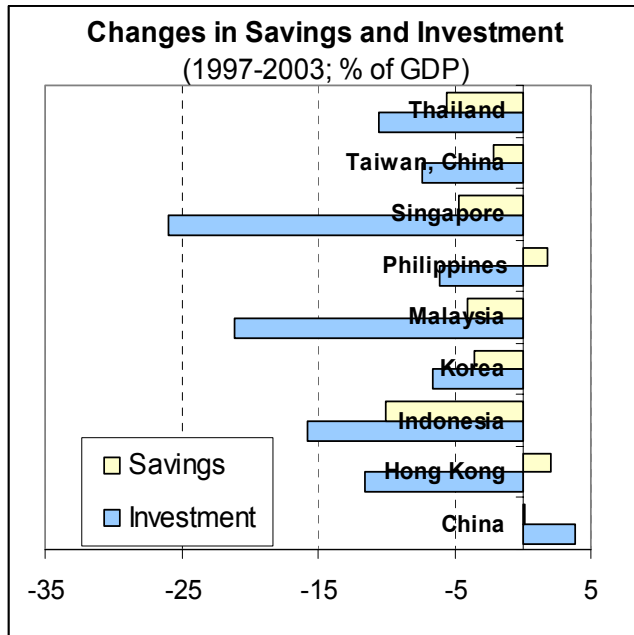


was an 11 percent fall in investment to GDP ratios. Savings ratios also declined, but by much less, on average falling by about 3 percent points of GDP. There was therefore a net swing towards surplus on the external current account balance of about 8 percentage points of GDP, primarily due to lower investment.

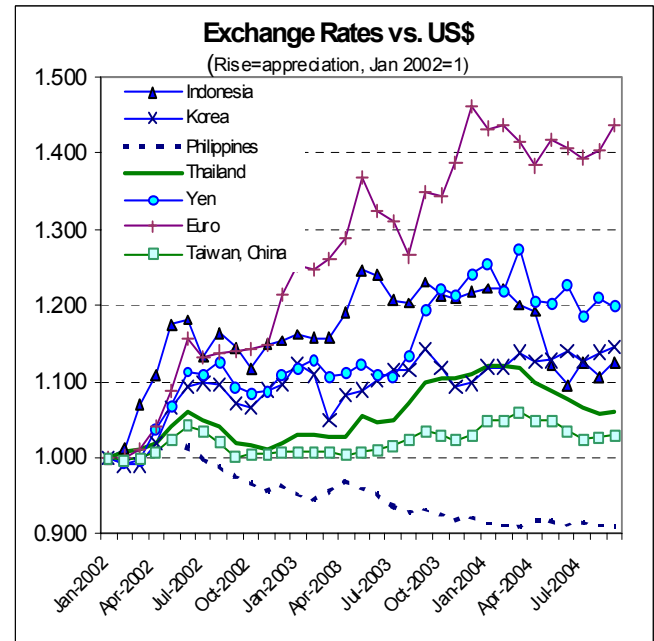
Exhibit 26



The recent upswing in East Asian investment therefore makes a contribution towards the global adjustment process. As Table 6 above shows, the East Asian current account surplus has started to fall in 2004 (although the change is disguised to some extent by the recent sluggishness in the Korean economy, which has led to a sharp increase in Korea's current account surplus). China, which has already made a contribution to adjustment as a result of its strong recent investment and import boom, may make less of a contribution for some time, as it attempts to reduce the over-heated pace of investment in the country. The issue will then become fostering more robust and sustained investment spending in the other Asian economies. Continued adjustment in exchange rates is also likely to play a role in the overall macroeconomic adjustment of the region (though not perhaps in every individual case). While in a number of cases such as China, Hong Kong and Malaysia, nominal exchange rates have remained constant against the dollar as a result of formal pegs or tight bands, in most other cases exchange rates have generally appreciated against the dollar over the last 2-3 years, rising by 5-10 percent in Thailand and Taiwan, China, and 10-20 percent in

Indonesia, Korea and Japan. A third significant contribution to adjustment can come from further trade liberalization in the region, especially in the area of services, where liberalization in East Asia has tended to lag other regions.

