.S. market. In March, export prices were down about 15% from a year earlier. But without a currency devaluation, Chinese exporters are unable to cut costs as fast as do their rivals, so they may lose market share. Meanwhile, China's exports have benefited greatly from strong U.S. demand, but equally are vulnerable to any downward adjustment across the Pacific Ocean.

Merchandise trade
US$ billion, seas.adj. 3mma

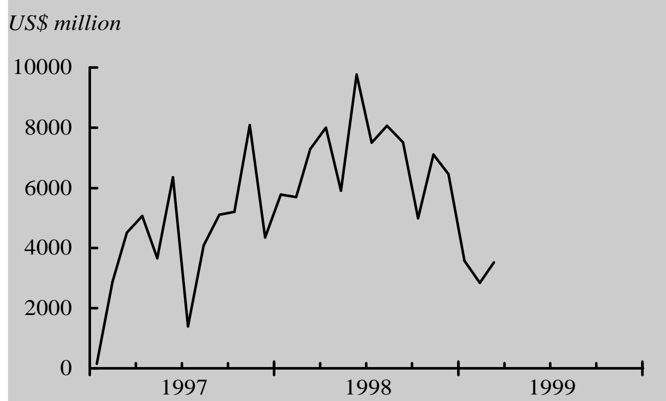


Tracking the effectiveness of capital controls

Since late 1998, the government has been cracking down hard on capital flight and smuggling. A proxy for the effectiveness of such campaigns can be constructed as follows:

Fx leakage = trade surplus (customs) + FDI inflows + foreign borrowing - changes in official fx reserves.

Fx leakage
US$ million



Outlook hinges on pace of economic reforms

Besides possible surprises from foreign demand and a Y2K problem for which Chinese companies are ill-prepared for lack of funding, the uncertain magnitudes of internal (reform) drag, external (trade) drag, and public investment stimulus leave China's overall economic outlook this year and next equally uncertain. Making things worse are Beijing's constant policy shifts and poor quality of statistics. Whether the government fo-

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cuses on growth quality or growth quantity will determine the dose of fiscal stimulus and the pace of economic reforms, which will in turn determine how much past excesses burden short-term growth and how accurate official data will become. J.P. Morgan's current forecast of 6.5% real GDP growth in 1999 and 5.5% in 2000 assumes that the government will continue to promote economic reforms and, at the same time, provide the fiscal investment and social welfare support necessary to maintain social stability. Overall, as China strengthens its safety net for the unemployed, it will be able to withstand lower real GDP growth.

Beijing is pushing reforms ahead

Right now, Beijing appears determined to push economic reforms ahead. Not only has it learned a valuable lesson from the regional financial crisis, it has also acquired a sense of financial crisis within, after the failure of GITIC and 44 other small financial institutions in the past two years and the current financial difficulties of some credit cooperatives. In his state of the nation address to the National People's congress in early March, Premier Zhu Rongji outlined specific measures to promote economic efficiency (box).

Reform is made more urgent by China's bold concession offer this month with a view to WTO membership. To face foreign competition, China has to improve the competitiveness of local companies and financial institutions. And to prepare for the consequent dramatic redistribution of resources and wealth, it must sharpen its macroeconomic, social, and even political management skills (see *China's WTO bid brings opportunities and risks,* GDW, Apr 16).

Admittedly, the economic environment, both internal and external, remains unfriendly to reforms. Domestic and global demand will stay relatively weak and market competition intense. That will continue to hurt the bottom line of corporate China. Ironically, the tough market environment may force the government to carry forward reforms in the state sector in particular. So far, Beijing has tried every measure other than large-scale privatization. Yet total profit of state industrial companies remains in the negative territory. True, large SOEs lifted their net earnings above zero in January-February, aided by the deep cut in interest rates, better access to bank credit, and the antismuggling campaign that limits competition from cheap overseas goods. But their gain was more than offset by losses among the other SOEs. While blaming the regional financial crisis, the government is feeling frustrated. By now, though, it may realize that reforms are the only way out, especially since it plans to open the market to foreign competition. Helping to cement such a determination is the introduction of a basic social welfare system (box, next page), which makes Beijing feel a bit more confident of maintaining social stability. Still, for it to

Measures to promote reform

- *Improving quality of state investment.* Avoid project repetition. Invest state funds primarily in infrastructure and environmental protection. In project selection, lean toward inland provinces
- *Enhancing efficiency in the state sector.* Give no new approvals or bank loans to low value-added industrial projects. Cut production overcapacity. Promote competition. Eliminate government intervention in state-company management. Set clear reward and punishment criteria for state-company managers. Crack down on corruption.
- *Limiting financial risk.* Maintain a stable renminbi. Improve prudential supervision of financial institutions. Increase autonomy of state commercial banks. Enhance internal credit risk control and cut costs. Classify loans in line with international practice. Work off existing bad loans by setting up bad loan banks. Define clear responsibility for new loan quality. Crack down on financial irregularities, bank debt, and tax evasion.

Measures to tackle banks' nonperforming loans

A bad loan bank called Cinda has been set up, with capital of yuan10 billion (US$1.2 billion) from the Ministry of Finance. It will buy nonperforming loans (NPLs) initially from the Construction Bank, with funding from bond issues or borrowing from the central bank. The latter indicates that a portion of banks' NPLs may be monetized.

Measures to reforms TICs including ITICs

Alarmed by the domino effect of GITIC's closure, China has, for the time being, opted for a less dramatic approach to cleaning up the trust and investment sector. It will do so mainly through merger and acquisition, debt rescheduling aided by government asset or cash injection, or takeover by nonfinancial companies.

- A minimum capital of yuan300 million (US$36 million), net of investment losses and doubtful debt, will be required.
- Only those meeting the capital requirement will be licenced to conduct trust and investment business.
- Those with good assets but short of the capital requirement will be merged or acquired.
- Those invested primarily in the real estate or industrial sectors can become property and industrial companies.
- Those that are affiliates of conglomerates can become finance companies of the latter.
- Assets and liabilities of the rest will be taken over by asset management or industrial/commercial companies to be set up.
- Foreign investment will be allowed.

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carry out large-scale privatization, it would have to overcome ideological barriers, improve the legal infrastructure, and strengthen the social welfare system. None of that will happen soon.

Efficiency promotion also applies to state spending

The slight tilt toward economic efficiency hints that the government itself may invest less freely than late last year. Its investment splurge will continue to offset the impact of banks' caution, with the budget deficit set to widen to 1.7% of GDP in 1999 from 1.1% in 1998 and yuan100 billion or so earmarked for public investment, a near-doubling from last year's figure. But 1998's spending concentrated toward year end, setting up an unfavorable comparison base for public investment growth in the second half of 1999. More importantly, the shortcomings of last year's spending spree have begun surfacing: Regional governments were keener to get money from the center than to ensure real return on projects. And more irregularities were exposed by last year's floods, which showed how poorly all dams were built, and by the collapse of a grand-scale bridge in central China. So the government is tightening the criteria for further investment.

Constraints on reforms: social stability

For all the effort to improve economic efficiency, there is a limit – the need to preserve social stability. Beijing is fully aware of the risk that the pains of economic reform may make the public more sensitive to social illnesses, such as widespread corruption, skewed income distribution, and law-and-order problems. The situation could even turn flammable in this year of emotional anniversaries. Consequently, it will continue to make sure that reforms are implemented at a measured pace and that economic growth does not falter too rapidly. At the same time, it has tightened security and intensified its crackdown on corruption.

This balancing act is hard to master. Theoretically, if and when economic growth slows rapidly and threatens social stability, Beijing could (1) postpone cost-cutting across the economy; (2) slow or backtrack on reform, by ordering state banks wholeheartedly to support growth; (3) devalue the currency; or (4) lift public spending. But the first two options may be a last resort as they would conflict with preparing companies and banks for looming foreign competition. And option three is ruled out before China seals the deal on WTO membership. This leaves public spending the only option in the near term. But this may run into resistance from those already concerned about the government's narrow tax base and growing debt burden.

Reality, however, turns out better than appears. True, the government's tax base is narrow and its debt burden has approached the warning line, by international standards. But for China, those standards will not apply, at least not for the coming few years. First, with domestic saving exceeding 40% of GDP, the government should have little difficulty in raising funds, with little crowding-out effect given the non-public sector's weak funding demand. Second, at present, public debt – external and internal, direct and indirect – totals only 32% of GDP, most of it long-term. True, it would probably reach 80%-90% of GDP, if the potential cost of bank recapitalization were included, and when the long-term debt matures, the burden will be huge. And by then, nongovernment sectors may compete strongly for funding. But in that event, the government could always sell

The infant social welfare system

In 1998, the Ministry of Labor and Social welfare was set up, marking the birth of a comprehensive social welfare system in China. It is in charge of the operation of medical care and pension schemes, unemployment insurance and a safety net for "Xia gang" workers – those made redundant but still on SOE payrolls.

- *Safety net for "Xia gang" workers*. Started from mid-1998, these workers can get stipends from their former employers while they are placed in training centers for redeployment. Any shortfall in funding should be made up by the central or regional governments. This is a transitional arrangement until unemployment insurance is further improved.
- *Unemployment insurance*. Introduced in 1996, it requires companies to pay 3% of total wages to a fund. Right now, the scheme covers about 37% of urban workers.
- *Pension system*. Launched in 1984, it was reshaped dramatically in 1991 to resemble the U.S. system. Its umbrella provides basic, supplementary, and individual pensions. The basic pension is mandatory for all employers and employees, who together must contribute a total of 11% of employee monthly wage. The scheme covers over 96% of workers in SOEs, 60% of those in collectively-owned companies, and over 95% of retirees. The scheme will be broadened to all other companies.
- *Medical insurance*. A broadened and improved scheme has been implemented in over 40 cities in the past two years. It requires workers to contribute to a medical insurance fund.

One pitfall to note: Failure of loss-making companies to pay dues and mismanagement of funds have been widespread. To make ends meet, the government has been broadening the coverage of all schemes, with new premium income footing insurance claims.

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the assets it is now nationalizing. If skeptics remain unconvinced, the central bank could indirectly monetize government spending by printing money for state banks to lend to borrowers, taking the full credit risk. That would be counter-deflationary. It would also sidestep the law forbidding central bank financing of the government. And commercial banks' lack of risk appetite need not be a problem. The central bank may already be considering such a course. Its monetary committee last week revised its stance to anti-deflationary – quite a switch for a body previously preoccupied by inflation fears. Also this month, Governor Dai has stated that the central bank will channel yuan15 billion into rural areas to boost consumption.

Currency depreciation an option after WTO entry

Renminbi depreciation sometime after China becomes a WTO member, probably by November this year, also could strengthen growth. And the deteriorating balance of payments could warrant it: Imports will likely jump as China tears down tariff and nontariff barriers . Exports may lag behind, despite cost-cutting and a further recovery in external demand. Of course, China's opening of so far closely-regulated and often monopolized service sectors should attract FDI, but capital outflows may rise as capital controls come down and as some existing FDI is forced out by foreign competition or corporate restructuring. All in all, net FDI may rise less than net goods trade deteriorates.

China has investment opportunities too

As a developing country, China has no lack of investment opportunities, judged by social returns, for now, and by commercial returns, when the economy recovers. Its infrastructure remains substandard, though progress has been made; its urbanization has lagged its industrialization, hindering service-sector development; and its environmental protection is near-nonexistent. Even within sectors plagued by oversupply, subsectors provide investment opportunities. Though retail sales are slack, for example, mobile phone subscribers are growing phenomenally. While electricity is in oversupply, demand is curtailed by old cables in urban areas and a lack of rural distribution networks.

In the past in China, every economic boom has been associated with the rapid development of certain sectors (see chart). By now, it is hard to identify one specific sector as the source of rapid economic growth going ahead. But many subsectors certainly remain bottlenecks to overall growth, and have yet to be explored. They may not deliver a boom, but should be enough to prevent recession in coming years.

Fiscal position and domestic public debt burden
yuan billion, unless stated otherwise

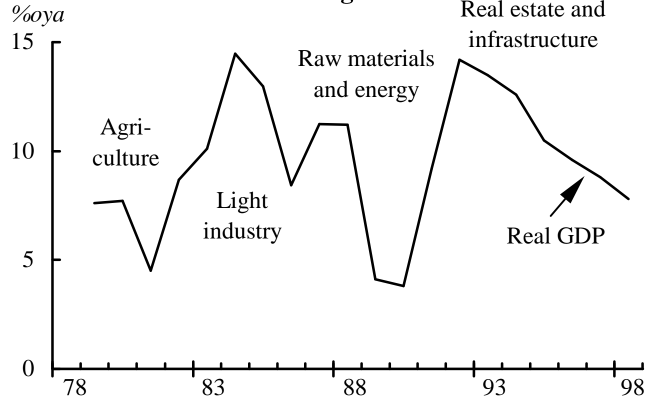
	1995	1996	1997	1998	1999p
Budget deficit	58.2	53.0	58.2	91.8*	150.3†
% of GDP	1.0	0.8	0.8	1.2	1.8
Revenue	624.2	740.8	865.1	985.3	1080.9
% of GDP	10.7	10.8	11.6	12.3	12.6
Expenditure	682.4	793.8	923.4	1077.1	1231.2
% of GDP	11.7	11.6	12.3	13.5	14.3
Domestic bonds outstanding	330	436	551	1089‡	1291‡
% of GDP	5.6	6.4	7.4	13.7	15.3
Domestic bonds financing	151.1	184.8	241.2	389.1	341.5
% of fiscal spending	16.3	19.1	24.5	39.5	31.6
Debt servicing	49.7	78.7	126.4	249.3	246.7
% of bond issuance	32.9	42.6	52.4	64.1	72.2

*Yuan48 billion of the yuan100 billion bond issued in late 1998 was unused last year and rolled over into 1999.
†This may turn out to be much smaller, as the State Development Bank continues to increase its role in stimulating domestic demand.
‡Including yuan270 billion issued in 1998 to recapitalize state banks.

Internal and external debt of the public sector
US$ billion

	1995	1996	1997	1998e	1999p
Internal - total	62.3	81.8	n.a.		
Direct debt	39.5	52.5	66.0	126.6	154.2
Quasi-government debt	3.1	3.1	n.a.		
Other debt	19.7	28.9	42.1		
External - total	90.1	91.4	93.6		
Direct debt	31.1	33.5	36.0	39.6	43.8
Other debt	59.0	57.9	57.6		
Total direct debt	70.6	86.0	102.0	163.2	192.4
% of GDP	10.1	10.4	11.3	16.9	19.1
Total indirect debt	68.7	87.2	n.a.		

Sectoral leaders of real GDP growth
%oya



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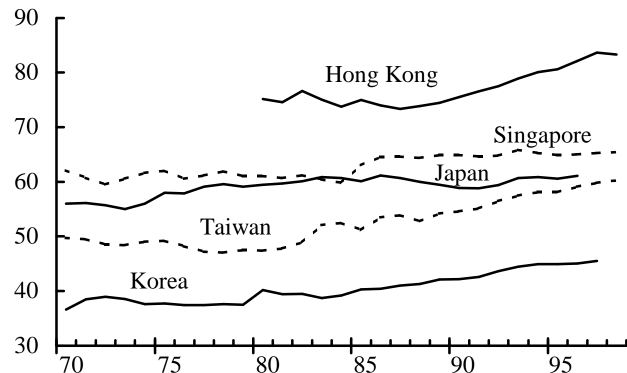
Asia's top economies must focus on services

- **Service-sector development in Japan and the top Tigers has markedly lagged economic progress, ...**
- **... but will become ever more important to maintain full employment, especially in Japan**
- **Labor market flexibility, deregulation, outsourcing, and efforts to promote consumption are key**

Japan's prolonged economic slump and the crisis in the rest of Asia have revealed many flaws long hidden beneath the region's past growth success. Poor financial standards and corporate governance plus inconsistent monetary policy regimes led to overinvestment and asset bubbles. Now, a lack of transparency and corporates' reluctance to restructure undermine to some extent the speed of economic and financial recovery. Nevertheless, prospects for the region's less developed countries remain bright if they continue on the path of reform. The region's leading economies, however, will have to do more to stay on the ball.

For Japan and the top Tigers – Hong Kong, Korea, Singapore, and Taiwan – the manufacturing- and export-driven growth model is running out of steam. Rising costs and competition from less developed countries limit the scope for manufacturing and export growth and increase the pressure to boost labor productivity. This leads inevitably to reduced labor demand in the manufacturing sector and higher unemployment unless surplus labor is absorbed elsewhere in the economy, most importantly the services sector.

Service-sector trends
% of GDP, constant prices



So far, Asia's top economies have lagged in service-sector development, which highlights both weaknesses of the past growth model and opportunities for future output and employment growth. The services sector's share in output and employment is low compared to the state of economic development, especially in Japan and Korea. Rigid labor markets and regulatory barriers explain most of this condition, but a lack of private consumption and slow outsourcing also have undermined service-sector growth. Exports account for the bulk of services activity in Hong Kong and Singapore, but only Hong Kong has experienced really significant relative growth of the sector over the last ten years.

Using the experience of the United States and other top services economies, this essay first highlights the factors currently undermining service-sector growth in the region, and goes on to derive policy implications and lessons for the rest of Asia.

Real GDP by sector
% of total

	Agriculture				Industry				Services			
	1970	1980	1990	1997	1970	1980	1990	1997	1970	1980	1990	1997
Japan*	5.1	3.3	2.5	2.0	38.9	37.2	38.6	36.9	56.0	59.5	58.9	61.1
Hong Kong	n.a.	0.8	0.2	0.1	n.a.	24.1	24.3	16.2	n.a.	75.1	75.5	83.7
Singapore	1.9	1.0	0.3	0.2	36.0	38.0	34.8	34.6	62.1	61.0	64.9	65.3
South Korea	37.0	18.2	9.6	6.7	26.4	41.6	48.2	47.8	36.7	40.2	42.1	45.5
Taiwan	15.5	7.3	4.0	2.6	34.7	45.3	41.9	37.8	49.7	47.4	54.6	59.8
Australia**	5.2	5.3	4.5	4.6	33.9	32.8	30.2	27.6	60.9	61.9	65.3	67.7
United States	1.5	1.3	1.1	1.8	24.0	24.3	23.4	24.1	74.5	74.4	75.5	74.1

Data only available: * through 1996; ** from 1975.

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What drives service-sector growth?

Service-sector development is widely considered to be the second leg in the economic development process. In the first, the period of industrialization, economic activity and labor resources shift from agriculture into manufacturing. This process is usually driven by rapid productivity increases in agriculture, a growing division of labor, and the expansion of trade. In this stage, services account already for a significant share of the economy and undergo structural changes to accommodate the expansion of the manufacturing sector, most notably in the commerce area, but are not a principal driver of economic activity.

