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GLOBAL ECONOMIC SLOWDOWN MACROECONOMIC IMPACT AND POLICY OPTIONS FOR SEACEN COUNTRIES

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by

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and
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PREFACE

The global economic slowdown and terrorist attack in the US in 2001 illustrate how vulnerable small open economies are in steering their economies amidst the sea of uncertainty. While the global economy has proven to be remarkably resilient to these adverse developments, the perception of a looming crisis at that time serves as a wake up call for the SEACEN economies to carefully examine their economic structures and reassess their economic strategies. Having just recovered from the financial crisis in 1997, the adverse external developments further strengthened the resolve of SEACEN economies to pursue structural reforms.

This Occasional Paper is prepared to assist SEACEN member countries in this pursuit. It aims to assess the impact of a synchronised slowdown in major industrial countries on the SEACEN economies and to review the policy options that member economies could consider. While the discussions are mainly focused on the events immediately after 2001, the lessons drawn are by no means specific to the period alone. If the global economy follows a cyclical pattern, the consequences and mitigating measures should be generally similar in nature.

The paper was undertaken as supplementary research study and jointly prepared by Mr. Ravindra Prasad Panday, Director, Economic Research Department, Nepal Rastra Bank, and Dr. P. Nandalal Weerasinghe, Economist, Economic Research Department, Central Bank of Sri Lanka. The authors gratefully acknowledge the kind assistance from all SEACEN member central banks in providing the necessary data, information, and assessments of the economic impact of the September 11 attack. They are also thankful for the comments, suggestions, and research assistance provided by the staff of the Research Division of the SEACEN Centre during their tenure as Visiting Research Economists at the SEACEN Centre.

The views expressed in the paper are those of the authors and do not necessarily reflect those of the SEACEN Centre, Nepal Rastra Bank, Central Bank of Sri Lanka, or the other SEACEN member banks.

Dr. Subarjo Joyosumarto
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December 2003

ABSTRACT

The synchronised economic downturn in the U.S., Euro area and Japan in 2001, mainly caused by a correction in the global IT sector and the events of September 2001, sharply reduced the export demand in most SEACEN countries causing deterioration in external trade activities. The resulting economic contraction in most SEACEN countries demonstrated the vulnerability of these countries to external trade shocks. However, in comparison with the 1997 financial crisis, the impact has been less severe. More open economies with relatively large manufacturing sectors recorded economic contraction while others decelerated sharply.

Availability of policy options to minimise the impact of global slowdown largely depends on the soundness of macroeconomic fundamentals in member countries. For example, countries with strong macroeconomic fundamentals were able to use stimulus monetary and fiscal policies successfully to minimise the impact of global slowdown. Even member countries with some fiscal constraints were able to use monetary policy effectively to mitigate the impact. However, countries with macroeconomic imbalances had fewer options. Policy priority for these countries should be given to address structural rigidities by expediting the implementation of necessary structural reforms that help address existing macroeconomic imbalances. This would also help improve the effectiveness of policy responses. In an environment of increasing global integration, countries with macroeconomic imbalances would continue to be vulnerable to fluctuations of the global economy.

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1. Introduction

The transformation of the world into a global village has followed the liberalisation of economic policies by many countries. This process of globalisation is further hastened by unrelenting financial innovations and the rapid development of technology in the area of information and communication. As a consequence, economies are becoming increasingly integrated and dependent on each other while at the same time, also becoming increasingly vulnerable to external shocks. A disturbance in one country or region could very easily and quickly, spread to other countries and regions as borne out by the Asian financial crisis of 1997/98.

The SEACEN countries' increasing integration to the global economy, has made their economies more sensitive to the business cycles of the industrial economies. Member countries face new challenges particularly during times of synchronised downturns in major industrial countries. In this context, a major challenge faced by SEACEN countries is how to shield the negative impact of global economic downturn while maintaining the level of integration so that benefits of upswings continue to move countries into a higher growth path. The performance of some member countries during the last decade reflects positive impact of the robust growth in the US economy. Similarly, the recent slowdown experienced by industrial countries has spurred a similar cycle for SEACEN members, albeit at a varying degree. Therefore, it would be useful to analyse the factors which caused varying impacts across countries so that policy implications could be derived to negate adverse impacts of external downturns.

The impact of the global slowdown on SEACEN countries would depend mainly on the degree of economic integration, particularly trade linkages with industrial countries. The fact that the growth in the volume of world trade in goods and services declined to negative 0.2 per cent in 2001 from 12.4 per cent in 2000 reflects the impact of the global slowdown on highly trade dependant countries. Therefore,

the intensity of policy response would also depend on the degree of economic integration to the world economy. For example, highly trade dependent countries such as Singapore and Malaysia have been more adversely affected than less trade dependant countries such as Myanmar and Nepal (Table 1). In particular, countries with strong trade linkages with the US, the Euro area and Japan have been severely affected. To mitigate the impact of the external slow-down, highly trade dependant countries need more speedy and intense policy responses. Standard policy responses to this kind of external shocks, such as stimulus macroeconomic policies to boost aggregate demand, have been well documented in the literature. However, the availability and effectiveness of standard policy options depend on the existing domestic macroeconomic environment and the degree of structural rigidities in individual economies. Therefore, standard policy options may not be applicable uniformly across all countries. Individual country positions during the slowdown need to be assessed prior to prescribing specific policy responses. This requires a detailed analysis of individual country positions at the time of the slowdown.

Table 1: Trade Openness (exports plus imports as a per cent of GDP)

	1997	1998	1999	2000
Indonesia	47.5	86.2	57.9	69.0
Korea	58.9	70.2	64.5	72.6
Malaysia	151.3	174.5	189.5	200.1
Mongolia	96.9	101.5	112.9	113.0
Myanmar	1.7	1.4	1.0	1.0
Nepal	43.5	37.7	42.0	44.5
Philippines	74.8	90.6	83.3	90.6
Singapore	265.0	250.9	266.1	287.3
Sri Lanka	67.8	67.4	77.4	70.1
Taiwan	79.1	78.6	81.8	90.8
Thailand	74.1	83.4	85.3	106.9

Source: Computed from IFS data and EIU data for Taiwan

On the basis of the above discussion, the structure of this paper is as follows. The second section of the paper will assess briefly the economic slowdown in the major industrial countries. The third section will discuss the impact of the slowdown on SEACEN countries. The fourth section will focus on the standard policy options available and the pre-conditions for successful applications. Attempt will be made to prescribe specific policy options for member countries to reduce vulnerability to this kind of external shock. This section will also assess policy responses already implemented by most countries in response to the slowdown. The assessment and analysis are focused on the period 2000-2002, based on available information as at June 2002.

2. Economic Slowdown in the Major Industrial Countries

The global slowdown in 2001 is seen as a consequence of a synchronised downturn in external demand, mainly caused by a correction in the global IT sector and the events 11 September 2001. In addition, the three major economies of the world, viz., the US, Euro area and Japan had become increasingly confronted with mostly negative developments in the economic front in the form of deteriorating corporate profits, falling stock prices, rising unemployment, and faltering investor confidence. The earlier optimistic view that US economic activity would rebound by the third quarter of 2001 had faded by mid-year as did subsequent hopes for a modest US rebound in late 2001. Moreover, in the second quarter of 2001, economic conditions in Japan deteriorated significantly and the pace of economic activity in the Euro area had also slowed substantially. This situation was unique in the context of a global economic slowdown as these three major world economies, which together account for roughly 45.0 percent of the world's output and absorb nearly 50.0 percent of total exports from the Asia and the Pacific region, were simultaneously experiencing recession.

The US economy, which has been the main engine of growth in the world economy, has already slowed to less than 2 percent at the end of 2000 (Table 2). It went further downward to 0.3 percent in the second quarter of 2001, as investment and exports continued to contract while domestic consumption slowed to 2.5 percent growth in the second quarter of 2001, its smallest expansion in four years. The cyclical downswing was further affected by the September 11 shock which badly affected the airline and tourism industries, culminating in a negative growth of 1.3 percent in the third quarter of 2001. Even though the real GDP growth rate recovered in the fourth quarter, subsequent financial and accounting scandals and lower corporate profits are expected to weigh heavily on the prospects of US growth in 2002.

Similarly, the Euro area economy has been experiencing a downtrend since 2000, although it was less affected by the information, communications and technology (ICT) correction as in the US. This was due to the slowing growth of exports to both the US and Asia and to the weakening domestic demand as high oil prices, slowing job growth, and declining equity values (especially in the telecommunication sector) impacted profits and real incomes. Private consumption growth slowed from 2.0 percent in the first quarter of 2001 to 1.7 percent in the second and remained stagnant at 1.7 percent in the third quarter while the unemployment rate remained high at 8.3 percent throughout the review period without strong prospects of improvement.

