Singapore
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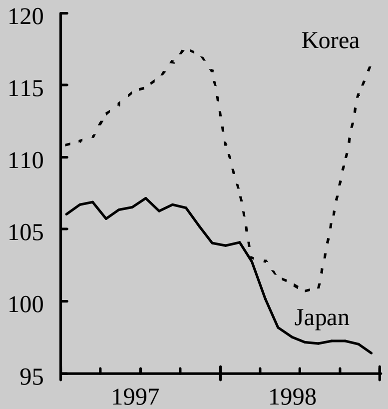
JPMorgan

Asian Financial Markets

First Quarter 1999

Industrial production
1995=100, sa, 3-mo. mov. avg



Contents

Recovery is becoming a reality...

- Asian news over the last three months has been largely positive. The J.P. Morgan forecast that the region is moving from recession to stabilization and recovery is becoming reality. The first building block was improvement in payment conditions. More recently, easy macro policies, reform progress, and rising export volumes where currencies have dropped are becoming the main drivers of output growth. Even so, the evolving recovery will be generally moderate and uneven across countries.

...but will be moderate and uneven

- Korea is leading the recovery, followed at some distance by Thailand and the Philippines, while Hong Kong and Singapore trail behind. Political uncertainties will delay recovery in Indonesia and the government's isolationist policy will do the same in Malaysia. Still, a more uniform growth pace of nearly 5% is likely to follow in 2000 and, if reforms continue, 5%-to-6% long-term growth is still in reach for the next decade.

- China and Japan are the main outliers and risk factors. Both countries have used extensive policy stimulus, but with mixed results and at the expense of structural reforms, while their corporate and financial sector health continues to deteriorate. Slow progress on these fronts is likely to keep Japan close to recession and to slow China in both 1999 and 2000.

Asia's recovery is a modest plus for Australia and New Zealand

- While tight policies and the Asian crisis have pulled New Zealand into recession, strong consumer spending has kept Australia rolling. Recovery in Asia is a plus for both countries, but while New Zealand should pick up, slackening domestic demand is set to slow Australia's economy.

Market conditions to improve further, but not everywhere

- In the near term, markets are likely to focus on devaluation risks in China, the implications for the Hong Kong peg, and the deterioration of supply and demand conditions in Japan's government bond market. Economic recovery and falling interest rates, however, are likely to support markets in much of the rest of Asia. Fallout from an emerging markets crisis or a sharp correction in the U.S. equity market are risks, but are unlikely to derail the improving market fundamentals. Besides China and Japan, India and Taiwan are most at risk to disappoint.

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Executive Summary

It’s the real thing, but not for Japan

- **Asian markets are celebrating the first signs of economic recovery**
- **But the recovery will be moderate and uneven and some countries will be left behind**
- **There is no quick fix for Japan’s predicament**

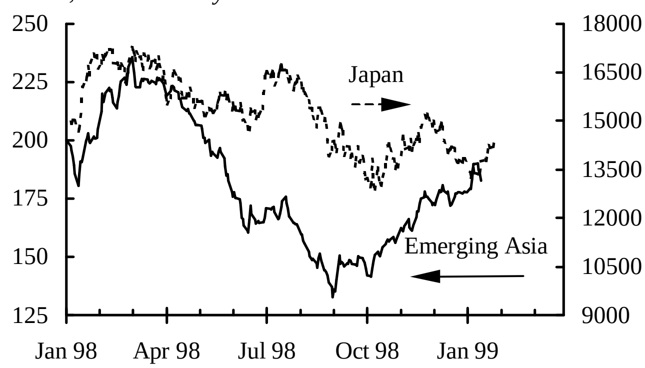
The recent rally in Asian financial markets has sparked new optimism, but also leaves doubts. Not all of the market developments have been positive. In particular, the strength of the yen and the increase in Japanese government bond yields are hardly harbingers of new life in Asia’s largest economy. Nevertheless, a lot has changed. There may be bumps still to come and recovery will be uneven, but this is the real thing.

Indeed, there is more to Asia’s market rally than just hope and a boost from Wall Street:

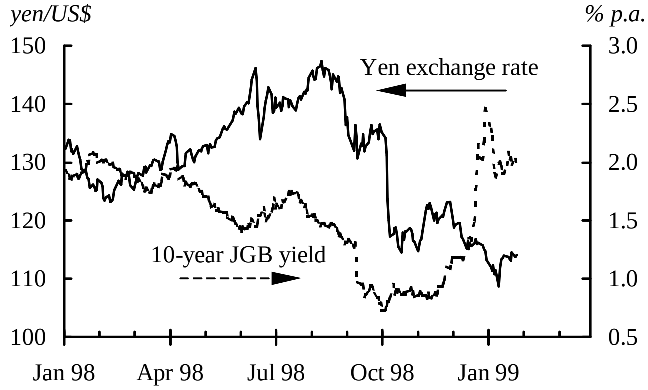
- Output has bottomed out and recovery is already reality in some parts of the region, notably Korea;
- Interest rates have dropped sharply, boosting liquidity and reducing interest expenses;
- Export volumes are rising from economies where currencies have dropped, leading to inventory rebuilding and some new investments;
- Although constrained by social and political factors and by poor institutional standards, reforms in Asia’s crisis countries are making progress.

With payments pressures largely gone, inflation on the decline, and macro policies focused on stimulating growth, these trends are likely to continue. The economies likely to perform best will be those where sustained real currency depreciations combine with stimulative policies and progress in financial and structural reforms. Still, there will be late comers and some may never join the party, at least this year. Moreover, risks remain both inside and outside the region.

Emerging Asian equities rally, while Japan’s struggle



... against a strong yen and rising JGB yields



China and Japan will buck the trend

China and Japan are the biggest outliers and risk factors in the regional growth outlook. Both countries have used extensive policy stimulus, but with mixed results and at the expense of structural reforms, while their corporate and financial sector health continues to deteriorate. Slow progress on these fronts is likely to keep Japan close to recession and slow China’s growth performance in both 1999 and 2000.

In the near term, however, markets are likely to focus on the devaluation risks of the Chinese renminbi (and their implication for the rest of the region, especially Hong Kong) and on Japan’s difficulties in funding its ballooning budget deficit.

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Renminbi adjustment is only a matter of time...

Given the drawbacks of the current stimulus policy and the pressure on its exporters, China's government has most likely accepted that a depreciation of the renminbi is inevitable. What matters is the timing. The government's key concern seems to be the impact of a currency adjustment on Hong Kong and the peg. True, there is no direct link between the two currencies, thanks to the renminbi's lack of convertibility. But with the economy weak, sentiment in Hong Kong is sensitive to changes in China's currency stance.

Thus, China will probably try to delay a policy change until the second half of the year, hoping for signs first of economic recovery in Hong Kong and further declines in U.S. interest rates. Moreover, it is likely to prefer a gradual depreciation, thereby shifting to a more flexible exchange rate policy. Whether the adjustment will be smooth remains to be seen, but the government's ability to hold out and control the foreign exchange market should not be underestimated.

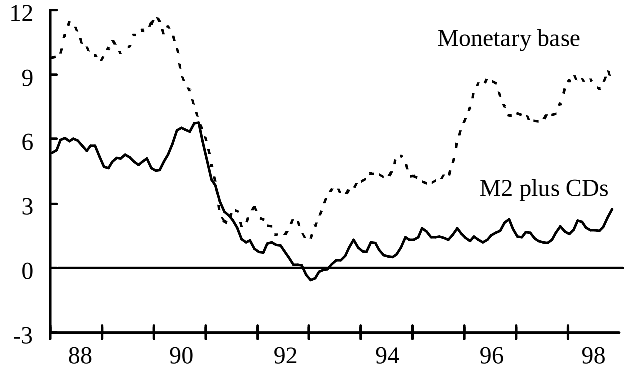
...and unlikely to derail the Hong Kong peg

For Hong Kong, the worst is probably over, but the SAR is suffering from outright deflation, high real interest rates, and a still-depressed property sector. Under these conditions, Hong Kong is clearly vulnerable to shocks, whether they come from China, a sharp correction in U.S. equity markets, or a new crisis in emerging markets. Still, the government will probably continue to view the dislocations from devaluation as potentially more damaging than the adjustment cost of maintaining the peg. And with monetary balances remaining strong and U.S. interest rates biased downward, there is a high chance that it will succeed.

Should the BoJ absorb the government's debt?

In Japan, market concerns have largely shifted from the poor state of the economy to the government's growing budget deficit and the sharp decline of funds available at the government's Trust Fund Bureau for the purchase of JGBs. While some of the fears are overblown – most notably, concerns that Japanese savers could withdraw large amounts of maturing deposits from the Post Office in coming years – the fundamental supply and demand equation for JGB is undoubtedly changing. That puts the sustainability of Japan's fiscal policy stance into question and raises the issue of what higher yields might mean for the rest of the economy.

BoJ has lost contril over broad money supply
%oya, 3-month moving average



Additional damage to the economy from higher yields would probably be limited, however, since the poor and deflationary state of the economy would likely keep yields from rising much above current levels. Still, if the outcome is only rising debt yet no lasting recovery, the sustainability of the current fiscal policy stance must be in doubt. But what are the alternatives?

A popular and radical proposal is to inflate the economy at any price by forcing the Bank of Japan (BoJ) to absorb the government debt. But besides meeting resistance from the increasingly independent-minded BoJ, this proposal would probably not bring the desired results. Investment in Japan is in a prolonged trend downward, as companies adjust to the decline in their long-term growth potential, and the resulting drag is compounded by paralysis and consolidation in the financial sector. Against this background, monetary and fiscal expansion lacks any multiplier effects. Thus, absorbing the government debt would boost the monetary base, but probably do little to accelerate broad money supply and real GDP.

Instead, any successful solution will probably have to combine easy fiscal and monetary policies with a series of painful structural reforms that resolve the problems of the financial sector and reduce subsidies to loss-making businesses, including public enterprises. But such adjustment will not come without substantial dislocations of the labor market, which are apt to test Japan's political and social consensus.

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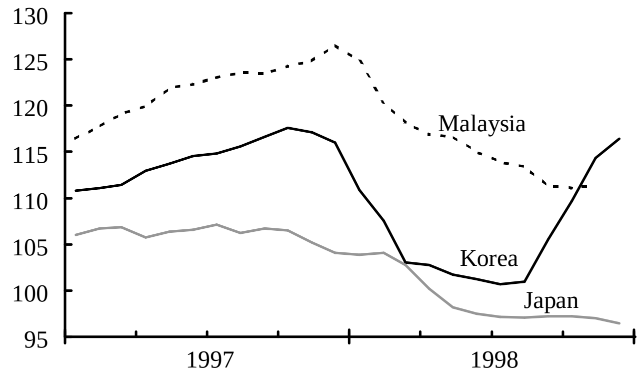
Asia's uneven recovery

- **Recovery is a reality, but not everywhere**
- **Payments pressures and policies have eased and activity surrounding the trade sector is rising**
- **Emerging Asia to return to 5% growth in 2000**
- **But Japan to stay close to recession and China to slow in both 1999 and 2000**

By now, there is little question that Asia has reached a bottom. Even the laggers are starting to stabilize and there are already some signs of recovery, most notably in Korea. The main forces behind the region's output stabilization are the fading of payments pressures and the pump-priming in China and Japan. Going forward, easier macro policies, reform progress, and activity surrounding the trade sector are likely to be the main sources of growth. However, the region's recovery will be moderate and uneven.

- On the external side, global growth conditions are expected to deteriorate, with world real GDP growth sliding from 1.6% in 1998 to roughly 1.0% in 1999.
- In Japan, the downward trend in private demand is likely to continue, despite the government's desperate stimulus efforts, and the economy is expected to move at best from recession back to stagnation.
- China will probably avoid recession, but its growth performance is set to slip in both 1999 and 2000.
- Countries that experienced sharp currency devaluations and made tangible reform progress are likely to lead the rebound – Korea, followed at some distance by Thailand and the Philippines – while political uncertainties in Indonesia and Malaysia's isolation policy are likely to delay recovery.
- Countries that maintained relatively strong currencies will lag the recovery – Hong Kong, Singapore, and Taiwan. At risk also is India, which in contrast to the rest of the region has suffered an unsustainable deterioration in its external and fiscal accounts.

Industrial production
1995=100, sa, 3-month moving average



Real GDP growth forecasts
% year-on-year

	1998e	1999f J.P. Morgan	1999f *Consensus**	2000f J.P. Morgan	2000f *Consensus**
Asia	-1.7	1.2	*0.6*	1.4	*2.0*
Japan	-2.9	0.0	*-1.1*	-1.0	*0.1*
Emerging Asia	0.1	3.0	*3.1*	4.9	*4.8*
China	7.8	6.5	*7.6*	5.8	*7.7*
Korea	-5.7	4.0	*1.0*	4.5	*3.5*
Philippines	-0.5	2.6	*1.5*	5.0	*3.2*
Thailand	-6.5	3.0	*0.0*	5.0	*3.3*
Indonesia	-13.7	-3.5	*-3.2*	5.0	*2.3*
Malaysia	-7.3	-1.0	*0.0*	5.0	*2.7*
Hong Kong	-5.0	-1.5	*-0.9*	3.0	*1.9*
Singapore	1.3	-1.0	*-0.8*	4.0	*3.1*
Taiwan	4.8	3.2	*4.5*	4.5	*4.9*
India	4.0	2.5	*5.0*	5.0	*5.4*

* Consensus Economics Inc., January 11, 1999.

For the region as a whole, the J.P. Morgan forecast is not much different from the consensus view. In contrast to the consensus, however, Morgan expects Japan's fiscal stimulus to hold GDP flat in 1999, but that another downturn will follow in 2000. For the rest of the region, Morgan is more optimistic on the growth outlook for those countries that have experienced deep recessions, but predicts more weakness in those countries that have largely escaped the regional crisis, most notably and importantly China.

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Output figures have improved, but not uniformly

Quarterly real GDP and monthly industrial production figures generally improved in the second half of last year. For the region as a whole, output reached a bottom, following sharp contractions in the first half of 1998. However, there are clear leaders and laggers and different degrees of stability.

- Most impressive has been the rebound in **Korean** industrial production, which has nearly reversed the earlier declines. As a result, real GDP probably bounced above its 1998 average in the fourth quarter. The very high pace of output increases is set to ease soon, but the decline in the inventory/sales ratio, the increase in capacity utilization, and the stabilization in labor market conditions will probably continue to support the recovery.

- In contrast, **Japan's** output stabilization is fragile, despite the government's massive fiscal stimulus. Inventory and capacity utilization conditions have not improved and corporates' financial position and labor market conditions continue to deteriorate.

- **China's** pump-priming efforts have been far more successful than Japan's. The quality of China's output data is questionable, but even if the rate of output growth is overstated, there are clear signs of reacceleration. However, excess inventory and capacity problems have not disappeared and plunging prices have eroded corporates' financial health.

- **Hong Kong** and **Singapore** are trailing the regional trend, with output and labor market conditions deteriorating through most of the second half of 1998.

- **Taiwan**, which held up well through most of 1998, started to slip toward the end of last year.

- Output indicators in **Indonesia**, **Malaysia**, the **Philippines** and **Thailand** are more volatile, but show a stabilization in the second half of 1998 after the free-fall in the first half. However, recovery is not yet a trend except perhaps for Thailand.

- Finally, **India**, which seemed isolated from the regional crisis, also started to show signs of weakness toward the end of 1998.

Output indicators

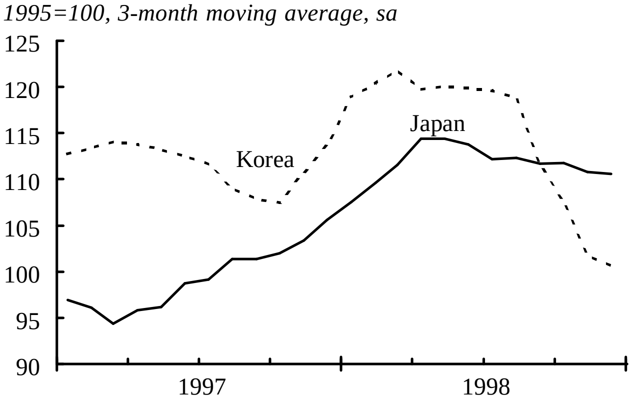
% quarter-on-quarter, seas. adj. annualized, unless stated

Country	Data	98Q1	98Q2	98Q3	Latest	period*
Japan	Real GDP	-4.8	-2.9	-2.6	n.a.	
	Ind. prod.	-4.9	-18.9	-1.1	-3.2	98Q4
China**	Real GDP	7.2	7.0	7.6	9.4	98Q4
	Ind. prod.	9.0	7.7	8.6	9.9	98Q4
Hong Kong	Real GDP	-12.8	-2.9	-6.4	n.a.	
India	Ind. prod.	-1.9	7.9	2.6	-2.9	Oct
Indonesia	Real GDP	-25.3	-32.1	-6.5	14.5	98Q4
Korea	Real GDP	-21.4	-4.6	1.7	n.a.	
	Ind. prod.	-37.8	-6.8	18.1	48.1	98Q4
Malaysia	Real GDP	-24.8	-8.3	-3.7	n.a.	
	Ind. prod.	-24.0	-10.4	-12.3	6.3	Oct-Nov
Philippines	Real GDP	-4.7	-2.0	1.6	-1.6	98Q4
Singapore	Real GDP	0.7	-1.4	-3.5	-5.2	98Q4
	Ind. prod.	-9.3	-6.8	-6.3	13.2	98Q4
Taiwan	Real GDP	1.9	3.1	6.0	n.a.	
	Ind. prod.	-8.9	4.9	9.9	-0.4	98Q4
Thailand	Ind. prod.	-21.8	11.3	-6.7	9.9	98Q4

* Annualized % change of latest average from third-quarter average.
** Average %oya change.

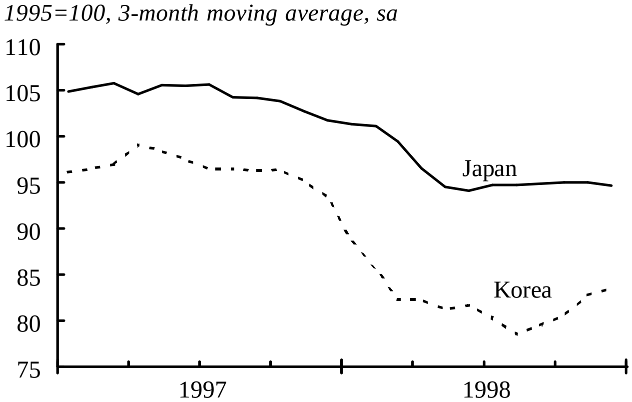
Inventory/shipment ratios

1995=100, 3-month moving average, sa



Capacity utilization

1995=100, 3-month moving average, sa



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The private demand meltdown is largely over

Except for Japan and Korea, there are few reliable and timely domestic demand indicators. Still, the available data show a picture compatible with the recent output trends. Private consumption and investment spending are largely stabilizing and even give some signs of recovery. The main exceptions are investment spending in Japan and private consumption in Hong Kong.

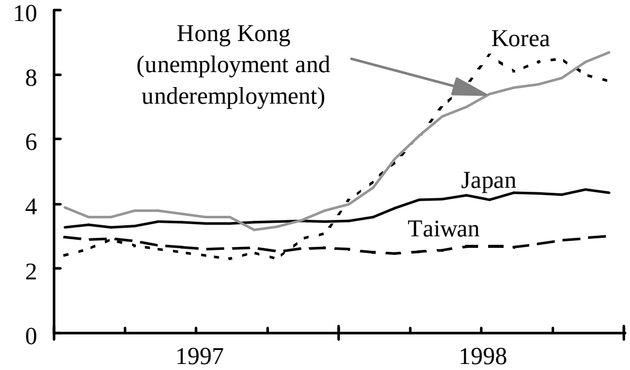
- **Private consumption:** Korean retail sales bounced smartly toward the end of last year, supported by stabilizing labor market conditions and improving consumer sentiment. In contrast, the November jump in Japanese retail sales proved temporary, as employment conditions and consumer sentiment have continued to worsen. Chinese retail sales surged in the third quarter and their fourth-quarter drop was largely payback. But retail sales in Hong Kong and, to a lesser extent, Singapore continued to fall through most of the second half of 1998. Finally, Thai and Malaysian car sales data, although more volatile, point to some stabilization and perhaps even recovery in private consumption.

- **Private investment:** Only Japan and Korea release private investment statistics. For Japan, the data show continued – although somewhat more moderate – declines in construction orders, housing starts, and machinery orders. For Korea, the data are more volatile, but show some stabilization in construction and machinery orders while building permits continued to decline until the end of last year.

Trade surpluses have peaked ...

Improved output conditions in China and Japan are largely the result of government pump-priming efforts. Elsewhere, however, cyclical improvements reflect a rapid easing of the payments pressures that forced businesses and households to slash spending at the beginning of last year. The size and speed of the spending cutbacks was visible in the region's dramatic import and trade balance adjustment. Not surprisingly, with cyclical conditions now improving, the rise in regional trade surpluses has come to an end. However, a rapid return to deficits is unlikely, while exports and investment in the trade sector are likely to drive recoveries where currencies have dropped sharply.

Unemployment rates
% of labor force, sa



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

Country	Data	98Q1	98Q2	98Q3	Latest	period*
Japan	Retail sales	-3.3	-7.9	-4.8	-1.0	98Q4
China	Retail sales	7.6	3.7	15.3	-2.1	98Q4
Hong Kong	Retail sales	-35.8	2.6	-20.1	-18.1	Oct-Nov
Korea	Retail sales	-32.0	-4.6	-5.8	19.5	Oct-Nov
Malaysia	Car sales	-93.3	-8.6	32.2	42.0	Oct-Nov
Singapore	Retail sales	-21.4	2.6	-20.8	-0.1	Oct-Nov
Thailand	Car sales	-63.7	-25.1	-64.6	412.9	Oct

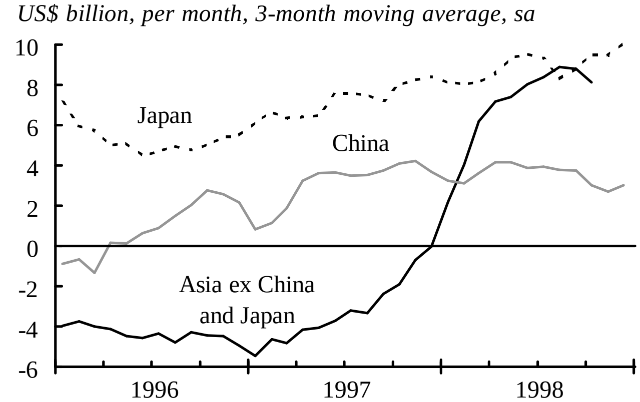
* Annualized % change of latest average from third-quarter average.

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

Country	Data	98Q1	98Q2	98Q3	Latest	period*
Japan	Constr. orders	9.9	-54.7	23.6	-27.7	98Q4
	Housing starts	4.7	-22.6	-27.0	-10.2	Oct-Nov
	Mach. orders	5.5	-50.1	-3.3	-15.5	Oct-Nov
Korea	Constr. orders	4.2	-89.4	49.2	-26.2	Oct-Nov
	Bldg. permits	-69.8	-90.0	-58.8	-30.6	Oct-Nov
	Mach. orders	-67.7	-26.4	150.7	-1.6	Oct-Nov

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

Asian trade balances
US$ billion, per month, 3-month moving average, sa



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...but volumes are likely to rise

Dollar-denominated trade statistics continue to show a picture of falling exports in most of the region except for the Philippines. However, available volume data show rising export activity in countries where currencies have devalued sharply and falling export activity in countries where currencies have remained strong. This trend is likely to continue through much of this year, with many Asian exporters carving out larger market shares, although in a weaker global trade environment. An additional plus for Asia's electronics exporters are recent signs of improving demand and price conditions in the global electronics business.

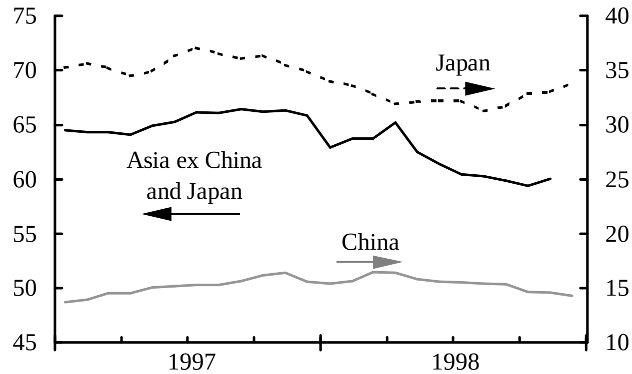
Volume increases in the trade sector are also likely to generate second-round effects, especially inventory increases and new investments in machinery and equipment. Most especially, foreign direct investment in the trade sector is set to surge.

However, with inventories and investment starting to recover, import volumes are set to rise as well and will probably outpace the increase in export volumes. Still, a rapid return to deficits is unlikely, as it will take many years for domestic demand conditions to recover fully, while prices of imported commodities are likely to remain soft. The main exception is probably China, whose trade surplus is expected to fall faster this year, reflecting the policy-driven reacceleration of domestic demand and exporters' difficulties in maintaining price competitiveness. Japan's exports are also set to suffer from the yen's appreciation, but the failure of the government's stimulus packages to boost private demand will probably keep imports at bay.

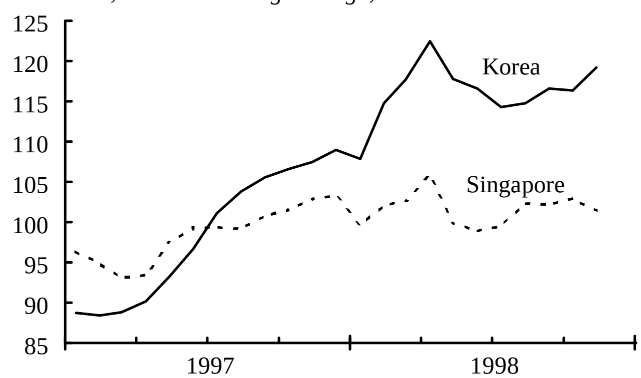
Policy conditions have eased...

A notable change and a plus for the region's growth outlook is the easing in monetary and fiscal policy conditions. Interest rates have fallen across the board as payments pressures and inflation risks have disappeared. The sole exception is India, where rising deficits and inflation pressures have forced a tightening of monetary policy. Besides China and Japan, Hong Kong, Korea, Malaysia, Singapore, and Taiwan have also eased fiscal policy. Still, overall policy conditions are not everywhere stimulative and, with inflation still falling, there is room for more interest rate cuts.

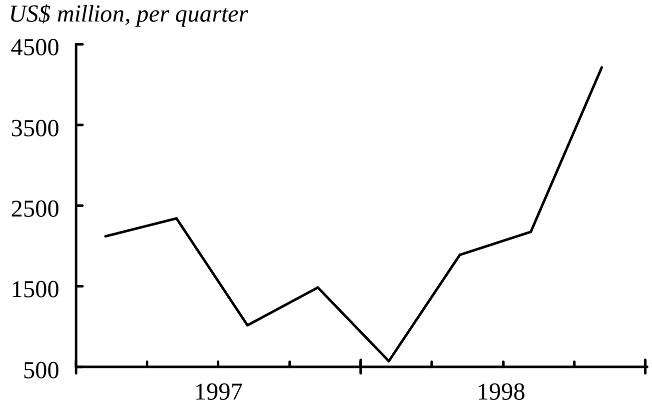
Dollar-denominated export values
US$ billion, per month, 3mma, sa, both scales



Export volumes
1997=100, 3-month moving average, sa



Korea: foreign direct investment commitments
US$ million, per quarter



...but are not everywhere stimulative

For Japan, the main issue is not a lack of policy stimulus, but an absence of spending multiplier effects, which highlights the need for speedy structural reforms. In the rest of the region, only Korea has truly achieved an across-the-board stimulative policy stance, which is no doubt starting to show up in its growth performance.

