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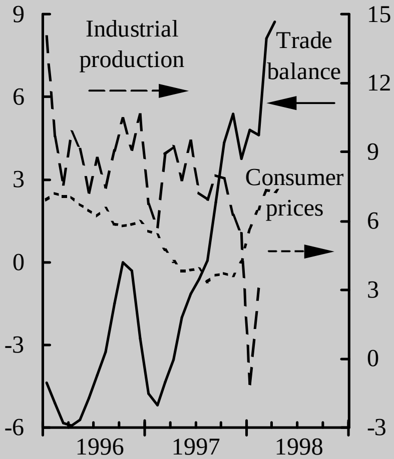
JPMorgan

Asian Financial Markets

Third Quarter 1998

Emerging Asia

US$ billion, 3mma *%oya*



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Uncertainty and adjustment pressures still dominate Asia

- The economic downturn that followed the financial crisis has been much deeper and broader-based across the region than expected, and this has triggered a whole new wave of market corrections. Growth forecasts have again been marked down sharply and regional real GDP (including Japan) is now expected to drop 1.9% in 1998. Moreover, uncertainty and downside risks predominate, especially concerning China and Japan.

But there are first signs that the free fall is coming to an end

- Although still mixed, second-quarter indicators point to some stabilization, as growing current account surpluses alleviate the balance-of-payments squeeze. Moreover, export volumes are rising from countries with sharply devalued currencies – notably from Korea and Thailand.

- Still, the region's next turn will depend largely on Japan, which fell into deep recession in the first half. In the second half, despite Japan's many political uncertainties and cyclical and structural headwinds, the government's recent fiscal stimulus package should be sufficient to arrest the downturn. The rub is that any growth will probably be only temporary.

- To avoid recession and offset its loss of export competitiveness, China has slowed the reform process and turned to domestic demand stimulus.

Asia now needs lower interest rates

- In the rest of the region, with the balance-of-payments crisis largely gone, currencies no longer in free fall, and inflation prospects mostly quite benign, it is time to cut interest rates. Thailand especially, and also Korea, have room to do so. However, in the countries with distressed banking systems, cutting interest rates will not be enough by itself to revive domestic demand. Instead, governments will have to shoulder much of the inevitable debt workout burden.

Region is not yet an investor market

- While liquidity conditions are likely to improve, Asia is not yet an investor market. Restructuring is still at an early stage, leaving too many risks for equity investors. However, with devaluation risks overpriced and interest rates falling, there are attractive trade opportunities in the region, especially in Korea and Thailand.

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Review and Outlook

Searching for a bottom

- **Financial market and real economic developments have surprised again on the downside**
- **But there are some first signs of stabilization**
- **Japan's fiscal stimulus and the prospect of lower interest rates in the rest of Asia are also pluses**
- **But normalcy will take years to recapture and much more restructuring will have to happen**
- **There are now more opportunities for currency and interest rate traders than for equity investors**

After the first quarter bounce, Asian financial market conditions slipped again in the second quarter. The deterioration was driven by two forces:

- First, evidence grew that Japan moved into a full-blown recession around the turn of the year. This, combined with the government's slow policy response, sent the yen and Nikkei into a tailspin and quickly affected markets in the rest of the region;

- Second, the recognition gradually took hold that the economic downturn that followed the financial crisis in the rest of Asia has turned out much deeper and broader-based across the region than expected.

Many uncertainties remain

- The results of Japan's Upper House election have sent a strong message to politicians, but the split majorities between the two houses of parliament increase the risk of political paralysis.

- China is struggling to avoid recession, while further yen weakness is putting pressure on the renminbi and the Hong Kong dollar.

- Corporate restructuring and its second-round effects will further undermine household incomes and confidence in most of Asia, and in some countries could lead to social and political instability.

Still, the output free fall is coming to an end

Against this background, it is difficult to be optimistic about Asia's near-term prospects. Nevertheless, there are developments that point to a shift in the trend. This shift is unlikely to be uniform. Some countries will see more weakness, while others may see early recoveries. But in the aggregate, these developments point toward an end to the region-wide free fall.

- First indicators for the second quarter point to an easing in the rate of output decline, and even to stabilization in some places, notably in countries such as Korea and Thailand that fell first and furthest.

- Export volumes from countries with sharp currency devaluations are rising smartly – notably from Indonesia, Korea, and Thailand – while a slowing of import declines helps to put a floor under export volumes from the rest of the region – notably Japan.

- Although lost in the confusion of Japan's recent election politics, the government actually announced in April a large fiscal stimulus package that subsequently passed both houses of parliament in June. This package is the largest in Japan's history (2.4% of GDP) and it is likely to arrest the economic downturn in the second half of the year.

- China has shifted policy focus from reforms to maintaining growth and labor market stability. No devaluation looks to be in the cards for some time, but state banks and regional governments have been ordered to boost lending and investment outlays.

Positive also is the prospect of lower interest rates. Balance of payments pressures and efforts to support plunging currencies dictated sharp interest rate hikes for a time. But with current account balances now in surplus and currencies no longer in free fall, the need for high rates is fading. Moreover, the benign inflation outlook creates ample room and need to cut interest rates in most countries, especially in Thailand.

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There will be more diversity of growth experience

- Japan's fiscal package plus the help of a weaker yen will arrest its economic downturn in the second half and there may even be some positive GDP growth. However, the economy is unlikely to stay airborne for long. The fiscal stimulus package is only temporary and whether the government and the opposition can agree on permanent tax cuts remains to be seen. Moreover, despite much talk, progress in restoring financial sector health is likely to be slow, muting the second-round effects of any policy stimulus.

- In the rest of Asia, countries that have experienced sharp output contractions and currency devaluations – especially Korea and Thailand – have the best chances for early export-led GDP recoveries, albeit from low levels. However, their banking sector problems will persist, even if they succeed in lowering interest rates, implying that their governments will have to assume a large chunk of the bad debts.

- Countries with relatively strong currencies are likely to suffer more weakness in activity unless they rapidly ease their policy stances. Here, Singapore and Taiwan are expected to give in, while Hong Kong seems willing to bite the bullet to maintain the peg.

- Finally, China will probably muddle through, stabilizing real GDP growth at around 6%. But there are downside risks, to both growth and the implications of the reform slowdown.

Who's afraid of a weaker yen?

The main downside risk to the scenario just presented would be a failure of the fiscal package to halt Japan's recession. Here, the uncertainties lie not so much in the implementation of the package but the cyclical and structural headwinds facing the economy. Japan is in a full recession with major downside momentum as corporates cut back on inventories and capital outlays, banks become reluctant to lend and even try to call back loans, and households adjust to unemployment increases. Plainly, if Japan fails to stop its downturn, the rest of the region will feel the drag.

However, a further depreciation of the yen should not be seen necessarily as a net negative for the region. To be sure, Korea, Singapore, and Taiwan would probably feel some competitive pressure, especially in the electronics sector, and their currencies would likely weaken in response. Moreover, there would probably be increased speculation on a renminbi and possibly a Hong Kong dollar devaluation. But in the final analysis, a weaker yen would simply make for a more competitive Asia in general and any benefit to Japan would be helpful to activity in the rest of the region.

Market implications are mixed

The prospect of growth stabilization yet also divergence has mixed financial market implications. A negative will be the developments expected to unfold in Japan. Increased policy paralysis will hurt the yen and the Nikkei even if the fiscal stimulus package puts a floor under output as expected. Moreover, fears of increased deficit spending are set to raise JGB yields despite BoJ efforts to keep funding rates low.

Although devaluations of the renminbi and Hong Kong dollar are not expected this year, the market's possibly aggressive anticipation of such events renders caution still advisable toward positioning in Asia. Caution is also an appropriate posture as central banks in the rest of the region are becoming more accommodative in their monetary policies. Still, the impact of easing on both currencies and long-term yields is likely to be modest, given the large current account improvements already achieved and the benign inflation prospects. Thus, positioning for interest rate declines is expected to yield attractive returns, especially in the Thai baht. The Singapore dollar and the Taiwan dollar, in contrast, are likely to underperform, given their relative strength and vulnerability to yen depreciation.

On the equities side, upside opportunities should stay limited for a while, despite the outlook for substantial liquidity improvement. There are clearly opportunities in individual stocks and for investors with patience, but there are also many and large uncertainties, given the early stage of Asia's corporate and financial-sector restructuring process and its still-slow reform progress.

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Asia one year after the start of the crisis

- **Uncertainty and adjustment pressures still dominate Asia, but there are first signs of stabilization**
- **Export performance is mixed, but volumes are up where currencies have dropped sharply**
- **Much depends on whether Japan can arrest its downturn and China avoid recession**
- **The region now needs lower interest rates – little stands in the way besides market uncertainties**
- **Governments in countries with insolvent banking systems are increasingly left to clean up the mess**

A full year after the crisis broke, gloom and doom still dominate Asia. The economic downturn following the financial crisis has run much deeper and more broadly across the region than expected and financial market conditions deteriorated again after a short respite in the first quarter. Moreover, many uncertainties remain. Much will depend on whether Japan can halt its downturn and China avoid becoming another victim of the crisis. Most corporate and financial sector restructuring still lies ahead, which will boost unemployment and undermine household incomes and confidence.

Against this background, it is tough to be confident about the prospects for recovery. However, there is likely to be increasing diversity across the region:

- Countries that are in a banking crisis and have experienced sharp real GDP contractions and currency devaluations – notably Korea and Thailand – have the best chance for an early export-led GDP recovery, although from very low levels. The focus in those countries is now on reducing interest rates. But even with lower rates, much will have to happen to restore corporate- and financial-sector health. And with reform progress still slow, governments will probably have to assume a large chunk of the bad debts. Indonesia and Malaysia also fall into this category, but while in Indonesia much will depend on first restoring political stability, real interest rates in Malaysia are already lower, which risks inflation and depositor flight.

Activity figures mixed, but show some stabilization
% quarter-on-quarter, seas. adj. annualized, unless stated

Country	Series*	97Q3	97Q4	98Q1	Latest	months**
All Asia	RGDP	3.4	-0.6	-7.6	n.a.	
ex Japan	RGDP	4.0	-0.3	-14.3	n.a.	
Japan	RGDP	3.2	-0.7	-5.3	n.a.	
	IP	0.6	-9.6	-3.8	-23.0	April-May
China***	RGDP	9.0	8.8	7.2	n.a.	
	IP	10.1	10.9	9.0	7.7	April-June
Hong Kong	RGDP	1.5	-4.4	-13.5	n.a.	
	RS	-4.5	-22.3	-34.7	7.4	April
Indonesia	RGDP	-0.6	-0.9	-27.9	-31.6	April-June
Korea	RGDP	8.4	-3.9	-33.1	n.a.	
	IP	7.3	-2.0	-30.2	-4.9	April-May
Malaysia	RGDP	6.3	9.5	-23.8	n.a.	
	IP	4.4	10.7	-18.5	-12.9	April-May
Philippines	RGDP	3.9	0.3	-1.1	n.a.	
Singapore	RGDP	5.9	0.8	0.5	n.a.	
	IP	8.1	8.5	-6.8	-16.4	April-May
Taiwan	RGDP	8.3	8.0	2.3	n.a.	
	IP	11.0	14.4	-7.4	3.1	April-May
Thailand	IP	-19.8	-26.5	-13.0	8.1	April

* RGDP = real GDP, IP = industrial production, RS = retail sales.
** Annualized % change of latest average from first quarter average.
*** Average %oya change.

- Countries with solvent financial systems – Hong Kong, the Philippines, Singapore, and Taiwan – have a choice between keeping relatively strong currencies and offsetting the impact of the regional crisis by accommodative policies. The Philippines is clearly following the latter path, while Singapore and Taiwan are still somewhat hesitant and Hong Kong is paying the price for maintaining the peg.

- China and Japan differ and yet are critical for Asia at large. Japan has ample resources to cure its banking problems and boost growth, but remains politically paralyzed. China finds a real conflict between maintaining growth and restructuring its banks and state enterprises. And with currency devaluation not an option for now, its reforms will have to slow.

The free fall is coming to an end...

First indicators for the second quarter point to an easing in the rate of output decline and even stabilization in some places. In Thailand, April industrial production

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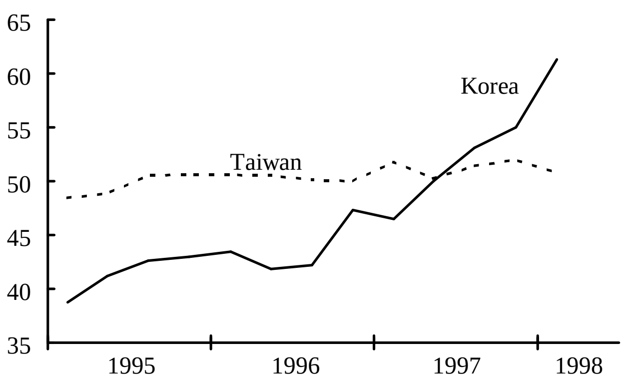
Some exports are rising and some are falling

On the surface, Asia's recent export performance is disappointing. Dollar-denominated exports fell an annualized 5.6% between 97Q2 and the April/May average for all of Asia and 2.5% for the region excluding Japan. Export values are down sharply for seven out of ten countries, with only China and the Philippines showing increases – although China's export boom is also starting to falter. Behind these disappointing overall figures, however, the recent trend is somewhat more encouraging.

- A big drag on exports is the high degree of intra-regional trade, which has been collapsing. With output now starting to stabilize, this drag will soon fade. At the same time, the fact that overall export values have not fallen more than implied by the regional downturn points to a fast shift toward export markets outside the region.
- Export volumes from countries that experienced sharp devaluations – notably Indonesia, Korea, and Thailand – have surged 20%-25% since the start of the crisis. The positive volume response suggests that credit constraints are not insuperable. However, the implied sharp drop in dollar export prices reduces profitability if exporters rely heavily on imports. Given Asia's already-large share in global trade and particular industries, further volume expansion will lead to more terms-of-trade declines and stiffer intraregional competition.
- The expected slowdown in the U.S. economy will mute Asia's export potential. However, more critical than general OECD demand conditions is the prospect of a Japanese recovery in the second half of the year (see page 8). Nor would further yen depreciation be a net negative for the rest of Asia. Korea, Singapore, and Taiwan would feel some competition and their currencies would probably weaken in response. But a lower yen would mean a more competitive region in general and any benefit to Japan would be a plus for the rest of Asia.
- In countries where currencies have dropped sharply and the collapse in domestic demand has boosted the export share in GDP (notably Korea and Thailand), exports will probably produce a recovery in output and inventories relatively quickly – although from very low levels. Countries with still relatively strong currencies (China, Singapore, Taiwan) will experience more export weakness.

Share of goods and services exports in GDP
%, seas. adj.



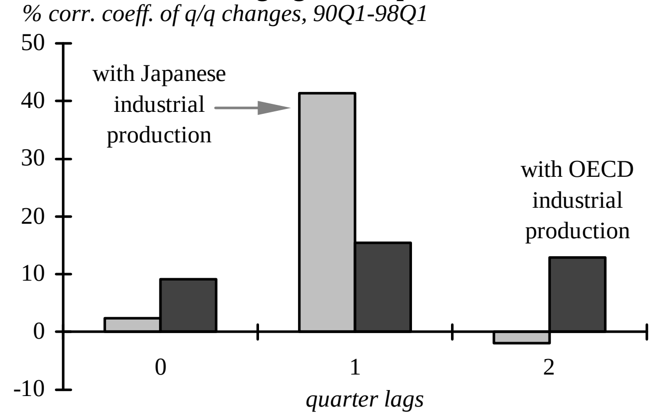
Dollar-denominated exports and export volumes
97Q2=100, seas. adj.

Country	Data	97Q3	97Q4	98Q1	Latest	Average
All Asia	value	101.8	99.2	97.4	94.9	April-May
ex Japan	value	103.2	101.0	101.6	97.7	April-May
Japan	value	99.4	96.3	90.5	90.1	April-May
	volume	*99.4*	*102.7*	*98.9*	*98.7*	*April-May*
China	value	104.7	102.1	109.1	103.5	April-June
Hong Kong	value	102.5	101.2	93.2	94.9	April-May
	volume	*104.3*	*103.1*	*95.7*	*98.7*	*April-May*
Indonesia	value	102.1	99.4	98.5	88.6	April
	volume	*106.8*	*102.2*	*126.0*	*121.7*	*April*
Korea	value	103.8	99.8	103.9	99.7	April-June
	volume	*105.7*	*111.7*	*124.3*	*125.7*	*April-May*
Malaysia	value	100.3	94.8	93.2	91.6	April-May
Philippines	value	101.9	107.2	113.1	117.9	April-May
Singapore	value	98.9	95.7	91.5	85.8	April-May
	volume	*101.3*	*102.5*	*102.8*	*98.3*	*April-May*
Taiwan	value	104.2	104.9	95.7	92.5	April-June
	volume	*108.5*	*117.9*	*110.4*	*103.9*	*April-May*
Thailand	value	101.4	101.9	98.9	93.0	April-May
	volume	*104.7*	*117.4*	*125.6*	*118.0*	*April-May*

Real effective exchange rates
97Q2=100

	Sep 97	Dec 97	Mar 98	Jun 98
Japan	101.2	99.1	99.8	92.1
Hong Kong	100.6	105.9	104.6	109.6
Indonesia	84.6	58.3	38.1	31.5
Korea	100.2	68.8	73.6	81.5
Malaysia	85.8	72.0	73.6	71.5
Philippines	84.4	77.8	79.0	73.9
Singapore	97.3	96.7	99.2	96.9
Taiwan	99.8	97.1	96.6	93.6
Thailand	78.4	66.5	72.9	72.5

Correlation of Emerging Asia export volumes*
% corr. coeff. of q/q changes, 90Q1-98Q1



* Hong Kong, Korea, Singapore, Taiwan (including re-exports).

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was above the first quarter average, and rates of output decline in Korea and, to a lesser extent, Malaysia slowed notably in April and May. Retail sales in Hong Kong, the territory's most important monthly economic indicator, rose in April, the first increase after nearly a year of month-on-month declines. The exceptions are: Indonesia, which has already reported an annualized 32% decline in real GDP between the first and second quarters; Japan, where business investment has been plunging and producers have been cutting back inventories; and Singapore, which has accelerated its catch "down" toward the rest of the region.

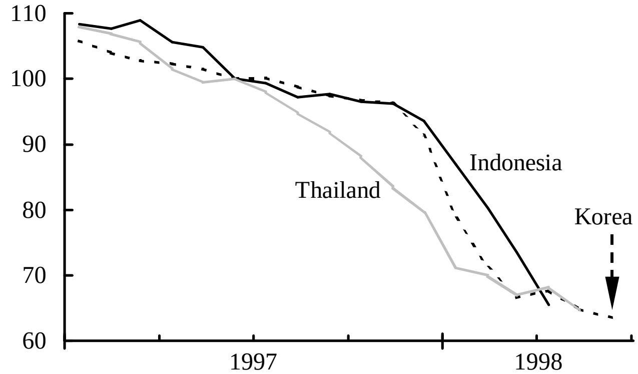
...as the balance-of-payments squeeze fades

In the crisis economies, the starting point for the recession was the sudden cutoff in the flow of funds (much of it from abroad) that had been financing large private-sector borrowing requirements. This payments squeeze forced a sudden and deep reduction in outlays, especially on capital goods, structures, and inventories, and was further compounded by a sharp tightening in monetary and fiscal policies. Not surprisingly, imports plunged 30%-40%, shifting current account balances from deficit to surplus. The turnaround in external balances, however, is exactly what is now removing the pressure for further spending cuts and starting to put a floor under production and imports.

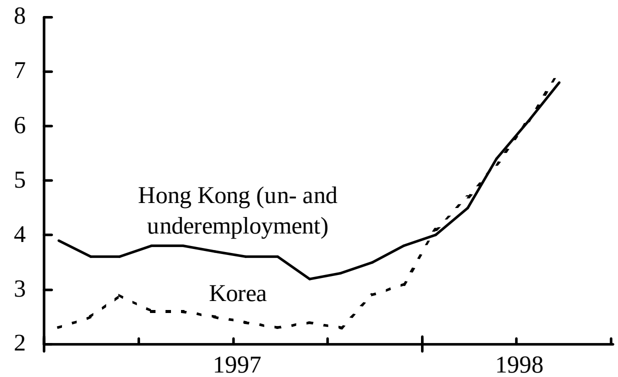
But second-round effects will last a while longer

Despite much improved balance-of-payments conditions, second-round effects of the original shock will remain drags on demand both within the crisis economies and across the region. The demand collapse in the crisis economies is pulling down exports in the strong economies. Labor market conditions are adjusting to much lower output levels and corporate restructuring, with rising unemployment squeezing consumer spending. Banks, with or without heavy loan losses, have become reluctant to lend. And wealth, even in the strong countries, has been eroded by the plunge in asset values. These adjustment forces are likely to remain drags on demand for some time. Thus, although the free-fall phase is ending, capital spending is also constrained by past excesses and high real interest rates, which means that the near-term direction of overall GDP will depend much on the performance of exports.