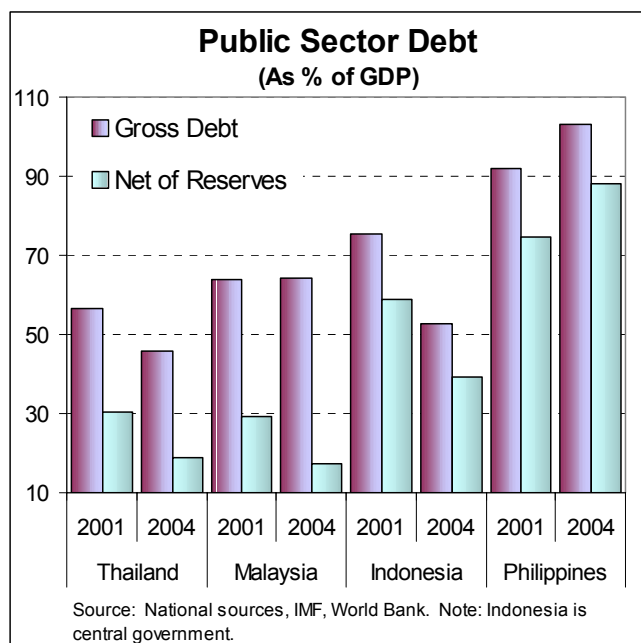
Exhibit 27



Domestic trends and policy challenges

The preceding discussion suggests that most East Asian economies have enjoyed an excellent economic recovery over the past two years, supported both by the strength of cyclical factors in the external environment, as well as improving macroeconomic, financial and corporate sector developments at home. This section looks at some of the domestic trends more closely. In addition, since the preceding discussion also suggests that East Asian economies are slowing from their recent cyclical peaks and external conditions are becoming more uncertain, it also considers the policy efforts and reforms that may be helpful to policy makers in the region as they seek to negotiate the uncertainties and cautiously steer economies from the sharp cyclical upswing of the last 2 years onto the path of sustained medium term expansion. One useful focus may be to remedy domestic policy weaknesses that are themselves sources of uncertainty, while strengthening policies and institutions that help alleviate risk and uncertainty.

Exhibit 28



Fiscal Policy

The years after the 1997-98 regional financial crisis saw substantial increases in the levels of gross public sector debt among the five crisis affected countries, -Indonesia, Korea, Malaysia, Philippines and Thailand. Public debt rose as a result of governments shouldering the cost of recapitalizing and restructuring insolvent financial institutions, the calling of other contingent claims on government, wider public sector deficits and real depreciation of currencies (although, of course, the specific contributions of these individual causes varied widely across countries). The average of gross public sector debt in these economies rose from about 30 percent of GDP in 1996 – which was rather less than the average level of public debt among all emerging market economies at that time - to about 60 percent in 2001, about the same as the emerging market average.

As Exhibit 28 indicates, gross public debt levels in Malaysia have been stable in recent years at a little over 60 percent of GDP, while falling recently to around 45 percent in Thailand and a little over 50 percent in Indonesia.¹⁴ In recent years most East Asian economies have also run current account surpluses and accumulated large official foreign exchange reserves. Viewed net of official reserves, public debt levels are estimated at a little

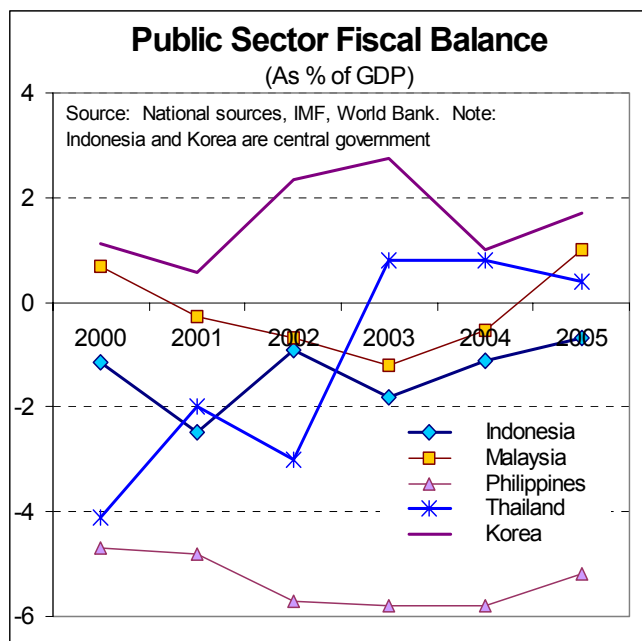
less than 20 percent of GDP in Malaysia and Thailand, and around 40 percent in Indonesia.