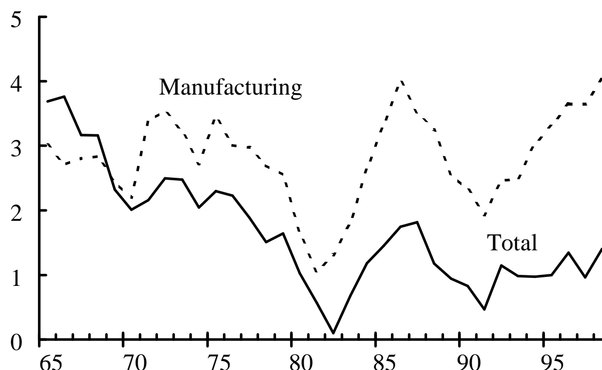
Once the process of industrialization has matured and relative cost and competitiveness pressures increase, sectoral differences in productivity growth rates tend to shift labor resources into the services sector. This was clearly the case in the United States, where productivity growth in the manufacturing sector increasingly outpaced productivity increases in the economy at large, starting at a small margin of less than one percent point per annum in the late 1960s and rising to a spread of 2.5 percent points in the late 1990s. Goods consumption, however, held relatively stable, falling only slightly as a share of GDP. This led to a decline in the share of employment in the goods-producing sector from nearly 40% in the 1960s to just 20% in 1998, while the share of service-sector employment rose by a similar amount to nearly 80% in 1998.

Less dominant but not insignificant for service-sector development is the rise in consumer demand for services such as recreation – which is a function of both higher incomes and lower working hours – and the outsourcing of services such as accounting, design, and engineering previously done in-house.

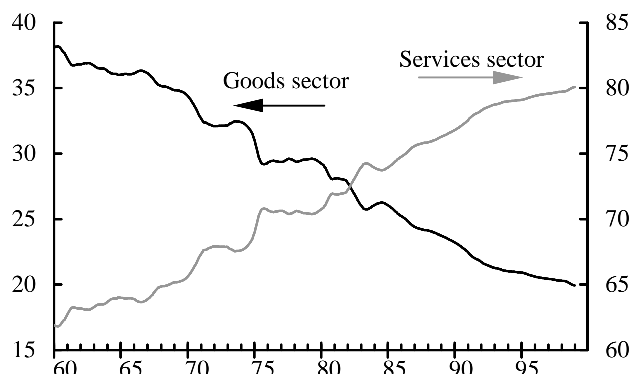
It's not as simple as it sounds

In reality, however, the transformation from manufacturing to services is not as smooth and simple as the textbook model suggest. The adjustment of the U.S. economy was long and not without frictions, as blue-collar workers often lacked the social skills to make the transition. Moreover, the transformation requires two key preconditions: first, there needs to be a high degree of *labor market flexibility*, which currently exists in only a few economies besides the United States; second, *regulations* need to be *entrepreneur friendly,* since new service-sector employment is mostly driven by the start-up of numerous small companies.

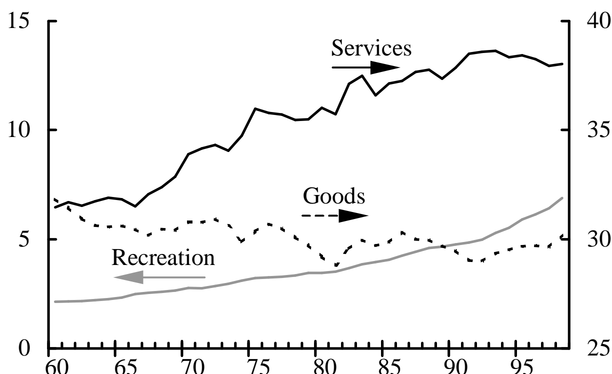
U.S. nonfarm productivity growth
%oya, 5-year moving average



U.S. nonfarm employment
% of GDP, both scales



U.S. real private consumption
% of GDP, both scales



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Besides these two preconditions, several factors can enhance the development of the services sector:

- Policies that promote *education* and *job training* to facilitate the transformation in the labor market;
- *Privatization* and *liberalization* of public and strongly regulated industries: Typical examples are privatization and liberalization in the communication and transport sector and in medical care;
- *Tax measures* that boost disposable incomes and private consumption and facilitate the start-up of new companies.

The common bias against services

Despite the success of the U.S. experience, lower service-sector productivity is often cited to discredit service-sector jobs for paying lower wages and adding less to overall income growth. This bias has been asserted by governments and lobby groups in other countries to resist service-sector promotion. The reality of the U.S. experience, however, shows that the claim is not true.

Average services wages in the United States are just 4% lower than average private nonfarm wages. This suggests that the product of unit prices and marginal productivity (i.e. the output of one additional employee) in the services sector is nearly as high as in the goods sector. True, jobs in retail and in eating and drinking places pay substantially less than average, but new jobs in these areas accounted for just 14% of the increase in private service-sector jobs over the last 20 years. In fact, most employment growth has occurred in areas that pay well above average wages, such as computer programming and other business services.

Besides, there is plenty of evidence in the United States and other economies that deregulation can lead to large productivity increases in some services areas. In the U.S. communications sector, for example, deregulation has brought productivity gains that exceeded the economy-wide average by two-thirds over the last 20 years. Similar above-average gains were reaped in the Australian communications sector following deregulation moves over the past 10 years.

U.S. service-sector real GDP and employment
% of total

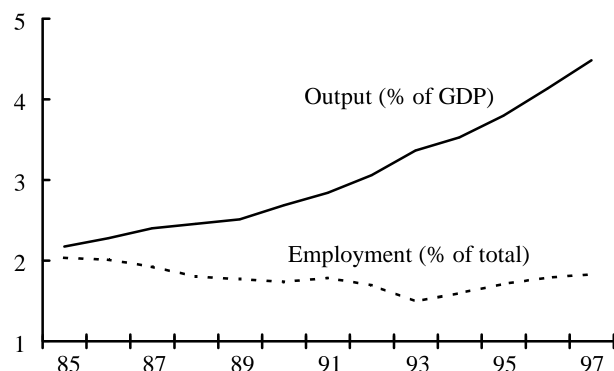
	Real GDP			Employment		
	1977	1987	1997	1977	1987	1997
Transportation	3.3	3.1	3.3	3.1	2.9	3.2
Communication	1.9	2.4	2.7	1.3	1.2	1.1
Utilities	3.1	2.6	2.8	0.8	0.8	0.7
Wholesale	4.7	5.7	7.3	5.3	5.4	5.2
Retail	4.8	5.3	6.3	11.3	11.7	11.4
Eating/drinking	3.7	3.7	3.5	4.4	5.5	5.9
Finance	4.2	5.0	4.6	2.3	2.9	2.6
Insurance	2.4	1.7	1.9	1.7	1.9	1.8
Real estate	10.8	11.3	11.2	1.1	1.2	1.1
Business/legal	2.5	4.7	5.6	3.1	5.6	7.1
Healthcare	6.0	6.0	5.2	5.1	6.3	7.7
Other private	8.2	8.2	8.4	11.2	11.8	14.3
Public	16.8	14.3	12.2	20.1	18.5	16.9

U.S. hourly earnings
dollars, not including professionals

	1970	1980	1990	1998
Private nonfarm	3.2	6.7	10.0	12.8
Goods sector	3.7	7.8	11.6	14.3
Manufacturing	3.4	7.3	10.8	13.5
Services sector	2.9	6.1	9.4	12.3
Transport, communication, utilities	3.9	8.9	12.9	15.3
Wholesale	3.4	7.0	10.8	14.0
Retail*	2.4	4.9	6.8	8.8
Finance, insurance, real estate	3.1	5.8	10.0	14.1
Business/legal	n.a.	n.a.	10.3	13.2
Healthcare	2.7	5.7	10.4	13.7
Other services	2.8	5.9	9.8	12.9

* Includes eating and drinking places.

Australia: communication services
percent



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Labor market rigidities and ...

Next to the United States and other countries with high service-sector activity, such as Australia, many leading Asian economies lack the necessary labor market flexibility to facilitate a shift into services. Service-sector employment has risen in Japan and all four Tigers, but, with the exception of Hong Kong and Singapore, this increase has been limited by labor rigidities.

In Japan, manufacturing productivity growth has fallen short of overall productivity growth in the economy over the last seven years. This is a sign of redundant employees being kept on payrolls, not inefficiencies in the production process. In Taiwan, which is usually considered to be more flexible and innovative, manufacturing productivity growth is just at par with that of the whole economy, pointing to some although less extreme labor surpluses in the manufacturing sector.

Lack of labor mobility is not limited to the manufacturing sector. In Japan, productivity in the construction sector fell on average by 1.3% per year in the 1980s and 3.0% in 1990s, pointing to even greater hoarding of redundant labor. In Korea, annual manufacturing productivity growth has consistently exceed the 5% economy-wide pace, but hoarding of surplus labor has cut productivity growth in the construction sector to just 1.3% in the 1990s. Moreover, agriculture employment in Japan, Korea, and Taiwan has remained surprisingly high, pointing to both inefficiencies in the production process and a failure of surplus labor to shift into other sectors.

Hong Kong and Singapore impress by their absence of structural labor market rigidities. Even so, the increase and level of service-sector employment in Hong Kong is much higher than in Singapore.

Productivity growth
% annual rate

	All sectors		Manufacturing	
	1980-89	1990-97	1980-89	1990-97
Japan*	2.0	0.8	2.8	0.1
Hong Kong**	4.9	4.8	10.1	12.7
Singapore	4.8	3.3	5.8	6.1
South Korea	5.2	5.0	7.6	9.1
Taiwan	5.5	5.0	4.2	5.2
Australia	0.9	1.8	n.a.	3.2
United States	1.1	1.1	2.6	3.5

Data only available: * through 1996; ** from 1983.

In contrast to Europe, where institutional factors, such as the role of labor unions and disincentives created by the social security system, have boosted unemployment, Asia's business cultures, its lack of social security and retraining facilities, and government interventions explain the region's hoarding of redundant labor.

The extreme case is Japan, where wage and work discipline in exchange for lifetime employment has so far been the bedrock of industrial relations. Not surprisingly, the government's fiscal pump-priming in recent years has sought to hold the rock solid (and social and political stability with it), not to advance restructuring.

Business cultures in Korea and Taiwan are not as extreme as in Japan, but both lack effective social security and retraining facilities while some government policies are biased to maintaining employment and social stability. In Korea, labor unions also play a stronger role, although not to the same extent as in Europe.

Employment by sector
% of total

	Agriculture				Industry				Services			
	1970	1980	1990	1997	1970	1980	1990	1997	1970	1980	1990	1997
Japan*	19.7	12.9	8.8	7.1	35.8	34.9	34.4	33.7	44.5	52.2	56.8	59.2
Hong Kong**	n.a.	n.a.	n.a.	n.a.	n.a.	51.9	34.8	16.7	n.a.	47.4	65.2	83.3
Singapore	3.5	1.6	0.3	0.3	30.1	37.7	36.7	30.2	66.4	60.7	62.1	69.5
South Korea	50.4	34.0	17.9	11.0	17.2	28.7	35.0	30.9	32.3	37.3	47.1	58.1
Taiwan	36.6	19.5	13.1	9.6	28.2	42.4	40.7	38.2	35.2	38.1	46.2	52.2
Australia***	n.a.	6.0	5.4	5.0	n.a.	24.8	22.7	19.4	n.a.	69.2	71.9	75.9
United States	4.4	3.4	1.7	2.6	31.8	27.4	22.4	19.8	63.8	69.2	75.9	77.6

Data only available: * through 1996; ** from 1981; *** from 1985.

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... regulatory restrictions limit services growth

Besides labor market rigidities, barriers to entry, especially for small businesses, and other regulations that limit competition are key factors that undermine activity and employment growth in the services sector. In Japan, the role of such factors is partly visible in the growing discrepancy between falling goods prices and rising prices for services in areas where competition is limited. One notable exception has been the increase in competition and decline in tariffs in the telecommunications sector following deregulation in 1987.

There have also been some positive liberalization moves in such areas as transport, utilities, and banking, but the overall degree of regulation and red tape governing Japan's services sector has not decreased but actually increased over the last two decades. And although there are essentially no rules that explicitly restrict foreign entry, the degree and peculiarity of domestic regulations and business practices limit the participation of foreign services providers and thereby too the transfer of knowledge and expertise.

At the same time, while Japan's economic regulations (on entry etc.) are restrictive, prudential and legal regulations are underdeveloped, which has increased business risks and undermined the outsourcing and development of accounting and legal services.

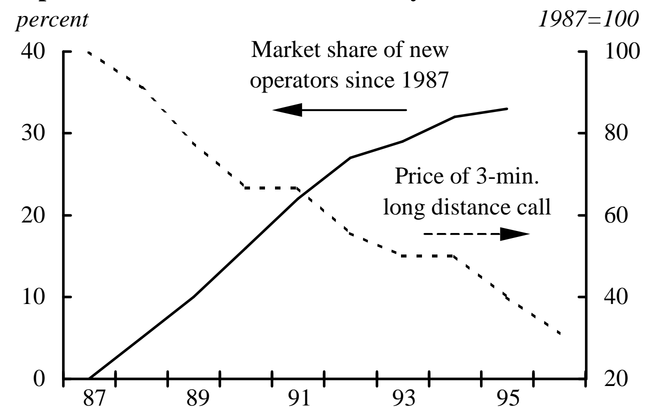
Access to start-up capital is another constraint for small services companies in Japan, thanks to the government's failure to address quickly the balance sheet and structural problems in the banking sector. The recent loan guarantee scheme was meant to address this problem, but in reality has become a mechanism for banks to unload existing bad loans.

In Korea and Taiwan, the regulatory environment is less restrictive than in Japan, especially for the start-up of small companies in traditional services areas. Communications, transport, utilities, and finance are heavily regulated and partly government controlled, but some liberalization is now taking place. As in Japan, poor prudential and legal standards have undermined the outsourcing and development of some business and legal services in Korea and Taiwan. In contrast to Japan, however, foreign entry in the services

Japan: different degrees of price changes
% change 1995-98, annual rate

Consumer price index	0.9
Durable goods	-2.4
Services	0.9
Domestic WPI	-0.9
Manufacturing goods	-0.9
Corporate services price index	0.1
Advertising	1.2
Communication	-1.2
Information services	1.3
Transport	0.3

Japan: telecommunications industry



Japan: degree of regulation by sectors
% of firms regulated within the same sector

	Regulated*			Strongly regulated**		
	1982	1989	1995	1982	1989	1995
Manufacturing	19	17	18	13	10	8
Construction	100	100	100	0	0	0
Utilities	100	100	100	100	100	98
Finance, insurance	100	100	100	100	100	100
Real estate	100	4	8	4	4	8
Transport, communication	94	95	98	56	91	96
Other services	33	55	53	23	24	26

* Regulated under law in at least one of four categories: 1) entry; 2) pricing; 3) quantity; 4) equipment standards.
** Regulated in all four categories.
Source: Fair Trade Commission.

sector in both Korea and Taiwan was explicitly limited. This has created a huge knowledge gap and combined with poor supervision has increased business risks in areas such as finance. Both countries are now working on reducing those barriers, but progress so far has been modest. Finally, in Korea, the preferential treatment of large conglomerates by the government has limited access to credit for small companies.

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Hong Kong and Singapore are much ahead, ...

In addition to their flexible labor markets, the regulatory frameworks in both Hong Kong and Singapore are much more favorable for the development of a modern services sector and so provide useful role models for Japan, Korea, and Taiwan. Both economies have a good balance between liberal business regulations and well developed prudential and legal standards, which has resulted in a high number of business start-ups in the services sector.

In Singapore, for example, nearly 10,000 new companies are registered each year, of which more than 80% are in the services sector. Moreover, nearly 20% of all services companies are foreign-owned and more than 60% of the stock of foreign direct investment (37% of GDP) is invested in the services sector. The associated transfer of knowledge and expertise is a key factor that has allowed Hong Kong and Singapore to become the two leading services centers in the region.

... but also face challenges

However, Hong Kong and Singapore also face challenges going forward. Services exports account for a large share of both economies' services output and many of those exports are in traditional areas such as transport, commerce, and tourism, which face increasing external competition and cost pressures. This was evident already prior to the Asian crisis in Singapore and more recently too in Hong Kong, which also faces uncertainties concerning the growth outlook and political stability of China at large.

On the external side, finance, business, and information services are the main areas where both economies have the potential to compensate for relative declines in traditional services activities. However, while there is probably enough room for both to grow in the areas of business and information services, their competition for dominance in financial services is apt to be increasingly fierce. So far, Hong Kong has been ahead, which gives it an advantage since financial services tend to accumulate around existing centers, but its China link could also become a disadvantage. Singapore has built a stronghold in currency and commodities trading, but its largely closed domestic market and narrower regulations are seen as a disadvantage.

Singapore: new companies and foreign ownership
% of total, 1995

	Newly founded companies	Foreign owned companies
Manufacturing	11.7	17.6
Construction	6.4	5.4
Commerce	37.3	19.4
Transport and communication	6.8	17.8
Business and financial services	32.6	21.9
Other services	4.7	13.1
Total as a percent of all existing companies	15.2	18.1

Singapore: stock of FDI by sector
% of total

	1985	1995
Manufacturing	50.5	36.3
Construction	0.9	1.2
Commerce	13.4	13.9
Transport and communication	0.0	3.2
Business financial services	33.8	45.3
Total (% of GDP)	57.4	59.0

Services activity by areas
% of GDP, current prices

	Hong Kong		Singapore	
	1980	1997	1980	1997
Transportation, communication, and utilities	8.2	10.9	16.3	12.9
Commerce and tourism	20.3	24.4	21.7	18.8
Finance and business	21.8	24.8	19.7	30.9
Other services	20.0	28.2	5.2	3.9

Exports and domestic use of services
% of GDP, constant prices

	Services exports				Domestic use
	1970	1980	1990	1997	of services*
Japan**	n.a.	n.a.	1.2	3.7	57.4
Hong Kong	n.a.	20.0	24.4	26.0	57.7
Singapore	9.6	23.2	28.5	32.1	33.2
South Korea	5.6	7.5	5.0	6.4	39.1
Taiwan	4.7	7.4	8.5	8.9	50.5
Australia	2.8	3.1	4.4	6.3	61.4
United States	1.3	1.9	2.8	3.4	70.7

* 1997 data unless otherwise noted.
** Data only available through 1996.

Lack of private consumption limits services demand

U.S. experience suggests that shifts in demand have played only a secondary role in driving service-sector activity and employment growth. However, with a large share of services being ultimately consumed by private households, the direction of private consumption and its share in GDP clearly matter for the development of the services sector. In the United States, private consumption has traditionally been a key driver of overall economic activity and consistently accounts for roughly two-thirds of GDP.

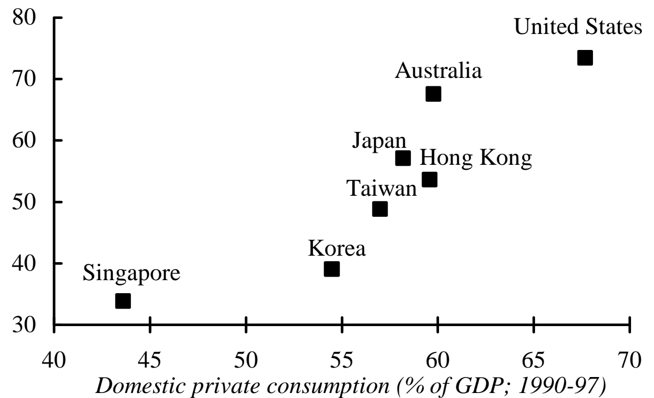
In Asia, private consumption has been less dynamic. Instead, overall growth has tended to be driven hitherto by investment and exports. In Japan, Korea, and Singapore, the share of private consumption in GDP has actually declined over the last two decades. Private consumption growth in Hong Kong and, especially, Taiwan was stronger in the late 1980s and early 1990s, but its momentum has stalled in the last few years, capping private consumption at roughly 60% of GDP.