In Japan, economic activities which had been in the doldrums, weakened further to record negative growth since the second quarter of 2001. sharply in the first quarter of 2001. The unexpected severity of the global information, communications and technology (ICT) sector slowdown adversely affected the economy with a double-digit contraction in exports and private investment demand throughout the year, after a strong performance in the last quarter of 2000. Consumption which sustained quarter-on-quarter growth of 2.0 percent in the second quarter, slowed down to less than 1.0 percent in the third

quarter with signs of further weakening. Industrial production was on a downward trend throughout 2001, contracting by 11.7 percent in August 2001 from a year earlier. The unemployment rate reached a post-war high of 5.1 percent as at the end of the third quarter of 2001.

The continued easing of inflation has been one of the bright spots in the economic developments of the major three economies. Inflationary pressure which was built throughout much of the first half of 2001, eased somewhat in the Euro area in the third quarter with the annual inflation measured by Consumer Price Index eased from 3.0 percent in June to 2.5 percent in the first quarter of 2002. In the US, consumer price inflation rate was subdued further to 0.3 percent in March 2002 from a year earlier. Similarly, in Japan, prices continued to drop, registering a negative 1 percent at the end of 2001 from a year earlier.

Table 2 Macro economic Indicators of the Three Major Economies

	2000	2001				2002
	Q4	Q1	Q2	Q3	Q4	Q1
	(Percent)					
Euro Area						
Real GDP growth rate	2.8	2.4	1.6	1.4	0.6	n.a.
Unemployment rate	8.5	8.4	8.3	8.3	8.4	8.4(as at Feb)
Consumer price inflation rate	2.6	2.6	3	2.5*	2.2*	2.5*
Japan						
Real GDP growth rate	2.4	1	-1.2	-0.5	-1.2	n.a.
Unemployment rate	4.8	4.9	5.1	5.1	5.1	n.a.
Consumer price inflation rate	-0.6	-0.5	-0.7	-0.8	-1	n.a.
United States						
Real GDP growth rate	1.9	1.3	0.3	-1.3	1.7	n.a.
Unemployment rate	4	4.2	4.5	4.8	5.6	5.6
Consumer price inflation rate	3.4	2.9	3.2	2.6**	1.6***	0.3

*Refers to harmonised Index of Consumer Prices (HICP)

** Unadjusted CPI for the 12-month period ending in September 2001.

***Unadjusted CPI for the 12-month period ending in December 2001.

Sources: ADO 2001 Update,
European Central Bank, September 2001, Monthly bulletin (online), available: www.ecb.int/pub/pdf/mb200204en.pdf; Government of Japan (online), available: www.stat.go.jp/english/19.htm; US Government, (online), available: www.fedstats.gov

The initial magnitude of the reduction in US demand following the attack and its spill over effects to Europe and Japan were somewhat underestimated. Moreover, the extent to which world trade would be reduced was not anticipated. The subsequent US-led military operations in Afghanistan, and the anthrax scares had also introduced an extra element of risk and uncertainty. This further slowed the already weakening global economy.

After the attack, the US and other major economies pursued some monetary easing with the expectation to bring about a modest rebound. This was somewhat evident by the retail sales index in the US, which although fell sharply in the wake of the attack, have again picked up quite strongly. In addition to this, the US stock market, which had sharply declined as a consequence of the attack, has now recovered to a desirable extent. The short-term interest rate in the US is now in line with the inflation rate measured by consumer price index and is mainly attributable mainly to the aggressive interest rate reduction by the FED in US.

Another positive development in the three major economies comes from supportive policy measures, especially in the US. After the September attack, the US and other major economies pursued some monetary easing with the expectation to bring about a modest rebound. This was somewhat evident by the retail sales index in the US, which although fell sharply in the wake of the attack, have picked up quite strongly in the subsequent quarters. In addition to this, the US stock market which had declined sharply as a consequence of the attack, has recovered to some extent. These developments were mainly a consequence several rounds of interest rate cuts by the Federal Reserve Board. The easing of monetary policy was supported by an expansionary fiscal policy in the form of tax cuts.

As for Japan, further monetary policy easing is deemed difficult as the Bank rates are already nearing zero. Fiscal policy is also constrained by high government debt as a result of previous stimulus packages. Consequently, policy thrust in Japan has been focused on structural reforms. Nonetheless, the authorities had taken measures to affect the possible impact of the 11 September attack by cutting the Bank of Japan's overnight discount rate by 15 basis points, increasing the bank reserves targets, and intervention in the foreign exchange market in order to stabilise the exchange rate.

3. Impact of Global Slowdown on SEACEN Countries

3.1 Overview

In a globalising world, the external environment plays a key role. The slowdown in the global economy in 2001, which sharply reduced export demand of the SEACEN countries and caused deterioration in external trade activities, deepened sharply following the 11 September attack. As a consequence, the economic contraction in the region was widespread even to the extent in recording negative growth rates with higher inflation in some of the member countries. Such adverse developments in the region in 2001 clearly demonstrated the vulnerability of the SEACEN countries to external shocks. However, when compared to the 1997 financial crisis, the impact has been less adverse. In particular, exchange rates have remained stable, inflation was subdued and reserve positions were comfortable in most member countries during the slowdown. However, exports and the tourism sector were affected severely due to a shock in the world travel industry caused by the September 11 attack on the World Trade Centre.

In addition, capital inflows in terms of portfolio investment, foreign direct investment (FDI) and loan capital also slowed down in some countries. The slowdown in FDI flows is partly due the slump in

Information Technology (IT) industry which attracted a bulk of FDI into member countries during the last decade. The recent trend in the shift of FDI into low cost destinations most notably China also contributed to the slowdown in FDI inflows to SEACEN member countries. The slow down in loan capital and portfolio investment

Chart 1: Rate of Growth of Real GDP

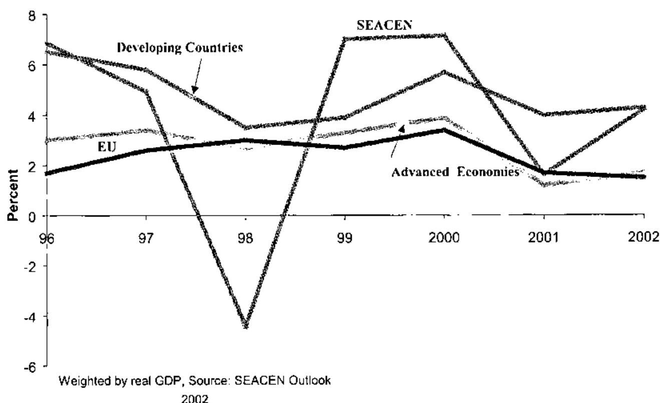
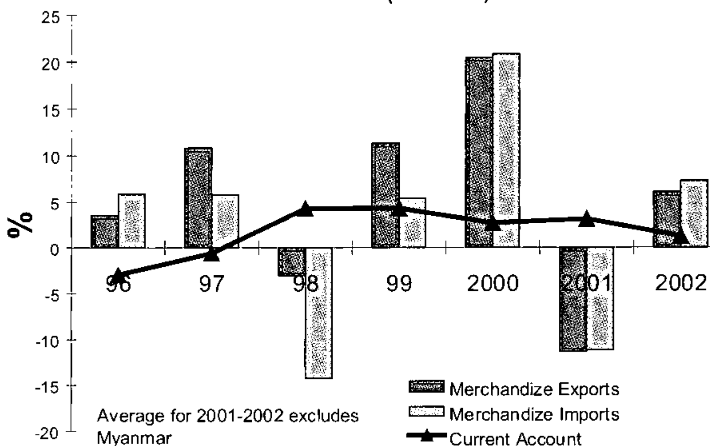


Chart 2: SEACEN Trade Developments
Average Growth Rate of Merchandise Exports and Imports
Current Account (% of GDP)



was a result of higher risk premiums associated with the uncertainty on the global economic outlook, particularly after the September attack. Capital outflows were however, not severe as during the financial crisis. Most member countries had already implemented reforms in the financial and corporate sectors in response to the Asian crisis. These reforms had placed SEACEN member countries in a better position to handle volatile capital and financial flows.

3.2 Sectoral Analyses

For an overall economic growth, the SEACEN economies as a whole postulated a growth of 1.6 percent in 2001 compared to the 7.2 percent growth registered in 2000 (See Chart 1). Among the SEACEN countries, Singapore, which has the most open economy, witnessed its GDP shrink by 2.0 percent in 2001 as against a growth of 10.3 percent in 2000. Similarly, Taiwan's economic growth shrank by 1.9 percent. GDP growth in Malaysia, Korea and Thailand also slowed down to 0.4 percent, 3.0 percent and 1.8 percent respectively in 2001 while those of Indonesia, Mongolia and Nepal also decelerated to 3.3 percent, 1.1 percent and 4.9 percent respectively. Sri Lanka, on the other hand experienced a contraction of 1.3 percent, due to exacerbated drought and security problems. Philippines experienced only a modest slowdown in economic growth of 3.4 percent compared with 4.0 percent in 2000, in spite of a decline in exports by 16.2 percent, which was mainly attributable to the robustness of its agriculture sector which remained resilient in the face of the external shocks.