In Indonesia the lower trend in public debt to GDP ratios over recent years has been supported by generally cautious fiscal policies; the central government overall deficit has generally been held at less than 2 percent of GDP (Exhibit 29 below), with the primary balance running a surplus. The overall deficit for 2004 is estimated at 1.3 percent of GDP, although both revenues and expenditures have been boosted by higher oil prices. Obviously, oil and gas revenues are up, but higher market prices for fuel have also pushed the cost of fuel subsidies sharply higher, from 1.7 percent of GDP in 2003 to an estimated 3 percent of GDP in 2004, a hefty chunk of total government expenditures which are 21-22 percent of GDP. Restructuring the fuel subsidy mechanism is one of the most important policy challenges facing the new government. Fuel subsidies encourage inefficiently high-energy consumption in several East Asian economies including Indonesia, while having a regressive effect on income distribution. A reduction in the subsidy combined with targeted compensation for the poor would free up significant resources for pro-poor development spending and for fiscal consolidation, while encouraging greater energy conservation and efficiency.

In Malaysia fiscal policy was mildly expansionary in 2000-03 as the government sought to counter adverse shocks and uncertainties in the external environment. In 2003 an Economic Stimulus Package sought to counteract adverse shocks emanating from the SARS epidemic and the Iraq War. Central government deficits ran at 5-6 percent of GDP in 2000-03, although public sector deficits were much lower, about 1 percent of GDP or less. (Exhibit 29). With the private economy recovering strongly, the government has aimed to achieve substantial fiscal consolidation. The central deficit is likely to fall to 4.5 percent in 2004, although this would be over 1 percent larger than the original budget for 2004, due to rising fuel subsidies. The deficit is budgeted to be further reduced to 3 ¾ percent in 2005, through higher sin taxes and curbs on current and capital spending, although not in fuel subsidies. In Thailand the central government and public sector balances moved into surplus in 2002/03 (October-September) with higher revenues responding to faster growth and more efficient tax administration. Responding to higher than expected surpluses, the government introduced a supplementary spending program in 2003/04, together with a temporary subsidy on diesel and gasoline. Public investment spending will grow for the first time since the financial crisis, and is expected to rise significantly in 2005 and beyond, when the government is considering a five year program of large scale public infrastructure projects.

¹⁴ Public debt to GDP in Indonesia was previously reported at around 70 percent. However, a recent revision of the national income accounts has raised estimates of GDP, reducing estimates of debt to GDP ratios.