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China's policy stance is polarized between pump-priming in the state enterprise sector and tight monetary conditions. The real effective exchange rate still appears competitive, but at the cost of huge price declines that have undermined corporate financial positions. How long the government can sustain this dichotomy is unclear, but monetary easing and, still more, a gradual currency adjustment seem inevitable.

In Hong Kong, monetary conditions remain tight, although the solid expansion of the real monetary aggregates points to continued high official faith in the sustainability of the currency peg. And with inflation turning to deflation, there is a need for further interest rate declines, but the room for interest rates to fall also depends on the direction of U.S. interest rate policy and sentiment surrounding China.

In much of the rest of the region, monetary conditions are just about neutral and there is clearly room for more interest rate declines, given the benign inflation prospects and low operating rates. In particular, Thailand has more room for monetary ease, since the baht's appreciation has eroded much of its earlier competitiveness gains.

By contrast, Malaysia has little room to ease policy further since the government's isolation and expansionary policies have undermined depositor confidence. Political uncertainties and the risk of depositor flight also limit the room for monetary easing in Indonesia. And India will probably first have to raise interest rates to stem the deterioration of its trade balance and offset inflationary pressures before it can move on to relax policy again.

Monetary and fiscal conditions

	Monetary conditions				Fiscal
	REER	Real rates	Real M2	Total	stance
Japan	0	0/+	+	0/+	++
China	0	–	0/–	0/–	++
Hong Kong	–	– –	+	–	+
India	0	0	+	0/+	0
Indonesia	++	– –	– –	–	–
Korea	+	+	+	+	+
Malaysia	+	+	– –	0	+
Philippines	+	0	–	0	0
Singapore	0	0	0	0	+
Taiwan	0	–	–	0/–	+
Thailand	0	+	–	0	0

Real effective exchange rate
1990=100

	Dec 1997	Dec 1998	Last 5-year average
Japan	102.5	106.6	113.4
China	89.6	78.4	81.1
Hong Kong	138.4	131.3	123.6
India	80.8	76.8	77.9
Indonesia	62.4	70.5	89.4
Korea	58.6	70.9	81.6
Malaysia	84.9	81.8	103.1
Philippines	90.9	95.7	104.5
Singapore	114.4	108.6	112.9
Taiwan	89.3	91.6	89.5
Thailand	75.5	98.9	97.8

Nominal and real short-term interest rates
% p.a.

	Nominal interest rates		Real interest rates*	
	Dec 1997	Dec 1998	Dec 1998	1990-97
Japan	0.4	0.2	0.7	2.2
China	8.6	6.3	4.9	0.6
Hong Kong	9.4	5.4	8.2	-1.9
India	7.2	9.6	2.6	2.1
Indonesia	28.5	37.5	13.5	2.1
Korea	35.0	6.6	5.0	8.9
Malaysia	9.1	6.3	0.7	3.0
Philippines	18.1	13.5	6.0	6.1
Singapore	6.3	1.6	2.1	1.7
Taiwan	8.4	5.9	7.1	4.4
Thailand	27.0	7.3	3.9	6.6

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

Nominal and real money supply (M2) growth
%oya

	Nominal M2 growth		Real M2 growth*	
	Dec 1997	Nov 1998	Nov 1998	1990-97
Japan	3.8	3.9**	3.3**	2.1
China***	19.6	15.3	16.4	19.7
Hong Kong	8.4	11.3	12.1	6.0
India (M3)	16.7	19.5	11.2	8.1
Indonesia	23.2	66.7	-11.5	18.2
Korea	14.1	22.0**	18.0**	11.9
Malaysia	22.7	4.5	-1.1	16.0
Philippines (M3)	21.0	7.2	-3.6	10.5
Singapore	10.3	7.5	9.0	10.0
Taiwan	8.0	9.8	5.9	10.5
Thailand	16.4	11.6	6.9	12.9

* Nominal M2 growth minus inflation rate.
** Dec 1998.
*** Quarterly data.

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There are more signs of reform progress

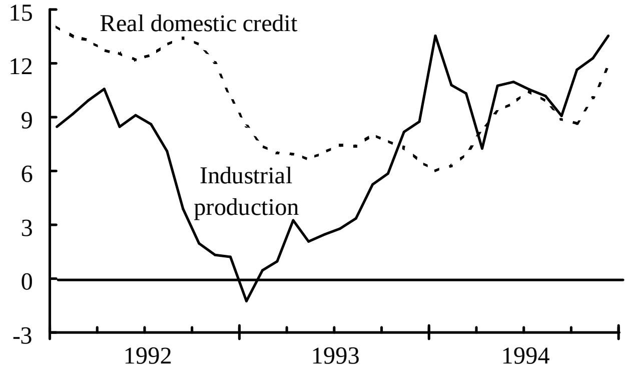
Going forward, the economies that are likely to perform best will be those where easier policies join with financial and structural reform progress. However, this does not mean that recovery depends solely on the restoration of corporate and financial sector health. Bank lending, for example, is usually a lagging business cycle indicator. In fact, the speed of economic recovery and the degree of monetary ease are key factors driving the process of restoring corporate and financial sector health. Even so, Japan's experience highlights that stimulus alone can have little impact if structural problems remain unresolved.

Among the crisis countries in Emerging Asia, governments were initially slow to recognize the need for reforms, but then changed their tune rapidly amid the dramatic collapse in economic and financial conditions and, in some places, political change – notably in Korea and Thailand. Still, the structure of reforms and their progress vary widely across the region.

Korea and Thailand are generally viewed as leading the reform effort, even though their reform paths are very different (see also: *Restructuring progress in Korea and Thailand*, pages 13-20). Both countries moved swiftly to implement emergency measures, close and nationalize insolvent financial institutions, and restore depositor confidence. However, the Korean government has been quick to shoulder much of the banks' bad loan problems, while the Thai government has laid out a plan that relies more on private-sector initiatives to clear the market and is tying banks' access to public funds to strict restructuring guidelines.

Not surprisingly, Korea's approach has delivered faster results, with banks starting to lend again, while Thailand's market approach has suffered from the lack of an efficient legal infrastructure and banks' reluctance to restructure their balance sheets. However, Thailand's problems are mostly limited to the financial sector, while Korea faces a much broader challenge that links banking sector issues to inefficient allocation of capital and labor throughout the economy. Considering the political and social constraints, Korea is on the right track, but has a long way to go, while Thailand needs to tighten the screws to enforce its reform plan and should ease banks' access to public funds.

Korea: bank lending is lagging, not leading, recovery
%oya, 3-month moving average



The structure of Indonesia's problems is similar to those in Thailand, but the damage is much worse and political uncertainties continue to undermine reform progress. Less noticed have been Malaysia's financial restructuring efforts, in which the government is actively buying bad loans and providing banks with fresh capital. However, much of the banks' loan problems remain tied to the government's preferential growth strategy, which has so far remained unchanged.

Funding the restructuring needs

Although government financial involvement in the reform process varies, the sheer size of the restructuring burden will have profound fiscal consequences. In practice, governments usually buy bad loans or bank shares in exchange for government bonds. By itself, this creates no additional net borrowing requirement, but boosts government interest expenses at a time when budget balances are already under pressure from the economic downturn and fiscal stimulus packages.

For the crisis economies in Emerging Asia, the ability to fund the growing budget deficits will depend on people's faith in the government and its reform policy. Despite the economic turmoil, saving rates have stayed high and even have increased in some countries. However, in the absence of efficient bond markets, governments rely largely on banks to give them loans or buy their securities. This highlights the importance of depositor confidence for both the accumulation and accessibility of private savings. In Korea and Thailand, people have that faith, but not in Indonesia, while depositors in Malaysia seem to be concerned over the government's isolation and expansion policies.

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Growth gaps are likely to narrow in 2000...

All in all, the economies of Emerging Asia will vary in their performance in 1999, but the laggers are expected to catch up in the year 2000, producing a regional GDP growth average of nearly 5%. Unfavorable external events are a risk, but far less so than a year ago, given the improved balance of payments position. Instead, the main risks are likely to come from the region's two largest economies: Japan and China.

...but Japan will stay close to recession...

Japan's adjustment is depressingly slow compared with the improvements in some parts of Emerging Asia – most notably Korea. The key drag on its growth is the downward adjustment of investment plans. After the boom of the bubble years, Japan's growth potential has declined and investment efficiency (ICOR*) in the traditional manufacturing and construction areas has dropped sharply. In response, companies have reduced capital spending but have been slow to realize new growth opportunities in the service sector. Not surprisingly, investment efficiency has remained poor and, with capital spending still high relative to both output and growth potential, the private investment slide is likely to continue another two years or more.

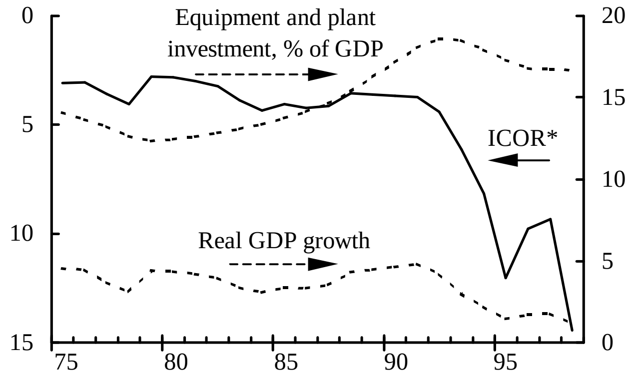
The prolonged capital stock adjustment is generating negative employment and consumption fallout. That fallout, combined with the paralysis in the banking sector and growing popular concerns over the safety of the pension system, has depressed domestic private demand and will continue to do so. Against this background, the government's pump-priming efforts have first-round effects but fail to boost sentiment or lead to second-round spending.

Worse, the fiscal packages are designed only to ease pain and actually reinforce many structural rigidities, especially in the overstaffed construction sector. Financial-sector reform progress has also remained slow. The provision of ¥60 trillion for bank recapitalization purposes is likely to limit systemic risks, but the government still lacks a comprehensive strategy to identify and solve banks' bad loan problems.

Not surprisingly, the combination of fiscal expansion and a weak economy has boosted the budget deficit

Japan's investment efficiency has plunged

ratio, 5-year mov. avg. *% p.a., 5-year mov. avg.*



* Incremental capital/output ratio: (Investment/GDP)/(Real GDP growth).

and put the sustainability of Japan's fiscal policy stance into question (see also: *Japan's fiscal headaches*, pages 21-28). Still, with an election approaching, fiscal pump-priming is likely to increase in 1999, keeping the economy about flat. However, an estimated fiscal deficit of nearly 10% of GDP will probably limit the government's ability to boost spending much further in 2000, and could thus set the stage for another downturn in the economy at large.

...and China will continue to slow

In contrast to Japan, China's pump-priming efforts have had some success in stimulating domestic demand. However, this has come at the cost of halting reforms in the state enterprise sector and the banking system, while the stability of the renminbi has forced exporters to cut prices and has undermined corporate financial health. The bankruptcy of GITIC highlights the government's efforts to force the weakest financial institutions to adjust. But the much larger problem of the state enterprise sector and the state banks remains on the back burner and is unlikely to be addressed swiftly, given the huge labor market implications.

Instead, the government will probably continue its strategy of muddling through, relying on its still-potent ability to steer the economy. This is likely to lead to a moderation of the pump-priming in the state sector and a gradual depreciation of the currency, provided Hong Kong continues to stabilize. On balance, however, fading stimulus and mounting structural head winds are expected to drag GDP growth further downward.

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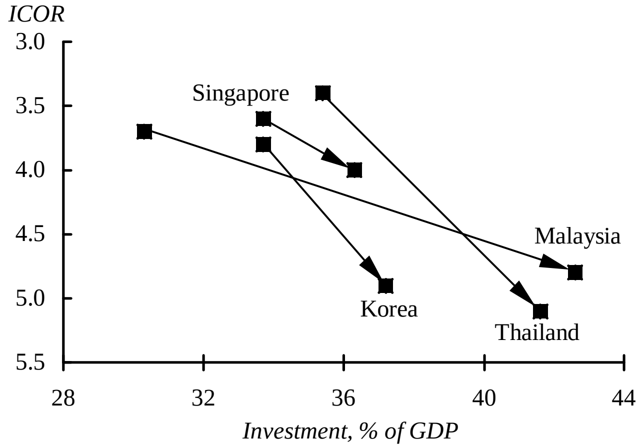
And what about the long haul?

In what ways and how fast China and Japan will resolve their problems is unclear. Weakness in both countries is likely to have some restraining impact on the rest of the region, but is unlikely to derail recoveries or long-term growth prospects. However, moving into the next decade, average growth is likely to be lower than in the 1990s even if countries continue to make sound improvements.

A feature common to most Asian countries in the boom years was overinvestment leading to efficiency losses – rising ICORs. Going forward, sustainable long-term growth should be built on lower investment rates – although a few countries could invest more – together with some improvement in efficiency. That said, structural factors, such as the maturing of the region's more advanced economies and a lack of skilled labor, are likely to cause efficiency losses in some parts of the region.

Thus, China, Korea, Malaysia, Singapore, and Thailand are likely to see the largest declines in their long-term growth potential compared to their peak performances in the mid 1990s, while only the Philippines has a good chance to raise its long-term growth rate. Moreover, much will depend on sustained reform progress, especially in the region's crisis countries and China. Still, most countries are likely to outperform their peers among other emerging economies, reflecting the region's ongoing high propensity to save, openness to trade and technology, and emphasis on education and fiscal discipline.

Investment boom eroded efficiency: 1987-92 vs. 1993-96



For Japan, 2% long-term growth is probably the limit, and achieving even that much will require a major effort in terms of a radical downsizing of inefficient investment, especially in the public sector, and a reorientation to new growth opportunities in the service sector. This adjustment will not come without substantial dislocations in the labor market, and these are apt to test Japan's political and social consensus.

Projecting long-term growth*
percent annualized

	Gross domestic fixed investment			*divided by*	Incremental capital output ratio			*equals*	Real GDP growth		
	1987-96	1993-96	2001-10		1987-96	1993-96	2001-10		1987-96	1993-96	2001-10
China	30.5	33.2	32.0		3.0	2.9	4.0		10.0	11.6	8.0
Hong Kong	28.2	31.1	28.0		4.8	6.1	7.0		5.9	5.1	4.0
India	22.1	21.8	24.0		3.7	3.3	4.0		5.9	6.5	6.0
Indonesia	26.6	28.5	26.0		3.9	3.8	4.0		6.9	7.5	6.5
Korea	35.1	37.2	30.0		4.2	4.9	5.5		8.3	7.6	5.5
Malaysia	35.2	42.6	30.0		4.2	4.8	5.0		6.5	8.8	6.0
Philippines	21.1	23.2	24.0		5.7	5.5	4.0		3.7	4.2	6.0
Singapore	33.9	36.3	30.0		3.8	4.0	6.0		9.0	9.1	5.0
Taiwan	22.3	23.8	22.0		3.1	3.9	4.5		7.3	6.1	5.0
Thailand	37.9	41.6	30.0		4.0	5.1	5.0		9.5	8.1	6.0
	1981-90	1991-98	2001-10		1981-90	1991-98	2001-10		1981-90	1991-98	2001-10
Japan	28.3	30.1	22.0		7.5	28.3	11.0		4.0	1.4	2.0

* These projections are built on a simple model that rests on the view that the key factors separating high-growth from low-growth countries are the rate of investment relative to GDP and the efficiency of investment represented by the incremental capital/output ratio (ICOR). See also: *Rethinking Asia's long-term growth outlook*, Asian Financial Markets, January 16, 1998, page 9.

Restructuring progress in Korea and Thailand

- **Different approaches to financial sector restructuring yield different results**
- **Korea's more activist policy has produced macroeconomic benefits faster than in Thailand**
- **Thailand's market-driven changes, if and when they come, may prove more resilient**
- **Deeper structural issues will likely linger in Korea**

Despite renewed turbulence in global financial markets, improved fundamentals have set the stage for the recovery of Emerging Asia's battered economies. Bellwethers in this healing process are Korea and Thailand. In both countries, near-term economic recovery and an eventual return toward potential growth must be supported by progress in restructuring and strengthening of their banking systems. Comparing reform progress in these countries is conceptually artificial – restructuring is not a horse race. But such a comparison does shed light on where the processes currently stand and on the countries' macroeconomic prospects.

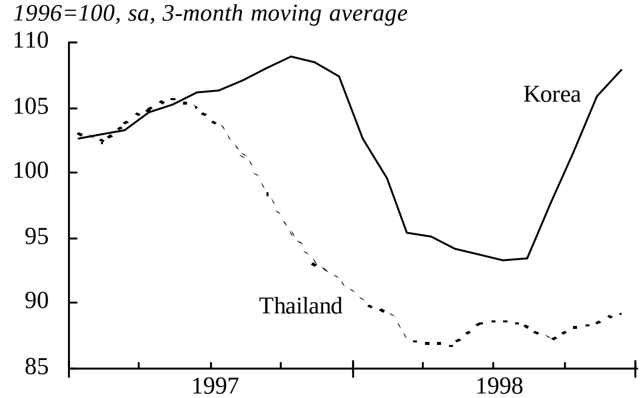
In a number of dimensions, bank restructuring has been faster in Korea than Thailand. True, both took quick action to close insolvent institutions and restore confidence in the banking system, but the willingness of the Korean government to shoulder more of the restructuring burden has meant that actions could be taken without waiting for the private market to clear. In particular, Korea has been able to remove a significant portion of nonperforming loans (NPLs) from its remaining banks, shore up their balance sheets with government-lent capital, and sell one of the banks the government had taken over. On these important reform fronts, Thailand has yet to produce significant results.

In terms of macroeconomic adjustment, Korea also appears to be ahead. Korean data already started to show a recovery in the manufacturing sector before the end of 1998, while Thai industrial production has not risen above the firm floor it started building in the second quarter of last year.

Reform progress so far
J.P. Morgan estimates as of end-1998

	Korea	Thailand
Domestic credit (end-1996, % of GDP)	165	155
% outstanding to manufacturing (end-1996)	40	24
% outstanding to real estate (end-1996)	1	12
Commercial banks		
Number as of end-1996	26	15
Closed	5	1
Merged	2	3
Nationalized	2	2
Foreign sale/joint venture	1	2
Merchant banks/finance companies		
Number as of end-1996	30	91
Closed	16	56
Merged	1	16
Peak nonperforming loans (% of total)	25	50
Current nonperforming loans (% of total)	15	46
Government expenditure (% of GDP)		
On NPL buyouts	4.7	0.0
On recapitalization	5.0	3.7

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



So, one may easily be left with the impression that all is well in Korea and not in Thailand. But it is far too early to draw such a conclusion for two reasons. First, key aspects of the bank reform process, like recapitalization and debt restructuring, are on the verge of producing results in Thailand. Second, 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.

Financial restructuring: the short and long of it

The process of financial sector reform is essentially about stabilizing a distressed banking sector, returning it to profitability quickly, and making it more resilient. Accordingly, the reform processes in Korea and Thailand can be broken down into actions designed to bring about short-run results and those with longer-run goals in mind. The short-run measures include:

- Emergency steps to restore depositor confidence;
- Strengthening of the balance sheets of the remaining banks;
- Improvement of banks' profitability so that lending resumes.

Steps to improve the efficiency and resilience of the financial system in the long run include:

- Addressing problems in the industrial structure of the banking system;
- Improving regulatory and prudential standards;
- Strengthening the legal infrastructure;
- Increasing foreign participation.

The long-run steps present difficult issues involving the culture of banking and business practices generally. The short-run measures are, in comparison, less controversial. However, recent crises around the world have shown that there are myriad ways for governments to try to revitalize their banks. In Chile during the early 1980s, the government simply bought the bad loans at par value. In 1995, Mexico, like Chile, paid banks generously when it bought their NPLs but in return forced them to recapitalize. In Sweden in the early 1990s, the banks themselves formed asset management companies (AMCs) to handle NPLs, with the AMCs funded by the government. In the United States, insolvent S&Ls were closed and their equity wiped out.

With these lessons in mind and under IMF tutelage, Korea and Thailand adopted different approaches to repairing their financial systems.

Emergency measures have been effective

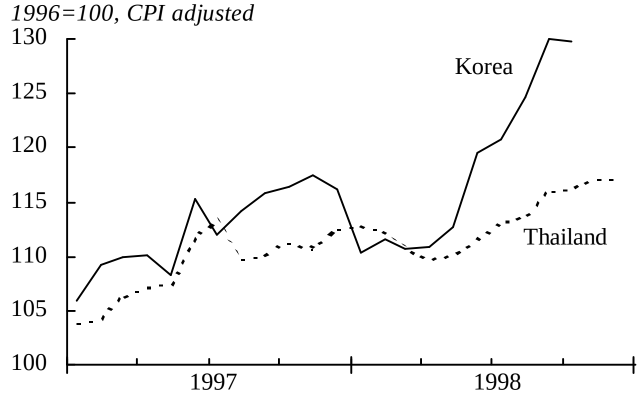
Step one in the process is to stop systemic panic. On that score, both Korea and Thailand performed effectively. The key action was to remove the weakest financial institutions from the system and to do so in a way that credibly signaled to depositors that those that remained were sound. Korea shut down 16 merchant banks, Thailand 56 finance companies, and both nationalized the weakest of their commercial banks. These actions, plus generous liquidity support from the central banks, allayed depositor fears. Though a "flight to quality" did occur among the surviving institutions, overall, funds stayed within the country and, importantly, within the banking system.

Strengthening bank balance sheets

Step two is a big one: getting the remaining banks up to minimum prudential capital standards. Repairing bank balance sheets can be accomplished by reducing liabilities like deposits and other debts, increasing the value of existing assets, or raising new capital.

Reducing liabilities. In both countries, the route of helping the banks by reducing their liabilities has been avoided. Forcing depositors to bear a significant portion of the burden was deemed politically unacceptable. So far, the Korea Deposit Insurance Corporation has spent won14.7 trillion on deposit repayment, basically amounting to a full guarantee of deposits. However, the law has been changed to reduce the amount of guaranteed principal and the categories of deposit covered, so a partial default on deposits and other claims may still occur. Thailand, which lacks a de-

Real bank deposits
1996=100, CPI adjusted



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posit insurance system, issued a blanket guarantee to all depositors and creditors (irrespective of size) of non-suspended finance companies and banks, and a more limited guarantee for depositors and creditors of suspended finance companies.

Rehabilitating problem assets: Asserting control over bad loans is an important ingredient in the balance-sheet-rehabilitation process. Once NPLs are resolved, even at a discount, possible further losses to the bank are averted and capital is freed from serving as loan-loss provision.

Korea's approach to dealing with its banks' bad loans is to use public money to buy them, then resell them to investors at a later date. The government-owned Korea Asset Management Corporation (KAMCO) buys NPLs at a discount, swapping them for KAMCO bonds. So far, KAMCO has purchased about 37% of existing NPLs and that share is expected to rise above 55%. Banks can manage their own NPLs if they think they can do a better job (that is, get a higher recovery rate) than KAMCO. However, up to this point, Korean banks have been entirely dependent on the government to dispose of their bad loans. Importantly, KAMCO's NPL carve-outs have come with few conditions on the banks, which means the banks have little incentive to improve their lending practices.

In Thailand, the government has largely left the task of loan workouts to the bank themselves. In theory, Thai banks should be better placed than a government AMC to resolve the NPLs, since they already have the loan files and some institutional knowledge of the borrower. Leaving the problem assets on the bank's own balance sheet also increases its incentive to maximize the value recovered and to avoid future losses by improving loan approval procedures. Finally, the Thai approach minimizes public sector involvement. But leaving this process to individual banks and their debtors to work out has resulted in a very slow resolution of Thailand's NPL situation. Exacerbating the problem is a legal infrastructure that gives creditors scant power over delinquent debtors. This weak legal background has allowed borrowers, regardless of their ability to pay, to decide not to repay their loans because they know that there is little creditors can do. The Thais call these "strategic NPLs." In August 1998, the

Government action on NPLs: buyer vs. facilitator

Korea carves out bad loans

The Korea Asset Management Corporation (KAMCO) has spent won19.9 trillion to purchase won44 trillion face value of NPLs. In exchange for the NPLs, the banks receive KAMCO bonds that pay a fixed coupon every three months. Banks can potentially liquidate these bonds anytime, but have no incentive to do so at the moment owing to the paucity of comparable instruments.

The discount rates at which KAMCO buys the NPLs differ by asset type. For example, KAMCO normally pays 45% of principal for secured loans, but only 3% for unsecured loans. However, if the assets are classified as "special category" (i.e. under court protection or involved in a restructuring process), the pricing depends on projected cashflows. Reportedly, the majority of the purchased NPLs are under special category.

Thailand tries to bring parties together

The goal of the Corporate Debt Restructuring Advisory Committee (CDRAC) is to coordinate debt workouts, outside formal bankruptcy proceedings, by laying out a framework within which debtors can negotiate with multiple creditors. CDRAC's framework (which is based on the so-called "London approach" used in the United Kingdom) is nonbinding and nonstatutory.

The voluntary nature of Thai workouts, in the absence of reformed bankruptcy and foreclosure laws, is the central reason for the slow progress of restructuring so far. However, the Bank of Thailand, which chairs CDRAC, has redoubled its efforts to have the process move forward by broadening CDRAC's focus away from just large debts, lobbying for amendments to laws that hinder restructuring, and using moral suasion to break impasses among creditors.

Corporate Debt Restructuring Advisory Committee (CDRAC) was established to facilitate resolution of the problem loans. However, while about baht674 billion of loans in need of restructuring have been registered with the CDRAC to date, only baht107 billion have been resolved. Discouragingly, total NPLs are estimated at over baht2 trillion (note that this includes consumer and other loans not covered by CDRAC).

One fast-moving process in Thailand that could nudge forward NPL resolution at the surviving institutions is the government's auctions of the assets (mostly nonperforming) of the closed finance companies. The Financial Sector Restructuring Authority (FRA) has already sold over 30% of the baht860 billion of assets it holds. Difficulties with the FRA auction design led to a disappointing mega-auction late last year, but nev-

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ertheless, the sale of these assets, at market-clearing prices, could help set price benchmarks in the debt negotiations. But while the FRA auctions are constructive in this sense, real progress in the CDRAC will only come about when the bankruptcy and foreclosure laws are passed, and when the government facilitators use their powers of moral suasion more liberally to hammer out agreements between debtors and their creditors. Even so, KAMCO's activities have quickly helped normalize the operations of Korea's banks.

In Thailand, responsibility for bad loans lies with the banks that made them. Unfortunately for Thailand, that means the loans themselves still lie there too.

Recapitalization: The third route to repairing a bank's balance sheet is for it to raise new capital. The Korean government ordered banks whose BIS ratios were under 8% to submit rehabilitation plans with the expectation that banks whose plans were deemed unrealistic would be closed. However, seemingly operating on a "too big to fail" criterion, the government closed only small and regional banks. It asked financially weak big banks to merge together, in the hope that their size would attract foreign capital. While the government was heavily criticized for this decision, nonviable large banks have in fact announced merger plans with the government directly injecting funds to recapitalize them fully. Still, to the extent that the recapitalization support has come with few conditions and no guarantee that the banks will fulfill the plans they submitted, the Korean recapitalization plan at this point still looks like an unconditional bailout and threatens the credibility of the reform process.

