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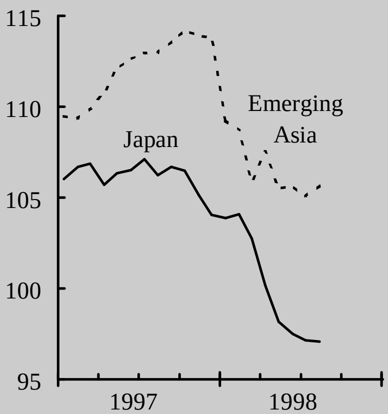
Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

JPMorgan

Asian Financial Markets

Fourth Quarter 1998

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



Contents

The recession is largely over...

- Developments in Asia over the last three months have been overshadowed by the turmoil in global financial markets. Nevertheless, financial and economic conditions in Asia continued to improve, with output finding a bottom and interest rates falling sharply. Much of this reflects the huge improvement in current account balances and the reduction of payment pressures. The interest rate decline, especially in Hong Kong, has been further helped by the U.S. rate cuts and the dollar's weakness.

...but recovery is only a forecast and not a reality

- While other parts of the world are now moving into recession, the focus in Asia is shifting to recovery. Competitive exchange rates and low interest rates make good preconditions for recovery, despite global recession risks. Still, there are risks and obstacles as well as leaders and laggers.

- Industrial production in Japan has stabilized and the outlook calls for the economy to return from recession to stagnation, but conditions remain fragile and policy emphasizes fiscal stimulus more than basic reform.

- In Emerging Asia, chances for an export-led recovery remain best for Korea and Thailand, along with the Philippines, while domestic impediments will hold Indonesia and Malaysia behind. For the rest of the region, the absence of sustained real currency depreciations is a disadvantage, but the outlook for Greater China has brightened, thanks to China's reflation and the declines in the dollar and U.S. interest rates.

Still room for more interest rate declines

- Interest rates are likely to fall further, despite already-substantial declines. In most countries, real interest rates are still too high, given the low levels of economic activity. Thus, central banks are likely to use any opportunity, especially local currency strength and cuts in the U.S. Fed funds rate, to cut domestic interest rates

Equity and property markets are near a bottom

- The improved interest rate scenario is welcome news for equity and real estate markets. They still face restructuring uncertainties and oversupply problems, but the favorable interest rate conditions are unlikely to change even in the event of a U.S. stock market crash.

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J.P. Morgan Research in Asia/Pacific

Economic Research

Bernhard Eschweiler, Singapore
(65) 326-9026
Head of Economic Research Asia/Pacific, India

Yasushi Okuda, Tokyo
(81-3) 5573-1172
Japan

John Kyriakopoulos, Sydney
(61-2) 9551-6467
Australia, New Zealand

Joan Zheng, Hong Kong
(852) 2841-1151
China, Hong Kong, Taiwan

Ji-won Lim, Hong Kong
(852) 2973-5439
South Korea

Vicky Wong, Hong Kong
(852) 2973-5465
Economic indicators

David Fernandez, Singapore
(65) 326-9452
Indonesia, Philippines, Thailand

Ong Sin-Beng, Singapore
(65) 326-9075
Malaysia, Singapore

Market Research

Bill Campbell, Tokyo
(81-3) 5573-1075
Head of Yen Fixed-Income Research

Akihiko Yokohama, Tokyo
(81-3) 5573-1071
Yen Fixed-Income Research

Andrew Skinner, Sydney
(61-2) 551-6288
Market Research Australia

Ronald Leven, Singapore
(65) 326-9063
Head of Asian Emerging Markets Research, China, Hong Kong, South Korea, Taiwan

Winston Koh, Singapore
(65) 326-9457
Indonesia, Thailand

Ong Guat Cheng, Singapore
(65) 326-9459
Malaysia, Philippines

Hsin-Li Chia, Singapore
(65) 326-9789
Singapore

Aashish Pitale, Mumbai
(91-22) 496-8765
India

Credit Research

Merrit Maddux, Tokyo
(81-3) 5573-1523
Head of Emerging Asia Corporate Credit Research

Jenny Wilson, Singapore
(65) 326-9551
Emerging Asia Corporate Credit Research

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

Review and Outlook

The focus shifts from recession to recovery

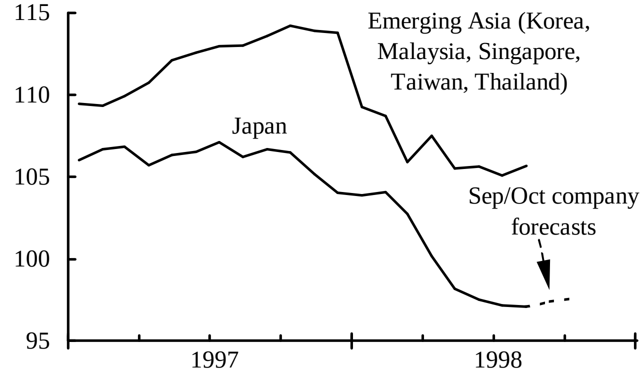
- **Asia has reached bottom and a modest recovery, albeit from low levels, is now likely to follow**
- **Global recession risks will dampen exports but weak dollar and lower interest rates are a plus**
- **Overcoming head winds, especially in the financial sector, remain a key challenge**
- **There is still room for interest rate declines**
- **The outlook for equities has improved, but valuation and restructuring risks remain high**

The last issue of *Asian Financial Markets* pointed to some first signs of financial and real economic stabilization in Asia. Since then, events in the region have been overshadowed by the turmoil in global financial markets. The recession that started in Asia at the end of last year has spread to other emerging economies and is now expected to overtake the U.S. economy in early 1999. As a result, J.P. Morgan has cut its 1999 global growth forecast from 2.3% to 0.9% (see *World Financial Markets*; Oct. 7).

Nevertheless, financial and output conditions in Asia continued to stabilize over the last three months despite the turmoil outside the region. There are leaders and laggers, but all in all, Asia has largely gone through the correction that is now starting in other parts of the world. On average, industrial production has reached a bottom, with Korea and Thailand in the lead and Malaysia and Singapore trailing behind. Currencies have strengthened slightly, but more importantly, interest rates have come down sharply, especially in Hong Kong, Korea, and Thailand.

Key to Asia's financial and output stabilization is the reduction of payments pressures, due to the collapse of domestic demand and the huge improvement of current account balances. But the plunge of the dollar and China's reflation efforts have significantly bolstered the improvement in regional financial and economic conditions, particularly in Hong Kong.

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



Risks and obstacles

Not surprisingly, the focus is now shifting to recovery. Lower interest rates and competitive exchange rates constitute favorable preconditions for recovery, but there are both risks as well as obstacles ahead.

- Global financial and economic conditions are unlikely to get much worse than in the current J.P. Morgan forecast. Even so, individual events, such as major exchange rate corrections or large debt defaults, could have significant repercussions for Asia.

- Within the region, renewed recession in Japan is the largest risk. Industrial production there stabilized during the summer, but the economy is still on shaky ground: Confidence is low, the government's banking reform strategy remains ineffective despite increased funding, and the local authorities' budget problems are undermining the fiscal stimulus.

- China's reflation also has its weak points. Pumping money into state enterprises creates waste and more bad loans, while the strong renminbi hurts state-sector profitability and spurs capital flight.

- Policymakers are no longer in denial, but slippage (Malaysia's introduction of capital controls and Hong Kong's stock market interventions) and political uncertainty (Indonesia) are still significant risks.

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

- Despite much-lower interest rates in many countries, domestic private demand is unlikely to be a strong source of growth, thanks to the deterioration of labor market conditions, overcapacity, banks' reluctance to lend, and the destruction of wealth.

- Financial and corporate reform progress has been slow due to poor institutional structures and the political difficulties of forcing concessions from business groups and labor unions. Increasingly, governments are coming to the rescue, but their ability to pay the interest cost of assumed debt is often hampered by their own funding problems, notably in Indonesia and Malaysia.

Leaders and laggers

Despite all these risks and obstacles, the forecast assumes that this year's real GDP contractions will in most cases give way to modest growth in 1999. Still, next to the region's low operating levels, real GDP growth in 1999 of 0.7% in Japan and 2.4% in Emerging Asia may not feel much like a recovery. Moreover, there will be increased diversity of growth experience.

- Muddling through remains the theme in Japan, with the emphasis on spending and not reform. Stagnation, not recovery, will follow the recession – hardly an engine of growth for the rest of Asia.

- In Emerging Asia, export-led recoveries are likely to occur in countries that have sustained substantial real currency depreciations (Indonesia, Korea, Malaysia, Philippines, and Thailand). Despite weak global demand, these countries will be able to build export volumes and export market shares, albeit at the cost of reduced terms of trade. Exporters using mostly domestic inputs can expect higher profit margins and in turn will boost capital spending.

- Export growth alone, however, may not suffice to lift overall real GDP if domestic demand conditions and banking problems remain a drag. Here, Indonesia and Malaysia are most at risk, while more substantial reform progress and sustained depositor confidence are putting Korea and Thailand ahead (along with the Philippines, which has not experienced a banking crisis).

- The countries in the rest of Emerging Asia that have avoided a severe banking crisis but that also have lost currency competitiveness will lag the regional turnaround (China, Hong Kong, India, Singapore, and Taiwan). Indeed, they are even at risk of further output and currency weakness. However, the growth outlook for Greater China has improved over the last few weeks, thanks to the reacceleration in Chinese output and the weakness of the dollar – which has allowed interest rates in Hong Kong to fall.

Interest rates to fall further

Although down substantially, interest rates in the region still have room to fall further.

- First, Asian central banks are likely to use dollar weakness and lower U.S. interest rates (J.P. Morgan expects the Fed fund rate to drop to 3.5% by the middle of next year) to cut domestic interest rates and avoid substantial currency appreciation.

- Second, interest rates are still high in real terms, given the benign inflation outlook and the poor state of the economies. Real interest rates in Indonesia, and to a lesser extent in Hong Kong and Singapore, are still above historical standards. And even in Korea, the Philippines, and Thailand, where real interest rates have returned to historical averages, low operating levels allow for more interest rate declines. The big exception is Malaysia. Its real interest rates are well below historical standards and, despite capital controls, risk prompting capital flight.

Outlook for equities has brightened

Equity markets have responded favorably to the stabilization in regional financial and economic conditions as well as the two cuts in U.S. interest rates. The drop in interest rates and output stabilization have improved liquidity and earnings fundamentals in both stock and property markets. However, valuation uncertainties remain high, due to slow restructuring progress and the failure of many markets to clear. Moreover, regional stock markets will be vulnerable to a correction of the Dow Jones in response to evidence of a weaker U.S. economy. Nevertheless, market support from the favorable interest rate changes is unlikely to be reversed.

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Bernhard Eschweiler (65) 326-9026
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Asia's property deflation one year on

- **Rent and property price movements have varied across the region, but the trend has been down**
- **Property prices are now closer to fair value but vacancies have surged and more supply is coming**
- **Many obstacles prevent market clearing even where prices are down below replacement costs**
- **Property values likely to drop another 5%-15% on average with China and Malaysia most at risk**

Overinvestment, asset inflation, and excessive bank borrowing in the property sector have long been viewed as among the key causes of Asia's financial crisis. A year ago, J.P. Morgan predicted that property prices would plunge 30% to 50% in the crisis economies, notably Indonesia, Malaysia, and Thailand, but that real estate values were also hugely overvalued and vulnerable to large corrections in the region's stronger economies such as China, Hong Kong, Singapore, and Taiwan (see *Asia's asset price deflation – now and to come*, Asian Financial Markets, Oct. 17, 1997, page 5).

One year on, the expected price adjustments have largely been realized, but with notable exceptions. For the key office sector, property price adjustments in Bangkok, Hong Kong, Jakarta, Manila, and Seoul have been broadly in line with expectations. But office prices in Kuala Lumpur, Shanghai, and Taipei have not fallen as expected, while office prices in Tokyo have failed to increase as predicted.

This essay reviews the situation and recent dynamics of the region's real estate sector and provides an outlook for the next 12 months along with the implications of the property sector adjustment for Asia's prospects for broad economic recovery. Despite often large declines in rents and property values, Asia's property sector adjustment is still at an early stage. The period of economic and financial meltdown is largely over and real activity has reached a bottom, but the region's economic downturn has been much deeper than expected and supply and demand conditions in the property sector continue to deteriorate.

Expected and actual average office price changes
percent change, local currency terms unless noted

	Past forecast*	Actual**	Outlook***
Bangkok	-35.0	-38.5	-5/-15
Hong Kong	-46.0	-43.0	-10/-20
Jakarta (*US$ terms*)	-35.0	-50.5	-10/-20
Kuala Lumpur	-39.0	-8.0	-20/-30
Manila	-13.0	-12.0	-5/-15
Seoul	0.0	2.5	0/-10
Shanghai (*US$ terms*)	-22.0	-4.0	-20/-30
Singapore	-38.0	-22.0	-10/-20
Taipei	-32.0	0.0	0/-5
Tokyo	8.0	-4.5	0/-5

* J.P. Morgan forecast of 1-to-3 year price changes from June 1997 (see *Asian Financial Markets*; Oct 17, 1997; page 11).
** Actual %oya office price changes as of June 1998 (see also table at bottom of following page).
*** J.P. Morgan forecast of 12-month price changes from June 1998.

With interest rates and property prices now down, most property markets seem close to fair value. Vacancy rates have surged, however, and are likely to rise further given the huge supply still to come. Thus, real estate prices generally will probably drop another 5% to 15%. China and Malaysia likely face even steeper declines – thanks to the former's massive supply of new property and already very high vacancy rates and the latter's probably unsustainable combination of capital controls and aggressive monetary easing.

A problem in assessing current property market conditions is the lack of sales activity. Property transactions have come close to a standstill in almost all markets except Hong Kong, Seoul, Taipei, and Tokyo. The lack of sales activity reflects investor uncertainty as well as structural obstacles such as tax distortions and poor legal standards. Still, with property values now in many countries below replacement cost, investor demand should soon pick up, while government auctions of foreclosed bank assets will help increase market liquidity, especially in Thailand.

The property sector adjustment still to come will be a drag on Asia's recovery and the restoration of financial health. Moreover, construction will be weak for several years ahead. Still, efforts to improve market liquidity should accelerate the adjustment process.

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

Rents and property values have dropped sharply...

Much as has been true of the general goods, services, and asset markets, deflation and not inflation has been the general response of the region's property markets to the financial crisis. Rent and property price adjustments reflect the tightening in financial conditions, the sharp decline in domestic demand, the buildup of excess capacities, and the previous overvaluation of real estate assets. However, the rent and property price changes have not been uniform across the region.

- In local currency terms, Bangkok, Hong Kong, and Shanghai have been hardest hit, followed at some distance by Singapore and Kuala Lumpur. In US$ terms, Bangkok and Jakarta fell the most, due to their sharp currency devaluations, followed by Kuala Lumpur, Manila, and Seoul.

- Rent and price adjustments have been largely in line with expectations. The biggest outlier is Taipei, where rents and prices on average have actually increased, thanks to continued strong domestic demand. Real estate in Kuala Lumpur and Shanghai has also been more resilient, while the recession has caused declines in Tokyo rents and property prices.

- Not surprisingly, rents have on average adjusted less than property values, thereby lifting property yields. The lead exception is Shanghai, where very high vacancies have sent rents tumbling, while low interest rates have shored up prices.

Office vacancy rates
percent, central business district

	June 1997	June 1998
Bangkok	17.7	27.0
Hong Kong	6.4	9.7
Jakarta	13.1	16.0
Kuala Lumpur	10.3	16.8
Manila	2.1	5.7
Seoul	n.a.	15.0
Shanghai	40.3	48.4
Singapore	9.3	11.1
Taipei	3.0	2.5
Tokyo	5.0	4.5

Sources: Colliers Jardine, Jones Lang Wootton, and J.P. Morgan estimates.

- By sector, rents and prices have fallen by up to 10% more for retail property than in the office and residential areas, reflecting the very poor performance of retail sales in the crisis economies.

...and vacancy rates have surged

Despite the rent and property price correction, vacancy rates have jumped across the region except in Taipei and Tokyo. In the crisis economies – notably Bangkok, Jakarta, Kuala Lumpur, and Seoul – net absorption of property space has been negative due to downsizing and bankruptcies. In the rest of Asia, net absorption has remained positive, but most often outpaced by huge capacity gains, especially in Shanghai, where office vacancy rates have risen to almost 50%.

Average rent and property price changes
%oya changes, June 1998

	Office property				Residential property				Retail property				US$
	Rents		Prices		Rents		Prices		Rents		Prices		fx
	LC*	US$	LC*	US$	LC*	US$	LC*	US$	LC*	US$	LC*	US$	rate
Bangkok	-34.0	-59.5	-38.5	-62.5	-17.0	-49.5	-20.0	-51.0	-42.5	-65.0	-43.0	-65.0	-39.0
Hong Kong	-12.5	-12.5	-43.0	-43.0	-17.5	-17.5	-35.0	-35.0	-24.0	-24.0	-30.5	-30.5	0.0
Jakarta**		-63.0		-50.5		-66.0		-33.0		-76.5		-77.5	-83.5
Kuala Lumpur	-12.0	-47.0	-8.0	-44.5	-23.0	-53.5	-16.0	-49.0	-18.0	-50.5	-12.5	-47.0	-39.5
Manila	3.0	-35.5	-12.0	-45.0	-9.0	-43.0	-12.5	-45.5	0.0	-37.5			-37.5
Seoul	3.0	-33.5	2.5	-33.5	-6.0	-39.5	-2.0	-37.0	-7.0	-40.0	-9.5	-41.5	-35.5
Shanghai**		-34.5		-4.0		-55.5		-36.0		-30.0			0.0
Singapore	-18.0	-30.5	-22.0	-34.0	-9.0	-23.0	-16.0	-29.0	-10.0	-24.5	-11.0	-25.0	-15.5
Taipei	16.5	-6.0	0.0	-19.0	-2.0	-20.5	6.0	-14.0	9.0	-11.5	4.0	-16.0	-19.0
Tokyo	0.0	-17.5	-4.5	-22.0	-15.0	-30.0	0.0	-17.5	-9.5	-25.0	0.0	-17.5	-17.5

* Local currency terms.
** Quoted in US$.
Sources: Colliers Jardine, Jones Lang Wootton, and J.P. Morgan estimates.

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Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

Property values have come closer to fair value...

In absolute US$ terms, rents and property prices in Bangkok, Jakarta, and Kuala Lumpur are by far the lowest, followed at some distance by Manila. At the top end of the range are Hong Kong and Tokyo, followed by Singapore. Property yields are higher in the less-developed markets. The large rent, capital value, and property yield discrepancies between the different markets are nothing unusual and reflect these countries' different developmental positions, land supplies, population densities, and efficiencies of property use. Nevertheless, rents, capital values, and property yields also need to be broadly consistent with each country's competitive and business cycle position and market discount rates.

The rental-discount model is a useful tool to determine the long-term rental growth rate required for current property prices to constitute fair value (see also *Asian Financial Markets*; Oct. 17, 1997, page 5). The required long-term rental growth rate is the difference between the discount rate and the property yield adjusted for corporate income taxes and a standard 95% occupancy rate. Property prices are roughly at fair value if the required long-term rental growth rate broadly matches long-term inflation expectations.

For most property markets, the required long-term rental growth rate falls between 3% and 5% under current interest rate and market conditions. This is a sharp drop from a year ago, when average required long-term rental growth was roughly double the current rate. Moreover, current required rental growth is substantially below past rental growth and inflation trends and appears broadly in line with long-term inflation expectations. The improvement here reflects the recent easing in interest rate conditions and the already-large capital value adjustments. All this suggests that most markets have come close to fair value.

...but will nevertheless fall some more

Nevertheless, property values are likely to fall some more. The obvious case is Indonesia, where property prices are hugely overvalued at current high interest rates. And although interest rates are expected to fall, this will probably not fully obviate the need for more price adjustments. For the rest of the region, the de-

Average office rents, prices, and yields
central business district, June 1998 figures

	Rents (US$/m² p.a.)	Prices (US$/m²)	Yields (% p.a.)
Bangkok	87	897	9.8
Hong Kong	968	14,920	6.5
Jakarta	97	1,030	9.4
Kuala Lumpur	101	1,275	7.9
Manila	239	1,874	12.7
Seoul	376	3,569	10.5
Shanghai	379	2,843	13.3
Singapore	480	11,579	4.2
Taipei	420	7,286	5.8
Tokyo	565	14,125	4.0

Sources: Colliers Jardine, Jones Lang Wootton, J.P. Morgan estimates.

Required long-term rental growth rate*
% p.a., central business district office space

	Discount rate**	–	Adjusted yield***	=	Required rental growth rate*
Bangkok	10.0		6.5		3.5
Hong Kong	9.8		5.2		4.6
Jakarta	40.6		6.3		34.3
Kuala Lumpur	8.3		5.3		3.0#
Manila	13.5		7.8		5.6
Seoul	12.1		7.6		4.5
Shanghai	8.2		8.5		-0.3
Singapore	6.3		2.9		3.3
Taipei	8.1		3.9		4.2
Tokyo	3.0		1.9		1.1

* Long-term rental growth required to warrant June 1998 capital values under normal occupancy conditions (95%).
** Weighted discount rate: 50% equity and 50% debt, adjusted for corporate income taxes.
*** Adjusted for corporate income taxes and 95% occupancy rate.
\# 7.3% under interest rate conditions prevailing prior to the recent introduction of capital controls.

New office supply and vacancy projections
central business district, J.P. Morgan estimates

	New supply Jul 98 to Jun 99		Vacancy rates (%)	
	('000s m²)	(% of stock)	Jun 98	Jun 99
Bangkok	250	11.0	27.0	30-35
Hong Kong	250	14.2	9.7	13-18
Jakarta	150	6.2	16.0	18-23
Kuala Lumpur	300	13.7	16.8	20-25
Manila	200	9.9	5.7	8-13
Seoul	500	3.9	15.0	15-20
Shanghai	900	26.1	48.4	50-55
Singapore	300	8.0	11.1	13-18
Taipei	50	5.3	2.5	3-5
Tokyo	700	1.0	4.5	4-5

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

cline in interest rates seems sustainable and more declines could follow, thanks to large balance of payments gains. However, the effectiveness of Malaysia's new capital controls is in doubt and could lead to higher interest rates in the future.

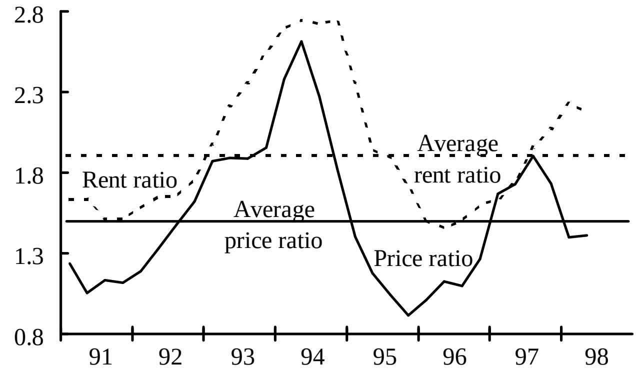
Besides interest rates, a critical component of the analysis is the assumption of normal occupancy rates (95%). Currently, this holds true only in Manila, Taipei, and Tokyo. Elsewhere, occupancy rates vary between 90% and 50% and are expected to fall further due to poor demand and the expected increase in supply (see table at bottom of previous page). Taking this into account, property prices appear distinctly (25% to 35%) overvalued in Shanghai, where occupancy is expected to drop below 50%, and modestly overvalued (5% to 15%) for most of the rest of the region.

Has Hong Kong real estate come close to a bottom?

Within the region, Hong Kong's property market attracts the most attention. Not only has Hong Kong one of the region's largest and most expensive real estate markets, but the health of its property sector, and consequently of its banks, is viewed as critical for the outlook for the currency peg. Conditions in Hong Kong's real estate market depend not only on the business cycle and interest rates, but also on service-sector competitiveness, since Hong Kong, like no other country in Asia, is essentially a financial and business services economy – manufacturing is less than 10% of GDP. With the peg vital to maintaining stability in its huge banking market, flexible rents, property prices, and wages are key for preserving competitiveness.

Hong Kong property was hugely overvalued when the crisis broke last year, but, on a stand alone basis, has since come close to fair value even allowing for higher vacancies. However, Hong Kong property prices, and especially too its rents, are still far above levels in Singapore and, to a lesser extent, Tokyo. With fluctuations, Hong Kong rents and property prices have on average in the past exceeded Singapore's by 90% and 50% respectively. This difference reflects not only Hong Kong's more limited land supply and higher population density but also its more efficient use of property – Hong Kong US$ GDP per square meter of office space is roughly twice that of Singapore.