Exhibit 29

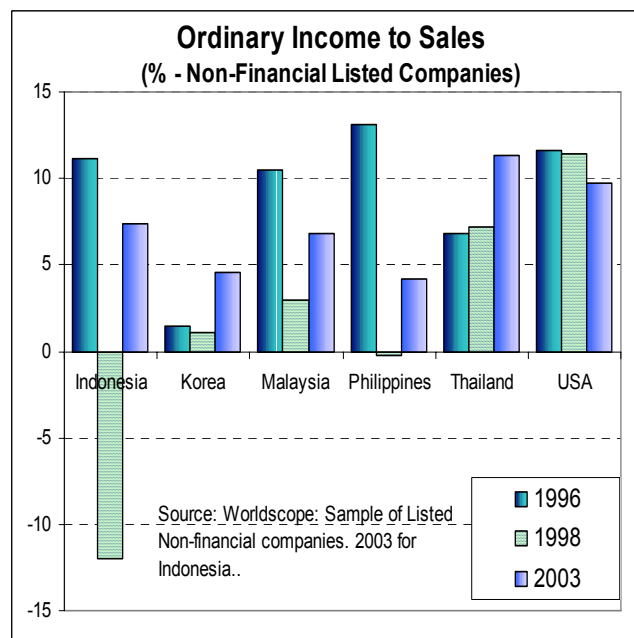


Public debt issues are much more significant in the Philippines. Gross public debt in the Philippines was already over 70 percent of GDP in the mid 1990s, and, even though the country was less affected by the regional financial crisis than others, public debt has continued to increase through an accumulation of off-budget liabilities, significant central government deficits, deficits in public enterprises and currency depreciation, reaching over 90 percent of GDP by 2001 and an estimated level over 100 percent by 2004. Even viewed net of official reserves public debt remained high. The public sector deficit remained large, at an estimated 5.7 percent of GDP for 2004. In light of the weakness of the fiscal position, President Macapagal-Arroyo announced in August that the country is in a fiscal crisis. A package of fiscal measures has been submitted to Congress, including increases in excise, sin and value added taxes, a tax on telecommunications, changes in income taxation, rationalization of tax incentives and measures to strengthen tax collection. The government estimates the measures would augment revenues by 1.7 percent of GDP, although congressional approval and timing of the measures remain uncertain. An increase in electric power tariffs was also approved by the industry's regulatory body, which should help reduce the public sector deficit by around 0.8 percent of GDP, but will need to be complemented by other efforts to reduce the losses of the national Power Company and reform the power sector. Taken together, these measures could go some way to reducing the growth of public debt, but the Philippines would still remain an outlier in East Asia with respect to the size of its public sector deficit and debt.

Corporate sector – recent trends and reforms¹⁵

The profitability and balance sheet position of East Asian firms have continued to strengthen, providing a more secure foundation for the recent upswing in investment spending observed around the region. Ordinary income to sales ratios for listed non-financial firms have risen substantially from their low points in 1998, during the financial crisis, and in cases such as Korea and Thailand, even from levels before the financial crisis. (Exhibit 30). Underlying the rise in ordinary income, stronger economic activity has led to some strengthening of profit margins at the operating income level. At the same time there has been continued progress in debt restructuring, which, combined with the low interest rates that have prevailed over the past year and a half, has also resulted in sharply lower interest expenses.

Exhibit 30



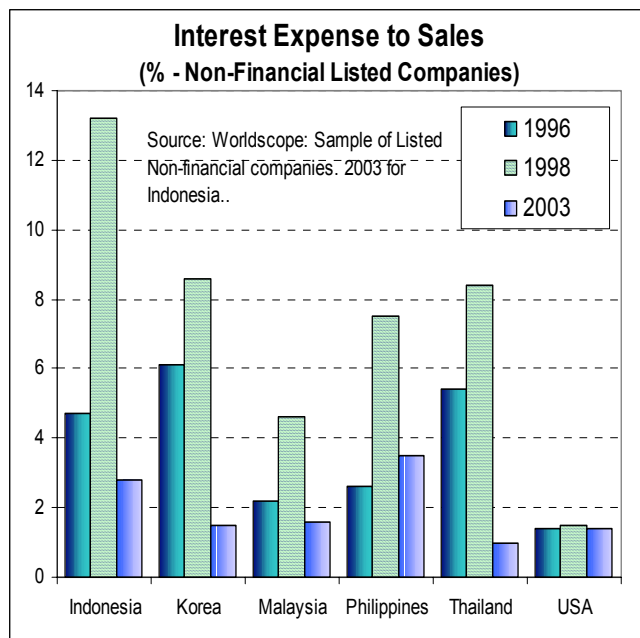
Progress on debt restructuring, and equity infusions has also led to lower leverage ratios, which are now broadly in line with international norms. At the end of 2003, average debt-to-equity ratios stood at around 1.5 in Indonesia, and 1.2 in Korea and Thailand.¹⁶ However, while the majority of firms have resolved debt overhangs and strengthened their financial position, there is still a segment of very weak firms across countries in the region. Thus while the median interest coverage ratio of firms has

¹⁵ Discussion of corporate and financial sector trends is based on "East Asian Financial and Corporate Sector Developments." World Bank (2004, forthcoming).

¹⁶ Based on a sample of listed companies in Indonesia, and Thailand. In Korea the ratio refers to the average of manufacturing firms.

improved markedly (Exhibit 31), in most countries, about 10-15 percent of total corporate debt is held by firms with interest coverage ratios of less than 1. (The exception is Korea, where the weaker firms are now the SMEs, which generally have lower absolute levels of debt.)