Similarly to its tack regarding the banks' NPLs, Thailand has not been nearly as activist as Korea in the recapitalization process. Initially, Thailand simply relaxed foreign ownership restrictions and told the banks that they had to meet minimum capital requirements or be closed. Early in 1998, Bangkok Bank and Thai Farmers raised new capital by issuing shares and Bank of Asia and Thai Danu partnered up with foreign banks. However, the other banks' problems in raising funds precipitated a change in the government's hands-off approach. Last August, the Thai government unveiled a fortified financial sector restructuring plan under which it would buy into these banks. The catch is that to participate in the government's recapitalization schemes, the banks must take some very painful steps. Under the Tier 1 scheme, a bank must first meet the new loan-loss classification and provisioning rules (otherwise to be phased in gradually over the next two years). This would mean major increases in NPLs and force write-downs of existing shareholders' equity. Under the Tier 2 scheme, a bank must bite a different bullet by restructuring corporate debt agreements, with the government buying the bank's debentures based on the size of the write-down that the bank takes (net of previous provisions).

Equity or asset write-downs are bitter pills for banks to swallow. Nevertheless, if these banks cannot recapitalize on their own, they have no other option. Earlier this month, banks that were interested in participating in either of the government's recapitalization schemes were required to submit Memoranda of Understanding to the Bank of Thailand, detailing their rehabilitation plans. At the moment, it appears that only Siam Commercial Bank and Nakornthorn bank will participate in the Tier 1 scheme. While more banks are likely to participate in the Tier 2 scheme, the small amounts applied for suggest that, overall, Thai banks aim to raise capital on their own.

Plans for the nationalized banks

Korea

To be privatized: A majority stake in Korea First has already been sold and a deal for Seoul Bank could be struck soon.

Undetermined: The government has purchased large stakes in other banks through its recapitalization scheme, but plans to sell off the stakes so acquired have not yet been announced.

Thailand

To be privatized: Bangkok Metropolitan and Siam City will fully provision based on the end-2000 standards (see box on page 19) and recapitalize themselves up to 8.5% of risk-weighted assets (through conversion of debts to the FIDF into equity). The government hopes to sell the two banks this year.

Merged with government banks: First Bangkok City was merged with Krung Thai (KTB), Union Bank of Bangkok with Krungthai Thanakit Finance, and Laem Thong with the newly-formed Radhanasin. All three banks will be fully provisioned, recapitalized, and eventually privatized. The bidding process for Radhanasin is scheduled to begin next month.

Closed: Bangkok Bank of Commerce's assets were split up – good assets were transferred to KTB (along with liabilities) and NPLs were used to form an asset management company.

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Raising capital: quick and dirty vs. slow and tidy

Korea's simple program

Korea's recapitalization scheme is straighforward. Banks issue new equity which the government buys in exchange for Korea Deposit Insurance Company (KDIC) bonds and cash until the bank reaches a capital ratio of 10%. Banks qualify for the program if they have submitted a rehabilitation plan that is approved by the Financial Supervisory Commission. Alternatively, if a healthy bank agrees to take over the assets of a nonviable bank, it also qualifies for recapitalization.

Thailand's two-tiered program

The Thai government's August 14 plan offers banks carrots, but also harsh sticks. The Tier 1 scheme brings in new capital, with government funds used to catalyze private sector capital, if a bank cleans up its loan book. To qualify, banks must first provision in accordance with the new loan classification and provisioning rules being phased-in by the end of 2000 (see box on page 19). If the bank's Tier 1 capital-adequacy ratio is below 2.5% after meeting the new provisioning rules, the government will inject capital to bring the ratio up to 2.5%. If the bank can attract Tier 1 capital from other sources, the government will match it one-for-one up to the 4% regulatory minimum.

The government will inject the Tier 1 capital by buying shares in exchange for tradable 10-year government bonds. The new government and/or private capital is to pay a dividend 1 percentage point above the yield on the government bond and will have preferred status over existing shareholders.

Thailand's Tier 2 scheme is designed both to accelerate the corporate debt restructuring process and to ease the credit crunch. A bank will be eligible for Tier 2 capital from the government based on two factors: (A) its total write-down, net of previous provisions; and (B) the net increase in its lending to the private sector. To encourage early action on both (A) and (B), the availability of Tier 2 capital from the government (up to a maximum of 2% of risk-adjusted assets) is to decline over time.

Size of capital injection	Available until
(A + 0.2B)	end-Jun 1999
(A + 0.2B)x0.75	end-Dec 1999
(A + 0.2B)x0.50	end-Jun 2000
(A + 0.2B)x0.25	end-Dec 2000

The government will inject the Tier 2 capital by buying 10-year bank debentures using nontradable 10-year government bonds.

Selling bad assets: waiting vs. rushing

Korea's KAMCO bides its time

So far, the Korea Asset Management Corporation (KAMCO) has on its books bad loans with a face value of almost won44 trillion ($37.4 billion). In September 1998, KAMCO held its first, very small auction of won250 billion ($200 million) worth of loans. As the assets were without collateral, the recovery rate was only 12% of face value. The second auction in December sold off won541 billion ($460 million) of loans at 35.6% of face value. Dates for larger auctions are expected to be announced soon, but KAMCO has no set deadline for the liquidation of its assets.

KAMCO auction results
won billion

	Date	Book value	Auction value
Unsecured loans	Sep	250	30
Secured loans	Dec	541	193

Thailand's FRA charges forward

Thailand's Financial Sector Restructuring Authority (FRA) was established in October 1997 to administer the liquidation of the assets of Thailand's closed finance companies. From a total of baht860 billion ($23.4 billion) of loans, the FRA has already sold over baht230 billion ($6.3 billion) of its core assets, at an average recovery rate of 32.5%. Earlier, smaller auctions of higher-quality loans yielded recovery rates close to 50%. But an attempt to sell over $10 billion worth of property-related loans on a single day resulted in 60% of the loans being held back and an average recovery rate of only 25%.

The FRA's original goal was to sell all of its assets before the end of 1998. The scheduling of another large auction for March indicates that the FRA still intends to close up shop soon, even if that means simply selling assets to another government entity.

FRA auction results and planned next sale
baht billion

	Date	Book value	Auction value
Auto hire-purchase contracts	Jun 25	52.0	24.9
Residential mortgage loans	Aug 13	24.6	11.5
Non-core assets	ongoing		27.7
Business loans 1	Dec 15	155.7	39.0
Business loans 2	Mar 10	231.1	–

Making it profitable to be a bank again

Getting banks on solid ground by rehabilitating their balance sheets is one thing, but their income statements also need to be improved. Of course, the former does help the latter: Actions to repair the balance sheet lower interest costs, reduce loan provisions or write-offs, raise revenue through loan recoveries, and improve income thanks to coupon payments from the government bonds. Government can also improve income by lowering banks' cost of funds, which would allow banks to widen their interest spreads. This has occurred in both Korea and Thailand, where policy rates have come down aggressively. This reverses the situation that prevailed in late 1997 and into 1998, when banks in both countries faced negative interest rate spreads.

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Are the reforms working?

Quantifying the effectiveness of the reform programs is very difficult, but renewed bank lending should be viewed as a positive sign. Of course, even healthy banks may choose not to extend new loans if they believe that there are no worthy borrowers. So, while the absence of loan growth does not prove that the reform process has failed, its presence is evidence of success. On that score, Korea's restructuring scheme seems to be already bearing fruit, with loans now growing after falling for most of 1998. This incipient revival of lending in Korea is difficult to interpret, however, because the government has clearly directed banks to extend more loans to the corporate sector and at lower interest rates. But from a short-run macroeconomic point of view, the motivation for lending is moot. The fact is that the credit crunch is easing in Korea and not in Thailand.

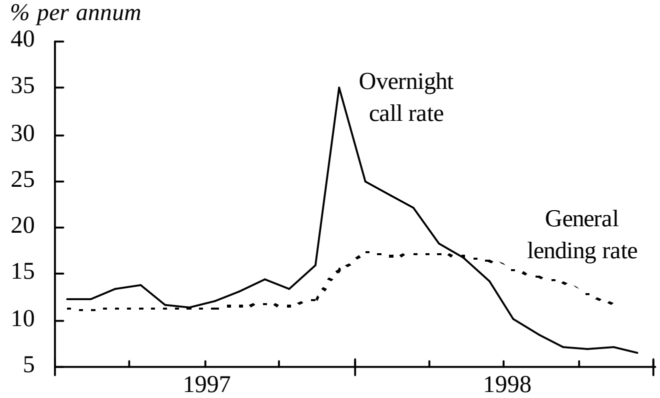
The causal link between Korea's twin revivals of bank lending and industrial production (and the continued stagnation of these two variables in Thailand) is open to debate. Nevertheless, it is clear that for these two economies, which depend heavily on bank intermediated credit, a resumption of bank lending is a necessary condition to sustain economic recovery.

Before turning to the longer-term issues of bank restructuring, it is worth touching on what these reform programs are costing the governments and their affordability. In a nutshell, both Korea and Thailand came into the crisis holding relatively low levels of public sector debt. So, despite the large projected costs of their restructuring programs, it is fair to say that both countries can tolerably bear the fiscal burden entailed (see *Funding Emerging Asia's budget deficits,* AFM, Fourth Quarter 1998).

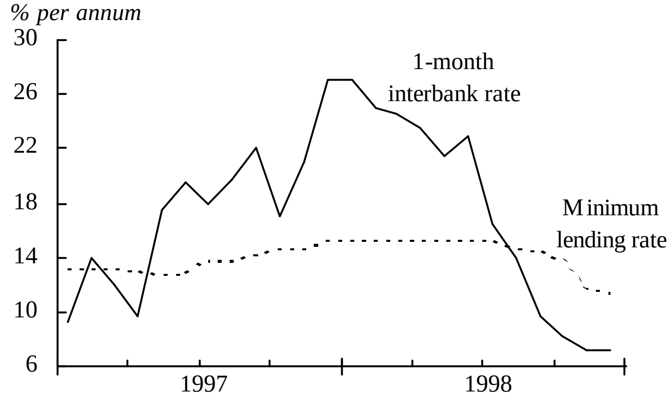
Will the banking systems be stronger?

The conclusion, so far, is that the financial sector restructuring process has gone further in Korea than in Thailand. However, whether these positive short-run effects can be sustained depends on these reforms actually tackling the roots of the problems that allowed the systems to fall into crisis in the first place. And on this score, there is more reason to be concerned about Korea than about Thailand. For while Korea has made

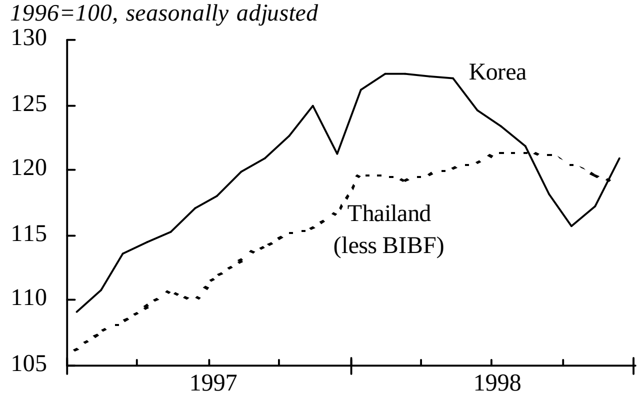
Korea: interest rates
% per annum



Thailand: interest rates
% per annum



Commercial bank loans outstanding
1996=100, seasonally adjusted



Central government fiscal positions
% of GDP

	Budget balance		Gross debt*	
	1998	1999	1998	1999
Korea	-5.0	-6.0	35	47
Thailand**	-4.5	-5.0	26	33

* End of period, including guarantees for state enterprise debts, financial restructuring bonds, and loans to the central bank.

** October to September fiscal year.

significant progress in improving the legal and supervisory environments in which its banks operate, that *modus operandi* is deeply linked to Korea's industrial structure, specifically to the *chaebol*. Thailand, in contrast, does not face this structural problem, yet is struggling to pass crucial legislation to compel borrowers to repay their debts and is tightening its prudential rules only gradually. So, going forward, the risk remains that the underlying weaknesses of the financial systems may persist in both countries after this phase of financial sector restructuring winds down.

Regulatory and legal changes

Korea has acted quickly to improve its bank regulatory environment. Prudential norms such as NPL definitions and provisioning requirements have been raised even above prevailing global standards. Also positive is the transfer of most regulatory and supervisory responsibilities from various agencies to the new Financial Supervisory Commission. Thailand, rather differently, is letting its banks ease into its new loan classification and provisioning rules. These rules are being introduced in phases, to be completed only by the end of 2000, while reorganization of the Bank of Thailand will not be completed until the end of next September.

The legal infrastructures in both countries have historically favored debtors. This continues to be true in Korea, even after the revision of key laws in 1997. However, the existence of KAMCO removes the immediate need for strengthening the creditors' position. Thailand cannot afford such a luxury. Many of its NPLs may simply be unviable, meaning that they cannot be restructured. Recoveries from these bad loans will therefore involve seizing assets, which can only occur if the country's bankruptcy and foreclosure laws are revamped. However, after a major legislative breakthrough in April 1998 that amended Thailand's 1945 Bankruptcy Act, the legal reform drive has bogged down. The deadline agreed with the IMF for passing the new laws was moved from October 1998 to mid-1999 and it is still questionable whether the new deadline will be met.

Foreign participation still key

Competition imposes market discipline on banks and is a key part of strengthening the banking system. Historically, both the Korean and Thai banking sectors have prevented foreign banks from having a significant presence, thereby muting potential competitive forces. On this score, both countries have now made significant moves to open their markets to foreign participation. As mentioned earlier, foreign banks so far have become controlling shareholders in two Thai banks. And more such buy-ins in Thailand may be on the way. A watershed event occurred at the end of 1998 when the Korean government sold a 51% stake in one of the banks it nationalized, Korea First, to a consortium led by U.S.-based Newbridge Capital.

Strengthening regulatory and supervisory systems

Both Korea and Thailand have strengthened their prudential norms, using NPL definitions and provisioning standards that are at or above globally-accepted standards. These new standards are now in force in Korea, while they are being phased in at six-month intervals starting in mid-1998 in Thailand.

	Provisioning level	
Months in arrears	Korea (Jan 99)	Thailand (end-2000)
< 1	0.5%	1%
1 to 3	2%	2%
3 to 6	20%	20% less 90% of collateral
6 to 12	75%	50% less 90% of collateral
> 12	100%	100% less 90% of collateral

Other positive changes include: In Korea, securities are now classified by maturity and marked to market each quarter and the list of items to be disclosed (risk management measures and assets by country, for example) has been expanded; and in Thailand, the practice of accruing, and recognizing as income, interest on accounts more than three months overdue has been abolished.

The way the governments examine and supervise their banks is also changing. Korea established the Financial Supervisory Commission to handle this task, assigning it duties formerly held by the Bank of Korea. Korea also introduced a prompt corrective action (PCA) system in June 1998, under which the government will monitor financial institutions with a BIS capital ratio of less than 4% for quality control on a quarterly basis. The most important indicators in the PCA system will be the capital ratio for banks, the operational net capital ratio for securities companies, and the solvency margin ratio for insurance companies. Still, for the time being, strict application of the PCA system is unlikely. Thailand, meanwhile, is in the midst of a reorganization of its central bank which should be completed later this year.

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Both countries hope to sell other nationalized banks this year. Korea is set to sell another bank, Seoul Bank, soon and Thailand's newly formed Radhanasin Bank could be put on the block in February. However, prospects are more uncertain for two nationalized Thai banks, Bangkok Metropolitan and Siam City, that the government originally hoped to sell by the end of 1998. Once again, the willingness of Korea's government to intervene has been critical in moving things forward more quickly. In the case of Korea First, the government offered to protect the buyer fully from additional NPL losses for one year and offered partial protection in the second year. At this stage, such sweeteners have not been offered by Thailand.

The Korea First story

Established in 1929, Korea First Bank (KFB) has long been one of Korea's leading commercial banks. It was nationalized in 1962 and after two decades of state ownership was again privatized in 1982. During those 20 years, KFB participated in the government's interventionist policy to support certain designated sectors and companies. But the government-directed policy lending, compounded by weak credit risk management, heavily burdened the bank, steadily eroding its asset quality. Still, in early 1990, the bank set itself ambitious targets and grew rapidly.

For a while, KFB appeared to grow out of the asset-quality problem and restored its reputation as a leading Korean commercial bank. However, problems reemerged in the mid-1990s as the economic environment turned unfavorable. These became more serious during 1997-98 with the high-profile bankruptcies of corporates – starting with Hanbo Steel, Sammi Steel, and Kia Motors – to which KFB had excessive exposures. By the end of 1997, it became clear that the bank could not survive on its own. The government then stepped in – KAMCO bought won2.4 trillion of bad loans at a 37% discount and bought a 93.8% stake in KFB for won1.5 trillion. It took another year to privatize KFB once again.

Industrial structure issues still loom

Despite the many dimensions in which reform has progressed in Korea, one card remains that could trump all the others already played – the very industrial structure in which the banks operate. Fundamentally, the two countries' financial sector crises differed in their underlying nature. In Korea, the problem lay primarily with the big banks, whose lending practices were driven by the government, either through direct government involvement in lending decisions or indirectly through government support of large conglomerates. When the performance of these conglomerates deteriorated, they brought Korea's banks down with them. In Thailand, the liberalization of the financial system and the external capital account, without adequate strengthening of regulatory and supervisory systems, led to the expansion of lending to riskier borrowers, typically in the nontraded goods sectors. This lending activity led to asset-price inflation and the bursting of that bubble put Thailand's finance companies and banks into distress. In both countries, an implicit guarantee by the government of a stable exchange rate made it attractive for the financial sector to borrow short-term in foreign currency to fund longer-term domestic loans.

So, in many ways, the bulk of Thailand's problems were solved immediately when the asset bubble burst and the exchange rate was allowed to float. In Korea, the problems run much deeper. To date, the design (to say nothing of the results) of the Korean restructuring plan fails to recognize comprehensively the severity of this structural problem. Instead, Korea has avoided asking single economic agents to suffer significant pain and has spread the costs of reform by having the government take the lead. Given the labor market constraints under which the government is operating, such an approach is understandable. However, Korea's reliance on government discretion, rather than market-based rules, plus the likelihood that the government-business-bank nexus will overall remain intact, could result in the persistence of systemic problems that will only be revealed when the next crisis strikes.

Watch this space every day

Bear in mind that these restructuring processes in Korea and Thailand are ongoing and important developments are occurring by the day. To this point, the process has clearly moved forward more quickly in Korea. But it is presently unclear whether Korea's momentum can be sustained and similarly unclear therefore whether this is instead a "tortoise-and-the-hare" story in which Thailand ultimately takes the prize.

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Japan's fiscal headaches

- **Worsening supply and demand conditions have boosted JGB yields**
- **Surging budget deficits and lack of public-sector bond demand caused the deterioration**
- **But hidden liabilities are as much a concern**
- **These trends are likely to continue, threatening the sustainability of Japan's fiscal policy stance**
- **Reforms are key to restore lasting growth**

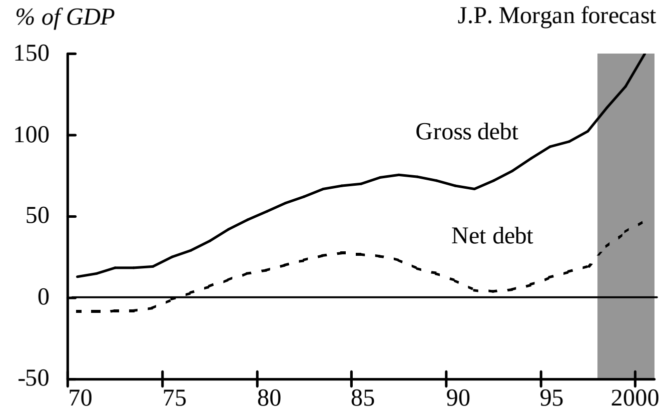
Japan's fiscal position has deteriorated rapidly since 1990, and the outlook remains bleak. The central government's budget deficit will amount to nearly 7% of GDP by the time the current fiscal year (FY1998) ends on March 31, 1999. And it looks likely to exceed 9% of GDP in FY1999 and reach nearly 11% of GDP in FY2000. Accordingly, J.P. Morgan projects that the consolidated debt position of the public sector as a whole will hit 47.5% of GDP on a net basis, and 150% on a gross basis, by the end of FY2000. (The OECD's forecast is only modestly more optimistic, calling for an 8.3%-of-GDP deficit by 2000. See chart at right.)

These figures are only the tip of an iceberg around which the government must navigate in order to sustain its debt. Much is known about the potential dangers represented by the country's aging population structure. But other formidable obstacles are presented by the cyclical trends already in place – government expenditure growth far outstripping revenue growth as private sector demand endures a prolonged decline – and by rapidly mounting off-balance sheet liabilities.

One manifestation of the change is the government's rapidly waning ability to keep absorbing a large portion of its own debt. The fundamental requirement for dealing with all of these issues is the economy's return to autonomous growth, and for this more fiscal stimulus is, unfortunately, a prerequisite. A serious concern, however, is that the economy's potential rate of long-term economic growth will be reduced in so far as much of the government's present spending hinders

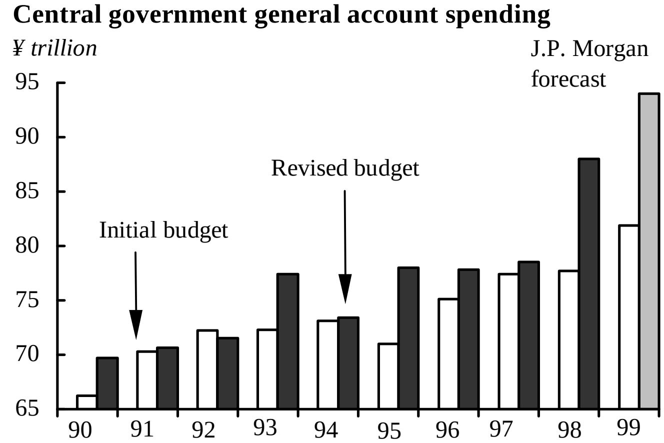
General government debt

% of GDP



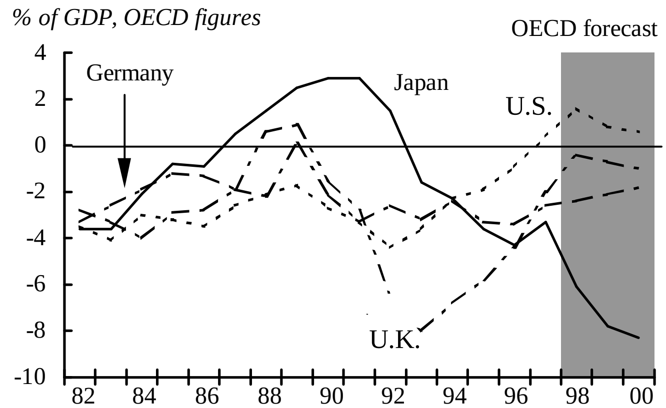
Central government general account spending

¥ trillion



General government financial balances

% of GDP, OECD figures



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rather than promotes supply-side structural adjustment that would enhance the economy's growth potential.

A worsening supply/demand balance for JGBs

The first real signs of market concern about the rising public sector debt burden came at the end of last year. Government bond yields jumped from historically low levels as several events called attention to the potential for developing oversupply:

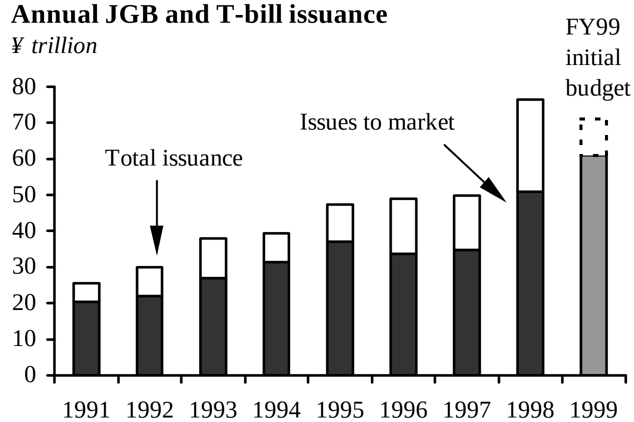
- Moody's announcement in November, that it was downgrading Japan's sovereign debt rating, called attention explicitly to concerns about the rapid rise in central government debt.

- Government officials indicated that the Trust Fund Bureau (TFB) of the Ministry of Finance (MoF) would have to pull back from its traditional scale of participation in the market. Initially, the news came that the Bureau would reduce its primary market absorption from 26% of total issuance in 1998 to just 6% in 1999. Then followed rumors, subsequently confirmed, that the TFB would cease altogether its regular secondary-market purchases, which had been running at ¥200 billion monthly.

- Market participants speculated about the Post Office's huge upcoming maturities – specifically, the high-yielding long-term deposits that come due in 2000 (chart). Concerns grew over the possibility that withdrawal of a large quantity of time deposits from the Post Office could adversely affect the government's ability to continue funding a large part of its own debt in coming years. The logic behind this was that bond and debt portfolios held by the Post Office, directly or – in far larger magnitude – indirectly through the Post Office's placements with the TFB, might be liquidated in advance of 2000 in order to repay investors.

- The Bank of Japan (BoJ) poured cold water on speculation that it might step in to take up the slack. To be sure, BoJ monetary policy continues to aim at ease in order to support the economy, which may well entail large open market purchases of securities. But BoJ officials are in no mood to prejudice their newly established policy independence by

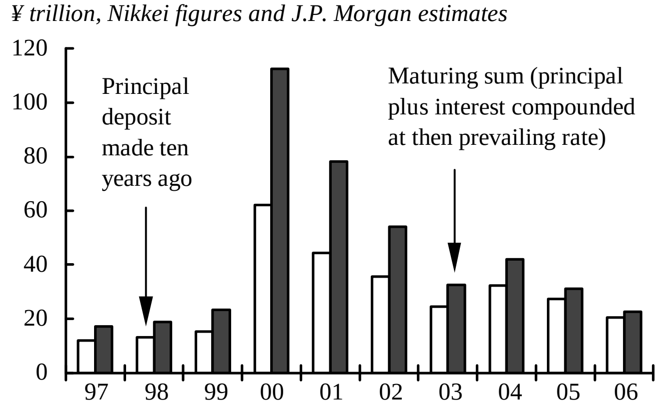
Annual JGB and T-bill issuance
¥ trillion



Outstanding JGBs by holder

	End FY91		End FY96	
	¥ tril	%	¥ tril	%
Total	189.5	100.0	257.3	100.0
Government	77.7	36.0	95.2	34.2
Bank of Japan	15.9	8.4	45.0	16.2
Banks	27.7	14.6	28.0	10.3
Other financial institutions	21.4	11.3	38.2	13.8
Others	46.7	24.7	71.0	25.5

Maturity structure of fixed-term postal savings deposits
¥ trillion, Nikkei figures and J.P. Morgan estimates



Note: These estimates assume that no term deposits are cancelled before maturity. Given that persons who deposited the maximum amount allowed per individual will be able to roll over only about half of the maturing sum, and since rollover interest rates will be much less attractive than those paid on deposits from ten years ago, Morgan believes that the Post Office could lose as much as ¥100 trillion in term deposits in 2000 if no action is taken by the government.