The relative weakness of private consumption has limited domestic services demand in Asia. The domestic use of services output – total services output minus services exports – stands at less than 60% of GDP in Hong Kong and Japan, roughly 50% and 40% respectively in Taiwan and Korea, and well below 40% in Singapore. In contrast, the domestic use of U.S. services output accounts for more than 70% of GDP.

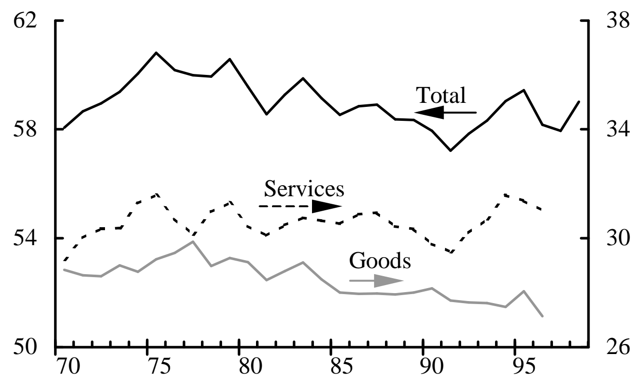
The lower shares of private consumption in GDP are the mirror image of Asia's famously high saving rates. To be sure, high saving rates have played an important role in Asia's industrialization and continue to do so in the region's less developed countries. For the region's most developed countries, however, sustained high saving and investment rates have become an obstacle to promoting service-sector activity and employment growth and, at the same time, lead increasingly to overcapacity and the inefficient use of capital in the industrial sector, as seen in Japan.

To some extent, the higher saving rates may be a function of cultural preferences, but a good part simply reflects limited choice, which again is a sign of regulatory and other structural impediments on the supply side. There have also been few reductions in average weekly work hours despite rapid economic progress and productivity growth, limiting households' ability to spend on goods and in particular services such as entertainment and recreation – in Singapore, average weekly work hours have actually risen above 47 in the late 1990s from around 45 in the early 1980s.

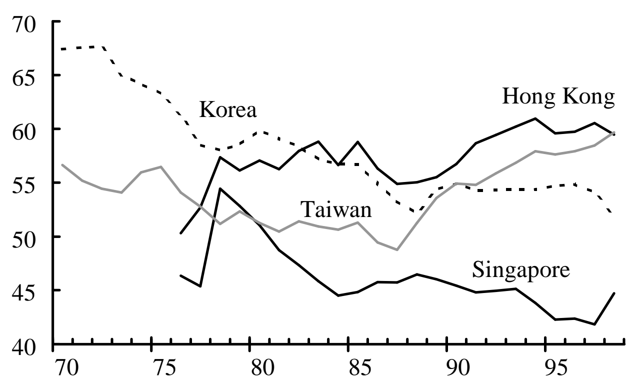
Domestic private consumption and use of services
Services output minus services exports (% of GDP; 1990-97)



Japan: real private consumption
% of GDP, both scales



Real private consumption
% of GDP



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Policy implications

The policy implications of the previous findings are straightforward. Most of all, policymakers must drop their often blind preference for manufacturing and export orientation and their bias against services. At the same time, policies that artificially promote the development of the services sector and create wrong and unsustainable incentives should be avoided. Instead, the key is to create a fair and flexible playing field that facilitates the natural evolution of the services sector. The current crisis provides an ideal opportunity to move ahead with these policy changes and reforms.

- Business cultures and industrial relations are unlikely to change overnight, but governments can do a lot to remove the obstacles that have delayed the employment shift into services, especially in Japan: First, reduce the subsidies and interventions that have kept surplus labor in areas outside the services sector; second, strengthen social security and retaining facilities without creating disincentives that lead to high long-term unemployment.

- With unemployment now rising as a result of the crisis, most important is the creation of a regulatory and business environment that facilitates: the setup of new service-sector companies; efficiency gains through increased competition; the transfer of knowledge through foreign participation; and the outsourcing of services previously done in-house. In principle, this means that barriers to entry should be small but that prudential, legal, and administrative standards need to be sound and transparent.

- Particular attention needs to be paid to the financial sector, which constitutes an important part of the services sector and, at the same time, will have to provide the funding for the start-up and expansion of other services companies. Thus, restoration of financial-sector health and the strengthening of prudential and operational standards are top priorities, especially in Japan and Korea. But policy measures should also create new growth opportunities through deregulation and increased foreign participation, while governments need to hold back more from influencing banks' lending decisions and providing financial guarantees.

Real GDP by sector in Emerging Asia, 1997
% of GDP, constant prices

	Agriculture	Industry	Services
China*	18.7	49.2	32.1
India	24.5	26.9	48.6
Indonesia	14.8	42.0	43.2
Malaysia	12.0	45.1	42.9
Philippines	20.5	32.6	46.9
Thailand*	10.6	39.4	50.0

* Nominal terms.
** 1996 data.

- Finally, there is some role that tax policy can play in the promotion of service-sector growth. This is especially true for Japan, where business and income taxes are significantly higher than in the rest of the region and companies and households are uncertain about the tax outlook because of the government's frequent policy changes. In the rest of the region, taxes are not a constraint except for some high transaction duties. Still, U.S. experience has shown that marginal tax cuts help promote household spending and the setup of new services companies.

Lessons for the rest of Asia

For the region's less developed economies, where industrialization is still in full swing, service-sector development is of secondary importance. Agriculture still accounts for a large fraction of economic activity, ranging from 10% to 25% of GDP, while the share of the industrial sector continues to rise. Not surprisingly, service-sector activity in most countries ranges between 40% and 50% of GDP. Nevertheless, governments are well advised to learn some lessons from experience both good and bad in Japan and the top Tigers and therefore to combine their current reform efforts with policies that remove labor market rigidities and regulatory barriers.

China faces a different challenge due to the large role of the state sector: Agriculture has been kept artificially large, industry has been overextended, and services have been neglected. Deregulation, reforms, and foreign competition will put the state sector and labor market under huge pressure, especially once China joins the WTO. Thus, raising service-sector employment will be vital and foreign participation can help.

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Japan is still a long way from real recovery

- **Economy has been stabilized by a raft of fiscal and monetary initiatives**
- **But capital stock adjustment will heighten deflationary pressures in fiscal 1999**
- **Government will respond with more pump-priming measures, but its fiscal ammo is running out**
- **Risk of the economy falling into a another dip will increase as the year progresses**

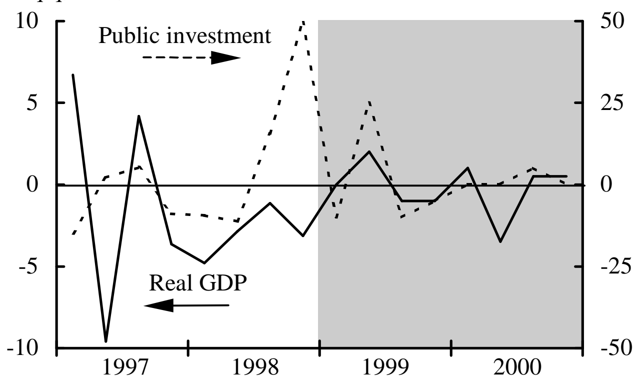
Key forecasts
calendar years

	1998e	1999f	2000f
Real GDP (%oya)	-2.9	-0.7	-0.5
Consumer prices (%oya)	0.6	-0.1	-0.2
Current account (US$ bil)	121.0	105.4	102.2
Fiscal balance (% of GDP)	-6.9	-8.5	-9.2
Net government borrowing (¥ tril)	34.0	41.2	44.4
3-mo. LIBOR rate (% p.a.)*	0.3	0.2	0.2
10-year bond yield (% p.a.)*	1.5	1.6	1.9
Yen/US$*	130	133	135

* Year end.

Economy is on the brink of major restructuring, not recovery

Real GDP and public investment
%q/q, saar, both scales



Quarterly real GDP forecasts and components
%q/q, saar

	99Q1	99Q2	99Q3	99Q4
Real GDP	0.0	2.0	-1.0	-1.0
Private consumption	1.5	1.0	1.0	1.0
Government consumption	1.0	1.0	1.0	1.0
Business investment	0.0	-8.0	-8.0	-8.0
Residential construction	15.0	25.0	5.0	-10.0
Public investment	-10.0	25.0	-10.0	-5.0
Exports of goods and services	-1.0	0.5	1.0	1.0
Imports of goods and services	2.0	2.5	-2.5	-1.0
Contributions to real GDP				
Domestic final sales	0.5	2.3	-1.3	-1.5
Inventories	-0.2	-0.1	-0.1	0.2
Net trade	-0.4	-0.2	0.4	0.3

- A straightforward comparison of major economic and financial indicators at the beginning and end of the first quarter would appear to provide grounds for optimism. Egged on by announcements of radical restructuring at leading companies and further Bank of Japan easing, many foreign investors have bought the story that from here the only way is up.
- But the stabilization of the financial system combined with the small upturns in production and consumption do not point to imminent recovery. Much of the improvement relies on the impact of short-term stimulus programs, such as the credit guarantee scheme, cheap housing loans, and public work programs, yet large corporates plan to accelerate cutbacks in employment and investment. Against this background, the fiscal stimulus lacks multiplier effects and the economy becomes vulnerable when the fiscal boost fades by the middle of this year.
- The authorities will respond with fresh fiscal and monetary initiatives, but new spending will probably just offset the expiry of previous programs, thanks to growing budget deficit concerns.
- The J.P. forecast now anticipates slightly stronger growth in the second quarter. However, this is expected to be followed by weaker public spending and faster investment cutbacks, advancing part of the weakness that was previously expected to occur in 2000 into the second half of this year.

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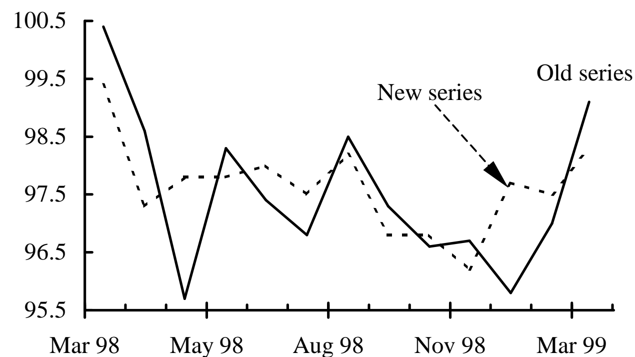
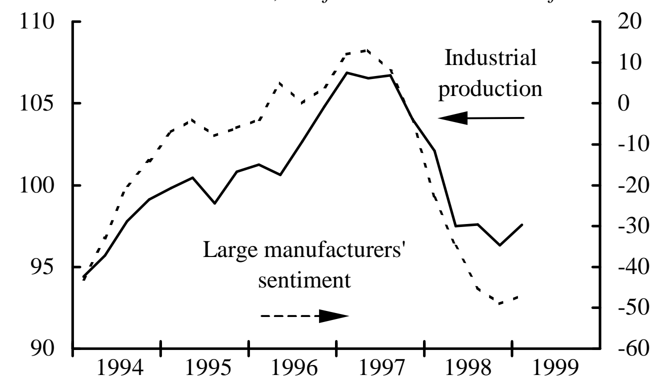
Production has stabilized but is going nowhere fast from here

Industrial production and seasonal adjustment
1995=100, sa

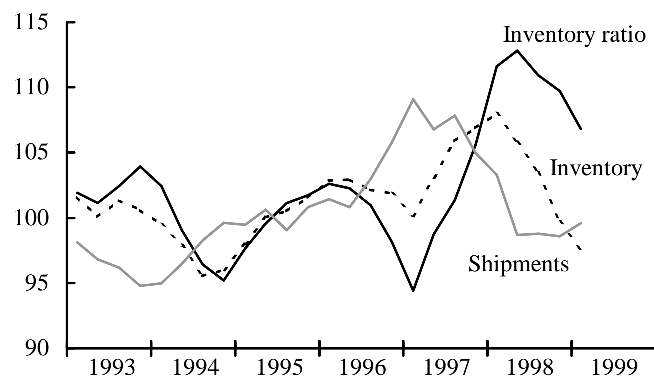


Industrial production and business confidence
1995=100, sa *DI, % "favourable" minus "unfavorable"*

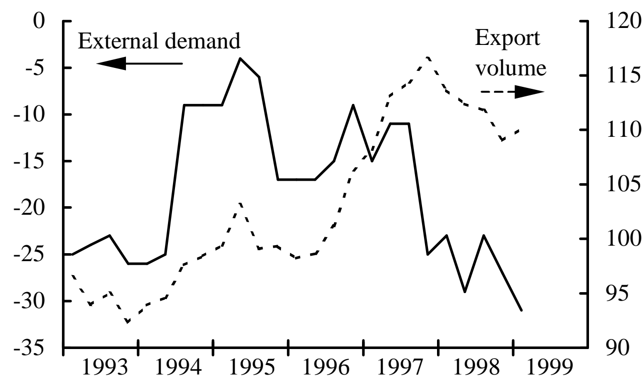


- According to the MITI's new seasonally adjusted data, industrial production picked up 5.2% annualized in the first quarter, reversing the decline in the fourth quarter of last year. Part of the rise, however, was due to a temporary rise in transport equipment. Excluding transport equipment, investment goods production remained weak, while consumption goods production picked up.
- On balance, production has clearly stabilized but there are no strong signs pointing to a pickup. Producers' forecasts for April and May suggest that output in the second quarter will not keep rising at the first-quarter pace. As a result, the inventory-shipment ratio remains relatively high, leading probably to more destocking.
- External demand is not likely to provide major support in the coming months. The fear of mounting trade friction with the United States in fields such as steel, flat glass, auto parts, and medical products has already led some producers to implement voluntary restraints. Moreover, the yen remains strong and external economic conditions are, on balance, worsening. Growth will slow in North America and, though reviving in Europe, will merely continue to stabilize in Emerging Asia as a whole.

Manufacturers' inventory and shipments
1995=100, sa



Manufacturers' external demand and export volume
DI, % "Tight" minus "Loose" *1995=100, sa*



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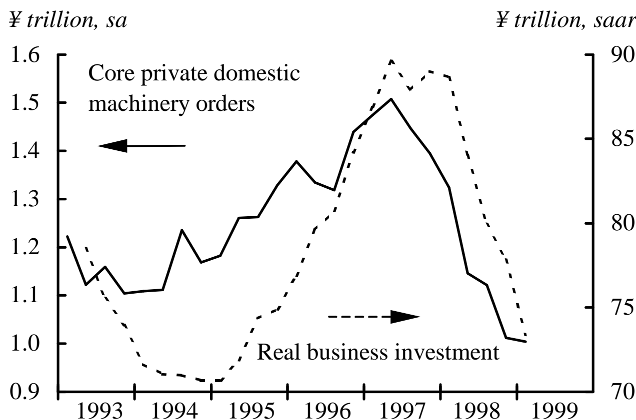
Reduction of excess capacity will be the dominant theme of fiscal 1999

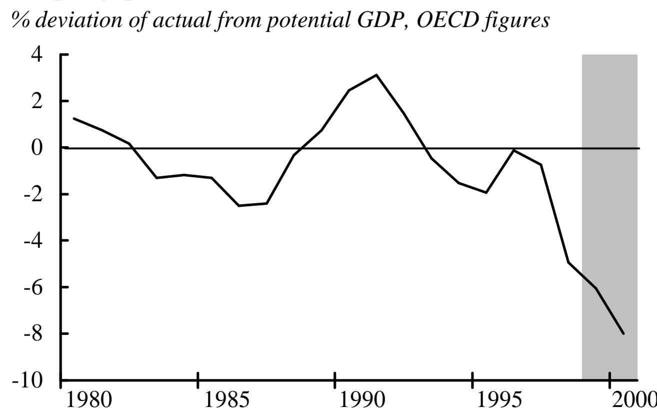
Machinery orders and business investment

¥ trillion, sa *¥ trillion, saar*



Output gap

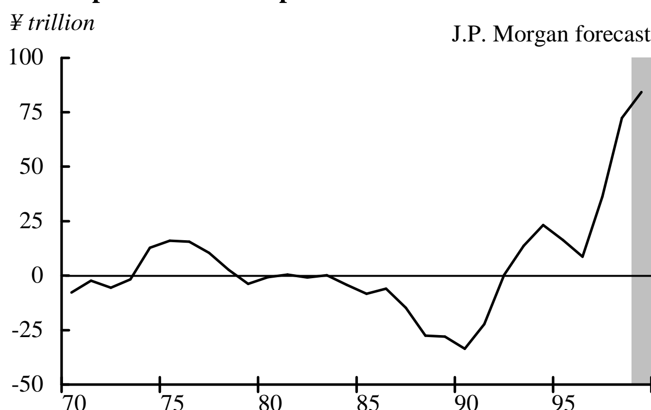
% deviation of actual from potential GDP, OECD figures



- Business investment apparently exceeded expectations in the first quarter. In sharp contrast to the 6.4% drop (q/q, not annualized) forecast in January by machinery producers themselves, core private domestic machinery orders look set to come in about flat for the quarter. But this pattern will certainly prove unsustainable in the second quarter.
- Cutbacks in capital investment will intensify in the fiscal year just begun as the corporate sector finally gets to grips with the necessity of stock adjustment. Japan's broader economic and financial environment is now potentially much less supportive than in the past. The output gap is much larger and interest rates have no scope to fall further. Morgan estimates that the private sector has excess capital stock of nearly ¥85 trillion in 1999.
- Accordingly, manufacturers have continued to report a deterioration in their excess capacity and employment positions even though they agree that the economy stabilized in the final quarter of 1998.
- The BoJ's March Tankan also has indicated that greatest retrenchment of investment is planned in sectors such as wholesaling (a 44% cut from the 1998 level), real estate (34%), steel (28%), construction (23%), precision machinery (20%) and autos (19%). Press releases outlining corporate plans to close plants and reduce payrolls suggest that the 1999 cutbacks will occur on an unprecedented scale.