Exhibit 31



Continued efforts to resolve the situation of weak firms and deal with the remaining stock of distressed assets can make a significant contribution to sustaining the present economic recovery and the rebound in investment. From the perspective of firms, uncertainties about the conditions for resolution of their distressed debt cast a pall over prospects for new investment and financing. From the perspective of banks, a relatively high continued level of Non Performing Loans (NPLs) is costly and reduces bank profits. It can also contribute to risk aversion, reducing banks' willingness to lend even if they are adequately provisioned, restricting the scope for real sector growth¹⁷. Since the special debt workout frameworks that were established in the aftermath of the crisis have mostly been wound down, progress on corporate restructuring will increasingly depend on the effective functioning of the legal and judicial system¹⁸. Indeed, most countries in the region are taking measures to strengthen the legal

¹⁷ Some analysis done on banks in Thailand for example, suggests a negative relationship between banks' NPLs and credit growth, even after controlling for banks' capital positions.

¹⁸ In Thailand, the CDRAC voluntary debt workout framework closed in mid-2003, in Malaysia, the CDRC was wound down in 2003, and in Indonesia, the JITF closed in December 2003.

framework for bankruptcy, though further progress is needed, particularly with regard to implementation.

In *Korea*, for instance, the unified insolvency bill, submitted to the National Assembly in late 2002 is still awaiting approval. In *Thailand*, an amendment to the Bankruptcy Act aiming to improve the individual bankruptcy framework was endorsed by the Cabinet, but a specific time for submission to Parliament has not been designated. Moreover the amendment does not cover the corporate bankruptcy framework, which retains significant weaknesses and loopholes. Actions to lessen the case backlog in the Civil Courts (such as providing more budgetary resources and special hours for trials) are still awaiting approval from the National Judicial Committee.

In *Indonesia*, observers agree that the new Bankruptcy Law adopted after the financial crisis is a sound one. Amendments to help correct problems in implementation (seeking, among other things, to better control spurious bankruptcy petitions) have been approved in parliament. The Commercial Court was another important innovation, set up as a special chamber of the existing district courts to help deal with the complex issues raised in the implementation of the bankruptcy law. Delays in issuing and implementing regulations designed to insulate the commercial court from the major problems affecting the judiciary have meant that it too has acquired some of the same problems as the wider judiciary, including weaknesses in administration, and transparency and accountability, and inadequate funding. However, an updated version of the Commercial Court Blueprint and action plan for reform were published in early 2004, covering administration, transparency, funding and enforcement of court decisions, and a number of these reforms have recently been initiated.

In *China* a new draft Bankruptcy Law covering private enterprises had its first reading in the National People's Congress in June. Creditors or debtors would be empowered to petition for bankruptcy without having to seek government approval. In contrast to existing arrangements, the new draft law gives priority to secured creditors over workers. While the draft law's requirement that any reorganization plan achieve majority approval by each group of claimants (i.e. secured creditors, workers and unsecured creditors) could leave reorganization plans hostage to worker demands, the draft includes a provision for the court to approve ("cram down") a disputed plan as long as specified absolute priorities are met. While representing a major step forward, the draft law warrants further review. One clear implication is that the new Bankruptcy Law will require large increases in the number and quality of insolvency judges, administrators and other insolvency professionals.

Financial Sector

Banks have also benefited from the acceleration of economic activity over the past one and a half years. The profitability of commercial banks—as measured by the rates of return to assets and equity—has improved sizably in Indonesia and Thailand, and marginally in the Philippines and Korea, and remains comfortable in Malaysia. (Exhibit 32) Average risk-weighted Capital Adequacy Ratios (CAR) have also been above the 8 percent BIS norm in all five countries for several years now, while NPL ratios have continued to decline, reflecting, to varying degrees, continued restructuring efforts, improved capacity of borrowers to repay, and new loan growth (Exhibit 33 and Appendix Tables 9).

Two caveats should be noted however. First, despite progress, NPL ratios remain in double digits in Thailand and the Philippines. The BOT has taken several measures to expedite NPL resolution by Thai banks, including tightening provisioning requirements on long-standing NPLs and amending laws to allow the government assessment management company (AMC) to acquire NPLs from private banks and AMCs. However, the amendments have not yet been reviewed by Parliament. In the Philippines the SPV Law provides tax breaks and other incentives to encourage financial institutions to clear their books of bad assets, but progress in disposing of these assets has been minimal. So far, only a handful of SPVs have been registered. There remains a large gap between the valuations placed on these assets by banks and investors, making banks reluctant to sell the assets. Strengthening the effectiveness of the SPV Act with supporting legislation such as the Corporate Recovery Bill and the Securitization Bill is also essential to provide the necessary environment for distressed asset resolution.