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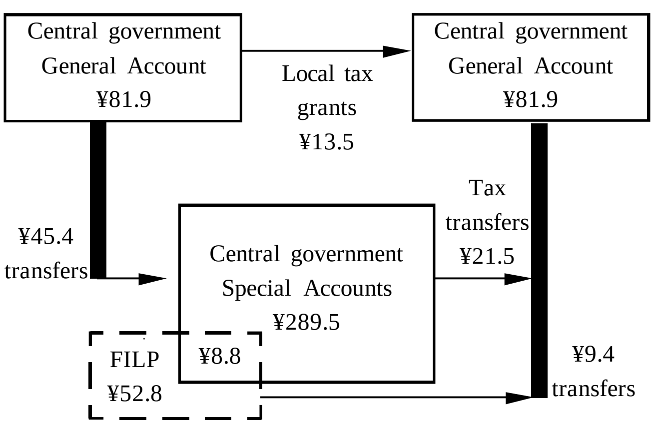
Accounting for the public sector

Japan's public sector is vast and its multilayered accounts are fiendishly difficult to untangle – a situation that analysts have long suspected is by design as much as by accident. The country's general government sector includes numerous overlapping budgets, several of which are only fully revealed in their revised forms two years in arrears. This alone makes timely assessment of fiscal policy difficult, especially when the fiscal stance is changing. However, there also exists a myriad of public and quasi-public corporations, agencies and lending institutions (such as the Japan Development Bank) which receive funding directly or indirectly from the government yet are left out of the general government classification because their management is, nominally at least, independent.

Conceptually, though, the main tenets of the country's general government budget are relatively straightforward. The central government's general account forms the shell for its regular budget, which is highly visible because it is submitted to the Diet along with the annual Fiscal Investment and Loan Program (FILP) budget. FILP is a state-administered program which appropriates public deposit funds for strategic policy uses. Although FILP is part of the MoF's Trust Fund Bureau (TFB), it falls outside of the "general government" classification because its resources belong to organs such as the Post Office which, though public, are supposed to have an arms' length relationship with the government.

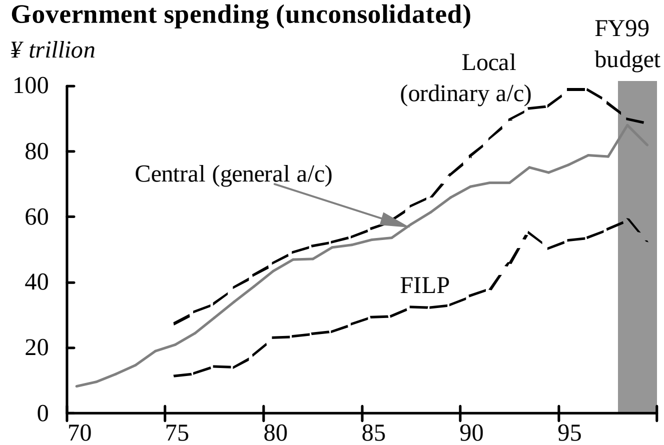
The central government also has jurisdiction over 38 Special accounts through which a range of established programs are operated. These include the various national health care and pensions (i.e., social security) programs, postal savings and postal life insurance fund management activities, national debt consolidation, mortgage finance via the Housing Loan Corporation, small business support, and various industrial and regional/infrastructure development projects. Local government accounts cover both prefectural and municipal finances and also pay transfers to public enterprises.

General government FY99 initial budget
all figures in trillions



Note: All accounts contain substantial overlap; in particular, the total shown for "Special Accounts" of the central government is much larger than the MoF's own partially consolidated statements for central general and special accounts together. The government does not publish consolidated figures covering central, local, and special accounts together.

Government spending (unconsolidated)
¥ trillion



Outstanding FILP funding by source
¥ trillion, March 31, 1998

Postal savings	139
Postal life insurance	99
National pension fund	134
Other	45
Total	395

Consolidated balance sheet of general government
¥ trillion, March 31, 1997, official figures

	Central	Agencies	Local	Social sec.	Total*
Gross assets	84.4	63.9	43.3	228.5	408.1
(as % of GDP)	16.8	12.7	8.6	45.4	81.0
Gross liabilities	310.7	57.6	124.9	1.5	482.7
(as % of GDP)	61.7	11.4	24.8	0.3	95.8
Net assets	-226.4	6.3	-81.6	227.1	-74.6
(as % of GDP)	-45.0	1.3	-16.2	45.1	-14.8

* Figures may not add up because of consolidation.

agreeing to JGB-buying targets set to meet other goals – particularly goals set by the government – such as smoothing JGB market conditions.

Indeed, to the extent the BoJ has a legislated responsibility for regular monetary operations that include JGB purchases, those are to fund the "natural" growth of money stock in line with the expanding economy, and can only be expected to slow in an environment of near-zero growth.

In fact, BoJ officials have recently begun to express concern about the central bank's balance sheet, which has become increasingly illiquid as a result of the accumulating BoJ loans to the Deposit Insurance Corporation – informally guaranteed by the government but nevertheless not the sort of liquid asset that the central bank can use to meet operational responsibilities – for emergency funding of two banks that were recently nationalized.

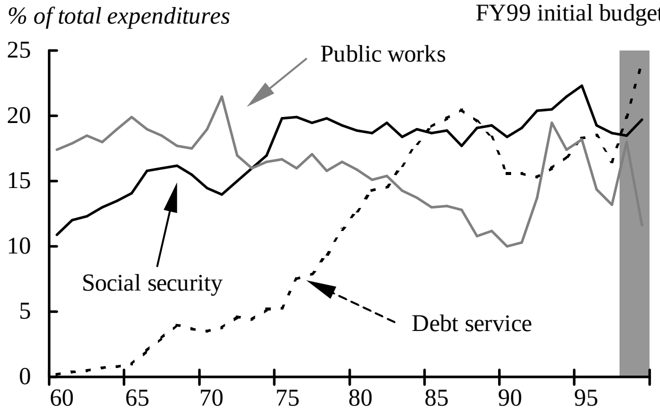
This new concern comes on top of the BoJ's continuing large holdings of illiquid short-term Financing Bills (FBs) which the BoJ traditionally has been required to take up at off-market prices. The MoF has finally agreed to the BoJ's long-standing request to end that requirement, and will start issuing FBs at market auction in the coming fiscal year. While not directly related to the question of BoJ market purchases of JGBs, this newly asserted public concern over the quality of the central bank's balance sheet has added to market jitters about future public demand for JGBs.

Responding to this combination of uncertainties, JGB market yields soared from a low of 0.7% to 2.0% in the fourth quarter. And, in light of the potential for further declines in public sector holdings, the market's concern looks underdone if anything.

Japan's existing public sector holdings of government liabilities are vast by international standards. The latest available figures show that public institutions held a whopping 61% of outstanding central government bonds and borrowings at the end of the end of March 1997. This compares with a range of 1–16% for other leading OECD economies. But having grown from relatively high to very high levels in recent years,

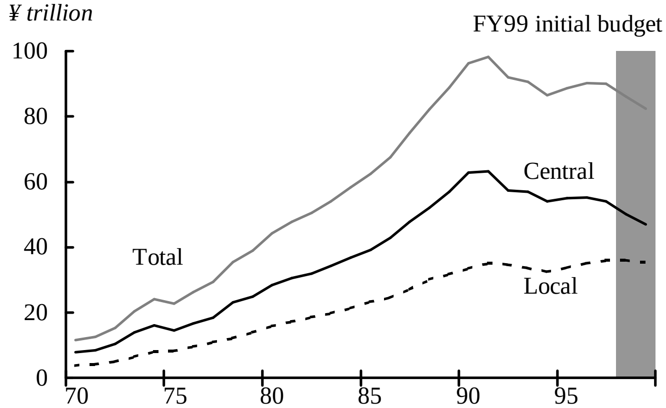
Components of central government spending

% of total expenditures



Annual tax revenue

¥ trillion



there is little scope for further expansion as outstanding debt rises.

The deteriorating fiscal balance

Japan's fiscal position first worsened in the early 1970s, when the government extended a broad range of social benefits to its population, bringing Japan roughly in line with other industrial countries in terms of unemployment, pension, and health care provisions. However, with the economy still growing at a real average rate of 5%, the boost to government spending as a share of GDP was fairly quickly overcome during the 1970s and 1980s – and the government also benefited from capital gains taxes reaped in two asset inflations during the mid-1970s and the late 1980s.

In the 1990s, however, the economy's prolonged slump has changed the calculus entirely. And even be-

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yond the current cyclical time frame, it has become obvious that the level of state provisions will have to be cut and/or the level of private contributions increased to deal with the future escalation in pensions and health care costs as the population ages. The challenges which Japan faces on this front are quantitatively larger as a result of its demographic structure, but not qualitatively different from those of other OECD countries.

More concerning, however, is the plunge into red ink of the primary budget balance which began in 1992 (chart) A second leg down got under way in 1998 as a result of the recession and new countercyclical public works spending launched over the past year. And, the deterioration looks set to continue for at least another year: J.P. Morgan forecasts an extra ¥12 trillion in pump-priming measures to come during fiscal 1999 in the form of supplementary budgets. But on the basis of recent experience, it seems unlikely that this will lead to anything but a temporary boost in domestic demand. The private sector has reacted with growing skepticism to recent stimulus packages precisely because the latter have been transparently shortsighted (see *Japan's prolonged investment slump,* pages 29-34).

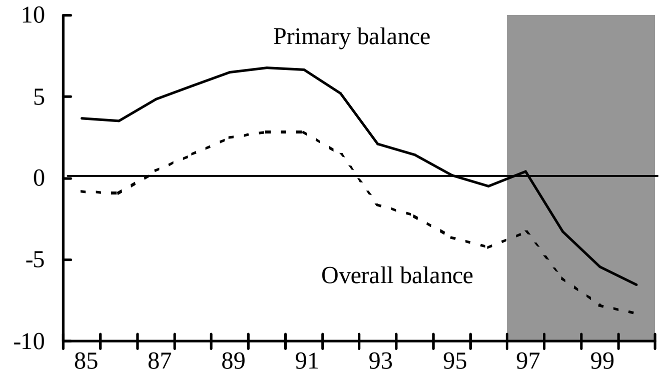
Hidden liabilities are ballooning

Another major threat to the public finances relates to the increasing incidence of off-balance sheet public sector liabilities. It is widely recognized that the government is shouldering immense hidden liabilities which only materialize when it is called upon to honor its explicitly or implicitly extended guarantees. A stellar example of this occurred last year when a large portion of the debt accumulated by Japan National Railway, which was privatized in 1987, finally made its way onto the state's books: national debt was increased at a stroke by 5.4% of GDP (¥26.9 trillion).

Off-balance sheet liabilities have increased sharply as a result of repeated attempts to support the financial system and a large part of the real economy as noted above. Notable recent developments include:

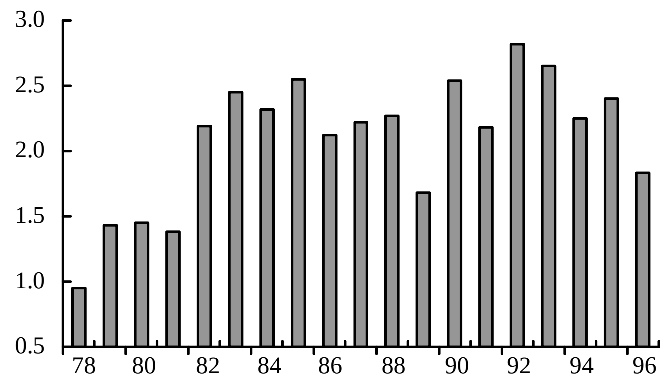
- A long-term increase in outstanding government-guaranteed bonds and FILP investments and loans (two charts at right show net lending increments of

Primary budget balance of general government
% of GDP, OECD figures



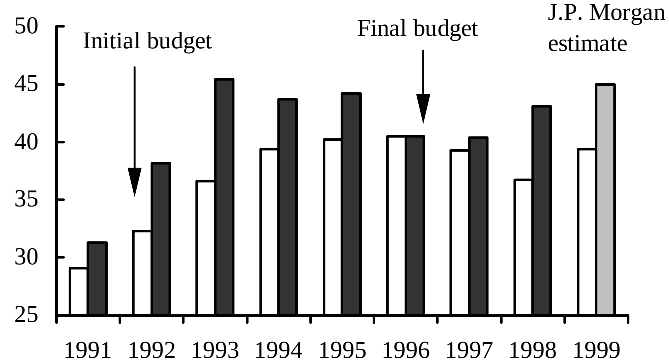
Note: OECD estimates are based on submissions by member countries, and therefore use "official" assumptions of economic growth and only initial budget estimates. Thus, they incorporate a conservative bias.

Net new government guaranteed corporate bond issues
¥ trillion



Note: Outstanding government guaranteed corporate bonds amounted to ¥47.3 trillion as of March 31, 1997.

FILP investments and loans
¥ trillion



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recent years). Many of FILP's "investments" amount to little more than direct subsidies of otherwise economically nonviable projects, and as its lending rates are based on 10-year government bond yields, it has failed to generate returns above its ultra-low funding costs since fiscal 1995. (The funding cost is based on the formula: 3-year postal deposit rate x 0.95). Moody's has estimated that FILP losses could total 10% of GDP if nonperforming loans were properly accounted for.

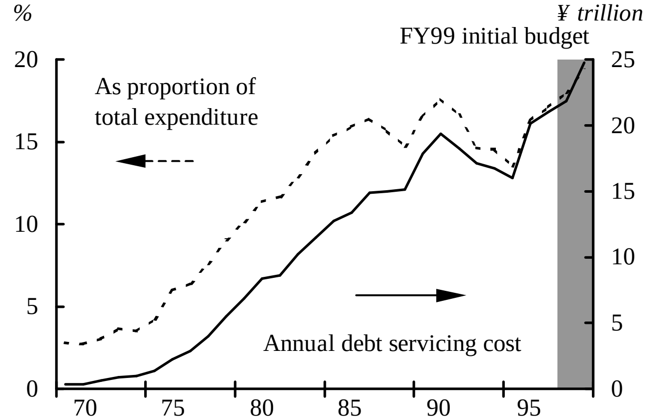
- The financial stabilization fund, which was established at ¥30 trillion in March, then doubled to ¥60 trillion in November. This money is to be used (i) boost the asset bases of existing financial institutions, (ii) protect depositors in the case of bank failures, and (iii) fund the reconstruction/disposal of failed banks. In the last three months of 1998, BoJ loans to the Deposit Insurance Corporation rose by more than ¥6 trillion to ¥8 trillion, reflecting costs incurred in the process of the nationalization of Long Term Credit Bank and Nippon Credit Bank.

- In October, the government increased the size of the prefectural credit guarantee system by ¥20 trillion, from its existing scale of around ¥15 trillion. Under this scheme, small and medium-sized firms can borrow up to ¥50 million in uncollateralized loans. During October and November alone, 400,000 applications for almost ¥10 trillion of the additional money reportedly were filed.

- In November, the BoJ established a ¥4.1 trillion temporary lending facility to aid financial institutions which increase corporate lending in the run-up to the year end by increasing its commercial paper repo operations. At the end of December its holdings of commercial paper had swollen to ¥80 trillion, approximately a quarter of all outstanding issues.

- Also in November, the government announced measures to extend the lending functions of state-affiliated financial institutions as part of a new ¥24 trillion economic stimulus package. A new credit-guarantee system is thus to be established for small firms whose main banks have failed. Also, the Japan Development Bank's (JDB) mandate was expanded to allow it to provide operating funds to firms in non-strategic industries that are experiencing temporary difficulty. ¥3 trillion was added to its annual lending budget, and it has been empowered to guarantee an additional ¥2 trillion in loans extended by private banks.

Central government debt servicing cost



Further, if the government sticks to its policy of directly or indirectly supporting less competitive sectors of the economy in order to minimize negative secondary effects of restructuring, it will continue to accumulate obligations. As the failure of Nissan Mutual Life (April 1997) showed, there is no shortage of candidates for potential injections of public funds and government guarantees.

Net debt to rise to nearly 50% of GDP by FY2000

The combination outlined above – declining public demand for government debt, straightforward business cycle and policy dynamics, and mounting incidence of hidden liabilities – ensures that Japan's public finances will look weaker as time goes on. Within the next two years alone, this is likely to push net general government debt to 47.5% of GDP and gross debt to 150% of GDP.

Restoration of growth is key to sustain debt burden

As government debt grows and with interest rates no longer in decline, debt servicing costs are bound to add to the level of government debt over time even if they are relatively light now. Moreover, the situation will

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How bad is Japan's current debt level?

Snapshots of Japan's relative fiscal health provide very different images depending upon the definition adopted (see table and chart below). This makes it imperative that analysts choose a representative benchmark when assessing the extent of the damage. A net measure which excludes social security assets and goes on to make some allowance for the write-down of other government assets is arguably the best proxy for evaluating Japan's relative standing.

Gross unconsolidated measures are unsatisfactory because they fail to take account of double-counting. All governments hold some proportion of their own debt, but the proportion varies considerably from country to country. Comparing consolidated gross figures also poses problems because of institutional differences. For example, Japan's TFB owns about a third of outstanding government securities, but is usually not considered part of the "general government." Still, the TFB's programs support many of the government's strategic goals and its inclusion would have raised Japan's gross debt by around 10% in FY1996.

Net measures avoid this problem as the TFB holds no net assets of its own. However, comparing crude net figures is misleading for other reasons. First, they treat social security assets as resources that can be redeployed by the government to cancel out debt obligations elsewhere on its balance sheet. In fact, many countries' current social security surpluses are earmarked to meet future pensions and welfare liabilities, so it is wrong simply to treat them as an ordinary financial assets. A better approach is to exclude social security surpluses from debt calculations altogether.

Second, crude net calculations also rely upon the dubious assumption that the government's other assets should be logged at 100% of face value. In reality, many of these assets are illiquid and their realization would incur substantial losses. Their true value is difficult to estimate in part because the solvency of many of the organizations that have benefitted from public loans and investments is itself dependent upon continuing state subsidies. Thus, it makes sense to insist on applying some level of asset write-down.

While arbitrary, a 50% discount does not seem unreasonable. This penalizes Japan disproportionately for its large asset holdings, but also benefits it by assuming (generously) that its assets are of a similar quality to others.' This best "guesstimate" reveals Japan's public finances to be in much worse state than its competitors. Even by the standards of two years ago, adjusted net debt amounted to over 70% of GDP against a range of 50%-60% for the United States, Germany, and the United Kingdom (table below).

Measures of on-balance sheet debt

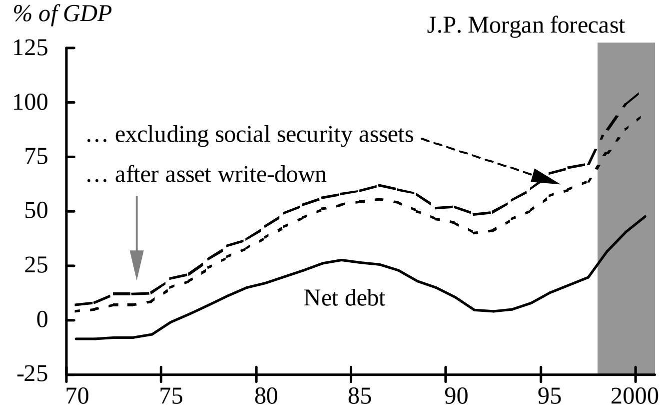
% of GDP, 1996, OECD figures and J.P. Morgan estimates

	Japan	U.S.	Germany	U.K.
Gross debt - unconsolidated*	85.7	84.6	64.4	65.4
consolidated**	82.7	63.1	60.2	59.7
Net debt	15.4	48.4	48.1	44.0
excl. social security balance	59.4	48.4	51.5	44.0
after asset write-down***	71.1	55.8	55.9	51.9

* OECD definition
** Nets out proportion of assets (including social security assets) which are also liabilities of other parts of general government
*** Applies arbitrary write-down rate of 50% to other assets

Net government debt

% of GDP



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worsen if the economy continues to perform poorly while the government continues to boost spending.

On the other hand, trying to stop the growth in government debt by tightening fiscal policy is not a feasible solution either. Given the high level of debt and implied interest expenditures, keeping the level of government debt stable would imply shifting the primary budget balance (excluding interest payments) into a surplus of at least 4% of GDP. Coming from a primary deficit that is expected to rise from more than 3% of GDP in FY1998 to nearly 7% of GDP in FY2000, such shift in the fiscal policy stance would imply a tightening of at least 10% of GDP, which would further damage the state of the economy and, ultimately, the government's fiscal position.

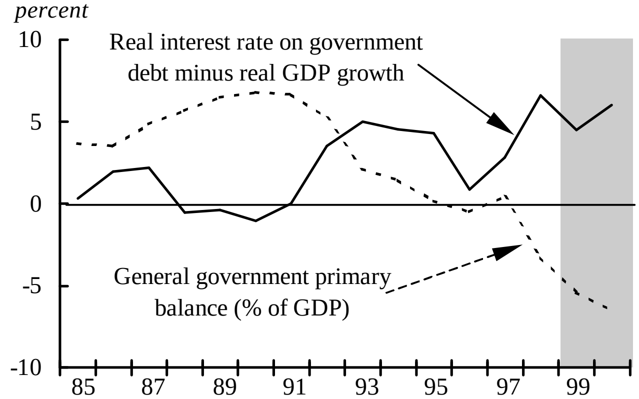
A return to lasting real GDP growth will be a prerequisite for Japan to sustain the rising debt servicing costs in the coming decade and prevent an endless escalation of the level of government debt. This is because sustained real GDP growth in excess of the real interest rate the government pays on its debt (1) will reduce the interest expense burden relative to GDP, and (2) will boost tax revenues and reduce transfer payments, such as unemployment benefits, leading to an improvement of the primary budget balance.

Keep policy easy but promote structural reform

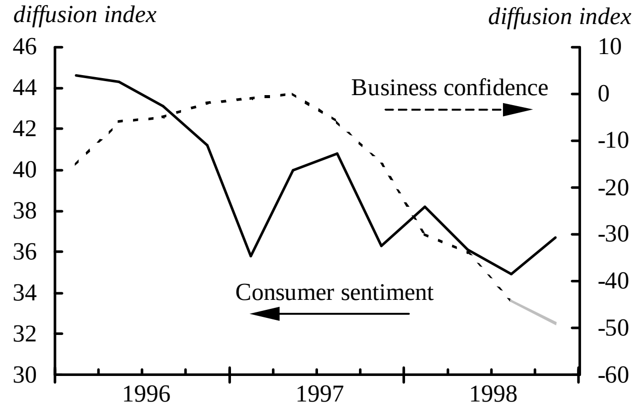
Thus, even though the government's fiscal position has deteriorated, expanding fiscal policy now is easily justified if this gets the economy back on track. The problem with Japan's fiscal stimulus packages, however, is that they are designed to ease the pain but actually reinforce many structural rigidities that prevent the economy from recovering. Indeed, business and consumer confidence fell throughout last year despite the announcement of several spending packages, highlighting growing public awareness of the shortcomings of the government's fiscal policy approach.

The right mix will have to combine easy fiscal and monetary policies with structural reforms. A great deal of attention has been paid to the issue of social security reform. This is undoubtedly important, but it is also clear that reform will occur one way or the other. In fact, some changes have already been made and

Japan's deteriorating debt dynamics



Business and consumer confidence



other, more painful ones are actively discussed and generally well understood by the public. Less obvious is how adjustment will be made in other main areas:

- The high level of public works programs, which only maintains an artificially high level of employment in the construction sector;
- The government's various support schemes for small loss-making enterprises;
- And the government's large holdings of mostly inefficient state enterprises.

Adjustments in these areas, along with more speedy reform in the financial sector, would surely cause huge dislocations in the labor market and test Japan's political and social consensus. To ease the pain and accelerate the creation of new jobs, fiscal ease will have to come through the provision of more unemployment benefits, spending on reeducation, and importantly, corporate and personal income tax reductions.

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Japan's prolonged investment slump

- **Outlook remains weak despite some signs of output stabilization and fiscal stimulus**
- **Capital stock adjustment leads to negative employment and consumption effects**
- **Government's stimulus policy will boost budget deficit, but with few multiplier effects on output**
- **With monetary policy also paralyzed, structural reforms are the only way to lift growth outlook**

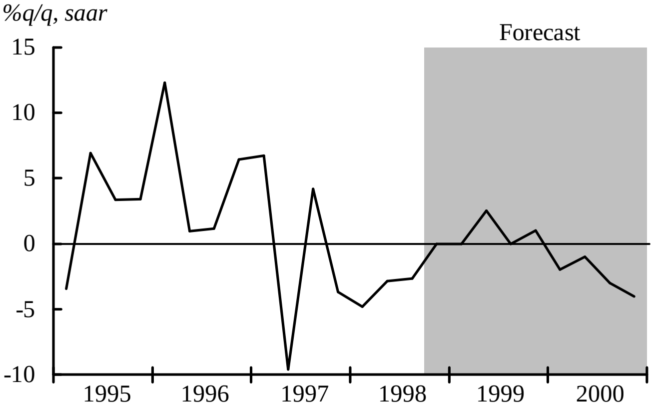
Key forecasts
calendar years

	1998e	1999f	2000f
Real GDP (%oya)	-2.9	0.0	-1.0
Consumer prices (%oya)	0.7	-0.4	-0.6
Current account (US$ bil)	122.5	122.0	132.9
Fiscal balance (% of GDP)	-6.9	-9.2	-10.9
Net government borrowing (¥ tril.)	34.0	45.5	53.0
3-mo. Eurodeposit rate (% p.a.)*	0.3	0.4	0.5
10-year bond yield (% p.a.)*	1.5	2.3	2.7
Yen/US$*	131	133	135

* Year end.

Stimulus packages together may stop the economy shrinking, but are unlikely to achieve recovery

Real GDP growth
%q/q, saar



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

	98Q3	98Q4f	99Q1f	99Q2f
Real GDP	-2.6	0.0	0.0	2.5
Private consumption	-1.1	2.0	0.0	3.0
Business investment	-17.3	-15.0	-5.0	0.0
Residential construction	-22.5	0.0	10.0	5.0
Public investment	15.4	25.0	0.0	25.0
Government consumption	3.5	1.0	1.0	1.0
Exports of goods and services	6.7	-1.0	0.0	-5.0
Imports of goods and services	-1.4	1.0	0.0	3.0
Contributions to real GDP				
Domestic final sales	-3.2	0.6	-0.3	4.1
Inventories	-0.4	-0.3	0.3	-0.5
Net trade	1.0	-0.2	0.0	-1.0

- 1998 witnessed the worst recession in Japan's post-war history. Assuming a flat fourth quarter, annual average real GDP probably fell 2.9%.
- Recently there have been some bright spots – industrial production and exports have stabilized, public construction orders have risen, and even private consumption shows some signs of life.
- However, the rest of economy remains on a weak track. Inventories are high and sentiment is poor. Of particular concern is business investment, which continues on its long-term downward trend.
- Fiscal initiatives are expected to accelerate in 1999 as the government tries to revive the economy in the run-up to elections that must be held no later than October 2000.
- The fiscal boost may be sufficient to stop the recession, but a genuine economic recovery is unlikely to follow. Moreover, the government's ability to prime the pump is likely to fade in 2000, possibly leading to another downturn in activity.
- A key problem of the government's stimulus packages is that they are designed to ease pain, but not to promote structural adjustment. Not surprisingly, the combination of higher spending, lower tax rates, and a weak economy have severely undermined the government's fiscal balances.