The global slowdown had the most impact on the manufacturing sector in the SEACEN region. Singapore's manufacturing sector shrank by 12.0 percent as against an average growth of more than 14.0 percent in the previous two years. Likewise, in Malaysia, the manufacturing sector shrank by 5.0 percent in 2001 as against an

average growth of more than 17.0 percent in the previous two years. Meanwhile, the manufacturing sector in Korea grew only by 2.0 percent as against an average growth of more than 18.0 percent in the previous two years, and in the Philippines, its manufacturing sector witnessed a decelerating growth in spite of a very mild slowdown in its GDP growth.

On the external front, the slowdown of the growth in the SEACEN region in 2001 was also a direct outcome of a sharp fall in its exports (see Chart 2). The deceleration in world trade in 2001 reduced the demand for the region's exports particularly for ICT products[1] and affected especially countries such as Korea, Malaysia, Philippines and Singapore where a large proportion of exports are in the form of electronic goods that are heavily dependent on the US market.

In some SEACEN countries, besides declining exports, the situation was worsened by a net outflow of private foreign capital, the largest outflows being in the form of net portfolio investments and net inflows from non-bank creditors. Net foreign direct investment also declined, albeit at a slower rate. The large net outflows in non-bank credit from the region were mostly repayments made especially by Indonesia, Korea and Thailand. In Indonesia, the net outflows were mainly continuing repayments of inter-company loans while in Korea and Thailand, net repayments were for cheaper domestic loans.

The SEACEN economies had very diverse experience with regard to domestic demand in 2001. In Malaysia, Singapore and Thailand, the growth in the domestic demand is generally seen to have declined but has increased in Korea, remained relatively unchanged in the

1. The World Bank's estimates that world trade declined by 1.0 percent in 2001 as against a growth of 13.0 percent in 2000.

Philippines and decelerated sharply in Indonesia. Since exports has declined sharply, economic growth in the SEACEN economies in 2001 was mainly the result of growth in domestic demand, which remained positive albeit at a slower pace in many of the countries.

Weakening exports and decelerating growth helped to contain inflation in most SEACEN countries with the exception of Indonesia. Singapore, which had a low inflation rate of 1.3 percent in 2000, experienced a mild deflation in 2001 whereas in Malaysia, inflation was maintained at about 1.4 percent throughout 2001. However, in Korea and Thailand, inflation edged up somewhat in the beginning of 2001, but has gradually declined since then to reach 4.1 percent and 1.7 percent respectively. In the Philippines, annual inflation accelerated to 6.1 percent in 2001 from 4.4 percent in 2000 whereas in Indonesia, inflation in 2001 reached double digits at 12.6 percent from 9.4 percent in 2000.

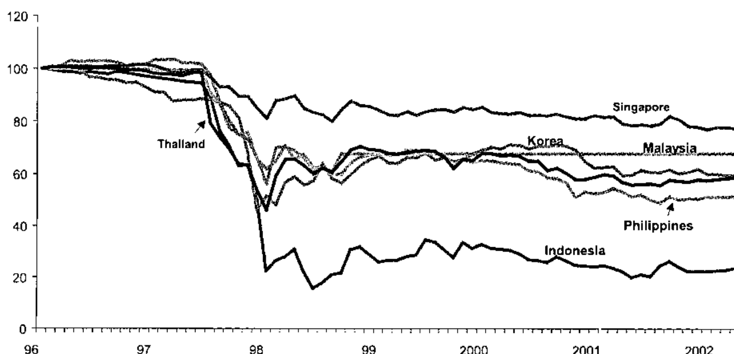
The equity markets in the SEACEN countries, which posted declining trends till the third quarter of 2001, have made significant rebounds toward the fourth quarter. In local currency term, these gains have ranged from 23.0 percent in Malaysia to 73.0 percent in Korea. The main factors attributable to the surge in the regional stock prices were the recovery in the US stock market from the earlier sharp drops resulting from the 11 September attack, a better than expected growth among many of the SEACEN economies and the declining interest rates.

However, most of the SEACEN countries posted a decline in stock market capitalisation in spite of the surge in the stock prices during the fourth quarter in 2001. The market capitalisation of these economies ranged from 11.0 percent in Thailand to about 35.0 percent in Indonesia in terms of dollar values. The decline in market capitalisation as a percent of GDP in 2001 was 32.0 percent for

Indonesia, 15.0 percent for Singapore, 24.0 percent for Malaysia and 6.0 percent for Thailand. However, it increased moderately in the Philippines as a result of the contraction in the dollar value of the country's GDP in 2001.

Exchange rates in the SEACEN region had remained relatively stable in 2001 on the whole, despite the fact that some member countries have adopted flexible exchange rate regimes (Chart 3). The Indonesian rupiah and the Korean won each depreciated by about 4.0 percent, whereas the Singapore dollar depreciated by about 5.0 percent in 2001. However, the countries that have maintained stable nominal exchange rates against the US dollar have experienced a modest appreciation of their currencies against the Japanese yen. The major portion of the appreciation was seen after the 11 September attack, when the Japanese yen started to depreciate against the US dollar. The appreciation of the SEACEN regional currencies against the yen have ranged from about 7.0 percent for the Singapore dollar to about 13.0 percent for the Malaysian ringgit.

Chart 3: Bilateral U.S Dollar Exchange Rates of Selected SEACEN Countries
(U.S dollare per currency unit, January 1996=100)



The real effective exchange rates of several of these economies, with an exception of Singapore[2] have started to appreciate gradually. This appreciation, since 11 September 2001, is 2.5 percent for Indonesia, 5.0 percent for Korea, 6.0 percent for Malaysia, 8.0 percent for Thailand and 9.0 percent for the Philippines. Although the real effective exchange rates are still lower than the pre-crisis level, the continued real appreciation of the currencies could erode the export competitiveness of the SEACEN economies.

3.3 Outstanding Issues of Concern

Based on the above discussion, it could be concluded that the impact of the recent global economic slowdown , particularly those triggered by the September 11 event, has so far not been as severe for the SEACEN region as a whole. In fact, a number of SEACEN countries managed to continue their recovery paths, while a few countries experienced deterioration due mainly to the cyclical downturn of the electronics industry and the secondary effect of the September attack. Nonetheless, the outlook of SEACEN region growth continues to be uncertain with several areas of concern remaining to be addressed.

With investment and exports expected to be among the engines of growth, the region's dependency on the global economic rebound is considerably high. While domestic conditions play crucial role in creating conducive environment for investment, global economic conditions would also be important. Global economic slowdown will induce foreign investors to withdraw investment worldwide. As such the investor's confidence is always prejudiced by the unfavourable global as well as the regional environments. The prolonged weakness in investment could slow down the economic activity and trade globally,

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2. Singapore has had a remarkably stable real effective exchange rate for many years now, even at the height of the Asian crises.

and an increased transaction costs on international trade could also reduce the US propensity to import goods for a given level of aggregate demand. In addition, the weakening of non-oil primary commodity prices may hurt some SEACEN countries such as Mongolia that rely on commodity exports.

A possible source of a faltering global rebound is the inability of the US economy to sustain its emerging recovery because consumption may slow and exports remain lethargic. Also an adjustment to the US current account balance may be a good reason for the lower external demand even in the event of a US recovery. There is also the possibility that, with US emerging out from the economic slowdown ahead of Euro area and Japan, its current account deficit will widen further before it begins to shrink, thereby increasing the chance of a sharp adjustment being precipitated by events that erode the global attraction for US financial assets. This would reduce the US propensity to import. The increase in trade costs in the wake of heightened security concerns would also add to the tendency.

Furthermore, any doubt on the people's mind about US ability to manage properly the prolonged critical situation that has been ever persisting especially after the 11 September crisis is likely to negatively affect the confidence in US economy. As a result, financial flows may reverse, and exchange rate correction may be disruptive which may further slacken the import demand in US. While on the other hand, if instability starts to appear elsewhere in other region, investors could still consider US as a safe place to invest and thus pull out funds from the emerging markets. This is a potential hindrance for SEACEN regional long-term growth.

In the medium term, there is also some uncertainty regarding world oil price hike. A hike in oil prices will significantly harm the Asian economies as was recently experienced due to ongoing unrest in Middle East, Palestine- Israel confrontation and political upheaval

in Venezuela. Also, the risk of an extended period of global economic malaise is accentuated by the possibility of a prolonged period of turbulence caused by acts of terrorism or even by a possible military operations led by the US to attack Iraq. SEACEN countries like Nepal and Philippines in the SEACEN region that rely on worker remittances could be hurt by such political turmoil in the Middle East.