Second, these aggregate numbers mask considerable differences across groups of banks, and some segments remain vulnerable. In Indonesia for instance, the financial position of state banks remains considerably weaker. In Thailand, private banks continue to be riddled with high NPLs.

Rising household debt

One trend and potential vulnerability across countries in the region has been rising household debt and with it, increases in the share of NPLs from household lending.

Household debt has grown the fastest in Korea, especially between 2000 and 2002. Since 2002, the number of people in default on their debt has risen sharply to reach 3.7 million. Delinquencies on credit cards are the main factor, following a more than 5 fold expansion in credit card debts during 2000-2002. While delinquencies on bank loans remain below 2 percent, delinquencies on credit card debt amounted to 14 percent. Efforts by indebted households to repair their balance sheets have

led them to reduce consumption, which has fallen in every one of the five quarters from the second quarter of 2003 through the second quarter of 2004, sharply slowing GDP growth.

Exhibit 32

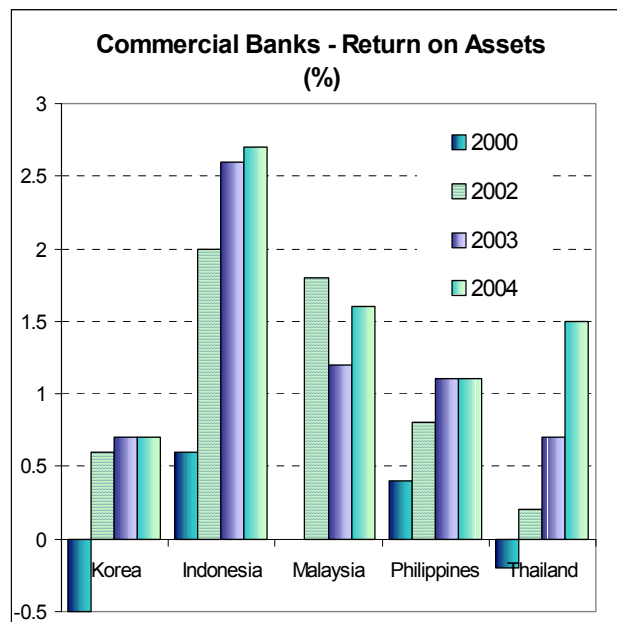
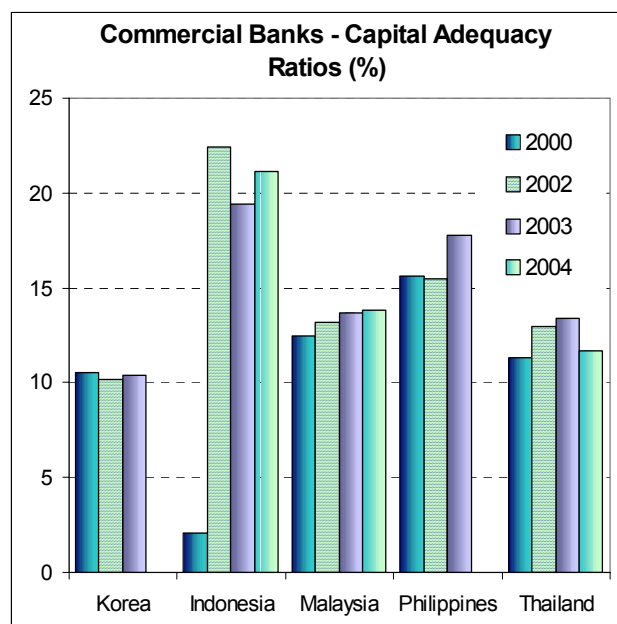


Exhibit 33



Government policies aimed at stimulating domestic demand by providing tax deductions and lotteries were a factor contributing to the growth in credit card use. And weakness in supervision allowed credit card companies to issue cards without requiring basic information needed to assess credit risk, such as the borrower's income. Household credit extended by commercial banks amounted to 35.8 percent of GDP at

the end of 2003, under 60 percent of the total credit extended to households. The financial institutions and the government have established a number of channels for resolving household debts, including establishing Hanmaeum Finance (the bad bank) to restructure individual debts, the Credit Counseling and Recovery service (CCRS) to run an individual workout program for personal delinquents, private workouts, a personal debtor recovery system, where the court system will implement a new rehabilitation procedure, and personal bankruptcies. Nine percent of the total number of delinquent borrowers have been resolved so far.