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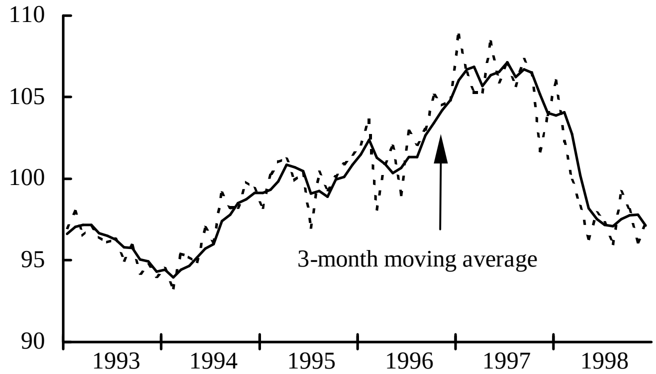
Industrial production has stabilized, but slow inventory adjustment leaves uncertainty

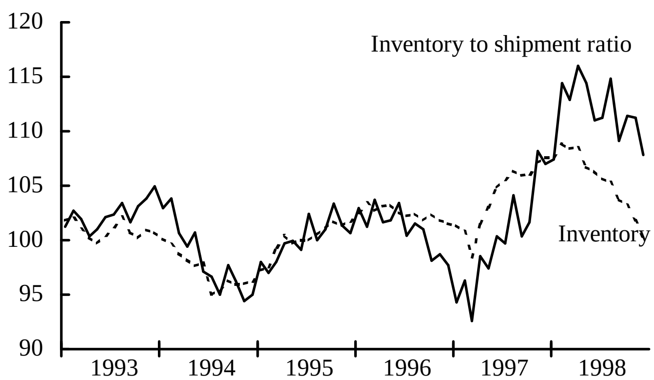
Industrial production

1995=100, sa



Producers' inventory

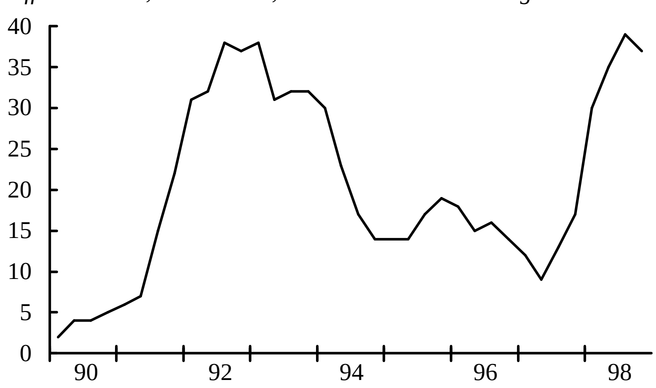
1995=100, sa



- Industrial production has largely stabilized since the July-September quarter. In the October-December quarter, it was down only 0.4% (from the previous quarter, not annualized), and it is set to rise 0.6% in the current quarter according to producers' projections for January and February.
- The still-high level of inventories, however, makes it difficult to argue for genuine production recovery.
- Inventory adjustment lost its momentum during last quarter. The inventory to shipment ratio fell 1.4% compared to its 1.8% drop during the July-September quarter.
- The difficulty for producers is a lack of support from final demand. The level of inventories itself has been falling smoothly, but weakness in shipments has resulted in involuntary accumulation.
- The big question going forward is how much further inventories will have to fall before manufacturers start to increase their production again.
- A clue can be found in the Bank of Japan (BoJ)'s quarterly Tankan survey. The diffusion index (DI) related to producers' perceptions of inventories has hardly improved as yet. The next survey is scheduled for release in early April.

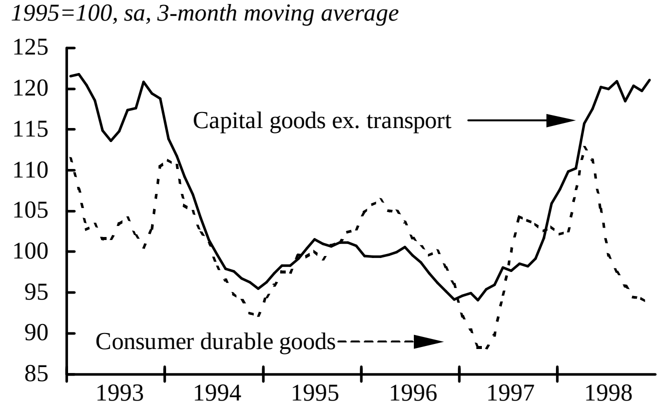
Producers' perceptions of inventories

diffusion index, BoJ Tankan, "excess" minus "shortage"



Inventory to shipment ratio

1995=100, sa, 3-month moving average



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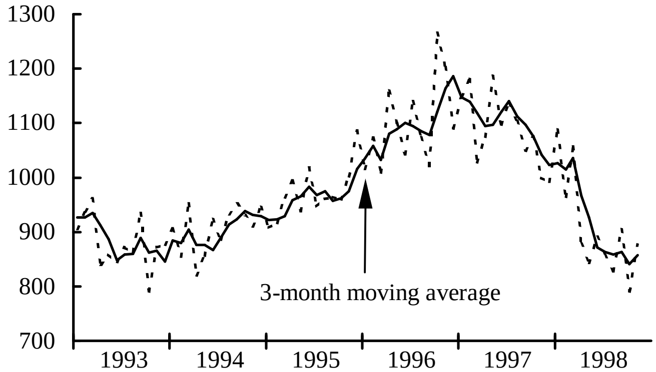
Investment is in a prolonged downward trend

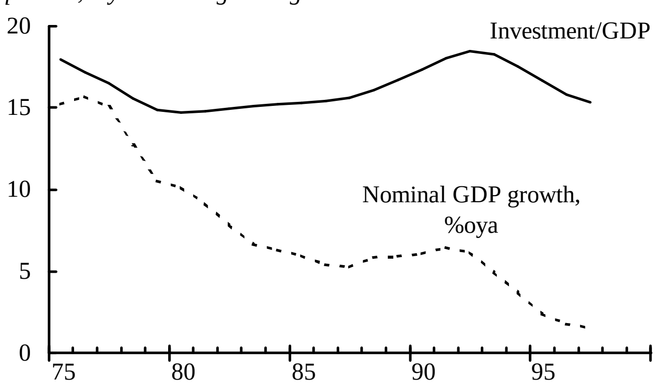
Private domestic machinery orders

¥ billion, excluding ships and electric generators, sa



Japan's over-investment

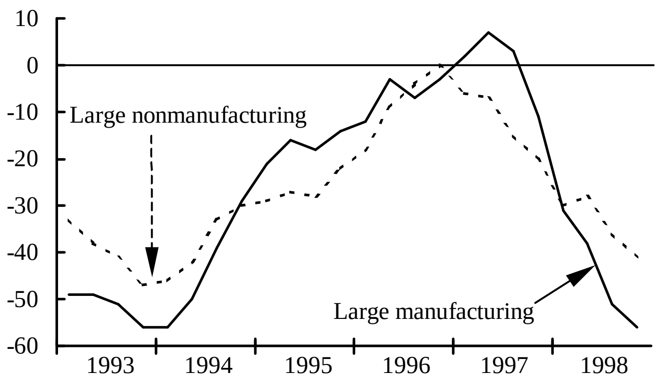
percent, 5-year moving average



- The main drag on GDP growth comes from business investment, which is caught in a prolonged downward trend as companies adjust to the lower growth potential for output.
- Private core domestic machinery orders, regarded as the best leading indicator of business investment, continue to fall. They will probably have fallen for the third consecutive quarter in the October-December period, although the pace of decline is no longer as sharp as occurred in late 1997 and early 1998.
- Looking ahead, the investment slide will likely continue for a few more years as investment is still high relative to output and growth potential.
- The downward trend in investment is aggravated by the problems in the banking sector, which has led to a tightening of lending standards and an inefficient distribution of credit.
- Despite a series of fiscal and financial packages, business confidence has failed to recover, highlighting the severety of the corporate slump and the ongoing decline in profitability.

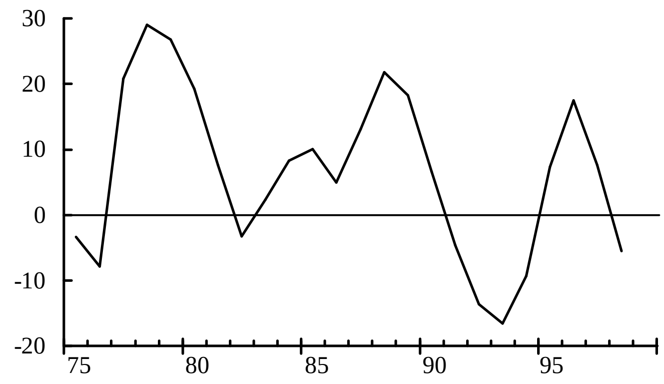
Corporate confidence

DI, BOJ Tankan survey, "favorable" minus "unfavorable"



Current profit growth

%oya, nominal, MoF survey, fiscal year, 3-year moving average



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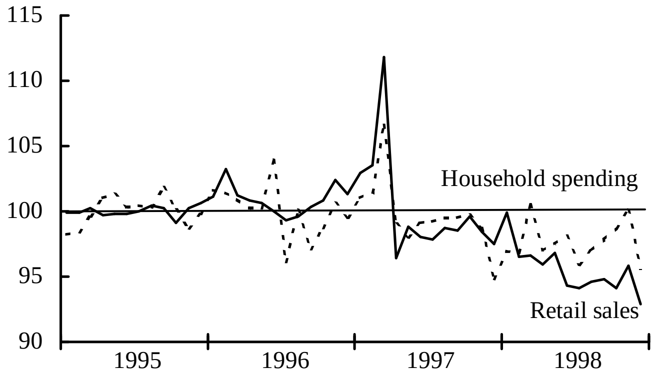
Households are under ever-intensifying pressure

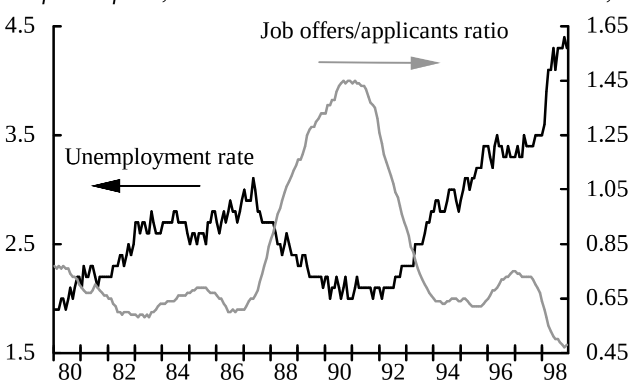
Private consumption

1995=100, sa



Labor market indicators

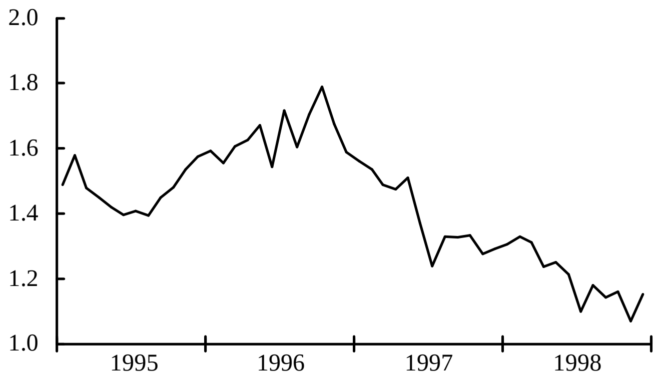
% of labor force, sa *ratio, sa*



- Consumption-related indicators were strong in the final quarter of 1998. For example, real household spending averaged 2.6% higher (not annualized) in October-November than its second-quarter level. However, this rise owed entirely to the special consumption tax rebate sale during November, which boosted sales at major chain stores by 20% to 30%. Available December sales data already show some renewed weakening.
- Underlying household fundamentals continued to deteriorate during 1998. The unemployment rate rose to a new all-time high of 4.4%, and consumer sentiment slipped, despite the government's fiscal stimulus efforts. The rise in unemployment results in part from the downward structural trend in business investment. Its negative effect on household spending is compounded by people's worries over the safety of their pension plans.
- Housing investment is also heading downward. Condominium building is the main drag here, whereas construction of owner-occupied houses has been relatively strong thanks to increased loans from the government-affiliated Housing Loan Corporation (HLC).
- The HLC mortgage rate has been kept at 2.2%, but fears of higher interest rates will likely prompt some front-loading of housing demand in the first half of 1999, followed by a setback in the second half.

Housing starts

million units, saar



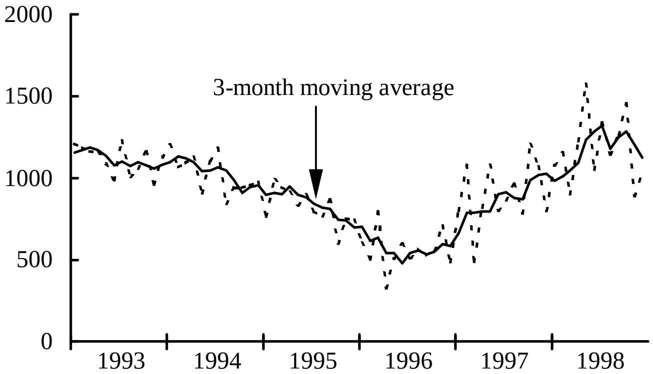
Consumers' perceptions of economic conditions

diffusion index, Dentsu survey, "good" minus "bad"

Rise in trade surplus has come to an end

Customs-cleared trade surplus

¥ billion, sa

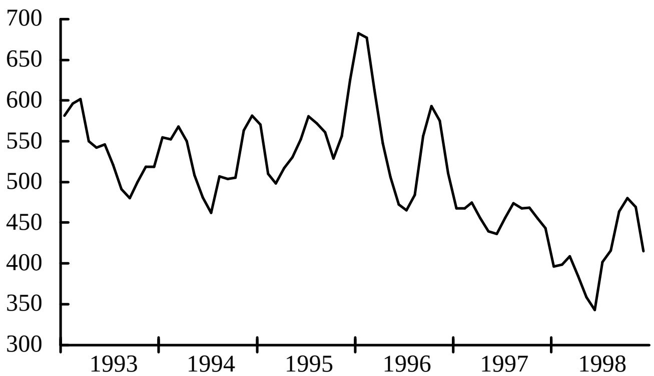


- The November slump in the trade surplus was exaggerated by the recent fall in the dollar/yen rate. Still, beyond the monthly volatility of the data, the trade surplus seems to have peaked.
- Going forward, weaker global demand and a stronger yen will undermine exports. But the trade surplus is likely to remain relatively high as poor domestic demand conditions will keep imports weak.

1999 fiscal policy will be even more expansionary than 1998's, with budget deficit worryingly high

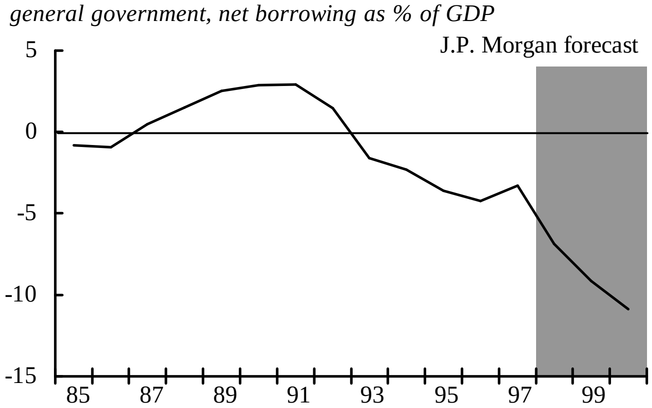
Public construction orders

¥billion, sa, 3-month moving average



Budget deficit

general government, net borrowing as % of GDP



- Considering its size (¥16 trillion, or 3% of GDP), the impact of last April's package was surprisingly short-lived, being undermined by the financial difficulties of local governments. Public works orders surged in September but fell back in October and November. The November package worth ¥24 trillion is expected to show up in the orders data in the April-June quarter.
- The initial budget for fiscal 1999 was big, but falls well short of final 1998 spending. Thus, J.P. Morgan expects to see two additional stimulus packages worth ¥12 trillion during the course of 1999.
- However, the impact of fiscal stimulus on activity is expected to remain handicapped by a lack of multiplier effects and the poor fiscal position of local governments. Instead, much of the fiscal boost will serve only to boost the budget deficit. Overall,fiscal policy as currently conducted by the government is unlikely to achieve private recovery simply because it lacks a meaningful structural reform component.

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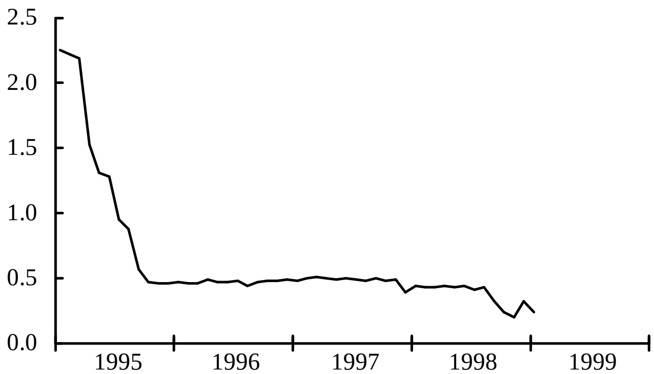
BoJ will stay accommodative

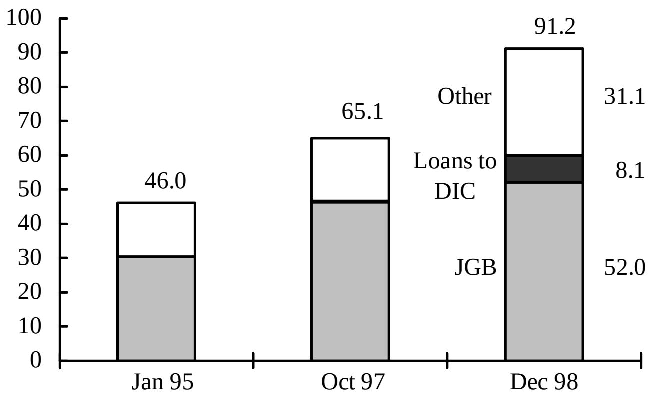
Uncollateralized overnight call rate

percent per annum, average



Bank of Japan's assets

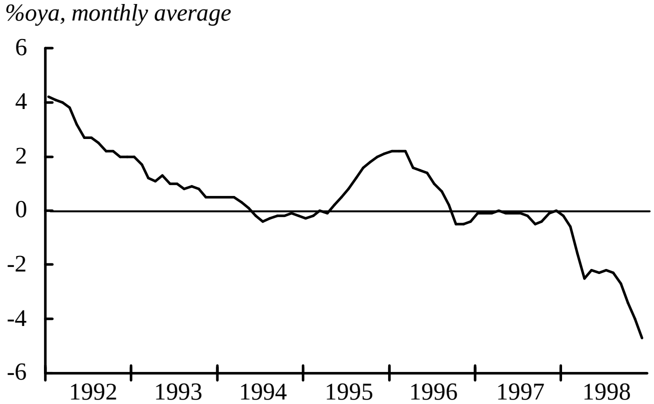
¥ trillion



- The BoJ has tried to maintain an accommodative stance over the last six months. Measures to this end include the overnight call rate cut from 0.5% to 0.25% in September, the liquidity injection after two major banks were nationalized, and November's announcement of support for corporate finance.
- Despite all the BoJ's efforts, the credit crunch shows no sign of easing. Private banks' loans outstanding dropped 4.7% from a year ago in December. True, their large decline in recent months owes partly to special factors, but even if these factors are excluded the drop in bank loans is unprecedented.
- Furthermore, the rise in the yen and the surge in bond yields have clearly deepened the perception of tighter monetary conditions.
- Going forward, the BoJ is likely to maintain its accommodative policy stance and increase efforts to boost broad money supply growth. However, specific government bond purchase programs to reduce JGB yields are unlikely.
- Financial reforms will be critical for the effectiveness of monetary policy. The good news here is the Financial Supervision Agency (FSA) effort to apply more rigid conditions on capital injection into banks. These could force banks to write off more of their nonperforming loans and otherwise to restructure themselves. However, given the sheer size of the problem, the reform process is unlikely be smooth and will take a long time.

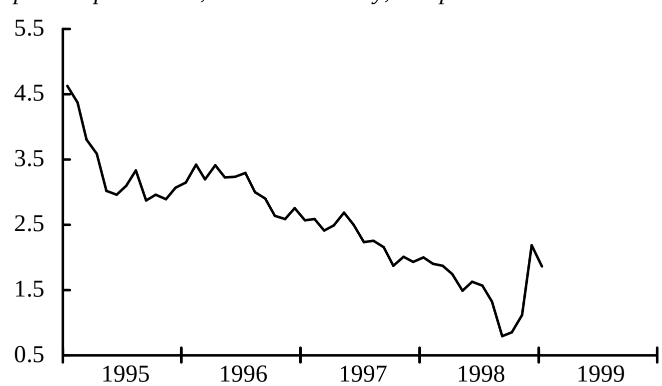
Bank loans outstanding

%oya, monthly average



J.P. Morgan 10-year government yiels

percent per annum, constant maturity, end period



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Emerging Asia: Recovery prospects tentative

- **Output is stabilizing or picking up a little across the region**
- **Very benign inflation, easy monetary policy, improving external positions are aiding the healing**
- **Healing of banking sectors is progressing most rapidly in Korea and Malaysia**
- **Thailand's market-driven approach to bank reconstruction is losing some momentum**
- **In this area, Indonesia has barely begun the rebuilding process**

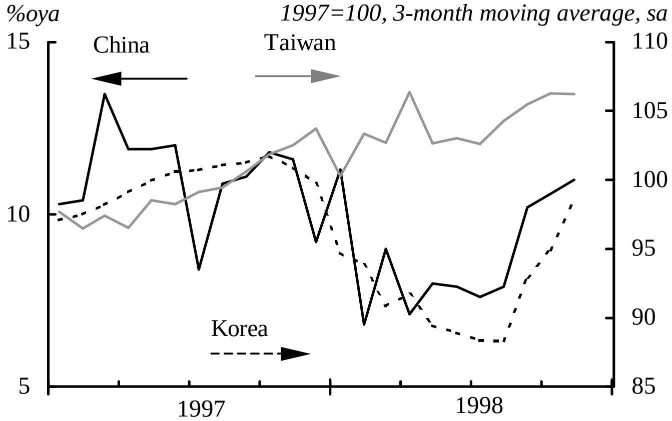
Real GDP growth forecasts
%oya, calendar years

	1997	1998e	1999f	2000f
Emerging Asia (10)	6.1	-0.1	3.0	4.9
China	8.8	7.8	6.5	5.8
Hong Kong	5.3	-5.0	-1.5	3.0
India*	5.0	4.0	2.5	5.0
Indonesia	4.9	-13.7	-3.5	5.0
Korea	5.5	-5.7	4.0	4.5
Malaysia	7.8	-7.3	-1.0	5.0
Philippines	5.2	-0.5	2.6	5.0
Singapore	7.8	1.3	-1.0	4.0
Taiwan	6.8	4.8	3.2	4.5
Thailand	-0.4	-6.5	3.0	5.0

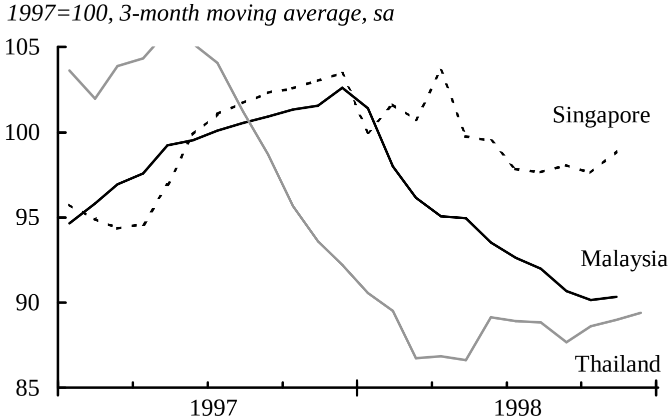
* Fiscal year beginning Apr 1.

The region's economies are mostly recovering, but could yet go off the rails again

North Asia: industrial production
%oya *1997=100, 3-month moving average, sa*



South Asia: industrial production
1997=100, 3-month moving average, sa



- By and large, output trends in Emerging Asia have moved from stabilization to mild recovery.
- North Asia is faring quite well. Korean production shows the greatest strength, with strong pickups in semiconductor and other electronics-related areas.
- China, making up more than a quarter of Emerging Asia's economy, reports a marked reacceleration of output. But this revival, based heavily on the authorities' aggressive boosting of state fixed investment (some 50% of all investment), may not prove sustainable given the new foreign credit crunch and the competitive pressures in the export sector.
- Taiwan, despite its strong trade linkages with the rest of Asia, has not been drastically affected by the regional demand slowdown. Looking ahead, the slowdown in external demand will dent its exports (and the broader economy) but its niche position in certain markets will provide some buffer.
- Production trends in South Asia, while not as strong as in North Asia, nonetheless are turning for the better, especially in Thailand. Malaysia and Singapore, while stabilizing, have yet to show real recovery.
- The big risk to the 1999 recovery story for Emerging Asia remains that of a sharper-than-expected fall in demand from Japan and outside the region.

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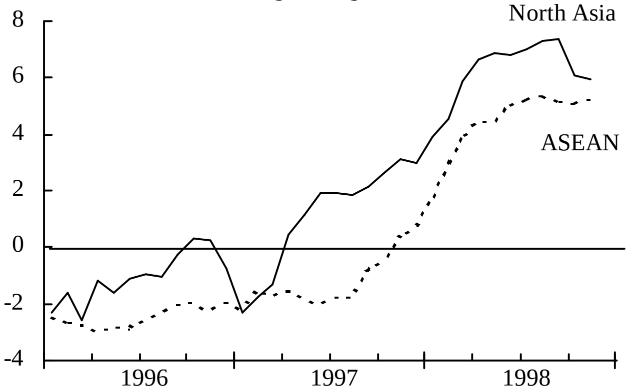
Obstacles and head winds still impede vigorous GDP upswings

Emerging Asia: trade balances
US$ billion, 3-month moving average, sa



Emerging Asia: export performance
Jan 1997=100, US$ terms, sa

	Jun 97	Dec 97	Jun 98	Latest	Month
North Asia					
China	98.2	89.2	100.8	93.8	Dec
Hong Kong (domestic)	98.6	99.7	97.7	83.7	Nov
South Korea	102.3	97.6	94.6	101.6	Dec
Taiwan	100.9	101.9	92.1	87.3	Dec
ASEAN					
Indonesia (non-oil)	97.9	101.7	109.8	89.4	Oct
Malaysia	100.0	91.4	90.5	98.4	Nov
Philippines	99.7	105.4	111.9	121.6	Nov
Singapore (non-oil dom.)	101.6	99.7	90.8	91.3	Dec
Thailand	98.9	102.2	94.1	91.23	Dec

Emerging Asia: headline consumer prices
%oya

	Average 1990-1996	Jun 97	Dec 97	Jun 98	Dec 98
North Asia					
China	10.7	2.8	0.4	-1.3	-1.0
Hong Kong	8.9	5.4	4.8	4.0	-1.4
South Korea	6.4	4.0	6.6	7.5	4.0
Taiwan	3.7	1.8	0.3	1.4	2.1
ASEAN					
Indonesia	8.9	5.3	10.3	56.7	77.6
Malaysia	3.8	2.2	2.9	6.2	5.3
Philippines	10.8	5.7	7.3	10.7	10.4
Singapore	2.5	1.7	2.0	-0.2	-1.5
Thailand	5.1	4.4	7.6	10.7	4.3

- Supporting Asia's recovery have been significantly improved external liquidity positions, much lower-than-expected inflation, and stimulative monetary and fiscal policies that should aid the reform drive.
- However, despite the positive signs that stabilization is giving way to a moderate upswing, significant head winds could slow Asia's recovery and restructuring process.
- The risks are both external and internal. Note first, though, that the central view that Emerging Asia is on the mend does not depend on a strong bounce in exports but rather on a gradual upward trend. And while net trade is forecast to be a drag, GDP growth will mainly occur through inventory restocking.
- That said, the global economy could deteriorate far more than the otherwise already-cautious J.P. Morgan outlook supposes, say if Europe's manufacturing keeps slowing and its consumers lose heart, or if the U.S. economy stumbles in a way no one presently projects. In addition, a possible Chinese renminbi devaluation could have a negative enough impact on sentiment as to unleash another round of regional financial market shocks.
- Besides the external environment, domestic uncertainties vis-à-vis the banking sector and corporate debt restructuring remain a risk to GDP recovery. While carrots are generally in place across the region to facilitate banking sector recapitalization and corporate debt restructuring, sticks to compel constructive outcomes are inadequate or even missing altogether. Notably still missing are comprehensive bankruptcy and foreclosure laws to enable banks to foreclose on the assets of unwilling or insolvent debtors. Implementing such laws will be a crucial step toward resolving overall banking sector issues.
- Perhaps especially disheartening in this area is the failure of the Thais to complete new legislation. Similarly, Thailand's failure to auction off fully the assets of the 56 foreclosed finance companies shows that even where structures are in place to permit rationalization of bad assets and the reestablishment of market-clearing prices, resolve may flag in pressing asset price deflation through to its painful but ultimately constructive end.