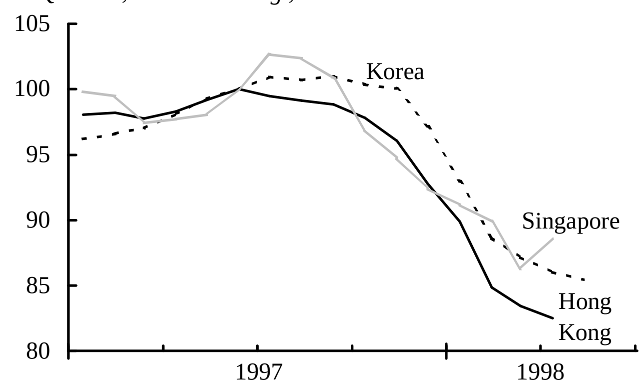
The import squeeze in the IMF-3 is starting to ease...
97Q2=100, US$ terms, 3-mo. mov. avg., sa



...but unenployment is on the rise, ...
% of labor force



...keeping retail sales under downward pressure
97Q2=100, 3-mo. mov. avg., sa



Some export-led recoveries are starting to unfold

In dollar terms, the region's export performance appears to be uniformly disappointing except for the Philippines' continued double-digit export growth rate. However, a closer look at the available export volume data shows a different picture (see facing page). Export volumes from countries that experienced sharp currency devaluations are rising smartly (Indonesia, Korea, and Thailand), while export volumes are falling

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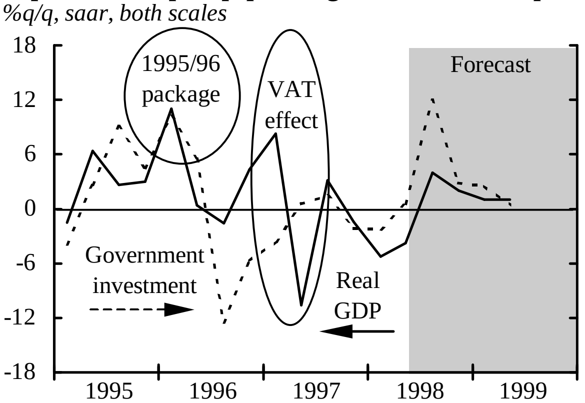
Arresting Japan's downturn in the second half

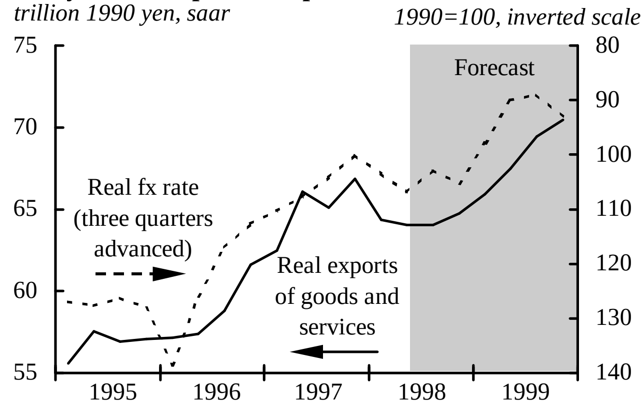
The Japanese economy is in the midst of a hard landing, but the latest fiscal package plus yen depreciation are expected to arrest the recession in the second half and possibly lead to some positive though temporary growth (see also Japan outlook, page 23).

- The new fiscal package, which was announced on April 24 and passed both houses of parliament by June 17, is the largest stimulus package in Japan's history. The headline figure of ¥16.0 trillion exceeds even the ¥14.2 trillion of the previous fiscal program in 1995/96. In net terms, the new fiscal measures amount to ¥12.0 trillion (2.4% of GDP) versus ¥7.4 trillion (1.6% of GDP) in 1995/96. Of the net, ¥7.7 trillion are earmarked for public work programs and ¥4.3 trillion for tax cuts and rebates. Given the short implementation period of public work programs, the bulk of the spending stimulus should boost output in the third quarter, with smaller increases to follow in the fourth quarter and the first quarter of 1999. Overall, real public investment is likely to rise an annualized 18% between this summer and next spring.
- Starting from the fourth quarter, yen depreciation will add to the growth recovery. The collapse of Japanese exports to the rest of Asia is coming to an end as the free fall in the rest of the region starts to reach a bottom – export volumes already stabilized in April/May (see page 6). The yen is already down more than 10% from a year ago and is expected to fall another 10% through year end. With Japanese exports typically responding to a real effective exchange rate depreciation with a two-to-three quarter lag, real exports of goods and services are likely to accelerate in the third or fourth quarters. The expected slowdown in the U.S. economy and still soft demand conditions in the rest of Asia will probably moderate the export recovery but not offset the yen stimulus. Overall, real exports of goods and services are expected to rise an annualized 2% in the second half and another 8.5% in the first half of 1999.
- Nevertheless, the final growth impact of the fiscal package and the yen's decline is likely to be much smaller than in 1995/96. Given very high inventory levels (both in absolute terms and relative to sales), part of the initial demand recovery will be absorbed by destocking. Moreover, unlike in 1995/96, corporate restructuring is advancing, while the plight of the banking system is further constraining bank lending. Consequently, unemployment is likely to rise further, reducing households' spending power and confidence, and business investment will probably continue to edge lower. And in a pattern similar to what followed the stimulus package in 1995/96, growth is expected to slip again during 1999, as the fiscal stimulus is only temporary and second-round effects are likely to remain small due to ongoing structural obstacles.

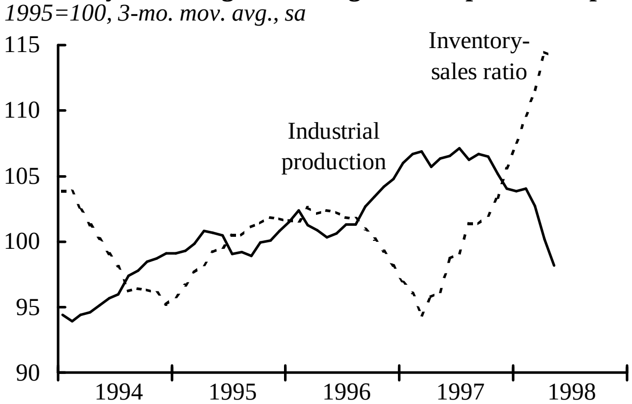
Japan's fiscal pump-priming now and in the past
%q/q, saar, both scales



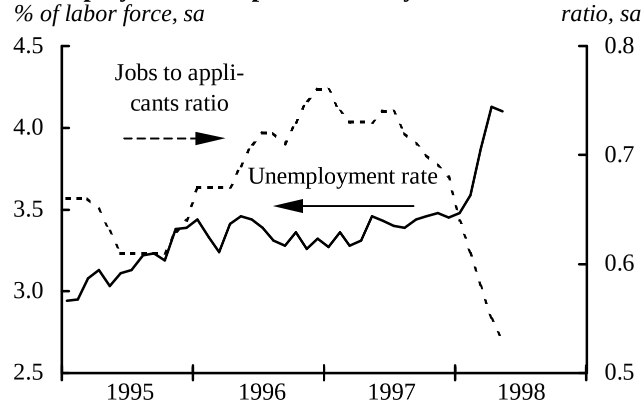
The yen and Japanese exports
trillion 1990 yen, saar *1990=100, inverted scale*



Inventory overhangs loom large over Japanese output
1995=100, 3-mo. mov. avg., sa



Unemployment is Japan's latest cyclical headwind
% of labor force, sa *ratio, sa*



continued from page 7

from countries with only modest currency adjustments or none (Hong Kong, Japan, Singapore, and Taiwan). These differences are likely to last for a few more quarters and result in different growth profiles.

- There are limits to how much exports can grow, given external demand constraints, especially the prospect of a U.S. slowdown, and the already-large share of Asian exports in global trade and particular industries. Nevertheless, export volumes from countries with much more competitive currencies are likely to grow further, which should lead to positive real GDP growth by the turn of the year, given the growing export sector shares in these economies.

- Although the pulldown effect of the regional demand collapse is already declining, export volumes from countries with still relatively strong currencies are likely to fall further, which could lead to prolonged economic slowdowns or even recessions unless the drag is offset by strong policy stimulus.

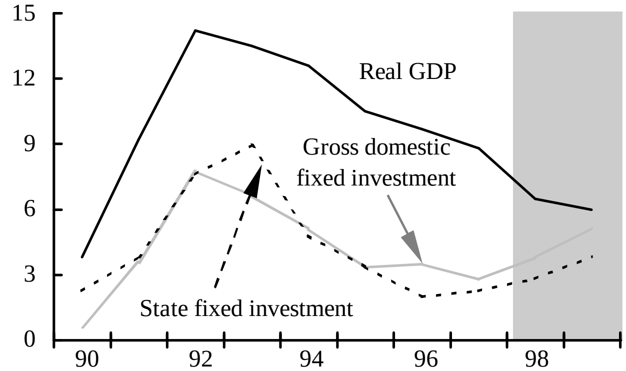
Japan's stimulus is strong but temporary

One country that is already in recession and that needs a stimulus is Japan. Moreover, stimulus is critical not only for Japan's own business cycle but also for the rest of the region (see page 6).

Somewhat lost amid Japan's recent election politics is the fact that the big fiscal stimulus package announced in April passed both houses of parliament in June (see facing page). This package is Japan's largest ever and despite strong cyclical headwinds should stop the downturn and possibly lift real GDP by an annualized 2.5% in the second half. A plus for Japan's business cycle is also the government's tolerance of a weak yen, which already has fallen 10% since 1998 opened and is likely to fall another 10% through year end.

The bad news is that the new fiscal stimulus measures are of a temporary nature only. There is much talk of permanent tax cuts, but these are not an executive decision. To implement a permanent tax cut, the government needs a tax plan from the tax commission, which is unlikely to be finished before year end. Moreover, the government must win a majority in parliament to change the law that requires reduction of the budget

State investment matters a lot for China's growth
%oya and % contribution to real GDP growth



deficit to 3% of GDP by the year 2005, a change even more uncertain now after the recent election results. Thus, with structural and cyclical headwinds likely to persist and the prospect of more fiscal stimulus uncertain, growth is set to slip again during 1999.

China struggles to maintain growth

Another country vital to the region and again in need of stimulus is China. Thanks to its still largely closed nature and strong external balances, China has not been pulled into the regional turmoil. But the budget constraints brought by state sector and banking system reform have slowed domestic demand to an almost deflationary degree, while the lack of currency adjustment is starting to impede exports. Given the pressure on Hong Kong, plus the regional and global political influence that China gains by holding its currency fixed, a devaluation (although eventually inevitable) is probably not its preferred policy option for some time.

To avoid a further slowdown or even recession, China needs to revive domestic demand. But with households facing many new uncertainties and therefore likely to be cautious, stimulus must come mainly from the government's traditional policy tools. Indeed, Beijing is already pressuring state banks to increase lending to infrastructure and housing projects and the export sector. Interest rates have been cut and tax rebates to certain exporters have been increased. Ultimately, much of the stimulus will boost fixed investment by the state sector, which already rose 12.7% in January-May from the same period a year ago – up from 8% growth in all of 1997. But while a boost to state investment (20% of the economy) has a good chance of stabilizing real

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Inflation is no block to interest rate declines

Many factors determine policymakers' latitude to cut interest rates, but inflation is clearly one of the most important. A useful guide to the scope for interest rate cuts comes therefore from real interest rates and comparison of current interest rates and inflation prospects with past interest rate and inflation averages.

- Although an acceleration in inflation was unavoidable in countries where currencies dropped sharply, the fallout has been surprisingly contained with the notable exception of Indonesia. This reflects the tightness in monetary conditions and the consequent collapse in domestic demand as well as wage and fiscal discipline. In fact, price dynamics seem to be shifting from inflation to deflation in some countries – Korea's CPI fell an annualized 3.5% from February to June. In countries with relatively strong currencies – notably China, Singapore, and Taiwan – inflation rates are hovering just around zero.
- Moreover, given the slump in regional domestic demand and the improbability of a quick recovery, inflation prospects for the rest of this year and into 1999 augur more declines. With the exception of Indonesia and to a lesser degree Malaysia and Thailand, inflation rates are expected to fall well below their historical averages. In contrast, most countries' current short-term interest rates are well above their past averages, pointing to unusually high real interest rates.
- By this test, the country with by far the highest real interest rates is Thailand. Given the slump in the economy, this points to a rate cut potential of as much as 1000 basis points. In contrast, Indonesian interest rates will probably have to rise to offset the high inflation uncertainties. In Korea, where nominal interest rates have come down a lot more than Thailand's, an appreciating currency and the prospect of near deflation still leaves room to cut interest rates by as much as another 400 basis points.
- China's past average of roughly zero real interest rates was probably too low, but with real rates now at 7%, it surely has room to cut. Singapore and Taiwan also have no reason to worry about inflation, but should lower interest rates to cushion their economies against the spillover effects of the regional downturn. However, inflation should be more of a worry for Malaysia and the Philippines and there already relatively low interest rates leave less room to cut. Hong Kong's real interest rates are also unusually high by past standards, but here interest rates are driven entirely by the peg commitment.

Interest rates and inflation constraints

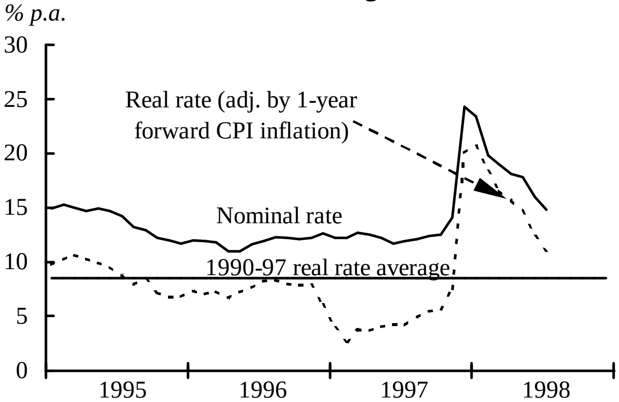
percent annualized

	Short-term interest rates				CPI inflation rates						Room to cut interest rates*
	Average 1990-97	96 Dec	97 Dec	98 Jul	Average 1990-97	96 Dec	97 Dec	98 Jul	Forecasts 98 Dec	Forecasts 99 Dec	(basis points)
China	10.1	10.0	9.0	6.9	10.0	7.0	0.4	-1.3	-1.5	1.0	200-400
Hong Kong	5.9	5.6	9.4	9.0	8.7	6.6	5.2	4.6#	1.8	-0.2	Peg driven
Indonesia	16.9	13.3	28.5	60.0	8.4	6.6	11.6	59.5	80.0	13.0	None
Korea	14.5	12.6	24.3	14.8	6.1	4.9	6.6	7.5	4.5	3.3	200-400
Malaysia	7.0	7.3	9.1	11.0	3.6	3.3	2.9	6.2	8.0	6.8	0-150
Philippines	15.5	11.7	18.1	14.8	10.0	5.2	6.1	10.7	11.5	6.0	0-150
Singapore	4.1	3.0	6.5	6.6	2.5	2.0	2.0	0.5#	1.5	1.9	200-350
Taiwan	7.4	5.8	8.4	7.1	3.4	2.5	0.3	1.4	2.0	0.2	150-250
Thailand	12.0	9.3	27.0	20.0	5.2	4.8	7.6	10.6	9.0	6.0	600-1000

* This measure is not a forecast or policy recommendation and is instead based solely on the inflation outlook.
# May 1998.

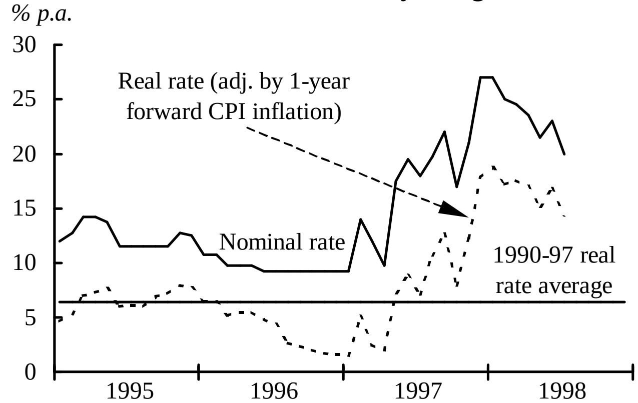
Korea's interest rates are falling...

% p.a.



... but Thai interest rates have stayed high

% p.a.



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GDP growth at around 6%, it is also set to delay the reform process and potentially create new distortions that will have to be corrected later (see also page 30).

Singapore and Taiwan can ease, Hong Kong not

For Singapore and Taiwan also, policy stimulus is the right response to the crisis. Given their reliance on trade and manufacturing, both need more competitive currencies, which means lower interest rates. Moreover, there is scope for fiscal stimulus, especially in Singapore. The Philippines has no room fiscally, but has not resisted currency adjustment and has already brought down interest rates. Only Hong Kong has little room to stimulate the economy, as long as it keeps the peg. Given the importance of monetary stability for Hong Kong as a financial center, a devaluation would cause more problems than it would solve. Thus, recession is the bitter price to pay, but domestic price adjustment seems to be proceeding quickly and without collapsing the banking system (see also page 31).

Asia needs much lower interest rates now

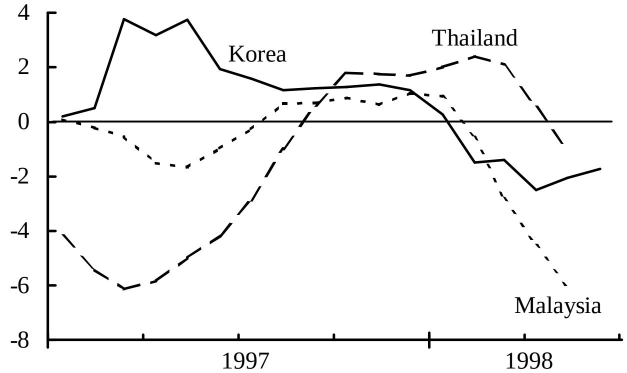
Besides the need and room for policy stimulus in most of the non-crisis countries, there is a general need for lower short-term interest rates in the region, especially the crisis economies. Short-term interest rates soared during the financial crisis, partly in response to balance-of-payments pressures and partly as a result of monetary policy tightening to support plunging currencies. But the need for tight short-term rates is largely gone and it is time to ease, given the economic slump.

- Current account and balance-of-payments positions have shifted from deficit to surplus and currencies are no longer in free fall. Only the Indonesian rupiah remains vulnerable to domestic capital flight.

- Despite many countries' banking troubles and flight-to-quality problems, overall depositor confidence has been largely maintained, as seen in still-high broad money supply growth rates. The big exception is Indonesia and to a lesser degree Malaysia.

- Contrary to widespread fears, the inflation fallout following the large-scale devaluations has been benign, except in Indonesia.

M2 growth is still high, but falling in Malaysia
%oya, 3-mo. mov. avg., difference from 5-year trend



Indeed, the lack of inflationary pressures, and in some cases even deflationary trends, leaves ample scope for interest rate declines (see facing page). Thailand, especially, has the room and need to cut short-term rates, but unlike Korea has not been very successful so far. The obstacles here have been adverse market conditions and the BoT's struggle to collect enough foreign reserves to repay its forward obligations. However, these pressures should fade soon, leaving little to prevent cutting interest rates.

Lower interest rates not sufficient to boost demand

Still, Japan's experience shows that lower short-term interest rates will not alone revive domestic demand if the banking system is essentially insolvent and lacks capital to expand its balance sheet. In fact, where banking regulation and supervision are poor, low interest rates may prolong a credit crunch, as banks feel little pressure to address their balance sheet problems.

Restoring financial sector health is thus key for a return to normalcy. Unfortunately, reform progress remains disappointing in both Japan and the other crisis-hit economies in Emerging Asia. Recognition of the size and depth of the banking problems still lags reality (see next page), while pressures from shareholders, businesses, and unions often compromise the political will to accelerate reforms. And even where political will is stronger, the poor shape of accounting, legal, and supervisory standards is often insuperable. Moreover, much still has to happen to restructure the operations and debts of the borrowers, such as corporates in Korea or real estate developers in Japan and Thailand. Worse, with reforms and loss recognition proceeding slowly, the high cost of carry and the impact of recession will further erode debtors' ability to pay and banks' asset quality.

Governments will have to absorb much of the debt

With transparent and market-based reforms unlikely to progress rapidly, and with foreign and domestic investors apt to remain sidelined for some time, the burden of absorbing banks' bad loans will increasingly fall on governments. To some extent, this has already happened in countries where the central bank's lender-of-last-resort activities have effectively put the government in control of a large number of banks – notably in Indonesia, Korea, and Thailand. Nationalizing large parts of a banking system and its bad loans does not raise the level of outstanding debt and once economies return to normalcy governments can again sell the acquired assets. But in the meantime, governments have to fund the interest expense of the assumed debts. Given the size of the potential bailout and even assuming relatively low interest rates, additional interest payments could easily amount to 2%-5% of GDP. With fiscal balances already under cyclical pressure and little room left to cut spending or raise taxes, debt financing is the main alternative. Some funding will also come from privatization proceeds, but with many state enterprises in need of restructuring, revenues are unlikely to come in quickly and in large amounts.

With saving rates and deposit growth still high in most countries, but investment rates and credit growth down sharply and unlikely to bounce back quickly, most demand for government bonds is likely to come from domestic buyers, especially banks. In fact, buying low-risk government bonds will help banks restore asset quality. And issuing government bonds will serve as a catalyst for disintermediation and the development of corporate bond markets. Still, the bank balance sheet and public deficit adjustment process will take time and depress economic growth for several years.

Banking-sector recapitalization needs are huge and consolidation progress has been slow

J.P. Morgan's analysts estimate that nonperforming loans (NPLs) in countries with distressed banking systems range from about 50% of total loans in Indonesia to 18% in Japan. These figures are based on sometimes sketchy information and are thus fluid. NPLs in Japan are mostly the unresolved legacy of the bursting of the asset bubble in the late 1980s. (The 18% figure compares to the official estimate of 14.5%; neither estimate makes much allowance for possible credit deterioration, especially among corporates, resulting from the current recession.) To build bank capital back to the 8% BIS CAR level, assuming recovery rates of 25% to 65% on NPLs (the higher figure being more likely where, as in Japan, banks have taken significant write-downs already), would require injection of funds amounting to 20%-30% of GDP for these insolvent banking systems.