Hong Kong property is "catching down" to Singapore's
ratio of Hong Kong property to Singapore's, US$ terms

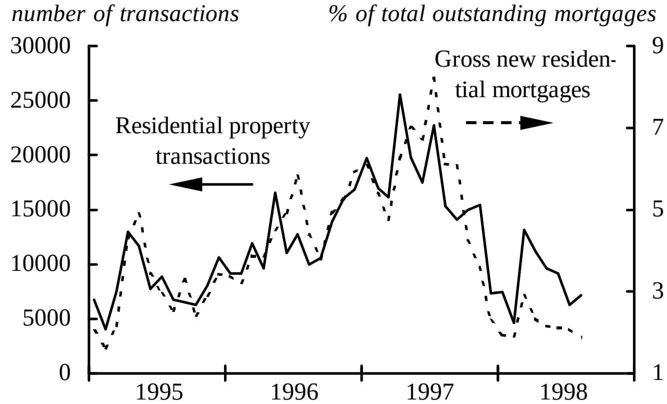


Hong Kong office price adjustment scenarios
% change from June 1998 levels

Singapore rental changes		0	-10	-20
Implied Hong Kong rental changes*		-12	-21	-30
Implied Hong Kong capital	5%	10	-1	-12
value changes to achieve	6%	-8	**-17**	-26
property yields of:	7%	-21	-29	-37

* Hong Kong US$ rentals set equal to 1.9 times Singapore US$ rentals.

Hong Kong property transactions and mortgages
number of transactions *% of total outstanding mortgages*



Property prices have already fallen enough to restore competitiveness, but rents will probably have to fall another 20% to catch down to their level in Singapore, where rents are likely to fall another 10% as well. Thus, to maintain property yields of around 6%, Hong Kong property prices must probably fall another 17%. The good news is that Hong Kong's property market has remained liquid, which will ease the adjustment process and allow the market to clear quickly. Transaction volumes have dropped, but are still significant, and banks continue to extend new mortgages at a pace of 2% of total outstanding mortgages per month.

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

Market liquidity has often completely dried up

Hong Kong's still-significant level of market transactions is more the exception than the rule within the region. In fact, market liquidity has completely dried up in the crisis economies, which substantially complicates the assessment of current property prices. The lack of property transactions reflects investor uncertainty and developers' reluctance to sell at low prices, but is also a sign of structural distortions, such as poor accounting, disclosure, legal, and foreclosure standards. High capital gains and transaction taxes also often deter potential investors, while potential sellers in Thailand are hurt by high tax assessment values.

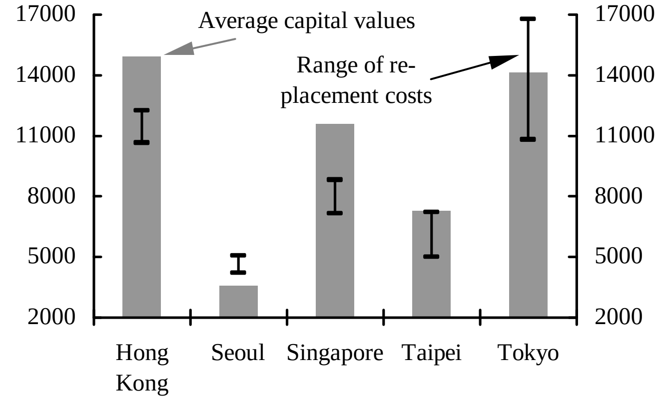
By far the biggest obstacle, however, is the reluctance of banks and governments to accept losses and allow markets to clear at low prices. This is especially true of Japan and Malaysia and, to a lesser extent, Indonesia and Korea. By contrast, Thailand's authorities are making strong efforts to clear the market. Thailand's Financial Restructuring Agency (FRA) has already auctioned mortgage loans for US$600 million and will launch a wholesale auction of property loans with a total book value of US$16.5 billion on December 2.

Property values are falling below replacement costs

The scale of Thailand's December FRA auction risks putting additional downward pressure on property prices. Even so, with current prices already significantly below replacement costs (total cost of land, construction, and capital in current market conditions) and with the government providing additional tax incentives, especially for property funds, investor demand is likely to be strong. Indeed, the FRA's auction of residential mortgages in August pointed to capital value declines of roughly 50%, which was consistent with market values in June minus another 10%.

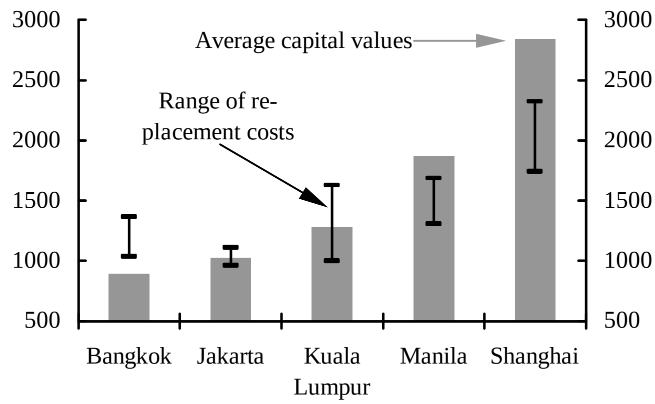
Office capital values and replacement costs

US$ per square metre, June 1998, J.P. Morgan estimates



Office capital values and replacement costs

US$ per square metre, June 1998, J.P. Morgan estimates



Structural obstacles in the property market

	Japan	Indonesia	Korea	Malaysia	Thailand
Accounting and disclosure standards	Poor	Very poor	Poor but improving	Fair but deteriorating	Poor but improving
Legal and foreclosure standards	Inefficient and debtor friendly	Very inefficient	Inefficient and debtor friendly	Efficient but politically biased	Inefficient but creditor friendly
Tax issues	High capital gains, sales, and stamp taxes	High sales and transfer taxes	High capital gains, registration, and sales taxes	High capital gains, registration, and sales taxes	Distorted capital gains tax but new tax exemptions
Foreign entry rules	No restrictions	No restrictions	Limited restrictions	Need government approval	Land ownership restricted
Banks' willingness to write off NPLs	Low	Low	Low	Low	Improving
Political will to force market clearing	Low	Improving	Improving	Very low	High

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

Besides in Bangkok, property values have also dropped to or below the range of replacement costs in many other centers – Jakarta, Kuala Lumpur, and most notably Seoul. Property values in Hong Kong, Manila, Shanghai, and Singapore are still significantly above replacement costs, but even those margins are likely to narrow or even disappear, given the expected price declines still to come.

This comparison of capital values with replacement costs has several useful applications.

- Replacement costs help determine the potential market bottom. To be sure, prices can fall well below replacement costs, but this will increase demand and bring the bottom closer – probably most imminently in Korea and Thailand.

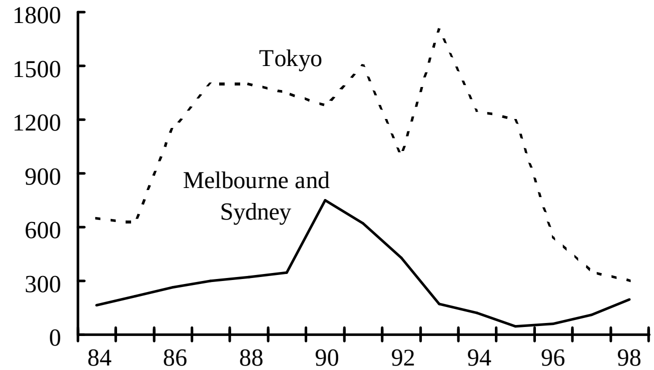
- Property prices do not have to fall below replacement costs, but if prices are high and supply far exceeds demand, prices can drop sharply before they reach a bottom – this is the risk now facing China.

- Property prices that stay at or below replacement costs for a long time betray a failure of the market to clear, presumably due to structural obstacles. This can have negative effects on economies at large – as has long been the case in Japan and now is a risk for Indonesia and Malaysia.

- Although replacement costs are not the same as actual project costs, they are good pointers to developers' financial strength. By this measure and taking into account further expected price declines, only developers in Hong Kong, the Philippines, Singapore, and Taiwan are likely to remain solvent.

- With capital values at or below replacement costs and vacancies high, any property market is unlikely to see much new construction activity for some time. This was true for Australia early in this decade, is more recently for Japan, and will henceforward apply for the rest of Asia. The risks of extended weakness are particularly high in Indonesia, Korea, Malaysia, Thailand, and potentially China.

New office supply: before and after the bubble
'000s square meters



Financial sector property exposure
June 1998 estimates unless noted

	Dom. credit (% of GDP)	Property exposure (% of total loans)	Loan/collateral ratio (%)*
Hong Kong	175	40-55	50-70
Indonesia	75	25-30	80-100
Japan	170	20-25	80-120
Korea	165	10-15	60-100
Malaysia	165	30-40	80-100
Philippines	60	15-20	70-80
Singapore	115	30-40	70-80
Thailand	155	30-40	80-100

* Prior to crisis (June 1997).

Property adjustment to be a drag for recovery

Although the worst of the property price declines is probably over, the adjustments still to come will be a drag on the region's economic recovery. Besides the weak construction outlook, the main drag will be transmitted through the financial sector. The region's financial sectors are large both in total credit outstanding and property exposure, while past lending standards have been reckless with just a few exceptions – notably Hong Kong, the Philippines, and Singapore.

The negative economic implications of the financial troubles in Asia's crisis economies are well known, but it will still make a difference whether property markets are allowed to clear quickly. Here, Thailand's chances for recovery are better than those of Indonesia and Malaysia. The flexibility and liquidity of Hong Kong's property market plus the stronger position of its banks also afford better preconditions for recovery.

Funding Emerging Asia's budget deficits

- **Absorbing bad bank loans is critical for recovery, but will boost government interest expenses**
- **Funding growing fiscal needs requires high saving, depositor confidence, and low interest rates**
- **Korea and Thailand can rely mostly on domestic funds to cover their budget financing needs...**
- **...but Indonesia and Malaysia will struggle**

With the phase of financial meltdown now well behind and output reaching a bottom, focus in Emerging Asia is shifting to recovery. Competitive exchange rates plus much lower interest rates provide good preconditions for recovery, but the poor health of banks, along with high unemployment and substantial overcapacity, will be a drag for some time. Thus, restoring financial-sector health and avoiding Japan's mistakes in that effort are now top priorities for Asia's crisis economies.

So far, bank reform progress has been undermined by a lack of expertise, legal support, and accounting standards as well as political difficulties in obtaining concessions from bank owners, debtors, and labor unions. Instead, governments increasingly have felt obliged to act as principal agents that clear banks' balance sheets by absorbing the bulk of nonperforming loans (NPLs). In principle, this means swapping NPLs for government bonds. By itself, this creates no additional net borrowing requirement, but boosts government interest expenses at a time when fiscal balances are already under pressure from the economic downturn.

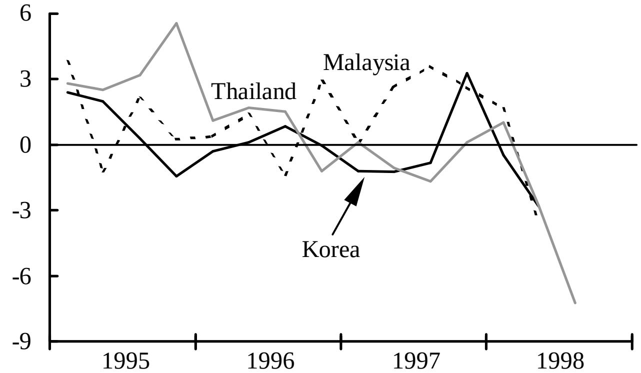
The ability to fund the growing deficits will depend on people's faith in the government and its financial reform policy. In Korea and Thailand, people have that faith, but not in Indonesia, while Malaysia's policy changes jeopardize people's trust in the government.

Budget balances have already moved into deficit...

In Korea, Malaysia, and Thailand, the seasonally adjusted fiscal surpluses of late last year turned to deficits of around 3% of GDP in the second quarter of 1998. And judging by Thailand's September fiscal-year-end report, deficits in the region's crisis countries probably reached 5% to 7% of GDP in the third quarter. Full-year deficit projections vary according to fiscal-year definitions and degrees of economic decline. Indonesia's will be the widest, at about 9% of GDP, while those of Korea, Malaysia, and Thailand will run some 4% to 5% of GDP.

Moreover, although governments' direct debt used to be low, their gross debt *(including* guarantees for state enterprise debt and financial restructuring bonds as well as IMF loans) has surged, by now likely reaching 35% of GDP in Korea and up to 60% in Indonesia. But while Indonesia's government debt is entirely foreign-currency based and Thailand's is too to a large extent, more than 50% of Korea's and Malaysia's debt is denominated in local currency (table at top of next page).

Central government budget balances
% of GDP, seasonally adjusted



Central government fiscal positions
% of GDP, calendar year except where noted

	Budget balance		Gross debt*	
	1997	1998e	1997	1998e
Indonesia**	-3.5	-9.0	70.5	62.0#
Korea	0.0	-5.0	18.7	35.0
Malaysia	2.4	-5.0	48.0	56.0
Thailand***	-1.4	-3.9	34.7	55.0

* End of period, including guarantees for state enterprise debts, financial restructuring bonds, and loans to central bank.
** April to March fiscal year, with program aid defined as borrowing.
*** October to September fiscal year.
# The decline in the debt/GDP ratio is due to the inflation-induced rise in nominal GDP, not an absolute decline in gross debt.

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

Deficits will rise further despite cyclical turnaround

Business cycle conditions in Asia's crisis countries are expected to improve in 1999: Real GDP in Korea and Thailand is projected to grow 2%-3%; Malaysia's expansion policy is likely to stall the recession; and even Indonesia will probably record a bottom around the turn of the year – although base effects will cause its real GDP to average lower in 1999 than in 1998. Even so, although much improved, economic conditions will remain poor and are unlikely to lift government finances, while fiscal stimulus packages, notably in Korea and Malaysia, will add to the revenue shortfalls.

Moreover, the rise in gross debt will send interest expenses surging. The biggest increase in gross debt will probably come not from a rise in net borrowing but from issuance of government bonds that will be used to buy bad bank loans and fund financial restructuring agencies. How large this issuance will be it is too early to say. It will depend heavily on performance in both the economy and financial restructuring itself. But based on current NPL estimates, issuance needs are likely to vary between 20% and 50% of GDP.

Korea and Thailand have already announced plans to issue domestic bonds worth roughly 15% of GDP, of which so far about one-fifth have been placed in the market. In addition, Korea has issued US$4 billion of foreign bonds, while Thailand has plans to issue US$3-5 billion overseas if market conditions are favorable. Indonesia and Malaysia have also hinted at plans to issue domestic and foreign bonds to fund financial restructuring, but have revealed no details.

Although interest rates have come down a lot and are likely to fall further, the annual interest expense burden of governments' financial reform debts will reach at least 2% of GDP and could climb as high as 5% of GDP. This means that government deficits are set to rise further in 1999 and last for many years – although at lower levels – until economies have fully recovered.

Private net saving is key to funding public deficits

Given the size of public-sector net borrowing needs as well as the clear limits on raising capital in foreign markets, funding government deficits will require huge increases in private net saving. Here, the good news is

Composition of central government gross debt*

% of total, June 1998 estimates

	Indonesia	Korea	Malaysia	Thailand
Domestic	0.0	55.0	61.0	28.5
Bonds and bills	0.0	21.5	58.0	28.5
Loans	0.0	33.5	3.0	0.0
Foreign	100.0	45.0	38.0	71.5
Bonds	low	13.0	23.0	8.0
Loans	high	32.0	15.0	63.5
Total (US$ billion)	69.0	66.5	30.3	36.9

* Includes state enterprise debts and financial restructuring bonds guaranteed by the government plus loans to the central bank.

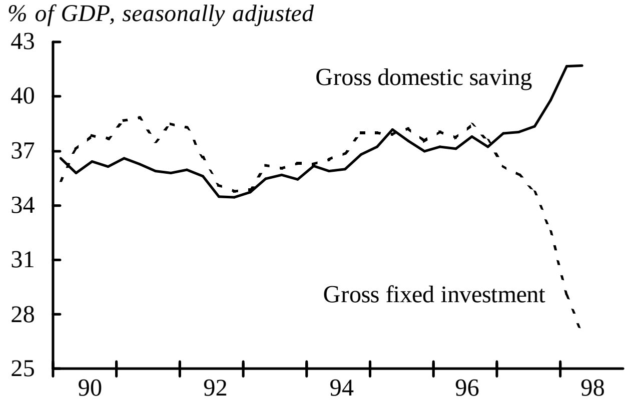
Banks' nonperforming loans

end of 1998, J.P. Morgan estimates

	Indonesia	Korea	Malaysia	Thailand
US$ billion	30-40	120-180	20-40	50-70
% of GDP	40-50	40-60	30-60	40-60

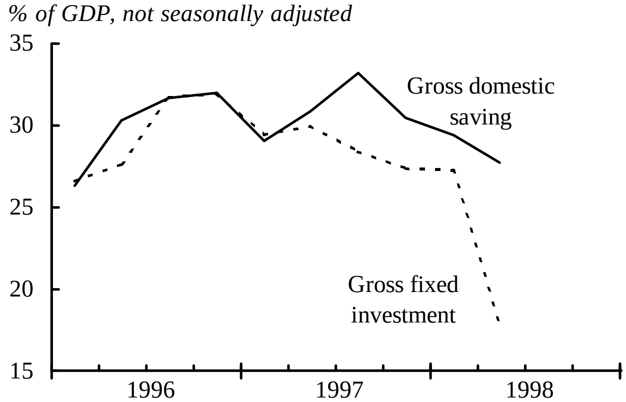
Korean saving and investment

% of GDP, seasonally adjusted



Indonesia: saving and investment

% of GDP, not seasonally adjusted



Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

that current account balances in all the crisis economies have moved from deficit into surplus, pointing to huge net private saving in excess of current government deficits. Few detailed figures are available, but Korea's quarterly national income statistics show that its huge current account improvement results not solely from drastically lower investment but also from a higher saving rate. The sharp decline of domestic consumption indicators in Malaysia and Thailand also points to higher saving. Only Indonesia exhibits a small decline in saving efforts, but this decline was far exceeded by the plunge in investment.

With overcapacity still large (especially in the property sector), banks reluctant to lend, and weak labor markets undermining household confidence, private net saving will likely stay elevated for several years. Even a drop in exports due to a global recession is unlikely to cause a sharp fall in private saving as it would prompt further decline in domestic consumption and a drop in imports needed to support export production. Malaysia, though, is at risk of a sharp decline in *recorded* private net saving (and the current account surplus) if exporters understate their receipts and importers overstate their bills in order to circumvent the newly introduced capital controls.

Depositor confidence is key to tapping private saving

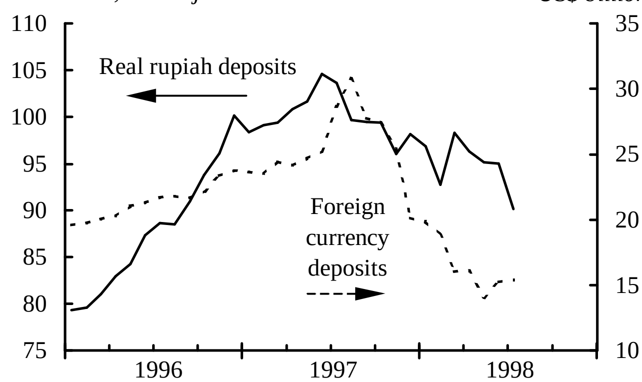
Sustaining large private net saving alone, however, is not enough if governments have only limited access to private funds. In Indonesia, for example, the government has relied entirely on IMF-led funding to finance its deficit. More commonly, in the absence of efficient bond markets, governments rely largely on banks to give them loans or buy their securities. But this highlights the importance of depositor confidence for both the accumulation and accessibility of private savings.

The banking crisis has shaken depositor confidence. Resulting damage has varied. Confidence is at its lowest ebb in Indonesia's banking system, in which foreign currency deposits are down by half and rupiah deposits have fallen sharply too in real terms. Private savings have moved offshore or have been reinvested in the export sector. In Korea and Thailand, inflation-adjusted bank deposits have held up well and reaccelerated recently, especially in Korea. Both have experienced a flight to quality, but overall depositor confidence has been maintained by their governments' willingness to boost interest rates during the crisis period and by relatively credible bank reform strategies. In contrast, real bank deposits in Malaysia have been falling since the beginning of the year, reflecting poorly on the government's interest rate and financial reform

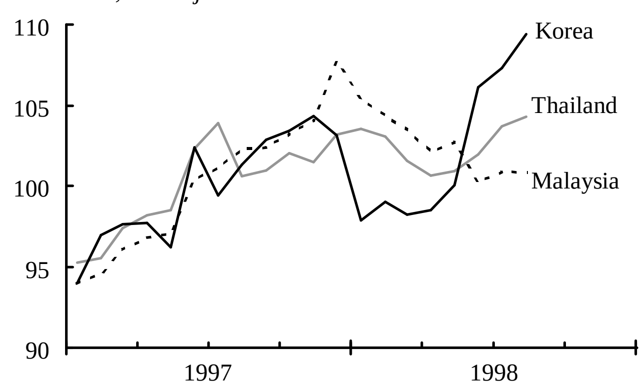
Saving and investment rates
% of GDP

	1990-95	1996	1997	1998e
Indonesia				
Gross domestic saving	31.5	33.9	29.6	28.0
Gross fixed investment	27.3	30.4	30.9	21.5
Korea				
Gross domestic saving	36.0	37.4	38.6	43.0
Gross fixed investment	37.1	38.0	34.7	27.0
Malaysia				
Gross domestic saving	37.1	40.7	42.4	45.0
Gross fixed investment	39.1	46.8	47.1	39.5
Thailand				
Gross domestic saving	35.9	36.8	39.0	40.5
Gross fixed investment	34.8	42.8	39.1	35.0

Indonesia: real rupiah and foreign currency deposits
1997=100, CPI adjusted *US$ billion*



Real bank deposits
1997=100, CPI adjusted



Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

policies. Moreover, deposits in Malaysia are likely to shrink further, thanks to the forced reduction of interest rates and the increased risk of banking problems caused by the new lending and accounting standards.

Banks look for positive yield curve to buy bonds

Provided their deposit base remains healthy, banks in the crisis countries will be interested in buying government bonds in order to improve their financial performance and asset quality. However, much will depend on the level and structure of interest rates. If interest rates are high and yield curves inverted, banks have no incentive to buy bonds unless they expect large capital gains from a near-term drop in yields. But if short-term interest rates are low, the yield curve upward-sloping, and alternative outlets unappetizing, banks will probably buy large amounts of government bonds.

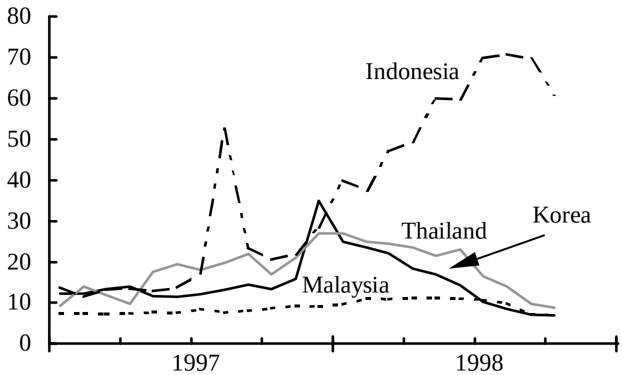
In Korea and Thailand, interest rate conditions have improved dramatically, thanks to the huge current account swing and high depositor confidence. Short-term interest rates have dropped from the high twenties to single digit, yield curves have disinverted, and long-term bond yields have declined as well. This situation provides not only ideal preconditions for banks to buy government bonds, but also helps the governments to reduce interest expenses.

In contrast, conditions in Indonesia suffer from continued low depositor confidence. And in Malaysia, interest rates have declined, but due largely to aggressive monetary easing. In fact, liquidity could soon tighten again if depositor confidence deteriorates and banks are forced to puff up their loan portfolios.