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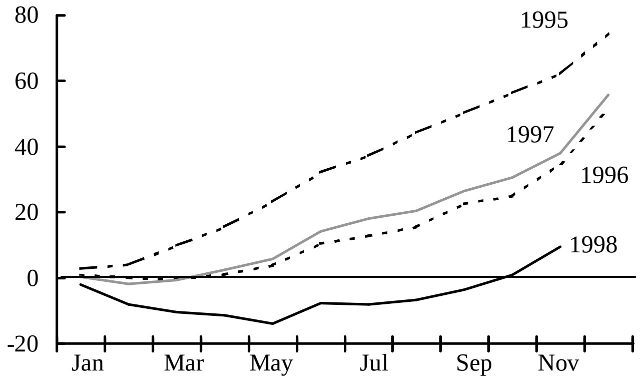
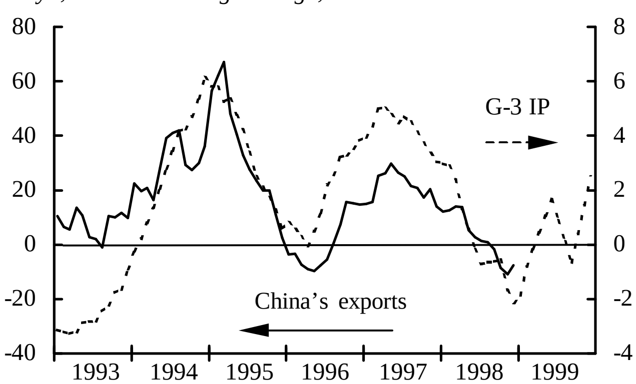
China has turned from a regional stabilizer to a regional risk factor

China: state industry profits
yuan billion, cumulative



China's exports and G-3 industrial production
%oya, 3-month moving average, both scales



Government bonds issued in 1998

- Domestic bonds to retire maturing debt and finance budget deficit, announced in March as part of the FY98 budget: yuan280.8 billion
- Special domestic bonds: yuan100 billion to finance infrastructure investment; yuan270 billion to recapitalize the four largest state banks
- Global bonds: US$1 billion
- Domestic bonds of State Development Bank to finance investment: yuan15 billion

Government bonds to be issued in 1999

- Bonds to retire maturing debt and finance budget deficit, to be announced in March as part of the FY99 budget: yuan 316.5 billion
- As in 1998, special bonds will likely be issued in addition

- While the rest of Emerging Asia is either stabilizing or recovering, China faces more uncertainty. Its legacy from the past is equally sickly – a weak financial sector, overinvestment, and a heavily indebted corporate sector. But its proactive monetary tightening in 1993, and monetary and fiscal stimulation since 1996, saved it from the regional crisis. Yet China's flatter business cycle also makes its adjustment process longer, there being no alternative to restoring competitiveness. Meanwhile, the financial crisis is intensifying and the global economic environment deteriorating. The pain is manifested in the collapse of GITIC and other itics, the debt restructuring of Guangdong Enterprises, and the soured relationship with foreign creditors. And more bad news lies ahead as prices slide in the economy and the corporate sector's debt burdens grow.
- The deteriorating financial condition of corporate China will continue to have serious implications for the labor markets and the financial sector. Against a backdrop of sparse social welfare benefits, widespread and deep-rooted corruption, and extreme income inequality, the rising jobless rate and financial failures could ignite social instability, especially in this year of emotional anniversaries.
- Aware of this risk, and alarmed too by growing labor unrest in central China and the past year's political and social developments in some other Asian countries, top Chinese leaders have decided to put stability at the top of their agenda for 1999. This demands stable economic growth and hence continuation of last year's fiscal pump-priming. And to limit financial risk, the government will continue to stand firmly behind its banks, while consolidating nonbank financial institutions.
- For now, the policy focus on stability also applies to the currency. And the market is unlikely to force the official hand, despite the intensifying foreign credit crunch. But at a later stage, the official will to maintain currency stability may weaken. If China's trade and urban labor markets underperform official expectations, currency depreciation may become an easy remedy, especially if downward pressure on the Hong Kong dollar eases significantly and no longer constrains China's exchange rate policy.

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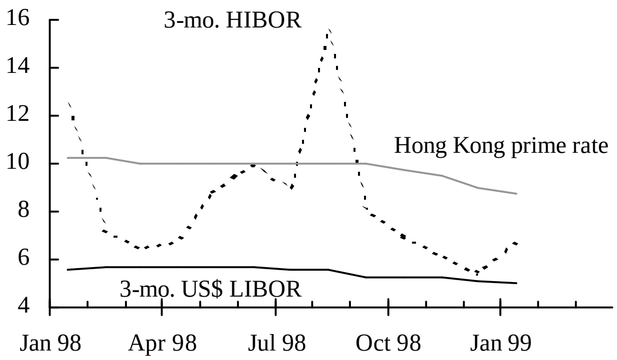
Hong Kong still faces a bumpy road ahead

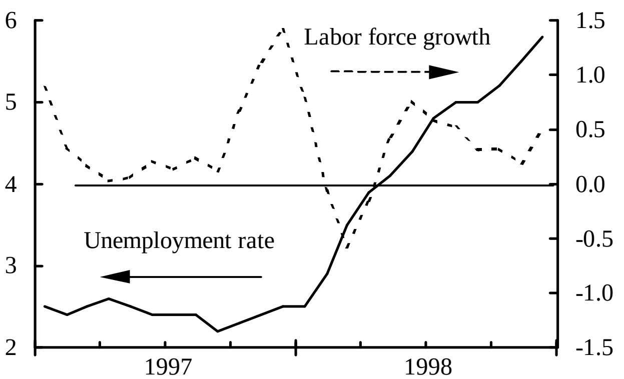
U.S. and Hong Kong interest rates

% p.a.



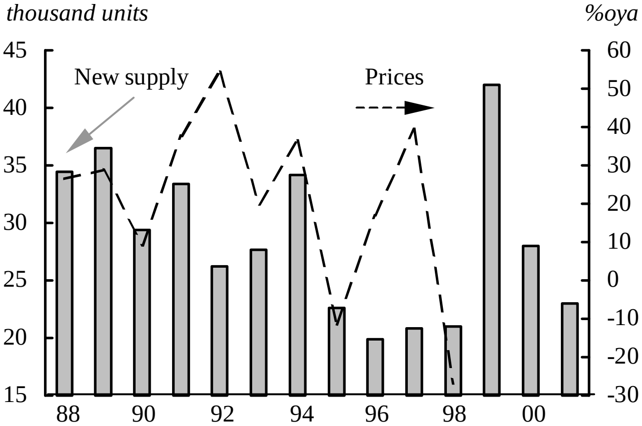
Hong Kong: unemployment rate and labor force growth

% of labor force *%m/m, 3-month moving average*



Hong Kong: private housing supply* and prices

thousand units *%oya*



* J.P. Morgan estimates.

- By now, the worst is over for Hong Kong. Interest rates in 1999 should be much less volatile, certainly less than they were last August, since the SAR has improved its liquidity management system, while hedge funds are financially weakened.
- Even so, the road ahead may not be smooth and rosy. First, amid intense deflationary pressures, real interest rates may stay at historical highs for a while, deterring investment and consumption. Given the China and Brazil uncertainties, the risk premium on the Hong Kong dollar will persist and even jump from time to time; in turn, prime rate can drop little without further U.S. rate cuts, especially since Hong Kong banks are still battling rising nonperforming loans and plummeting profitability. Even if prime rate continues to fall, access to nonmortgage loans will remain tight, as banks remain risk-averse. Indeed, cutbacks by Japanese banks may offset any loan expansion by local banks.
- Second, the labor market will continue to deteriorate, and probably rapidly so in February, as many companies are expected to cease business after the Chinese New Year, and even the lucky survivors will have to learn to cope with the new environment of deflation. With no offset from falling interest rates as in the past four months, the rising jobless rate may start to erode public confidence. Indeed, anecdotal evidence suggests that the house-buying frenzy is cooling. And housing prices may even correct downward in the short term, given the large amount of housing supply in the pipeline.
- Even while monetary conditions are constrained by the currency board system, the upcoming fiscal budget for 1999/2000 can be only moderately stimulative. In turn, at least through the first half of 1999, the economy will lack any powerful engine to raise it out of the doldrums. Hopes instead are pinned on the closing months of the year, and will certainly brighten if the U.S. Fed cuts rates in August and the financial markets stabilize in the rest of the world, assuming also that most of the bad news about China has come out by then. And back at home, the property market and construction activity should be further boosted later this year by the expected housing shortage beyond the year 2000.

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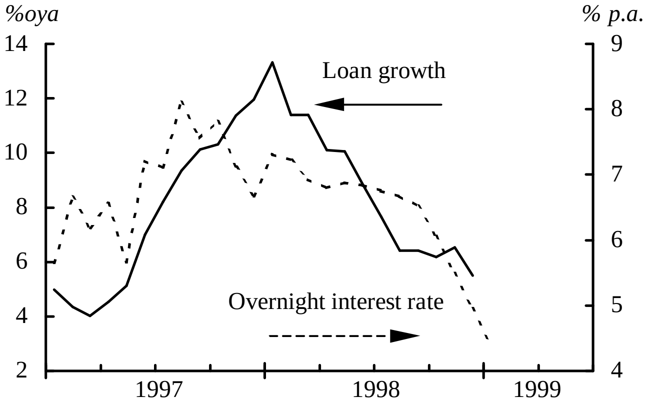
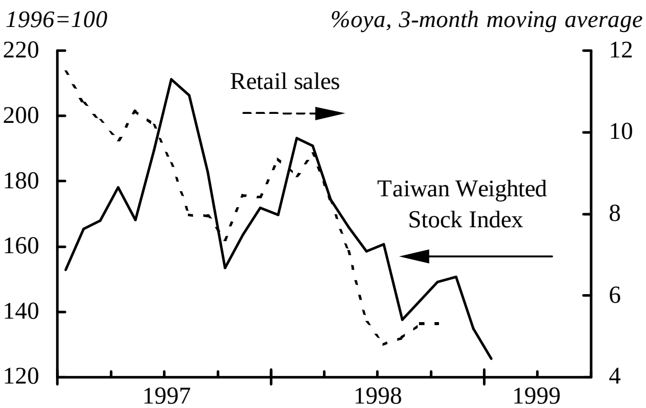
Taiwan: Battle continues between the government and market forces

Taiwan: loan growth and overnight interest rate



Taiwan: stock index and retail sales



Measures of banking sector strength: domestic banks
end of period

	1995	1996	1997	98Q3
% of total loans and investment				
Exposure to real estate	37.0	37.3	35.8	35.1
Mortgage loans	27.5	29.2	28.1	27.2
Construction sector	6.4	5.2	4.8	4.9
Real estate sector	3.1	2.9	2.9	3.0
Exposure to stock market				
Stock trade margin funding	2.4	2.4	2.4	2.5
Nonperforming loans	2.9	3.6	2.9	5.0*
Owners' equity/risky assets, % ratio	13.6	12.9	11.4	11.6†
Liquidity, % ratio	12.7	15.3	11.8	13.1†
Loan/deposit, % ratio	85.7	82.5	82.5	83.6†

* As of end-Oct. † As of end-Jun.

- Like China, Taiwan has managed to steer clear of the regional financial crisis, but is not trouble-free. Late last year, it suffered a string of corporate and financial failures. While additional failures have been temporarily halted by government emergency measures, the stock market has been unable to overcome disappointment about corporate earnings and its fear of more corporate failures. Sinking stock prices will erode consumer confidence, given retail investors' high presence in the market. Meanwhile, worsening asset quality means banks will stay risk-averse. So corporate Taiwan will face tight liquidity conditions for quite a while to come.

- But unlike China or the rest of Asia, Taiwan experienced no significant or widespread asset bubble prior to the Asian crisis. True, oversupply still burdens its property market, and some companies in other sectors threw prudence to the wind by increasing their leverage to fund needless expansion. But the economy as a whole was not swept by "exuberance." Granted, bank credit totals a lofty 150% of GDP, as high as in Thailand or South Korea. But corporate Taiwan has relied much more on equity funding, thereby limiting its overall leverage.

- Importantly, economic adjustment in Taiwan is unlikely to be as drastic as in the rest of Asia. Its exports, while plunging, will ultimately be cushioned by a competitive high-tech industry. Moreover, exporters are benefiting from cheap commodities imported from overseas (65% of total imports). And absent significant downward pressure on the currency, the government and the central bank will continue to inject liquidity into the economy.

- Certainly, Taiwan's financial sector is not as healthy as its counterparts in Hong Kong and Singapore. But it is much stronger than those in the IMF-3 countries and is not being pressured by any dramatic downturn in the overall economy. Within the financial sector, asset-quality problems may indeed face the large state-owned domestic banks and the small financial institutions. But the former will continue to enjoy the government's full backing, and hence depositors' confidence, while the latter are limited in scale.

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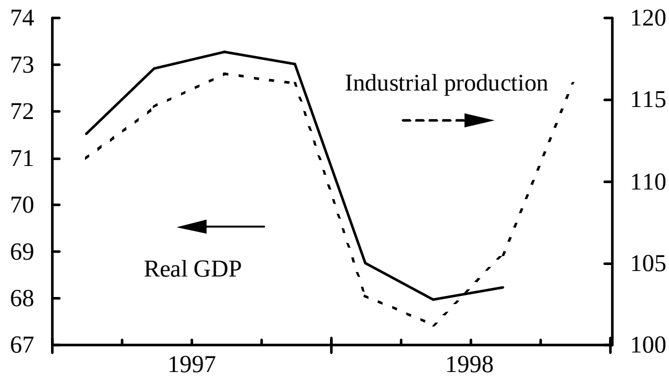
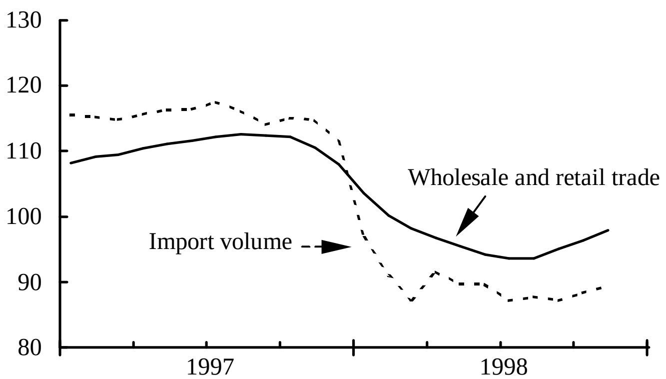
South Korea: Signs of recovery abound, but head winds linger

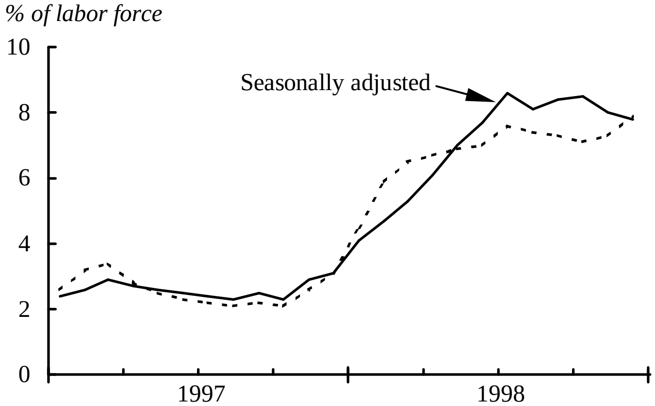
South Korea: real GDP and industrial productioı
won trillion, 1990 prices, sa *1995=100, sa*



South Korea: wholesale and retail trade and import volume
1995=100, sa



South Korea: unemployment
% of labor force



- After a year's belt-tightening, Korea is now reaping gain for that earlier pain. The balance of payments has hugely improved, production growth has turned positive, and domestic demand is showing signs of recovery. Still, structural reform has a long way to go, and the head winds impeding reform progress will never be negligible.
- The main engine for GDP growth has been exports, which will likely continue strong but volatile. True, the won has steadily appreciated against the greenback, undermining the competitiveness of Korean exports. Also, fallout from Brazil's troubles and their prospective contagion effect on the rest of Latin America are certainly not positive. But exports to Brazil have been only 1.2% of Korea's total exports, and importantly, within what is otherwise a bleak outlook for external demand, the U.S. economic slowdown seems to have been delayed and Asian demand has been bottoming out. Moreover, the won is still 18% below its pre-devaluation average in real trade-weighted terms.
- Strong exports have spurred a sharp rise in industrial production since last September. Going forward, the growth pace should continue vigorous for the time being, not least because inventories have dropped drastically relative to sales, suggesting that producers will likely want to rebuild stocks.
- Interest rate cuts and an easing of the credit crunch have improved domestic demand conditions. Retail sales look to have already hit bottom, and import demand for both capital goods and materials has started to pick up.
- Still, domestic demand will not be quick to recover as the economy must travel a bumpy road of structural reforms. Pressured by the requirement that they must reduce their debt ratios, companies will continue cautious about expanding investment. And household consumption is unlikely to pick up sharply, especially as the so-called big deals among large conglomerates threaten workers' job security. While government programs should be able to cap the jobless count, labor markets will remain slack and awareness of on-and-off labor strikes will dispel some of the present euphoria over the economy.

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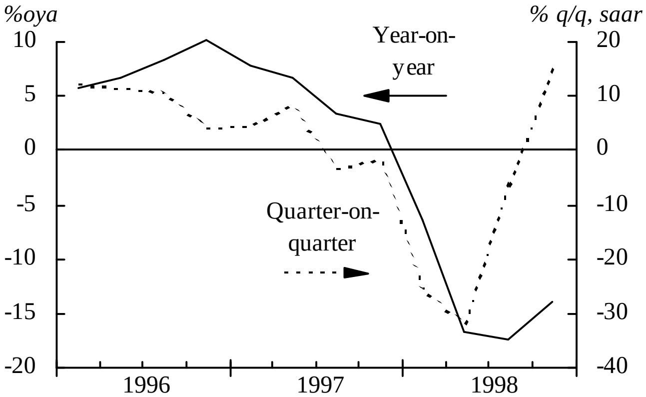
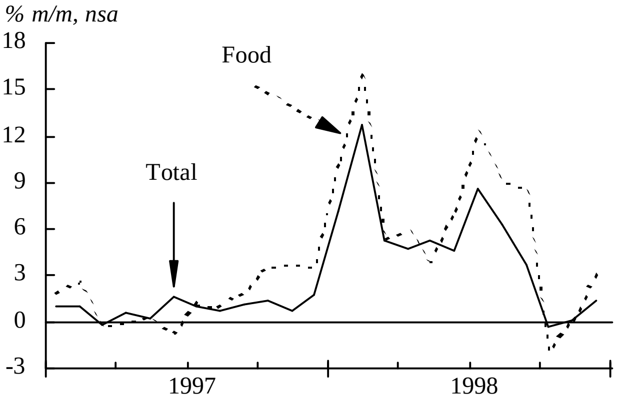
Indonesia is trying to prepare for further and historic political change

Indonesia: gross domestic product



Indonesia: consumer prices



Indonesia: government budget
rupiah trillion

	FY98/99	FY99/00
Expenditure	263.9	218.2
Civil services salaries/food allowances	24.8	32.0
Goods procurement	11.4	11.0
Regional subsidies	13.3	18.4
Debt service payments	66.2	44.8
Domestic	1.9	0.4
Foreign	64.3	44.4
Development spending	92.7	83.6
Bank restructuring	15.0	18.0
Revenue	263.9	218.2
Oil and gas receipts	49.7	21.0
Other receipts	99.6	119.8
Foreign sources	114.6	77.4
Program loans	74.0	47.4
Project loans	340.5	30.0

* FY99/2000 assumptions: Oil price, $10.5/barrel; exchange rate, IDR7,500/$; real GDP growth, 0%; CPI inflation, 17%.

- While monumental changes are simultaneously under way in Indonesia's economic and financial landscape, political change plainly trumps all else at the moment. The plan for elections on June 7 has been kept on track by this week's House (DPR) passage of new election laws. This is no real surprise, however, since the DPR is still controlled by the ruling Golkar party. In any case, not only Golkar, but all major political forces in Indonesia, have agreed that elections as scheduled are the only way for the country to move forward. The wild card in the deck is the possibility of general unrest and violence spreading across the sprawling archipelago, which could make the elections operationally impossible.
- The political turmoil contrasts with the official economic data and the government's policy agenda. On the data front, things look remarkably stable. While real GDP did shrink 13.7% in 1998 as a whole, the quarterly data imply a sharp pickup in the fourth quarter after five quarters of contraction. Presenting a similarly rosy appearance, the CPI data show inflation cooling significantly of late after a series of menacingly high price increases earlier in 1998.
- The Habibie government's policy agenda is striking for its orthodoxy. In turn, the budget proposal put forward earlier this month has been criticized by various DPR members (the criticism itself being unprecedented in Indonesia). The budget includes IDR18 trillion ($2.4 billion) for bank restructuring costs, which assumes that the government can pull in IDR16 trillion ($2.1 billion) from asset sales. That assumption, and others, may be questioned, but on the whole the budget is a realistic, pragmatic, and modestly expansionary plan.
- The budget, as well as the bank restructuring plan proper, is admirably responsible from the point of view of economic policy, as too is the prudently restrained stance of monetary policy. But the central question remains: Who will be holding the reins of power actually to implement these policies (or others) by the end of 1999?

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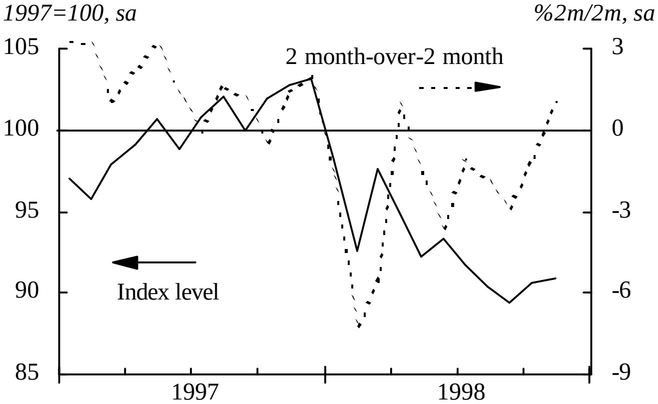
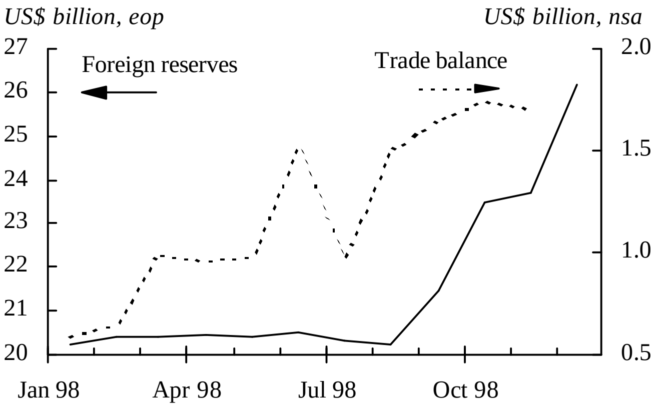
Malaysia: The doctor is in the house

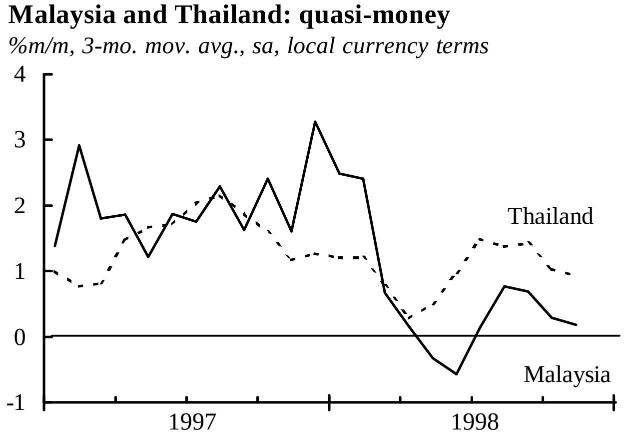
Malaysia: industrial production



Malaysia: foreign reserves and trade balance



Malaysia and Thailand: quasi-money

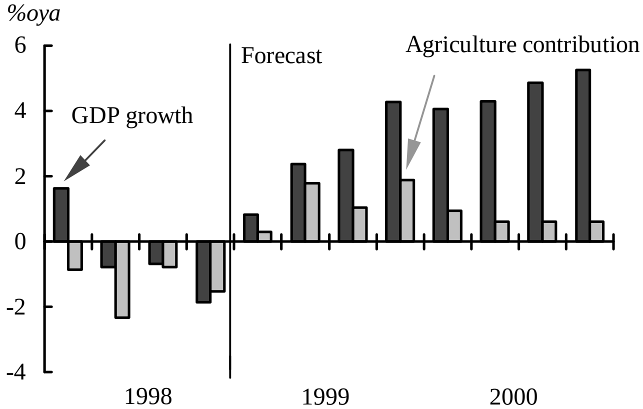


- Stabilization now appears to have taken root more firmly in Malaysia, at least judging by recent data releases. In particular, some sort of output bottom has formed, a bottom engineered by external demand, while domestic sentiment has improved, in turn engendering some revival of confidence in the banking system. The global environment, however, remains volatile, while domestic demand still appears weak, with employment indicators still worsening. Thus the overall outlook for the Malaysian economy remains uncertain and GDP may not stage much recovery in 1999.
- Recent moves by the authorities to limit bank exposure to the real-estate sector, and hints of further loosening of capital controls, are positive developments in economic policymaking, developments that may engender some further return of confidence. So too is the generally well considered plan to heal the banking sector (see *Are Malaysia's banks on the road to healing?*, Global Data Watch, Jan 22).
- Although the bonds issued by the recapitalization and Asset Management entities are zero-coupon, and therefore exert no short-term funding pressure, the longer-term funding needs should not be overlooked. In addition, data through last November suggest no real pickup in bank deposits (though they may have done so in December and January, judging by the net foreign assets figures). In turn, the ability of the authorities to tap the domestic capital markets to fund their net borrowing requirement may be limited. This highlights a return of foreign funds as critical for bolstering the economy. That they may not is a key risk now facing Malaysia.
- Note nonetheless that no change is likely in the underlying structure of Malaysia's New Economic Policy, which aims to provide a racially more equitable distribution of resources. This complicates corporate debt restructuring, with the authorities in some cases reluctant to permit full rationalization. That they may not presents a medium-term risk in as much as the extant overcapacity in certain sectors of the economy may not be fully resolved.