Against the scale of need, relatively little has been done so far. There has been little consolidation in Japan's banking sector, while the ¥30 trillion banking package is worth only 4.5% of GDP and the proposed "Bridge Bank" is not meant to get any extra funding. In Emerging Asia, Indonesia's situation is extreme. Thailand has consolidated its system the most; the liabilities are now the government's, but only a few of the existing banks are financially viable. In Korea, consolidation has been minimal, but the government plans to spend more than 10% of GDP to buy NPLs. In Malaysia, all finance companies are to be merged, yet nothing has been concluded. But the government's new programs to help banks write off NPLs and raise new capital potentially covers more than half the recapitalization need.

J.P. Morgan estimates as of June 1998

	Japan	Indonesia	Korea	Malaysia	Thailand
Domestic credit (% of GDP)	170	75	165	165	155
Nonperforming loans (% of total)	18	50	30	25	30
Recapitalization need* (% of GDP)	20	30	30	22	30
Original number of financial institutions	4,911	240	169	89	132
Closed/suspended	4	23	19	none	56
Nationalized/under supervision	7	47	2	none	11
Merged/to be merged	2	none	5	61	1
Bought by foreigners/ joint ventures	8	none	none	none	4

* The estimated amount of capital needed to restore 8% BIS CAR after writing off NPLs (assuming 60% recovery) and assuming no losses to depositors. These funds could come from the government, by sales of equity to the public (either initially or later in partial repayment of government support), by foreign investment in the sector, or by gradual accumulation of retained earnings. The funds are not necessarily needed immediately, as institutions can continue to operate with little or no capital if backed by credible government guarantee. In addition, even after full restructuring, banking sectors may well be smaller relative to GDP than prior to the crisis. This will almost certainly be true in Japan, where the securities markets already play a substantially larger role in the financial system.

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Another missed opportunity for India

- **India has missed opportunity to revive reform process and distinguish itself from rest of Asia**
- **Though set to fall, an uncompetitive rupee is squeezing growth**
- **Growth is impeded too by government-caused distortions of real economy and financial sector**

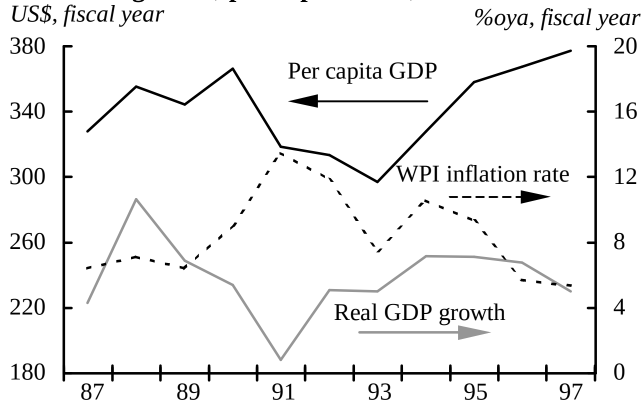
Until the outbreak of the Asian financial crisis last year, India had gone a long way to recover from its debt crisis in 1991: Investment, trade, and market deregulations had revived activity and brought in fresh foreign capital; real GDP growth rose to a respectable 7% annual clip; dollar-denominated per-capita GDP recovered from the steep declines of 1991-93; inflation was brought back into single digits; and foreign reserves surged more than a tenfold to nearly US$26 billion. Moreover, India largely escaped the first round of Asia's financial turmoil and there was hope that it would differentiate itself from the rest of the region.

But as so many times before, India has again missed its opportunity. Financial market conditions have visibly deteriorated in the last few months and the already ailing economy has not been isolated from the trade adjustment that has followed Asia's currency turmoil. To make matters worse, instead of reviving the stalled reform process, the new BJP-led coalition government has opted for confrontation with Pakistan and populist fiscal and trade measures that look sure to bloat the already-large budget deficit but will do little to lift investor sentiment and economic growth.

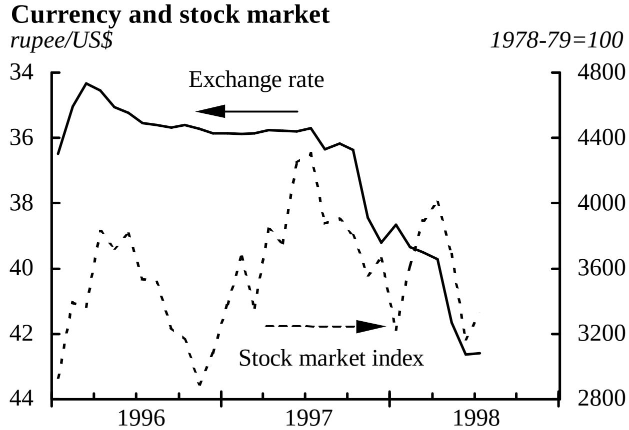
Growth is falling several gears...

Real GDP grew an estimated 5% in the fiscal year ended last March, down two percentage points from the 7% pace seen in the previous three fiscal years. Part of the slowdown was a weather-related slump in the agriculture sector. More disturbing has been the slowdown in the industrial sector, where growth slipped from double digits into low single digits – output rose just 3.4%oya in the three-month average from March to May. And while the agricultural slump is likely to turn going forward, industrial activity looks fated to remain weak, thanks largely to falling exports.

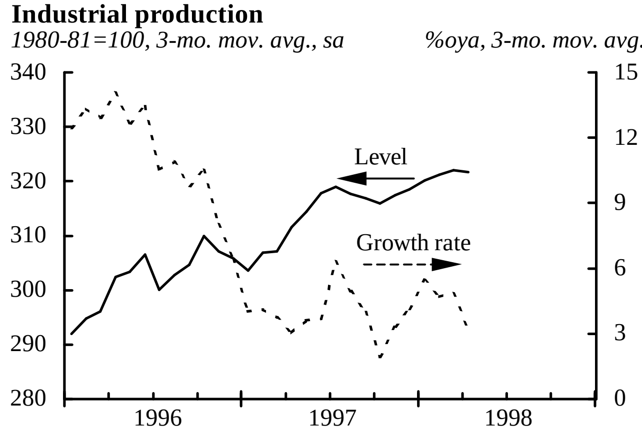
Economic growth, per capita GDP, and inflation



Currency and stock market



Industrial production



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...as an overvalued currency undermines exports

Dollar-denominated exports rose a modest 1% in FY1997/98 – while imports increased 3.4% – and fell an annualized 6.6% between last December and May. In the absence of strong domestic demand, the poor trade results reflect a loss of currency competitiveness, a trend that started twelve months prior to the outbreak of the Asian currency crisis when the central bank maintained a stable exchange rate in an environment of dollar strength and domestic cost pressures. And while the rupee has fallen 16% against the greenback in the last 12 months, this has not yet been sufficient to restore competitiveness, given the dollar's strength and the sharp devaluations in the rest of Asia.

Rupee to fall further to renew competitiveness,...

The trade deterioration is likely to put further pressure on the currency until competitiveness has been restored. Currency pressure is also set to come from a decline in foreign capital inflows. Portfolio capital inflows already fell 50% last fiscal year and are set to fall further, given poor market performance and the recent downgrade of India's credit rating by Moody's. Direct investment inflows were still up last fiscal year, but are unlikely to rise further given the decline in investor sentiment.

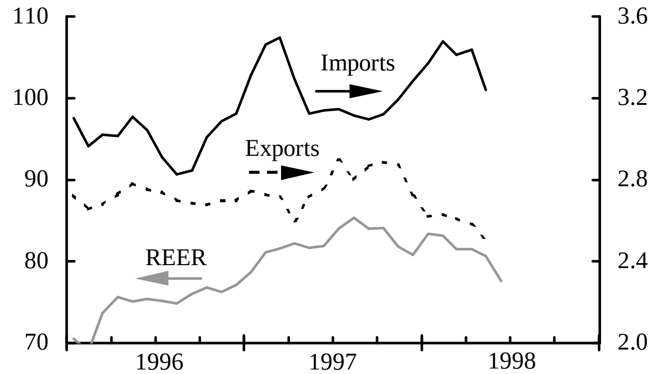
Indian residents can transfer only very limited amounts of money out of the country, but the record inflow of remittances from Indian nationals living abroad is unlikely to rise much further to offset the trade and capital account shortfalls. Finally, while the Reserve Bank of India has sufficient reserves to defend the currency for some time, the traumatic memories of the balance-of-payments crisis in 1991 are likely to prevent it from arresting the rupee's downward trend.

...but government-caused distortions remain

Yet while the rupee is expected to fall at least another 10% in the coming 12 months to restore competitiveness, this alone will not be enough to push India back to the 7% growth path seen in 1994-96. Here, the key obstacle remains the government's failure to revive the reform process and reduce its dominant role as an owner of enterprises and banks, absorber of saving, and allocator of real and financial assets.

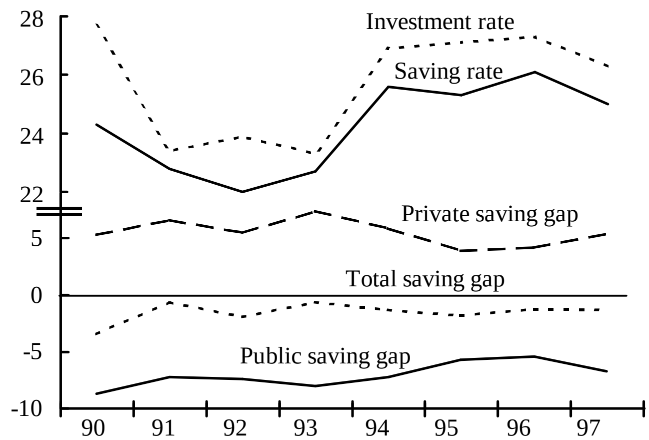
Trade and real effective exchange rate

1990=100 *US$ billion, 3-mo. mov. avg. sa*



Saving and investment rates

% of GDP, fiscal year



The government's chronic saving gap

One of the key factors restraining India's growth potential is its relatively low saving rate – 25% of GDP over the last five years versus an average of 35% in the rest of Asia. Part of the problem is India's high crude birth rate and, thus, low labor force participation rate. Still, the key problem is the government's chronic saving gap and, here, the central government's budget plan for fiscal year 1998/99 provides no change for the better.

- On the expenditure side, consolidation is not made a priority. Total spending is to rise nearly 14%, with all major spending blocks showing double-digit growth except for grants to state and union territories. But even these grants could shoot up as the year goes by, given the fragility of the coalition union government and the resulting temptation to use fiscal outlays to buy support from state governments.

- On the revenue side, the government is expecting big increases to offset the rise in outlays. But except for an additional 8% import duty (later cut to 4%), this is based not on higher tax rates or privatization proceeds but on a projected 14.8% increase in nominal GDP, which will probably be disappointed. In turn, this year's budget deficit is likely to reach 6.6% of GDP, higher than the government's projection of 5.6% and last year's deficit of 6.1%.

Tax distortions and subsidies

An inefficient tax structure and numerous subsidies are the main reasons behind the government's huge deficits and many other distortions in the economy.

- Although revenues from direct taxes have increased in recent years, they are still low as a percent of GDP. This is not uncommon for countries of India's developmental state, yet high tax deductions for new investments, for example, have not only undermined tax revenues but also cause corporates to reinvest their profits in unrelated and inefficient projects.

- The tax exemption of farming incomes is intended to support small farmers, but mostly benefits large landowners and foregoes huge revenues.

- The low direct tax take also explains the government's reluctance to cut indirect taxes. The justification for the additional import duty in this year's budget was to create a level playing field, since levies on domestic goods have been 8% higher than on imports. The right micro response would have been to cut domestic levies, but this would have led to a shortfall in tax revenues. Instead, import duties now average roughly 35%, putting India close to winning the world cup for protection.

- A recent government report showed total gross subsidies at 18.4% of GDP and net subsidies at 13.6% (after repayments), with the central government accounting for 30% of the net and state governments for the rest. To be sure, many of these subsidies are considered normal outlays in other countries. Nevertheless, numerous subsidies such as those for fertilizers, energy, transport, and higher education have led to abuse and wasteful use of resources.

Central government budget outlook
% of GDP, fiscal year

	1997/98	1998/99 forecasts	
	actual	Government	J.P. Morgan
Total revenues	10.5	10.9	10.0
Tax revenues	7.0	7.2	6.5
Total expenditures	16.6	16.5	16.7
Budget balance	-6.1	-5.6	-6.6
Nominal GDP (%oya)	10.3	14.8	12.0
Real GDP (%oya)	5.0	7.0	4.5

General government tax collection
% of GDP, fiscal year

	1991/92	1992/93	1995/96	1997/98
Direct taxes	2.5	2.6	3.0	3.6
Corporate taxes	1.3	1.3	1.5	1.5
Income tax	1.1	1.1	1.3	1.3
Indirect taxes	8.3	7.8	6.9	6.4
Customs	3.6	3.4	3.2	2.9

Government subsidies
% of GDP, fiscal year 1994/95

	Gross subsidy	Recovery rate*	Net subsidy
Total	18.4	26.2	13.5
Central	7.8	48.3	4.0
States	10.6	10.0	9.5

* % of gross subsidy.

Output and government ownership of state enterprises
percent, fiscal year

	1981/82	1991/92	1992/93	1994/95	1995/96
Output*	20.8	26.4	27.2	27.3	26.7
Ownership**	100.0	97.9	89.0	83.4	82.0

* % of GDP.
** Central government % average holding of 40 largest state enterprises.

State firms account for more than 25% of GDP

Besides fiscal policy, another source of distortions and inefficiencies in the economy is the government's large ownership of state enterprises. The output share of India's state enterprises in GDP has increased to more than 26% from 21% in the early 1980s. And even though the government's share of equity in state enterprises has declined by nearly a fifth from roughly 100% in the early 1980s, this was due mostly to new equity issuance to the private sector and not public disinvestment – privatization proceeds accounted for only 0.6% of total revenues in the 1997/98 budget.

Infrastructure, in particular the power sector, is an area dominated by state enterprises. Being a public good, infrastructure has a long history of government involvement that is not limited to India. But while increased private supply, privatization, reduction of subsidies and subventions, and market-based pricing of infrastructure products and services are now well established trends in both industrial and emerging economies, India is clearly a laggard.

In the state power sector, for example, subsidies, especially to agriculture, account for 1.6% of GDP. Despite government subventions and positive net earnings from sales to other sectors, the state power sector is persistently running commercial losses equivalent to 0.7% of GDP – which implies a negative rate of return of nearly 18%. The poor financial and managerial conditions of the state power sector have adversely affected the addition of new capacity. In turn, thanks also to low load factors, heavy transmission and distribution losses and other inefficiencies, the growth rate of electricity production has been consistently insufficient to support the economy's real GDP growth potential.

To address the energy shortages, central and state governments have enacted reform bills and set up new regulatory commissions in the last few years, but without any significant impact so far. Central plan outlays for the energy sector have been boosted in the 1998/99 budget plan, but much of the additional funding is supposed to come from government-guaranteed borrowing by the National Thermal Power Corporation and Coal India, effectively raising off-balance sheet public borrowing by another 0.6% of GDP.

Financial performance of state power sector
% of equity, fiscal year end

	1996/97	1997/98	1998/99*
Losses due to subsidies	-36.7	-39.6	-40.8
(% of GDP)	*-1.6*	*-1.6*	*-1.6*
Agriculture	-28.4	-31.1	-32.0
Government subventions	11.4	6.5	6.0
Other net earnings	8.1	15.5	17.0
Commercial losses	-17.2	-17.6	-17.8
(% of GDP)	*-0.8*	*-0.7*	*-0.7*
Electricity generated (%oya)	8.3	3.8	6.7

* Official target.

Central plan outlays
% of GDP, fiscal year

	1996/97	1997/98	1998/99*
Total outlays	6.0	5.7	6.5
Energy	1.5	1.5	1.9
Transport	1.1	0.9	1.0
Communications	0.8	0.8	0.9
Funding			
Central government	2.4	2.4	2.6
Public enterprises	3.6	3.3	3.9

* Official target.

Scheduled commercial banks' performance
%, 1996/97 fiscal year end

	Share of deposits	NPLs*	Profit margin**
State Bank of India	26.4	7.1	0.8
Nationalized banks	53.1	10.7	0.4
Public-sector banks	3.2	9.2	0.6
Private banks	10.0	5.0	1.2
Foreign banks	7.3	2.5	1.4
Total	100.0	8.5	0.7

* % of total loans.
** % of working capital.

Banks are an extension of fiscal policy

The banking sector is another area of large government ownership and involvement. Roughly 83% of all bank deposits and 82% of all bank assets are with government-controlled banks. The banking sector plays two key roles for the government: First, it is the main source of funding for the government deficit; second, it is a large source of funding for so-called priority sectors. Not surprisingly, these functions create additional distortions and inefficiencies and have negative consequences for banks' financial performance.

The requirement to fund the government deficit...

All banks – public, private, and foreign – are required to invest 25% of their deposits in government securities. And while this policy has helped reduce direct financing of the government's budget deficit by the Reserve Bank of India, it has caused a substantial crowding-out effect in the private sector – the loan deposit ratio in India is just 64% and commercial lending rates are between 250 and 650 basis points higher than treasury bill rates. Moreover, given the low interest rate on treasury bills, banks have only limited room to

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raise deposit rates to attract new funds or otherwise suffer losses, which explains in part the economy's relatively low monetization – the shares of deposits and M3 in GDP are 47.7% and 58.0% respectively.

...and lend to priority sectors...

Domestic public and private banks are required to direct 40% of their loans (foreign banks, 32%) to agriculture, small industries, exporters, and other so-called priority sectors. In reality, bank lending to priority sectors varies depending on overall credit demand conditions. In years of strong credit demand, the relative share of the priority sector in new bank loans usually declines below 40%, but remains large enough to limit banks' ability to lend to non-priority sectors. In times of weak credit demand, the priority sector's share in new loans rises much above the 40% mark.

Unfortunately, the priority-lending programs create substantial moral hazard problems and severely undermine banks' financial performance. Investments in the agricultural sector, for example, rely increasingly on bank funding. However, even though the default rate has come down somewhat in the last few years, it stands still at a shocking 37% of scheduled loan repayments. The requirement on banks to lend to the agriculture sector creates negative incentives for farmers to repay their loans and for banks to extend loans beyond the legal requirement even if a project is viable.

Credit growth and distribution
%, fiscal year

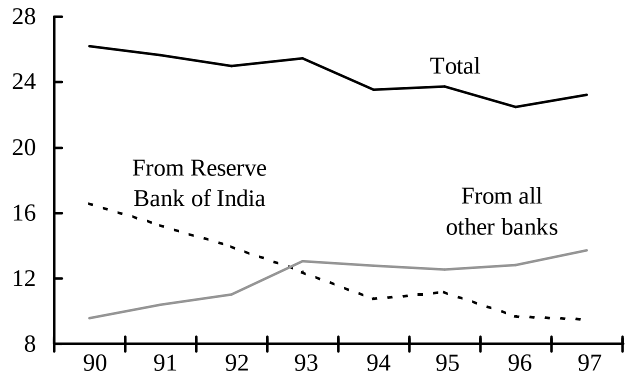
	1995/96	1996/97	1997/98*
Gross nonfood bank credit** (%oya)	20.2	8.9	11.7
Share of gross increase:			
Priority sectors	26.3	49.3	30.6
Agriculture	8.2	19.4	8.5
Small industries	11.4	11.3	17.2
Other	6.7	18.6	4.9
Medium/large industries	49.2	35.3	34.4
Wholesale trade	6.0	-0.3	3.4
Other	18.5	15.7	31.6
Net credit to priority sectors (% of total)	40.9	41.3	41.6

* April-January.
** Excluding public food procurement.

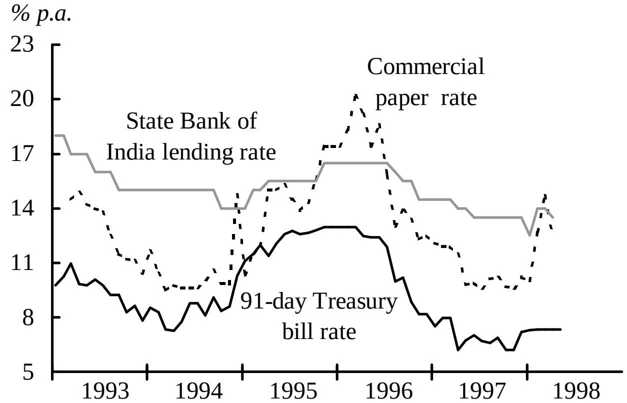
Assets and liabilities of the monetary system
% of GDP, 1997/98 fiscal year end

Liabilities		Assets	
M3	58.0	Total bank credit	53.6
Cash	10.3	to government	23.2
(% of deposits)	*21.6*	to private sector	30.4
Deposits	47.7	*(% of deposits)*	*63.7*
Other liabilities	4.7	Net foreign assets	9.1
Total	62.7	Total	62.7

Net bank credit to the government
% of GDP, fiscal year starting Apr 1



Interest rate structure
% p.a.



Agriculture performance
%, fiscal year

	1994/95	1995/96	1996/97	1997/98
Output growth	5.1	-3.0	7.9	-2.0
Share in GDP	28.9	26.1	26.1	24.3
Investment rate*	8.6	9.9	9.2	9.5
Net borrowing*	5.0	5.9	7.0	7.2
Default rate**	42.4	40.1	38.1	37.0

* Share of agriculture-sector GDP.
** Share of scheduled loan repayments.