External fiscal funding will be limited

As for external bond supply from Asia's crisis countries, issuance going forward will be limited. Korea and Thailand are well positioned to finance their deficits with domestic funds and will only consider limited foreign bond issues if market conditions are favorable. Given the weakness of domestic demand and banks' reluctance to lend to the private sector, crowding-out effects will probably be small. In fact, to the extent that government bond issuance promotes financial reform, its net effect is likely to be positive. For Korea, the existence of a developed bond market is also a plus, and Thailand now has an opportunity to catch up. Indonesia and Malaysia, by contrast, are likely to hit funding problems. In Indonesia, the restoration of confidence will depend heavily on political developments, but the country can expect at least some support from the IMF. Malaysia, however, will have little support once the US$4 billion of excess cash funds in Petronas and the Employee Provident Fund are exhausted.

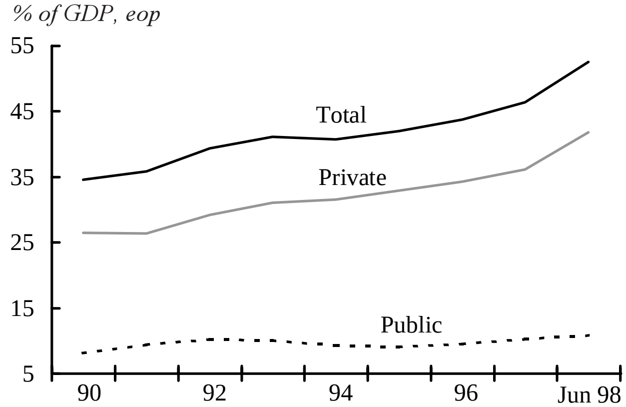
Short-term interest rates
% p.a.



Bond yields and yield curve differentials
% p.a. and basis points

	Dec 97	Oct 98
Indonesia		
1-year interbank rate (%)	23.0	40.0
minus 1-month interbank rate (bp)	-500	-2100
Korea		
3-year corporate bond yield (%)	24.3	10.2
minus overnight call rate (bp)	-1070	+260
Malaysia		
10-year government bond yield (%)	7.8	7.7
minus 3-month interbank rate (bp)	-130	+70
Thailand		
3/10-year state enterprise bond yield (%)	14.9	11.0
minus 1-month interbank rate (bp)	-1210	+250

Korea's domestic bond market
% of GDP, eop



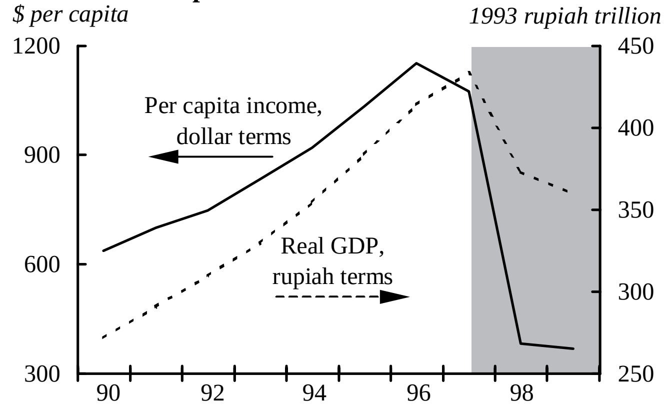
Indonesia's transition: now and to come

- **Suharto's resignation in May was only the closing scene of a monumental opening act**
- **The script for Act Two is still being written**

Indonesia, a country once touted by international agencies as a model of economic development, is in the midst of a wide-ranging and rapid metamorphosis. The eventual result of the changes in the real economy, the financial system, and the political structure remains uncertain. Over eleven months after approaching the IMF for assistance and five months after the resignation of Suharto, still, anything seems possible.

The economy may remain open and return to the resource-based sectors where lies its comparative advantage. Or, those plentiful resources may be allocated not by the market, but by policies that favor one ethnic group over others and that also are hostile to foreign capital. The banking system could be streamlined, leaving only a handful of extant core banks and forcing the owners to bear the burden of their losses. Or, political wrangling could stall the process, keeping funds out of the country and certainly out of the banking system. Most importantly, the political system may become a truly representative democracy, with active participation from citizens across the sprawling archipelago. Or, civil unrest, followed by a crackdown, may occur, and democracy may again be postponed.

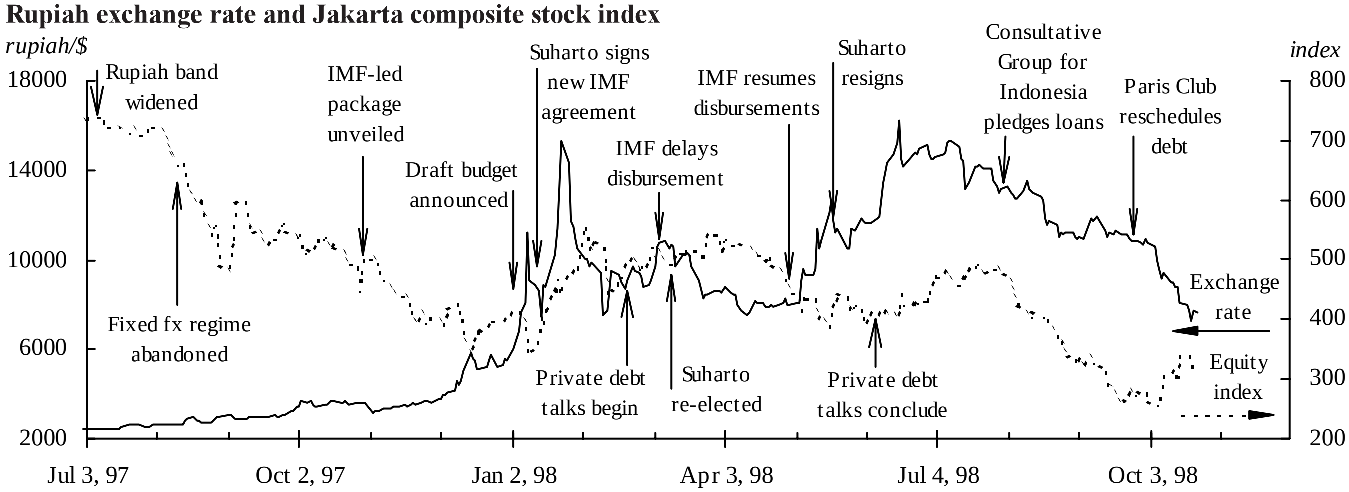
Gross domestic product



Though none of these binary scenarios can be ruled out, progress at a number of levels is encouraging:

- Output from devastated firms in the nontraded goods sector is being replaced by export-oriented, resource-based economic activity;
- Policymakers are together working constructively with the IMF and World Bank, leaving trade and capital markets open to foreign participation;
- The authorities managing the banking system restructuring have the backing of the government;
- The agenda for political system change may be flexible enough to satisfy the main opposition parties.

Rupiah exchange rate and Jakarta composite stock index



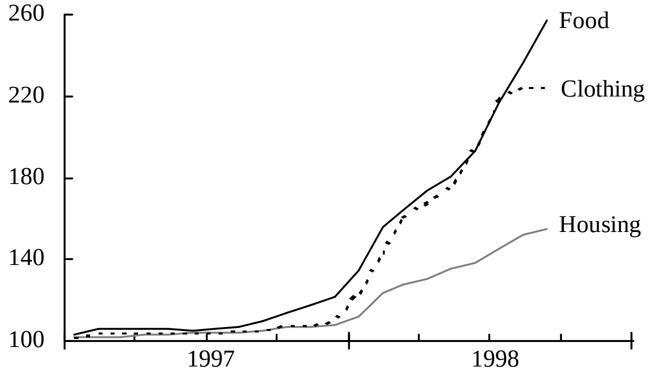
Counting the costs

Before giving a status report on the economic, financial, and political changes in Indonesia, it is useful to step back and take stock of the economic damage wrought by its multiple crises in past months. Real GDP in the third quarter fell to 1994 levels. Indonesian agencies estimate that 18 million or 20% of the work force are out of work and that two million more will lose their jobs by year end.

An astounding 80 million, or 40% of the country's 202 million population, are now below the official poverty line (a World Bank projection puts the number closer to 50 million) and the United Nations deems half the children under three to be malnourished. Hardest hit are those in the Greater Jakarta area (Jabotabek) where some estimates put the number of jobless at eight million. By April, about 50% of Jakarta's public buses were off the street, mainly because of the high cost of imported spare parts.

Annual inflation hit 82% in September, with food prices up 134%, including a 160% increase in the price of rice. Though domestic demand has certainly collapsed, demand-side factors have by no means been insignificant in fueling inflation. That is because people's confidence in the financial sector has been so low that they are inclined to buy goods as a hedge against inflation.

Consumer price components
1996=100



Gross domestic product
rupiah trillion, 1993 prices, annual rate

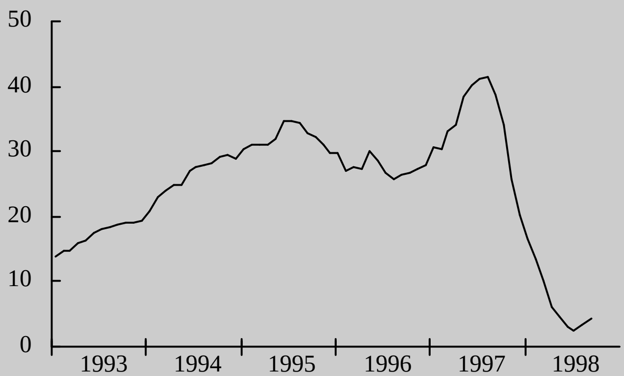
	Real GDP		% of total	
	1996	98Q2	1996	98Q2
Agriculture	63.7	68.0	15.4	18.9
Mining, oil, and gas	48.4	45.8	11.7	12.8
Food, beverages, and tobacco	43.6	38.5	10.5	10.7
Transportation services	29.7	27.3	7.1	7.6
Hotels and restaurants	13.9	12.0	3.3	3.3
Wood and related products	9.5	8.5	2.3	2.4
Wholesale and retail trade	55.5	42.9	13.4	11.9
Construction	32.9	20.1	7.9	5.6
Transportation equipment	11.2	3.9	2.7	1.1
Financial services	37.4	29.7	9.0	8.3
Other	68.6	63.0	16.6	17.5
Total GDP	414.4	359.7		

Automobile and motorcycle markets evaporate, ...

Production sectors catering exclusively to Indonesia's now-collapsed domestic demand are most in jeopardy from the ongoing economic crisis. For example, P.T. Astra International is a leading conglomerate with interests in the automotive industry, financial services, and agribusiness. It is the country's leading auto and motorcycle producer with a 55% market share in autos and 50% market share in motorcycles in 1997. Both car and motorcycle sales have plummeted since last year. Astra halted automobile production this past July, but resumed in September. With imports making up roughly 50% of the parts and components it uses and the domestic market accounting for basically all of its sales, Astra is very vulnerable to rupiah movements. To make matters worse, roughly 90% of its liabilities are denominated in foreign currency and only a portion of its debt principal and none of its interest expenses have been hedged.

In even worse shape is the other automobile company – P.T. Timor Putra Nasional (TPN). TPN, controlled by Suharto's youngest son, Tommy, planned to build the Timor national car (in a joint-venture with South Korea's Kia Motors), but the half-built factory was never completed. Now, the preferential tax treatment and low-interest loans that TPN received from the government are the focus of an ongoing investigation.

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



Domestically oriented industrial firms in limbo

The contraction in Indonesia's GDP has been most acute in heavy industries that focused on the domestic market, such as motor vehicles and parts, construction, and cement. Construction activity and employment has been hard hit, with many projects halted or postponed. Real construction activity fell 42.9% from a year earlier in the second quarter of 1998 and demand for cement declined by over one third. August data show car and motorcycle sales down 82% and 63%, respectively. Also devastated is the financial services sector, which is truly in limbo as the agencies overseeing the restructuring process are still determining which entities will survive, be closed, or be merged.

Much of the hard-hit heavy industry and services sectors is controlled by state-owned enterprises. Government-sponsored reviews by international auditing firms have determined that more than half the country's 159 state-owned companies are "unhealthy," with half their IDR461 trillion in assets classified as nonperforming. Some of the best of this group were to be privatized under plans laid out by State Enterprises Minister Tanri Abeng, who in June identified 12 companies to be sold. Since then, five have been taken off the table, including the largest firm, Telekomunikasi Indonesia. In September, the government sold a 14% stake in cement producer, Semen Gresik, to Mexico's Cemex. That the transaction is going through is encouraging, but the fact that the stake sold was slashed from the originally-planned 51% has caused some to question the determination of the government to pursue its privatization strategy aggressively.

That these sectors would be the hardest hit as a result of the currency and financial crises, and the attendant economic collapse, is not remarkable. However, in Indonesia, the question of whether these firms survive the downturn is complicated by the fact that many of them have ties to Suharto, his family, or his close associates. At many of these firms, government investigations into charges of corrupt, collusive, or nepotistic practices (known by their Bahasa Indonesian acronym, KKN) are ongoing and the information unearthed could be pivotal in deciding their eventual fate. On that score, 15 state companies have so far been found to have engaged in KKN.

...but fish and furniture fly out the door

More fortunate are production sectors that play to Indonesia's comparative advantage. For example, PT Daya Guna Samudera (DGS) is the country's largest fish harvester and seafood exporter. The company operates mainly in the Arafura Sea adjacent to the island of Irian Jaya. DGS sells primarily to Asian markets (China, Taiwan, Thailand, Japan, and Hong Kong), with 99% of its revenues derived from US$-denominated exports. In contrast, about 70% of its cost-of-goods-sold is rupiah-denominated. This currency mix of revenues and costs has resulted in surging profit margins. During 1997, DGS enlarged its capacity, expanding its fishing vessel fleet by 32%.

Tempoe Doloe Gallery is a family-run furniture maker in central Java. Along with custom making teak furniture, the company refurbishes antique pieces that it buys in the Yogyakarta area. Almost all of its products are exported and priced in U.S. dollars, while its costs are entirely rupiah-denominated. This year, the firm has been shipping an average of four containers of furniture a month, up from only one per month before the crisis.

Resource-based production endures the chaos

While focus will no doubt remain on the actions of government officials and business in the Jabotabek area, many Indonesians quietly continue to work and do well in jobs grounded in the wealth of natural resources that the country possesses.

For instance, while it is true that the relative importance of the agricultural sector has declined over time (down to 15% of GDP in 1996), it still employs about 40% of the workforce. And in spite of last year's El Niño drought, which caused production to shift away from rice to maize and soy beans, the sector as a whole has done remarkably well. Farmers are increasing production of fruits and vegetables, displacing imports that now are clearly out of reach for most Indonesians.

But producing import substitutes for a weakened domestic market has limited appeal. Instead, labor-intensive industries such as agriculture, timber-related products, fisheries, and textiles are taking advantage of the rupiah's massive real depreciation. And the data may well understate the extent of resource redeployment to these resource-based sectors, since the underground economy is widely said to be growing fast. Note, though, that rising export volumes in Indonesia, as in other Emerging Asian economies (save the Philippines), have not translated into rising dollar revenues as prices have plunged as fast as volumes have risen.

David G. Fernandez (65) 326-9452
fernandez_d@jpmorgan.com

Behind the headline number, exports are still shipping

In the first seven months of 1998, Indonesia's merchandise exports were down 3% from the year-earlier level in dollar terms. This gloomy number, however, obscures the vigor of certain sectors that have been able to ship their products abroad, capitalizing on the massive real depreciation of the rupiah.

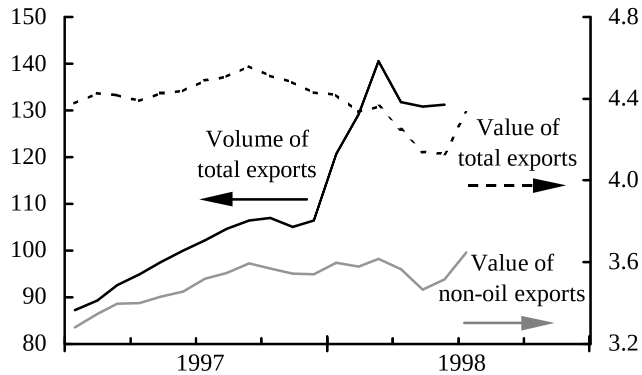
First, note that Indonesia's exports are still dominated by oil and gas. Though the sector's share of total exports has fallen markedly over the past decade, it still accounted for over 20% of dollar revenues in 1997 despite slack regional demand. Excluding oil and gas, exports in dollar terms are up 5% so far this year.

Second, like others in the region, Indonesia's exports have been hammered by terms-of-trade effects. That is, the country must ship a lot more exports to get a given amount of imports in return. In the export accounts, volumes are up, but dollar prices are down, which drags down export revenues. For goods exports overall, J.P. Morgan estimates that volumes are up over 30% from pre-crisis levels. Direct volume and value data for certain categories reinforce this story of strong export volume growth. Thus, at the end of the day, relative prices (that is, the real exchange rate) do still matter.

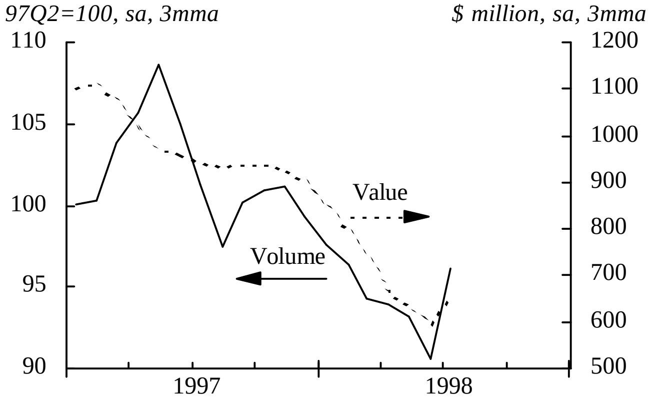
Merchandise exports
percent

	Change oya through July 98	Share of total in 1997
Total	-3.0	100.0
Oil and gas	-32.7	21.7
Non-oil	5.0	78.3
Agriculture	25.6	5.8
Wood and related products	-9.4	11.7
Textiles and garments	9.1	12.1

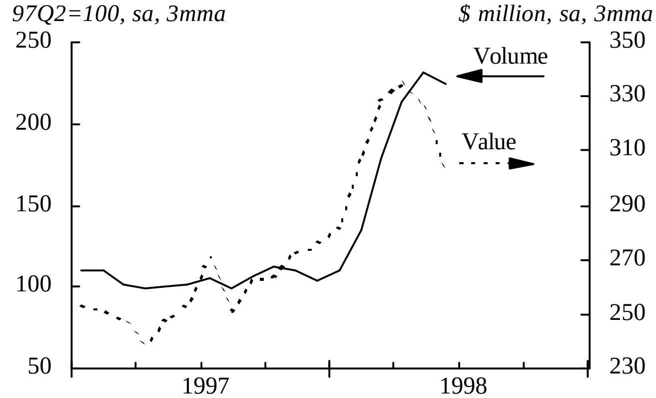
Merchandise exports
97Q2=100, sa, 3mma *$ billion, sa, 3mma*



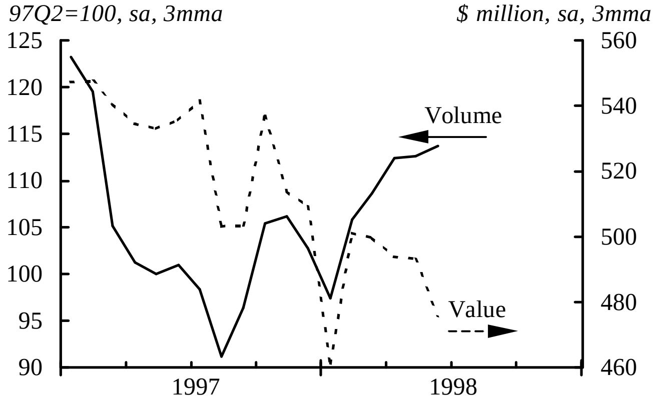
Oil and gas exports
97Q2=100, sa, 3mma *$ million, sa, 3mma*



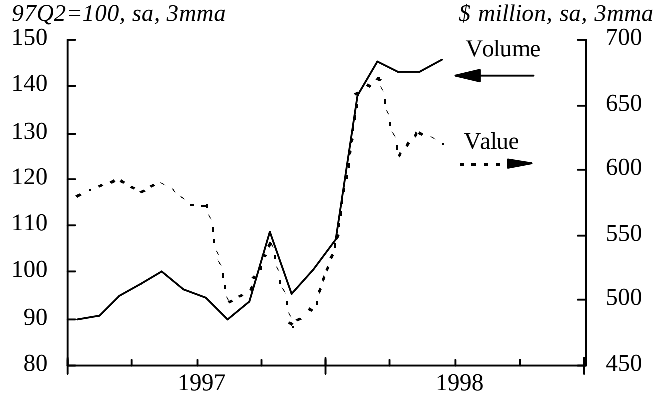
Agricultural exports
97Q2=100, sa, 3mma *$ million, sa, 3mma*



Wood and related exports
97Q2=100, sa, 3mma *$ million, sa, 3mma*



Textile and garments exports
97Q2=100, sa, 3mma *$ million, sa, 3mma*



Morgan Guaranty Trust Company
Economic Research
David G. Fernandez (65) 326-9452
fernandez_d@jpmorgan.com

continued from page 17

These data are consistent with reports of people leaving urban areas for the greener pastures of the outer islands. Indonesia's population is concentrated on the island of Java (about 60%), with over 20 million in Jabotabek alone, even though over 90% of the land currently used for food production is outside of Java. A major concern of the Suharto government was how to ameliorate this urbanization pattern. Ironically, after his departure, that problem appears, to a certain extent, to be solving itself.

Finally, it should be noted that one export-oriented sector that relies on natural resources is not doing well: tourism. This important, dollar-generating industry is reeling from a 40% drop in the number of tourist arrivals, despite the bargains that abound.

Financial system still yearns for stability...

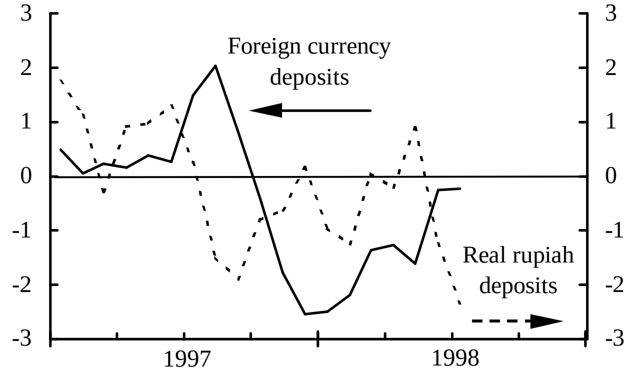
While Indonesians struggle to adapt to their new environment, restoration of banking system stability remains a priority for policymakers. Almost one year ago, the November 1997 closure of 16 banks shook depositor confidence. Deposit flight back then was largely driven by general uncertainty over which banks were sound and which should be avoided. Billions of dollars in foreign currency deposits fled the system.

In response to deposit flight and international banks' refusal of Indonesian banks' letters of credit, the Bank Indonesia (BI) announced in January that it would guarantee all deposits and liabilities of national banks (excluding shareholders' funds and subordinated debt) for a period of two years. Foreign currency deposits were guaranteed in rupiah. This blanket guarantee implies a minimum of close to IDR500 trillion just to cover the deposit base. Questions persist over the government's ability to live up to the promise.

Deposit funds that did not leave the country shifted toward state, foreign, and selected private banks. This flight-to-quality created a clear split within the system between liquid and distressed banks. BI's decision to provide liquidity support to the latter is the second part of the emergency strategy to restore confidence in the system. As one would expect, base money expanded rapidly after November as a result of this liquidity support. Wider monetary aggregates also shot up, but thanks mainly to the impact of the currency devaluation on the rupiah value of foreign-currency deposits.