Philippines: The government buys weather insurance

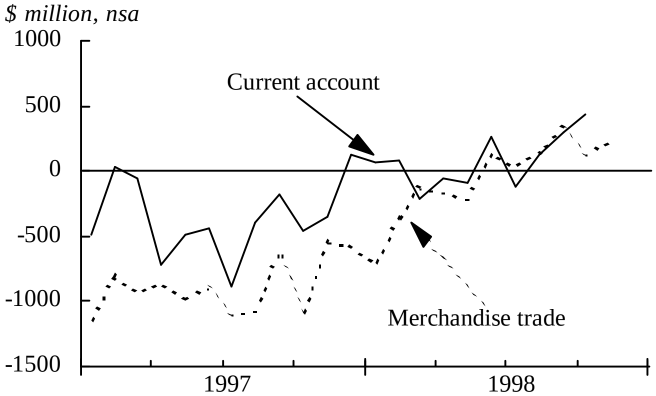
Philippines: gross domestic product

%oya



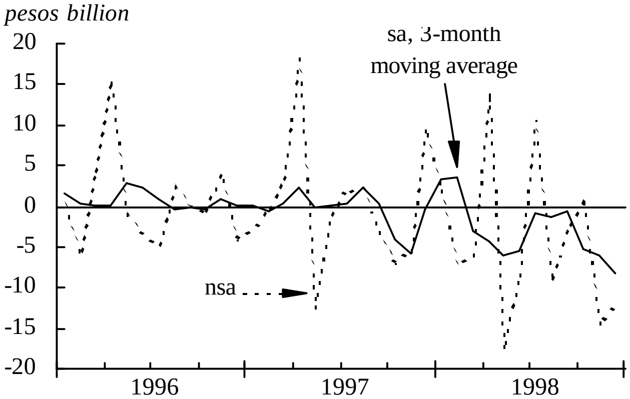
Philippines: trade and current account balances

$ million, nsa



Philippines: national government budget balance

pesos billion



- The Philippines basically sidestepped the regional crisis, but could not avoid poor weather conditions last year. Agriculture, which still contributes over 20% of national output, was a severe drag on the economy in 1998. Excluding that sector, Philippine real GDP would have grown 1.1%, instead of -0.5%. But barring another year of disastrous weather, GDP should grow a respectable 2.6% in 1999.
- What shielded the Philippines from the full brunt of the regional crisis was its relatively strong banking system and a consumer who never stopped spending. Another key factor was that exports grew even in dollar terms last year from the Philippines, whereas they stagnated from China and shrank from all the other Asian countries.
- The strong exports owed to recent foreign investments in the electronics industry and an export market orientation that looks beyond Asia. Expanding exports and declining imports carried both the current and trade accounts into the black in 1998. However, with the U.S. economy poised to slow significantly and imports recovering, net trade will again be a drag on the Philippines in 1999.
- In this fragile external environment, the government understandably intends to keep its countercyclical fiscal policy stance in place. Last year's deficit appears to have breached the ceiling agreed with the IMF (PHP49 billion) and this year the government is planning on spending every peso it can, with its deficit likely to rise from 2.0% of GDP to around 2.3%. Much of the deficit's expansion will come from a scaling-back of expected revenues, but modest spending increases on education, health, housing, and employment are also part of the plan.
- This month's successful $1 billion two-tranche global bond offering will help fill the hole in the budget, but more external funding needs to be raised. The financing plan calling for official loans plus more global bond issuance still looks achievable, however. Add to the fiscal plan an accommodative monetary policy, and GDP growth in 1999 is all but assured – as long as the weather cooperates.

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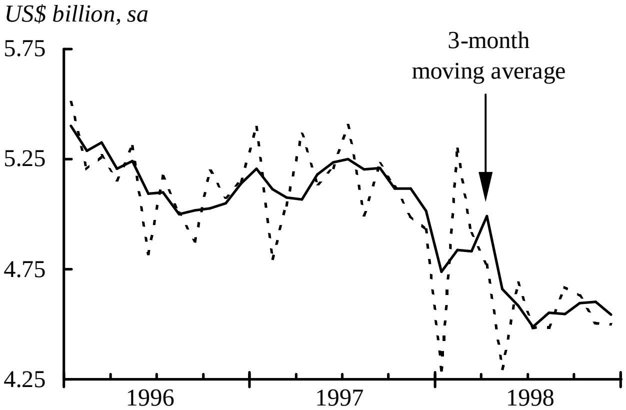
Singapore: Stabilization is under way but recovery remains uncertain

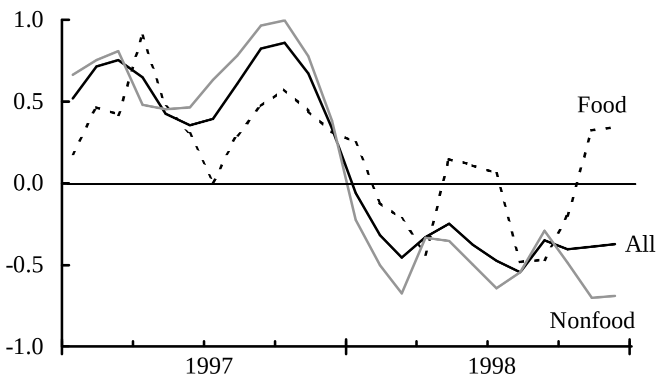
Singapore: non-oil domestic exports

US$ billion, sa



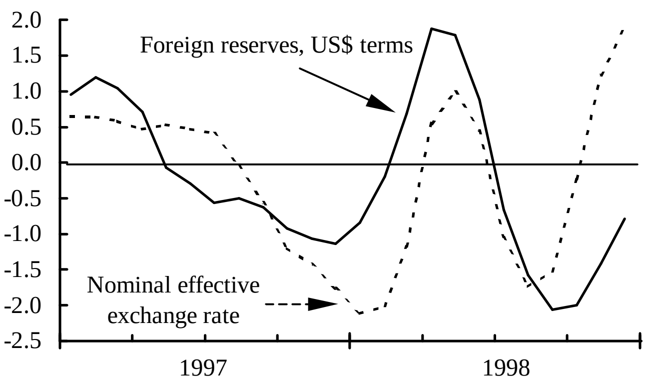
Singapore: consumer prices

%3m/3m, sa



Singapore: foreign reserves and nominal exchange rate

%3m/3m, normalized in 1996-98 standard deviation units



- Recent indicators from the island republic, including December's surprisingly big jump in manufacturing production suggest that some semblance of output and export stabilization has emerged.
- However, there are several risks to the view that Singapore's exports have truly hit bottom. The North Asian countries, specifically Korea, have recently begun aggressively to ramp up production of semiconductors. This tactic had a negative impact on global prices when last tried in 1997, and this time could once again lead eventually to production cutbacks. Already, Singapore's electronics-related export prices appear to be dipping again after firming up in the middle of 1998.
- Going forward, the demand outlook is not reassuring. The U.S. economy (which takes 28% of Singapore's non-oil domestic exports) likely will average no better than 1.5%-2.5% real GDP growth in this first half of 1999, while activity in the Euro Area (which takes another 24%) looks to be slowing faster than expected hitherto. If so, and especially in the event of further supply pressure from North Asia, another production slowdown could ensue in Singapore.
- Because the outlook for both exports and the economy remains unclear, easy monetary policy will continue to be a central policy theme in Singapore. The inflation outlook likewise argues for monetary ease. Global goods prices are expected to continue to weaken as global demand slows in these early months of 1999. With both foreign costs and domestic costs falling (especially once the labor cost cuts are implemented), headline consumer prices in Singapore are expected to fall further – indeed even faster going ahead than they did in the second half of 1998. In turn, the authorities will continue to lean toward lower domestic interest rates.
- In recent months, the monetary authorities have been accumulating foreign reserves despite a still weakish nominal exchange rate. The scale of such intervention can be expected to escalate into 1999.

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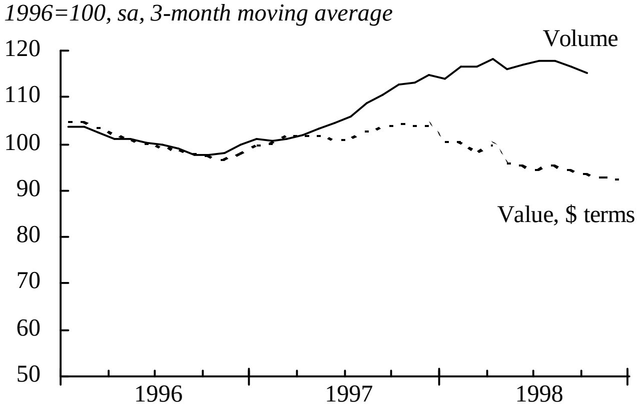
Thailand: Stabilized, yes, but when will a real upswing begin?

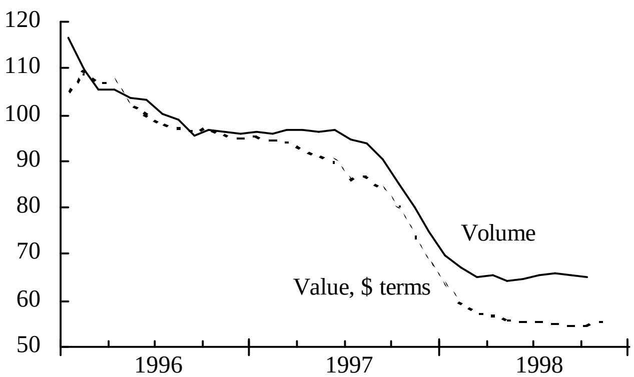
Thailand: exports

1996=100, sa, 3-month moving average



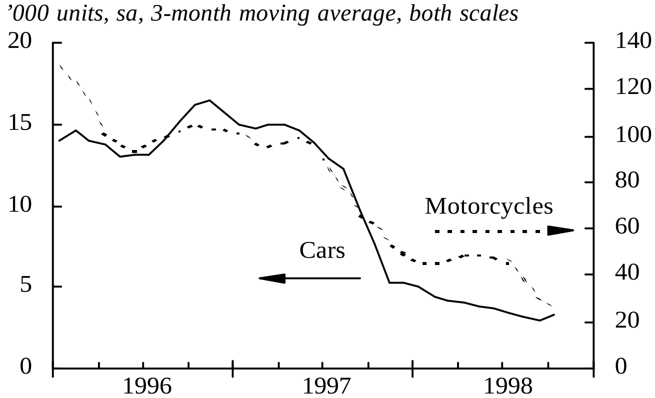
Thailand: imports

1996=100, sa, 3-month moving average



Thailand: passenger car and motorcycle sales

'000 units, sa, 3-month moving average, both scales



- Thailand's steadfast adherence to a clearly-enunciated, orthodox approach to the financial and economic crises is being tested. The Chuan administration is now 15 months old, three months shy of the average duration of a Thai government since 1988. With the parliament's latest confidence vote now behind it, Chuan and his team look likely to outlast the mean. That said, their longer-term prospects would be greatly enhanced by more visible results from their carefully crafted reform plans.
- Restructuring and reviving the financial sector continues to be a priority for the government, but on this critical front progress has been slow. Interest rates have come down, but until key legal reforms are passed and implemented, and corporate debts renegotiated, bank lending will continue to stagnate (see essay, pages 13-20).
- Nevertheless, there are reasons to be optimistic on the real economy. The J.P. Morgan forecast of 3% real GDP growth in 1999 depends on a number of positive factors: interest rates remaining low, very modest growth in exports, manufacturing production increasing to reverse inventory drawdowns, fiscal stimulus, and no further significant contractions in household consumption and private investment. At this point, while the conditions are in place for this optimistic scenario to occur, data released so far signal only stability – not revival.
- Thai exports have clearly benefited from the baht's depreciation, with volumes rising steadily even though their dollar value has fallen. The flattening out of export volumes recently and the prospect of a soft external environment mean that any further gains made this year will be modest. Note that there has been nothing modest about the collapse of imports, which is the reason why Thailand now runs, and will continue to run, large trade surpluses.
- Even if the Morgan forecast becomes reality, this does not mean that Thai consumers will prosper this year. More restructuring means more unemployment, so spending, especially on big-ticket items, will continue to be dull.

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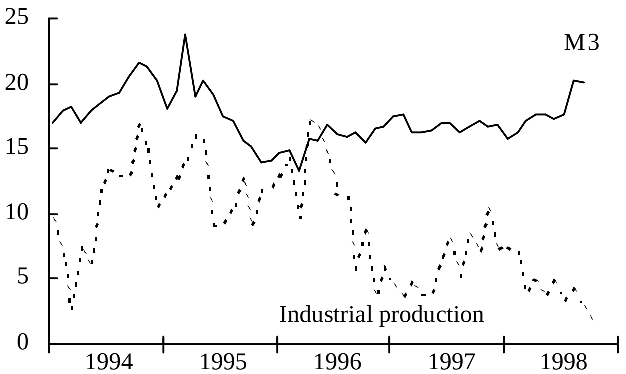
India expected to tighten monetary policy

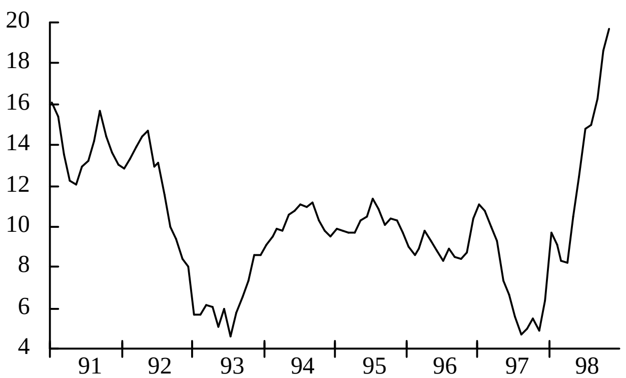
India: industrial production and M3

% oya



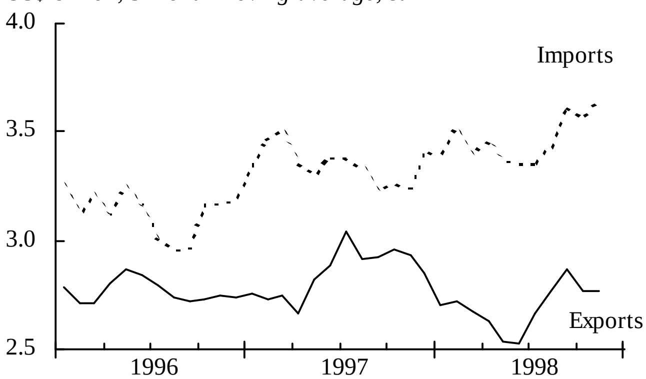
India: consumer prices

% oya



India: trade

US$ billion, 3-month moving average, sa



- While economic conditions have started to stabilize in the rest of Asia, the prospects for the Indian economy have deteriorated. Economic growth is sluggish and yet inflation, at least in consumer prices, was dramatically on the rise until very recently. Industrial production has continued to weaken while exports are facing ever keener competition from Asia.
- On the fiscal side, the central government's higher borrowing needs have been met to a certain extent through monetization. This, along with the cost-push effects of the weaker rupee, has helped fuel inflationary pressures. Indeed, pressures here have boosted interest rates, and in turn are undermining economic activity.
- On the external side, the trade deficit between April and November nearly doubled from the same period a year earlier, thanks to still uninspiring exports and rapidly rising imports. Although down 9% since the start of the fiscal year last April, the rupee remains uncompetitive in real terms, while domestic demand is stubbornly strong leading to a consistent widening of the trade deficit.
- Taken together, the worsening budget deficit, a deteriorating external position, and surging inflation are making the economic sustainability of monetary policy increasingly tenuous and may well force the Reserve Bank to tighten rates
- The upshot of such policy tightening will be a slowdown in domestic demand, while poor operating results in the corporate sector are likely to lead to additional investment cutbacks. All in all, real GDP growth should fall below 3% in the next fiscal year, with outright recession being a clear risk to the outlook. On the plus side, trade balances should improve and CPI inflation fall despite a weaker currency. Less positively, the government will have trouble reducing the overall budget deficit, thanks to a further shortfall in tax revenues.

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Australia and New Zealand converge in 1999

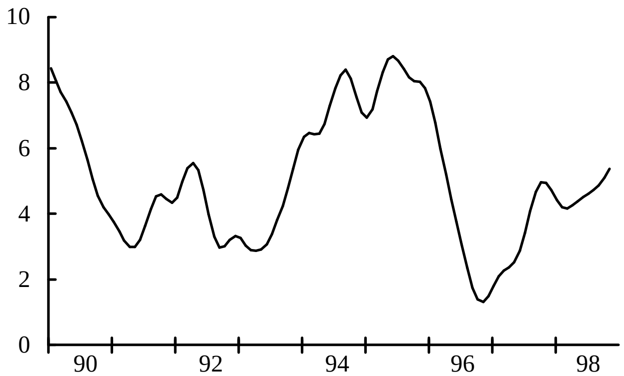
- **Low interest rates continue to support growth, strong in Australia, recovering in New Zealand**
- **But sharply lower commodity prices are still a drag on growth, through reduced export receipts**
- **Inflation will stay quiescent, judging by the scant pass-through of earlier currency depreciation**
- **Currencies are vulnerable while current account deficits remain high, but big tumbles are unlikely**

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

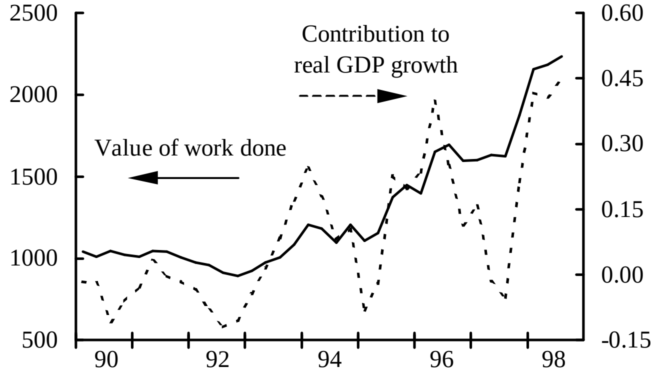
	1998	1999f	2000f
Australia			
Real GDP (%oya)	4.7	2.2	3.0
Consumer prices (%oya)	0.9	2.0	2.8
Current account (% of GDP)	-4.7	-5.1	-4.1
Fiscal balance (% of GDP)	2.8	1.5	2.2
New Zealand			
Real GDP (%oya)	-0.5	2.0	3.8
Consumer prices (%oya)	1.3	1.6	1.9
Current account (% of GDP)	-6.2	-5.3	-4.1
Fiscal balance (% of GDP)	2.6	-0.3	-1.5

Australia's consumer spending powers on...

Retail sales
%oya, trend value



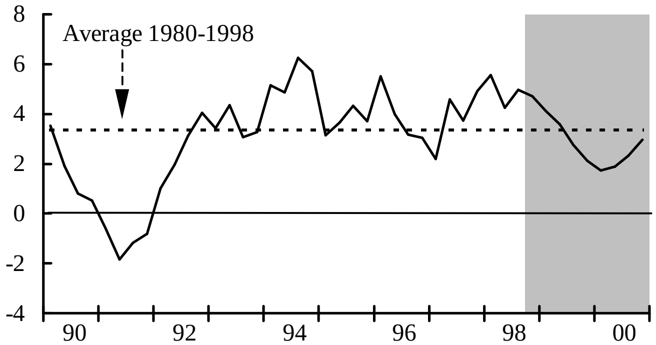
Engineering construction - private
A$ mil, 1996-97 prices, sa *percentage points oya*



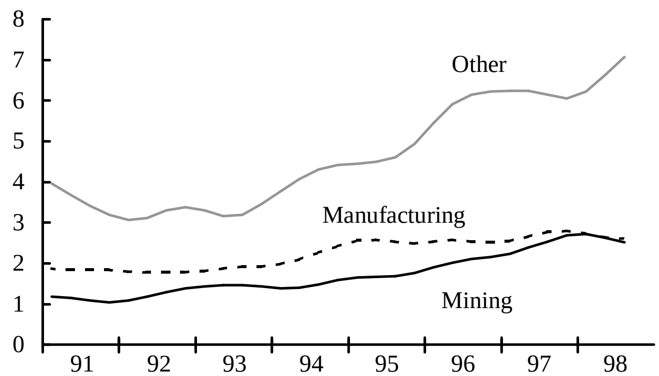
- Consumer spending and major infrastructure projects have been the key contributors to economic growth, remaining strikingly robust in the face of external head winds.
- The strong and steady growth in consumer spending through 1998, and its expected continuing momentum into early 1999, is driven by record-low borrowing costs (at least in nominal terms), rising real wages, solid jobs growth, and windfall gains from the AMP demutualization.
- A sharp correction in equity prices or a weakening of the labor market are the main threats that could cause consumer spending to stumble.
- The July 2000 introduction of the new goods and services tax (GST) will prompt households to delay purchases of goods that will get cheaper – like autos and electrical goods. But household spending on new homes, currently exempt from sales tax, will be brought forward as the GST will raise their cost.
- Sydney-2000-Olympics-related and other infrastructure construction (particularly new toll roads in Sydney and Melbourne) boosted GDP growth by around 0.5 percentage point in 1998. This boost (along with consumer spending) kept domestic demand resilient in the face of the sharp falls in manufactures exports and commodity prices.

...but GDP growth will still slow in 1999, if to uncertain degree

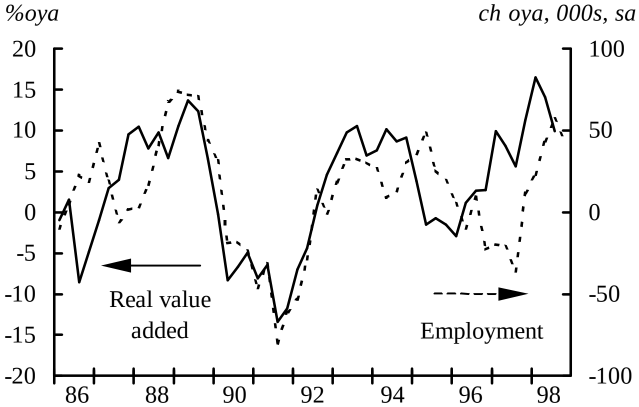
Real GDP growth
%oya, sa



Business investment
A$ bil, 1996-97 prices, trend



Construction
%oya *ch oya, 000s, sa*



- Despite recent upbeat economic reports suggesting continuing strength right now, GDP growth will slow in 1999, while still recording an eighth year of expansion. Sub-trend growth appears inevitable this year because published growth hitherto – to the third quarter of 1998 – has remained above average for six quarters. Less certain is the degree to which growth will moderate. This will have important implications for interest rates.
- The somewhat slower pace of overall spending growth will result from an outright fall in business equipment investment, a fading of the dynamism in construction, and a weakening of consumer spending (though this last not until midyear).
- Mining investment will now be curtailed for several years at least, after growing at an average of 16% annually over the past five years, due to depressed commodity prices (for coal, iron ore, gold, and base metals). Mining investment was already down nearly 9% over the year to the third quarter of 1998, and it will remain weak in 1999. Fewer mining projects will be viable unless commodity prices rebound by at least 15%-20%. Still, depressed commodity prices may prove a blessing in disguise to the extent that a higher proportion of business investment now occurs in high-tech manufacturing and high-value-added services – although such a structural shift may take several years to mature.
- Residential construction appears to have peaked around the middle of 1998 and the slowdown here will continue into the first half of 1999. However, a sharp fall is not likely as new housing remains very affordable at the current record-low mortgage interest rates. Moreover, last year's peak was relatively modest compared with those in previous cycles, so a bust now is less likely. In addition, recent news that net immigration in 1998 exceeded target by around 25,000 people points to higher underlying demand for new housing than earlier expected.
- Infrastructure construction will cool this year as Olympics-related spending moderates and work on major toll roads falls rapidly. Overall, the construction sector in 1999 is not likely to repeat its 50,000 (9%) surge in head count of 1998.

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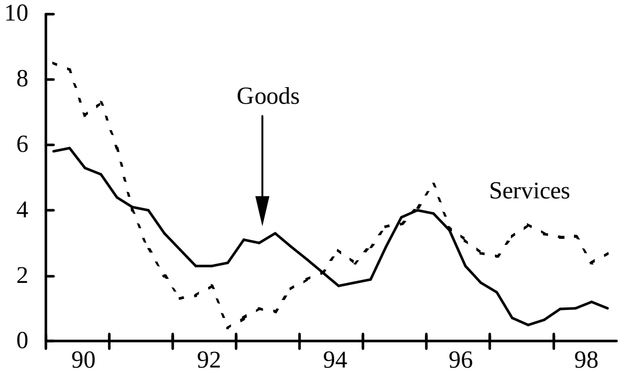
Inflation remains quiescent...

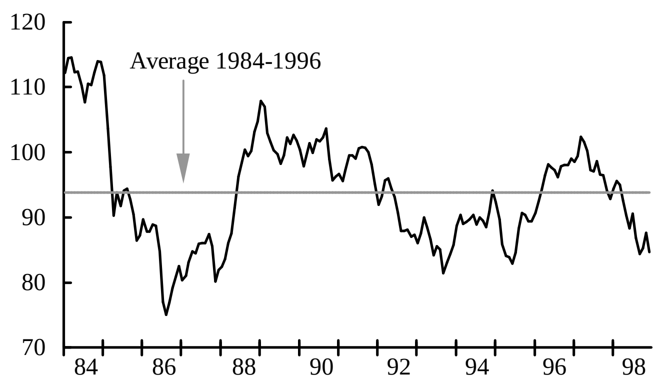
Private sector consumer prices
%oya



- Inflation is quiescent. Fears of sharply higher consumer prices from the Australian dollar's 20% depreciation against the greenback are proving misplaced. Unit labor costs are steady despite the unemployment rate's drop to an eight-year low.
- Traded goods prices to consumers have accelerated little. The intense competition born of global overcapacity in manufacturing restrains pass-through of higher import prices to consumers. The plunge in crude oil and other commodity prices has also offset the Australian dollar's decline. Indeed, the prices of imported and domestically produced raw materials used in manufacturing are actually falling.

...but the large current account deficit needs to decline, and could well do so

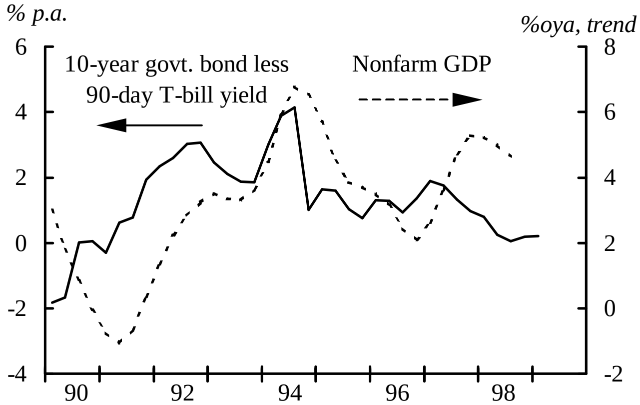
Real broad effective exchange rat
1990=100



- The current account deficit widened in 1998, passing 5% of GDP in a few quarters. But while high compared with most industrialized countries, Australia's deficit was actually lower than its previous cyclical peaks of 6%-7% of GDP.
- True, depressed commodity prices will continue to hurt export receipts this year, but improved international competitiveness – the real broad effective exchange rate is 10% below average – and declining mining investment (which is very import-intensive) will provide an offset. Indeed, the pace of growth in import volumes has contracted sharply in response to higher import prices.

The Reserve Bank will cut rates again when growth stalls

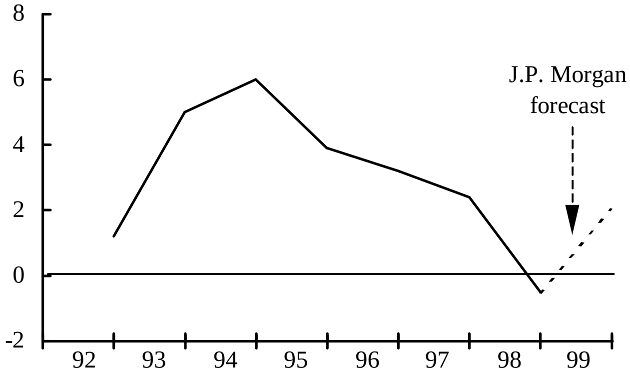
The yield curve and growth
% p.a.