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...undermines banks' financial performance

The requirement to fund the government budget deficit and lend to priority sectors leaves banks with poor asset quality and financial performance. The official estimate of average nonperforming loans (NPLs) is 8.5%, but private-sector estimates suggest a higher figure of 16%. The official estimate of banks' average profit margins is a meager 0.7%, with private-sector estimates pointing to profit margins close to zero. The performance of government-owned banks has somewhat improved in the last few years, but still falls far behind that of domestic private and foreign banks.

Also dampening banks' financial performance is the very high cash reserve requirement of 10% of total deposits. Moreover, with more than 60% of deposits tied up in cash holdings, government securities, and loans to priority sectors, banks have only limited room to lend to the rest of the economy and thereby to support growth in the truly private sector.

Capital markets have lost credibility

In the 1992-94 stock market boom, capital markets became an important alternative source of funding for private companies and enterprises. But in a nearly unregulated environment, many companies took the opportunity to raise capital without clear plans and often with fraudulent intentions. Much of the capital was siphoned off, leaving investors to nurse losses. Not surprisingly, investor appetite plunged and new capital market issues fell from 5.2% of GDP in 1994/95 to just 1% in 1997/98. Several initiatives to improve regulations and market activity have been started, but many obstacles remain, including high stamp duties and the requirement for pension and insurance funds to hold large amounts of government securities.

Foreigners, who used to be key investors in the Indian capital market, have also started to withdraw. True, net buying by foreign institutional investors has increased to roughly 50% of total issuance, but absolute portfolio inflows have dropped more than 50%. Besides uncertain market conditions and increased risk aversion, chronically poor corporate governance, accounting, and disclosure norms as well as tax obstacles, such as the 20% withholding tax, are likely to deter foreigners from reentering the Indian market for quite some time.

Total capital market issues and composition
% of total, fiscal year

	1993/94	1994/95	1995/96	1996/97	1997/98
Total (% of GDP)	4.9	5.2	2.7	1.3	1.0
Private corporations	55.9	72.3	56.7	53.0	n.a.
Public enterprises	44.1	27.7	43.3	47.0	n.a.
Equity	58.2	73.2	67.6	50.8	n.a.
Debt	41.8	26.8	32.4	49.2	n.a.
FII* net buying	13.0	9.8	23.5	55.0	45.6

* Foreign institutional investors.

Balance of payments
US$ billion, fiscal year

	1990/91	1995/96	1996/97	1997/98e
Current account	-9.7	-5.9	-3.7	-5.0
(% of GDP)	-3.2	-1.8	-1.1	-1.4
Trade balance	-9.4	-11.4	-14.3	-16.0
Invisibles balance	-0.2	5.7	10.6	11.0
Services	1.0	-0.2	2.4	2.0
Interest payments	-3.8	-3.2	-3.3	-3.4
Private transfers	2.1	8.5	11.1	12.0
Official grants	0.5	0.4	0.4	0.4
Capital account	8.4	3.0	9.5	8.5
External assistance	2.2	0.9	1.1	1.0
Net borrowing	2.2	1.3	1.0	1.0
IMF	1.2	-1.7	-1.0	-1.0
Nonresident deposits	1.5	1.1	2.5	1.2
Direct investment	0.1	1.9	2.5	3.2
Portfolio investment	0.0	2.7	3.3	1.6
Debt repayment	-1.2	-1.0	-0.7	-1.0
Other	2.3	-2.2	-0.3	2.5
Reserves (- = increase)	1.3	2.9	-5.8	-3.5
Memo: (year-end data)				
Reserves	2.3	17.0	22.4	25.9
External debt	80.9	97.3	97.5	99.0
Short-term debt	8.5	15.7	16.8	17.8

FDI unlikely to surge without reforms

With portfolio inflows declining and remittances unlikely to keep rising as in the past, foreign direct investment (FDI) is India's main hope for reviving investment and maintaining a stable balance of payments. In contrast to its antipathy to FDI displayed at the election campaign, the BJP has not in practice turned against foreign investors, instead actually granting approvals in some areas where foreign access had previously been limited. Still, much more will have to happen in order to boost FDI substantially, including a reduction of the income tax for foreign corporates from 48% at present to the 35% rate paid by domestic corporates.

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Japan struggles to halt the recession

- **Japan is in a severe recession, but fiscal stimulus will stop downturn in second half**
- **Exports should also do better, but downtrend in business investment is likely to continue**
- **Overcoming structural headwinds, especially in the banking sector, remains a key challenge**
- **Public discontent is rising, but recent election results have done little to break the deadlock**

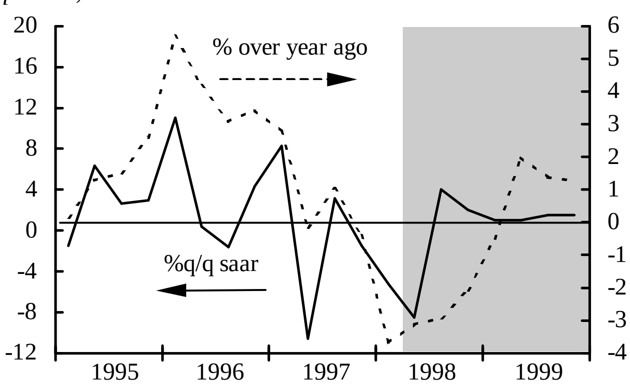
Key forecasts
calendar years

	1997	1998f	1999f
Real GDP (%oya)	0.8	-3.0	1.0
Consumer prices (%oya)	1.7	-0.1	-0.4
Current account (US$ bil)	97.4	107.3	124.0
Fiscal balance (% of GDP)	-4.2	-5.0	-5.1
3-mo. Eurodeposit rate (% p.a.)*	0.5	0.6	0.7
10-year bond yield (% p.a.)*	1.7	1.9	2.0
Yen/US$*	130	155	130

* Year end.

The forecast calls for a policy stimulus in the second half, but weakness to follow again in 1999

Real GDP growth
percent, both scales



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

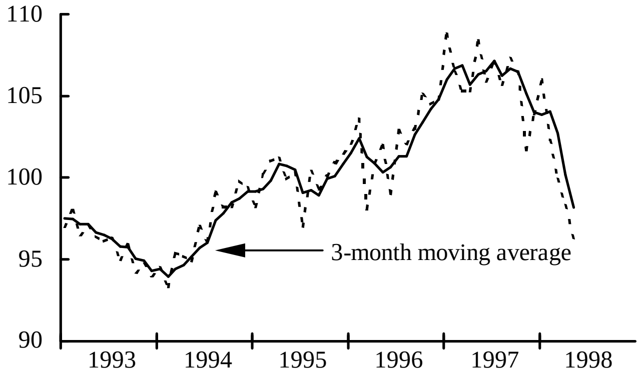
	98Q1	98Q2f	98Q3f	98Q4f
Real GDP	-5.3	-8.5	4.0	2.0
Private consumption	0.4	-3.0	2.8	0.5
Business investment	-18.8	-30.0	7.5	-3.8
Residential construction	7.1	-10.0	5.0	10.0
Public investment	-7.4	1.8	40.0	9.5
Government consumption	-2.2	1.0	2.0	0.0
Exports of goods and services	-14.2	-2.0	0.0	4.5
Imports of goods and services	-5.3	-6.0	-3.8	-2.9
Contributions to real GDP				
Domestic final sales	-3.8	-7.5	3.7	1.0
Inventories	0.0	-1.4	-0.2	0.1
Net trade	-1.5	0.4	0.5	0.9

- Japan moved into full-blown recession during the first half of the year. Following a weaker-than-expected first quarter and recent evidence of further sharp declines in the second quarter, the J.P. Morgan real GDP growth forecast for calendar 1998 is revised down from -1.9% to -3.0%.
- Behind this annual real GDP growth forecast is a quarter-on-quarter pattern of another steep contraction in the second quarter, followed by a stabilization and modest growth in the second half.
- The key driver from here will be public investment, which is expected to surge in the third quarter, offsetting the ongoing drag from domestic private demand, especially business investment.
- However, weakness should resume in 1999, as the short-term fiscal stimulus fades again. By the fourth quarter of next year, real GDP is expected to have grown just a notch above 1% from the same quarter a year earlier.

Foreign demand collapse was followed by plunge in domestic demand and destocking pressures

Industrial production

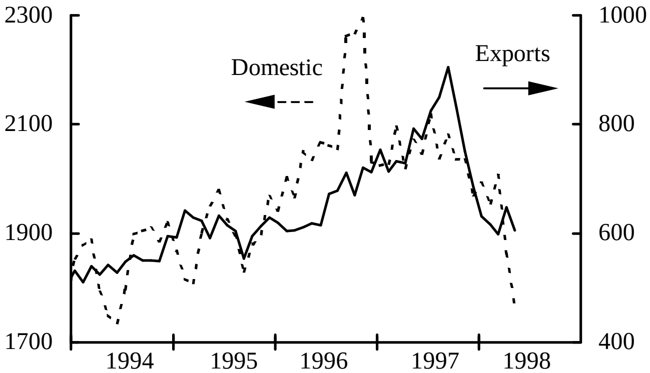
1995=100, sa



- The industrial sector is at the core of Japan's current recession and the rate of decline has even accelerated in the second quarter.
- Industrial production in April and May fell an annualized 23% from the first-quarter average, following declines of -9.6% and 3.8% in the fourth quarter of last year and the first quarter of this year respectively.

Total machinery and construction orders

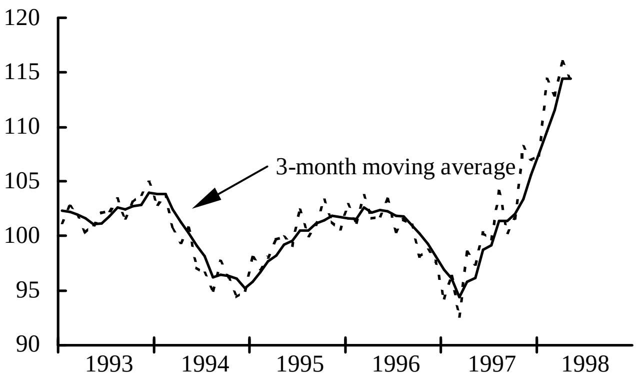
¥ billion, sa, 3-month moving average



- The trigger of the past nine months' output decline was the sudden collapse in foreign orders that followed the financial and balance-of-payments crisis in the rest of the Asia.
- The good news is that the free fall in export orders came to an end early this year. But the bad news is that stabilization here was only to be followed by a sharp decline in domestic orders, which in the data through May had not yet reached a bottom.

Inventory ratio

1995=100, sa

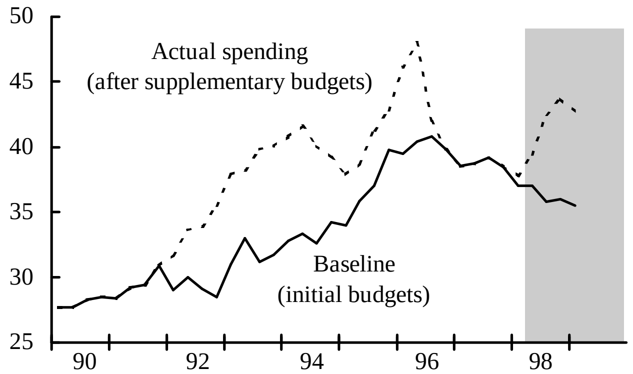


- The cyclical downturn has been further compounded by producers' efforts to stop the inventory buildup. But while demand was falling faster than producers could cut production during most of last year and the first four months of this year, May saw the first significant decline in inventories in eight months.
- Nonetheless, inventories remain so high that destocking will remain a drag on output growth for almost the entire remainder of 1998, unless demand recovers.

Public investment will provide a boost in the second half

Public investment

¥ trillion, as in 1990 prices GDP base



- Despite the gloom and doom, and the feeling that the politicians are not doing enough to fix the economy, one should not forget that Japan's largest fiscal stimulus package (its net impact is 2.4% of GDP) passed both houses of parliament by June 17 and is likely to take effect in the third quarter.
- Public works programs worth ¥7.7 trillion are slated for the second half of 1998. These should boost public investment by an annualized 40% in the third quarter and another 9.5% in the fourth quarter.
- The stimulus package also provides another ¥4.4 trillion in temporary tax rebates and small tax cuts.

Exports will also help arrest the downturn

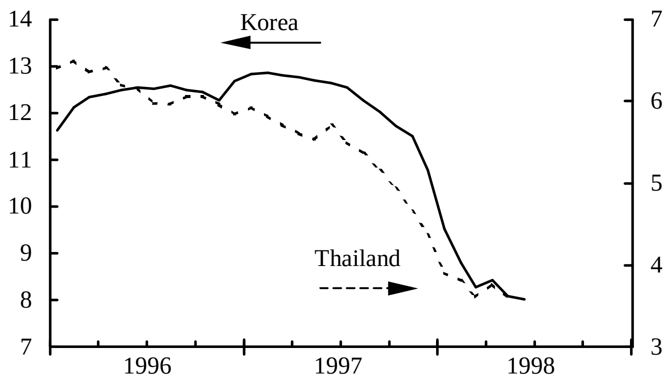
Export volumes

1990=100, sa

	% of total	97Q3	97Q4	98Q1	Latest average (April-May)
Total	100	117.2	121.0	116.6	116.4
United States	28	88.5	94.2	97.7	99.6
EU	16	93.1	103.5	99.6	109.7
Asia	42	158.8	159.4	139.8	137.5
China	5	257.9	300.0	252.9	254.4
NIEs	24	141.8	145.8	130.7	127.2

Asian imports

$ billion, sa, 3-month moving average

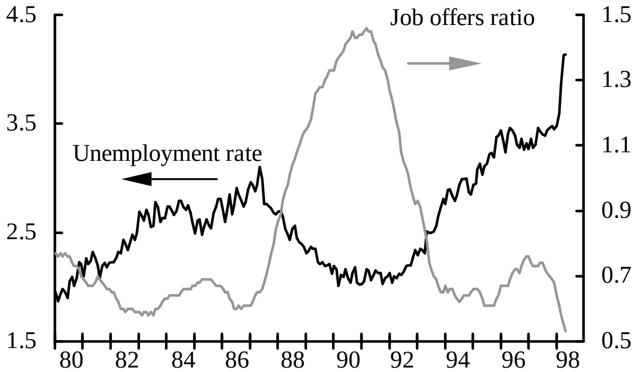


- Besides fiscal stimulus, exports are another factor that will help arrest the downturn in the second half and possibly provide for some overall GDP growth.
- Export volumes plunged in the first quarter as demand collapsed in the rest of Asia. But they went on to stabilize in April and May as the free fall in import demand from the rest of Asia started to fade.
- Japan also has regained some competitiveness from the decline of the yen. The real effective exchange rate has fallen 10% since the start of the year, and a further 10% decline is expected by year end.
- The expected U.S. slowdown will be a drag on exports, but with demand from Europe likely to keep rising, the net impact is unlikely to be negative. In fact, exports are expected to accelerate modestly from the fourth quarter of this year.
- Still, despite the positive impact of the fiscal package and the stabilization of exports, domestic private-sector demand trends are likely to be lackluster at best, offsetting much of the stimulus.

Labor market adjustment will preclude genuine consumption recovery in 1998

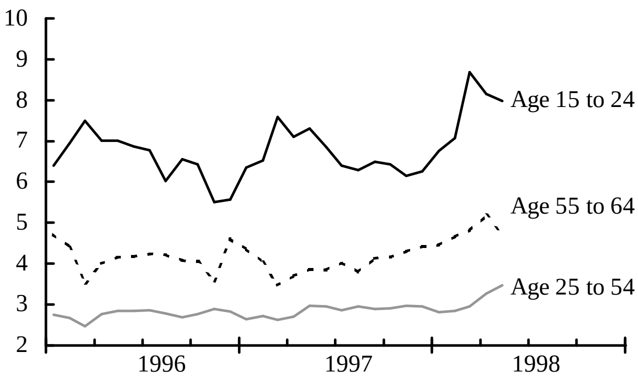
Labor market indicators

% of labor force, sa *ratio, sa*



Unemployment rate by age group

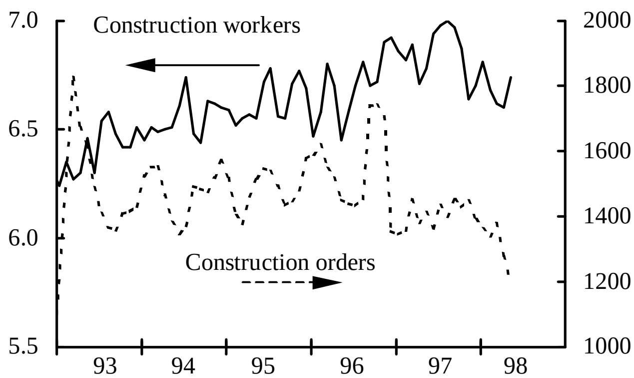
% of labor force, sa



- The labor market is deteriorating fast. This time, the nature of the deterioration is more structural than cyclical. This is well illustrated by the rise in unemployment in the existing labor force (ages 25 to 54), which escaped any significant layoffs in the post-bubble downturn.
- Particular concern lies with construction. The number of construction jobs has not fallen despite the decline in orders, and so will come under real pressure once the latest package plays out in early 1999.
- J.P. Morgan expects the unemployment rate to rise to 4.8% by year end and 5.2% by December 1999.
- The recent labor market development is bad news for consumption. Not only will disposable income come under pressure, but consumer confidence will be shaken as well.
- Given these uncertainties, households will probably save more, and little of the temporary tax rebate is likely to be spent.

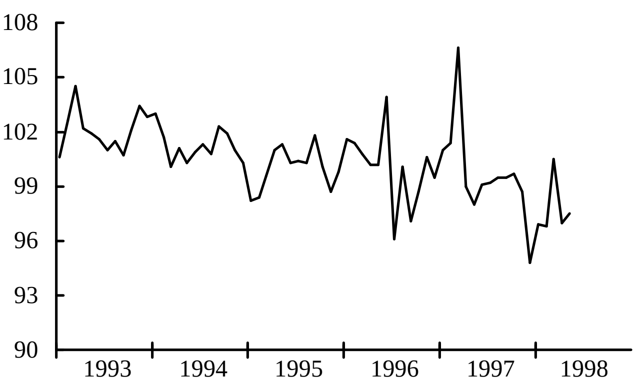
Construction employment

millions, nsa *¥ billion, sa*



Real household consumption

1995=100, sa



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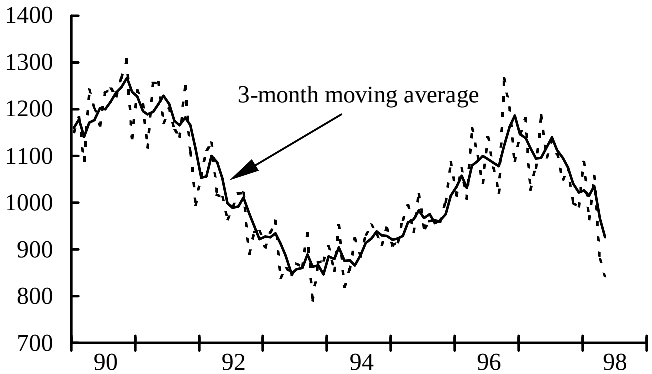
Capital investment is now leading a downturn

Private domestic machinery orders

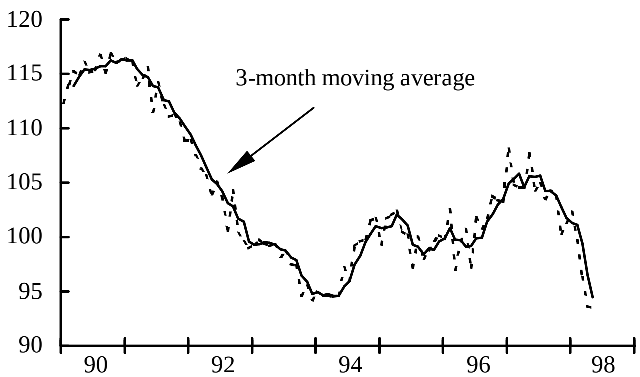
excluding ships and electric generators, ¥ billion



- Much of the recent fall in domestic demand was driven by business investment. Private core domestic machinery orders plunged 17% (not annualized) in April and May from their first-quarter average.
- Going forward, the free fall will start to ease, but business investment is expected to slide lower until at least early 1999.
- Excess capacity is expanding due to the production slump. Corporate profits will continue to fall as private consumption is unlikely to recover.
- Furthermore, lending institutions are still reluctant to provide loans, affecting investment especially by small companies.

Capacity utilization

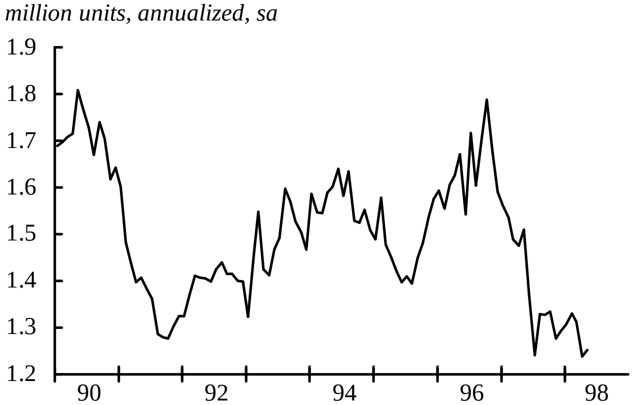
1995=100, sa



Housing investment continues to disappoint, but favorable conditions are still in place

Housing starts

million units, annualized, sa



- Housing investment proved disappointing in the second quarter, falling back from a modest recovery in the first quarter. However, there seems to be a bottom under housing investment, following its sharp declines from late 1996 and early 1997.
- Underlying conditions such as interest rates and prices remain favorable for the housing sector, but uncertainty over the course of the economy and household incomes is a drag.