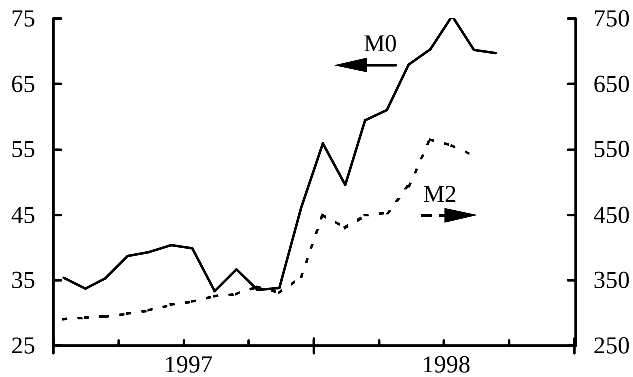
Monthly changes in commercial bank deposits

$ billion, 3mma *1996=100, CPI adjusted, 3mma*



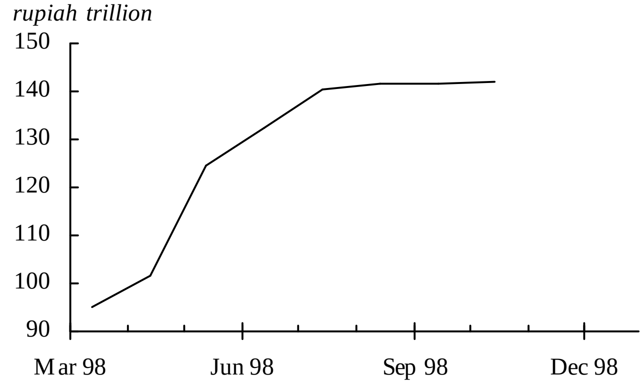
Monetary aggregates

rupiah trillion, eop, both scales



Outstanding liquidity support to IBRA banks

rupiah trillion



With the government guarantee in place and liquidity support continuing, the third part of the stabilization strategy is keeping interest rates high. Interest rates on

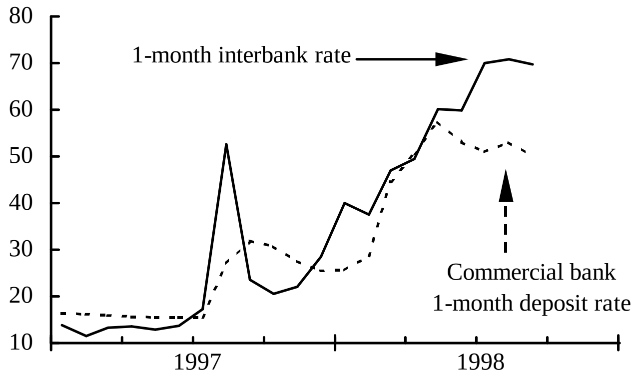
Morgan Guaranty Trust Company
Economic Research
David G. Fernandez (65) 326-9452
fernandez_d@jpmorgan.com

central bank paper (SBIs) rose early in 1998, but did not keep pace with actual inflation nor inflation expectations. As a result, real interest rates turned substantially negative, creating a strong disincentive for depositors to stay in rupiah. In March, the authorities became more aggressive, making the already-inverted SBI yield curve even more so by doubling one- and two-month rates. Seven months later, rates at the short end are still near 60%. These high rates have attracted interest to SBI auctions (where issuance size has increased to speed the mopping-up of BI's liquidity support) and they also lend crucial support to the currency. Eventually, Indonesia will join the global trend toward lower interest rates, but significant cuts cannot happen until the government succeeds in restoring local confidence in the financial market.

Still largely unresolved is the problem that brought Indonesia to the IMF in the first place – the external debts of both the private and public sector. On the official debt side, immediate pressure on the government was relieved when, in September, Paris Club creditors rescheduled and restructured $4.2 billion of outstanding sovereign debt. With only one global bond outstanding (with principal of $400 million), negotiations over $1.8 billion in debts owed to banks expected to result in a similar restructuring, and IMF funds flowing in every month, the liquidity problems of the sovereign are resolved for the time being.

The same cannot be said for the country's private external debtors. The talks on this debt that culminated in the June Frankfurt agreement produced a framework for resolving the debt issue. But while admirable in its design, most of the Frankfurt plan remains just that – a plan. The plan's centerpiece calls for an Indo-

Short-term interest rates
percent p.a.



External debt
$ billion, end-September 1998 estimates

Public sector	69.6
Government	58.4
IMF credit	7.0
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	142.0

Indonesian Debt Restructuring Agency

Modeled after a plan introduced in Mexico in 1982, INDRA is to provide an exchange rate guarantee for firms whose debts are restructured to an eight-year maturity with a three-year grace period on principal payments. The foreign exchange guarantee is based on market rates, with the INDRA guaranteed rate calculated as the lowest IDR/$ using a one-month moving average. During the grace period, the firm is to continue to pay INDRA rupiah to service its debts. After the grace period, INDRA is to pay out dollars to the creditor at the guaranteed rate.

Structure of the banking system
end August 1998

	# of banks		Deposits		Net assets		Capital	NPL ratio	
	Total	Under IBRA	IDR tril.	% share	IDR tril.	% share	IDR tril.	Official*	J.P. Morgan
State	7	4	232.0	50.1	236.3	48.7	2.7	24.2	
Private national	107	38	201.2	43.4	213.1	43.9	10.9	13.2	
Local government	27	11	9.6	2.1	11.0	2.3	1.4	15.8	
Joint	34	2	20.7	4.5	24.6	5.1	3.9	25.3	
Foreign	10	0	52.5	11.3	55.3	11.4	2.5	24.4	
Total	222	55	463.5	100.0	484.9	100.0	18.9	19.8	60-70

* As of March 1998.

nesian Debt Restructuring Agency (INDRA) to facilitate resolution of the over $60 billion in corporate debt by taking on the debt's exchange risk, but not the corporate risk. So far there have been no takers, but if the current strength in the rupiah is maintained that situation could change.

...while mapping out structural changes

While "meatball surgery" on the financial sector continues, longer-term repairs are still in their very early stages. State banks under the care of the Indonesian Bank Restructuring Agency (IBRA) have been merged and IBRA recently froze the operations of three more banks. But its main task now is to screen banks and decide whether to recapitalize, merge, or liquidate them. In the end, only a few relatively strong core banks will survive, but starting with over 200 banks, the winnowing-out process has only just begun. Despite the fact that the impact of the decisions made now by the authorities will be felt for years, even decades, to come, the time premium on decision is high. The sooner a core group of banks emerges, the sooner public confidence in the banking system will return.

The 55 banks under IBRA supervision hold about 40% of the banking system's assets. In early April, seven of these banks were suspended, while six private banks and one state bank were placed under IBRA management (including private banks Danamon and BDNI which alone have about 20% of the banking system's assets). With these moves, the very worst banks were separated from the others.

One item of note on the immediate agenda is the readying by IBRA's Asset Management Unit (AMU) of non-core assets of closed banks for auction in late November through the state auction office. And with three more banks officially added in August, the AMU's portfolio will continue to grow.

In the end, asset auctions and the ongoing struggle to recover the liquidity assistance extended by the central bank will fall well short of meeting the funding needs of the bank restructuring plan. This means that, eventually, the government will pick up the tab (see *Funding Emerging Asia's budget deficits,* page 11).

A wide range of possible political scenarios

While IBRA's decisions over the banks are critical, the restructuring of firm's external debts important, and the survival of certain sectors heartening, no aspect of Indonesia's transformation dominates the changes occurring in the political system. The ongoing openness of the political debate itself is remarkable, but indicates too that while an orderly transition of power next year is still possible, a return to the May chaos remains equally so.

Before Suharto's resignation, opposition parties were not allowed to exist. Now there are over 100 parties registered, and more are on the way. These parties are gearing up for the House election slated for next May. In turn, these legislators will cast the lion's share of the votes for president in December 1999.

At least that is the plan. Since May, there has been no organized mass movement comparable to that spearheaded by university students and Amien Rais. However, across the Indonesian archipelago, incidents of civil unrest continue to flare up, motivated by dissatisfaction with the government, anger against ethnic-Chinese, job losses, food shortages, and price increases. If social conditions do not improve soon, the unrest is likely to escalate. And if the November session of the People's Consultative Assembly (MPR) does not make decisions that meet with the approval of opposition leaders, those leaders (plus others eager to feed on the people's despair) may decide that it is time to channel the people's frustrations more directly toward President Habibie's government. An equally troubling scenario would have some of these disparate groups turning against each other.

Elections planned for next year will be unlike any held in Indonesia hitherto. In the past, citizens simply voted for one of the three approved parties, with the House seat going to the party that won in each district.

Key political dates

Nov. 10, 1998	Special session of the People's Consultative Assembly (MPR) to decide on election dates, Presidential term limit, President's extraordinary powers, and principals of reform process.
May 15, 1999	Likely date of House (DPR) elections.
Dec. 1999	MPR elects President and Vice President

Now, it seems likely that during the May polls, the ballots in each of the 420 voting districts will have individual candidate's names and party affiliation.

Exactly how many House candidates, representing how many parties, will be on those ballots is one of many points currently being debated. The government-proposed plan calls for a screening mechanism (representation in 14 of the 27 provinces or collecting one million signatures) that would pare down the field. While the desire to eliminate "nuisance" parties is understandable, such barriers to entry, coming after 32 years during which every opposition party was considered a nuisance, are being greeted with trepidation.

Another contentious issue about the structure of the House is the number of seats reserved for the armed forces (ABRI). Since the mid-1960s, ABRI's "dual function" as both a military and civic force has been the rationale for its seats. While the proposed plan is for those seats to be reduced to 55 from 75 (down from 100 just two years ago), whether a tarnished ABRI should have any seats is still an open question.

Also debated is the current plan to follow the form laid out in the 1945 Constitution and have the DPR elect the new President. Polls show that an overwhelming majority of Indonesians want a direct presidential election. Additionally, it is not clear why there needs to be a seven-month pause between the DPR and presidential votes. These, and many more, political issues could be flash points for a renewal of civil unrest. But the fractured opposition seems hesitant to act before the election scheme is more fully laid out. So Indonesia's transformation continues peacefully – at least for now.

Key political parties

Golkar – state political party
Leader: Akbar Tanjung. In the past, the political machinery could mobilize votes through the network of civil servants, village officials, and the armed forces. This organizational advantage, plus superior funding and influence are the strengths that may still return B.J. Habibie to the Presidency.

PDI (Megawati faction) – Indonesian Democratic Party
Leader: Megawati Sukarnoputri. Daughter of late President Sukarno and powerful counter-symbol to Suharto, she was removed from the PDI leadership in June 1996 and now leads a faction of the party. Her strength is among non-Muslims and Muslims opposed to religion-based political parties.

PKB – National Awakening Party
Leader: Matori Abdul Djalil. This party is associated with Abdurrahman Wahid (Gus Dur) who leads the moderate Muslim group, Nahdlatul Ulama (NU). NU's rural-based network and near-40 million membership make it a formidable force.

PAN – National Message Party
Leader: Amien Rais. This nonreligious party is associated with the country's second largest Muslim group, Muhammadiyah, with membership of around 28 million. Rais is a favorite of Jakarta Muslim intellectuals, with potential for broader support given his high visibility in the spring anti-Suharto movement.

The shape of things to come?

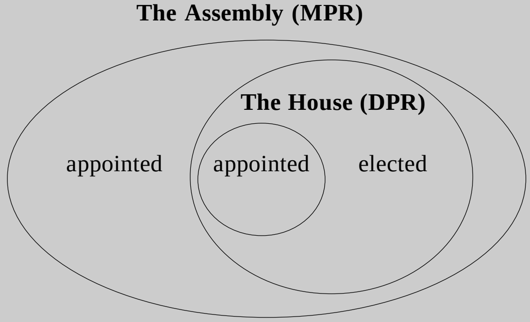
Current distribution of seats in House and Assembly

	House	Assembly
Golkar (ruling party)	325	588
ABRI (armed forces)	75	113
PPP (Islamic party)	89	134
PDI (alliance of other parties)	11	16
Regional delegates	--	149
Total	500	1000

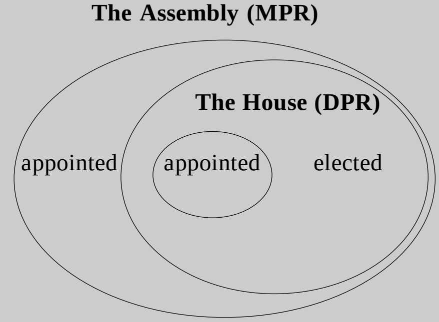
Proposed configuration of House and Assembly

	House	Assembly
Elected	495	495
ABRI	55	55
Social/community groups	--	69
Regional delegates	--	81

The Assembly (MPR)



The Assembly (MPR)



J.P. Morgan Securities Asia Pte. Ltd.
Economic Research
Yasushi Okuda (81-3) 5575-1172
okuda_yasushi@jpmorgan.com

Japan still wrestles with recession

- **Output more or less stabilized in the summer but prolonged recession remains a big risk**
- **Activity and sentiment in the private sector continue to deteriorate...**
- **...while fiscal stimulus efforts are partly undermined by poor local budget conditions**
- **Financial reform is still muddled despite much larger funding package**

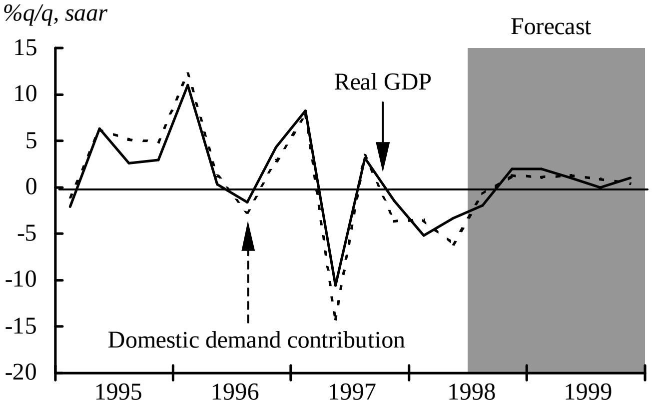
Key forecasts
calendar years

	1997	1998f	1999f
Real GDP (%oya)	0.8	-2.7	0.7
Consumer prices (%oya)	1.7	0.4	-0.2
Current account (US$ bil)	94.2	110.3	121.4
Fiscal balance (% of GDP)	-4.2	-4.9	-5.1
Net government borrowing (¥ tril.)	15.7	25.6	26.8
3-mo. Eurodeposit rate (% p.a.)*	0.5	0.4	0.4
10-year bond yield (% p.a.)*	2.3	0.9	1.7
Yen/US$*	121	110	150

* Year end.

Forecast still calls for the economy to move from recession to stagnation

Real GDP growth
%q/q, saar



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

	98Q2	98Q3f	98Q4f	99Q1f
Real GDP	-3.3	-2.0	2.0	2.0
Private consumption	-3.1	-2.0	1.0	1.5
Business investment	-20.1	-10.0	-5.0	-3.0
Residential construction	-4.0	-5.0	8.0	5.0
Public investment	0.3	30.0	15.0	5.0
Government consumption	-2.6	2.0	0.0	0.0
Exports of goods and services	-1.8	4.0	4.0	4.0
Imports of goods and services	-24.5	8.0	0.0	1.0
Contributions to real GDP				
Domestic final sales	-5.8	-0.7	1.3	1.1
Inventories	-0.3	-1.0	0.1	0.5
Net trade	2.9	-0.3	0.5	0.4

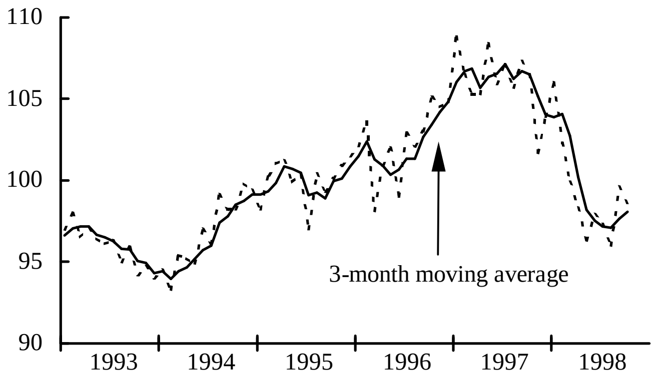
- The second quarter GDP report heralded more bad news for the Japanese economy. In particular, every component of private demand (consumption, business investment, and housing) fell. A much steeper decline in real GDP was only avoided thanks to a positive net trade contribution. But this was due to a slump in imports rather than export strength.
- The third quarter data released so far (most of which are for July and August) point to some stabilization in output and private demand. Still, sentiment is poor and inventories are high.
- In response, the government is expected to announce a new stimulus package of ¥10 trillion or more in November. But the effects of the fiscal stimulus efforts will probably remain muted by local authorities' own poor budget condition and a lack of powerful second-round effects.
- Critically too, there is no end in sight to the credit crunch despite the new bank bills as well as the Bank of Japan's determined injection of more liquidity.
- All in all, the forecast calls for stabilization of real GDP in the second half of this year but no genuine recovery is expected to follow in 1999. Moreover, strong structural head winds and the government's inability to solve the financial crisis leave a substantial risk of renewed recession.

J.P. Morgan Securities Asia Pte. Ltd.
Economic Research
Yasushi Okuda (81-3) 5575-1172
okuda_yasushi@jpmorgan.com

Industrial production has stabilized, but the halt to inventory adjustment raises risks anew

Industrial production

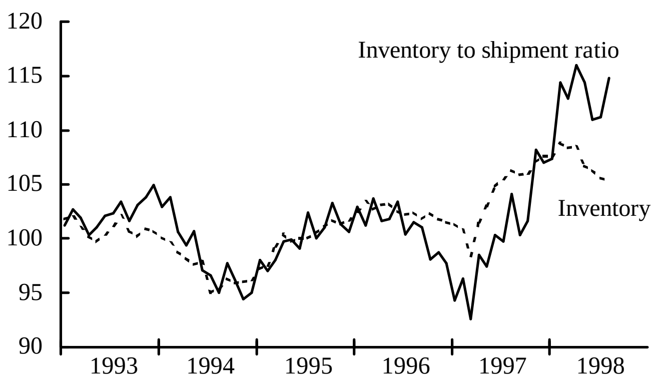
1995=100, sa



- Industrial production plummeted in the April-June quarter, as producers relentlessly cut back output in order to bring inventories under control.
- In comparison, decline was much more modest in the data so far available for the third quarter. Industrial production in July and August dropped an annualized 3%, versus a plunge of 19% in the second quarter. The amelioration reflected some improvement on the inventory front in early summer.

Producers' inventory

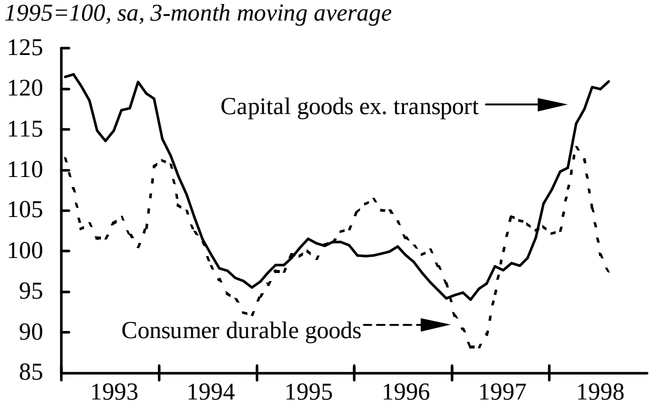
1995=100, sa



- The inventory to shipment ratio dropped 1.4% in May and another 3.0% in June. Even its trend, measured by a three-month moving average, turned downward in June.
- Recently, however, it has become less clear that the inventory adjustment has continued, especially following release of the large upward revision to the August inventory ratio change, from +1.8% to +3.2%.

Inventory to shipment ratio

1995=100, sa, 3-month moving average



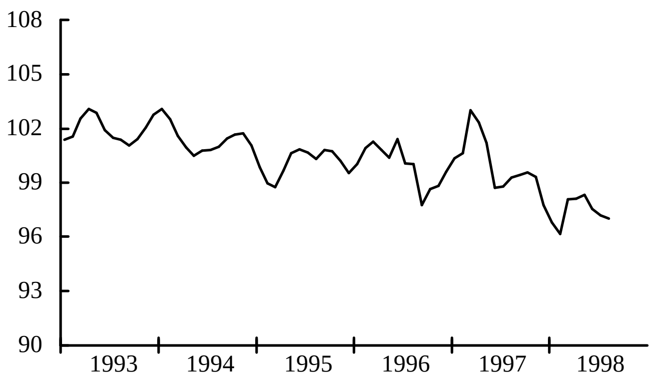
- The problem for manufacturers is that no matter how hard they cut back production, demand is falling even faster. This is particularly serious for capital goods markers, who are hit directly by the plunge in business investment. Consumer goods makers fare better in comparison.
- The inventory decline was the only bright spot in the private economy during the summer. If this now has flickered out, there will be further downward pressure on corporate sales and profits.

J.P. Morgan Securities Asia Pte. Ltd.
Economic Research
Yasushi Okuda (81-3) 5575-1172
okuda_yasushi@jpmorgan.com

Poor labor market conditions and fragile confidence cap household spending

Real household spending

1995=100, sa, 3-month moving average



- Private consumption data remain subdued. For example, real household spending fell an annualized 4% in July and August. In addition, September Tokyo department store sales (the only September retail sales data available so far) were down 1% from the August level.
- The exception to these weak readings are car sales, which posted a 25% annualized gain in the full third quarter, although the sales count may have included some window dressing by car dealers ahead of the financial half year end.

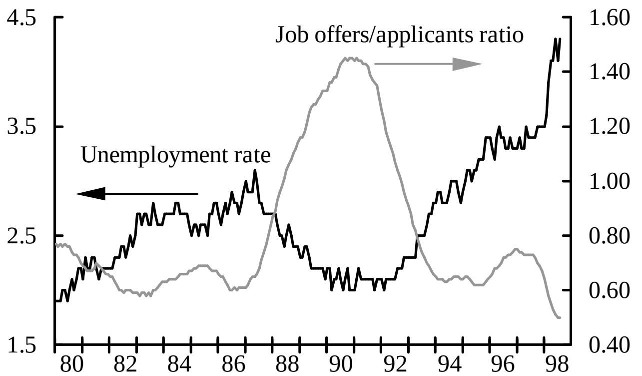
Consumers' perception of economic conditions

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

- The stumbling block to consumption recovery is a lack of confidence. Consumers are very worried about labor market conditions, which are characterized by rising unemployment and falling wages.
- The bimonthly survey by *Dentsu,* a large advertising company, indicates that a series of policy initiatives, including the ¥4 trillion household income tax cut to be made permanent from next year, have done nothing to lift consumer confidence. The government is mulling over giving shopping coupons, rather than cash, in a desperate attempt to boost consumption.

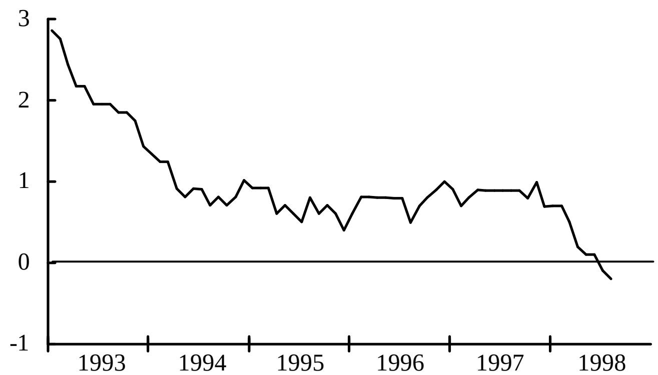
Labor market indicators

% of labor force, sa *ratio, sa*



Nominal regular wage

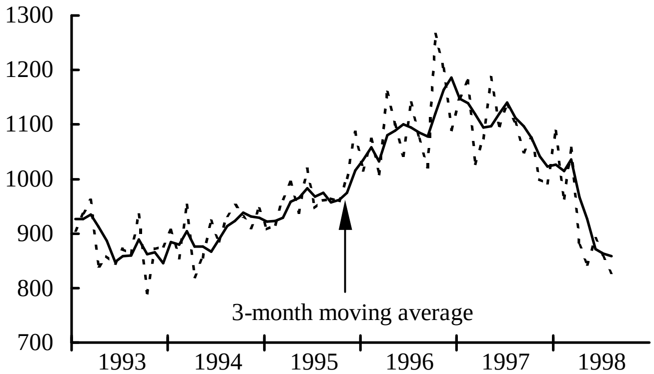
%oya



Poor business conditions will undermine investment until mid-1999

Private domestic machinery orders

excluding ships and electric generators, ¥ billion, sa

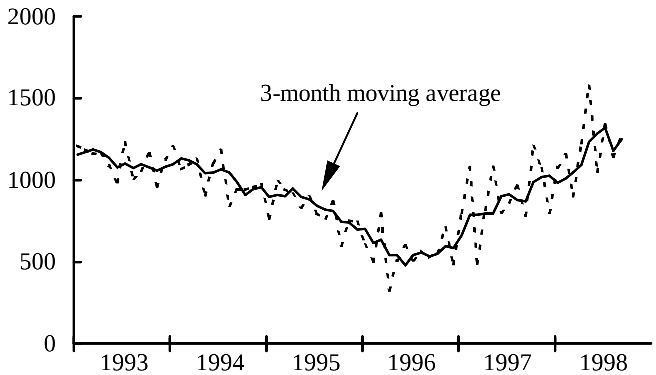


- Business investment will remain the weakest demand area of the economy. Private machinery orders, a leading indicator for business investment, dropped an annualized 12% in the data available so far for the third quarter following a 50% plunge in the second quarter. The forecast looks for orders to record continued quarterly declines until the opening quarter of 1999.
- The problem for investment is similar in kind to that afflicting household consumption – a lack of confidence and pressure on earnings – but its magnitude is much more severe.