Household debt has also grown in Malaysia and Thailand, without, so far running into serious difficulties. Starting from a relatively low base, Malaysian bank loans to households in the form of mortgages and consumer loans almost doubled between 1998 and 2003, while credit card use rose sharply. With the recent emergence of alternative corporate financing instruments, and the corresponding reduction in the corporate sector's reliance on bank financing, banking institutions have increasingly focused their lending on the household sector, especially through the expansion of their credit card business. Whereas the total stock of banking system NPLs has declined in recent years, to RM 58.3 billion at end-2003, reflecting the successful asset recovery efforts of Danaharta and corporate restructuring, NPLs to households have risen throughout the period, to RM 19.3 billion. In particular, while NPLs on consumer loans have declined from their peak of RM 11.2 billion in 2001 to RM 8.4 billion in 2003, mortgage-related NPLs have risen by 46 percent since 2001, to RM 10.1 billion. Credit card-related NPLs have also risen sharply, but their share in total household NPLs still remains small (3 percent).

In Thailand the share of household loans to total credit rose to 34 percent in 2003 or by 10 percent over the past three years, due both to strong growth in household lending and low credit growth to corporates. This shift towards household lending has taken place across all institutions' growth, although it has been particularly strong for finance companies. Housing loans continue to be the major component of household credit and mortgages have the highest NPL ratio—with inflows into the pool of NPLs in the personal consumption sector amounting to B 34 billion in 2003, despite strong economic growth. Credit card NPLs however, have remained around 3 percent of credit card loans—much lower than Korea (14 percent). The Bank of Thailand has implemented a series of measures to curb excessive borrowing by individuals. Banks are now required to disclose on a consolidated basis all penalty fees charged on missed payments on personal loans. Credit card regulation was tightened again in April 2004 to require that the credit be limited to five times the card holder's income, increasing the minimum monthly debt servicing on a credit card balance from 5 percent to 10 percent, and

requiring that credit cards which are in arrears for more than three months be revoked.

Strengthening financial supervision and regulation

Countries are also making progress in strengthening the financial system in terms of regulation and supervision. In Indonesia, the central bank and the ministry of finance have signed a memorandum of understanding on how to handle banks in financial difficulties, covering decision-making and coordination between the two bodies, the provision of a financing facility; and the source of financing through the issue of government securities. The Parliament passed a milestone law on deposit insurance in August 2003. The new deposit insurance program replaced the existing blanket guarantee on all banks' liabilities, and provided for creating the Indonesian deposit guarantee corporation (LPS), to insure deposits up to Rp 100 million. The MOU and the establishment of the LPS mean that the main elements of a financial safety net are now in place. Finally Bank Indonesia (BI) also announced a new regulation to improve the assessment of commercial bank health. BI will require each bank to conduct a self-assessment every quarter and submit it to BI for review. Should the bank score unsatisfactorily, BI will require bank management to provide action plans for corrective action.

In the Philippines, legislative amendments to the charter of PDIC – the deposit insurance agency - were recently approved, which among other things, restored the power of the PDIC to examine the books of member banks and also improved the legal protection for PDIC staff to some degree. It is also important that the BSP charter amendments recently filed with Congress should be enacted and put into effect promptly. The amendments enhance the central bank BSP's capacity to deal with problem banks and facilitate a fast transition to consolidated risk based supervision and international supervision standards. The amendments are also expected to provide better protection against lawsuits for bank regulators. A MOU was also signed by the BSP, PDIC, SEC and Insurance Commission (IC), creating a Financial Sector Forum (FSF), which is expected to provide an institutionalized regulatory framework for core supervision and regulation of the financial system. Another positive development is the progress made towards establishing a centralized credit bureau, which the BSP is currently studying in consultation with stakeholders. The new bureau would maintain information on both positive and negative aspects of individual and corporate borrowers' credit history, unlike the existing data sharing facilities which records only negative information.

In Thailand, the BOT has adopted a number of measures in line with the New Basel Capital Accord, the full implementation of which is planned for late 2008. The supervision and examination process has shifted from

transaction testing to reviewing a bank's risk management system and process. A policy statement on good governance was issued in 2002, which requires greater disclosure from banks, particularly with regard to their risk profile.