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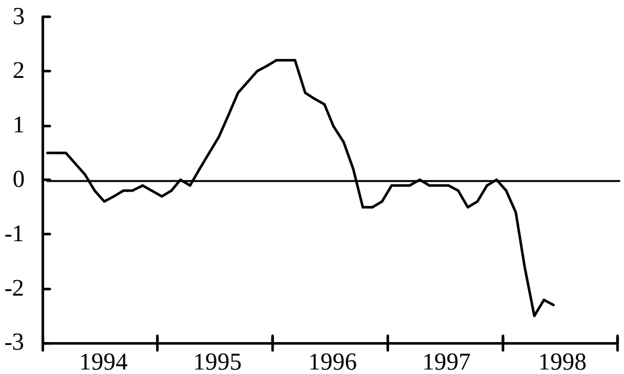
Financial woes persist, in spite of the new government proposal

Bank lending

%oya



- Besides the cyclical and structural adjustment factors facing private households and corporates, little is happening to improve conditions in the financial sector. In fact, beset already by huge asset quality problems from the bursting of the asset bubble in the late 1980s, Japan's banks are now being hammered by the loan losses coming from the recession.
- Not surprisingly, after years of stagnation, bank lending actually started to contract this year.
- The government's ¥30 trillion financial stabilization package announced last December is a step in the right direction, but falls way short of the overall amount needed to restore balance-sheet health.
- Plans to create a "Bridge Bank" to absorb some of the bad assets are also encouraging. However, there are no separate funding plans in addition to the ¥30 trillion of the financial stabilization package.

Political turmoil could lead to more rather than less policy paralysis

Political landscape after the July 12 election

	Lower House	Upper House
Liberal Democratic Party	263	103
Democratic Party	92	49
Komeito	47	22
Japan Communist Party	26	23
Social Democratic Party	15	14
Liberal Party	40	12
Sakigake	2	3
Others	14	26
Total	499	252

- The key obstacle to long-term fiscal measures as well as a more aggressive banking restructuring initiative is Japan's state of political paralysis.
- The ruling Liberal Democratic Party lost heavily in the July Upper House election, resulting in the resignation of Prime Minister Hashimoto. The election outcome was clearly a vote of no confidence in Hashimoto's economic policy.
- The next general election is scheduled for October 2000. This gives the LDP only a bit more than a year to get the economy moving.
- However, the next party leader and prime minister, no matter who the LDP may select, will face an uphill battle to get legislation through both houses of parliament, now that the opposition controls the Upper House.
- Moreover, given the short time period ahead to deliver results, the government is likely to look more for quick fixes than for thorough, but potentially more painful, solutions to Japan's structural problems.

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Emerging Asia: How low can it go?

- **Sharpness of first-quarter contractions has resulted in (another) cut of real GDP forecasts**
- **Signs of stabilization in some countries, but downside risks to some forecasts remain**
- **China stimulates investment to cushion growth slowdown at the price of delay in reforms**
- **Hong Kong's price adjustment is quick and brutal, but banking sector not fatally damaged**
- **Ongoing debt and bank restructuring will weigh on Indonesia, Korea, Malaysia, and Thailand**

Real GDP growth forecasts
%oya, calendar years

	1997	1998f	1999f
Emerging Asia (10)	6.2	-0.1	3.3
China	8.8	6.5	6.0
Hong Kong	5.3	-3.0	1.6
India*	5.0	4.5	5.0
Indonesia	4.5	-14.0	-3.5
Korea	5.5	-6.0	2.6
Malaysia	7.2	-5.1	0.1
Philippines	5.2	0.4	4.0
Singapore	7.8	0.0	0.1
Taiwan	6.8	4.3	4.0
Thailand	0.5	-6.0	2.5

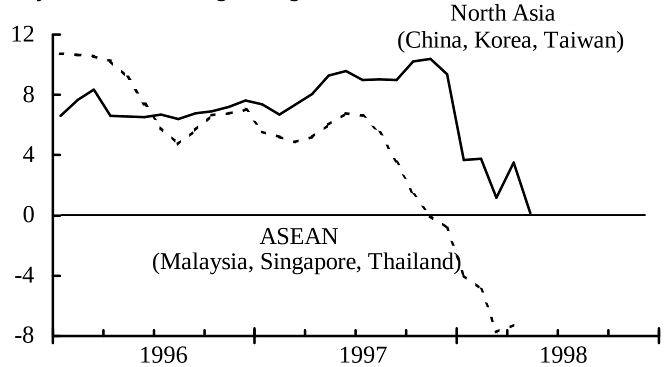
* Fiscal year beginning Apr 1.

Financial and economic conditions

Financial indicators

	US$ fx rate (Jun 97=100)		Interest rates (% p.a.)		Stock prices (Jun 97=100)	
	Dec 97	Jul 98	Dec 97	Jul 98	Dec 97	Jul 98
North Asia						
China	100	100	8.6	7.9	78	58
Hong Kong	100	100	9.4	9.3	71	55
South Korea	52	65	35.0	13.2	50	43
Taiwan	85	81	8.5	7.0	91	84
ASEAN						
Indonesia	44	17	28.5	59.7	55	65
Malaysia	65	61	9.1	11.0	55	42
Philippines	66	63	18.1	14.8	67	65
Singapore	85	85	6.3	6.5	77	56
Thailand	53	59	27.0	20.0	71	52
India	99	95	7.2	7.3	86	76

Industrial production
%oya, 3-month moving average



- Much of the air has been let out of the first-quarter bounce in currencies, with most now back down to where they started the year. The nominal depreciation of the Indonesian rupiah is stunning, while the Korean won stands out as the one currency that has actually gained throughout the first half of the year.
- Across Emerging Asia, equity markets also have sprung a leak after pumping up earlier in the year. Given the softness in many currencies, these stock market declines look even worse when viewed in U.S. dollar terms.
- Onshore interest rates have been easing in the countries that have shown commitment to financial restructuring (Korea, Thailand) or came into the crisis with a relatively strong banking system (the Philippines). In contrast, Malaysian rates are headed higher while Indonesia's remain in the stratosphere.
- Though the real economic slowdown hit North Asia well after ASEAN, the depth of the eventual contractions has been sharper than expected for the entire region. As a result, Morgan's 1998 GDP forecasts for nearly every country have been marked down. The sharpest downward revisions have been made to the Hong Kong, Indonesia, and Malaysia projections. The one exception is China, where the long-bearish 1998 outlook is unchanged, but the 1999 growth forecast has been reduced to 6%.

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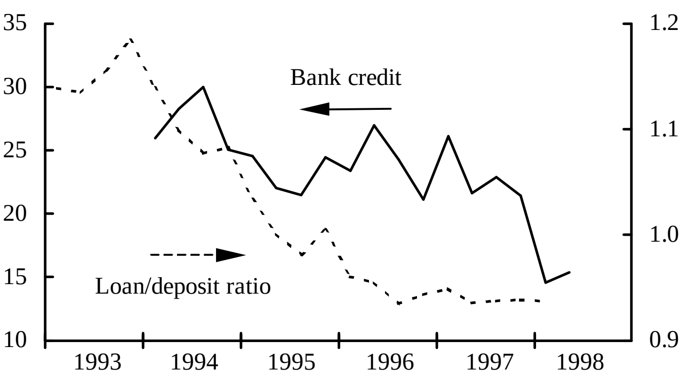
China is caught between a rock and hard place

China: fx receipts, tax revenues, and SOE profits
%oya

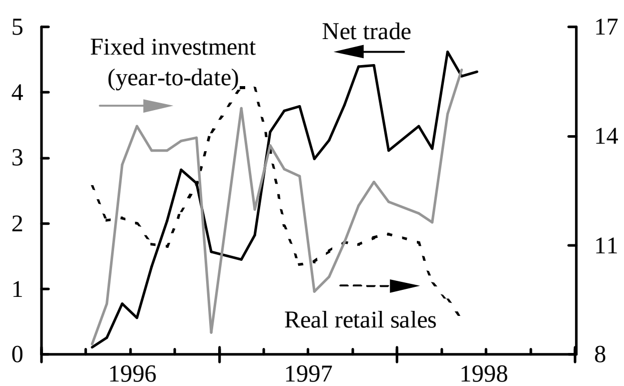
	1997				1998	
	Q1	Q2	Q3	Q4	Q1	Jan-May
Exports	25.7	26.2	23.9	20.9	13.3	7.6
FDI inflows (utilized)	-4.4	8.5	18.1	7.2	14.1	-1.5
External loans (utilized)	-40.6	80.6	12.2	-18.2	-61.0	n.a.
External loans (contracted)	-58.2	-65.3	57.7	-51.4	-90.1	n.a.
	1997				**1998**	
	Mar	Jun	Sep	Dec	Apr	May
Tax revenues	31.4	42.5	4.0	12.5†	0.2	n.a.
Profits of SOEs (yuan bil)‡	-0.6	14.1	26.5	55.9	-11.3	-13.8

† Nov 97.‡ Year-to-date.

China: bank credit and loan/deposit ratio



China: real retail sales, fixed investment, and net trade
ch. oya, US$ bil., 3-mo. mov. avg. *%oya, 3-mo. mov. avg.*



- Regional turmoil is hitting China hard. It has not only put pressure on the country's exports and foreign investment, but more importantly, has eroded the corporate sector's profitability. Consequently, all companies in China, state-owned ones in particular, have been forced to reform in order to survive. This means raising efficiency by cutting costs, rationalizing operations, and improving management.
- The bid to improve profitability, however, comes at a social cost – surging unemployment. Indeed, the labor market has deteriorated so fast that the government has recently been forced to abandon reforms in the banking sector. Instead, it is putting pressure on state banks to increase lending to specific sectors (infrastructure, housing, exports), has slashed interest rates, and is increasing tax rebates to certain exporters. In addition, regional governments have pledged to increase investment projects, which should help GDP growth later in the year.
- Renminbi devaluation is not on the agenda for now, especially since state fixed investment, the engine of economic growth, has already shown signs of acceleration. Indeed, as long as regional instability persists, a devaluation might be counterproductive, since it could simply trigger another round of regional currency meltdown. In addition, given the political stakes involved, China will not give up its currency stability lightly. Nor will the market force the hand of Chinese officials, given the country's US$140 billion foreign exchange reserves, tight official control over capital outflows, and gargantuan trade surplus. Once regional stability is restored, though, the renminbi will be allowed to depreciate gradually.

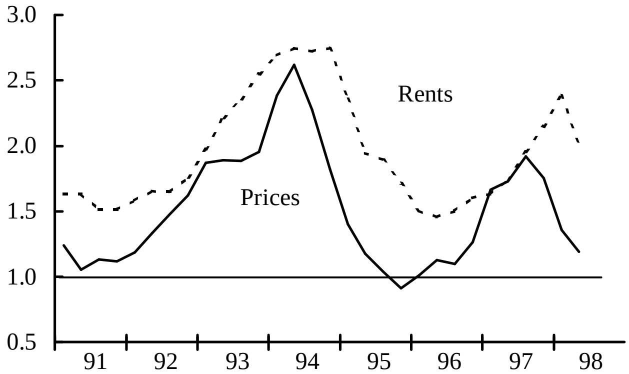
China's measures to spur demand and stabilize the yuan

- Higher tax rebates on exports of coal, textiles, rolled steel, cement, and some machinery products
- Improved exporter and home purchaser access to bank credit
- Increased investment in sectors such as rail, roads, posts and telecommunications, housing, and agriculture, with government bonds being issued to provide funding
- Five interest rate cuts on renminbi loans since May 1996
- Tighter grip over capital outflows and tax evasion

Hong Kong falls hard after its earlier climb

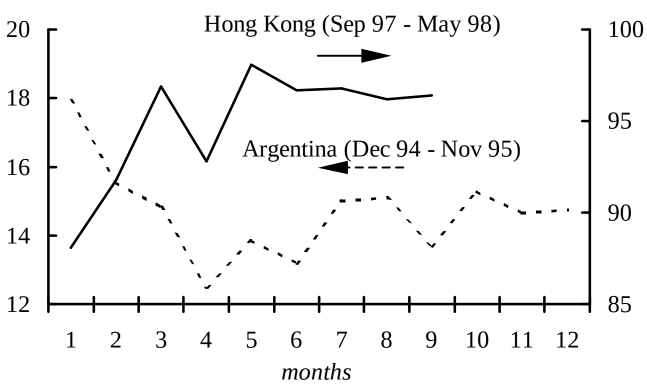
Property prices and rents: Hong Kong / Singapore

US$ terms, ratio, for properties in central business district



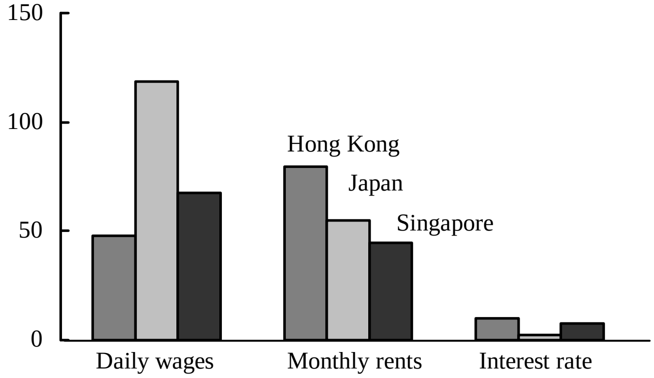
Foreign exchange reserves in perspective

US$ billion



Cost of production factors in the region

US$, % p.a., end-1997 or most recent data



- With the monetary authority determined to hold the peg, Hong Kong has to endure severe domestic price declines to restore competitiveness. The flexible nature of its economy suggests that the adjustment is and will be swift and dramatic. Already, private residential housing prices have nose-dived by 50% from the peak reached around last August. By now, office prices have collapsed almost to the level currently seen in Singapore. The bad news is that Hong Kong's arch rivals, Singapore and Japan, have yet to see their asset prices stabilize. This indicates that the fiscal stimulus packages introduced so far in the Special Region may be unable to stop the economy declining by 3% in 1998.
- Despite the downward pressure on the Hong Kong dollar, public confidence in the banking sector has held up very well. Although bank deposits started to edge down in May, the dip was modest. In fact, foreign exchange reserves are up 9.4% from last September, in sharp contrast to what happened to Argentina during its "tequila" crisis back in 1995.
- The public's calm may not be groundless. Although some banks are vulnerable to asset-quality deterioration and rising loan defaults, the banking sector as a whole remains strong in terms of liquidity and capital. In a worst-case scenario, the government, including the HKMA, has the option of bailing out weak banks, given its fiscal and excess foreign exchange reserves. Alternatively, it could put pressure on the three note-issuing banks to support weak ones, arguably as payback for the oligopolistic rents they have been earning.

Hong Kong: composition of M3 and bank deposits

US$ billion

	M3	Deposits			
	HK$	Fx	HK$	US$	Other fx
Jun 97	218	47	202	66	5
Sep 97	223	148	206	69	75
Dec 97	215	149	198	78	67
Jan 98	213	154	194	82	69
Mar 98	219	153	201	80	70
Apr 98	219	151	201	79	69
May 98	217	150	199	78	67

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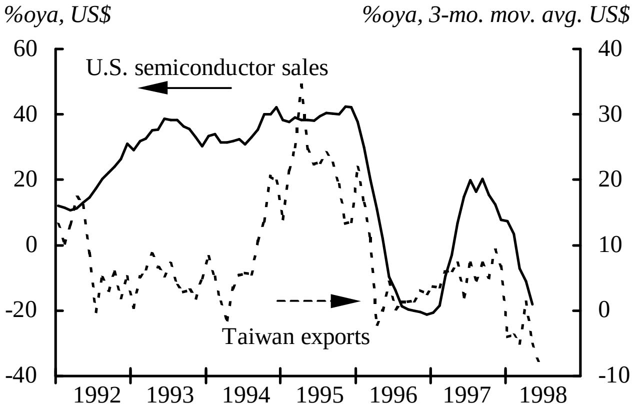
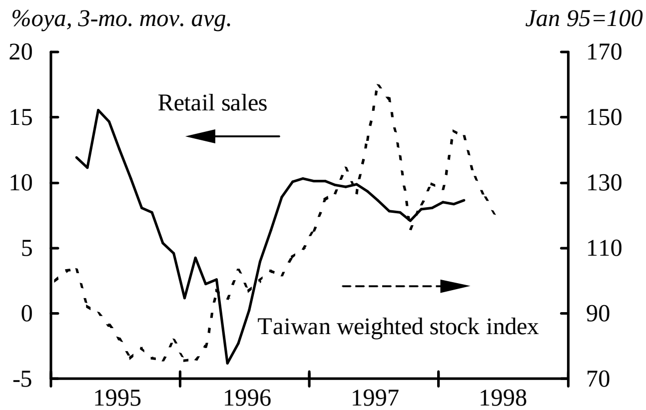
Taiwan is feeling the heat but is not on fire

Taiwan's exports and U.S. semiconductor sales

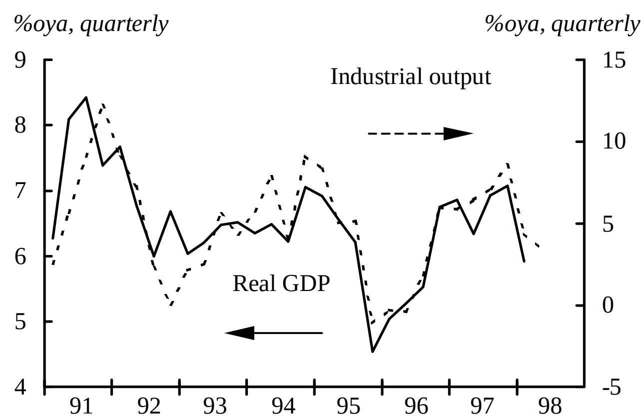


Taiwan: retail sales and stock market index

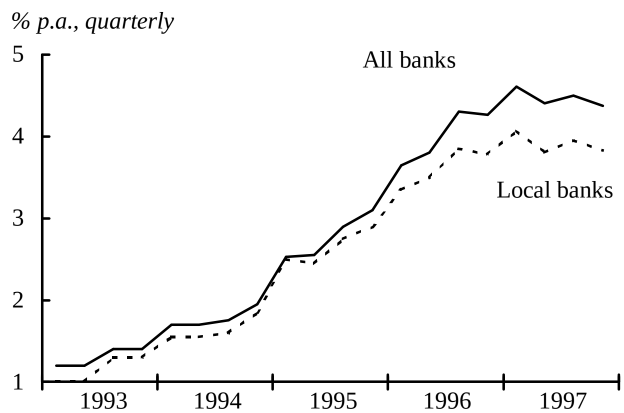


- Taiwan is not immune to the regional meltdown. Indeed, its exports have been weakening, declining by 7.1% over a year ago in the first half of 1998, down from positive growth of 3.8% in the same period last year. And the downward spiral is probably accelerating, thanks to slowing electronics and telecommunications sales in the United States and rising competition from Japan and Korea. Consequently, Taiwanese producers are scaling back their ambitious investment plans, and requesting their workers to take more days off.
- Mirroring the deterioration has been the decline in share prices and the currency. The stock market has lost 25% of its value from its peak reached in mid-1997 and the currency has weakened 19% against the greenback. The associated negative wealth effects are certainly discouraging consumer spending.
- Still, Taiwan will continue to stand out as the dry land in the regional financial storm. While its exports are being hit by weakening external demand, its imports are benefiting from the meltdown in international prices for raw materials (65% of its total imports). And with inflation muted and no large trade deficit, the government can afford to run an accommodative monetary policy and to speed the approval process for public projects. These positives should cushion the margin squeeze on the corporate sector, in turn limiting job losses and pain to the banks.

Taiwan: real GDP and industrial output



Taiwan: loans overdue for three months or more



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South Korea's reform path remains bumpy

Conditionally viable banks
billion won, as of March 1998

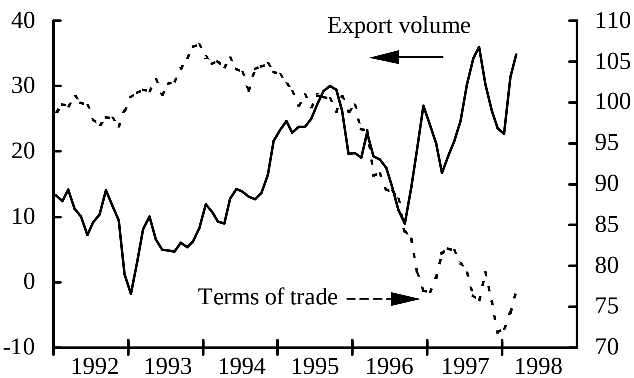
	Loans	NPL	NPL ratio*	BIS ratio†
Chohung	36568	6926	19.2	1.49
Korea Commercial	28823	7249	24.3	1.81
Hanil	36593	6772	20.2	4.53
Korea Exchange	39558	10792	28.6	2.13
Peace	5054	601	12.9	-1.57
Kangwon	2315	1034	45.8	-16.0
Chungbuk	2096	801	28.5	-5.52

Nonviable banks
billion won, as of March 1998

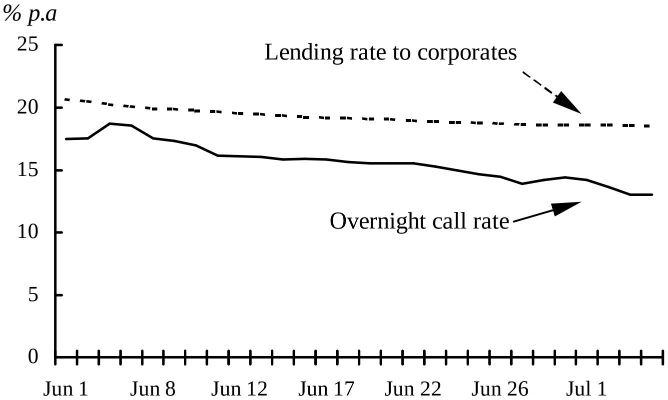
	Loans	NPL	NPL ratio*	BIS ratio†
Daedong	4927	1735	34.1	-6.75
Dongwha	7199	2255	28.5	-3.72
Kyungki	6203	2862	49.0	-9.61
Dongnam	5087	1118	20.9	-5.81
Chungchong	3243	1619	36.3	-5.97

* % of total loans. † % capital adequacy.