Exports have stabilized, but now face yen strength and weaker global demand

Customs-cleared trade surplus

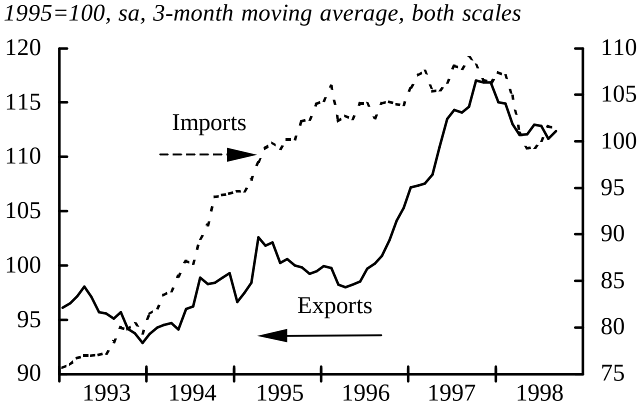
¥ billion, sa



- Trade surplus expansion continues, but is coming about through weak imports, not strong exports.
- In fact, export volume plunged 12% in the first quarter, but then showed more moderate declines, of about 3% in the second quarter and 1% in the third quarter. Looking ahead, however, exports will be hindered by unfavorable external demand and, if sustained, by the dollar's sudden weakening
- By region, exports to Asia are no longer the huge drag that they were. Instead, exports to the United States have shown signs of weakening since the start of this year, and even those to Europe have been soft recently.

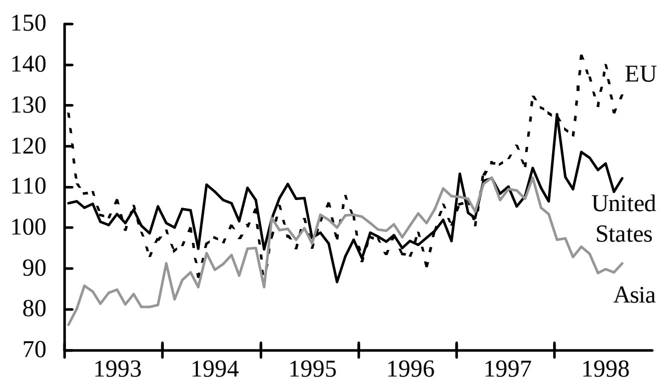
Trade volume

1995=100, sa, 3-month moving average, both scales



Export volume by region

1995=100, sa



J.P. Morgan Securities Asia Pte. Ltd.
Economic Research
Yasushi Okuda (81-3) 5575-1172
okuda_yasushi@jpmorgan.com

Fiscal policy will be supportive, but less than expected due to revenue shortfall

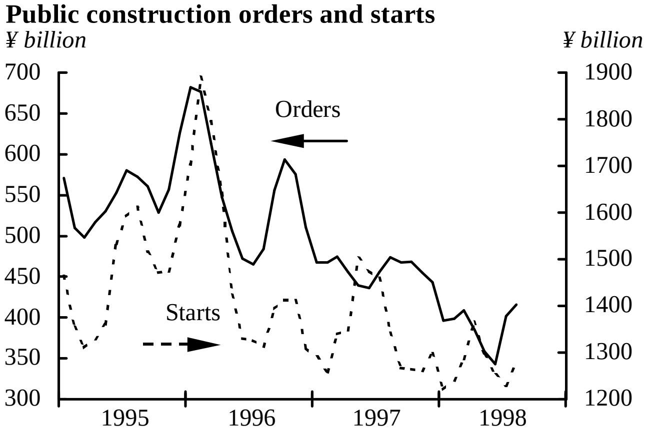
Fiscal stimulus so far

April 24	Announcement of ¥16 trillion stimulus package
June 17	First supplementary budget enacted
July 30	Obuchi named as new Prime Minister
August 4	Announcement of ¥7 trillion tax cuts to be effective from 1999.

Fiscal initiatives to be expected going forward

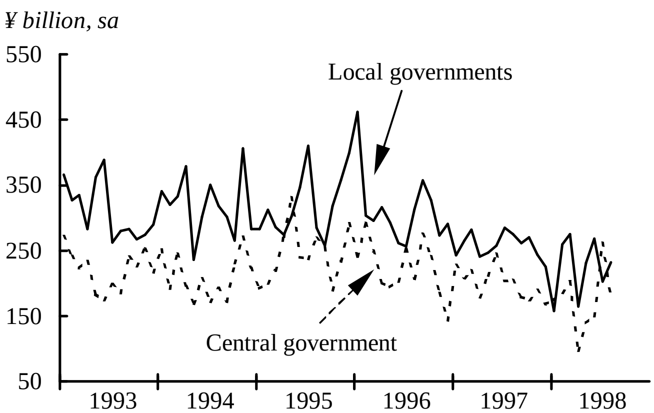
November	Announcement of new stimulus package and possible legislation
mid December	Economic Planning Agency to unveil two-year recovery plan
end December	Cabinet to approve the initial budget for fiscal 1999 (April 1999 to March 2000).

Public construction orders and starts

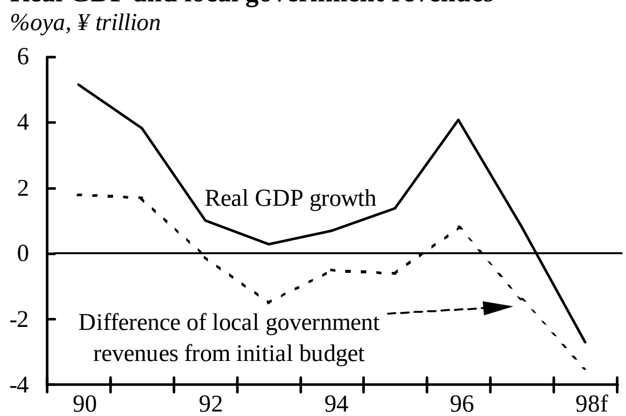


- The government enacted a first supplementary budget, including ¥4.6 trillion spending, in mid-June, but the signs were mixed up to the August data of public works actually coming through. September construction data will be released on October 30.
- Not surprisingly, continuous deterioration of economic fundamentals has put mounting pressure on the government to "do more." The government has responded by hinting another package that will promise net spending of over ¥10 trillion, as well as a larger tax cut than the ¥7 trillion announced in August. However, this is just "talk" at this point.
- What is undermining the implementation of the spending packages so far is the poor financial condition of local governments.
- Due to the recession, local government revenues are expected to fall short of their initial budget targets by 5% to 10%. For example, corporate tax revenues were down 10% from April to August compared to the same period's take last year. In response, the Ministry of Home Affairs has allowed local governments to issue "deficit" bonds for the first time since 1975 to pay their current bills and salaries.

Public construction orders



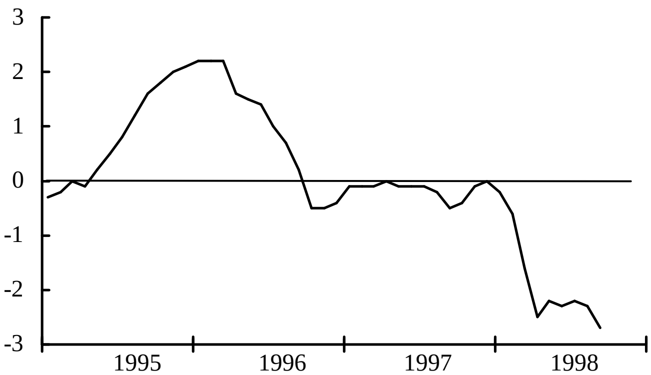
Real GDP and local government revenues



Financial problems will persist despite new bank bill and BoJ support

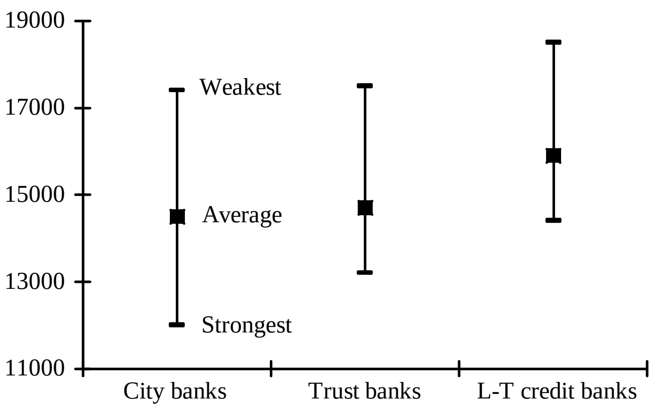
Bank loans outstanding

%oya, monthly average



Sensitivity of Japan's banks to stock market changes

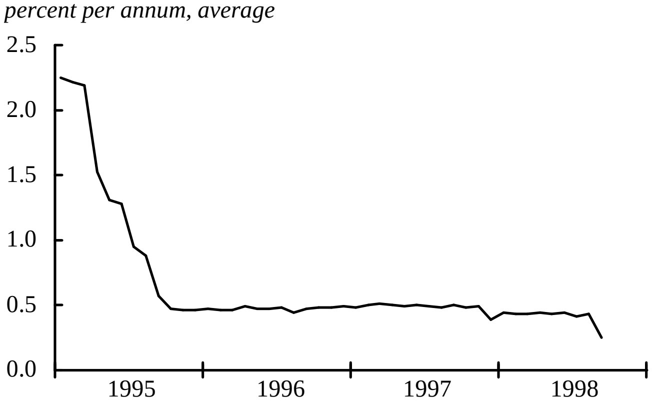
level of Nikkei 225 at which banks' hidden reserves disappear



- The financial sector remains a heavy drag on the economy. The credit crunch intensified rather than eased ahead of September's financial half year end.
- The recent plunge in the Nikkei stock price to a 12-year low has turned banks' hidden gains into hidden losses, eroding their capital adequacy ratios.
- The finance bills enacted in mid-October made a huge amount of money (¥60 trillion, or 12% GDP) available for recapitalizing banks, managing failed banks, and protecting depositors. Nonetheless, the overall bank reform strategy remains muddled and banks are likely to remain reluctant to ask for public funds.
- The Bank of Japan opted for a token 25-basis-point rate cut at its September 9 meeting. At the same time, it resolved to inject ample liquidity into the economy if necessary, even though that could result in the policy rate falling to 0%.
- The meeting minutes revealed that global financial market volatility was a trigger for the easing. So far, however, the rate cut has led to hardly any improvement in financial conditions. Speculation on further easing therefore persists, such as through a lowering of the bank reserve requirement ratio. In reality, trimming that ratio would be unlikely to work, since banks' deposits with the BoJ stand above the minimum requirement thanks to the BoJ's "safe haven" status.

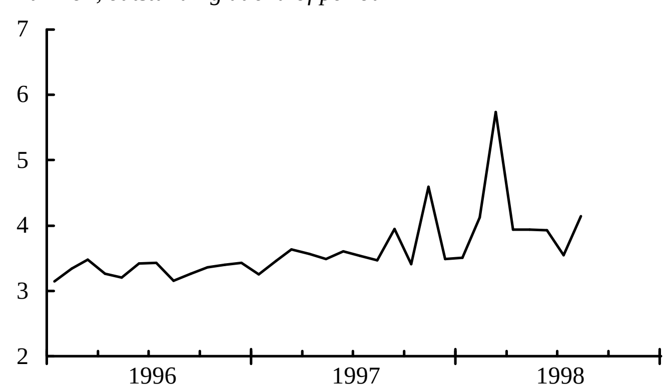
Uncollateralized overnight call rate

percent per annum, average



Bank reserves at the Bank of Japan

¥ trillion, outstanding at end of period



Morgan Guaranty Trust Company
Economic Research
Sin Beng Ong (65) 326-9075
ong_sin_beng@jpmorgan.com

Emerging Asia: On the path to recovery?

- **First-half 1998 production collapse has stopped and output stabilization is underway**
- **Incipient signs of recovery are emerging in some countries**
- **However, path to recovery remains rocky with significant head winds**
- **Korea and Thailand have taken solid steps in financial sector restructuring**
- **Malaysia and Indonesia have barely begun**

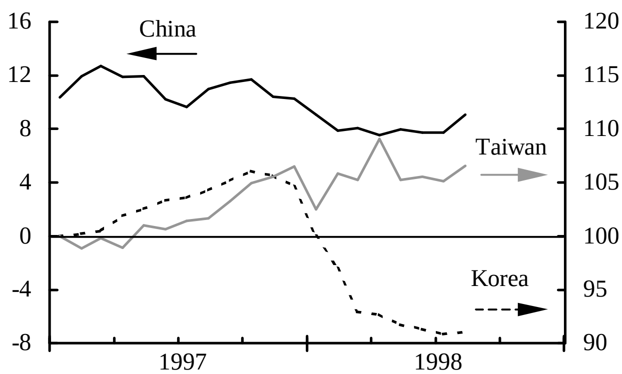
Real GDP growth forecasts
%oya, calendar years

	1997	1998f	1999f
Emerging Asia (10)	6.1	-0.2	2.4
China	8.8	7.0	5.5
Hong Kong	5.3	-5.0	-1.5
India*	5.0	4.0	4.0
Indonesia	4.5	-14.0	-3.5
Korea	5.5	-6.0	2.0
Malaysia	7.8	-5.0	0.5
Philippines	5.2	-0.5	2.5
Singapore	7.8	0.0	-2.0
Taiwan	6.8	4.0	2.0
Thailand	-0.4	-6.0	2.5

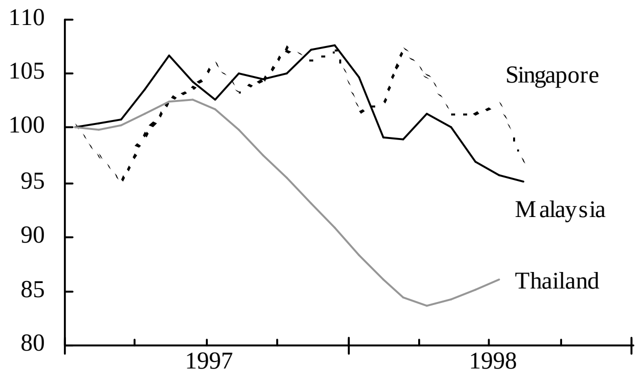
* Fiscal year beginning Apr 1.

Economic conditions have stabilized and conditions for recovery are falling into place

North Asia: industrial production
%oya, 2-mo. mov. avg. *Jan 1997=100, 3-mo. mov. avg., sa*



South Asia: industrial production
Jan 1997=100, 2-month moving average, sa



- Overall, output trends in Emerging Asia have moved from contraction to stability.
- In Thailand and Korea, production contracted sharply in the first half but appears subsequently to have stabilized and even shows incipient signs of recovery. This progress, together with the ongoing financial and corporate restructuring, will likely pave the way to a more distinct economic recovery.
- China, making up almost one third of Emerging Asia's economy, shows signs not merely of output stabilization but also of some modest reacceleration. This renewed vigor owes partly to the authorities' aggressive efforts to spur activity by stepping up state fixed investment (some 50% of all investment).
- Taiwan, despite its strong trade linkages with the rest of Asia, has not seen its economy crippled by the regional demand slowdown.
- In Southeast Asia, especially in Singapore and Malaysia, the production downturn still continues. Singapore here faces a combination of weak external demand and relatively high domestic costs. The upcoming cost reduction program should help restore some lost competitiveness.

Sin Beng Ong (65) 326-9075
ong_sin_beng@jpmorgan.com

Exports are reacting to relative pricing but may moderate in the months ahead

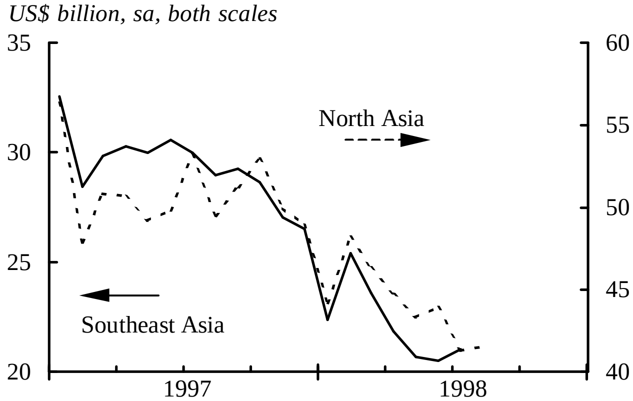
Emerging Asia: export performance
Jan 1997=100, US$ terms, sa

	Jun 97	Dec 97	Jun 98	Latest	Month
North Asia					
China	100.2	89.8	102.9	100.9	Sep
Hong Kong (domestic)	93.9	94.8	93.2	88.1	Aug
South Korea	107.1	101.2	100.0	102.0	Sep
Taiwan	99.5	101.7	90.9	90.9	Sep
ASEAN					
Indonesia (non-oil)	118.5	122.5	130.8	132.1	Jul
Malaysia	93.9	83.8	84.5	80.6	Aug
Philippines	107.5	118.0	122.9	130.1	Aug
Singapore (non-oil dom.)	89.9	88.1	80.4	82.8	Sep
Thailand	100.6	103.6	95.7	94.9	Jul

Emerging Asia: export volumes
Jan 1997=100, sa

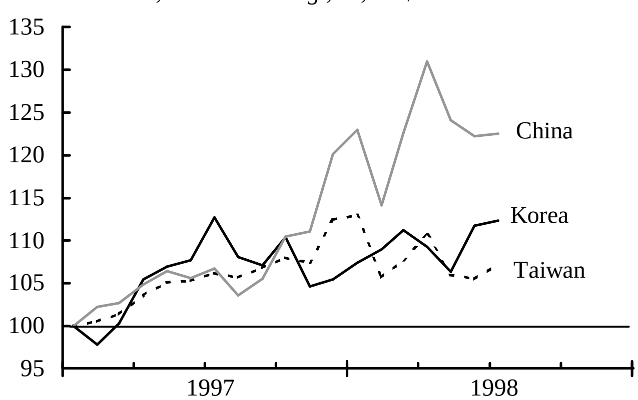
	Jun 97	Dec 97	Jun 98	Jul 98
South Korea	108.7	118.7	130.0	126.5
Indonesia	112.5	123.5	162.1	n.a.
Thailand	98.1	118.5	113.3	114.0

Emerging Asia: imports
US$ billion, sa, both scales

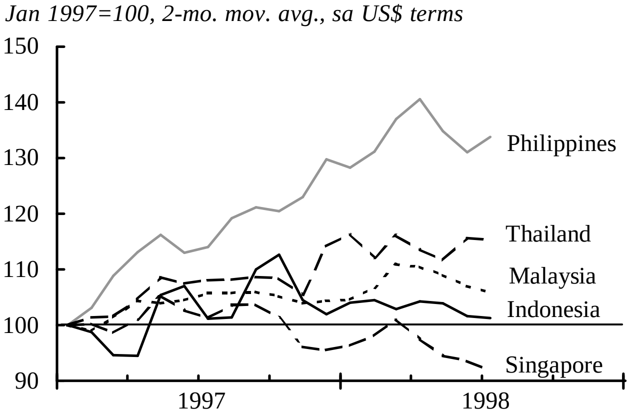


- The Asian export engine is starting to sputter back to life. The area's currency depreciations are affecting relative export prices in US$ terms and the consequences are beginning to show as more buoyant export figures. The depreciations have of course been negative for area imports, though the figures here have recently shown signs of stabilizing or, in the case of Southeast Asia, actually picking up.
- North Asia has turned in no better than moderate headline export performance. Exports to markets outside Asia, however, tell a slightly different story. For example, U.S. demand for North Asian products has been quite lively, especially for Korean and Chinese products. Surprisingly, Taiwan's exports, despite a relatively strong currency, have kept pace with Korea's.
- In Southeast Asia, the headline export figures at first glance (except for Indonesia and the Philippines) are similarly uninspiring. But again, imports into the United States reveal strength. U.S. sales by Indonesia, Malaysia, and Thailand show signs of renewed acceleration while the Philippines' performance has been nothing short of stellar. The lagger here is Singapore.
- Overall, a mild export recovery appears to be taking shape. However, with the global economy expected to slow into 1999, the prospects for Emerging Asian exports are increasingly uncertain.

U.S. imports from North Asia
Jan 1997=100, 2-mo. mov. avg., sa, US$ terms



U.S. imports from Southeast Asia
Jan 1997=100, 2-mo. mov. avg., sa US$ terms



Sin Beng Ong (65) 326-9075
ong_sin_beng@jpmorgan.com

Financial conditions have stabilized with more room still for interest rates to decline

Financial indicators

	US dollar exchange rate (Jan 98=100)		Interest rates (% p.a.)		Stock prices (Jan 98=100)	
	Jun 98	Oct 98	Jun 98	Oct 98	Jun 98	Oct 98
North Asia						
China	100	100	7.9	6.9	82	67
Hong Kong	100	100	9.8	5.3	80	90
South Korea	122	127	14.3	6.9	79	102
Taiwan	99	103	7.5	6.1	92	85
ASEAN						
Indonesia	70	137	59.8	64.9	112	77
Malaysia	107	117	11.0	7.1	80	74
Philippines	103	102	18.1	14.3	93	79
Singapore	102	107	6.4	3.3	70	74
Thailand	126	141	23.0	8.8	72	86
India	91	91	7.3	n.a.	88	74

Real interest rates

benchmark interest rates less inflation 1 year ahead

	Average Jan 90-Jun 97	Jan 97	Jul 97	Sep 98
North Asia				
China	0.3	9.8	11.5	0.4
Hong Kong	-2.2	0.6	4.1	8.7
South Korea	8.7	6.5	35.0	13.2
Taiwan	8.5	8.1	8.5	7.0
ASEAN				
Indonesia	4.6	-20.5	-28.7	54.7
Malaysia	3.1	1.9	9.1	1.1
Philippines	6.1	3.3	4.6	6.3
Singapore	1.5	2.2	5.2	4.8
Thailand	6.1	5.1	12.2	5.5

Emerging Asia: headline consumer prices

%oya

	Jan 97	Jun 97	Dec 97	Sep 98	Dec 99f
North Asia					
China	5.9	2.8	0.4	-1.5	6.5
Hong Kong	6.5	5.4	4.8	2.3	-0.2
South Korea	4.7	4.0	6.6	6.9	-0.5
Taiwan	2.0	1.8	0.3	0.4	-0.8
ASEAN					
Indonesia	5.5	5.1	11.6	82.4	15.0
Malaysia	3.2	2.2	2.9	5.5	6.1
Philippines	5.5	5.7	7.3	10.0	5.5
Singapore	2.0	1.7	2.0	-0.8*	-0.5
Thailand	4.4	4.4	7.6	7.0	5.0

* August 1998 figure.

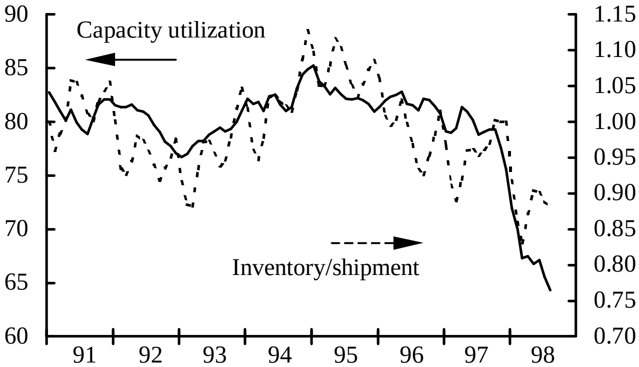
- Balance of payments dynamics and the recent turnaround of the U.S. dollar generally have brought about a marked strengthening of regional currencies despite continuing declines in regional interest rates.
- On the interest rate front, the welcome surprise has been that economic recession has kept pass-through of last year's currency depreciations to very moderate proportions. And with inflationary pressures expected to recede even further into 1999 (as global demand continues to slow) there appears to be additional room to reduce domestic rates.
- Hong Kong, Indonesia, Korea, and Singapore have most scope to reduce rates from current levels, at least as gauged by 1999-year-end inflation forecasts. The Philippines and Thailand have exhausted that scope if judged simply by historical real interest rate experience, but with their economies in recession, some further flexibility can expected.
- Malaysia, by contrast, has no scope left to cut interest rates despite its recently imposed capital controls. Indeed, the recent pause in rate reductions suggests that the authorities recognize that a limit has been reached.
- Further regional rate cuts will be assisted by the downward rate trend forecast globally for 1999.
- Asian stock market performance has been mixed over the last three months, but, with a few exceptions, equity prices seem to have reached a bottom and some are even on the way to recovery. This shift reflects the massive easing in local interest rates and more recently the decline in U.S. rates. Increasing evidence of an output bottom also has helped to stabilize regional stock markets.
- Nevertheless, there are still risk factors and head winds to contend with. First, there is the risk of a U.S. stock market correction, once evidence of a U.S. recession grows stronger. Second, with corporate and financial restructuring still slow, valuation uncertainty is likely to prevail, which will keep foreign investor confidence in the region depressed.