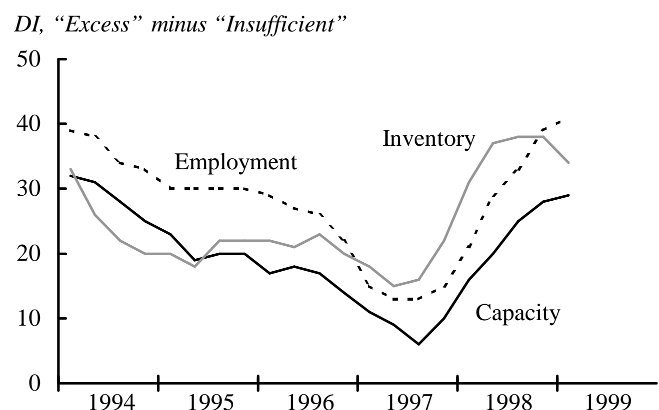
Excess private sector capital stock

¥ trillion



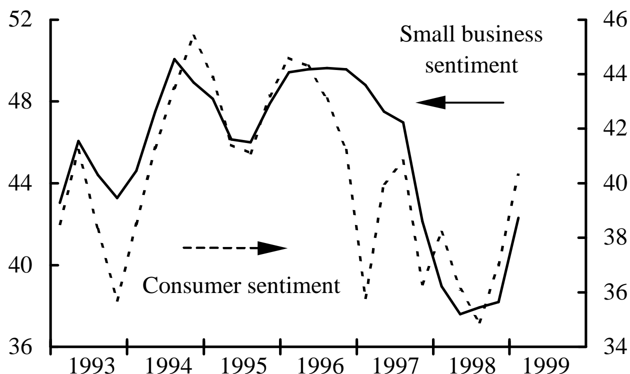
Manufacturers' excesses

DI, "Excess" minus "Insufficient"

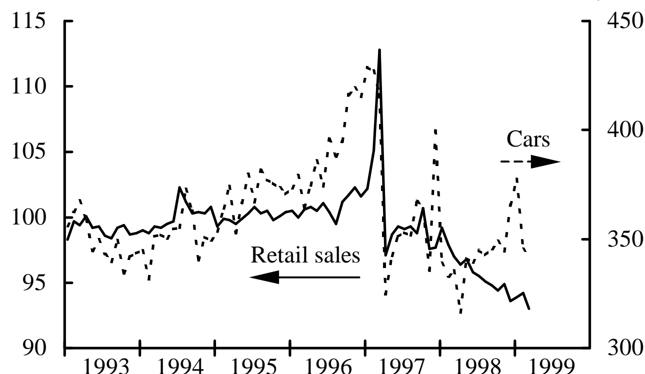


Despite the government's best efforts, restructuring will deal a new blow to consumption

Consumer and small business sentiment
DI, "Good" minus "Bad", both scales

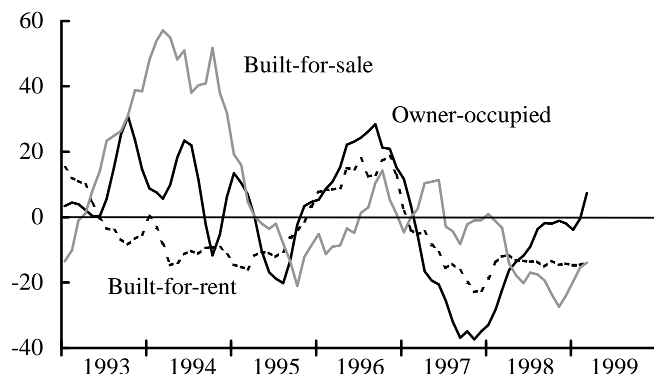


Retail sales and passenger car registrations
1995=100, sa *thousand units, sa*



- Consumer sentiment has responded to the recent fiscal and monetary initiatives that put a floor under the economy in the fourth quarter of 1998. Interestingly, it seems that government measures to stabilize the financial system and support small businesses (e.g., via credit guarantees) have indirectly bolstered sentiment more than have direct measures such as "free" shopping vouchers for those with young children and the elderly or the promise of income tax cuts from April for higher earners.
- Nevertheless, any pickup in personal consumption has been modest at best. Retail sales for the first quarter as a whole were down 4.5%, partly as a result of bad weather that depressed weekend sales in March. PCs and mini-vehicles were two notable exceptions that bucked the moribund trend.
- Residential investment fared better. Starts of owner-occupied housing rose as demand front-loaded ahead of what was advertised as a big hike in the government-affiliated Housing Loan Corporation's mortgage rate from 2.2% to 2.8% in April. In fact, the rise was held down to 2.4% which, alongside tax changes, should continue to boost demand.
- But the downside risks posed by corporate restructuring are likely to win out in the medium term. This year's *shunto* spring wage settlements were the lowest ever and the unemployment rate is now 4.8% and set to exceed 5% by the end of the year.

Housing starts
%oya, 3-month moving average



Unemployment rate and ratio of job offers to seekers
%, sa *ratio of job offers to seekers, sa*

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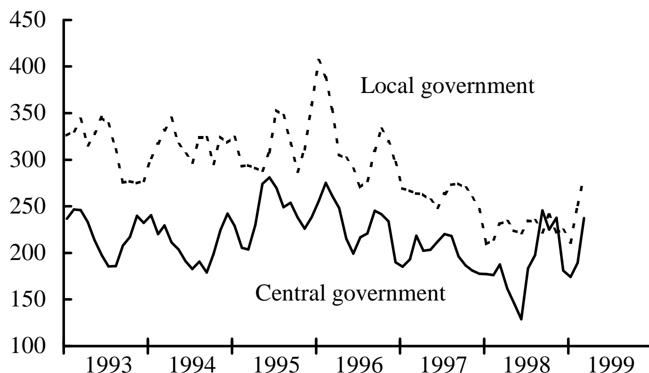
The November package has arrived, and there is still a bit more where that came from

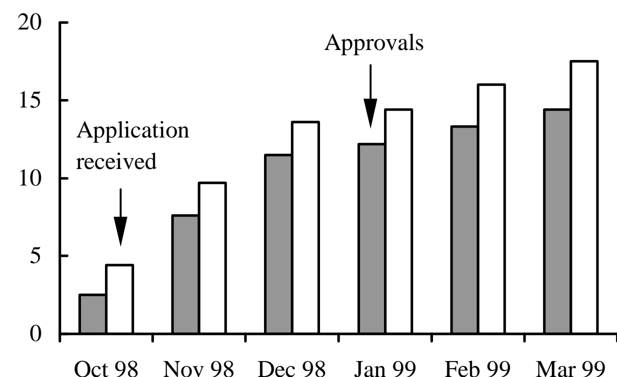
Public construction orders

¥ billion, sa, 3-month moving average



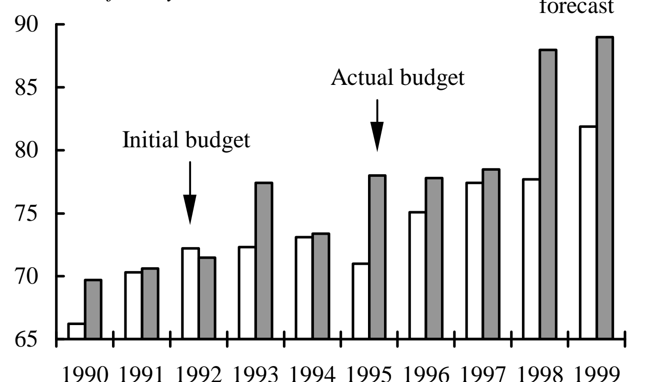
Special ¥20 trillion credit guarantee program

¥ trillion



Central government general account

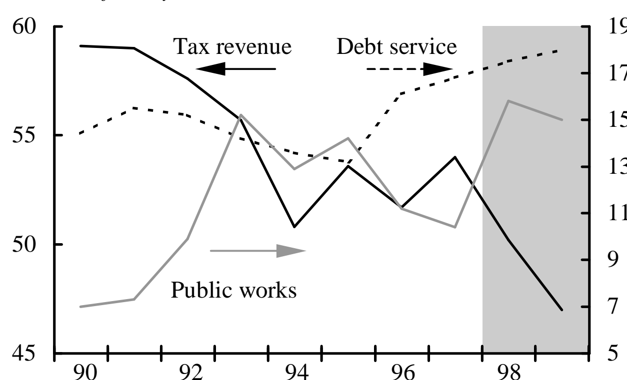
¥ trillion, fiscal year



- The ¥24 trillion November 1998 stimulus package arrived ahead of schedule, as shown by the February and March jumps in public construction orders.
- The ¥20 trillion special credit guarantee scheme for small firms has also done much to underpin the private sector by curbing corporate bankruptcy growth to 26% (over a year ago) on average between December 1998 and March 1999.
- But more pump-priming will be needed in the latter half of this new fiscal year, since the government's initial budget for Fiscal 1999 incorporates a cut of ¥8 trillion in general expenditures compared to the final budget for Fiscal 1998.
- The Morgan forecast assumes a supplementary budget will be announced this summer offering ¥3-5 trillion in "real water" spending. Aside from a modest increase in public works spending, it will probably incorporate new measures to bolster employment through labor subsidies, extra help for small firms (possibly in the form of government guarantees of corporate debt issues), and tax breaks to help firms scrap excess plant and equipment.
- But scope for further stimulus is diminishing rapidly as the market has begun to attach a credit premium to government debt. The annual budget deficit is set to reach almost 10% of GDP in fiscal 2000, and the government is widely suspected to be shouldering massive "hidden" off-balance-sheet liabilities associated with its Fiscal Investment and Loan Program.

Major budget components

¥ trillion, fiscal year, both scales



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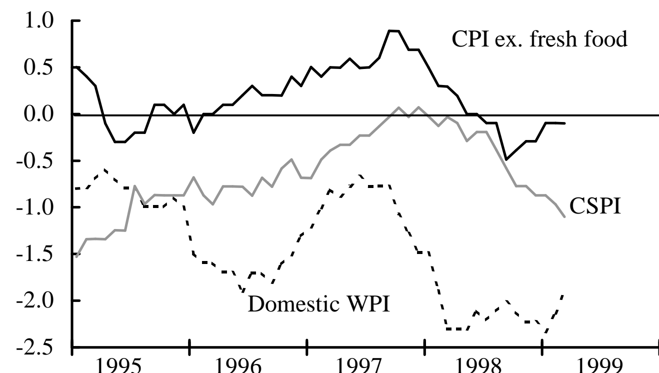
The economy is not yet in a deflationary spiral, but the risk of it falling into one will increase

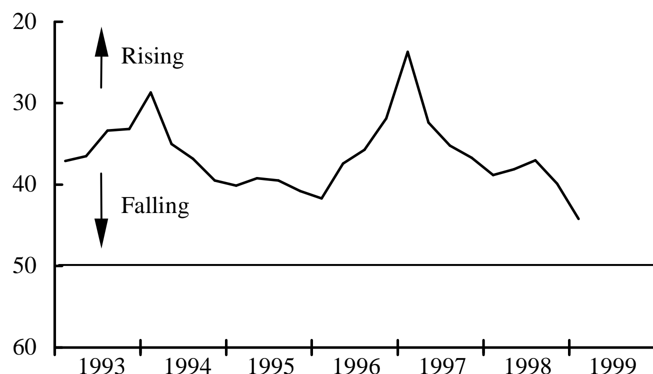
Price indicators

%oya, nsa, adjusted for VAT hike



Consumers' perception of prices

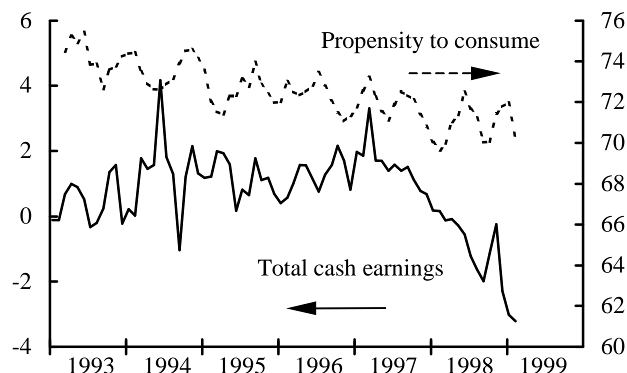
DI, sa, reading above 50 means majority believe prices are falling



- Mild deflation continues to characterize price movements, even though downward pressures abated a bit in the first quarter. The pressures ebbed thanks to a small improvement in economic conditions rather than extra easing by the BoJ in mid February, although that easing was significant in bringing down benchmark interest rates across the curve.
- At present, the economy is not in a deflationary spiral. Surveys show that both consumer and producer expectations of price movements continue to underestimate the magnitude of actual declines. This implies that spending is not being purposefully withheld in anticipation that prices will decline further, a process that could become a self-fulfilling prophesy.
- The one area in which prices are set to rise much in the near future is energy. Rising world oil prices will make their presence felt strongly in Japan's overall wholesale prices. But the magnitude of the output gap and associated profit squeeze will constrain the extent to which producers pass on higher input prices into domestic output prices. The effect on consumer prices will be smaller still, for similar reasons and because they are "stickier" by nature.
- Nevertheless, deflationary pressures are set to increase in the coming months thanks to the yawning output gap, corporate restructuring, and the inevitable decline in public spending. As this reality becomes clearer, the BoJ will be forced to consider purchasing government debt (see also page 5).

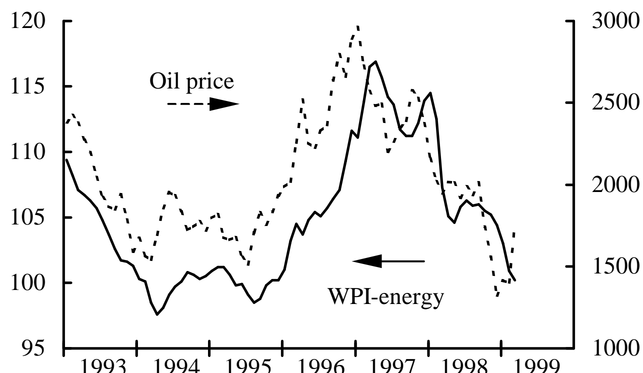
Wages and households' propensity to consume

%oya, nsa, 3mma *% of disposable income, sa, 3mma*



WPI - energy and oil prices

1995=100, nsa *¥ per barrel, WTI spot price*



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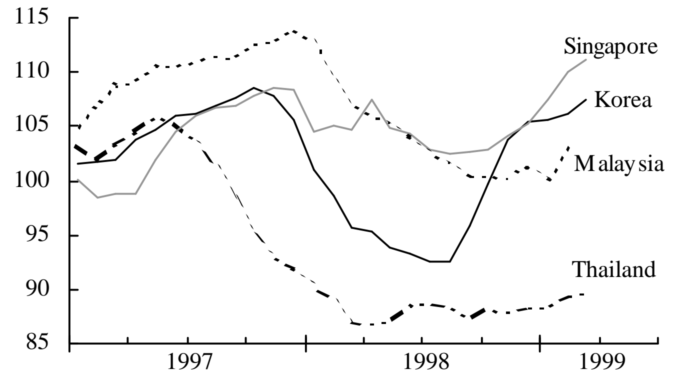
Emerging Asia: more leaders than laggers

- **Region's mild recovery on track and broader than previously expected**
- **Readjustment of trade balances proceeds gradually, preserving payments surpluses**
- **Government policies solidly accommodative – with more easing on the way for some**
- **Thailand, Korea, and Malaysia restructure in their own distinctive ways**
- **Outlook brightens in Singapore and Hong Kong**
- **China and India go against the region's improving trend, while Indonesia still lags behind**

Industrial production
1996=100, sa, 3-month moving average



Real GDP growth forecasts vs. consensus
%oya, calendar years

		1999		2000	
	1998	J.P. Morgan	Consensus*	J.P. Morgan	Consensus*
Emerging Asia (10)	0.1	3.3	3.5	4.9	4.8
excluding China	-2.8	2.2	2.1	4.5	4.0
China	7.8	6.5	7.2	5.8	7.2
Hong Kong	-5.1	-0.8	-1.1	2.8	2.0
India**	5.0	3.0	5.3	5.0	5.9
Indonesia	-13.7	-3.5	-3.8	5.0	2.1
Korea	-5.8	4.0	3.2	4.5	4.2
Malaysia	-6.7	2.0	0.9	4.0	3.2
Philippines	-0.5	2.6	1.6	5.0	3.2
Singapore	1.5	2.4	0.9	4.3	3.0
Taiwan	4.8	3.7	4.3	4.5	4.8
Thailand	-9.1	2.5	0.5	5.0	3.0

* Consensus Economics Inc., April 12, 1999.
** For fiscal year beginning April 1.

Data releases over the past three months reaffirm the J.P. Morgan view that Emerging Asia's economic recovery is the real thing. While the rebounds in 1999 still look to be mild and largely constitute payback for last year's sharp contractions, the list of countries seen as growing this year continues to expand.

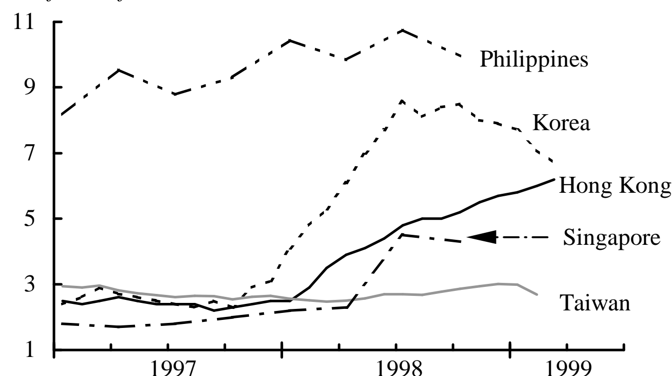
- The forecast of an Emerging Asian recovery holds good despite a sluggish growth outlook for the industrial world. OECD growth is forecast to be low and steady over the next 18 months, with a slowdown in the United States being compensated by strength in the Euro area and an ephemeral rise in Japanese GDP.
- The countries that experienced sharp currency depreciations will continue to lead the regional recovery. Korea has consolidated the sharp production gains of late last year. Rebounds in Thailand and the Philippines will be sizable but less dramatic.
- Malaysia also continues to benefit from a cheap currency, and recent evidence of reform progress has removed enough uncertainty from the forecast to place it on the leader board.
- Even Singapore and Hong Kong, with their relatively strong currencies, look set to perform well this year. Singapore has already been buoyed primarily by better regional demand and Hong Kong by improvements in market sentiment that should produce an economic rebound in the first half of this year.
- China's fiscal stimulus efforts may just be sufficient to keep the economy's growth rate from slipping significantly, though questions remain about the quality of that growth.
- India's growth performance will slip, while Indonesia will continue sliding, with politics in both countries largely determining their economic fortunes.

Output recovery broad, but moderate

Across Emerging Asia, 1999 is on track to be a much better year than the last. However, the quarterly pattern of the Morgan forecasts generally indicates that the recovery is not likely to build significant momentum as the year unfolds.

- Quarterly data show that GDP in Korea and Thailand stabilized by mid-1998 and the forecast is that the others (save Indonesia) will begin growing during the first half of 1999.
- Surprisingly, Singapore and Malaysia look to start off 1999 strong, driven by electronics production and growing regional demand. Much of this revival reflects inventory restocking and will likely fade as global growth remains dull. In contrast, Taiwan will start off the year poorly, but the electronics sector there should revive growth by the second quarter.
- The Philippines will benefit from better first-quarter harvests and its peerless export performance.
- Unemployment will be a lagging indicator of the regional recovery, though government support programs will cap the numbers in Korea and Thailand.
- Those government programs, combined with improving sentiment, will help private consumption stabilize this year. In fact, private consumption indicators in some countries – notably Korea, Malaysia, and Singapore – have already started to turn positive. Impressive gains in the equity markets in these countries are likely adding fuel to those gains.