South Korea : export volume and terms of trade
%oya, 3-mo. mov. avg. *index*



South Korea: call rate and lending rate to corporates
% p.a



- As expected, the Korean government has speeded up its corporate and bank restructuring efforts since winning the June 4 regional elections. Banks have been pushed to identify and cease lending to nonviable corporate borrowers, and healthy banks have been ordered to take over their poor cousins (with compensation from the government). While steps in the right direction, these exercises have failed to restore confidence in the country's reform program, as only insignificant companies and banks have been put on the "death" list.
- The good news is that the worst of the liquidity crunch is over. With a surging current account surplus, strong support for the currency, and a falling inflation rate, the central bank can afford to ease monetary policy. Already, the call rate has dropped significantly in the past week.
- But for corporate Korea, any easing in the liquidity squeeze will come only gradually. Being under enormous pressure to recapitalize and preserve asset quality, banks will continue to be cautious in extending loans. Indeed, interest rates have stayed high at about 20% p.a. for 1-year bank loans, and the sharp drop in the 3-year corporate bond yield indicates only the lack of funding demand from the top four *chaebols*. While banks can stay afloat by closing branches and firing employees, and exporters by taking advantage of a cheap currency and imported raw materials, the bulk of corporate Korea is finding it hard to stay above water.

Corporate sector's financial assets and liabilities
billion won, as of March 1998

Assets		Liabilities*	
Bank deposits	147.8	Bank loans	340.9
Short-term paper	7.3	Short-term paper	72.7
Bonds	28.5	Bonds	180.9
Securities	23.8	Government loans	7.0
Receivables	97.5	Payables	74.1
Other	100.4	Other	121.4
Total	405.2	Total	797.0

* Interest-bearing debt only.

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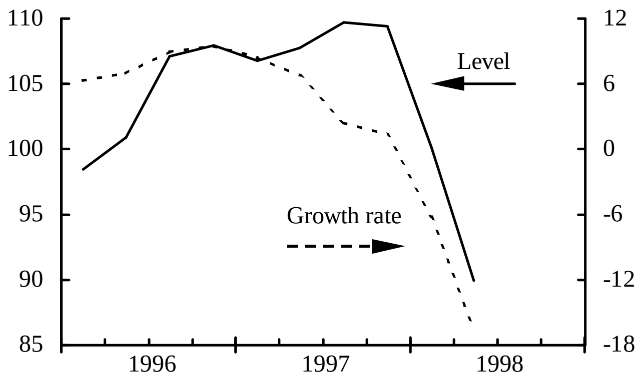
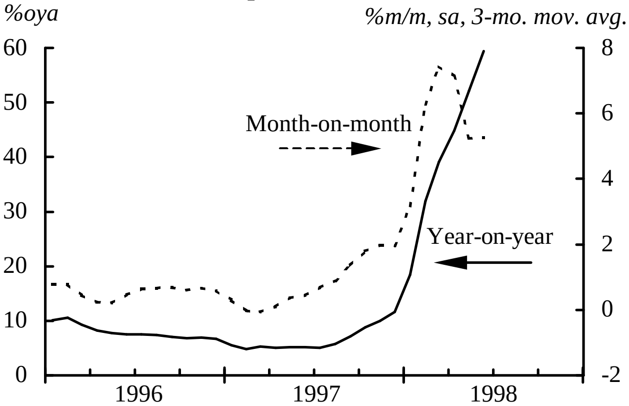
Indonesia debt workouts are handicapped by uncertain environment

Indonesia: real GDP
rupiah trillion *%oya*



Indonesia: consumer prices
%oya *%m/m, sa, 3-mo. mov. avg.*

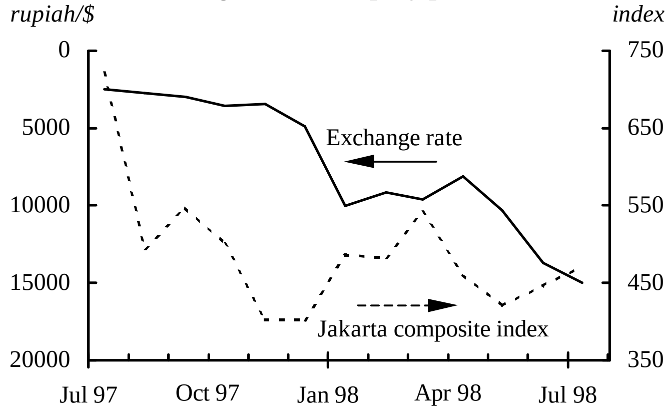


Indonesia: external debt
$ billion, end-March 1998

Public sector	65.6
Government	54.4
IMF credit	3.0
State-owned enterprises	11.2
State banks	5.6
Nonbank enterprises	5.6
Private sector	72.5
Private banks	8.0
Nonbank corporations	64.5
Total	138.0

- Though the quality of the economic data coming out of Indonesia in recent weeks (on inflation, unemployment, and GDP) is certainly open to question, what is undeniable is that the economy is in a tragic state. The World Bank estimates that the crisis will cost some 20 million Indonesians their jobs and push 50 million into poverty.
- The June 25 agreement with the IMF marks the beginning of the latest phase of official assistance inflows. Previously committed loan packages from the World Bank, ADB, and IMF have already been resumed, with the IMF beefing up its standby facility. Importantly, though, the question of whether sovereign debt payments will continue has not yet been decided, and this decision will depend on how much new official bilateral and multilateral assistance will be forthcoming.
- The government is actively trying to catalyze the private external debt workouts laid out in Frankfurt last month. On all three facets of this initiative – resuming the flow of trade credits, rolling over private bank debt, and restructuring corporate debt – progress has been very slow and it is questionable whether any amount of government promotion or jawboning will get most of the parties together.
- The fundamental problem paralyzing the Indonesian economy is uncertainty over the direction of political reform. At this point, anything seems possible on the political front. The uncertainty may frighten debtors and creditors to the bargaining table but, equally, could send the message that it is better to sit back and wait to see what happens.

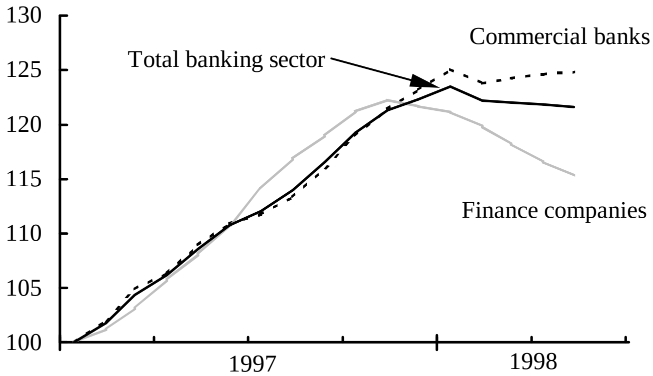
Indonesia: exchange rate and equity prices
rupiah/$ *index*



Malaysia's banking and corporate problems pose monetary policy dilemma

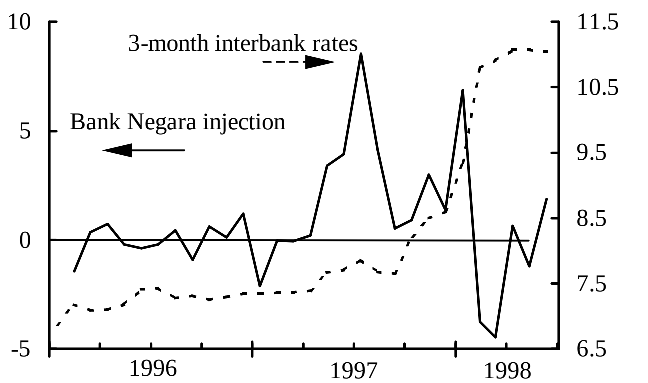
Malaysia: credit growth

Jan 1997=100, nsa



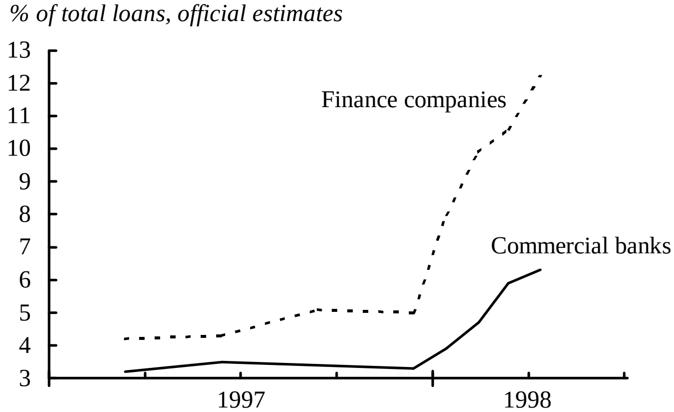
Malaysia: Bank Negara injection and interest rates

RM billion, monthly changes *% p.a., eop*



Malaysia: nonperforming loans

% of total loans, official estimates



- Recent private sector credit figures suggest that a credit crunch of increasing severity is setting in. Much of this crunch likely traces to increasingly risk-averse behavior by the banks, whose problems are deepening as their uncollected interest receivables from assets continue to escalate.
- Malaysian policymakers therefore face the unusual challenge of maintaining price stability and keeping real rates of return to depositors positive while at the same time not raising rates so high as to paralyze the corporate sector and by association the banking sector as well. The stance adopted since the beginning of the year has been to tighten monetary policy, causing the benchmark 3-month interbank rate to move up to 11% from around 8.5%. The main motives here were probably an anxiety to contain inflation (then rising quite rapidly) and also a desire to force banks to restructure. However, the tack has likely caused further pain for debtors.
- Nonperforming loans (NPLs) have been rising quickly, making banks increasingly reluctant to extend new loans. The Asset Management Corporation (AMC) may provide some relief by buying up NPLs but it will have to be operated within a larger context that includes structural reform.
- Within this uncertain economic environment, it remains imperative that insolvent debtors be separated from illiquid debtors. Unfortunately, with many banks experiencing tight liquidity and facing ever-rising NPLs, the temptation will grow to sell nonperforming assets regardless of the actual longer-term viability of the debtor. Indeed, incentive structures will need to be carefully managed lest the AMC end up causing more corporate pain than gain.
- There appears now to be a growing desire to lower interest rates to ease domestic pain that is becoming quite acute. Yet the case for monetary restraint also remains powerful. Policymakers thus face substantial risks no matter what path they take.

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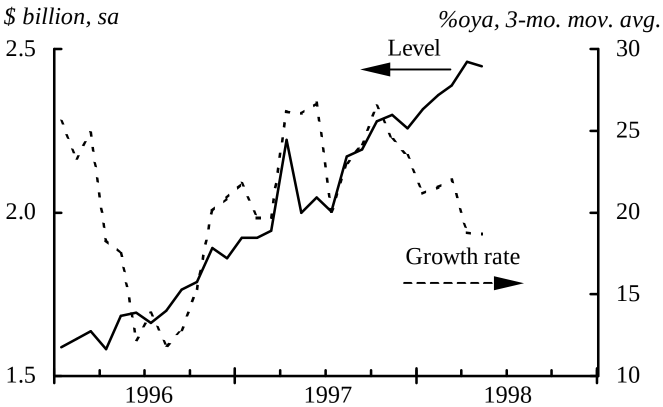
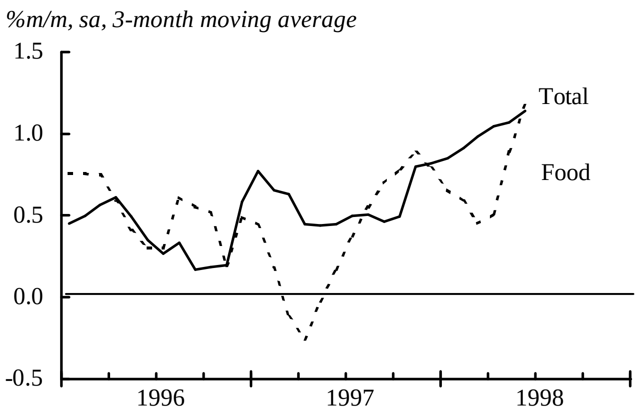
Philippines' Estrada takes over at a critical time

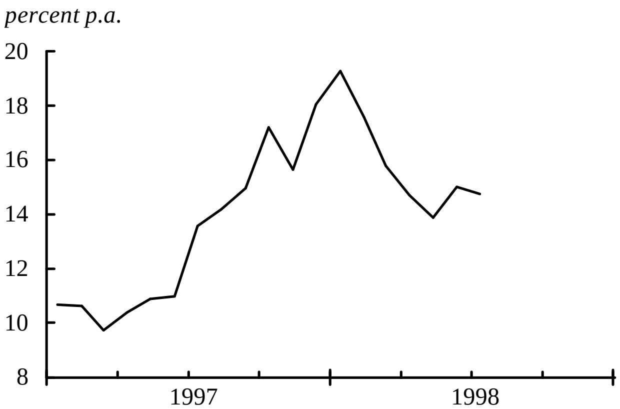
Philippines: merchandise exports



Philippines: consumer prices



Philippines: rate on 91-day Treasury bill at tender



- President Estrada and his team take the helm as Emerging Asia's economic storm continues to rage. Though likely to be the ASEAN country least buffeted by the turmoil, the sailing will not be smooth for the Philippines through the rest of 1998. Expectations must be scaled back, resulting in significant revisions to most macroeconomic targets – real GDP and GNP down, inflation up, and budget balances thrust from surplus to deficit. Unfortunately, there is little constructive that the new team can do to shelter the economy in the near term. In fact, activist policy moves would more likely do damage by worsening market sentiment that has been relatively positive on the country through most of the crisis.
- Export growth continues to impress at an astounding 20%oya in the first five months of the year. With U.S. growth slowing, this pace is not sustainable, but should be enough to stave off recession for 1998 as a whole.
- Unlike in Thailand and Korea, where inflation momentum is showing signs of slowing, Philippine inflation has picked up steam in the past few months. The Estrada government will raise this year's inflation target from a 7.5%-to-8.5% range to close to 10%. Food prices, which were benign earlier in the year, are now starting to rise. For the incoming administration, eager to reward voters with lower interest rates, this is bad news. What should be stressed is that, unlike in most of its neighbors, rates in the Philippines have already come down toward their pre-crisis levels. However, the market believes that onshore interest rates have seen their bottom.
- The current official target for a PhP5 billion surplus in the national government 1998 accounts will also have to be revised. The only question is how large the deficit will be, with Estrada cabinet members talking numbers from PhP30 to 70 billion. Cyclical issues are naturally putting pressure on the budget, but should not be allowed to obscure the structural problems demanding attack in the fiscal system: disarray in the Bureau of Internal Revenue that leads to inefficient collection, distorted financial sector taxation, generous discretionary spending allocations, and lax spending monitoring, to name but a few.

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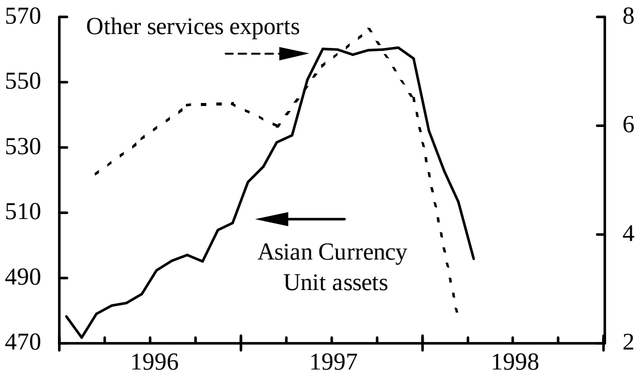
Singapore begins to catch up with regional slowdown

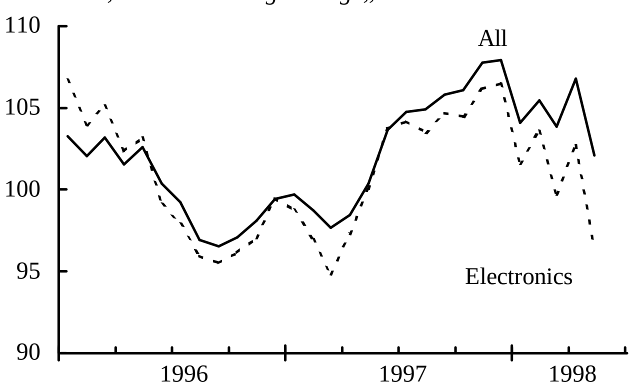
Singapore: services exports and Asian currency assets

US$ billion *S$ billion*



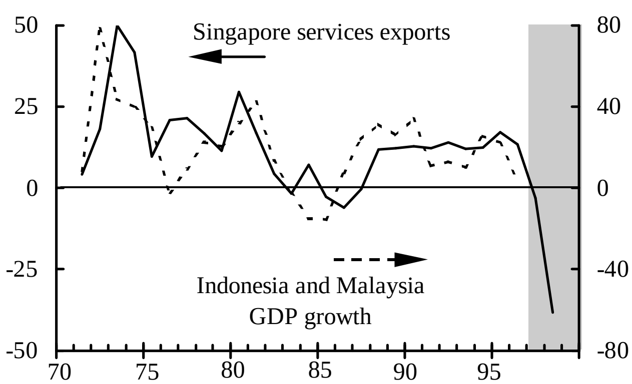
Singapore: production

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



Singapore: services exports and regional growth

%oya, nominal, US$ terms, both scales



- Over the past decade, much of Singapore's rapid growth leveraged off the fast growth of the region at large. Regional circumstances this time, however, are not at all propitious for Singapore. While recession grips the rest of the region, it has yet to clamp hard on Singapore's economy. Still, recent data releases show the manufacturing services sectors beginning to turn, which may herald the beginning of an outright contraction.
- Singapore itself can do little to change the region's growth prospects. But for its own sake, it can work to redress the loss in competitiveness that it has suffered. Already the authorities have begun to implement a series of measures to moderate the regional impact on businesses. While positive, the net effect of Singapore's latest measures is expected to be modest next to the severity of the regional slowdown. The reasons, of course, are the collapse of domestic demand across most of Emerging Asia, the pervasive credit problems that lie behind that collapse, and the plunge in currency values for several of Singapore's key rivals which leaves the competitiveness of the island republic severely impaired.
- Focus tends to go to the poor near-term prospects for Singapore's crucial electronics and other non-oil domestic exports, which last year were worth some 63% of GDP. Of very major importance too are the island's services exports – transportation, communications, financial, and others. These are provided preponderantly to other economies of the region and together were worth some 31% of GDP last year.
- Overall, the authorities face considerable uncertainty about the length and depth of the regional recession: The prospect is that 1999 will not be much better than this year, and the slowdown could last for several years. In these circumstances, officials apparently feel it is best to err on the side of caution, leaving some of their limited fiscal ammunition for possible use later on. Indeed, more measures are apt to be forthcoming should the economic outlook worsen much further from here.

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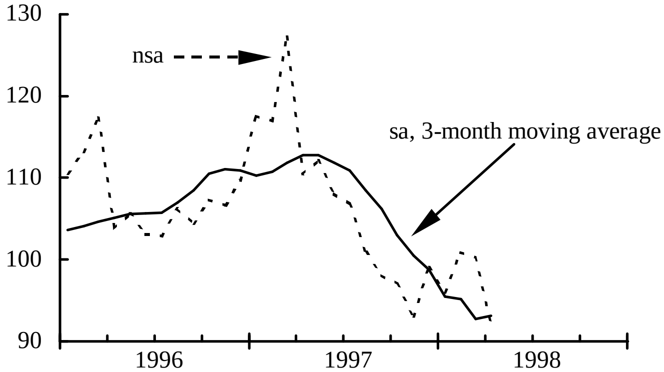
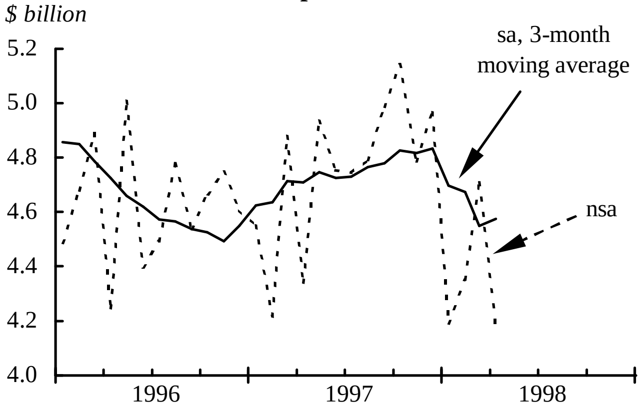
Thailand's signals just say "no"

Thailand: manufacturing production
1995=100

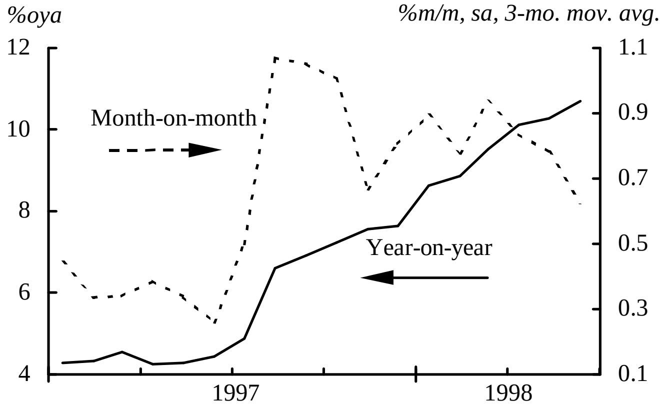


- Evidence is mounting – across a broad spectrum of macroeconomic data – that the 1998 business contraction will be deeper than originally forecast (Morgan now sees a 6% fall in real GDP). On a hopeful note, manufacturing production and import data show incipient signs that parts of the economy may have ceased to decline.
- However, a wide range of data on private consumption (auto and motorcycle sales, consumer imports, department store sales, and beverage consumption) as well as private investment indicates that domestic demand continues to fall. And given the rising unemployment rate, there is little reason to expect the situation to turn around before the year is out.
- The cornerstone of Thai policymakers' recovery plan has been renewed export growth. Disappointing actual exports in the first four months of 1998 (they were down 3.1% from a year earlier) underlie the downward revision of the GDP forecast. An important distinction to make is between flat-to-declining export values in dollars and rising export volumes –Morgan estimates that export volumes are up 25% to 30% since the onset of the crisis. Unfortunately, Thailand's exporters have been hard hit by falls of similar magnitude in dollar prices for their goods.
- As for inflation, the worst seems over. But with real interest rates consequently still very high, recent moves by the Bank of Thailand to bring nominal rates down are very welcome.