Morgan Guaranty Trust Company
Economic Research
Sin Beng Ong (65) 326-9075
ong_sin_beng@jpmorgan.com

Recovery is starting but obstacles and head winds remain

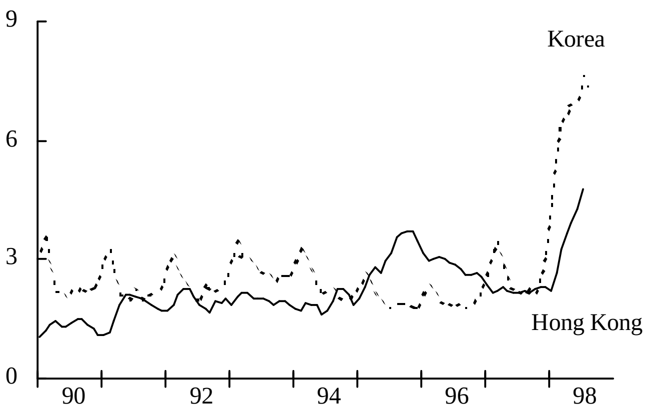
Korea: capacity utilization and inventory ratio

% of capacity, 3mma, nsa *ratio, 3mma, nsa*



Hong Kong and Korea: unemployment rate

% of labor force



IMF-3: structure of external debt

US$ billion, June 1998

	Indonesia*	Korea	Thailand
Public sector	69.6	31.0	26.4
Long term	n.a.	31.0	26.4
Short term	n.a.	0.0	0.0
Private sector	72.5	119.8	61.8
Long term	35.4	81.9	36.9
Short term	37.1	37.9	24.9
Financial sector	8.0	80.8	35.6**
Long term	n.a.	62.0	12.3
Short term	n.a.	18.8	23.3
Nonfinancial	64.5	39.0	26.2
Long term	n.a.	19.9	24.6
Short term	n.a.	19.1	1.7
Total	142.1	150.8	88.2
% of GDP	181.9	34.1	74.9
Interest payments, % of exports	14.0	8.6	9.0

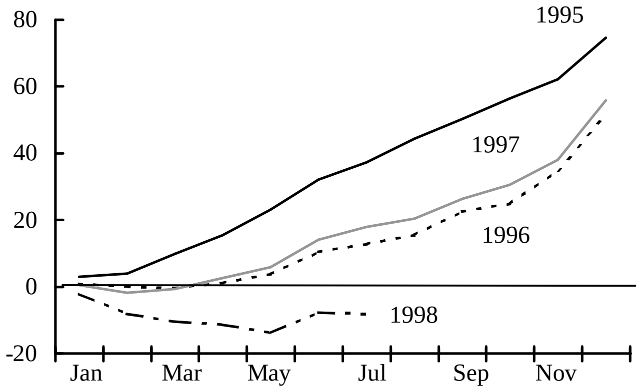
* End-March 1998 figures.
** Includes Bangkok International Banking Facility (BIBF) loans.

- Despite positive signs that the production slump in Asia has begun to stabilize and that exports are on the verge of recovery, major head winds could yet derail Asia's recovery and restructuring process.
- Perhaps the foremost near-term pressure on the countries that have most aggressively pursued reforms comes from the income and spending fallout of the rising unemployment that corporate and financial sector restructuring will necessarily entail.
- For instance, in Korea, corporate restructuring has still to be pursued in a consistent and forceful manner. Foot-dragging on the issue, combined with still very low capacity utilization rates, are apt to cause more problems for the republic.
- Although exports are stabilizing, not all segments of the region's industrial sectors will benefit equally from changed relative prices. Those that are actually disadvantaged will need rationalization at further cost to the labor force.
- The recovery process must include restructuring of debt, not just of domestic debt but also of foreign debt. Short-term balance of payments pressures are over but the next steps in medium-term domestic and external debt stock adjustment have yet to be fully worked out.
- Similarly, the pricing adjustments needed for asset prices to clear remain incomplete (see *Asia's property deflation a year on,* p. 5). In this context, the planned December 2 auction by the Thai Financial Restructuring Authority (FRA) of its remaining seized assets will be closely watched as a broad benchmark of market-clearing prices.
- Financial sector restructuring still has a long way to go in Emerging Asia, even where it is furthest advanced. Lower interest rates throughout the region will aid the process, but with external financing limited, the bulk of recapitalization funding will have to come from domestic saving (see *Funding Emerging Asia's budget deficits*, p. 11). Whether it will be adequately available when needed will depend on just when the ongoing asset price deflation runs its course.

China is showing signs of domestic demand revival

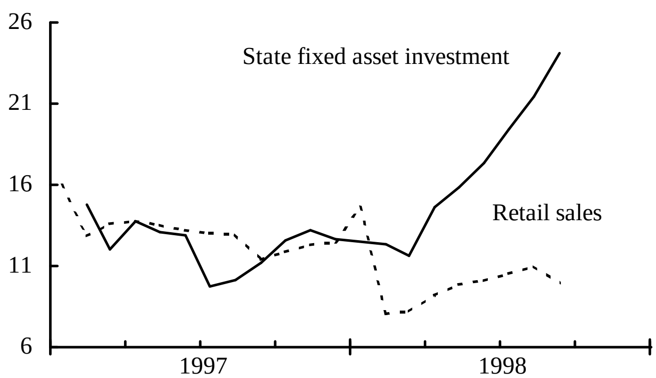
China: state industrial profitability

yuan billion, cumulative



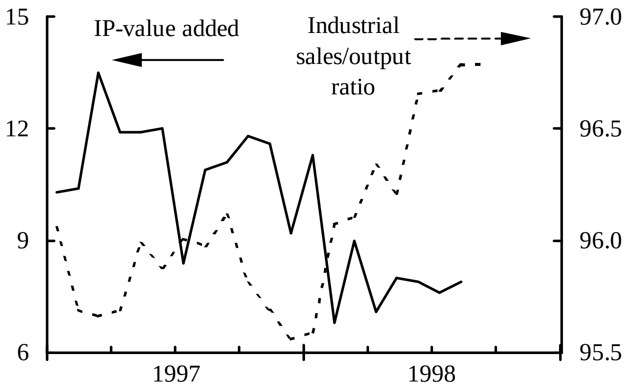
China: state fixed asset investment and retail sales

%oya, year-to-date, real terms



China: industrial output and sales/output ratio

%oya *% ratio, sa, 3-mo. mov. avg.*



- The hit to China from the region's turmoil has been intensifying and is reflected in the deterioration of corporate profitability. Sharp cuts in interest rates and hikes in export tax rebates have limited but not eliminated the losses of state industrial companies as a whole, indicating potential job losses in the sector.
- To create jobs, the government has been aggressively and successfully promoting domestic demand, in particular by investing in infrastructure. State fixed investment has climbed 20% year-on-year in 1998 to date and surged a striking 33.8% in September. This has in turn encouraged consumer spending, seen in the gradual revival of retail sales growth.
- On the supply side, the government has been cracking down on smuggling, limiting imports, and ensuring credit access for exporters. These official measures are starting to bear fruit even in the industrial sector. Output growth there has stabilized, and more importantly, the sales/output ratio is edging upward.
- The domestic demand revival got a kick-start from fiscal pump-priming and support from increased bank lending. Since mid-1998, the government has issued yuan145 billion in bonds to finance infrastructure investment, in addition to the yuan280 billion budgeted to retire maturing debt and finance the budget deficit. And under government pressure, banks expanded their lending by 16.4% from a year ago in the first eight months (lending growth earlier hit a low of 14.8%oya in the first quarter). In consequence, the banks' asset quality will continue to deteriorate. But since their existing nonperforming loans, estimated at 40% of their total loans as of end-1997, have already been monetized by the central bank, the banks should not fall off a cliff, even if another 20% of their loan books turn nonperforming.

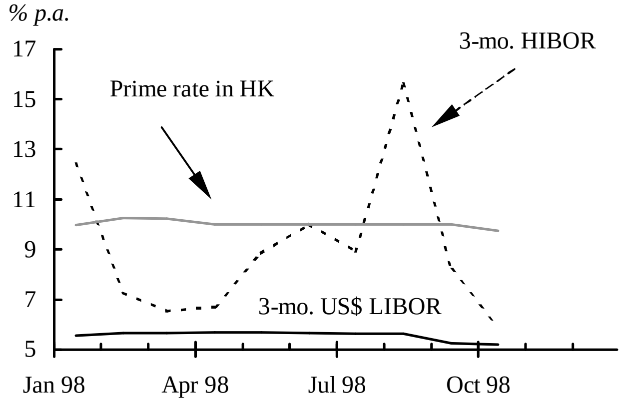
China: government bond issues

- Yuan280 billion announced in March as part of FY98 budget to retire maturing debt and finance budget deficit
- Yuan45 billion issued to commercial banks other than the largest four to finance public investment
- Yuan100 billion issued to the four largest state commercial banks to finance public investment
- Yuan270 billion issued to the four largest state commercial banks for their recapitalization

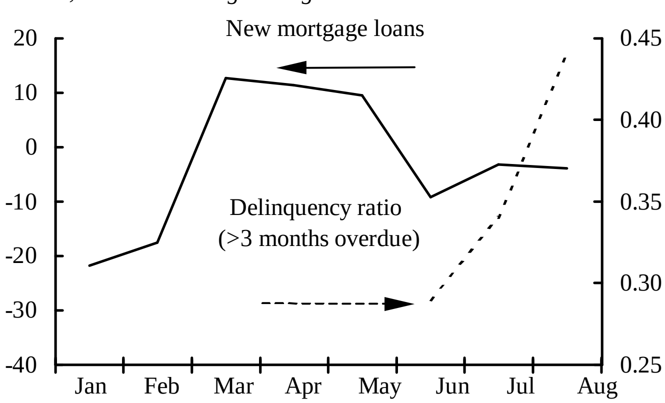
Joan Zheng (852) 2841-1151
zheng_joan@jpmorgan.com

A weak dollar spells relief for Hong Kong's still-deepening domestic adjustment

Hong Kong: interest rates
% p.a.



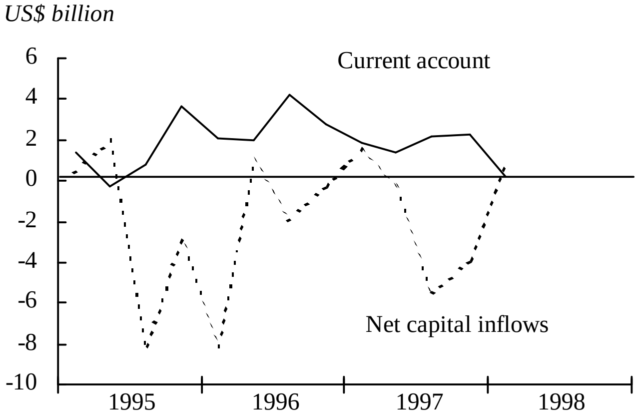
Hong Kong: new mortgage loans and delinquencies
%m/m, 3-month moving average *ratio*



- Financial markets in Hong Kong have shown signs of stability, in reaction both to domestic demand revival in China and to the weaker US$ spurred by the Fed's 25 basis point funds rate cuts on September 29 and October 16.
- Yet within Hong Kong, official stimulus measures remain modest in magnitude, and the severest recession in Hong Kong's statistical history is now set to test the banks. Still, the risk of a systemic meltdown is limited for two reasons. First, Hong Kong is less vulnerable to interest rate hikes than is the rest of Asia, as its corporates and households share the debt burden. Second, the property price meltdown should not precipitate a banking crisis. Even were property prices to fall 90% from their level at the time property loans were made, and if 12% of property loans and 14% of non-property loans were to default, bad loans would amount to only 10% of total loans and be fully covered by the banks' own capital.
- The key threat to banks' survival is liquidity. To protect themselves, most banks have been building up liquidity since last October and will also benefit from improved access to the HKMA discount window. Still, small banks remain vulnerable to liquidity constraints or bank runs, either of which could spur a flight to quality favoring strong and sound banks. And in the worst-case scenario, the monetary authority can always tap into its excess foreign exchange reserves to bail out weak banks as necessary.

Taiwan looking for near-term financial market stability but emphasis may change after elections

Taiwan: balance of payments
US$ billion



- In the run-up to the election in Taiwan on December 5, the authorities are trying hard to maintain stability. The central bank intervened decisively in the exchange market in mid-June, sharply reversing the earlier NT$/US$ rate slide. Since then, it has been scrutinizing every sizable foreign exchange trade.
- The authorities' "moral suasion" has been aided by the greenback's weakness, a moderate rise in the trade surplus, and the reserves stock of US$83 billion. Once the political leash is off, however, the government may be willing to let the currency weaken and so give itself more room to cut interest rates – by that time, it will no longer have to sound confident about GDP growth.

Jiwon Lim (852) 2973-5439
lim_ji_won@jpmorgan.com

South Korea's reform process has yet to turn the corner

Restructuring of Korean financial institutions
as of October 1998

	Total (Dec 97)	Institutions that are closed	suspended	merged
Commercial and specialized banks	33	5	0	3
Merchant banking corporations	30	16	0	2
Securities companies	43	2	4	0
Insurance companies	50	0	4	2
Investment trust companies	8	1	1	-
Leasing companies	25	-	-	-
Other*	1,916	2	59	-

*Mutual credits, credit unions, community credit cooperatives, etc.

Financial sector nonperforming loans and fiscal support
won trillion, as of June 1998

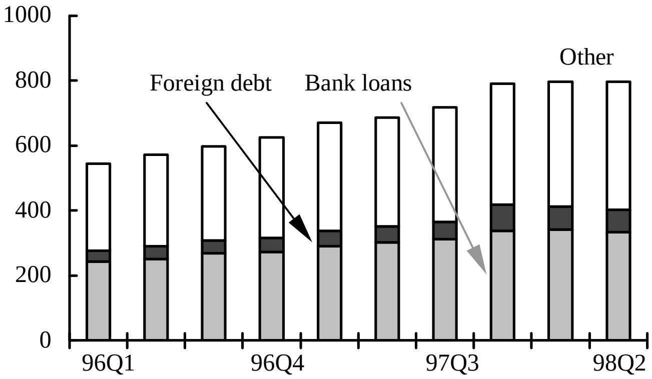
	Bank	Nonbank	Total
Nonperforming loans	113	37	150
Planned fiscal support*	-	-	50
Purchase of NPLs	-	-	25
Recapitalization/deposit repayment	-	-	25

* About won20 trillion of NPLs had been purchased at a 45% discount by end-September.

South Korea: corporate sector reform schedule

End-1998	• Evaluate restructuring plans of top 5 chaebols • Submit debt workout plans for financially weak subsidiaries of the next largest chaebols (6-64)
End-1999	• Reduce debt-equity ratio of 30 largest chaebols below 200% • Consolidate financial statements
End-2000	• Terminate mutual debt payment guarantees among top 5 chaebols

South Korea: corporate sector's financial liabilities
won trillion, interest-bearing liabilities only



- While the contraction of Korea's real economy has been leveling out, the reform process has yet to turn the corner. Timid implementation of reform blueprints has failed to win the full confidence of investors, and rapid stabilization on the external front has not been matched on the corporate debt front.

- The financial sector remains shaky despite the government's earnest effort to recapitalize it. To be sure, 94 nonviable financial institutions have been closed or suspended, about 20% of employees have been laid off, and consolidation of the banking sector has accelerated with several commercial banks merged or acquired (first table). Still, the nonperforming loans of banks and other financial institutions eclipse the government's planned fiscal support, and will keep on rising since the economy is likely to remain weak for some time (second table).

- Corporate sector reform captures the major focus, and here medium-term strategies look hollow. More than half the firms designated as nonviable are still operating with their creditor banks' help. Also, corporate domestic debt has fallen little if at all, rendering unrealistic the target of reducing the average debt-equity ratio to below 200% by the end of 1999 (bottom chart). The government's threatened new push for streamlining the large chaebols' business units should produce something concrete by which the market can gauge reform progress. Nonetheless, any meaningful achievement will not come without overall downsizing, which will present further awkward challenges at the micro level.

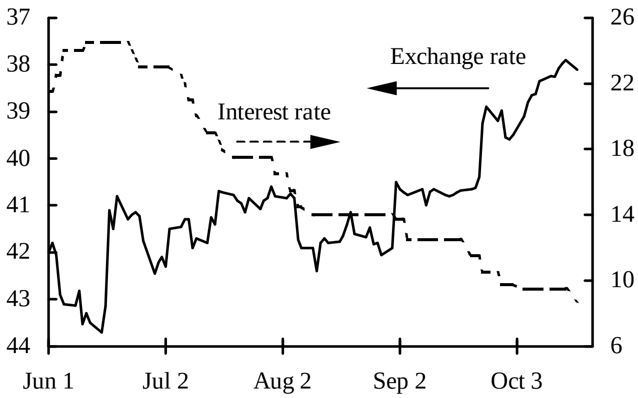
- Labor market rigidity will be the toughest challenge for the reform process to tackle. Rising unemployment will provoke further on-and-off labor strikes, braking reform progress. Still, some compromise between labor and management groups, brokered by the government, looks likely. That will limit the risk of social unrest, but will also surely compound restructuring costs for debt-laden companies and financial institutions. There is a silver lining: The severance pay offered by the early retirement program, a popular but costly mechanism to lay off workers, now approaches the cost of normal layoffs and will thus serve to bring a new element of flexibility to the labor markets in the future.

Morgan Guaranty Trust Company
Economic Research
David G. Fernandez (65) 326-9452
fernandez_d@jpmorgan.com

Thailand: the good student graduates to the next level

Thailand: exchange rate and 1-month interbank rate

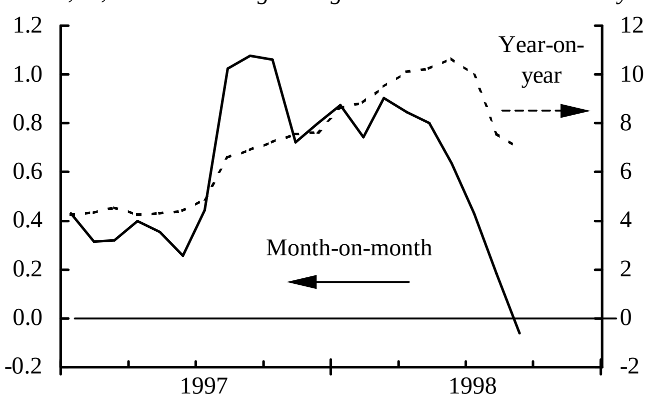
baht/$ *percent p.a.*



- At the World Bank/IMF meetings, Thailand's economic team was again the toast of Washington. And for good reason. Since last August, the country has worked together with these institutions to revive and restructure its damaged financial system, laying the groundwork for a sustained economic recovery. In the past three months, Thailand has started to see some gain for its pain.
- The baht remained stable for most of the third quarter, but broke out of its tight range in late September (before the dollar's October weakening). The move was remarkable because it occurred in the face of a series of onshore interest rate cuts that began in June. Rates have continued to fall and the baht has continued to strengthen.

Thailand: consumer prices

%m/m, sa, 3-month moving average *%oya*

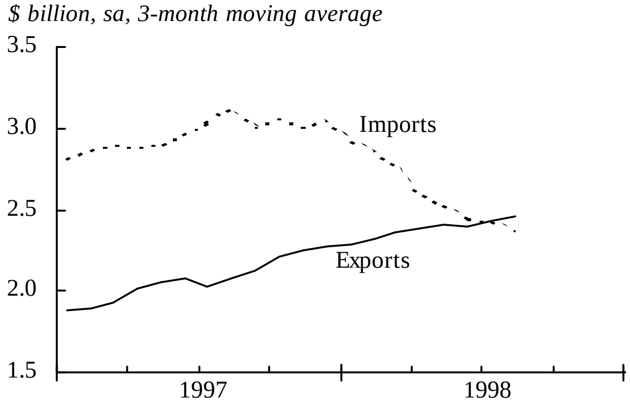


- The rapid cooling of inflation, current account surpluses of $1 billion or so per month, settlement of the bulk of the short-term foreign-currency obligations of banks and the central bank, plus early signs of foreign capital inflows, all have combined to build already-strong sentiment favoring Thailand.
- All this is admirable, but the real economy continues to suffer. Manufacturing production and imports have indeed stabilized, but are holding steady at very low levels and as yet show only very early signs of turnaround. But if the banking sector recapitalization and corporate debt restructuring proceed as planned, real-side recovery will indeed be for real.

Philippines tries to ride out the storm with its new skipper at the helm

Philippines: merchandise trade

$ billion, sa, 3-month moving average



- After 100 days in office, the Estrada administration may be at the point where it can effectively quell the negative market sentiment, both onshore and offshore, that greeted its accession to office.
- Were it not for the El Niño-related drought hit to agriculture, GDP would be expanding and the story would be easier to sell about the Philippines being different from its troubled neighbors. In truth, the country's resilient export growth and a banking system that is bending, but not breaking, do set it apart. At this point, however, whether the country will report positive GDP growth this year again turns on the weather – this time, the rains.

Morgan Guaranty Trust Company
Economic Research
Sin Beng Ong (65) 326-9075
ong_sin_beng@jpmorgan.com

Malaysia has isolated itself from the financial markets and is beginning its own brand of reform

Malaysia: balance of payments
US$ billion, nsa

	97Q1	97Q2	97Q3	97Q4	98Q1
Current account	-0.72	-3.03	-0.78	-0.55	1.64
Merchandise trade	1.66	-0.77	1.50	1.43	2.88
Services	-0.61	-0.56	-0.71	-0.71	-0.21
Income	-1.38	-1.32	-1.25	-1.02	-0.82
Transfers	-0.40	-0.39	-0.31	-0.25	-0.21
Capital account	1.58	2.45	-2.39	-0.25	-2.10
Official long term	0.32	0.54	0.60	0.25	-0.33
Private long term	2.20	2.77	-0.79	1.30	0.70
Private short term	1.65	-1.73	-5.15	0.79	-2.31
Errors and omissions	-2.59	0.88	2.95	-2.58	-0.16
Overall balance	0.86	-0.58	-3.17	-0.80	-0.46

Malaysia: external debt
US$ billion, end of period

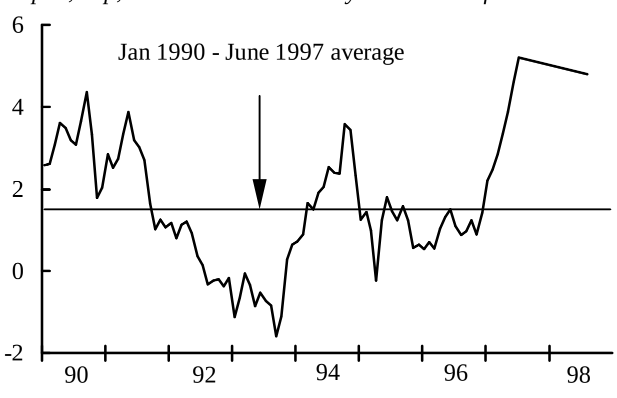
	97Q3	97Q4	98Q1	98Q2
Long term	31.83	32.29	32.09	31.95
Federal government	3.41	3.33	3.05	3.28
NFPEs*	13.03	13.48	13.34	13.12
Private sector	15.38	15.48	15.70	15.55
Short term	12.87	11.30	10.36	8.81
Banking sector	9.66	8.39	7.45	6.02
Nonbank private sector	3.21	2.91	2.91	2.79
Total	44.70	43.59	42.45	40.76
Debt service	0.76	1.51	1.41	n.a.
% of G and S exports	4.3	7.0	7.1	n.a.
Total G and S exports	17.66	21.64	19.93	n.a.
Total foreign reserves	n.a.	21.71	20.40	20.48

* Nonfinancial public enterprises such as Tenaga, Petronas, and Telekom.