It is evident that fluctuations of the exchange rates among the dollar, the yen, and the euro can exacerbate trade deficits of emerging market economies, precipitating balance of payment crisis. A country that has dollar denominated liabilities but that earns yen or euros from its exports could see its ability to service its debts suffer if the dollar appreciates relative to the other currencies. The rise of the dollar in the 1980 hurt Latin American economies, the fall of the yen in the mid- 1990s hurt the economies of Southeast Asia, and the decline of the euro exacerbated Argentina's trade deficit. Hence the emerging market economies should act on the assumption that the major exchange rates will be volatile. That implies a further reason to avoid debt that is denominated in dollars or any other single currency[3]. A country that borrows abroad might protect itself from currency fluctuations by borrowing in mix currencies.

An area of concern is the banking sector. However, the banking sector of most of the SEACEN economies has shown some encouraging signs. The ratio of non-performing loans (NPLS) continued to decline in most of these countries; with the exception of Malaysia and the Philippines, banks' capital adequacy ratio stayed above the 8.0 percent norm, and the bank profitability, except for a few exceptions is seen to be increasing.

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3. Private and public borrowers must also take into account the possibility of interest rate movement that are not based on local conditions, making the optimal debt level less than it would otherwise be and increasing the optimal maturity of that debt.

In Indonesia, for example, the ratio of non-performing loans has fallen remarkably from about 50.0 percent in 1998 to about 12.0 percent in December 2001. Similarly, in Thailand, it has fallen from 43.0 percent in 1998 to about 10.0 percent in February 2002 and in Korea where such ratio was already low, it has further reduced to about 3.0 percent as at December 2001. However, in Malaysia, because of the sharp economic slowdown and its adverse effects on corporate borrowers from the bank, the NPL ratio has mildly accelerated to about 10.0 percent in 2001. In the Philippines, the NPL ratio has been on a rising trend from 10.0 percent in 1998 to more than 18.0 percent in 2001.

The sharp decline in the non-performing loans in the banking sector is the result of the transfer of problem loans from bank's balance sheets to publicly funded asset management companies (AMCs). However, if the NPLs held by the AMCs are added to those still in the banking system, the picture is a little bleak. These aggregate NPL ratios are as high as 50.0 percent in Indonesia and 25.0 percent in Thailand, thereby reflecting the fact that these AMCs have been able to dispose only a small proportion of the NPLs transferred to them by the banks. For example, in Indonesia, by December 2001, about 88.0 percent of the bank's problem loans had been transferred to the Indonesian Banks Restructuring Agency (IBRA), of which only about 7.0 percent was able to be disposed.

Similar is the case with Thailand, as at end 2001, about 50.0 percent of the banking sector's NPLs have been transferred to the Thai Asset Management Company (TAMC). However, the TAMC is unlikely to have disposed a significant amount of such loans as the company was established only in June 2001. However, the situation of AMCs in Korea and Malaysia is a little different. About 7.0 percent of the banking sector's NPLs in Korea had been transferred to the Korea Asset Management Corporation (KAMCO) by December 2001 and it was able to dispose about 58.0 percent of the

NPLs by January 2002. In Malaysia, about 40.0 percent of the banking sector's NPLs had been transferred to its Asset Management Company, Danaharta, of which about 88.0 percent was disposed by the year-end. The reason behind a high aggregate NPL ratio can be accounted for the slow progress in the operational restructuring of the corporate sectors in most of the SEACEN countries. In recent years, these countries have made some progress in financial restructuring of their corporate sectors through debt rescheduling, debt-equity swaps, debt forgiveness and indexation of interest payments to earnings. However, progress made especially in the operational sides has been very slow. In many cases, changes in the management have not come into effect even in corporate restructuring. In addition, banks as well as AMCs are observed to be reluctant in taking tough measures such as selling off non-performing assets or converting debt into equity and also in forcing corporations to close non-viable businesses, sell over-valued assets and undertake other means of operational restructuring.

It is seen from country experiences that AMCs can be effectively used for financial restructuring than operational restructuring. The main reason behind this besides the skills that the commercial banks and AMCs lack to conduct these operations is the political factors, which have limited the ability of publicly owned agencies to conduct difficult corporate restructuring. For example, governments are reluctant to fire excess workers and close non-viable business.

Another possible area of vulnerability is the possibility of growing public debts. With the slower growth and larger fiscal spending, growing public debts is seen as emerging risk. However as the SEACEN economies recover, pressure on public debt burden and future contingent liabilities would be reduced to a large degree. The overall budget deficit of the central government has also remained relatively small. In addition, the debt service ratio for all member countries except Indonesia, where it stood at around 45.0 percent,

was relatively low in 2000. Some SEACEN countries may see a moderate increase in the debt-service ratio in 2002 but there should not be any major risk in repaying public debts. In the case of Indonesia, the country is rescheduling its debt with the Paris Club.

4. Policy Options

In the light of the outstanding issues of concern, coupled with the continued uncertainty over the sustainability of economic recovery in the major industrial economies, the SEACEN economies are faced with a major challenge on how to steer their economies through difficult times ahead. This section discusses various policy options available to policy makers, covering both a general framework of standard policy options and country specific policy options.

4.1 General Framework

4.1.1 Macroeconomic Policies

The conventional short-term policy response to lower external demand is to boost domestic demand through expansionary monetary and fiscal policies. The proactive easing of monetary policy by industrial countries in response to lower aggregate demand provides more space for SEACEN countries to use monetary policy in this situation. However, both policy options are available only for countries that have maintained strong economic fundamentals such as low inflation, healthy fiscal positions and comfortable levels of reserves and sovereign debt. Countries with macroeconomic imbalances would have fewer options in the short-term and will likely to be more vulnerable to the impact of external business cycle. These countries should speed up the implementation of necessary structural reforms to address existing macroeconomic imbalances.

In making the choice of policy instruments between fiscal and monetary policies, monetary policy is the standard tool of choice for dealing with cyclical fluctuations, and can be implemented more quickly and flexibly than fiscal policy although the effectiveness of fiscal policy can be faster depending on fiscal measures. For example, the effectiveness of a tax cut is faster than a higher fiscal expenditure on infrastructure projects. For this reason, monetary policy has been used more often than fiscal policy for demand management purposes. For countries with a degree of uncertainty and constraints on fiscal policies, it seems plausible that the primary emphasis should remain on monetary policy, with automatic fiscal stabilisers playing a supportive role, although the case for discretionary fiscal measures increases if the situation deteriorates further.

For countries that have less room for macroeconomic policy manoeuvering, although it should be used where it exists, necessary structural reforms must be implemented without delay to help reduce vulnerability. For medium term growth, ongoing progress in structural reforms and addressing associated macroeconomic imbalances will be the key in sustaining strong medium term growth.

It should also be borne in mind that if the global recovery appears to be arising sooner than earlier expected, policy makers would need to begin to withdraw a portion of policy stimulus that is already in the pipeline. A key policy challenge in the upswing is the appropriate timing and calibrating of the monetary policy response. A balance needs to be struck in making sure that the current stimulus is not withdrawn too early so as to mute the recovery, nor too late, so that strong macroeconomic fundamentals are compromised. The degree of uncertainty regarding the sustainability of the current recovery must have a major bearing on the decision as to when to withdraw the accommodative policy stance.

4.1.2 Structural Reforms

The effectiveness of the macroeconomic policy response, particularly, an easing of monetary policy, would depend on the development of the financial and corporate sectors of countries. Most SEACEN countries began to introduce bold reforms in the financial and corporate sectors in response to the financial crisis in 1997. Countries that implemented reforms successfully appeared to have recovered faster with the recovery of the global slowdown. In these countries, policy responses and the impact of the recovery in the global economy trickled down to the domestic economies effectively and quickly, cushioning the impact of lower external demand.

For countries that have delayed the implementation of necessary reforms, even if policy options were available, the effectiveness of the policy response would be less, due to weak transmission mechanisms. For these countries, expansionary macro policies would need to be accompanied by the speedy implementation of structural reforms to make policy responses more effective.

For the third group of countries, i.e., those that were experiencing macroeconomic imbalances at the beginning of the slowdown, there is less room for macroeconomic policy manoeuvring. In most cases, structural rigidities of economies cause macroeconomic imbalances. For these countries, priority should be given to addressing these structural rigidities by introducing bold structural reforms while taking necessary steps to improve macroeconomic imbalances. Structural reforms are also necessary not only for the short-term effectiveness of demand management policies, but also to move into high levels of per capita income growth in the medium term.

The benefit of pursuing sound macroeconomic policies and structural reforms is demonstrated by the performance of the Australian and New Zealand economies during the slowdown. Both are small,

highly trade dependent economies but have proved resilient and growth held up remarkably well despite the slowing down in global growth. The strong economic fundamentals that prevailed in both countries enabled these countries to embark on expansionary policy options while well-developed corporate and financial sectors facilitated effectiveness of the policy responses. Both countries implemented expansionary monetary policy accompanied by fiscal stimulus packages. These policy responses trickled down the economies effectively that maintained aggregate demand to achieve a growth momentum during the external slowdown.