Unemployment rate
% of labor force, sa

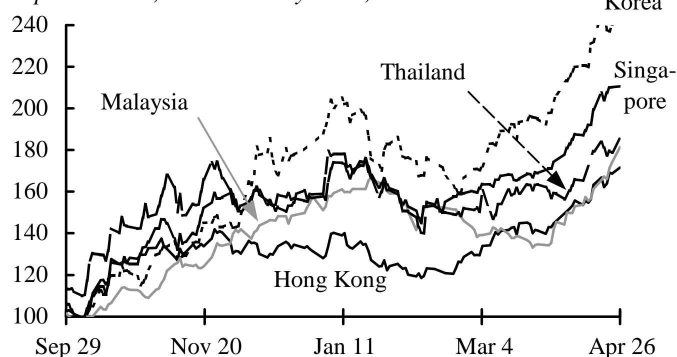


Private consumption indicators
% quarter-on-quarter, seas. adj. annualized

Country	Data	98Q2	98Q3	98Q4	Latest	period*
China	Retail sales	5.7	14.3	4.6	4.5	99Q1
Hong Kong	Retail sales	1.0	-20.6	-16.7	-14.6	Jan-Feb
Korea	Retail sales	-13.3	11.3	13.2	12.5	Jan-Feb
Malaysia	Car sales	-11.9	53.9	122.5	306.3	99Q1
Singapore	Retail sales	18.7	-19.2	0.6	11.9	Jan-Feb
Thailand	Car sales	-22.9	-61.4	511.2	-87.2	Jan

* Annualized % change of latest average from fourth-quarter average.

Equity market performance
Sep 1998=100, local currency terms, benchmark indices



Real GDP growth forecasts
percent

			quarter-on-quarter, seasonally adjusted						over year ago					
			1998		1999				1998		1999			
	1998	1999	Q3	Q4	Q1	Q2	Q3	Q4	Q3	Q4	Q1	Q2	Q3	Q4
Emerging Asia ex India	-1.0	3.3	0.2	1.3	0.8	0.9	1.3	1.2	-2.3	-1.5	1.4	3.2	4.3	4.2
ex India and China	-4.6	1.9	-0.7	0.3	0.7	1.0	1.5	1.5	-6.4	-5.8	-1.8	1.3	3.5	4.7
China	7.8	6.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	7.6	9.3	9.2	7.8	6.1	3.0
Hong Kong	-5.1	-0.8	-1.3	-0.2	-0.4	0.2	0.4	1.1	-6.9	-5.6	-2.6	-1.7	0.0	1.3
Indonesia	-13.7	-3.5	-7.0	-1.1	-0.3	-0.4	5.5	3.6	-18.4	-19.6	-15.1	-8.7	3.4	8.4
Korea	-5.8	4.0	0.3	1.0	1.5	1.5	1.0	1.0	-7.1	-5.3	1.4	4.4	5.1	5.1
Malaysia	-6.7	2.0	-1.4	-1.3	1.0	0.8	0.8	0.6	-9.0	-8.2	-1.0	1.9	4.0	3.1
Philippines	-0.5	2.6	0.4	-0.4	1.1	1.2	0.3	1.7	-0.9	-1.7	0.6	2.3	2.2	4.4
Singapore	1.5	2.4	-0.1	0.5	2.0	0.2	0.3	0.3	-0.6	-0.8	1.6	2.6	2.9	2.7
Taiwan	4.8	3.7	1.4	0.7	-0.2	1.6	1.6	1.6	4.6	3.7	2.7	3.5	3.7	4.7
Thailand	-9.1	2.5	0.1	1.3	1.0	1.1	1.3	1.3	-11.1	-7.7	-3.5	3.6	4.8	4.8

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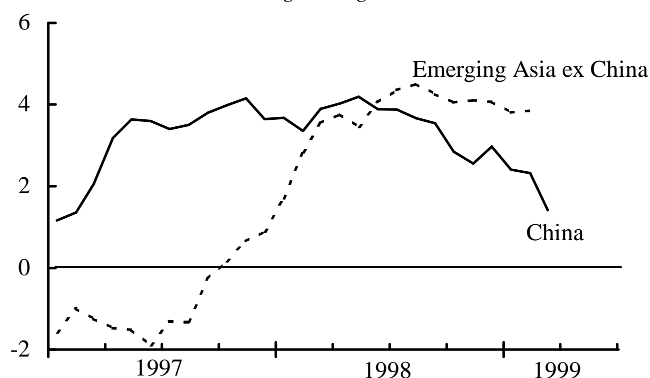
Balance of payments readjusting only gradually

The rapid easing of payments pressures last year was a critical factor that allowed this year's healing to occur. The easing was sizable as well as swift. Between 1997 and 1998, Emerging Asia (excluding China) saw an $86 billion swing in its current account from small deficit to large surplus. And despite the steep reduction in bank lending to the region and capital flight from some countries (Indonesia, in particular), the region's overall balance of payments (excluding China) turned in a solid surplus in 1998.

This year, those current account surpluses will recede. However, because the speed with which they fade will largely be a function of the speed of each country's economic recovery, do not expect them to disappear quickly. In aggregate, the region's current account surplus (excluding China) is forecast to slip but still to exceed $60 billion. On the capital account side, external bank debts have largely been repaid, portfolio investments have begun their tentative return to the region, and FDI will be boosted by more sales of distressed assets. All in all, 1999 promises to be another year in which Emerging Asia's balance of payments remains in the black.

- The principal exception will be China. Already, its trade surplus is falling thanks to rising imports, while the prospects for its exports remain poor. To make matters worse, FDI inflows look set to slow. The result will be slippage in the country's current account surplus and an overall balance of payments deficit.
- The crisis economies of Thailand, Korea, and even Indonesia best exemplify the message that payments balances will remain strong and positive in 1999. In each economy, trade and current account surpluses are forecast to fall, but net private capital flows should strengthen. Korea and Thailand look firmly set to post payments surpluses in 1999. The situation in Indonesia, of course, is subject to substantial political risk.
- Also fitting this model are Malaysia and the Philippines. The former is benefiting from a gradual removal of capital controls as international sentiment continues to improve. The latter already has raised substantial external funding earlier this year.

Merchandise trade balance
$ billion, sa, 3-month moving average



Current account and balance of payments forecasts
$ billion

	1997		1998		1999	
	CA	BoP	CA	BoP	CA	BoP
Emerging Asia	23.2	31.4	109.4	51.7	72.6	28.8
excluding China	-7.0	-4.5	79.4	46.4	62.2	36.0
China	30.1	35.9	30.0	5.2	10.4	-7.2
Hong Kong	1.4	29.4	4.8	-3.6	7.1	-1.0
India	-5.6	3.9	-8.7	2.0	-6.0	2.0
Indonesia	-6.2	-2.6	3.6	2.2	2.1	3.6
Korea	-7.9	-11.9	40.3	31.7	20.9	9.0
Malaysia	-3.9	-3.9	4.9	3.5	4.4	5.5
Philippines	-4.3	-2.5	1.3	1.7	1.8	2.0
Singapore	14.8	-5.5	15.5	3.7	15.0	8.5
Taiwan	7.7	-0.7	3.4	4.8	5.5	-0.7
Thailand	-2.9	-10.7	14.2	1.5	11.4	7.0

Bank loans from abroad
$ billion, eop

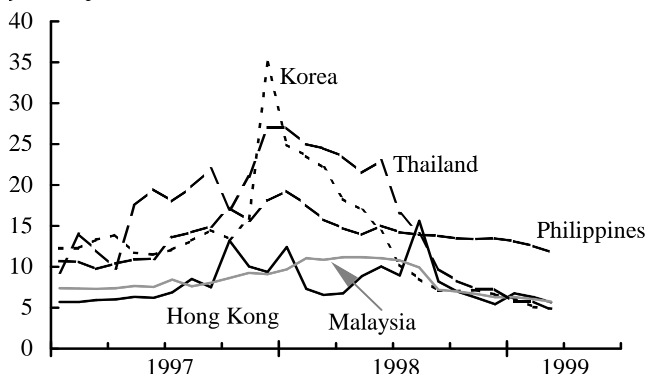
	1996	1997	98Q1	98Q2	98Q3
Emerging Asia	401.4	390.5	357.9	340.3	321.9
excluding China	323.5	307.1	274.5	259.6	247.1
China	77.9	83.4	83.4	80.7	74.8
Hong Kong	n.a.	n.a.	n.a.	n.a.	n.a.
India	19.0	21.8	22.0	21.9	22.3
Indonesia	55.9	60.5	55.7	52.2	50.7
Korea	95.4	88.1	72.3	68.8	64.2
Malaysia	22.3	25.2	22.5	21.4	20.3
Philippines	12.3	14.5	14.1	13.2	12.9
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.
Taiwan	22.3	20.7	20.1	20.3	19.2
Thailand	96.3	76.3	67.8	61.8	57.5

Monetary conditions are still too tight

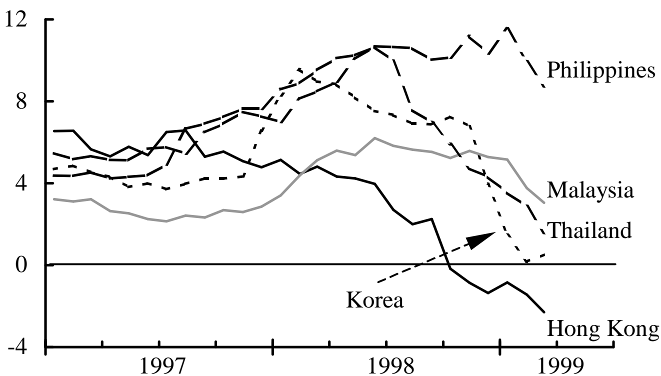
With Emerging Asia's economic recovery underway, but shallow, and payments balances forecast to remain positive, conditions remain ripe for the region's central banks in nearly all cases to keep monetary conditions accommodative. But despite the sharp nominal depreciations of many currencies in 1997 and the repeated rounds of interest rate cuts in 1998 (cuts that have continued into this year), monetary conditions are still not strongly stimulative in Emerging Asia. Since inflation not an issue anywhere in the region, with the partial exception of India, policymakers could quite reasonably push short-term interest rates down further or allow their exchange rates to weaken. In some cases, both moves would be justified.

- Thailand and Korea have both driven interest rates to very low levels, so their monetary easing phases have essentially run their course. However, their currencies have not declined in tandem. In fact, the baht and the won have both essentially surrendered the competitiveness gains made in 1997. Accordingly, the monetary authorities in these two countries are likely to continue to choose to build their foreign reserves going forward, though the unsterilized nature of such operations will lessen their currency impact.
- At the other end of the spectrum, real interest rates are still very high in China, Hong Kong, and Indonesia. In Hong Kong, the direction of rates continues to be constrained by U.S. interest rate policy and sentiment toward China. In Indonesia, mild inflation and a still positive payments position should allow rates to fall significantly, but the upcoming elections are likely to limit the influence of such fundamental factors.
- Given their nominal exchange rate pegs to the U.S. dollar, China and Hong Kong remain stuck in less competitive positions because of the depreciations experienced by their trade partners. In contrast, Indonesia's rupiah remains very competitive because its massive nominal depreciation has outstripped the sharp rise in the domestic price level.

Nominal short-term interest rates
percent per annum



Consumer prices
%oya



- Malaysia has preserved its competitiveness gains as a result of pegging its currency to the dollar last year. Therefore, when that peg eventually goes, the first move for the ringgit will be toward strength. On the interest rate front, rates have eased in Malaysia, but the authorities have room to make further cuts.
- In the Philippines, rates have fallen more gradually, and are still declining after first pausing for the typhoon-related bump in inflation to pass. Even at their current levels, interest rates are not fully stimulative, but the authorities may have to wait for further confirmation of the slowdown in inflation before pushing rates down further. The main potential problem with following such a policy is that it might precipitate a weakening of the peso, but that is a risk the authorities should be willing to take.

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But fiscal policy easing is solidly under way

While regional monetary conditions are not yet fully stimulative, fiscal policies are almost uniformly so (India is the exception, not without reason). For some economies, larger budget deficits in part reflect financial sector restructuring costs, but for all a dose of old-fashioned pump-priming is present as well.

Importantly, in most countries, public sector deficits should shrink as the economies recover. The winnowing of the deficits will take years in some cases, but with public debts generally low and saving rates high, longer-term interest rates are generally set to fall.

- China's public investment has been the principal driving force for its economy's growth since last year. Though the government has shifted its policy once again toward more "quality-oriented" growth, fiscal deficits will continue to grow.
- With the blessing of the IMF, Thailand and the Philippines have revised and widened their budget deficit targets in order to maintain the momentum in their economic recoveries.
- India's budget can best be described as neutral, though the country's mounting debts and still solid economic performance make a strong case for fiscal tightening, if only politics would allow.

Real effective exchange rate
1990=100

	Dec 97	Mar 99	Last 5-year average
China	89.6	85.6	81.9
Hong Kong	138.4	129.2	124.2
India	80.8	79.6	78.0
Indonesia	62.4	64.8	87.5
Korea	58.6	79.1	81.0
Malaysia	84.9	85.8	102.1
Philippines	90.9	106.3	105.0
Singapore	114.4	107.6	112.9
Taiwan	89.3	91.6	89.6
Thailand	75.5	91.5	92.8

Nominal and real short-term interest rates
percent per annum

	Nominal interest rates		Real interest rates*	
	Dec 97	Mar 99	Mar 99	1990-97
China	8.6	6.4	6.2	0.6
Hong Kong	9.4	5.7	5.4	-1.9
India	7.2	8.8	1.8	2.1
Indonesia	28.5	38.7	18.0	2.1
Korea	35.0	4.9	1.8	8.9
Malaysia	9.1	5.8	4.2	3.0
Philippines	18.1	11.8	6.9	6.1
Singapore	6.3	1.6	1.1	1.7
Taiwan	8.4	5.2	4.3	4.4
Thailand	27.0	4.8	-1.8	6.6

* Nominal interest rate minus 12-months-forward inflation rate.

Nominal and real money supply (M2) growth
%oya

	Nominal M2 growth		Real M2 growth*	
	Dec 97	Feb 99	Feb 99	1990-97
China***	19.6	15.3	16.4	19.7
Hong Kong	8.3	9.3	10.7	6.3
India (M3)	16.8	20.5	11.1	7.5
Indonesia	23.2	40.1	-13.3	18.2
Korea	14.1	36.1**	36.6**	11.9
Malaysia	22.7	4.0	0.3	16.0
Philippines (M3)	20.9	7.7	-2.4	10.4
Singapore	10.3	28.4	29.1	10.0
Taiwan	8.0	8.2	6.1	10.5
Thailand	16.4	8.1	5.2	12.9

* Nominal M2 growth minus contemporaneous inflation rate.
** Mar 1999. *** Quarterly data.

Primary public sector balance and debt stock
% of GDP

	Primary balance			
	1998	1999	Debt stock*	Saving rate*
China	-1.1	-2.3	17	45
Hong Kong	-1.9	-3.1	-	33
India*	-5.9	-5.7	50	28
Indonesia	-7.0	-6.5	72	22
Korea	-4.0	-6.0	35	38
Malaysia	-1.8	-5.5	37	45
Philippines	-2.7	-3.5	42	14
Singapore	2.4	-2.5	-	45
Taiwan	-7.0	-8.5	12	26
Thailand	-4.5	-6.0	25	37

* 1998 figures.

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Korea, Thailand, and now Malaysia: restructuring leaders march to different drummers

The regional crisis necessitated restructuring of the financial sectors in the most affected countries: Indonesia, Korea, Malaysia, and Thailand. Until now, the focus has been on Korea and Thailand, whose different approaches to the problem have been producing different macroeconomic results (for details see *Restructuring progress in Korea and Thailand*, AFM, 99Q1). Now evidence is mounting that Malaysia – basically by following Korea's model – has gone a fair distance toward restoring the health of its banking sector. This is one factor that is helping to brighten Morgan's economic outlook for the country.

For all three countries, it is still too early to pronounce judgment on the success, in relative or absolute terms, of the different reform approaches. At the moment, Korea and Malaysia are producing better results more quickly in terms of NPL reductions and levels of bank capital. However, largely on their own, Thailand's banks have raised capital and its banks' NPLs have most likely peaked. Note that, further down the road, Thailand faces fewer structural constraints on its reform process than does either Korea or Malaysia.

- In broad terms, Korea's approach to its reform process has been activist, while Thailand's strategy, after taking over its weakest institutions, has been more *laissez faire*. Early on in the crisis, both governments managed the closure, merger, and nationalization of bank and nonbank financial institutions. These moves quickly helped to shore up depositor confidence. At this point, the two countries' paths diverge. Korea's government has further taken on the responsibility for buying bad loans, providing banks with new capital, and overseeing the restructuring of the *chaebol*. In contrast, the Thai government has left it to the banks to work out their bad loans and its recapitalization scheme is so burdensome that few banks have chosen to participate in it.
- Malaysia's plan more closely resembles Korea's but has certain key characteristics that make it distinctive. Like Korea, Malaysia set up government agencies to carve out banks' NPLs and is funding large recapitalization schemes. Also like Korea, Malaysia is taking its time about managing the bad assets it has absorbed. But unlike Korea, or Thailand for that

Financial sector reform progress so far
J.P. Morgan estimates

	Korea	Thailand	Malaysia
Domestic credit (end 1996, % of GDP)	165	155	165
% lending to manufacturing (end 1996)	70	24	15
% lending to real estate (end 1996)	2	12	34
Deposit money/commercial banks			
# as of end 1996	26	15	35
Closed	5	1	0
Merged	2	3	2
Nationalized	2	2	0
Foreign sale/joint venture	4	2	0
Merchant banks/finance companies			
# as of end 1996	30	91	39
Closed	16	56	0
Merged	1	16	16
Peak nonperforming loans (% of total)	25	50	25
Current nonperforming loans (% of total)	15	46	19
Government expenditure (% of GDP)			
On NPL buyouts	4.7	0.0	7.9
On recapitalization	5.0	3.7	2.2

Lowering bank NPLs: an easy way and a hard way

During the crisis, the stock of outstanding bank loans contracted sharply in Korea, Malaysia, and Thailand. Extant banks in these countries must first repair their balance sheets before resuming normal lending operations, so their governments are typically keen to assist this process. One important part of that process is asserting control over bad loans. Korea and Malaysia have chosen to use public money to speed this process while Thailand has left the task to the banks themselves.

The Korean Asset Management Corporation (KAMCO) buys NPLs at a discount from the banks, with the discount rate varying by asset type. To date, KAMCO has purchased about $37.4 billion of NPLs in exchange for $16.9 billion of KAMCO bonds. These carve-outs account for about 37% of the NPLs in the Korean banking system.