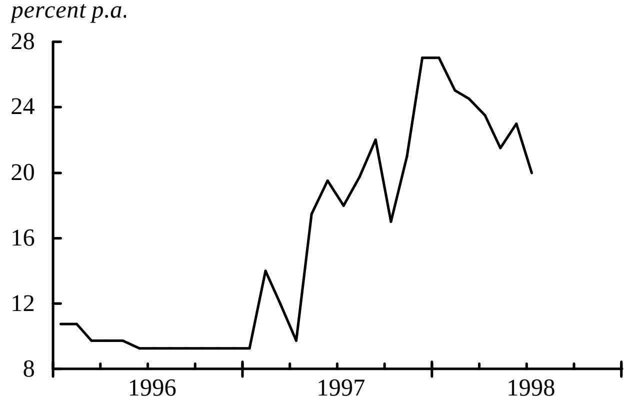
Thailand: merchandise exports
$ billion



Thailand: consumer prices
%oya *%m/m, sa, 3-mo. mov. avg.*



Thailand: one-month Bangkok interbank offer rate
percent p.a.



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Australia and New Zealand are slowing

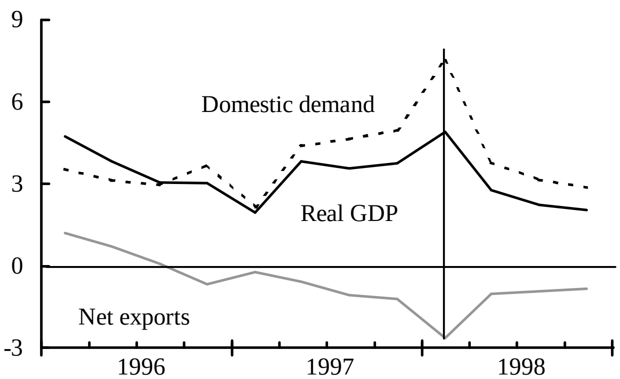
- **Domestic demand is now being hit by secondary fallout from the Asian drag on exports**
- **Australia's low interest rates will cushion but not prevent a significant slowing in growth**
- **New Zealand's interest rates are now falling but too late to stop growth from sliding further**
- **The current account deficit has likely peaked but the fiscal surplus will be under pressure**

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

	1997	1998f	1999f
Australia			
Real GDP (%oya)	3.3	3.0	2.4
Consumer prices (%oya)	0.3	0.9	2.4
Current account (% of GDP)	-3.3	-5.8	-4.8
Fiscal balance (% of GDP)	0.5	2.3	2.9
New Zealand			
Real GDP (%oya)	2.5	1.5	2.5
Consumer prices (%oya)	1.2	1.3	1.6
Current account (% of GDP)	-5.4	-9.0	-7.3
Fiscal balance (% of GDP)	2.5	1.5	1.5

Australia's domestic demand is moderating

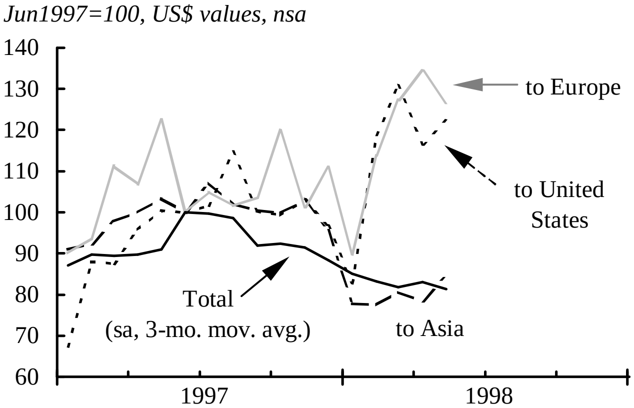
Australia: contributions to economic growth
percentage points oya



- Asian headwinds and their second round drag on domestic demand will cut real GDP growth by 1.5 percentage points to 2% year on year in 1998-99. True, low interest rates are supporting consumer spending and construction. Moreover, exports are close to bottoming. But inventories will be a drag and business investment will also suffer from poor confidence, declining profits, and lower capacity utilization (particularly in manufacturing).
- Consumer spending will likely be the last component of demand to slow much – but not until employment weakens and job insecurity harms household confidence. Any hike in official interest rates to support the currency would accelerate the downturn, and if sustained, risk recession.

...as export drag gets smaller

Australia: merchandise exports
Jun1997=100, US$ values, nsa



- Australia's exports to Asia may have bottomed in the first half of this year as signs have emerged of stabilization in Asian industrial production, assisted by rising Asian export volumes. Shipments to Europe and the United States have held up at significantly higher levels than before Asia's crisis, reflecting improved competitiveness following the currency's slide and solid demand in those markets.
- However, downside risks to exports remain so long as Japan's industrial production is plummeting and doubts continue over whether China can avoid a full-scale recession.

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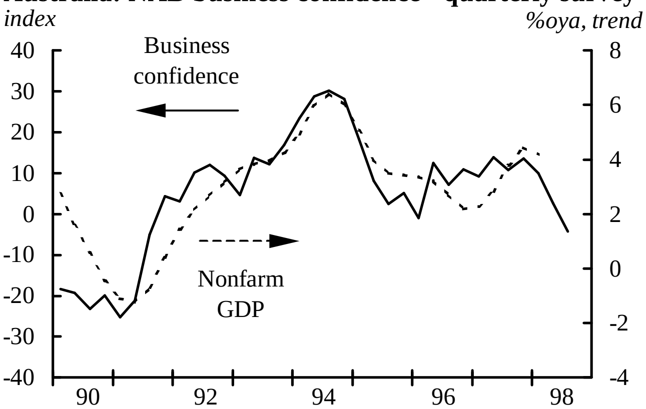
Economic growth is stalling

Australia: NAB business confidence - quarterly survey



Australia: employment

	Dec 97	Jun 98
Change in total numbers employed ('000m/m, 6-mo. mov. avg., sa)	19.6	12.3
Full-time	15.0	6.6
Part-time	4.6	5.7
Hours worked (%3m/3m, saar)	3.2	1.9
Unemployment rate (% of labor force)	8.2	8.2

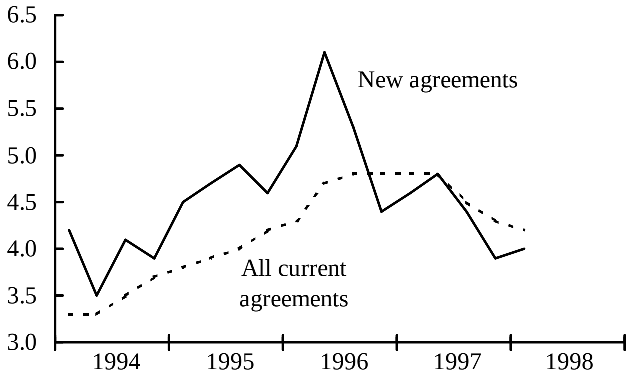
Australia: sectoral employment trends
change over six months, '000, sa

	Nov 97	May 98
Total	117	60
Agriculture and mining	20	-21
Manufacturing	-2	-31
Construction	18	26
Services	81	86

- Improving business confidence following last year's two interest rate cuts and stronger sales has been derailed – an early casualty of the Asian crisis and reflecting well-founded concerns that sales would crumble.
- Tentative signs have emerged that poorer business confidence is adversely affecting investment and hiring. Manufacturers, in particular, are likely to cut investment significantly because of lower profits and declining capacity utilization (exports have fallen and domestic demand is moderating). They have already been shedding jobs. Airlines, which have suffered a sizeable fall-off in Asian passengers, have deferred new aircraft purchases once again. Moreover, Olympics-related construction will moderate over the next few years.
- A sizable and largely unintended inventory buildup is a by-product of the Asian hit to exports and weaker domestic demand. Over one-third of the increase in inventories is in manufactured goods. An unwinding of inventories will depress growth in production and employment over coming quarters.
- Job gains, while clearly moderating following the Asian crisis, have not come to a screeching halt. Instead, employment growth has been pared back to a pace insufficient to trim unemployment further, and the jobless rate is stuck above 8%. Although total employment gains have not stalled, full-time job growth is considerably weaker. Employers have already begun scaling back hours worked, a move somewhat masked by a still high level of job vacancies. In addition, overtime has been cut.
- Consumer spending and housing construction, which had been rising strongly, appear to be waning. Although auto sales surged in response to price cuts, retail spending was far from buoyant two months into the second quarter, following a flat first quarter. A softer labor market is the likely culprit, since it has both moderated income gains and raised job insecurity. The latest residential building approvals report for May points to some cooling in house construction. The rise in fixed interest rates on mortgages in June will clearly not assist the construction outlook.

The fall in the currency is the only inflation threat...

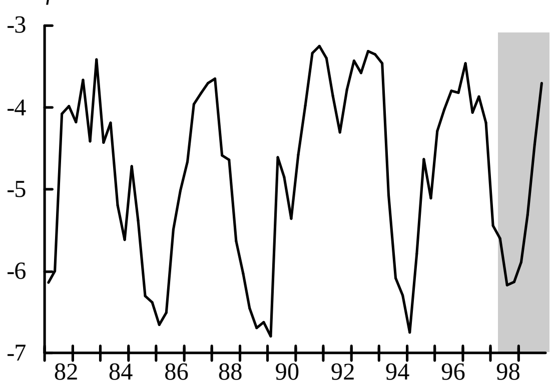
Australia: private sector wage settlements
average annualized wage increase, %



- There is an absence of domestically generated inflation pressures, with labor costs growing moderately. Imported inflation should thus prove temporary, so long as inflation expectations remain stable.
- Import prices are up 8% over a year ago and further rises are in prospect following the currency's decline in the second quarter. But pass-through to consumer prices is likely to be restrained, and profit margins to be squeezed, by intense competitive pressures (including from Asian exports) and moderating domestic demand. Price discounting, now under way to make a quick dent in sizable and largely unintended accumulation of inventories (witness autos), will dampen imported inflation.

...as the current account deficit is close to a peak

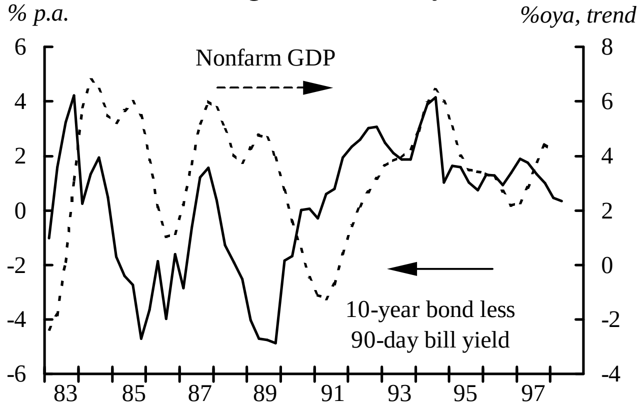
Current account balance
% of GDP



- The May trade report hinted that the current account deficit is close to a peak. While exports to Asia may have stopped falling, the bulk of the trade improvement has come from lower imports due to weak domestic demand. However, moderation in U.S. import demand could still potentially produce further weakness in Australian exports and commodity prices, unless offset by a recovery in Asia.
- Since growth in Japan is not expected to recover sustainably in the near term, and China could slow further, external factors are still likely to weigh on the Australian dollar. But moderating import growth should prevent another plunge in the currency based on fears of a widening current account deficit.

The Reserve Bank could face a tough decision

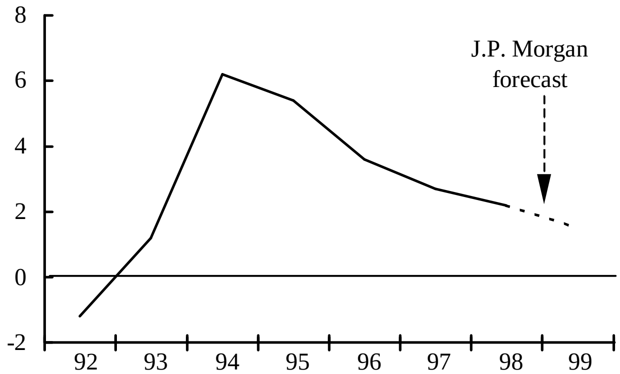
Australia: real GDP growth and the yield curve
% p.a. *%oya, trend*



- A central bank's worst nightmare – a falling exchange rate and declining economic growth – may soon face the RBA. The optimal policy response in such circumstances is to keep interest rates steady, so long as imported inflation appears likely to be tempered by weakening demand and higher unemployment.
- In any case, there is no guarantee that higher interest rates would stop the currency's slide but they would assuredly further weaken economic growth. It follows that any rise in official rates should prove temporary.

New Zealand's growth prospects are diminishing...

New Zealand: real GDP growth
%y/y, years ended Mar 31



- New Zealand is also being buffeted by Asia's recession, just as the economy was weakening in response to high real interest rates (exceeding 8% at their peak). The fragile state of economic activity ahead of the full impact from the Asian crisis was evident when unemployment rose to 7.1% of the workforce in the first quarter, from 6.4 percent a year earlier, the highest since 1994 when New Zealand was recovering from recession.
- The growth outlook has deteriorated following further downgrading of Asian growth prospects. J.P. Morgan expects real GDP growth to fall to 1.5% in 1998 and recover slightly to 2.5% in 1999, still below trend. Only fiscal policy is boosting growth, with a NZ$3.5 billion (or 3.5% of GDP) net increase in spending allocated in the 1997 and 1998 budgets. A personal income tax cut of around 1% of GDP took effect on July 1, but declining consumer sentiment suggests precautionary saving is likely to rise.
- While the sharp fall in the New Zealand dollar will cushion the blow to the tradeables sector, earlier high real interest rates are slowing domestic spending. In turn, the very high current account deficit is beginning to improve, largely through import moderation.
- Inflation has eased despite the currency's sharp depreciation, as the negative output gap has widened, thereby squeezing profit margins, while oil prices in U.S. dollars have declined sharply.

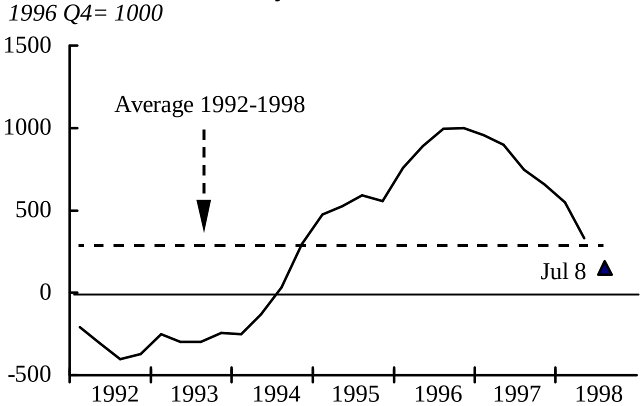
New Zealand: CPIX inflation*

	1997		1998	
	Q3	Q4	Q1	Q2
%q/q	0.7	0.5	0.3	0.3
%q/q saar	2.6	1.9	1.1	1.1
%oya	1.8	1.6	1.7	1.7

* CPIX is the CPI excluding credit services.

...and so the RBNZ has room to ease monetary conditions further

New Zealand: monetary conditions index
1996 Q4= 1000



- Deteriorating growth prospects have prompted the RBNZ to let monetary conditions ease by 200 basis points from the level it desired in its May statement. The MCI is now down nearly 1000 points since the end of 1996, yet current conditions are only slightly on the loose side relative to the historical average.
- While the currency could retest earlier lows (of US$0.49) on yen weakness, an improving current account deficit suggests that another plunge is less likely. Accordingly, interest rates will probably fall further in response to another sanctioned easing in monetary conditions, likely to be announced in the RBNZ's policy statement on August 20.

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Foreign exchange and interest rates

- **What sort of top for $/yen?**
- **Volatility shifts from Asian currencies to local rates with bias toward curve-steepening**
- **A$ and NZ$ still cannot shake the yen link**

Greenback to peak out against yen before year end

Japan's Upper House elections appear to have added to the fundamentals behind the $/yen rise, inasmuch as the LDP's loss of majority control should make it more difficult to pass legislation. The pace of financial reform is likely to slow, regardless of who replaces Hashimoto as Prime Minister.

The market is already discounting the positive headline growth numbers that the May fiscal package should engender for a time since without a significant bank workout program or additional fiscal action in the form of permanent tax cuts, there is little hope that any economic upturn will persist into next year. With little hope of a sustained Japanese recovery and uncertainty about bank balance sheets still weighing on asset prices, the upward trend in $/yen is apt to persist. However, the pace of the dollar's rise should slow and a peak is expected before the end of the year.

Note first that the surprise Fed intervention in June has helped to break the dollar's upward momentum. More importantly, while there is little chance of a near-term Bank of Japan rate hike, JGB yields are apt to continue edging upward on the prospect of increasing issuance and will likely test 2% by year end; and as the chart on the next page shows, past dollar gains were led by the earlier rally in JGBs, so that rally's reversal should, at a minimum, start to hinder the greenback's climb. Besides, the U.S. economy's projected second-half slowdown is not constructive for the dollar, particularly as the current account deficit is likely to go on widening.

Note too that any sign that U.S. unemployment is starting to turn upward is likely to make the Clinton Administration more sensitive to dollar strength. In addition, concerns on U.S. competitiveness have started to raise stock market concerns about corporate profits.

Exchange rate and interest rate forecasts

	Actual	Forecasts	
	Jul-15	3 month	12 month
US$ exchange rate			
Japan	140.5	155	145
Australia	0.62	0.56	0.60
New Zealand	0.52	0.48	0.50
China	8.28	8.29	8.32
Hong Kong	7.7495	7.75	7.75
India	42.6	43.3	46.0
Indonesia	14,350	14,875	14,000
Malaysia	4.16	4.15	4.18
Philippines	41.69	40.0	37.0
Singapore	1.6935	1.73	1.73
South Korea	1,283	1,350	1,450
Taiwan	34.4	35.0	34.0
Thailand	41.3	39.5	38.0
3-month interest rate*			
United States	5.68	5.7	5.8
Japan	0.64	0.6	0.6
Australia	5.12	5.0	5.3
New Zealand	7.25	8.5	7.5
China	10.2	13.3	14.0
Hong Kong	8.3	9.2	8.0
India	19.0	23.0	20.0
Indonesia	49.4	45.0	40.0
Malaysia	23.5	20.0	18.0
Philippines	17.3	19.0	17.0
Singapore	7.2	8.0	7.5
South Korea	26.4	22.0	18.0
Taiwan	10.0	9.8	7.5
Thailand	24.2	26.0	20.0
10-year gov. bond yields**			
United States	5.47	5.5	5.8
Japan	1.65	1.9	2.0
Australia	5.46	5.6	5.9
New Zealand	6.26	6.6	6.7
External debt spreads***			
EMBI+****	593	525	425
Hutchinson Wampoa (Hong Kong) 07	280	250	190
Indonesia 06	760	700	600
Korea 03	410	400	275
Korea 08	427	425	300
Petronas (Malaysia) 06	379	325	225
Philippines 08	372	310	255
Philippines 16	361	330	275
Thailand 07	379	350	275

* % p.a., United States, Japan, Australia and New Zealand are deposit offer rates. All others are mid-level offshore money market rates, which often deviate significantly from onshore rates.
** % p.a., based on local convention.
*** Basis points, spreads of dollar-denominated government (or corporate) bonds over U.S. treasury bonds.
**** J.P. Morgan Emerging Markets Bond Index.

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China and Hong Kong currencies to stand fast

Although the Fed's June intervention seems to have been prompted by a Chinese threat to devalue unless the United States and Japan made a material effort to cap the dollar, the new highs that the dollar will probably set later this quarter are unlikely to precipitate a devaluation of the RMB. First, the Chinese government appears mollified by the positive outcome of the Clinton visit and its enhanced status with the G-7 (now, like Russia, China is an unofficial member). Second, Chinese trade performance has not yet fallen relative to targets for sustaining growth, as it should prior to any decision to devalue the RMB. Given that the RMB-USD peg is therefore expected to hold, the risks of an HKD peg breakdown are marginal.