4.1.3 Trade Ties

The fact that the major impact of the slowdown was generated by significantly lower growth in global trade flows demonstrates the need for lower trade barriers among countries. If domestic markets were open to each other, trade flows would have been higher. Diversification of export markets by strengthening multilateral trade ties could reduce member countries' vulnerability to business cycles in industrial countries. Multilateral trading arrangements could provide market access in mutually beneficial ways so that high dependence on a single market could be reduced.

Whilst the areas discussed above are considered as available policy options in general for member countries, the specific mix of policy options for individual countries may vary depending on country specific factors such as exchange rate regimes, structure of external trade, their macroeconomic balances, the level of integration to the global economy and structural rigidities. Therefore, appropriate policy responses for individual economies depend on assessment of individual member countries' positions in relation to above factors. Based on this framework, the following section makes an assessment of individual country positions and suggests appropriate policies in response to adverse external sector developments.

4.2 Country Specific Policy Options

4.2.1 Indonesia

Indonesia was less affected by the external slowdown than other countries in the region mainly due to diversification of exports and relatively low concentration on the US market, particularly electronics products. In comparison to other countries in the region, the domestic market is larger as total trade as a percentage of GDP is 69 per cent in 2000. As a result, in 2001, GDP growth slowed down only moderately to 3.3 per cent from 4.9 per cent in 2000 despite a contraction exports growth to a negative 10 per cent from a positive 28 per cent in 2000. GDP growth is projected to decline marginally to a positive growth of 3 per cent in 2002.

Table 3: Key Economic Indicators - Indonesia

	1998	1999	2000	2001	2002
GDP Growth (%)	-13.2	0.8	4.9	3.3	3.0
Export Growth (%)	-10.5	1.7	27.6	-9.8	10.5
Openness (trade as a % of GDP)	86.2	57.9	69.0	63.5	n.a
Inflation (%)	77.6	2.0	9.4	12.6	13.1
Debt Service Ratio /1	33.0	31.3	44.8	n.a	n.a
Fiscal Balance (% of GDP)	-1.7	-2.8	-1.6	-2.3	n.a

Sources: 1) SEACEN Trends and Outlook 2002 and various country reports
2) SEACEN Financial Statistics

1/ Percentage of export of goods and services

To mitigate the impact of the global slowdown, Indonesia appears to have less room to manoeuvre the standard macroeconomic policy options due to existing macroeconomic imbalances and structural rigidities. In 2001, inflation was already running around 13 per cent compared to 9 per cent in 2000, providing less room for monetary policy easing in response to the global slowdown. Even if there was any room for policy manoeuvring, implementation of monetary policy has been unusually difficult and encountered several problems. There is a high demand for currency in circulation by the public, mainly due to the increasing role of the informal sector in the economy. The level of bank intermediation is very low, which makes monetary policy instruments less effective. This requires aggressive use of monetary policy actions such as open market operations, foreign exchange sterilisation and raising rupiah intervention interest rates[4].

On the fiscal front, the sharp rise in the public debt following the 1997-98 crisis has limited the flexibility in easing fiscal policy in the short-term. Fiscal policy needs to be focused mainly on attaining a sustainable level of public debt. Debt service ratio had already risen to 44.8 per cent of exports of goods and services in 2000.

In this environment, even if needed, Indonesia appears to have difficulty in using policy stimulus to mitigate the lower external demand. To improve the vulnerability of the Indonesian economy to these kinds of external shocks, priority should be given to addressing existing structural problems while attempting to achieve macroeconomic balance. Indonesia initiated bold structural reforms after the 1997-98 crisis but the implementation was slow mainly due to the political instability that prevailed until recently. With the current relatively stable political environment, the speedy implementation of financial

4. Country report to the SEACEN Centre: 2002

sector reforms is needed to make monetary policy more effective. A medium-term fiscal consolidation program needs to be implemented while addressing rigidities in revenue mobilisation, privatisation and expenditure management. With more stable political environment, there are signs of improving market sentiments as the exchange rate has been more stable in 2002[5].

To move to a higher growth path in the medium term and to reduce vulnerability to external shocks, structural reforms are needed in some other areas such as establishment of proper asset recovery procedures, debt restructuring and addressing legal and governance issues.

4.2.2 Korea

Among highly trade dependant economies, South Korea has weathered the global downturn in 2001 better than many other economies in the region. GDP growth remained positive at around 3 per cent in 2001 despite exports recorded a negative 14 per cent growth from positive 21 per cent growth in 2000. The recovery is most advanced in Korea as GDP growth rebounded to 3.7 per cent and 5.4 per cent in the fourth quarter of 2001 and the first quarter 2002, respectively. Increasing domestic consumption and construction mainly drove the growth in the fourth quarter. The recovery in exports contributed to the higher GDP growth in the first quarter 2002.

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5. Statement by the Bank Indonesia at the 37th Conference of the SEACEN Governors in June 2002

Table 4: Key Economic Indicators - Korea

	1998	1999	2000	2001	2002
GDP Growth (%)	-6.7	10.9	9.3	3.0	4.8
Export Growth (%)	-4.7	9.9	21.2	-14.0	7.0
Openness (trade as a % of GDP)	70.2	64.5	72.6	68.5	n.a.
Inflation (%)	7.5	0.8	2.3	4.1	3.5
Debt Service Ratio /1	n.a	n.a	n.a	n.a	n.a
Fiscal Balance (% of GDP)	-4.2	-2.7	1.1	1.3	n.a

Sources: 1) SEACEN Trends and Outlook 2002 and various country reports
2) SEACEN Financial Statistics

1/ Percentage of export of goods and services

Korea implemented a standard macroeconomic policy package in response to the crisis. Both monetary and fiscal policies were supportive with more emphasis placed on monetary easing. Korean authorities lowered the target call rate four times during the year from 5.25 per cent to 4 per cent. The Bank of Korea raised its aggregate credit ceiling (for low-interest lending to deposit banks) and lowered interest rates on such lending. However, the Bank of Korea had to strike a balance between the risks of lowering interest rate to stimulate the economy and the prospect of rising inflation as inflation was already on the rise in the year 2001[6]. However, by the end May

6. ADB Outlook, 2002

2002, there was still no inflationary pressure as consumer price inflation has come down to 2.6 percent[7]. Government also implemented complementary fiscal policy by increasing expenditure and lowering tax rates. In particular, the government used the tax policy to stabilize consumption. Despite supplementary higher fiscal expenditure to boost domestic activities, government surplus improved to 1.3 per cent of GDP in 2001 from 1.0 per cent of GDP in 2000 due to large surplus in the National Pension Fund[8].

Private consumption and construction investment responded quickly to policy responses partly offsetting the lower external demand. The effectiveness of policy transmission in Korea is partly due to the successful restructuring of the banking and corporate sectors after the financial crisis in 1997. The corporate sector was better positioned to face the downturn, which did not require large-scale layoffs. In addition, increased credit availability for consumers partly as a result of successful reduction of NPL of commercial banks, in the fourth quarter 2001 increased activities in real estate market and construction sectors.

Korea has also improved its external debt position by the early repayment of an IMF programme loan and is now well placed to benefit from a global recovery. There are positive signs already emerging of a stronger recovery in the second quarter 2002. With a strong fiscal position, a comfortable reserve position and inflation still within the target range, Korea is well equipped with policy options to weather any uncertainty in external demand. The continuous progress in strengthening the corporate sector will move Korea into a market oriented higher growth path in the long term.

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7. Statement by the Bank of Korea at the 37th Conference of the SEACEN Governors in June 2002
8. ADB Outlook, 2002

4.2.3 Malaysia

The impact of the slowdown was significant for Malaysia as the US is one of the major export markets. In addition, electronics exports, which were severely affected due to the global cyclical downturn, accounted for about 42 per cent of Malaysian exports. With the recovery in external demand, negative growth in exports started to improve from the fourth quarter 2001 but still remained negative in the first quarter 2002. However, GDP growth recovered faster, showing a 1.3 per cent growth in the first quarter mainly due to expansionary macro policies implemented in response to the lower external demand. The contributory factors were stimulus macroeconomic policies, particularly fiscal expansion and the resilience of private consumption. Diversification of the economic structure also helped partly reduce the impact of the export slowdown. The export oriented manufacturing sector contracted by 10.4 per cent in 2001, but the domestic oriented manufacturing grew by 7.0 per cent, offsetting the contraction in export oriented manufacturing[9].