In a similar way, Malaysia's Danaharta has carved out $5.8 billion of NPLs, about 16% of the system's bad loans. Danaharta purchases these NPLs at discounts that generally depend on the valuation of the loans' collateral. In return, the banks get zero-coupon Danaharta bonds.

After closing down and nationalizing weak financial institutions in 1997, Thailand left the job of dealing with NPLs to the banks that remained. The Bank of Thailand has set up a coordinating committee to help facilitate the debt restructuring process, but public funds are not being directly spent on bad-loan purchases.

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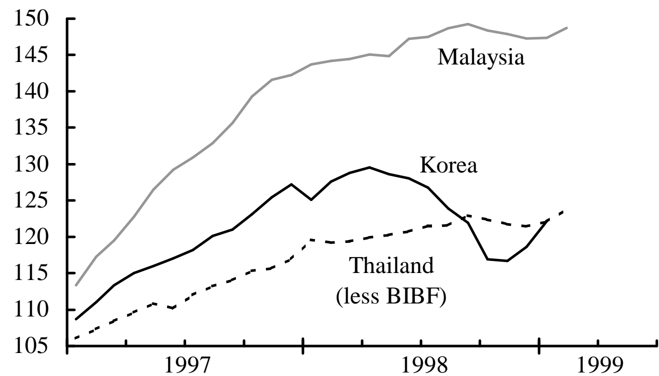
matter, Malaysia did not choose swiftly to shut down or nationalize troubled institutions, waiting instead to shepherd mergers. In addition, Malaysia does not currently plan on increasing the presence of foreign banks (but, also unlike the other two, foreign banks already had held a significant share of Malaysian deposits before the crisis).

- The problems of Korea's banks are inextricably tied to a nexus of much larger issues – the role of the conglomerates, the government's involvement in business, even the broader social compact – which may limit how far reforms can realistically go. On the corporate front, public companies are planning to cut over 20% of their workforce over the next three years and restructuring schemes of the top five *chaebol* would result in even more layoffs. These prospective restructurings are prompting some labor union protests, but the risk of a nationwide strike is limited. Nevertheless, while President Kim's government remains committed to *chaebol* reform, the Assembly election next April will, by political necessity, limit how aggressively it can push the reform process.
- Malaysia must face a similarly complex, but different set of structural issues. The government's New Economic Policy is designed to increase the participation of the country's ethnic Malay population in the corporate sector. And that policy could clash with the demands of that sector's restructuring.
- So, while the approaches of Korea and Malaysia will facilitate faster macroeconomic healing, both countries face significant structural issues that could endanger economic recovery in the medium term. And unlike Korea, Malaysia does not have a new set of government leaders with a stated commitment to tackling those structural issues.
- Thailand's more decentralized system is relatively free of such problems. Its more free-wheeling economy, however, lacks strong bankruptcy and foreclosure procedures to deal with enterprises gone bad. Prime Minister Chuan's government chalked up key victories on this score last month when, after much delay, a series of financial laws were pushed past a reluctant Senate. Importantly, the laws passed maintained the spirit of the government-sponsored bills. Of course, these new laws have yet to be tested and the market will keenly track their implementation, but at least they are finally ready for the King's signature.

Bank loans outstanding
1996=100, seasonally adjusted



Disposing of bad assets: Thailand wins a one-horse race

The governments of all three countries took over some of their financial sector's bad assets and, eventually, those bad assets will return to private sector hands – a process that helps asset prices adjust. Thailand started its bad-asset sales early in 1998 and the agency holding them, the Financial Sector Restructuring Authority (FRA), will finish the job this year. So far, of the $22.9 billion book-value of assets taken over, the FRA has sold about $17.9 billion (though another government body bought $4.9 billion in the March auction) at an average recovery rate of 33%.

In sharp contrast, Korea has barely started its asset sales while Malaysia is still mulling over plans for asset disposal. Korea's Asset Management Corporation (KAMCO) holds bad loans with a face value of about $37.4 billion, but so far has sold less than $1 billion. This year KAMCO plans to sell $13.6 billion of bad loans. In Malaysia, to date the government has taken over about $5.8 billion of NPLs and, so far, has stated only that it will manage the assets over the next 10 years.

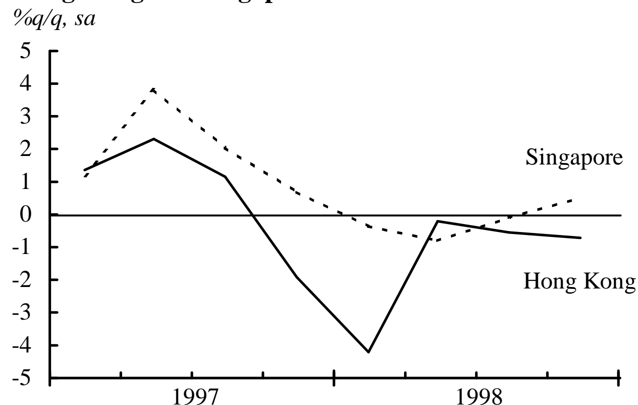
Thai FRA auction results
baht billion

	Date	Book value	Auction value
Auto hire-purchase contracts	Jun 25, 98	52.0	24.9
Residential mortgage loans	Aug 13, 98	24.6	11.5
Non-core assets	ongoing	216.2	107.5
Business loans 1	Dec 15, 98	155.7	39.0
Business loans 2	Mar 10, 99	221.5	40.3

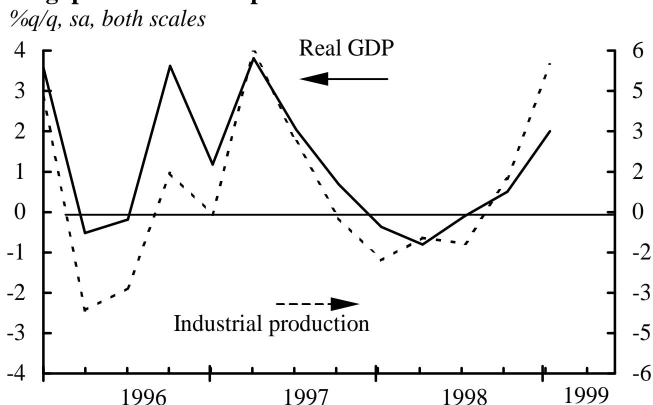
Hong Kong and Singapore: a tale of two different cities

- Hong Kong and Singapore, the region's two key services providers, have over the last two years taken widely differing growth paths (top chart). Hong Kong's economic contraction lasted through into the final quarter of 1998 while Singapore's economy had bottomed out by then.
- Coming into this year, Singapore looks to have turned strongly upward, driven by its key manufacturing sector (some 25% of GDP in 1998, second chart). The expectation is that the services sector complemented this rise in manufacturing production. Services already showed signs of life at the end of 1998 and should have fared still better during the first quarter as regional services demand picked up quite strongly. With engines firing together in both manufacturing and services (54% of 1998 GDP), the first quarter likely turned out very well. In addition, wealth effects from a surging equity market are expected to boost household consumption, consumption that was likely held back in 1998 in anticipation of a prolonged slowdown.
- Hong Kong, in contrast, is tied to the slowing fortunes of a mainland China economy that is expected to slow to 6.5% growth in 1999 from 7.8% in 1998. Therefore, Hong Kong may achieve a less resilient recovery. Also, while nominal interest rates are falling in Hong Kong, the pace of price deflation there is not expected to slow soon. The resulting higher real interest rates may delay investment outlays.
- Nevertheless, as in Singapore, sentiment appears to be picking up in Hong Kong. This is reflected in strong gains in the stock market and increasing transactions volume in the property market. And though the bottom may have been reached in the property market, the abundant supply of housing and the absence of major property developers so far from the newly-restarted government land auction mean that property prices are unlikely to rise soon. So, the sustainability of the upswing in market sentiment is questionable, but for as long as it lasts, it should help to revive Hong Kong's still-flagging consumer demand.

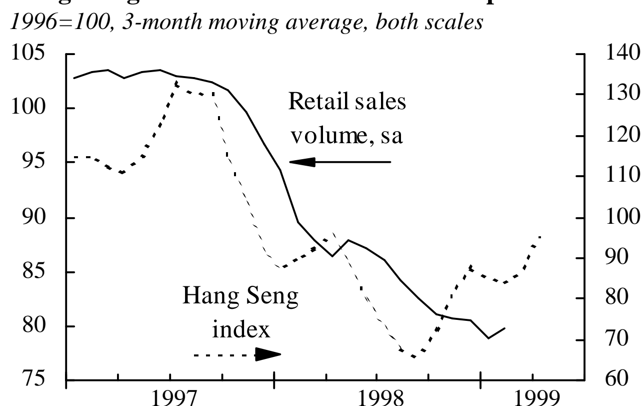
Hong Kong and Singapore: real GDP
%q/q, sa



Singapore: industrial production and real GDP
%q/q, sa, both scales



Hong Kong: retail sales volume and stock prices
1996=100, 3-month moving average, both scales



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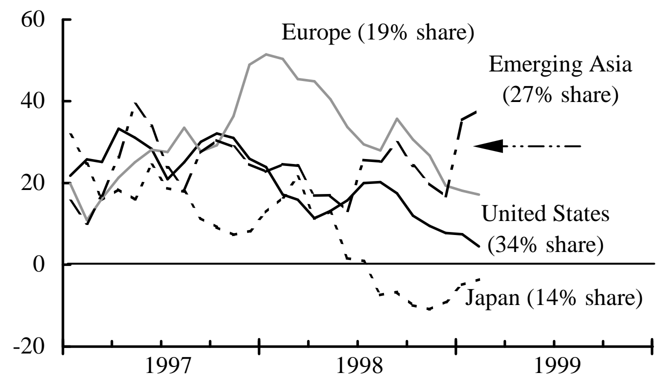
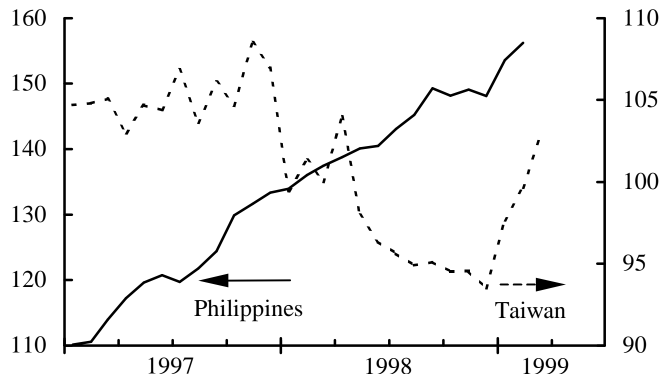
Philippines and Taiwan: on the sidelines, and happily so

- While the IMF three economies steal the limelight, the quieter Asian periphery of Taiwan and the Philippines continue to motor along.
- Taiwan's export outlook is less gloomy than before: The United States – Taiwan's largest market – no longer appears headed into recession and Asian economies are stabilizing or recovering. Already, exports were strong in the first quarter as regional demand picked up. And Taiwan's nimble cottage-industry type of electronics manufacturing base should cope with any demand moderation ahead. Philippines export data also reflect the renewed regional strength (top two charts), buoying in turn the prospects for its industrial activity, investment, and overall GDP relative to what seemed likely just a few months ago.
- As for Taiwan's imports and trade balance, the absence of either strong domestic demand or a sharp recovery in international commodities prices will keep imports sluggish for 1999 as a whole, though recovering somewhat later this year. So the less gloomy outlook for exports will make for a slightly higher annual trade surplus in 1999 than in 1998, although monthly surpluses will likely shrink toward the end of this year.
- In the past three months, the Philippine economy has performed admirably, keeping it a leader in Emerging Asia's uneven recovery. Exports have stayed at high levels and have even started rising again of late. Indeed, Philippine export performance has been nothing short of spectacular so far (second chart) and, going forward, the region should take up some of any U.S. demand slackening.
- In all, there is scant reason to change the Morgan forecast of 2.6% real GDP growth for the Philippines in 1999. Much of the bounce will pay back for last year's horrible harvests – if agricultural output this year simply returns to its 1997 level, the overall economy would grow 1.4% even with zero growth in manufacturing and services. Also boding well for GDP growth is the U.S. economy's resilience and the revival of intraregional trade in Asia.

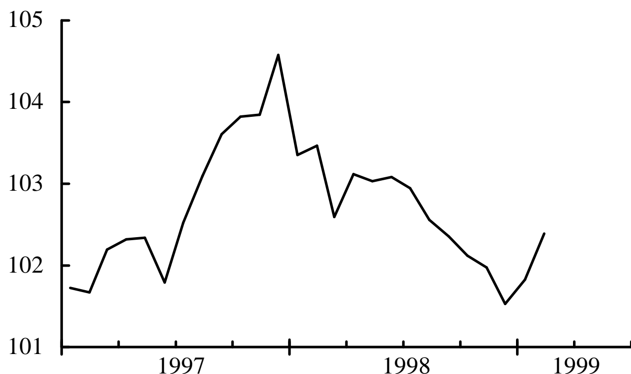
Philippines: exports by destination
%oya, 3-month moving average



Philippines and Taiwan: exports
1996=100, US$ terms, sa, both scales



Taiwan: composite index of coincident indicators
1996=100, sa, 3-month moving average

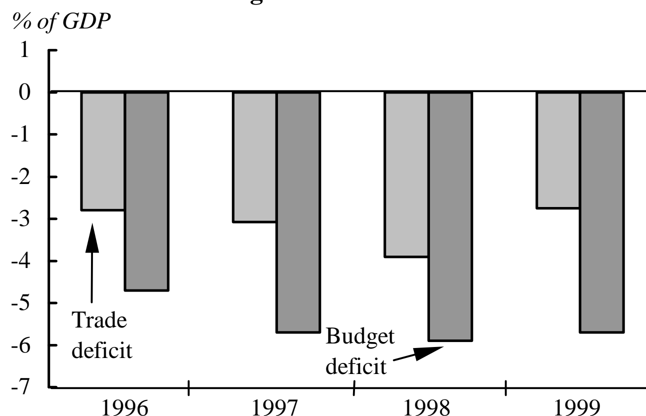


China, India, and Indonesia: laggards still

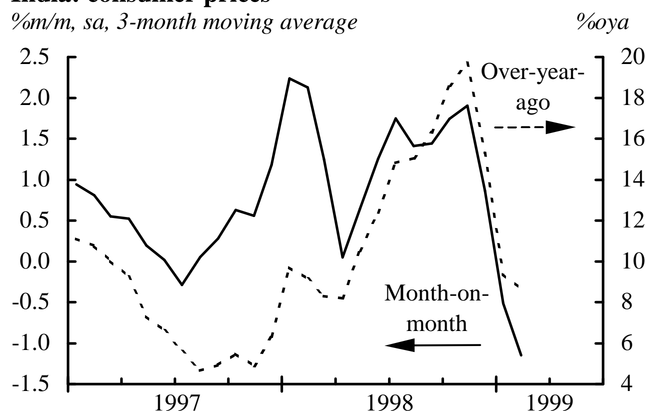
China and India, less open economies and less negatively affected by the regional crisis, will not benefit this year from any positive growth payback. Much worse, both countries have put on hold measures to address their economies' structural problems. As a result of its stepped-up efforts to gain admission to the WTO, China is likely to restart its reform efforts to prepare for foreign competition. India's twin budget and trade deficits must be addressed, but the recent collapse of the BJP-led coalition government means that the political will to attack these issues will not materialize soon. Finally, Indonesia has laid out plans to repair its massive banking sector and corporate debt problems. But like in India, plan implementation will have to wait until the political situation stabilizes.

- China's pump-priming has pushed state fixed investment higher, making up the gap created by a pullback in the non-state sector. But, as the government shifts away again from this quantity-but-not-quality approach, growth will suffer (see pages 11-18).
- Prospects for India's economy were already deteriorating before the fall of the government this month. The central government's budget deficit continues to fester and there is little reason to think that a new government (once it is formed) will put deficit reduction high on its agenda. Meanwhile, with Indian exports still facing stiff competition from within the region, trade deficits will stay sizable. The only bright spot is that the food-driven inflation figures have come down sharply of late.
- Over the past three months, things have been remarkably stable in Indonesia. For a country rapidly approaching historic elections in June, stability is a great plus. For an economy devastated over the past year, stability at these low levels of economic activity is painful. Most macroeconomic indicators – real GDP, net international reserves, inflation, the exchange rate, bank deposits – have all performed well recently. The only disappointment has been exports, which have continued to sag even from already depressed levels. But, if the June elections go forward, and if a new government with popular legitimacy comes into power later this year, then needed healing may finally begin. But these are big "ifs."

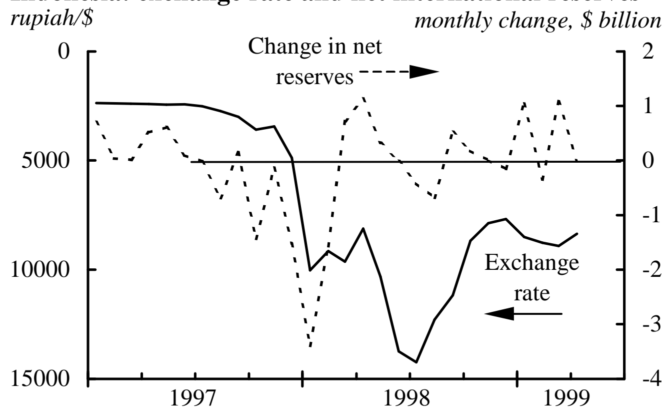
India: trade and budget deficits
% of GDP



India: consumer prices
%m/m, sa, 3-month moving average *%oya*



Indonesia: exchange rate and net international reserves
rupiah/$ *monthly change, $ billion*



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Australia and New Zealand in good shape

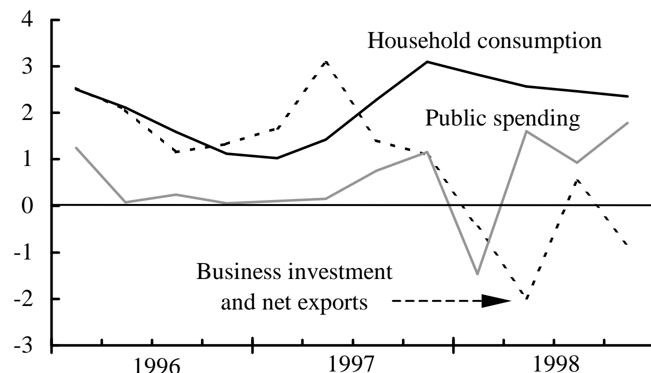
- **Both economies are growing, Australia strongly, New Zealand modestly, due to low interest rates**
- **In Australia, near-booming consumer spending is masking the drag from trade**
- **Growth prospects will largely depend on external demand and that is expected to remain weak**
- **An absence of inflation pressures suggests interest rates will remain low for some time yet**

Key forecasts
calendar years, except fiscal balance: years ending June 30

	1998	1999f	2000f
Australia			
Real GDP (%oya)	4.9	2.7	3.2
Consumer prices (%oya)	0.9	1.7	2.8
Current account (% of GDP)	-4.9	-5.5	-4.1
Fiscal balance (% of GDP)	2.8	1.6	1.9
New Zealand			
Real GDP (%oya)	-0.3	2.0	3.6
Consumer prices (%oya)	1.3	1.0	1.4
Current account (% of GDP)	-6.0	-6.0	-4.7
Fiscal balance (% of GDP)	2.6	0.2	-0.5

Australia's consumption vigor outweighs external drag, and so shores up growth overall

Contributions to growth
%oya, sa



Jobs growth by sector
change from Feb 1998 to Feb 1999, thousands, sa

Sector	
Agriculture	-10.4
Manufacturing	-35.1
Mining	-6.5
Construction	19.4
Utilities	-2.5
Services	155.8
Public	72.5
Total	193.2

- Consumers remain the engine of the economy's growth, thanks to low interest rates, continuing job gains, rising real wages, and increases in wealth that also have boosted confidence.
- The near-boom in consumer spending, along with a sharp rise in public spending, has swamped the impact on economic growth of Asia's recession and the earlier plunge in commodity prices, suggesting that Australia has weathered the storm. GDP growth has not moderated much since the crisis began in mid-1997, though collateral damage was extensive, with exports and business investment slumping.
- The sectoral divergence in spending also shows up in the labor market, where job gains in services (especially retailing) have more than offset losses in manufacturing, mining, and agriculture.
- While a slowing in GDP growth from 1998's near-5% clip is inevitable, the extent of the moderation ahead is uncertain. A soft landing is the likely outcome, however, provided interest rates remain low and stable and global growth picks up to trend.
- In the absence of a sharp deceleration in consumer spending, and with only a modest decline in residential construction in prospect, Australia's GDP growth this year could well depend principally on external conditions – the extent of any pickup in global growth and its spillover to commodity prices.