- On the external front, Malaysia at first glance faces little pressure. It is presently running a significant trade surplus of some US$1.0-1.5 billion per month. At the same time, the stock of short-term external debt is not large (some US$8.8 billion at midyear) while the total debt servicing burden is relatively small – about US$1.5 billion per quarter for now since the bulk of the debt has a maturity greater than one year. Seemingly, therefore, the balance of payments and external debt position should be quite manageable in the near term even in the absence of foreign direct investment inflows.
- There are two key near-term pressures, however. First, depositor confidence could erode and thereby curtail the liquidity available to support new lending growth at the mandated 8% year-on-year clip. Slippage here would compound problems for the corporate sector. Second, rising nonperforming loans will give banks mounting liquidity and solvency problems. Unless recapitalized with liquid capital (which would largely have to come from the government), the banks will be in no shape to extend new loans.
- But the government knows that it has its own funding problems. To cope, it has indicated that it will tap the resources of the Employees Provident Fund (EPF) and even possibly Petronas, but the capital available from these is limited. Annual cash flow of the EPF and Petronas amounts to a bit more than US$3 billion (5% of GDP), while their reserves are already largely invested in the banking system.

Singapore continues to embrace market-friendly policies but cannot avoid recession in 1999

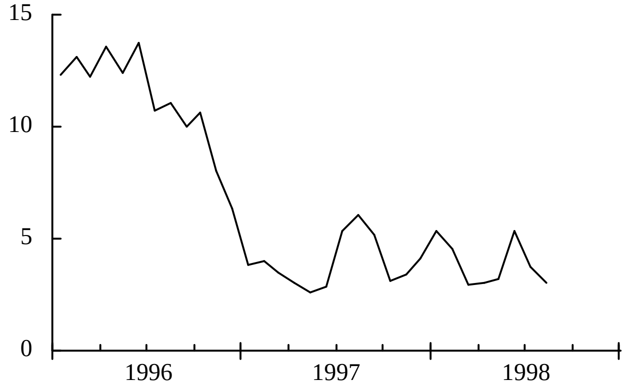
Singapore: real interest rates
% p.a., eop, 1-month CD rate less year-ahead inflation



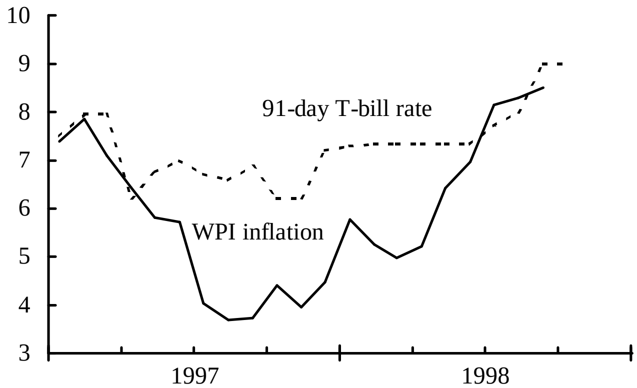
- The near-term prospects for Singapore's economy continue uncertain. Persistent global oversupply in the key electronics sector and still-weak regional demand will continue to weigh on both goods and services exports well into 1999.
- The authorities are expected to continue bending monetary policy toward a softer stance as consumer prices move into deflation. Their overriding concern appears to be not so much to engineer an export-led recovery but more to prevent further unemployment. Wage restraint and further services cost reduction will be key to that end.

India: not good, not bad, but ugly

India: industrial production
%oya, 3-month moving average

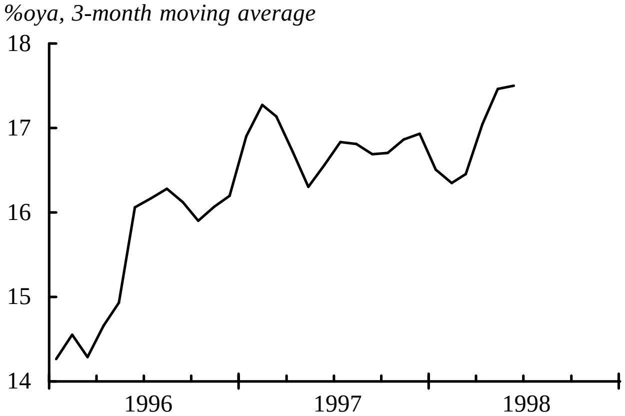


India: wholesale prices and Treasury bill rate
% per annum

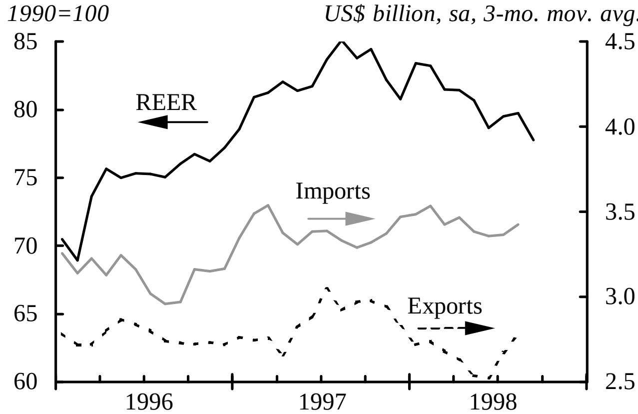


- India's closed nature has substantially protected it from the Asian crisis, but has also allowed it to delay necessary adjustments and reforms. Now, with the focus in the rest of Emerging Asia moving to recovery, India looks increasingly like a lagger.
- The performance of the economy is lackluster, with real GDP growth likely to fall to 4% in FY1998/99 and probably staying there in the following year.
- In contrast to the rest of Asia, inflation has visibly accelerated. However, currency depreciation is only a symptom of India's inflation pressures. The real cause is continued strong money supply growth despite much slower real economic activity.
- Not surprisingly, India's external balances are under pressure, with exports struggling, imports strong, and capital inflows slowing rapidly. The rupee is down in both nominal and real terms, but still seems overvalued, while interest rates have failed to fall in response to Fed rate cuts and the dollar's decline.
- Balance of payments pressures leave the Reserve Bank of India little choice but to let the rupee depreciate. Yet, there is little room to cut interest rates as long as inflation and money supply growth stay high. Nor is fiscal policy an option, since the government is likely to run a larger-than-targeted deficit. Thus, even though India has escaped crisis, its prospects will fade unless it revives reforms.

India: M3 money supply
%oya, 3-month moving average



India: exports, imports, and real exchange rate
1990=100 *US$ billion, sa, 3-mo. mov. avg.*



J.P. Morgan Australia Pty Ltd
Economic Research
John Kyriakopoulos (61-2) 9551-6467
kyriakopoulos_john@jpmorgan.com

Australia and New Zealand get hit some more

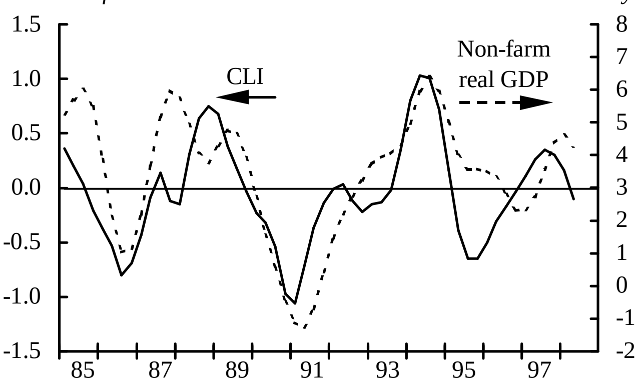
- **Bleak global outlook and tighter financial conditions slash Australia/New Zealand growth hopes**
- **Australia can avoid a recession if the Reserve Bank reduces interest rates soon**
- **New Zealand's central bank has been too slow to ease and remains too cautious**

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

	1997	1998f	1999f
Australia			
Real GDP (%oya)	3.3	3.7	1.3
Consumer prices (%oya)	0.3	1.1	2.4
Current account (% of GDP)	-3.2	-4.9	-4.2
Fiscal balance (% of GDP)	0.5	2.9	1.4
New Zealand			
Real GDP (%oya)	2.6	-1.0	1.5
Consumer prices (%oya)	1.2	1.3	1.3
Current account (% of GDP)	-5.2	-6.0	-4.8
Fiscal balance (% of GDP)	2.0	2.6	0.0

Australia's GDP growth has peaked...

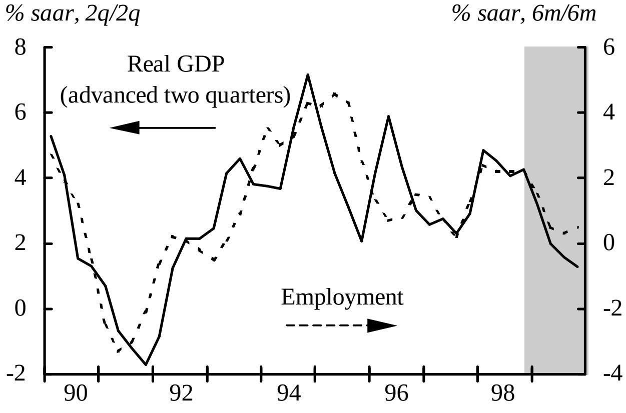
Composite leading indicator and real GDP growth
deviation from trend *%oya*



- The best of GDP growth is now history for Australia. The downgraded global growth forecast will exert a larger drag on exports than previously expected. In addition, the recent deterioration in domestic and international financial markets will further crimp growth in domestic demand. The fiscal stimulus coming from the projected sharp reduction in Federal budget surpluses – through the net cost of the tax reform package and additional spending measures – is 18 months away. That will be too late to save the economy from weakening in 1999.
- J.P. Morgan expects real GDP growth to fall by almost two-thirds, from 3.7% in 1998 to 1.3% in 1999. The latter would be the worst result since 1992.

...and employment will follow

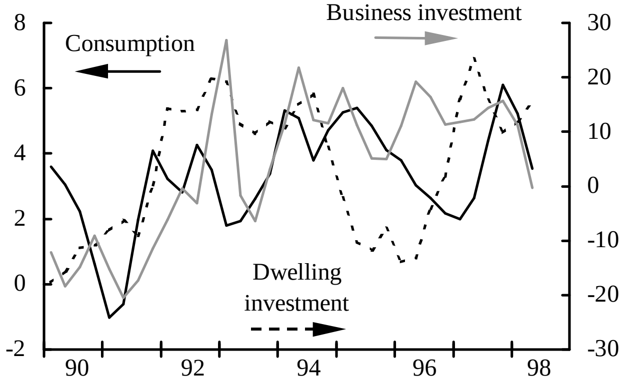
GDP and employment
% saar, 2q/2q *% saar, 6m/6m*



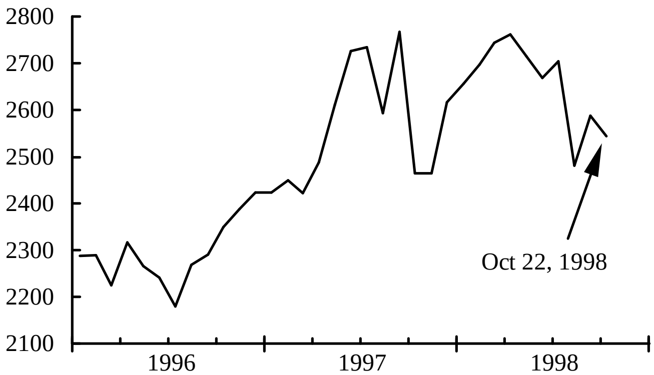
- Employment growth has not slowed much to date, providing some comfort to those expecting GDP growth to slow only modestly. The sanguine view focuses on the boost to household income and spending from continuing job gains, but ignores the lag of employment behind output trends.
- Jobs growth lags GDP growth by around two quarters on average. A key leading indicator of employment is already signaling a downturn, while employment is sagging in export industries (tourism, manufacturing, mining, and agriculture). It is only the strong growth of a few service industries hitherto that has kept overall job gains from stalling.

Supports for domestic demand are fading

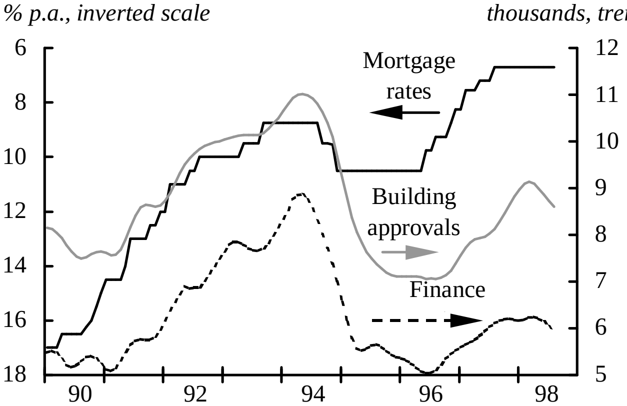
Private final demand
% ch, saar, 2q/2q (both scales)



All Ordinaries stock market index
index



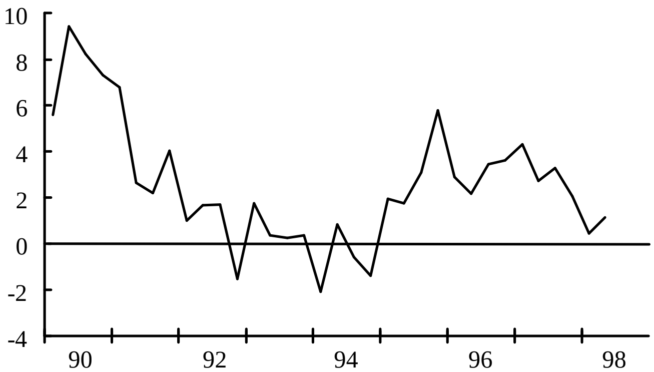
Indicators of residential construction
% p.a., inverted scale *thousands, trend*



- Private final demand growth of 4% has been cushioning so far the blow to GDP growth from plunging manufactured exports, a sharp fall in tourist arrivals, and lower commodity prices. However, signs of a slowdown in domestic spending are emerging, a by-product of external drag but also reflecting domestic factors such as residential construction running out of steam. Tightening financial conditions will also crimp spending growth.
- Business equipment and machinery investment is declining, dragged down by the mining and manufacturing sectors, whose profits are being squeezed and whose capacity utilization is declining. Equipment and machinery investment rose around 15% in 1997-98; were it instead to hold flat in 1999, GDP growth would be lower by a full percentage point.
- There are tentative signs that the two-year upswing in residential construction is nearing a peak. Dwellings investment, which includes alterations and additions, boosted GDP over the past year by around 0.75 percentage points directly, and by rather more, including spending on furniture, white goods, and other household items. Leading indicators of residential construction have turned down, despite low interest rates, for two reasons. First, mortgage interest rates stopped declining, and house price rises outstripped wage increases, eroding affordability. Second, residential building approvals, at just under 160,000 this past year, exceed underlying demand.
- Nonresidential construction continues to grow, although at a much more moderate pace recently. It is supported by substantial infrastructure construction (particularly privately funded toll roads). Office building construction is underway again in Sydney after a long lull following the early 1990s property slump. However, mining-related infrastructure construction is likely to be cut back in response to the slide in commodity prices.
- Consumer spending continues to grow solidly, if less rapidly than earlier. It is underpinned for now by low borrowing rates, real wage gains, and rising employment. But lower business investment and declining residential construction will weaken employment, and ultimately, consumer spending.

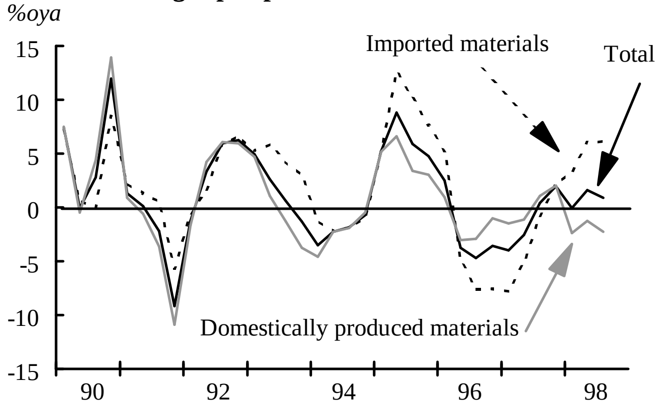
Inflation to remain benign despite sharp currency depreciation

Unit labor cost
%oya

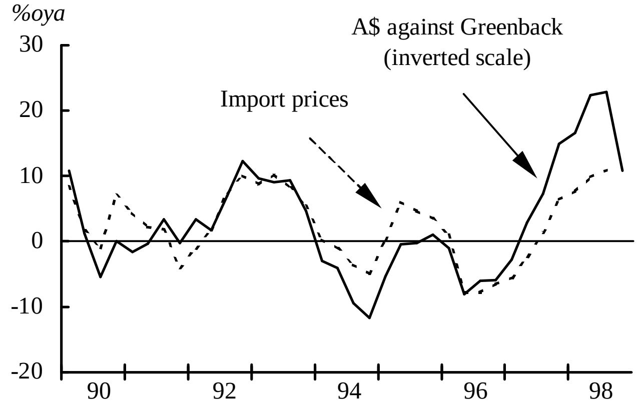


- J.P. Morgan expects inflation to remain benign, despite the Australian dollar's 25% depreciation against the greenback. Import prices have risen by a more modest 11%, thanks in part to lower world prices for commodities and manufactured goods, but also to a less dramatic fall in the imported-weighted exchange rate. Profit margins remain under intense competitive pressures, restraining firms' ability to pass on higher imported material costs.
- More importantly, wage growth is moderating. Unit labor costs show very little rise, providing business with scope to offset higher imported input costs.

Manufacturing input prices
%oya

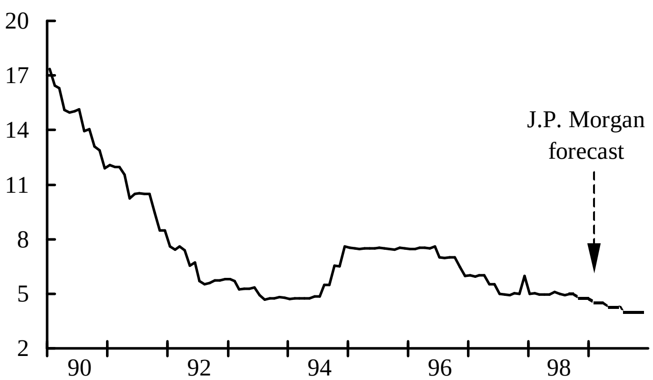


Import prices and the Australian dollar
%oya



RBA to cut rates by 100 basis points

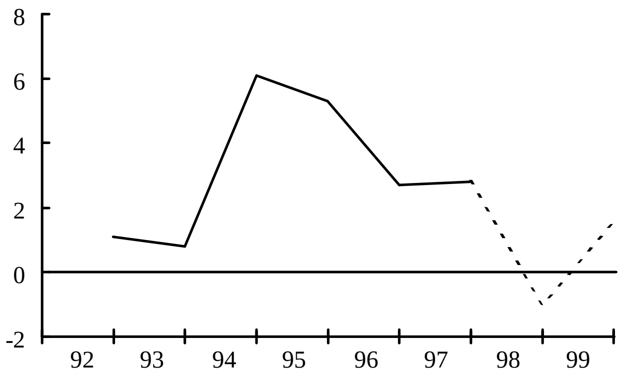
Official cash rate
% pa



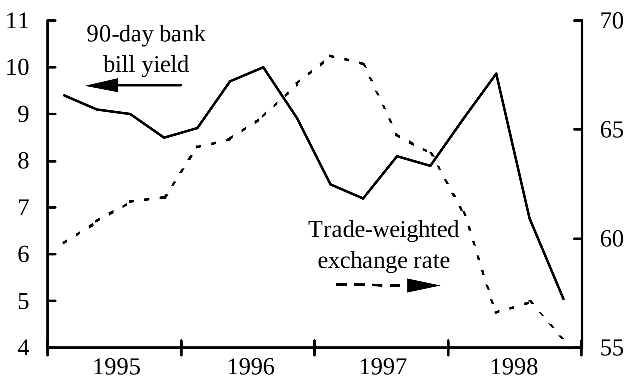
- The RBA will cut official interest rates by 100 basis points to 4% by the end of the third quarter 1999, in order to forestall a recession and a consequent large jump in unemployment. The first cut of 25 basis points is expected by year end, with three additional 25-basis-point cuts in the first, second, and third quarters of 1999. By not fully matching expected U.S. Fed rate cuts, the RBA will provide some support to the Australian dollar.
- Failure to cut official interest rates in the face of the forecast recession in the United States would risk a similar outcome in Australia.

New Zealand's recession will be deep without further easing...

New Zealand real GDP and forecast
%oya



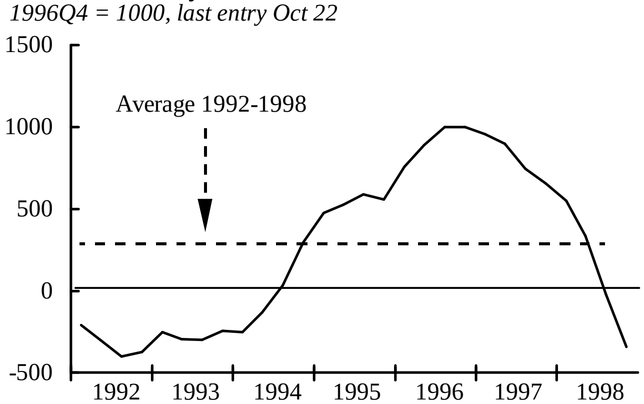
New Zealand financial indicators
%p.a. *index*



- A second consecutive quarterly fall in GDP confirmed that New Zealand entered recession in the first half of 1998. Back in 1996, excessive borrowing by households to overinvest in real estate contributed to high real interest rates because foreign lenders demanded a hefty risk premium. More recently, stubbornly high interest rates reflected the central bank's slowness to ease. The RBNZ underestimated the impact of tight policy on domestic demand, particularly that of debt-laden households, and more recently failed to gauge the magnitude of the drag on exports and commodity prices from Asia's recession. A severe drought, which cut rural production, also contributed to the slump in GDP.
- Acknowledgment that the economy was already in or headed for a recession has prompted an aggressive easing of monetary conditions this year. The RBNZ has sanctioned a 650-basis-point decline, to zero, in the monetary conditions index (MCI) so far. However, financial markets, a step ahead of the central bank, have pushed the MCI to -350, but with resistance from the RBNZ. Most of the easing this year has come through much-needed lower interest rates, with 90-day bank bill rates now at 5%, after topping 10% just three months ago. The MCI is now well into negative territory, as it was in the early 1990s recession. Back then, this was sufficient to kick-start the economy, although the international environment was more benign at that time than now.

...but the RBNZ appears reluctant to allow the MCI to fall much further

RBNZ monetary conditions index
1996Q4 = 1000, last entry Oct 22



- The recent sharp fall in interest rates and the lower New Zealand dollar will help rally business confidence and thereby cushion the economic downturn. The currency's depreciation is increasing manufactures exports to regions beyond Asia, although commodity exports remain weak. Personal income tax cuts in July are also boosting household income. However, Morgan foresees no resumption of GDP growth until the first quarter of 1999.
- There is a good chance that the MCI will need to fall further to kick-start the economy in the face of strengthening external head winds.

Morgan Guaranty Trust Company
Asian Market Research
Winston Koh (65) 326-9457
koh_winston@jpmorgan.com

Foreign exchange and interest rates

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

A weaker yen remains on the cards for 1999

Notwithstanding the substantial uncertainties surrounding the outlook for the Japanese economy, the heightened risk aversion in global financial markets has propelled the yen to trade within the 114-118 range. Global investors have been deterred from returning to the short-yen trade that earlier had driven the yen almost to the 150 level. In particular, Japanese investors have been discouraged from increasing their currency exposure in overseas assets, with many further electing to increase their hedge ratios to reduce such exposure.

While pessimism and a flight to safety still pervade the markets, with a consequent tightening of liquidity, the gloom lately has lifted a little on a string of positive events. The U.S. Congress has effectively agreed to increase the IMF's resources by almost US$90 billion, while the Japanese Diet has approved a ¥60 trillion bank reform bill. Given expectations of further U.S. rate cuts to keep recession at bay and reports of sharply reduced leverage at hedge funds, financial market conditions seem likely to ease.