Table 5: Key Economic Indicators - Malaysia

	1998	1999	2000	2001	2002
GDP Growth (%)	-7.4	6.1	8.3	0.4	4.2
Export Growth (%)	-29.7	12.2	16.1	-10.4	5.9
Openness (trade as a % of GDP)	181.7	189.5	199.9	183.8	182.1
Inflation (%)	5.3	2.8	1.6	1.4	1.8
Debt Service Ratio /1	7.0	6.3	5.8	6.8	6.7
Fiscal Balance (% of GDP)	-1.8	-3.2	-5.8	-5.5	-5.6

Sources: 1) SEACEN Trends and Outlook 2002 and various country reports
2) SEACEN Financial Statistics
1/ Percentage of export of goods and services

9. Country report to the SEACEN Centre: 2002

Strong macroeconomic fundamentals provided the necessary flexibility to implement pro-growth fiscal policies without creating imbalances in the domestic economy. At the beginning of the slowdown, total government debt was manageable, around 37 per cent of GDP, while its debt service ratio was only about 16 per cent of operating expenditure. Accordingly, fiscal stimulus was the appropriate policy response for Malaysia to mitigate the lower external demand. Government implemented a series of fiscal stimulus programmes in March and September 2001 offering tax relief tax relief and higher spending on health, education and social protection. With the stimulus package, the fiscal deficit for the year 2001 was expected to rise to 6.5 per cent of GDP from 5.8 per cent in 2000. However, higher fiscal expenditure was offset by stronger revenue performance, which resulted in a lower fiscal deficit (5.5 per cent of GDP). The better than expected revenue collection was attributable largely to improved procedures for income tax collection as well as higher dividend payments from public enterprises[10].

On the monetary policy front, the use of interest rate as an instrument for monetary policy implementation is constrained to some extent by the pegged exchange rate regime. Therefore, interest rate was cut only by 50 basis points during the year 2001. Monetary policy operations were aimed at managing liquidity positions in order to maintain stable interest rates. To supplement domestic activities during the slowdown, indirect policy measures such as establishment of special funds to make more credit available at lower rates for small and medium enterprises and agricultural sector were introduced [11].

Under a pegged exchange rate regime, it is more important to maintain strong macroeconomic fundamentals and consistent

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10. Annual Report 2001, Bank Negara Malaysia
11. Annual Report 2001, Bank Negara Malaysia

macroeconomic policy to avoid pressure on the ringgit, which could lead to speculative attacks on the currency. When external demand recovers, fiscal stimulus packages may need to be withdrawn to maintain macroeconomic balance. In the medium term, fiscal consolidation would be important for Malaysia to maintain a strong balance of payments position, which is necessary to maintain the pegged exchange rate regime.

Another downside risk is the possible misalignment of the external value of the ringgit against major trading partner countries as the ringgit is pegged to the US dollar, as this may impact the export competitiveness. For instance, the continuous appreciation of the ringgit until the first quarter of 2002 required Malaysia to achieve steady improvements in productivity in the export sector in order to maintain the competitiveness of Malaysian exports. Pegging to a basket of currencies could be a solution to minimise the downward risk of a continuous appreciation of the US dollar.

On structural reforms, Malaysia has achieved a significant progress in financial and corporate sector reforms since the financial crisis in 1997. These reforms have allowed Malaysia to manage marginally increased non-performing loans in 2001 due to the deterioration of economic conditions. In particular, corporate debt and non-debt restructuring programme, the domestic bank consolidation programme and development of capital market have achieved much progress in 2001, reducing the vulnerability of corporate and banking sectors. The successful implementation of the recently announced Financial Sector Master Plan would enhance the competitiveness and efficiency of the financial system and eventually integrate domestic financial market to global financial markets.

4.2.4 Mongolia

Although Mongolia is highly dependent on international trade, the impact of the slowdown in industrial countries was less severe as

compared to other SEACEN countries that have similar levels of trade dependence. China and Russia are major export markets to which over 70 per cent of Mongolian exports are destined[12]. Growth in these two export markets was robust in 2001. However, GDP growth slowed down to 1.1 per cent in both 2000 and 2001 from 3.2 per cent in 1999. Severe natural shocks such as two successive harsh winters and the outbreak of foot and mouth disease affected agricultural output adversely. In addition, lower external demand reduced prices of major primary commodities such as copper and gold. As a result of these developments, exports declined by 17 per cent in 2001.

Table 6: Key Economic Indicators - Mongolia

	1998	1999	2000	2001	2002
GDP Growth (%)	3.5	3.2	1.1	1.1	3.0
Export Growth (%)	-18.8	-1.7	18.2	-17.4	9.4
Openness (trade as a % of GDP)	101.5	112.9	113.0	n.a	n.a
Inflation (%)	9.4	10.0	8.1	11.2	6.0
Debt Service Ratio /1	7.3	9.3	6.0	7.0	5.3
Fiscal Balance (% of GDP)	-12.5	-12.2	-6.0	-4.0	n.a

Sources: 1) SEACEN Trends and Outlook 2002 and various country reports
2) SEACEN Financial Statistics
3) ADB Outlook 2002.

1/ Percentage of export of goods and services

12. Economic Intelligence Unit

Even if Mongolia needed any macroeconomic policy manoeuvering in response to a lower external demand, existing macroeconomic imbalances would restrain any policy flexibility. Inflation was on the rise from 8.1 per cent in 2000 to 11.2 per cent in 2001. Monetary tightening was needed. However, monetary expansion led to higher inflation in 2001. Fiscal policy was aimed at bringing down the deficit by increasing taxes. As a result, the government was able to reduce the deficit by 2 percentage points of GDP. External debt has reached 90 per cent of GDP in 2000 but debt service ratio was still 7 per cent of exports as a large part of external debt is on concessional terms and conditions. High external debt ratio indicates a need for Mongolia to move into a higher growth path to maintain external debt sustainability in the medium term. Therefore, policy priorities should be aimed at addressing structural rigidities that cause macroeconomic imbalances such as high inflation, rising external debt and high fiscal deficit. To reduce the vulnerability to external shocks, structural reforms are needed in other areas such as the banking sector, non-financial public enterprises, and regulatory frameworks to facilitate market-oriented reforms and removal of subsidies. Until these issues are resolved, prospects for growth will remain below potential. The recently signed agreement with donor agencies on the basis of a poverty reduction strategy paper provides a good framework to move into a higher growth path.

4.2.5 Myanmar

The impact of the global slowdown was lower in Myanmar as it is a relatively closed economy as compared to most member countries, as reflected in total exports plus imports accounted for less than 2 per cent of GDP in 1999. Exports mainly consist of primary agricultural commodities and natural gas. Therefore, under the present environment, any global slowdown is not likely to affect Myanmar's performance adversely.

Table 7: Key Economic Indicators - Myanmar

	1998	1999	2000	2001	2002
GDP Growth (%)	5.8	10.9	6.2	4.8	4.2
Export Growth (%)	4.3	42.7	7.6	n.a	n.a
Openness (trade as a % of GDP)	1.4	1.0	1.0	n.a	n.a
Inflation (%)	51.5	18.4	-0.1	21.1	15.0
Debt Service Ratio /1	7.3	9.3	6.0	7.0	n.a
Fiscal Balance (% of GDP)	0.3	-0.9	0.3	4.4	n.a

Sources: *1) SEACEN Trends and Outlook 2002 and various country reports*
2) SEACEN Financial Statistics
3/ Statement by Executive Director for SEAG, IMF at the SEACEN Governors, Mongolia, June 2002.

1/ Percentage of export of goods and services

Despite lower external demand, according to provisional data, exports have increased by 28.6 per cent during the financial year 2000/2001 from the previous year[13]. Major contributing factors were significant increase in gas exports generated by a new project and higher agricultural output.

13. Country report submitted to the 37th Conference of the SEACEN Governors in June 2002

In terms of general macroeconomic conditions, the CPI inflation which has been on a declining trend since 1999/2000 has risen again to double digit level in 2001/2002. The increase may be attributable to the rise in wages as well as the rise in import prices. The price pressure, however, is offset to some extent by a decline in budget deficits to 4.4 per cent in 2001/2002. These developments suggest that Myanmar should continue its efforts to restructure the economy and remove structural rigidities in the economy.

For monetary policy, progress has been made in conducting more flexible monetary policy through interest rates and reserve requirements, aiming at investment to boost economic activities. The Central Bank of Myanmar also took measures to strengthen the banking sector by establishing the Banking Regulation Department to revise the existing bank regulations to ensure that the banking sector is developing according to the needs of the changing economic environment.

4.2.6 Nepal

As a landlocked and relatively closed economy, the impact of the slowdown in industrial countries is lower for Nepal compared to most member countries. The ratio of total merchandise trade to GDP was 45 per cent of GDP in 2001. Nepal recorded a GDP growth of 4.9 per cent during the fiscal year 2000/2001. However, the impact of the global slowdown, particularly the events of September 11, will affect the performance for the fiscal year 2001/2002. GDP growth is expected to slow down to 2 per cent during the period. Tourism, ready-made garments, carpets, pashmina shawl and woolen exports have been affected severely.