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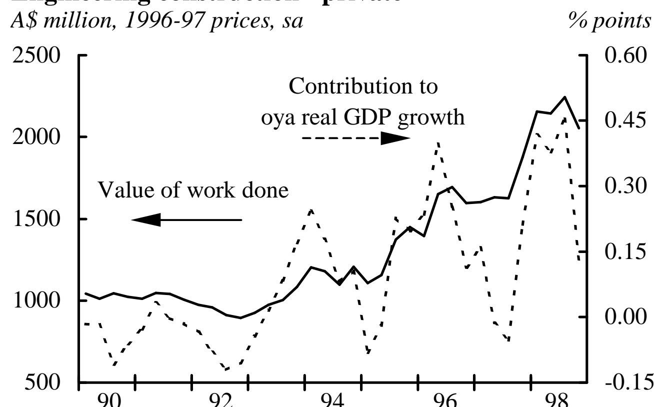
Exports are likely to be the key to GDP growth

Engineering construction - private
A$ million, 1996-97 prices, sa *% points*

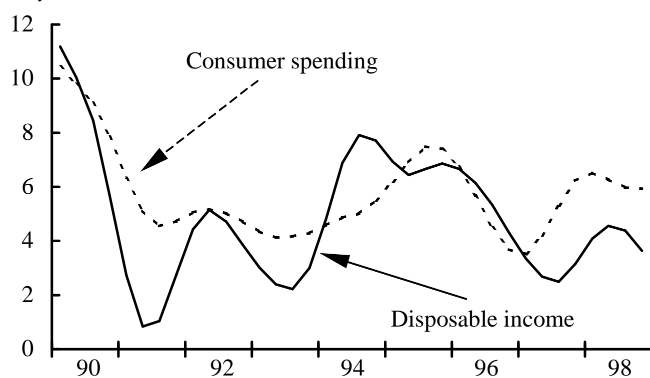


Real GDP growth in Australia's export markets
%y/y

	1998	1999f	2000f
Japan (22.0)	0.6	-0.6	-0.9
Other Asia (36.4)	0.1	3.3	5.0
Europe (11.7)	2.4	1.5	2.7
United States (8.9)	3.9	3.2	1.9
New Zealand (6.5)	-0.7	2.5	3.6
Total	**0.7**	**1.7**	**2.4**

Note: J.P. Morgan forecasts. Total weighted by export shares (in parenthesis). The five regions take almost 85% of Australia's exports.

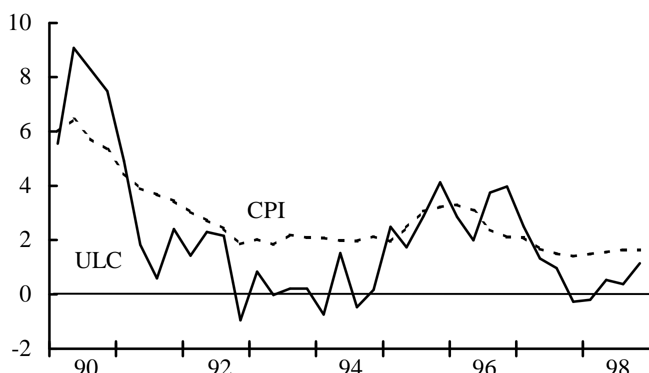
Household income and consumption
%oya, trend



- The earlier boost to growth from a sharp rise in infrastructure spending is fading fast, as Sydney 2000 Olympics-related construction is completed and spending on major road projects winds down.
- Moreover, almost one-third of private infrastructure construction relates to mining, which is cutting back capital spending because of low commodity prices.
- Having plunged already in 1998, exports are unlikely to fall much further in 1999. But neither are they likely to offer much, if any, support to growth this year, despite an improved global growth outlook. While Australia should benefit from a rebound in Emerging Asia, Japan is expected to hold down growth in the region as a whole. Moreover, European growth has slowed, while the United States is likely to do the same later this year. Trading-partner growth over the next few years is forecast to fall well short of the 4% annual pace that it has averaged over the past decade.
- Commodity prices, while probably having troughed, are unlikely to rebound as sharply as during earlier cyclical upswings. A strong recovery in Australia's terms of trade has in the past given growth a significant lift, but will not be around to do so this time.
- To date, spending growth has remained strong, despite the hit to income growth from the sharp terms-of-trade decline. The lower exchange rate has provided a cushion, but has not prevented widening of the current account deficit to around 5.5% of GDP.
- Despite moderating household income growth, few expect much of a slowing in consumer spending growth, thanks to the low level of interest rates which is encouraging households to take on more debt. But consumer spending growth can hardly continue for much longer to outstrip income growth by so wide a margin as of late, given the already historically low saving rate of just 1.3%.
- Consumer spending will almost assuredly weaken later this year in response to more modest job gains and wage growth. However, rising asset prices (for equities and residential property) could enable households to rebuild savings without cutting back their spending particularly sharply.

Low inflation is here to stay

Unit labor costs and CPI inflation
%oya



- While global deflationary forces have helped restrain the pass-through of earlier rises in import prices, domestic factors are principally responsible for the continuing quiescence of inflation, even during a period of above-average GDP growth.
- The very modest growth of unit labor costs has benefited from a decade of reforms that have made labor and product markets more flexible and that have boosted productivity. Indeed, private sector wage growth has been moderating despite the substantial drop in unemployment over the past two years to levels earlier associated with rising inflation.

Monetary policy is on hold, unless growth slows more sharply than anticipated

Indicators of economic growth

	3 months ago	Latest
Spending		
Retail sales (%3m/3m, saar)	7.4	6.8 (Feb)
Building approvals (%3m/3m, saar)	-18.0	16.4 (Feb)
Business survey (NAB)		
Trading conditions (net balance)	7	6 (Q1)
Confidence (net balance)	1	4 (Q1)
Labor market		
Employment (%3m/3m, saar)	1.6	1.6 (Mar)
Unemployment rate (%, sa)	7.6	7.4 (Mar)
Trade		
Exports (%3m/3m, saar)	-8.8	-18.0 (Feb)
Imports (%3m/3m, saar)	4.8	-15.6 (Feb)
Prices		
Underlying CPI (%oya)	1.6	1.6 (Q4)
Manufactured output (%oya)	-0.4	-0.6 (Q1)
Financial conditions		
Credit (%oya, sa)	10.5	11.5 (Feb)
2-year bonds (% p.a.)	4.8	5.0 (Apr 28)
All ordinaries equity index	2856	3123 (Apr 28)

- With inflation undershooting the RBA's 2%-3% target, speculation on a rate cut has heightened.
- But recent economic reports and developments in asset prices do not suggest that much of a weakening in the pace of GDP growth has occurred as yet or even is in prospect over coming months.
- Financial conditions have remained supportive of solid spending growth. Market interest rates remain low, while credit growth has accelerated a little. The equity market has boomed, reaching an all-time high recently, albeit led by the resource sector which is in line to gain from better global growth prospects.
- Developments so far this year have likely made the central bank less confident of its November 1998 prediction that GDP growth would slow to 2.5%-3% this year. Indeed, recent economic reports and improving financial conditions have reinforced the central bank's view from February that "... the economy has been stronger than expected in the recent period, and appears to have entered 1999 with considerable momentum." This poses the question of why the RBA would need to cut rates right now.
- J.P. Morgan does still expect the RBA eventually to produce a small rate cut of 25 basis points, but not before economic growth slows somewhat, a development not anticipated until the third quarter.

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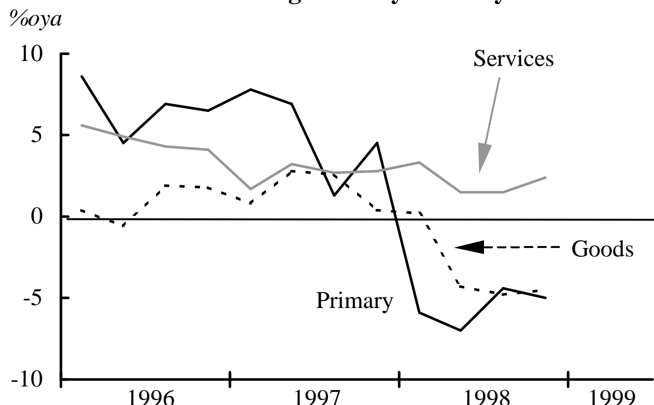
New Zealand's overall GDP growth rate will be held back by exports

New Zealand: real GDP growth by industry
%oya



Real GDP growth in New Zealand's export markets
%y/y

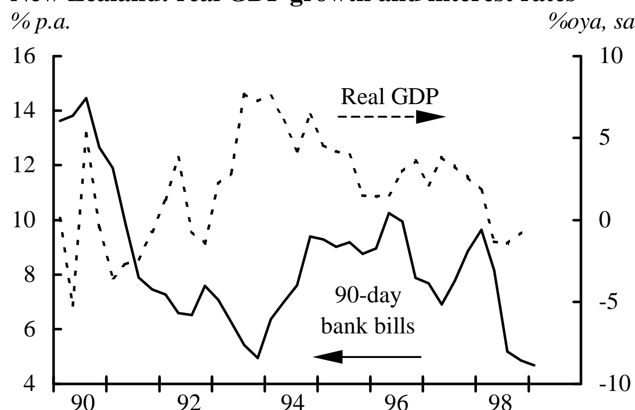
	1998	1999f	2000f
Japan (14.4.)	0.6	-0.6	-0.9
Other Asia (24)	0.1	3.3	5.0
Europe (16.0)	2.4	1.5	2.7
United States (10.4)	3.9	3.2	1.9
Australia (20.2)	4.9	2.7	3.2
Total	**1.9**	**1.8**	**2.3**

Note: J.P. Morgan forecasts. Total weighted by export shares (in parenthesis). The five regions take 85% of New Zealand's total exports.

- New Zealand's dilemma in 1999 will be to deliver good economic growth without putting pressure on the already large current account deficit of 6% of GDP. Inflation is likely to be well behaved, given the economy's substantial excess capacity, and less of a headache for policymakers than in the past.
- The economy entered this year with good momentum, GDP growth having turned positive in the third and fourth quarters of 1998. However, the pace of growth has yet to exceed its potential rate of around 3%, no doubt due to depressed exports and the slump in residential construction.
- The moderate recovery in growth spans divergent conditions across sectors. Services are growing strongly in response to low interest rates, while manufacturing and agriculture are struggling because of weak external demand.
- New Zealand's trading-partner growth is not expected to improve in 1999 on a full-year reckoning, as a pickup in Asia will likely be offset by slower growth in Australia, Europe, and the United States.
- External demand is thus not providing much of a boost to GDP growth, at least not during this initial phase of recovery from recession, contrary to New Zealand's experience in the early 1990s.
- Consumers will need to provide most of the overall demand growth this time, but could be restrained by high levels of debt, despite low interest rates.

The RBNZ looks likely to keep rates steady for a lengthy period

New Zealand: real GDP growth and interest rates
% p.a. *%oya, sa*



- The central bank is likely to respond to improving economic growth somewhat differently than it did back in the early 1990s.
- The significantly more moderate GDP recovery path this time, coupled with a hefty negative output gap, suggests interest rates can remain low for a lengthy period, certainly over the remainder of this year.
- The key risk to rates is that mooted personal income tax cuts could be delivered without new policies to encourage household saving. Loose fiscal policy would likely require higher interest rates to prevent a worsening in the current account deficit.

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Foreign exchange and interest rates

- **Will Japanese investors stay at home?**
- **Asian currencies will benefit from a slower pace of interest rate easing**
- **The world becomes friendlier to the Antipodes**

Japanese financial trends should emerge in May

In the interest of fulfilling its pledge to keep overnight rates close to zero, the Bank of Japan is flooding the interbank market with liquidity. Overnight rates have averaged 0.03% over the past month, confirming that all price constraint on bank funding has been removed. But despite the deluge of liquidity, the impact on money supply remains marginal because funds are flowing out of the interbank market and into other forms of relatively liquid asset. Banks remain reluctant to pass their virtually free liquidity on into new lending for fear of taking new credit risk onto their balance sheets.

The failure of base money growth to pass through to broader aggregates growth marginalizes any expansionary or inflationary impact on domestic demand. The combination of cheap liquidity and credit risk aversion continues to underpin financial demand for JGBs, whose prices are therefore holding up well despite horrendously huge supply – the government's aggressive fiscal programs assure a heavy issuance calendar for many months to come. While the heavy supply still looks likely to drag down bond prices over the next year, nothing on the immediate horizon is apt to disturb the present constructive sentiment. Moreover, the seasonal shift with the new fiscal year enable the BoJ to pull back on liquidity creation without putting upward pressure on interest rates. JGB rates are likely to remain stable into midyear and will not move higher until well into the third quarter.

May will test JPY potential to head toward 130

The Japanese government seems comfortable with the two-month old JPY118-123/USD trading range as it gives exporters a comfortable competitive cushion without putting pressure on other Asian currencies. It still seems probable, however, that the dollar will break to the top side of the range and head toward 130 later

Exchange rate and interest rate forecasts

	Actual	Forecasts	
	Apr-28	3 month	12 month
US$ exchange rate			
Japan	119.17	130.00	136.00
Australia	0.66	0.66	0.70
New Zealand	0.55	0.55	0.59
China	8.28	8.28	8.46
Hong Kong	7.75	7.76	7.78
India	42.80	44.96	47.15
Indonesia	8,525	8,348	7,500
Malaysia	3.80	3.80	3.60
Philippines	38.03	37.35	37.00
Singapore	1.70	1.70	1.68
South Korea	1,180	1,115	1,185
Taiwan	32.70	32.30	33.00
Thailand	37.51	36.50	36.00
3-month interest rate*			
United States	4.99	5.00	4.72
Japan	0.16	0.13	0.15
Australia	4.78	4.70	4.60
New Zealand	4.63	4.52	4.35
China	6.54	6.30	10.62
Hong Kong	5.13	7.00	8.00
India	11.40	13.70	13.00
Indonesia	26.78	33.48	23.46
Philippines	10.21	8.13	7.65
Singapore	1.33	1.00	1.65
South Korea	5.20	5.17	4.50
Taiwan	5.00	4.00	5.00
Thailand	5.39	4.15	5.81
10-year gov. bond yields**			
United States	5.25	5.05	4.83
Japan	1.38	1.50	1.80
Australia	5.45	5.15	5.08
New Zealand	5.75	5.56	5.28
External debt spreads***			
EMBI****	930	800	650
China 06	170	160	160
ICICI (India) 07	335	350	360
Indonesia 06	795	800	700
Korea 03	190	185	150
Korea 08	220	220	175
Petronas (Malaysia) 06	280	260	200
Philippines 08	339	310	225
Philippines 16	396	350	275
Thailand 07	195	220	175
Hutchison (Hong Kong) 07	165	160	160

* % 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.
*** Basis points, spreads of dollar-denominated government (or corporate) bonds over U.S. treasury bonds.
**** J.P. Morgan Emerging Markets Bond Index.

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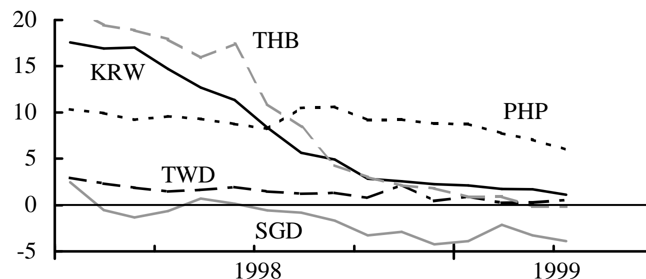
this year. Chances are that poor credit conditions and low interest rates at home will push Japanese investors into foreign assets. The low-inflation U.S. economic expansion is expected to extend into the third quarter keeping U.S. assets – especially equities – attractive. However, the ever-growing Japanese current account surplus is worrisome, and the expected dollar rebound presumes an acceleration of the pace of investment outflow from Japan. The first half of May will offer a critical test of this hypothesis, as the period right after Golden Week is traditionally a bellwether for Japanese investor flows. Note too that extension of the Nikkei rally into May would cast doubt on J.P. Morgan's bullish dollar forecast, since it would serve as a magnet to Japanese –and foreign – investors.

Pace of Emerging Asian rate declines should slow

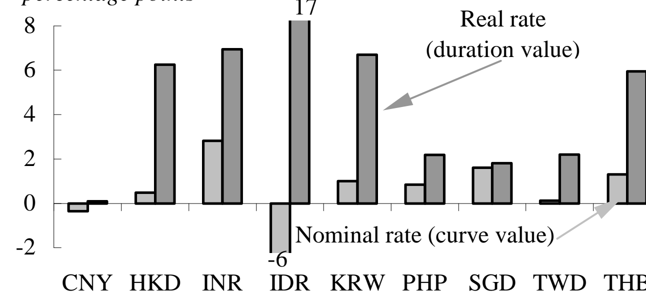
Short-term interest rates have come crashing down across Emerging Asia in recent months in response to weak domestic demand and the absence of any signs of inflation. However, the pace of their descent has abated as short-term rates converge toward U.S. levels (top chart). Singapore has demonstrated that local rates can trade through the U.S. level. While still lower rates cannot be ruled out, the pace of decline will likely continue to slow, particularly since economic activity is expected to pick up in most Asian countries over the course of the year. The Korean and Thai central banks have already indicated that they want rates to sink less quickly from here. The Philippines is the only Asian country with clear near-term potential for substantial rate cuts, though Indonesian rates could also drop sharply if the political situation remains calm.