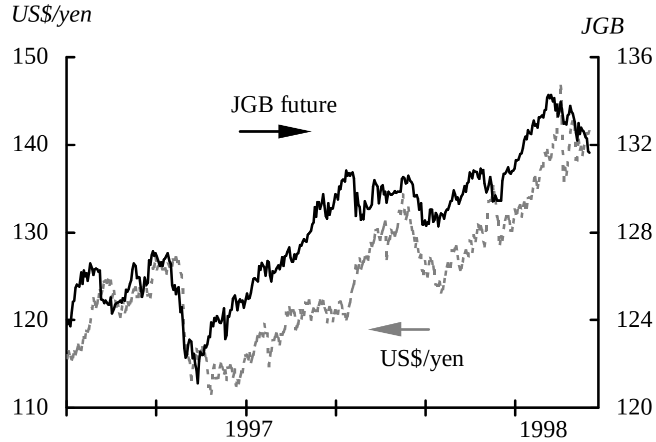
Although an RMB or HKD devaluation is not expected, caution is still advised toward positioning in Asia since the market may aggressively price in such an event as $/yen makes new highs. Caution is also an appropriate response to an apparent shift in economic policy across Asia. The immediate – and necessary – response to last year's balance-of-payments problem was severe demand compression. It worked. A collapse in domestic demand savaged imports and so generated substantial swings toward current account surplus. But, the external crisis has now evolved into a domestic growth crisis – of collapsing domestic production and surging unemployment – which is only marginally alleviated by higher exports.

Interest rates heading lower in Emerging Asia

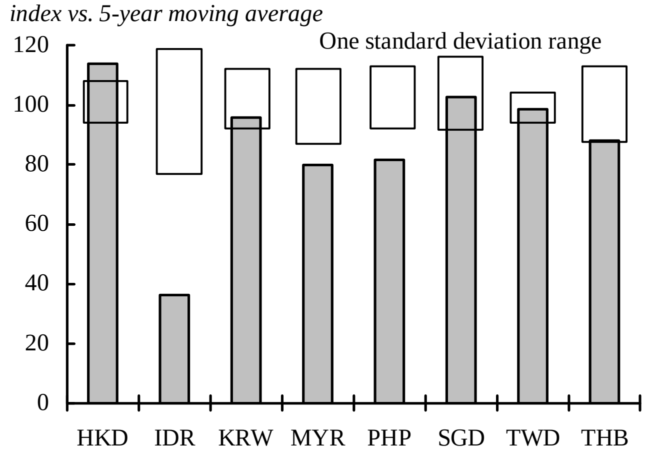
Responding to this phase shift, monetary policies in Asia are becoming more accommodating. Apart from Hong Kong, where the currency peg determines interest rates, real short-term domestic rates – and in most cases, nominal rates – are moving sharply lower throughout Asia, and this is now feeding through to offshore rates, moderating extreme front-end curve inversions. The HKMA also has a bias to take rates lower when consistent with conditions in the HKD market.

While broad-based short-term policy rates are declining in Asia, the impact on both currencies and long-term yields is expected to remain modest. Credit spreads remain bloated, which hinders translation of

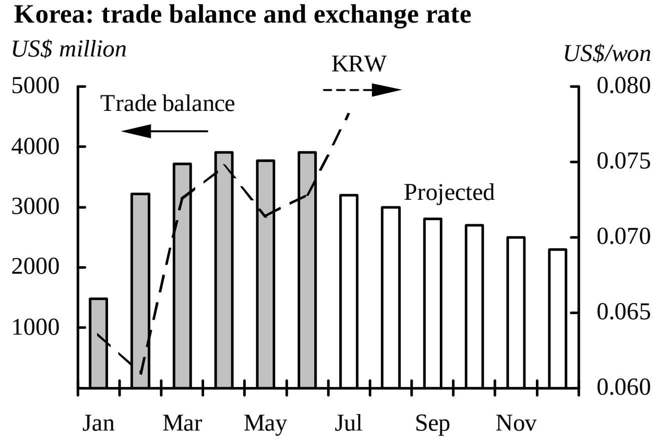
Japan: exchange rate and the JGB market



Asia:real trade-weighted currency level



Korea: trade balance and exchange rate



lower policy rates into market lending rates. Accommodative monetary policy is also not necessarily inappropriate. Indeed, several Asian nations with solvent banking systems, especially Singapore and Taiwan, utilized monetary stimulus early on to offset the regional downturn. And extreme real rates and inverted curves gave Thailand and Korea room to ease without risking immediate currency weakness. Long-term rates are likely to remain underpinned in most markets by increased bond supply and the pricing in of higher inflationary risk as a consequence of accelerated money growth. Hence, yield curves are likely to steepen positively as short-rates move lower.

Extreme inversions at the front end of the Korean curve long offered great potential for sharp downward movements in short-term interest rates. Indeed, the KRW strengthened toward 1998 highs as Korean rates declined. The offshore curve is now on the verge of becoming positively sloped, which should hinder KRW gains. Another hindrance will be an expected declining trend in the Korean trade surplus during the second half (see chart). The KRW will probably fade, but 1325-50 is emerging as a resistance that may hinder a quick return to the old 1350-1400 range.

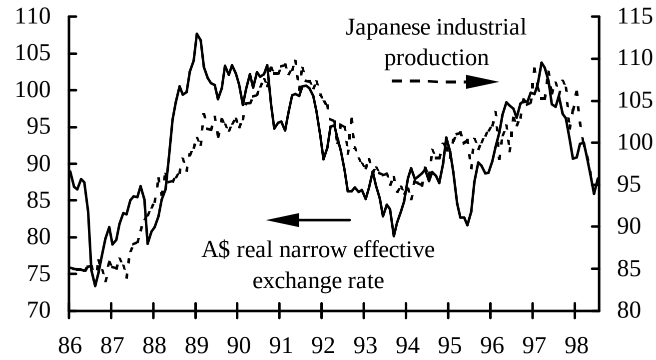
The Thai curve, like Korea's, has also flattened substantially over the past month with little impact on $/THB, which remains bound in a month-old 40.5-41.5 range. Plans are already in the pipeline to convert the debt of the Financial Institution Development Fund into government debt, which should put a floor under the long end of the Thai curve. In turn, any further easing by the Thai central bank is likely to steepen the curve and give the THB a softer bias. The THB may also suffer from the improving outlook for the MYR.

The outlook for MYR is less bearish than before in response to the country's initial but positive restructuring steps – especially the establishment of the AMC and a vehicle for recapitalizing the banks. Holding short MYR/THB has been a popular trade because Thailand has better fundamentals than Malaysia's and it offered positive carry with minimal exposure to the yen. By now, though, the carry advantage has largely disappeared – indeed, 1-month MYR rates have traded through THB, which could trigger profit taking.

SGD and TWD will probably maintain a weakening bias because they have led the way in monetary ease, their rates remain the region's lowest, and curves are positively sloped. Also, these currencies are the most strongly correlated with the yen and so should suffer as the yen's downward trend reemerges.

Japanese IP and the Australian $

1990=100



In the Philippines, a budding inflation problem is likely to put upward pressure on bond rates, giving the central bank less leeway to cut policy rates. The yield curve is expected to steepen anyway, but this will mainly reflect relatively good growth prospects. Bottom line: the PHP should stay well supported.

The Indonesian market will probably be Asia's laggard in rate cuts. Extreme credit and political risk means that cuts in official rates are unlikely to feed through into the market. The IDR remains chronically undervalued even with an inflation rate of 50%, but its recovery will probably have to await national elections around the end of the year.

No basic turnarounds for Aussie and Kiwi dollars

The AUD and NZD have surged on the $/yen reversal and the rebound in commodity prices – especially for gold – but are running into resistance as they test 1-month highs. Assuming $/yen weakness is temporary, there is no reason to look for a fundamental turnaround in either the AUD or he NZD. Both currencies (and commodity prices too) remain strongly linked to a recovery in the Japanese economy. The currency gains have sidelined worries about central bank tightening – especially in Australia – which has supported bond markets. Although the risk of a return to weakening currency trends should cap bond prices, new lows in these currencies will likely have to be seen before bond rates are much affected. Still, Australian bonds are somewhat more at risk, because the One Nation party's rising popularity is likely to slow government implementation of marketfriendly policies.

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Equities

- **Asia's recent stock market slump reflected recognition of depth and length of regional recession**
- **Japanese politics, restructuring risks, and recapitalization needs to remain negatives**
- **But interest rate environment to improve**

Across Asia, stock markets fell sharply in the second quarter, offsetting the gains of the first quarter and in many cases plunging to new lows. In local currency terms, Korea, Malaysia, Singapore, and Thailand have been hit the hardest. However, Indonesia underperformed the rest of the region by far in dollar terms. The main driver of the general downturn was a growing recognition that the regional recession will be deeper and last longer than expected. Moreover, markets also started to feel the huge funding burden of recapitalizing the region's insolvent banks.

Asia is not yet an investor market

Despite the sharp declines in asset values, Asia is not yet attractive as an investor market. Indeed, although markets have stabilized in the last few weeks, downside risk still looms over the region.

- From the outside, the risk of a correction in the U.S. market is increasing, as profits stagnate and the economy slows sharply.

- Within the region, the biggest near-term uncertainty is Japan. The defeat of the LDP in the Upper House election that led to the resignation of Prime Minister Hashimoto makes the government even more sclerotic than before. As a result, little is expected to happen in the next few months with respect to tax changes and banking reform. Instead, fear of a more populist deficit policy could cause the yen, JGBs, and the Nikkei to sell off.

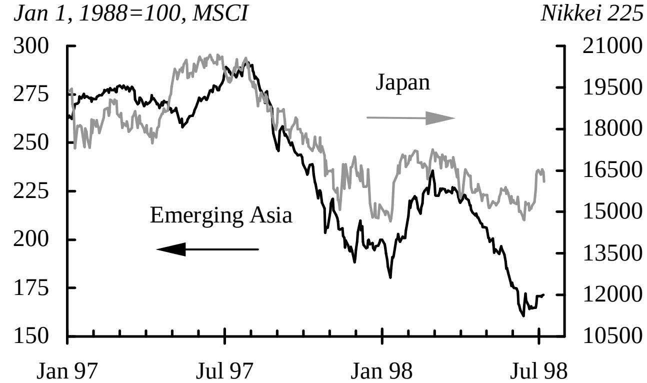
- With the economic free fall now coming to an end, the scope for earnings disappointments in the rest of Asia has become more limited. However, risks remain large, given the fragile health of the corporate and financial sectors and the slow reform progress.

Equity market moves
% changes

	Over last 3 months		Over last 12 months	
	LC-terms	$-terms	LC-terms	$-terms
World*	4.1	3.4	21.3	15.7
United States	1.2	1.2	15.5	15.5
Japan	-2.7	-10.4	-18.9	-34.8
Australia	-2.1	-7.9	2.0	-15.6
New Zealand	-10.4	-16.2	-17.6	-36.9
Emerging Markets*	-16.3	-20.6	-26.0	-40.4
Emerging Asia*	-23.3	-27.5	-40.3	-57.7
China	-21.2	-21.2	-35.8	-35.8
Hong Kong	-27.7	-27.7	-44.7	-44.8
India	-18.7	-24.2	22.3	-34.6
Indonesia	-12.1	-53.6	-36.4	-89.8
Korea	-34.8	-31.3	-60.3	-73.1
Malaysia	-36.6	-46.3	-57.5	-75.1
Philippines	-17.8	-26.0	-28.2	-54.8
Singapore	-31.6	-37.1	-44.6	-54.1
Taiwan	-13.3	-16.8	-16.4	-44.6
Thailand	-38.3	-41.1	-57.8	-70.7

* Morgan Stanley Composite Index

Emerging Asia and Japan stock markets
Jan 1, 1988=100, MSCI



U.S. pretax corporate profits
%oya

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But liquidity conditions will improve

The good news is that liquidity conditions are likely to improve from here. With current account and balance of payments positions turned into surplus, currencies no longer in free fall, and inflation not the threat that it was once feared to be, policymakers have ample room to cut interest rates, most notably in Thailand. However, falling interest rates will not necessarily translate into rising stock markets.

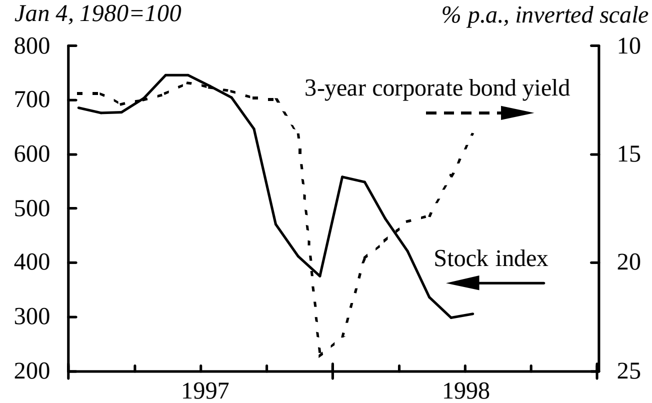
- In *Korea*, for example, interest rates have been falling substantially since the beginning of the year, yet stock prices have been sliding apart from a short-lived surge in January when speculators pushed up the market in anticipation of a rescheduling agreement for the banks' foreign debt. The market clearly adjusted to a steeper-than-expected economic downturn as well as the very slow restructuring progress in the corporate and banking sectors. With the economy nearing a bottom, yet interest rates probably to fall further and some export-led growth likely to emerge by year end, the Korean stock market outlook is improving, but its upside is limited if restructuring progress continues to disappoint.

- Interest rates in *Thailand* have also come down since the start of the year, but far less than have Korea's. Indeed, Thai real interest rates are still unusually high, preventing any meaningful recovery in stock prices. But with the BoT coming closer to repaying its forward obligations, the probability of large-scale interest rate declines is now higher than ever. And although slow restructuring progress remains a concern in Thailand as well, the problems are more concentrated in real estate and finance and do not encompass the whole economy.

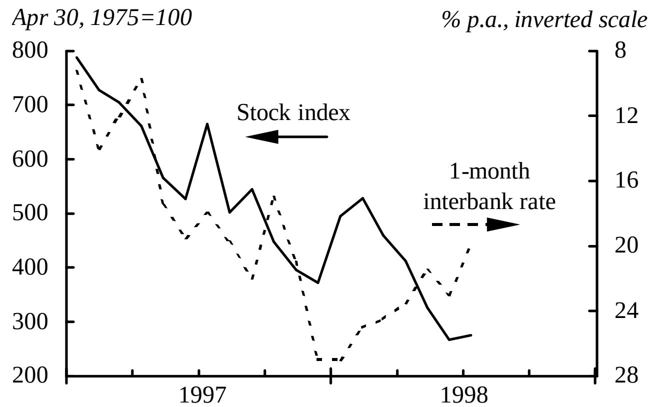
- *Hong Kong*, by contrast, has no leeway to cut interest rates as long as pressure on the currency persists. Here, the prospect of a weaker yen and the perceived risk of a renminbi devaluation are likely to weigh on Hong Kong's stock market for some time to come, especially on property stocks.

- The market that is likely to perform best, then, is the *Philippines*, where interest rates have already come down a lot, valuations are cheap, and restructuring is not a major concern.

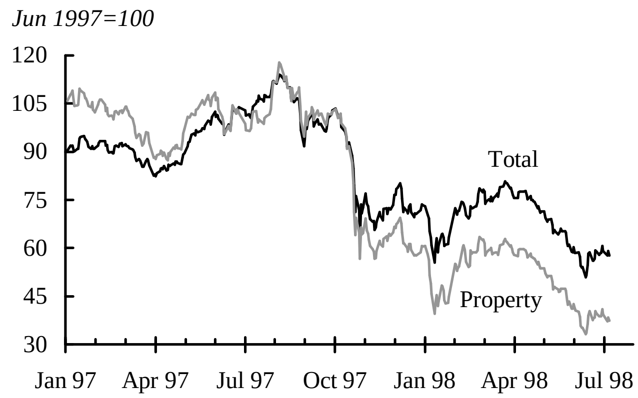
Korean stocks down despite steep interest rate cuts



Still-high interest rates depress Thai stocks



Hong Kong: total and property stocks



Key market factors

	Valuation	Liquidity	Restructuring
Japan	Pricey	Easy	Slow
Hong Kong	Fair	Tight	No issue
Indonesia	Very pricey	Tight	Very slow
Korea	Pricey	Easing	Slow
Malaysia	Pricey	Moderate	Slow
Philippines	Cheap	Moderate	No issue
Singapore	Fair	Moderate	No issue
Taiwan	Pricey	Moderate	No issue
Thailand	Fair	Easing	Moderate

The regional economic outlook in summary

	1997 Nominal GDP in US$			Real GDP % year-on-year				Consumer prices % year-on-year			
	total billion	% of region	per capita 000s	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f
Japan	4664		37.1	4.1	0.8	-3.0	1.0	0.1	1.7	-0.1	-0.4
Australia	418		22.7	3.7	3.3	3.0	2.4	2.6	0.3	0.9	2.4
New Zealand	64		17.9	3.2	2.5	1.5	2.5	2.3	1.2	1.3	1.6
Emerging Asia	2815	100.0	1.1	7.6	6.2	-0.1	3.3	6.5	4.2	8.4	4.6
China	902	32.0	0.7	9.7	8.8	6.5	6.0	8.3	2.8	-2.8	-0.5
Hong Kong	172	6.1	26.5	5.0	5.3	-3.0	1.6	6.0	5.7	3.2	-2.4
India	363	12.9	0.7	6.8	5.0	4.5	5.0	9.0	7.2	8.5	9.0
Indonesia	217	7.7	1.1	8.0	4.5	-14.0	-3.5	7.9	6.6	60.0	27.0
Korea	442	15.7	9.6	7.1	5.5	-6.0	2.6	5.0	4.4	8.0	3.0
Malaysia	100	3.6	4.6	8.6	7.2	-5.1	0.1	3.5	2.7	6.1	6.7
Philippines	82	2.9	1.1	5.8	5.2	0.4	4.0	8.4	5.1	10.0	7.5
Singapore	99	3.5	31.9	7.0	7.8	0.0	0.1	1.4	2.0	1.3	1.7
Taiwan	283	10.1	13.0	5.7	6.8	4.3	4.0	3.1	0.9	2.2	-0.1
Thailand	154	5.5	2.5	7.7	0.5	-6.0	2.5	5.8	5.6	10.0	6.0

	Current account balance US$ billion				Current account balance % of GDP				Foreign reserves US$ billion			
	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f
Japan	65.5	97.4	107.3	124.0	1.4	2.3	3.1	3.4				
Australia	-15.7	-13.2	-19.9	-17.7	-4.0	-3.3	-5.8	-4.8				
New Zealand	-2.5	-3.5	-4.7	-4.0	-3.8	-5.4	-9.0	-7.3				
Emerging Asia	-22.4	20.9	89.8	64.4	-0.8	0.7	3.6	2.5	491.0	490.7	514.8	538.6
China	7.2	29.7	20.2	9.3	0.9	3.3	2.1	1.0	107.0	140.4	137.5	131.9
Hong Kong	3.0	1.4	9.8	11.3	1.9	0.8	5.7	6.6	63.8	75.1	69.5	72.6
India	-3.7	-5.0	-7.0	-8.8	-1.1	-1.4	-1.9	-2.3	22.4	25.9	27.4	28.9
Indonesia	-7.6	-6.2	3.1	2.8	-3.3	-2.9	3.9	3.7	24.0	20.5	20.5	26.5
Korea	-23.0	-8.6	36.0	23.9	-4.7	-1.9	11.5	7.4	34.0	21.1	43.1	53.1
Malaysia	-4.9	-3.9	6.2	5.3	-4.9	-3.9	9.3	8.1	27.0	21.7	24.0	25.5
Philippines	-4.0	-4.3	2.5	5.3	-4.8	-5.2	3.5	6.4	10.0	7.3	10.3	12.3
Singapore	14.3	13.1	6.0	5.5	15.2	13.2	6.8	6.2	76.9	71.4	71.4	73.4
Taiwan	11.0	7.7	-1.2	-1.7	4.0	2.7	-0.5	-0.6	88.0	81.2	80.1	82.3
Thailand	-14.7	-2.9	14.2	11.6	-7.9	-1.9	12.0	7.8	37.7	26.2	31.2	32.2

	External debt % of GDP, end of period				Short-term foreign debt US$ billion, end of period				Government balance % of GDP, end of period			
	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f	1996	1997e	1998f	1999f
Japan									-4.4	-4.2	-5.0	-5.1
Australia									-1.0	0.5	2.3	2.9
New Zealand									3.0	2.5	1.5	1.5
China	17.5	17.3	17.0	17.4	35.2	38.8	36.0	34.9	-0.9	-0.7	-2.5	-3.1
Hong Kong									1.3	4.5	-3.0	-2.3
India	27.4	27.1	27.3	27.3	16.8	17.8	18.8	20.8	-5.0	-6.1	-6.6	-6.0
Indonesia	55.4	62.4	181.5	188.6	41.3	36.8	29.0	18.4	1.0	1.2	-6.0	-6.0
Korea	26.9	32.0	45.1	43.1	87.7	52.8	45.9	42.9	-1.1	1.0	-3.8	-4.0
Malaysia	40.3	43.3	66.4	67.9	11.2	12.8	12.9	12.9	3.9	2.7	-4.5	0.0
Philippines	57.3	62.3	79.7	73.5	12.6	12.6	13.2	14.6	-0.5	-1.8	-2.5	-0.5
Singapore									7.0	6.0	-1.0	-1.0
Taiwan	15.1	15.2	18.0	17.7	28.7	29.2	29.5	30.0	-8.7	-6.9	-8.8	-7.5
Thailand	50.9	62.9	77.9	57.1	38.0	28.3	21.3	16.3	2.4	-1.0	-3.5	-3.0