Table 8: Key Economic Indicators - Nepal

	1998	1999	2000	2001	2002
GDP Growth (%)	3.3	4.4	6.4	5.0	3.5
Export Growth (%)	11.9	18.2	42.4	3.7	5.0
Openness (trade as a % of GDP)	37.7	42.0	44.5	44.9	n.a
Inflation (%)	8.3	11.3	3.5	2.4	5.0
Debt Service Ratio /1	6.1	6.1	5.9	3.9	5.5
Fiscal Balance (% of GDP)	-4.6	-3.9	-3.3	-4.2	-6.0

Sources: 1) SEACEN Trends and Outlook 2002 and various country reports
2) SEACEN Financial Statistics

1/ Percentage of export of goods and services

The fiscal deficit increased to 4.2 per cent of GDP during the fiscal year 2000/2001 from 3.3 per cent in the previous year despite adopting a structural adjustment programme with a number of fiscal reform measures[14]. Both higher expenditure growth and slower revenue growth contributed to the higher deficit. With persistent fiscal imbalances due to structural problems in tax administration, monetary policy seems to be the preferred option to support domestic activities.

14. Country Report; June 2002

Accordingly, several monetary policy easing measures were introduced in response to lower external demand: a) cash reserve ratio was reduced by one percentage point to 9 per cent; b) bank and refinances rates were reduced by one to two percentage points; and c) refinancing facilities were provided to affected industries at concessional rates. Despite the monetary policy package, demand for private sector credit was sluggish due to poor performance of manufacturing and tourism industries. Therefore, the full impact of the accommodative monetary policy will be felt with some improvements in investor confidence.

The Nepal Rastra Bank also introduced several reforms in the financial sector. A new Nepal Rastra Bank Act and the Loan Recovery Act 2002 have been enacted. An assets management company is being established. However, persistent fiscal deficits over the years indicate the need for continuous efforts to implement structural reforms in fiscal management as well. Increasing defense related expenditure due to the internal conflict exerts more pressure on the fiscal deficit. Addressing structural rigidities in the fiscal sector will be the key to achieving macroeconomic balance, which will provide more policy options for Nepal to reduce its external vulnerability.

4.2.7 Philippines

The Philippines economy is an open economy. Nevertheless, GDP growth was less affected despite export growth slowing down to a negative 16 per cent in 2001 from a positive 9 per cent in 2000. GDP growth decelerated only to 3.4 per cent in 2001 from 4 per cent in 2000. The slowdown in exports was mainly due to the lower demand for electronic exports, which accounted for more than 50 per cent of total exports. GDP growth was held up mainly by stronger performance in agricultural and services sectors and robust consumer spending. A larger and steady flow of worker remittances,

estimated to be over 8 per cent of GDP partly helped maintain domestic consumption.

Table 9: Key Economic Indicators - Philippines

	1998	1999	2000	2001	2002
GDP Growth (%)	-0.6	3.4	4.0	3.4	4.0
Export Growth (%)	16.9	19.1	9.0	-16.2	3.0
Openness (trade as a % of GDP)	90.6	83.3	90.6	83.7	n.a
Inflation (%)	9.7	6.7	4.4	6.1	5.0
Debt Service Ratio /1	11.7	13.4	12.7	16.4	15.0
Fiscal Balance (% of GDP)	-1.8	-3.6	-3.8	-3.8	-3.2

Sources: 1) SEACEN Trends and Outlook 2002 and variou country reports
2) SEACEN Financial Statistics

1/ Percentage of export of goods and services

In addition, the relatively low and declining inflation environment in 2000 has provided enough space for monetary policy easing in 2001 in response to the lower external demand. The Bangko Sentral ng Pilipinas (BSP) responded promptly to the expectation of lower external demand by starting to ease monetary policy from December 2000. Interest rate has been cut 12 times by a total of 725 basis points since then. The liquidity reserve requirement was also reduced by 2 percentage points, freeing up more funds for lending. Monetary policy easing in the Philippines has been effective in raising aggregate

demand. Domestic demand has responded well, offsetting the impact of the lower external demand.

However, the use of expansionary fiscal policies in response to the lower external demand is constrained in the Philippines due to rising fiscal deficit in the recent years. In fact, the reduction of the fiscal deficit was the priority and the government was able to meet the target in 2001. Effectiveness of the monetary policy implementation eased the pressure on government to use expansionary fiscal policy in response to lower external demand. The fiscal deficit has remained almost at the same level during 2000 and 2001. The low interest rate environment and improved tax administration have helped the government to maintain its fiscal target without implementing harsh expenditure cuts which would have adverse impacts on aggregate demand during the period of low external demand. Speeding up privatisation will further relieve fiscal constraints the government is now facing.

The Philippines experience demonstrates the effective use of monetary policy while addressing the fiscal imbalance in the event of lower external demand. In this situation, if fiscal policy was eased it could exert pressure on interest rates and thus constraining the implementation of monetary policy. It could also crowd out private consumption and investment that is more effective in boosting aggregate demand rather than increasing government expenditure. Except for the relatively high fiscal deficit, economic fundamentals were strong enough to provide sufficient space for the effective implementation of the monetary policy.

On the structural reforms, tax administration reforms aimed at strengthening revenues helped achieve the fiscal target. The continuation of the reform agenda aimed at further strengthening fiscal revenues and improving the health of the banking system will limit vulnerability to external shocks. The BSP was able to move into an explicit inflation targeting framework, which indicates positive developments in the

financial sector. Further strengthening the health of the banking sector will be the key for the success of the inflation targeting framework.

4.2.8 Singapore

The fact that exports accounted for 143 per cent of GDP in 2001 with over 50 per cent of these exports being electronic goods reflects the extent of the impact of the global slowdown on Singapore economy. GDP contracted by 2.4 per cent in 2001 against 9.4 per cent growth in 2000. The revival of the economy therefore largely depends on the upturn in the global electronic cycle and on the recovery in the US economy and other key partner countries. The manufacturing sector, the largest single contributor to the GDP, depends highly on electronic exports. Two major destinations of exports are Malaysia and the US. Demand from both countries declined in 2001.

Table 10: Key Economic Indicators - Singapore

	1998	1999	2000	2001	2002
GDP Growth (%)	-0.9	6.4	9.4	-2.4	2.2
Export Growth (%)	-15.0	5.8	19.8	-10.9	3.2
Openness (trade as a % of GDP)	251.6	271.8	292.3	275.9	274.1
Inflation (%)	-0.3	0.0	1.3	1.0	-0.4
Debt Service Ratio /1	n.a	n.a	n.a	n.a	n.a
Fiscal Balance (% of GDP)	0.7	3.4	2.5	-1.8	0.1

Sources: 1) SEACEN Trends and Outlook 2002 and various country reports
2) SEACEN Financial Statistics

1/ Percentage of export of goods and services

Despite strong economic fundamentals, monetary policy flexibility is constrained in Singapore as the Monetary Authority of Singapore (MAS) primarily targets the exchange rate in the implementation of monetary policy. Therefore, fiscal policy is the most viable instrument for policy manoeuvring in response to the lower external demand. The government implemented a series of off budget measures to boost domestic demand. In July 2001, the first off-budget measure, which was aimed at accelerating expenditures on economic and social infrastructure projects and cutting business costs through property tax and rental rebates, amounted to Singapore dollar (S$) 2.2 billion. In October 2001, another fiscal package amounting to S$ 11.3 billion was implemented with a range of corporate and personal income tax rebates; cuts in utility, education and hospital costs; the distribution of "New Singapore Shares" to citizens; assistance to SMEs; and the expansion of the social safety net program (ADB 2002). The two fiscal packages worth about 8.4 per cent of GDP have reversed the domestic downturn during the third quarter 2002. The fiscal package will turn the fiscal surplus in 2001 into a deficit in 2002 as a major part of fiscal package would be implemented during the fiscal year 2002. However, a significant recovery would mainly depend on the recovery in the US economy and NIEs in Asia as the weight of external demand on the domestic economy is much higher. Performance in the fourth quarter 2001 and the first quarter 2002 clearly indicates that the Singaporean economy is responding fast to the global recovery. On a seasonally adjusted basis, GDP grew by 1.7 per cent and 5.6 per cent during the two corresponding quarters, respectively[15].

MAS also eased its tight stance on the exchange rate target in October 2001 by widening its target exchange rate band, which

15. Country report submitted to the 37th Conference of the SEACEN Governors in June 2002

allowed greater flexibility in managing the exchange rate. With market and economic conditions becoming less volatile, the MAS restored to a narrower policy band in 2002. Meantime, the government also continued to restructure key sectors, particularly financial services, telecommunications, energy and the media, to improve their competitiveness. The government has already introduced some steps to liberalize the telecommunication and commercial banking sectors, which would improve the competition of these sectors.