Despite the expected upturn, economic growth in Asia will remain below potential for several more years, implying that excess capacity and high unemployment will be powerful forces keeping inflation low. The rate-cutting process is maturing, but it will probably be well into 2000 before higher rates emerge. Contrarily, a very different scenario is priced into the yield curves of most Asian countries; longer-term rates have been slow to follow short-term rates downward, thereby causing yield curves to steepen. The steep curves imply a quick expected rebound in nominal or real interest rates (bottom chart). Since Morgan believes

1-month spread over USD LIBOR
percentage points



Implied change in 1-year interest rates
percentage points



that short-term rates will stay low, curve flatteners are attractive in most Asian markets, though such trades are better avoided in markets like INR and IDR where inverted curves make the carry negative.

The sharp rise in real rates implied in the KRW and THB curves indicates that inflation risk is overpriced and that outright duration is also attractive. Political uncertainty, however, dictates a more cautious approach to the IDR and INR markets.

Risk of a weaker CNY is pushed off to next year

HKD duration also represents good value, as the market is overestimating both Hong Kong inflation and the risks of a CNY or HKD devaluation. We believe that the CNY will now be fixed into next year. Although the trade surplus is rapidly eroding, first-quarter GDP and corporate profits were much better than expected. The delay in deciding China's petition for WTO membership gives another incentive to hang on to the peg into next year. Besides, any early sharp devaluation would exacerbate the debt servicing of the itics and red chips. Ultimately it would be less disruptive for China to rebuild exchange rate competitiveness through a steady downward crawl.

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Emerging Asian fx rates will lean to strength

Emerging Asian exchange volatility is off across the region since the start of the year – even the IDR and CNY forwards have been quiet. The rangebound JPY has contributed to this financial peace, but the stability has fundamental support as well. The still-large current account surpluses enjoyed by most Asian countries support currency strength. But the extreme under-valuations have largely disappeared and central banks are uniformly standing against upward currency trends.

With the threat of a Chinese devaluation sidelined for the next few months, the low volatility environment will likely continue but with a bias toward Asian currency strength. Central bank intervention has been a powerful tool because the simultaneous decline in rates meant that intervention was not fully sterilized. But the growing reluctance to cut short-term interest rates will blunt the impact of intervention, so central banks will now have to tolerate gradual currency appreciation. While the JPY is expected to weaken, the magnitude of its projected decline will not be enough to be a major factor for Emerging Asian currencies other than on a short-term intraday basis. Indeed, any weakness they display on the back of a falling JPY should generally be treated as an opportunity to go long. In the expected low fx volatility environment, exposure preference should be driven by opportunity to earn carry. Particularly attractive here are outright exposure in the PHP and selective exposure to KRW, TWD, and THB.

Funding in SGD becomes problematic

While interest rates are apt to stay low in Singapore – as is true elsewhere in Asia – the SGD's weakening trend appears to be maturing. Singapore's March CPI data suggest that deflationary pressures are abating faster than expected, which may make the MAS less tolerant of a weakening currency. But the island's economic recovery will probably moderate in the second quarter and the USD/JPY recovery should underpin USD/SGD. The SGD funding trade still looks attractive, but will have to be abandoned if the economy gains momentum or JPY weakness is not forthcoming. Another risk worth noting is that the MYR could revalue, an event that would put upward pressure on the SGD.

Politics dominate MYR, IDR, and INR

The Malaysians are gradually unwinding the capital controls introduced last September – in particular, the one-year freeze on capital repatriation has been replaced with an exit tax – and controls will likely be largely eliminated by their September anniversary. The calmer local market environment reduces the incentive to keep controls in place and the government's planned sovereign debt issue is likely to be better received if controls are phasing out. The MYR peg has left it undervalued compared to both the THB and SGD so the currency will probably be allowed to strengthen as controls come off, with a long-term target of 3.50. In particular, look for the MYR to move ahead of national elections – which could occur as early as this summer.

The calmness of the IDR market belies the continued violence in Indonesia and the problematic prospects for the June elections. Despite the attractive carry, it looks inadvisable to position in the IDR. The same is true for the INR, since it appears that the collapse of India's ruling coalition will force yet another national election. The likely extended period of policy paralysis and the ballooning fiscal deficit make it dangerous to take duration exposure in the Indian market.

World will remain AUD- and NZD-supportive

The recovery of global commodity prices has been a fillip for the commodity-dependent Australia and New Zealand. The Asian recovery is also constructive for its stimulus to output and because investors still look at these markets as more liquid proxies for the Asian emerging markets. Rebounding economic activity should put further rate easing on hold, particularly in Australia since the Reserve Bank there has abandoned its past mechanical approach to monetary policy, an approach that would have forced it to ease in the event of low inflation.

As with the other Asian currencies, AUD and NZD volatility will likely remain low but with a bias for the currencies to strengthen. The 10bp AUD 10-year bond spread over the U.S. market is modestly attractive, given the expected strength of the currency. Moreover, the possibility of an agency upgrade of Australia's sovereign rating should underpin bond prices.

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Equities

- **Japan outperformed in 99Q1 but slowed recently while the rest of the region picked up momentum**
- **Macro fundamentals remain positive for most of the region except for China, India and Japan**
- **Extreme U.S. valuation poses risk for Asia**

Except for Japan, Asian equity markets largely underperformed in the first quarter compared to their peers in OECD and emerging markets. With the notable exception of India, however, stock markets in Emerging Asia started to outperform most other markets in April, while the Japanese market lost some of its earlier momentum.

The rally in the Japanese market was driven largely by foreign inflows, triggered by the BoJ easing in February and some selective corporate restructuring news. The rest of the region first suffered from devaluation fears surrounding China and Hong Kong but then benefited from the continued U.S. stock market rally and rising foreign investor risk appetite following the benign fallout of the Brazilian devaluation. Going forward, improving macroeconomic fundamentals should support stock markets in most of the region except for China, India, and Japan. The main risk facing the region's stock markets is the increasingly rich valuation of the U.S. market, where stocks continue to rally despite rising bond yields.

Fundamentals do not support further rise in Japan

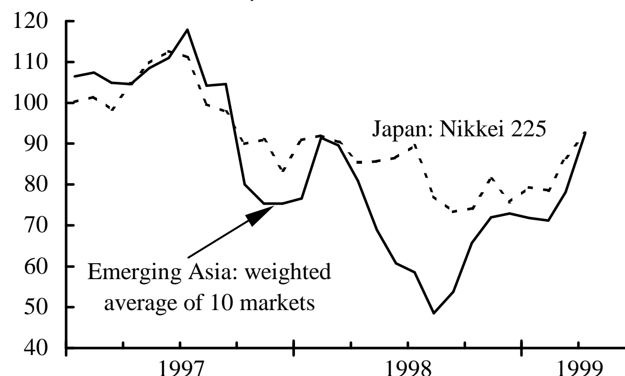
The pickup in foreign purchases of Japanese stocks should not be seen as a sign of much-increased faith in the economy and its prospects for recovery. Global stock investors have been underweight and short the Japanese market for years and recent flows reflect mostly marginal changes in relative risk positions. The macroeconomic data continue to depict an economy supported only by public demand, while private demand, especially investment, languishes. The BoJ is set to maintain an accommodative policy stance, but cannot put right the overwhelming problems on the supply side of the economy, while recent restructuring news touches only the tip of the iceberg and is unlikely to boost profits as early as this fiscal year.

Equity market moves
% changes, eop, latest Apr 28, 1999

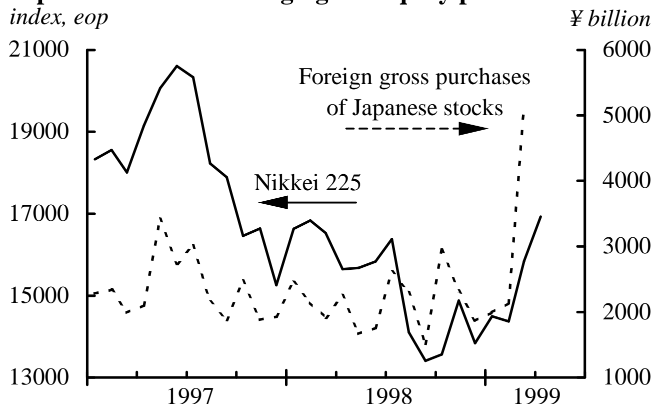
	Dec 98 to Mar 99		Mar 99 to date	
	LC terms	$ terms	LC terms	$ terms
World*	6.0	3.3	5.8	5.4
U.S. (S&P 500)	4.6	4.6	5.0	5.0
Japan	14.4	9.4	7.0	6.2
Australia	5.5	9.1	5.3	8.5
New Zealand	3.8	4.9	6.3	9.7
Emerging Markets**	16.9	12.4	10.1	12.5
Emerging Asia**	9.6	9.9	14.3	16.0
China	-6.3	-6.3	3.4	3.4
Hong Kong	8.8	8.9	20.0	20.0
India	22.4	22.5	-12.5	-13.3
Indonesia	-1.0	-8.5	22.2	23.9
Korea	10.0	7.9	27.6	32.8
Malaysia	-14.2	-14.2	31.6	31.6
Philippines	3.0	3.4	21.3	23.6
Singapore	9.0	4.1	21.0	23.0
Taiwan	7.2	4.2	8.9	10.5
Thailand	-1.1	-4.2	20.3	20.4

* Morgan Stanley Composite Index, April 27 latest.
** MSCI, excludes Hong Kong and Singapore, April 27 latest.

Stock markets: Japan versus the rest of Asia
1997=100, local currency terms



Japan: Nikkei and foreign gross equity purchases
index, eop *¥ billion*



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Low rates and recovery support Emerging Asia

In contrast to Japan, the recoveries of most other Asian markets seem well supported by macroeconomic fundamentals. Key is the combination of much lower interest rates and rising output. This not only boosts market liquidity but also has a profound effect on earnings and asset quality. Banks are still digesting the legacy of the past, but the incidence of new bankruptcies and loan defaults has dropped sharply.

These dynamics have been most visible in **Korea**, where the stock market has already returned to its pre-crisis level. Ample domestic liquidity and foreign fund inflows are expected to support the market further. Even so, without further corporate restructuring progress valuations are likely to become rich. In contrast to Korea, better value can be found where markets have been lagging but fundamentals have recently improved. Such cases include:

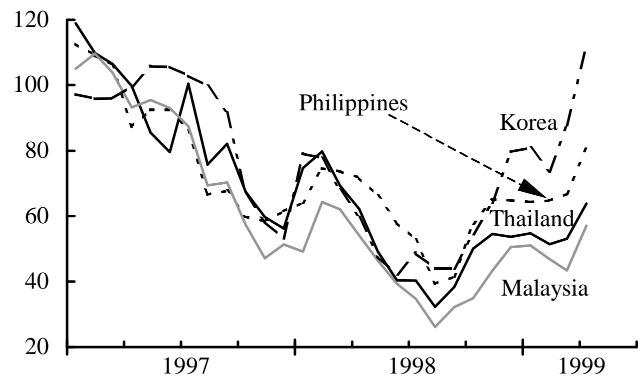
- **Thailand,** which has been held back by the slow speed of bank restructuring and output recovery. However, the recent passage of the foreclosure law, record low interest rates, and a series of new fiscal stimulus measures are set to speed the process up;

- **The Philippines,** which has been less successful in lowering interest rates, thanks to higher inflation. But with inflation and interest rates now declining and capital inflows accelerating, liquidity conditions are set to improve;

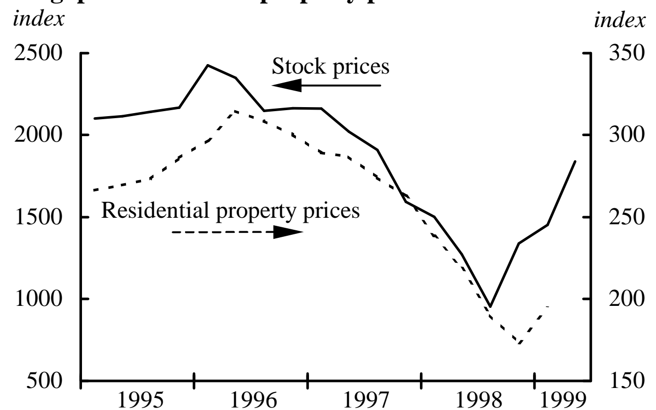
- **Malaysia,** which underperformed due to the interruption of capital flows, slow output stabilization, and political uncertainties. Nevertheless, trade and reserve figures are improving, allowing interest rates to decline, industrial production is starting to recover, and bank restructuring is making progress. Uncertainties and concerns persist, especially about a corporate sector that has been a key beneficiary of the government's preferential growth policy, but sentiment has notably improved.

Signs of output stabilization and falling inflation and interest rates also support **Indonesia**. However, political uncertainties in the run-up to the June election and the potential risk of unstable election results still argue for a cautious approach.

Stock prices: leaders and laggers
1997H1=100, local currency terms



Singapore: stock and property prices



Hong Kong and **Singapore** have rallied far, regaining more than three-quarters of their earlier losses. Residential property prices are rising and interest rates are low in Singapore and still falling in Hong Kong. But the upside seems limited from here, given both economies' slower expected recovery. Moreover, both are likely to lose more in case the U.S. market sells off. **Taiwan** also trails the regional recovery story, but the government's stimulus efforts and falling interest rates are now providing some support for its stocks.

China's policy stimulus has led to a recovery in output growth, but has done little to improve corporate financial health and the situation is unlikely to get better over the next year or more. The **Indian** market also is expected to underperform, reflecting political uncertainties, the need to tighten domestic policy to prevent a budget and balance of payments crisis, and a deteriorating economic growth outlook.

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The regional economic outlook in summary

	1998 Nominal GDP in US$			Real GDP % year-on-year				Consumer prices % year-on-year			
	total billion	% of region	per capita 000s	1997	1998e	1999f	2000f	1997	1998e	1999f	2000f
Japan	3705		29.4	1.4	-2.9	-0.7	-0.5	1.7	0.6	-0.1	-0.2
Australia	363		19.5	3.7	4.9	2.7	3.2	0.3	0.9	1.7	2.8
New Zealand	53		13.9	2.0	-0.3	2.0	3.6	1.2	1.3	1.0	1.4
Emerging Asia	2500	100.0	0.9	6.0	0.1	3.3	4.9	4.2	9.0	3.5	4.3
China	966	38.6	0.8	8.8	7.8	6.5	6.0	2.8	-0.8	-1.2	2.2
Hong Kong	166	6.7	24.5	5.3	-5.1	-0.8	2.8	5.7	2.6	-2.8	1.8
India	368	14.7	0.8	5.0	5.0	3.0	5.0	7.2	13.2	8.5	7.0
Indonesia	84	3.4	0.4	4.9	-13.7	-3.5	5.0	6.2	58.4	24.0	14.0
Korea	321	12.8	6.9	5.0	-5.8	4.0	4.5	4.4	7.5	2.0	4.0
Malaysia	66	2.6	3.0	7.8	-6.7	2.0	4.0	2.7	5.3	2.6	2.4
Philippines	65	2.6	0.9	5.2	-0.5	2.6	5.0	5.0	9.0	7.5	5.0
Singapore	87	3.5	22.8	8.0	1.5	2.4	4.0	2.0	-0.3	-0.3	0.6
Taiwan	261	10.5	11.9	6.8	4.8	3.7	4.5	0.9	1.7	-0.3	1.2
Thailand	116	4.6	1.9	-1.3	-9.1	2.5	5.0	5.6	8.1	3.2	5.5

	Current account balance US$ billion				Current account balance % of GDP				Foreign reserves US$ billion			
	1997	1998e	1999f	2000f	1997	1998e	1999f	2000f	1997	1998e	1999f	2000f
Japan	94.7	121.0	105.4	102.2	2.3	3.2	2.7	2.9				
Australia	-12.9	-17.9	-20.7	-17.4	-3.2	-4.9	-5.5	-4.1				
New Zealand	-4.5	-3.2	-3.4	-3.0	-7.1	-6.0	-6.0	-4.7				
Emerging Asia	22.0	109.4	71.8	48.5	0.8	4.4	2.6	1.7	513.0	571.5	599.6	620.8
China	30.1	30.0	10.4	5.7	3.3	3.1	1.0	0.6	142.8	149.2	142.0	140.0
Hong Kong	1.4	4.8	7.1	5.7	0.8	2.9	4.4	3.4	93.2	89.6	88.6	89.5
India	-6.5	-8.7	-6.0	-5.3	-1.8	-2.4	-1.6	-1.4	26.3	27.3	29.3	31.8
Indonesia	-5.0	3.6	2.1	2.5	-2.3	4.3	1.8	1.6	20.6	22.8	26.4	27.4
Korea	-7.9	40.3	20.6	6.3	-1.7	12.6	5.2	1.4	21.1	52.4	61.4	64.4
Malaysia	-5.1	4.9	3.9	1.7	-5.2	7.5	5.6	2.3	20.8	26.2	31.1	34.1
Philippines	-4.4	1.3	1.8	0.5	-5.3	2.0	2.3	0.6	7.3	9.2	11.2	12.2
Singapore	14.8	15.5	15.0	17.2	15.4	17.8	17.1	18.7	71.4	75.1	83.6	91.6
Taiwan	7.6	3.4	5.5	4.9	2.7	1.3	2.0	1.7	83.5	90.3	89.7	92.5
Thailand	-3.0	14.2	11.4	9.1	-2.0	12.3	8.2	5.7	26.2	29.5	36.5	37.5

	External debt % of GDP, end of period				Short-term foreign debt US$ billion, end of period				Government balance % of GDP, end of period			
	1997	1998e	1999f	2000f	1997	1998e	1999f	2000f	1997	1998e	1999f	2000f
Japan									-3.8	-6.9	-8.4	-9.1
Australia									0.5	2.8	1.6	1.9
New Zealand									2.0	2.6	0.2	-0.5
China	17.6	16.9	15.4	16.0	36.3	25.6	24.2	26.6	-0.7	-1.1	-2.3	-3.0
Hong Kong									4.5	-1.9	-3.1	-2.6
India	27.9	28.4	29.3	30.6	11.7	13.2	14.2	15.2	-5.7	-5.9	-5.7	-5.2
Indonesia	62.4	166.8	123.2	91.7	36.2	27.9	20.9	19.4	1.2	-7.0	-6.5	-6.5
Korea	32.2	47.5	36.8	30.5	66.2	33.3	31.3	29.8	-0.8	-4.0	-6.0	-7.0
Malaysia	40.8	59.5	53.0	48.7	12.0	7.2	5.2	4.2	5.5	-1.8	-5.5	-2.0
Philippines	61.5	80.7	69.8	60.3	11.0	9.5	9.5	9.8	-1.0	-2.7	-3.5	-1.5
Singapore									1.1	2.4	-2.5	-0.5
Taiwan	15.6	17.3	16.5	15.8	29.2	28.0	27.6	28.0	-6.9	-7.0	-8.5	-7.8
Thailand	63.5	78.7	59.3	46.5	30.0	23.5	17.5	15.5	-0.9	-4.5	-6.0	-4.5

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