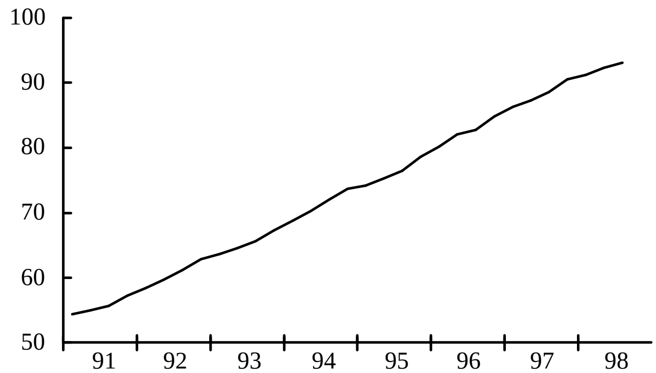
- The economy's resilience could once again raise fears that the RBA may need to raise interest rates. But those fears would be misplaced. So long as the inflation outlook remains benign there is no reason for the RBA to apply even the hand brake.
- J.P. Morgan believes the bias of official interest rates is downward, so long as inflation forecasts look for a peak below 2.5%.
- With little evidence of any broad-based weakening in economic growth, the RBA can remain patient. However, it is likely to act swiftly once domestic spending growth falters, as it inevitably will.

New Zealand emerges from recession...

New Zealand: real GDP growth
%y/y



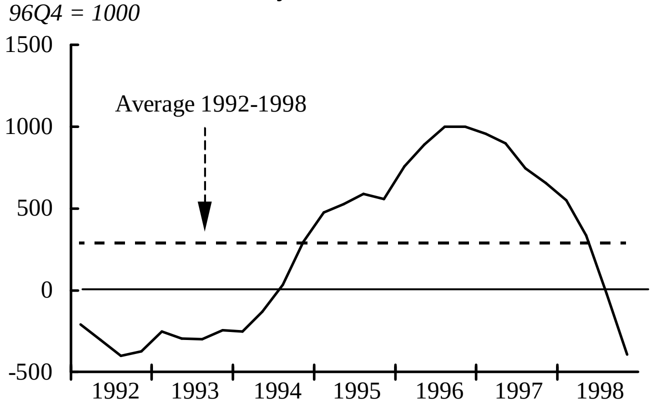
New Zealand: household debt
% of disposable income



- New Zealand's recession appears to have been short lived, lasting for just the first half of 1998 – although GDP did fall 1.8% – before a surprisingly strong rebound in the third quarter. Overall, GDP growth will continue in 1999, but likely at a modest pace that keeps the output gap substantially negative and inflation low.
- One reason for last year's rapid turnaround was a sharp drop in interest rates as the central bank played catch up and eased monetary conditions by the equivalent of 1000 basis points during 1998. Business and consumer confidence responded well to lower borrowing costs. Spending on autos also benefited from sharp price declines after the May budget abolished what were already low tariffs. Household spending was also boosted by income tax cuts (equal to 1% of GDP) from July 1998 and by windfalls gains from the AMP demutualization.
- The bubble in house prices was pricked by a sharp rise in interest rates through the first half of last year. Indeed, the decline in prices of around 6% exceeded the fall during the 1991-92 recession. While causing a great deal of pain to highly leveraged households, the sharp drop in house prices could prevent another borrowing binge, if it has actually taught a valuable lesson. There is little doubt that the several successive years of double-digit growth in housing credit contributed to the sharp widening in the current account deficit in 1996-98 and to the subsequent rise in interest rates.

...and so the RBNZ will need to nurture the recovery

New Zealand: monetary conditions index
96Q4 = 1000



- Monetary conditions are now well supportive of economic growth, and with the output gap likely to remain substantially negative through 1999, are likely to remain so for some time yet.
- Apart from the lofty current account deficit, the biggest risk to this benign outlook for interest rates could well come from the election due by October-November. Opinion polls point to a likely victory by the left-of-center opposition Labour Party, whose policy platform could unsettle financial markets. With 57% of government bonds held offshore, the attitude of foreign investors will be critical.

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Foreign exchange and interest rates

- **A more sustained recovery in risk appetites is needed before US$ can rally against yen**
- **With inflation under control, interest rates in Emerging Asia have room to fall further**
- **Recovery of economic growth in Asia will boost AUD and NZD**

The tide is gradually turning in favor of the yen

During the fourth quarter, the Japanese government shifted away from an overt weak JPY policy. The motivation for this shift was probably the scale of the bond issuance required by the fiscal expansion. Investors are loath to accumulate assets unless the government is committed to protecting purchasing power, so the consequence of a weak yen policy would likely be still higher JGB rates. The government expressed its intent to shift yen policy both through public statements and by intervention when the USD was still above 130.

More recently, when 110 was breached, the BoJ shifted to buying dollars, so policy appears now to be geared to a steady yen, with a likely range of roughly 110 to 120. While concerns for the CNY may have influenced the BoJ to contain JPY weakness last summer, the CNY is probably no longer a significant factor in JPY policy – a CNY devaluation would not prompt the BoJ to move back to a weak JPY policy.

For now, the risk of a range break is biased to the strong dollar side. The surprising strength of the U.S. economy and stock market, and the consequent delay in any further Fed easing, should underpin the U.S. currency into the second quarter. However, the dollar will encounter strong head winds above 120 and is unlikely to test its 1998 highs, not least because of the simple arithmetic of supply and demand – dollar supply will be increased by the rising Japanese trade surplus and dollar demand will be capped by global deleveraging. With the JPY/USD rate thus constrained on the upside, its actual movements should not reemerge as a driving factor for other Asian currencies.

Exchange rate and interest rate forecasts

	Actual	Forecasts	
	Jan-28	3 month	12 month
US$ exchange rate			
Japan	115.39	123	134
Australia	0.63	0.62	0.65
New Zealand	0.53	0.52	0.56
China	8.28	8.28	8.67
Hong Kong	7.75	7.75	7.77
India	42.50	44.95	48.45
Indonesia	9,213	8600	6700
Malaysia	3.80	3.80	3.50
Philippines	38.60	36.70	35.00
Singapore	1.69	1.70	1.69
South Korea	1,175	1,135	1,100
Taiwan	32.33	32.15	33.00
Thailand	36.89	35.70	32.00
3-month interest rate*			
United States	4.90	5.00	4.00
Japan	0.78	0.40	0.60
Australia	4.72	4.60	4.20
New Zealand	4.53	4.30	4.20
China	11.13	13.00	14.90
Hong Kong	6.38	6.95	10.60
India	12.17	16.30	15.70
Indonesia	43.03	43.00	33.50
Philippines	13.79	13.40	9.70
Singapore	1.86	1.70	1.15
South Korea	7.68	7.15	6.35
Taiwan	6.89	6.45	6.35
Thailand	8.51	7.70	6.50
10-year gov. bond yields**			
United States	4.70	4.70	4.30
Japan	1.86	2.25	2.70
Australia	5.02	4.62	4.55
New Zealand	5.51	5.30	4.50
External debt spreads***			
EMBI****	1,321	1,600	700
China 06	243	275	225
ICICI (India) 07	481	550	600
Indonesia 06	1,125	902	703
Korea 03	270	279	398
Korea 08	303	309	399
Petronas (Malaysia) 06	460	550	550
Philippines 08	428	410	376
Philippines 16	448	400	375
Thailand 07	290	326	276
Hutchison (Hong Kong) 07	262	600	350

* % 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.

The U.S. recession that J.P. Morgan previously projected has been postponed but not eliminated. Accordingly, as signs of a slowing U.S. economy emerge later this year, the dollar rally will lose steam, particularly since the current account deficit is apt to remain near record highs. And in a slowing economy, politicization of the U.S. deficit – the resurrection of Super 301, banana wars, etc. – will likely intensify, which traditionally has been a dollar negative.

JGBs have not quite hit bottom

Although last year's fiscal package will strengthen Japan's GDP growth in the second quarter, its bank balance sheet problems and absence of inflation will remain as incentives for the BoJ to keep rates low – indeed, it will not hike them for the foreseeable future. Nevertheless, JGB yields are projected to make new highs with the 10-year benchmark yield heading toward 3.0%. JGBs will be hurt for now by indigestion caused by surging supply and a resurgent dollar. But this dollar impact will fade by midyear and the deflationary environment is expected to persist well into 2000. Continued low inflation and an eventual market adjustment to the higher supply should allow JGB yields to stabilize by the second half of this year.

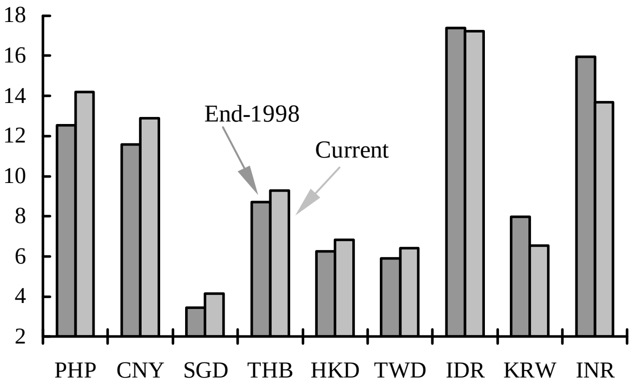
China is not ready to devalue

Following the Brazilian *real* float, speculation pushed forward exchange rates for CNY and HKD sharply lower. Fears that these two currencies would devalue created a hiccup that weakened currencies and raised interest rates in other Asian markets.

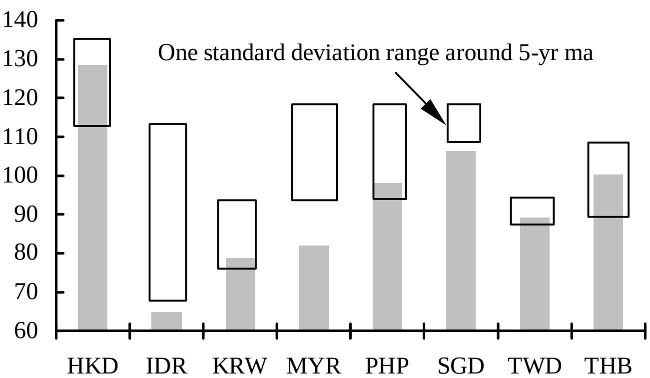
Yet almost certainly, the Chinese will not devalue before the second half of 1998, and then only if the trade surplus has disappeared. Insolvencies of more itics and, perhaps, corporates will likely occur in the months ahead. But, the impact on domestic credit should be modest and a weaker CNY would only worsen debt burdens on these institutions in local currency terms. Even so, the market will be hard to convince and a devaluation premium is likely to be priced into the Chinese market indefinitely.

Concerns about China will be echoed in the Hong Kong market, but last year's measures giving the

Implied 12-month interest rate in one year's time
% p.a.



Real trade-weighted exchange rates
1990=100



HKMA more flexibility in injecting liquidity are successfully shielding the local market. While 12-month rates have shot up quickly in recent weeks, short-term rates were slower to react so the curve has steepened and the typical crisis-generated front end inversion never materialized. As with China, a risk premium will continue to be priced into the HKD curve. But borrowing HKD is a relatively inexpensive way to hedge against China risk, and investors should fund aggressively in HKD if rates converge to U.S. levels as they did at the start of the year.

Look for opportunities to go long Asian duration

Low inflation – if not outright deflation – will be a dominant theme for 1999. The recent China anxiety-driven rise in interest rates has created opportunities to buy duration in some Asian markets. A Chinese devaluation might create temporary Asian currency weakness but would not change the weak domestic demand conditions across Asia that are the basis for low inflation. Whether or not China devalues, Asian demand will remain weak and inflation low. Asian rates will resume heading lower – particularly if the Fed eases later this year – so any curve-steepening should generally be treated as a buying opportunity.

Particularly attractive as duration plays are the curves in Singapore and Thailand which, unlike those in most other Asian markets, slope upward and thus price in rising interest rates. Not only is this inconsistent with the macroeconomic story, it also creates opportunity to go long duration and earn positive carry.

Although the TWD curve is flat, a general surge in local rates on the CNY devaluation scare make it another attractive duration play. PHP, KRW, IDR, however, have inverted curves, pricing in declining rate trends – while here too long duration should be the objective, this is not the time to buy. The one outlier market is India, where aggressive monetary and fiscal stimulus and a rising current account deficit create risks of an INR breakdown and inflation. This is a market where duration should be avoided.

Asian currency appreciation should slow

The rebound of Asian currencies during the second half of 1998 largely eliminated the cases of extreme undervaluation. Only the IDR and MYR remain significantly below their long-term real exchange rate trends. Although current account surpluses across the region continue to create a bias for currency strength, the pace of appreciation should slow as real undervaluation fades. Governments are becoming concerned about loss of competitiveness and central banks are becoming more proactive at resisting appreciation of their currencies. But the central banks' only effective means to protest stronger currencies is to cut rates, a fact that bolsters the appeal of long duration.

The KRW has the greatest appreciation potential for now because it remains relatively undervalued – see chart – and the prospects for economic growth in Korea are particularly promising. Moreover, in contrast to other Asian markets, the CNY effect was on the KRW rather than rates and this should reverse. Turning to the PHP, the potential for appreciation is more modest, but a bias remains toward strength and high short-term rates continue to make the currency attractive from a carry perspective. In addition, look for further strength in the THB – J.P. Morgan sees Thailand as making continued progress in market-oriented restructuring and has an above-consensus view of the country's economic recovery prospects.

Although the SGD is arguably becoming undervalued, a potential for further weakness remains. With overnight rates below 1%, a weaker currency is becoming the MAS's only vehicle to provide further monetary stimulus. And the government looks to be trying to reverse some of the real appreciation of the SGD that it engineered back in the early 1990s. The SGD remains an attractive funding vehicle for the higher-yielding Asian markets.

Indonesia and Malaysia remain "special cases"

The IDR has sold off sharply and offshore rates have jumped higher on a post-Ramadan pickup in violence and uncertainty over the release of the election rules. With those rules now established, social unrest should fade, at least until the run-up to the event in June. With the economy expected to improve and inflation headed to single digits, the near-term prospects for IDR appreciation are excellent. Malaysia is expected gradually to eliminate capital controls this year. It appears that international investors will be more apt to buy Malaysia as the market becomes tradable.

AUD and NZD have benefited from risk aversion

With commodity prices still in the doldrums, low inflation and large external deficits leave little upside for the AUD and NZD, particularly as currency strength would provide an opportunity to cut interest rates further. Absent a sustained AUD rebound, the RBA is expected to await a Fed move before cutting rates again. The RNZ has more room to cut, given the NZD's still-positive spread versus AUD and USD. Curves in both countries are quite flat, leaving little room for bonds to rally even if short-term rates are cut.

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Equities

- **Asia's recent rally was not driven exclusively by Wall Street and Fed easing**
- **Improved macro fundamentals support the market recovery**
- **Future upside depends on more good news, while external factors pose a risk**
- **Japan, China, India, and Taiwan are expected to underperform**

Asian equity markets performed well in the last quarter of 1998. With the notable exception of Japan, China, India, and Taiwan, regional stock markets far outperformed global standards, surging on average by 50% in local currency terms and even more in U.S. dollar terms. Most impressive was the rally in the Korean stock market, which essentially doubled in value. Since the start of 1999, however, the going has become tougher, with Asian markets essentially moving sideways and those of China and Hong Kong, especially, struggling with devaluation rumors.

The direction of the U.S. stock market and the three consecutive rate cuts by the Federal Reserve have undoubtedly been a force behind Asia's recent market performance. Still, the region's much improved macro fundamentals have been at least as important and are expected to continue to support Asian markets even if external factors – especially U.S. market conditions – deteriorate. Most important is the impact that the rise in output and the drop in interest rates will have on earnings and asset quality. Still, like the economic outlook, Asia's market performance will likely be uneven.

- **Japan**, Asia's largest equity market, is expected to underperform the rest of the region and could even spark some negative surprises. In the economy, output has stabilized but the bottom is fragile and recovery is not at hand. Corporate financial health continues to worsen and consolidation in the financial sector will likley create more negative fallout.

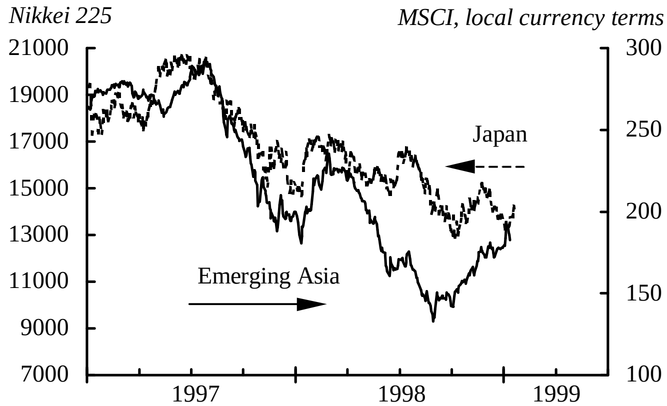
- In contrast, strong cyclical momentum is blowing behind the sails of the **Korean** market. To be sure, the very high pace of economic and market recovery

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

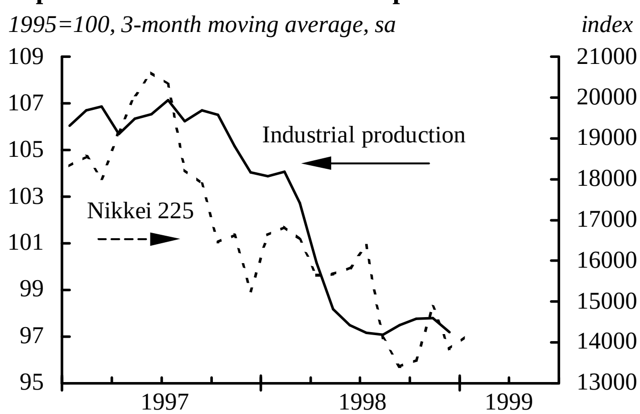
	Sep to Dec 1998		Dec 1998 to date	
	LC-terms	$-terms	LC-terms	$-terms
World*	18.6	20.7	1.1	0.4
United States	17.1	17.1	1.1	1.1
Japan	3.3	22.9	3.6	2.5
Australia	8.8	12.5	2.3	4.8
New Zealand	19.5	26.4	4.7	6.7
Emerging Markets**	14.2	17.4	3.0	-1.6
Emerging Asia**	20.5	29.1	1.4	-0.8
China	-17.3	-17.3	-14.0	-14.0
Hong Kong	27.5	27.5	-6.9	-6.9
India	-1.5	-1.6	7.8	7.7
Indonesia	44.1	92.8	2.3	-10.1
Korea	81.3	108.5	1.7	4.7
Malaysia	56.9	57.1	1.5	1.5
Philippines	56.3	75.8	1.5	2.1
Singapore	48.2	51.5	2.4	-0.1
Taiwan	-6.1	0.4	-5.6	-5.8
Thailand	40.2	51.1	2.9	2.6

* Morgan Stanley Composite Index
** MSCI, excludes Hong Kong and Singapore

Stock prices: Japan versus the rest of Asia



Japan: Nikkei 225 and industrial production



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of the last few months is unlikely to be sustained for much longer, but the news from the economic front should remain positive and support the market.

- **Thailand** and the **Philippines** are likely to follow Korea's trail, but with less momentum. Both countries have room to cut interest rates further, but Thailand's equity market upside will clearly depend on the government's ability to reinvigorate the financial reform drive in the next few months.

- **Indonesia** and **Malaysia** have performed surprisingly well over the last three months, but their economic prospects are weaker and contain more risks, especially in Indonesia.

- For **Hong Kong** and **Singapore**, much improved liquidity conditions have been the key driver behind their recent market recoveries. In contrast, their economic adjustment is clearly delayed. And while Singapore will probably succeed in keeping interest rates low by allowing the currency to weaken slightly, Hong Kong's interest rate and market outlook will be closely tied to U.S. monetary and market conditions and to sentiment surrounding the peg.

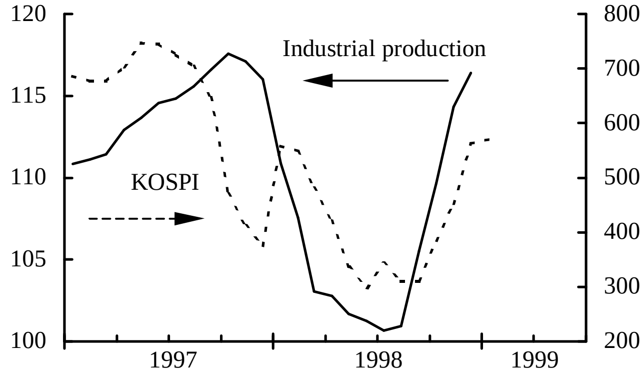
- Developments in **China** will be important both for its own market and for others in Asia, notably Hong Kong's. The J.P. Morgan forecast assumes that, provided market conditions are favorable, China will gradually depreciate its currency in the second half of this year. Still, even if that adjustment is smooth, the economy is expected to slow further while corporate financial health should remain poor.

- **Taiwan** has clearly lost its safe haven status, and its equity market is likely to suffer as investors adjust their overweight positions in response to signs of an economic slowdown and some difficulties in the financial sector.

- The main risk for **India's** market is the need for monetary tightening to stem the widening of the trade deficit and quell the inflationary pressures in the economy.

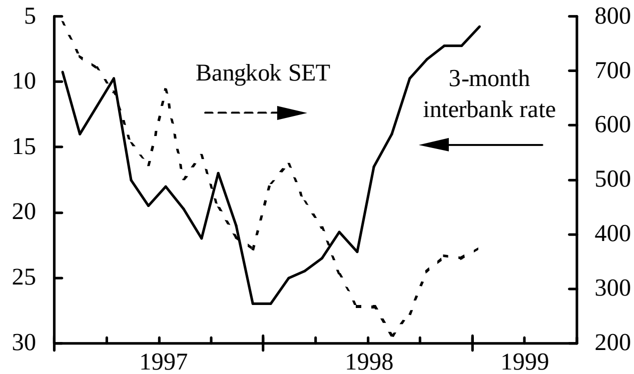
Korea: KOSPI and industrial production

1995=100, 3mma, sa *index*



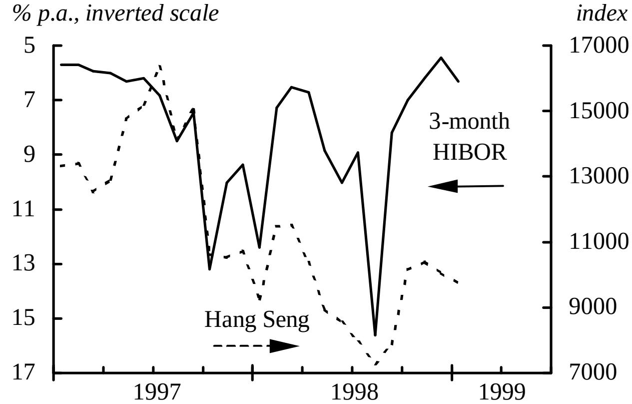
Thailand: Bangkok SET and 3-month interbank rate

%, p.a., inverted scale *index*



Hong Kong: Hang Seng and 3-month HIBOR

% p.a., inverted scale *index*



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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	0.0	-1.0	1.7	0.7	-0.4	-0.6
Australia	363		19.5	3.9	4.7	2.2	3.0	0.3	0.9	2.0	2.8
New Zealand	52		13.6	3.0	-0.5	2.0	3.8	1.2	1.2	1.6	1.9
Emerging Asia	2485	100.0	0.9	6.1	0.1	3.0	4.9	4.2	8.9	4.0	4.5
China	966	38.9	0.8	8.8	7.8	6.5	5.8	2.8	-0.8	1.4	3.2
Hong Kong	168	6.8	25.2	5.3	-5.0	-1.5	3.0	5.7	2.6	-2.8	2.2
India	365	14.7	0.8	5.0	4.0	2.5	5.0	7.2	12.0	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	306	12.3	6.6	5.5	-5.7	4.0	4.5	4.4	7.5	1.6	3.8
Malaysia	65	2.6	3.0	7.8	-7.3	-1.0	5.0	2.7	5.3	3.3	3.4
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	7.8	1.3	-1.0	4.0	2.0	-0.2	-0.5	1.5
Taiwan	258	10.4	11.7	6.8	4.8	3.2	4.5	0.9	1.7	-1.2	0.6
Thailand	119	4.8	1.9	-0.4	-6.5	3.0	5.0	5.6	8.1	3.4	5.0

	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	94.2	122.5	122.0	132.9	2.2	3.2	3.3	3.7				
Australia	-12.7	-17.3	-19.0	-17.6	-3.1	-4.7	-5.1	-4.1				
New Zealand	-3.1	-3.2	-2.8	-2.6	-4.8	-6.2	-5.3	-4.1				
Emerging Asia	20.9	105.7	66.9	45.5	0.7	4.3	2.4	1.6	509.0	557.8	581.1	605.0
China	30.1	24.8	3.8	2.6	3.3	2.6	0.4	0.3	142.8	145.0	139.2	137.7
Hong Kong	1.4	5.5	3.7	2.1	0.8	3.3	2.3	1.3	93.2	88.9	92.8	97.4
India	-6.5	-11.5	-6.4	-6.2	-1.8	-3.1	-1.7	-1.6	26.3	24.3	26.3	28.3
Indonesia	-6.3	4.6	2.9	0.4	-2.9	5.4	2.2	0.2	20.5	23.9	26.4	27.4
Korea	-7.9	42.1	26.9	11.7	-1.8	13.7	6.6	2.7	21.1	52.1	61.6	64.6
Malaysia	-5.1	4.9	4.4	1.8	-5.2	7.5	6.6	2.3	20.8	26.2	30.9	34.4
Philippines	-4.3	0.8	0.3	0.9	-5.2	1.2	0.3	1.0	7.3	10.9	12.9	13.9
Singapore	14.8	15.5	15.0	17.2	15.4	17.8	18.5	19.6	71.4	69.4	70.9	79.4
Taiwan	7.7	4.9	4.4	4.7	2.7	1.9	1.7	1.7	79.6	88.6	85.6	86.5
Thailand	-3.0	14.0	11.9	10.2	-2.0	11.8	7.6	5.7	26.2	28.5	34.5	35.5

	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	-9.2	-10.9
Australia									0.5	2.8	1.5	2.2
New Zealand									2.0	2.6	-0.3	-1.5
China	16.5	16.6	16.1	17.2	35.7	35.2	34.2	36.5	-0.7	-2.1	-3.3	-3.9
Hong Kong									4.5	-3.5	-5.0	-1.5
India	27.9	28.5	29.1	29.5	11.7	13.2	14.2	15.2	-6.1	-6.7	-6.3	-5.8
Indonesia	62.3	168.6	110.4	84.0	36.8	27.3	20.3	18.8	1.2	-7.0	-6.0	-6.0
Korea	35.8	50.5	34.8	28.7	68.6	31.0	29.0	27.5	-0.9	-5.0	-6.0	-7.0
Malaysia	42.5	67.7	67.7	60.6	14.4	13.6	11.6	10.6	5.5	-1.0	-6.5	-3.0
Philippines	61.3	80.1	72.5	63.3	11.1	10.0	11.0	11.5	-1.8	-3.6	-3.5	-1.0
Singapore									6.0	-1.0	-2.0	-0.5
Taiwan	15.2	17.4	18.6	18.1	29.2	29.5	29.8	30.2	-6.9	-7.0	-8.5	-7.8
Thailand	63.5	77.1	54.1	42.1	30.0	23.3	17.3	15.3	-0.9	-4.5	-5.0	-4.0