Happy times are not yet quite here, however. Investor risk aversion will continue to be a major market driver until global growth shows signs of recovery. No return of risk appetite seems likely before the turn of the year. By that time, a (seasonal) rebound in liquidity can be expected. U.S. interest rates will have declined further, and speculation on a Euro rate cut will be growing, fueled in part by the new currency's strength.

With capital flows dwindling as a result of global deleveraging, trade flows are becoming a more

Exchange rate and interest rate forecasts

	Actual	Forecasts	
	Oct 22	3 month	12 month
US$ exchange rate			
Japan	117.76	114	145
Australia	0.62	0.60	0.63
New Zealand	0.52	0.51	0.53
China	8.28	8.29	9.00
Hong Kong	7.75	7.75	7.76
India	42.26	44.25	48.00
Indonesia	7,625	10,000	11,000
Malaysia	3.80	3.75	4.25
Philippines	42.58	43.75	41.00
Singapore	1.63	1.65	1.75
South Korea	1,322	1,400	1,500
Taiwan	32.88	33.00	35.00
Thailand	37.72	38.25	40.00
3-month interest rate*			
United States	5.20	4.60	3.65
Japan	0.40	0.40	0.40
Australia	4.82	4.40	4.00
New Zealand	5.05	4.00	3.75
China	9.41	13.00	14.00
Hong Kong	5.99	6.50	8.00
India	13.05	16.00	18.00
Indonesia	52.87	45.00	42.00
Philippines	13.95	14.00	14.50
Singapore	2.89	3.00	2.25
South Korea	7.97	10.00	12.00
Taiwan	5.58	7.70	8.20
Thailand	10.76	7.40	7.00
10-year gov. bond yields**			
United States	4.31	4.30	4.35
Japan	0.78	1.08	1.65
Australia	4.92	4.55	4.65
New Zealand	5.54	4.75	4.45
External debt spreads***			
EMBI****	1,160	1600	800
China 06	215	275	225
ICICI (India) 07	586	550	500
Indonesia 06	1,367	1650	1200
Korea 03	548	800	500
Korea 08	543	850	500
Petronas (Malaysia) 06	814	1000	750
Philippines 08	569	850	600
Philippines 16	568	850	600
Thailand 07	511	600	350
Hutchison (Hong Kong) 07	500	600	350

* % p.a., United States, Japan, Australia and New Zealand are deposit offer rates, all others are mid-level offshore money market rates.

** % p.a., based on local convention.

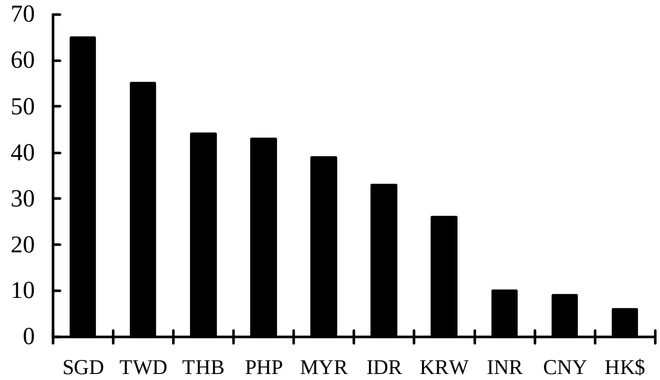
*** Basis points, spreads of dollar-denominated government (or corporate) bonds over U.S. treasury bonds.

**** J.P. Morgan Emerging Markets Bond Index.

Morgan Guaranty Trust Company
Asian Market Research
Winston Koh (65) 326-9457
koh_winston@jpmorgan.com

prominent driver of the exchange markets. On this score, Japan's current account surplus will provide further support for the yen and for the unwinding of remaining short-yen positions. This support will be partially offset, however, by anticipated seasonal capital outflows from Japan, now that the fiscal half-year has ended. In addition, the U.S. dollar will be buoyed by revived interest in U.S. stock markets, on expectations of further lowering of U.S. interest rates. Even so, the risk remains in the short term that the yen will test the 110 level. In the longer term, by contrast, risk aversion should fade and with the Japanese economy still fundamentally weak, and business confidence chronically depressed, the U.S. dollar will probably resume its march toward ¥150 by the end of 1999.

Correlation of Emerging Asian currencies with the yen
%, based on daily fx changes over 6 months



Asian interest rates have room to fall further

The currencies of Emerging Asia have benefited so far from the deleveraging of global financial markets. Going forward, however, capital flows to the region are unlikely to perk up much at all soon. In turn, countries that depend on external financing will likely experience fresh downward pressure on their currencies. By contrast, those with healthy current account positions will win a measure of support for their currencies.

Real offshore three-month yield
% p.a., adjusted by three-month forward inflation

	HK$	IDR	SGD	THB	CNY	KRW	PHP	TWD
Current	7.9	3.0	4.6	5.1	30.5	1.3	3.3	5.7
1993-96	-2.1	4.9	1.4	3.1	1.8	2.8	4.9	3.9
5-year avg	0.9	-2.7	2.8	6.3	6.9	7.3	7	5.2
5-year max	20.2	21.1	10.9	28.0	36.0	42.6	28.5	21.9
5-year min	-7.9	-93.3	-3.1	-2.0	-29.4	-4.4	-6.1	-10.7

The yen will continue to be a major driver of other Asian currencies in the coming months, as it has been since May this year. However, the critical factor for the outlook for Emerging Asian currencies is not the level of the U.S. dollar against the yen but the level of Japanese economic activity. If the yen's newfound strength depresses Japanese exports and compresses domestic demand further, the consequences for Asian economies will undoubtedly be negative. In itself, the yen's recent surge is unlikely to affect the longer-term outlook for Emerging Asian currencies. In fact, the impact of the yen as a driver of Emerging Asian currencies will likely diminish over the course of 1999 as investor flows start to return to the region.

Offshore interest rates (implied from foreign exchange forwards) have fallen substantially over the past few months in Emerging Asia to near pre-crisis levels. This drop in offshore rates has followed a shift in official policies in these countries to favor lower onshore rates as a means to stimulate domestic demand. Inflation is under control nearly everywhere and promises to stay benign in 1999. Given also the recessionary environment, there is room for nominal as well as real interest rates to ease further.

While nominal offshore interest rates have gyrated wildly since mid-1997, offshore real interest rates (calculated as nominal rates less realized inflation over the same horizon, annualized) have exhibited less volatility. Over a long period, real interest rates generally revert to equilibrium mean levels consistent with currency and sovereign risk. Currently, real interest rates in Emerging Asia are still substantially above the average levels that prevailed over the 1993-96 period, suggesting room for nominal rates to

Winston Koh (65) 326-9457
koh_winston@jpmorgan.com

decline further as long as inflationary pressures do not reignite.

With U.S. interest rates providing a floor in nearly all cases, the interest rate differentials of Emerging Asian currencies against the U.S. dollar should gradually narrow to reflect lower risk premiums and improved liquidity. Indeed, Singapore dollar rates have already traded through U.S. rates on many occasions.

The yen's recent strength has alleviated pressure on the HKD and the CNY, reducing devaluation risks for both. Bringing further relief are expectations of lower U.S. rates as well as recent measures by the HKMA to raise the cost of speculating on the HKD peg. Earlier bouts of intense selling pressure on the HKD were driven by the realization that Hong Kong's competitive position had deteriorated drastically as other Asian currencies plummeted in the second half of 1997. The recent yen-driven rally of Asian currencies against the U.S. dollar has eased some of this concern, but with the real effective exchange rate of the HKD still above its long-term average, pressure on the HKD will not lift entirely. Even so, the HKD peg should be expected to hold.

As for the CNY, the Chinese authorities will probably steer the CNY/USD rate to weaker levels in 1999, to catch up some way with the currency adjustments that have occurred elsewhere in the region. External pressure on the CNY is likely to be minimal, given the closure of the Shanghai grey market and more particularly in light of recent measures to combat speculation – including threats of capital punishment.

The KRW is set for renewed weakness, as external flows will not be supportive going into the year end. With offshore credit spreads sharply wider since the Russian default, Korean corporates find it cheaper to borrow KRW onshore to service their dollar debt. In addition, principal repayments are coming due for corporate and bank debts (restructured last Spring). In all, the potential for further gains in the KRW is elusive.

In ASEAN, the risk of any significant tightening of capital restrictions in Indonesia or the Philippines remains low. Unlike Malaysia, these countries still depend on IMF assistance, and it is inconceivable that the IMF would countenance attempts to impose controls like Malaysia's. Not inconceivable, however, is a tightening of regulation of exporters' foreign exchange earnings, as already mooted in Indonesia.

The THB, the most promising investment currency of the group, has outperformed other ASEAN currencies over the past six months or so. Investor interest in baht assets has noticeably increased in response to Thailand's steady progress in financial reform and its recent passage of an ambitious bank recapitalization plan. Thailand remains the most aggressive among Emerging Asian countries in restructuring its financial sector, and will attract a larger share of investment inflows as and when investor sentiment warms further.

The recent IDR rally should be expected to run on for a little longer, but is unlikely to be sustained unless investor flows return strongly. Nonetheless, the stronger IDR will likely prompt offshore rupiah rates to drift lower, in line with onshore SBI auction yields that have been falling steadily since late July.

The SGD, like the yen, is widely used as a funding vehicle within Asia and exhibits the highest correlation with the yen of all Emerging Asian currencies. This has benefited the SGD in the current round of broad-based unwinding of cross-border investments in Asia. Although the Singapore authorities will trim labor costs aggressively to boost competitiveness – rather than push the SGD weaker to accomplish the task – the SGD will probably retrace to weaker levels over the next few months as low SGD interest rates render it an attractive funding currency.

AUD and NZD have benefited from risk aversion

Commodity-linked currencies such as the AUD and the NZD have benefited from the recent sharp rise in risk aversion, as short positions are being unwound. A generally weaker U.S. dollar, signs of economic stabilization in Asia, and lower volatilities among Asian currencies have provided additional support. Going forward, a more positive Asian economic landscape will further boost the AUD and the NZD, since Asian markets absorb a large portion of the exports of both Australia and New Zealand.

Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

Equities

- **Dollar weakness and Fed rate cuts have given Asian stock markets a boost**
- **Liquidity and earnings fundamentals have improved but valuation uncertainty persists**
- **Cyclical leaders to outperform laggers**

After already outperforming much of the rest of the world in the third quarter, Asian equities have rallied over the last three weeks, thanks to the decline of the dollar and the two cuts in U.S. interest rates. However, Asian markets have been supported by more than just external factors. Output has reached a trough, pointing to a bottom in the earnings cycle, and liquidity has improved, thanks to the prolonged period of current account surpluses. The main exception is Japan, where continued bad news from the banking sector has undermined the market until very recently.

Going forward, the improvement in earnings and liquidity conditions will remain strong market drivers. However, there will be leaders and laggers and there are risks from persistent valuation uncertainties as well as the potential for a U.S. stock market correction.

Interest rates have dropped and will fall further

The most important change for equity markets in Emerging Asia has been the decline in interest rates. This process started initially in Korea and Thailand, where sustained current account surplus balances improved monetary liquidity. Interest rate declines have accelerated and broadened in the last few weeks following the fall of the dollar and the two Fed rate cuts. Hong Kong, which until recently experienced strong pressure on the currency peg, benefited especially from these favorable external events.

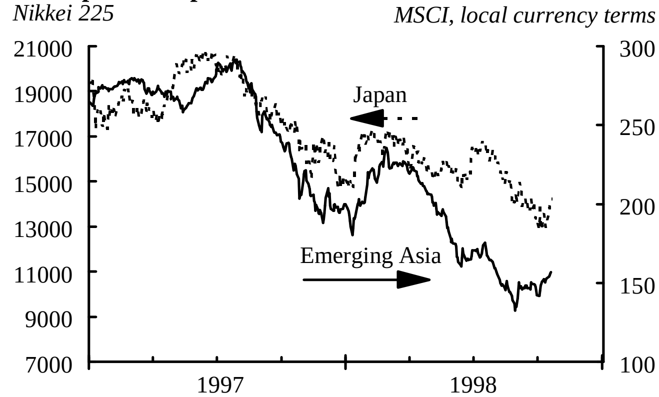
Going forward, interest rates are expected to drop further. First, Asian central banks are likely to use future U.S. interest rate cuts – J.P. Morgan expects the Fed funds rate to drop to 3.5% by mid-1999 – to reduce interest rates further and to avoid significant currency appreciations. Second, current account surpluses are expected to be sustained for some time, while real in-

Equity market moves
% changes, eop

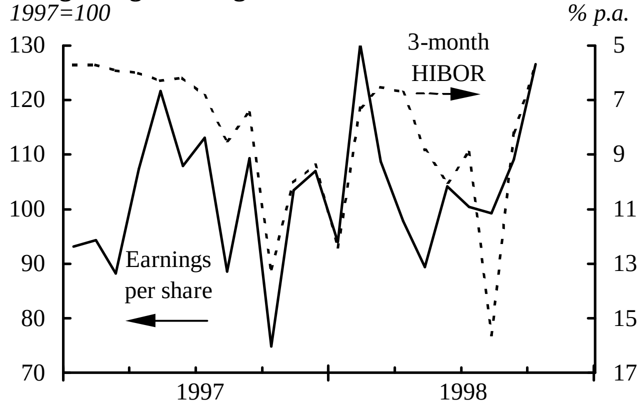
	Since 1998Q3		Over last 3 weeks	
	LC-terms	$-terms	LC-terms	$-terms
World*	-14.1	-12.3	4.7	6.7
United States	-12.4	-12.4	8.8	8.8
Japan	-15.3	-14.1	6.6	23.9
Australia	-3.1	-7.2	-1.6	3.7
New Zealand	-12.0	-15.4	6.6	11.9
Emerging Markets**	-19.2	-21.3	6.1	8.1
Emerging Asia**	-10.5	-12.5	6.1	10.2
China	-15.4	-15.4	2.6	2.6
Hong Kong	-7.7	-7.7	22.5	22.5
India	-4.6	-4.6	-10.9	-10.6
Indonesia	-38.1	-15.2	14.8	63.8
Korea	4.2	2.8	23.4	29.8
Malaysia	-18.0	-10.7	13.0	13.1
Philippines	-28.4	-31.8	18.7	22.2
Singapore	-11.9	-11.7	19.0	23.8
Taiwan	-9.5	-9.7	2.3	7.4
Thailand	-5.1	1.3	26.9	33.1

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

Stock prices: Japan versus the rest of Asia
Nikkei 225 *MSCI, local currency terms*



Hong Kong: earnings and interest rates
1997=100 *% p.a.*



terest rates are still high in most countries. Stock markets in Hong Kong, Korea, the Philippines, Singapore and Thailand are most likely to benefit from the improvement in liquidity conditions. However, in India, pressure on the currency persists and interest rates are unlikely to fall much, while real interest rates in Malaysia are already too low and could trigger capital flight despite the introduction of controls.

Earnings are reaching a trough

The decline in interest rates is also good news for earnings. For many companies, high leverage makes interest expenditures a significant portion of total costs. Moreover, interest-rate-sensitive sectors, such as property and finance, often form a large share of the total equity market. Not surprisingly, interest-rate-sensitive stocks in Hong Kong, Korea, Singapore, and Thailand have responded well to the decline in rates.

A second plus for earnings comes from the stabilization in output and the prospect of positive economic growth in the year ahead. Here, Korea, Thailand, and the Philippines are likely to lead the cycle.

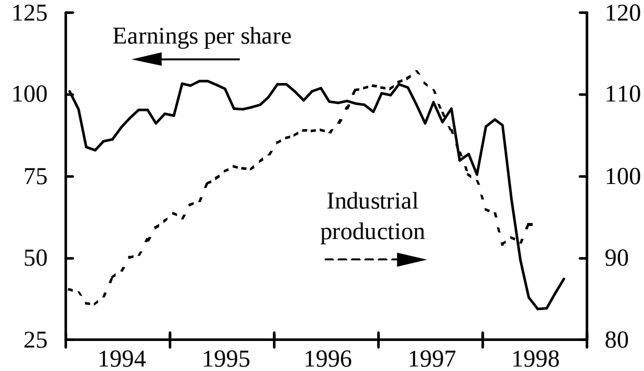
But investors are likely to remain cautious

Despite the positive liquidity and earnings news, investors are likely to remain cautious. Risk appetite is low and valuation uncertainties remain large, thanks to the slow pace of corporate restructuring and financial reform. Poor accounting, disclosure, and legal standards compound investor caution. Moreover, there are clearly risk factors outside the region, most notably the danger of a sharp correction in the U.S. stock market or a crisis in emerging markets possibly triggered by events in Brazil or Russia. Still, while such events could temporarily upset the performance of Asian stock markets, they are unlikely to outweigh the improved liquidity and earnings trends for long.

Caution is also still advised in the Japanese equity market. The reduction of risk positions and the announcement of a new bank recapitalization bill have recently helped the Nikkei. However, although the funding of the new recapitalization program appears more realistic, the disbursement mechanism is not built on a comprehensive strategy that differentiates banks according to their financial position – such criteria would mean naming weak banks, which even the government is trying to avoid. Thus, only a small portion of the funds are likely to be used where they are needed most, while restructuring will remain slow and nonperforming loans will continue to rise.

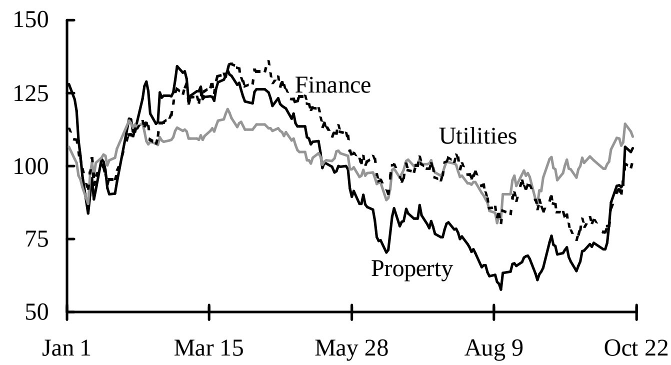
Thailand: earnings and industrial production

1995=100, 3mma *1995=100, sa, 3mma*



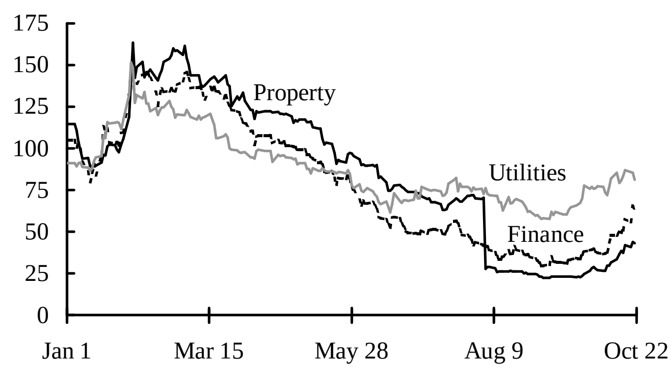
Hang Seng components

Jan 98=100



Bangkok SET components

Jan 98=100



Morgan Guaranty Trust Company
Economic Research
Bernhard Eschweiler (65) 326-9026
eschweiler_bernhard@jpmorgan.com

The regional economic outlook in summary

	1997 Nominal GDP in US$ total billion	% of region	per capita 000s	Real GDP % year-on-year 1996	1997e	1998f	1999f	Consumer prices % year-on-year 1996	1997e	1998f	1999f
Japan	4664		37.1	4.1	0.8	-2.7	0.7	0.1	1.7	0.4	-0.2
Australia	418		22.7	3.7	3.3	3.7	1.3	2.6	0.3	1.1	2.4
New Zealand	64		17.1	3.9	2.6	-1.0	1.5	2.3	1.2	1.3	1.3
Emerging Asia	2811	100.0	1.1	7.6	6.1	-0.2	2.4	6.5	4.2	9.6	5.6
China	902	32.1	0.7	9.7	8.8	7.0	5.5	8.3	2.8	-0.7	3.0
Hong Kong	173	6.2	26.6	4.6	5.3	-5.0	-1.5	6.0	5.7	2.8	-4.6
India	363	12.9	0.7	6.8	5.0	4.0	4.0	9.0	7.2	10.0	9.0
Indonesia	217	7.7	1.1	8.0	4.5	-14.0	-3.5	7.9	6.6	70.0	40.0
Korea	443	15.7	9.6	7.1	5.5	-6.0	2.0	5.0	4.4	8.0	0.5
Malaysia	98	3.5	4.5	8.6	7.8	-5.0	0.5	3.5	2.7	5.4	4.9
Philippines	82	2.9	1.1	5.8	5.2	-0.5	2.5	8.4	5.0	9.5	7.5
Singapore	96	3.4	25.8	6.9	7.8	0.0	-2.0	1.4	2.0	-0.2	-0.5
Taiwan	283	10.1	13.0	5.7	6.8	4.0	2.0	3.1	0.9	1.1	-1.2
Thailand	154	5.5	2.5	7.7	-0.4	-6.0	2.5	5.8	5.6	8.5	4.0

	Current account balance US$ billion 1996	1997e	1998f	1999f	Current account balance % of GDP 1996	1997e	1998f	1999f	Foreign reserves US$ billion 1996	1997e	1998f	1999f
Japan	67.5	94.2	110.3	121.4	1.5	2.2	2.9	3.3				
Australia	-15.6	-12.8	-17.3	-14.3	-4.0	-3.2	-4.9	-4.2				
New Zealand	-2.5	-3.3	-3.1	-2.5	-3.8	-5.2	-6.0	-4.8				
Emerging Asia	-21.9	23.1	97.5	40.7	-0.8	0.8	4.0	1.6	491.3	494.3	505.1	506.9
China	7.2	30.1	25.1	-4.0	0.9	3.3	2.6	-0.4	107.0	142.8	138.4	131.9
Hong Kong	3.0	1.4	3.2	4.5	1.9	0.8	1.9	2.8	63.8	75.1	63.1	59.7
India	-3.7	-5.6	-7.9	-7.8	-1.0	-1.6	-2.2	-2.1	22.7	26.3	23.8	23.8
Indonesia	-7.6	-6.2	7.1	7.9	-3.3	-2.9	9.1	8.7	24.0	20.5	23.0	27.0
Korea	-23.0	-7.9	33.8	20.7	-4.7	-1.8	11.1	6.9	34.0	21.1	48.1	58.1
Malaysia	-4.9	-3.9	4.9	-4.4	-4.9	-4.0	7.5	-6.3	27.0	22.5	18.8	13.3
Philippines	-4.0	-4.3	2.0	1.5	-4.8	-5.2	3.1	2.2	10.0	7.3	10.8	12.8
Singapore	14.7	14.8	15.5	13.8	15.9	15.4	18.5	16.6	76.9	71.4	69.4	70.9
Taiwan	11.0	7.7	1.6	-1.0	4.0	2.7	0.6	-0.4	88.0	81.2	82.1	79.3
Thailand	-14.7	-2.9	12.3	9.6	-7.9	-1.9	10.5	7.1	37.7	26.2	27.7	30.2

	External debt % of GDP, end of period 1996	1997e	1998f	1999f	Short-term foreign debt US$ billion, end of period 1996	1997e	1998f	1999f	Government balance % of GDP, end of period 1996	1997e	1998f	1999f
Japan									-4.4	-4.2	-4.9	-5.1
Australia									-1.0	0.5	2.9	1.4
New Zealand									3.0	2.0	2.6	0.0
China	17.2	17.3	16.9	16.6	34.4	39.9	37.1	36.1	-0.9	-0.7	-3.0	-5.5
Hong Kong									1.3	4.5	-3.5	-4.3
India	27.4	26.9	26.9	27.1	12.1	12.3	13.0	14.5	-5.0	-6.1	-6.6	-6.0
Indonesia	55.4	62.4	181.9	160.9	41.3	36.8	27.3	16.8	1.0	1.2	-9.0	-9.0
Korea	30.2	35.8	50.0	47.8	102.2	68.6	38.7	38.7	-1.1	0.0	-5.0	-7.0
Malaysia	37.5	41.9	61.7	52.1	11.2	12.3	12.4	10.9	3.9	2.7	-5.0	-5.5
Philippines	57.3	62.3	85.5	81.7	12.6	12.6	13.2	14.0	-0.5	-1.8	-3.6	-2.5
Singapore									7.0	6.0	-1.0	-2.0
Taiwan	15.1	15.2	18.0	19.4	28.7	29.2	29.5	30.0	-8.7	-6.9	-8.8	-7.5
Thailand	51.2	63.5	79.0	64.2	38.7	30.0	23.0	18.0	2.4	-1.0	-4.5	-4.5