4.2.9 Sri Lanka

Being a small open economy with relatively high dependence on international trade, the external slowdown affected Sri Lanka unfavourably. GDP growth recorded a negative 1.5 per cent in 2001 from a positive 6 per cent in 2000. This was the first year in which GDP contracted since gaining independence in 1947. Major sectors affected were manufacturing exports and tourism. The terrorist attack to the Sri Lankan international airport in July 2001 further aggravated the situation by affecting tourism, port related services, and international trade as a war risk premium was imposed on both sea and air freight. The September 11 attack worsened the situation. In addition, a severe drought affected agricultural output, and electricity generation adversely. The postponement of the implementation of economic reforms that were necessary to address persistent structural rigidities, which caused macroeconomic imbalances, due to political reasons, worsened the situation further.

Table 11: Key Economic Indicators - Sri Lanka

	1998	1999	2000	2001	2002
GDP Growth (%)	4.7	4.3	6.0	-1.5	4.0
Export Growth (%)	3.4	-3.9	19.8	-12.8	-2.4
Openness (trade as a % of GDP)	67.8	67.4	77.4	70.1	66.5
Inflation (%)	9.4	4.7	6.2	14.2	9.6
Debt Service Ratio /1	13.3	15.2	14.7	13.3	13.2
Fiscal Balance (% of GDP)	-9.2	-7.5	-9.9	-10.9	-8.9

Sources: 1) SEACEN Trends and Outlook 2002 and various country reports
2) SEACEN Financial Statistics

1/ Percentage of export of goods and services

As a result of these developments, the availability of standard stimulus macroeconomic policy options in response to lower external demand was constrained for Sri Lanka. The fiscal deficit exceeded the original target of 8.5 per cent of GDP to record 10.9 per cent in 2001. The Central Bank's policy interest rate (Reverse Repo) was 23 per cent at the beginning of the year. The significant policy development in the macroeconomic policy front effected in 2002 was the shift to a floating exchange rate regime from the managed exchange rate regime in January 2001. After the floatation of the currency in January 2001, the Central Bank was able to reduce the policy rate down to 14 per cent by the end of the year and continued to reduce the rate further in 2002. Short-term rates responded quickly, but general lending rates responded at a slower rate reflecting structural

problems in the banking sector. The change in the exchange rate regime not only halted the drain on official reserves under the previous managed floating system but also provided some space for the reduction in interest rates. Fiscal consolidation, a priority in the short-term, failed to achieve any progress during the election year 2001. As a result, Sri Lanka has become one of the member countries for which standard stimulus macro policy options are not available to mitigate lower external demand.

To reduce the vulnerability to external shocks, priority should be given to addressing structural rigidities that restrain strong fiscal adjustments. Meantime, reforms in the financial sector should also be expedited to make monetary policy transmission more effective. Further delays in the implementation of structural reforms, particularly in fiscal management will force Sri Lanka to follow cyclical fluctuations in the global economy. Further continuation of the fiscal imbalance will worsen the macroeconomic imbalance and consequently growth prospects will remain below potential.

4.2.10 Taiwan

In 2001, Taiwan experienced the weakest economic performance due to the global slowdown as Taiwan is a highly trade dependant economy with strong trade linkages with the US, Hong Kong and Japan. In 2001, GDP contracted by 2.2 per cent in comparison to a 5.9 per cent growth in 2000. This was the worst performance in 30 years. Machinery and electrical equipment sector was most severely affected, contracting by 12.0 per cent.

Strong economic fundamentals, which prevailed at the beginning of the recession, provided some space for Taiwan to use stimulus macroeconomic policies to mitigate the impact of the global recession. Taiwan implemented aggressive easing of monetary policy to cushion the effects of the declining external demand. Discount rates was cut

15 times since December 2000 to 1.375 per cent (historical low). Demonstrating the effectiveness of the monetary policy transmission mechanism, market rates also came down, reducing the cost of funds, which was beneficial to the economy. However, the aggressive monetary policy easing was not very effective in boosting consumer and investor confidence, as banks were reluctant to lend due to high and increasing levels of non-performing loans and concerns over corporate creditworthiness. Reforms in the financial and corporate sectors will improve the effectiveness of monetary policy implementation in Taiwan.

Table 12: Key Economic Indicators - Taiwan

	1998	1999	2000	2001	2002
GDP Growth (%)	4.6	5.4	5.9	-2.2	3.6
Export Growth (%)	-9.5	9.9	21.8	-17.3	6.3
Openness (trade as a % of GDP)	78.6	81.8	90.8	79.4	n.a
Inflation (%)	1.7	0.2	1.3	0.0	-0.2
Debt Service Ratio /1	n.a	n.a	n.a	n.a	n.a
Fiscal Balance (% of GDP)	0.1	-1.3	-4.8	-4.3	-4.2

Sources: 1) *SEACEN Trends and Outlook 2002 and various country reports*
2) *SEACEN Financial Statistics*

1/ Percentage of export of goods and services

A fiscal stimulus package also accompanied the monetary policy easing. A National Development Plan was launched to carry out a series of infrastructure projects costing about NT$ 800 billion. The Central Bank and the Ministry of Finance introduced NT$ 1.2 trillion in funds for a preferential housing loan project. However, there is a restriction on the use of fiscal policy in Taiwan due to the ceiling on new public sector borrowings which is 15 per cent of the total budget including debt repayments and contingent liabilities.

On the structural reform front, it is important for Taiwan to continue its ongoing reform agenda. In particular, financial reforms should be aimed at managing non-performing loans (NPL), which have been on the rise during the recession. Taiwan has taken necessary steps towards this direction by establishing asset management companies and providing necessary legal infrastructure to implement financial sector reforms. In July 2001, Taiwan promulgated the Statue for Establishment and Management of Financial Restructuring Fund totaling NT$ 140 billion. This fund absorbed losses of problematic financial institutions before turning their ownership to designated banks. In November 2001, the Financial Consolidation Act laid down the necessary legal framework for the establishment of asset management companies. Under this Act, a few asset management companies have already been set up. Amendment and legislation of the Banking Law, Insurance Law and Bill Finance Law will expand the business scope of financial institutions and improve their operational efficiency. Financial sector reforms will improve the effectiveness of macroeconomic policy responses and the impact will trickle down the economy faster, improving resilience of the Taiwanese economy to external events.

Taiwan's implementation of pragmatic policy responses in both macroeconomic and structural policy fronts anticipating a global slowdown even before the September 11 attack has improved its vulnerability to these kinds of external shocks. However, due to high

reliance on exports, particularly to industrial countries' markets, Taiwan was not able to avoid the contraction. Taiwan needs to withdraw policy stimulus gradually with the external sector recovery in order to maintain strong economic fundamentals in the medium term that provide flexibility in policy manoeuvering.

To reduce the vulnerability of the export sector, Taiwan also needs to reduce its high reliance on one sector, particularly electronics exports. This would further enhance Taiwan's resilience to global electronic cycles and move it to the next stage from a major manufacturing exporter to an exporter of high value added services. In fact, restructuring the export base is necessary for Taiwan as the present manufacturing base is being moved to mainland China to take the advantage of low labour cost. The emergence of a high value added service sector would address the resulting structural unemployment caused by the shift of manufacturing base to the mainland.

4.2.11 Thailand

GDP growth slowed down to 1.8 per cent in 2001 from 4.6 per cent in 2000 mainly due to the lower external demand. Export oriented sectors such as electronics and tourism, were affected. Thailand's exports were not affected as much as other regional economies due to its diversified export structure. For example, the share of electronics exports is 26 per cent; the lowest among major electronics exporters in the region. In terms of inflows to the current account, tourism and worker remittances also have a significant share of foreign exchange earnings reducing reliance on merchandise exports. The positive growth in domestically oriented industries during 2001 such as vehicles, parts, beverages and ornaments also cushioned the adverse impact of the external slowdown to a certain extent.

Table 13: Key Economic Indicators - Thailand

	1998	1999	2000	2001	2002
GDP Growth (%)	-10.8	4.4	4.6	1.8	2.5
Export Growth (%)	-6.8	7.4	19.6	-6.9	4.0
Openness (trade as a % of GDP)	83.4	85.3	106.9	107.9	n.a
Inflation (%)	8.1	0.3	1.6	1.7	2.0
Debt Service Ratio /1	21.4	19.4	15.4	17.4	15.0
Fiscal Balance (% of GDP)	-7.6	-11.2	-3.2	-2.1	-3.8

Sources: *1) SEACEN Trends and Outlook 2002 and various country reports*
2) SEACEN Financial Statistics

1/ Percentage of export of goods and services

Thailand implemented a mix of monetary and fiscal policies in response to lower external demand, as macroeconomic fundamentals were favourable. The fiscal deficit was declining to sustainable levels and the inflation was well below the upper range of the target in 2001. Headline inflation and core inflation were 1.7 per cent and 1.3 per cent respectively, while the target band under the inflation targeting framework was in the range of 0 - 3.5.

With low inflation, monetary policy is the most viable policy option, particularly in an inflation targeting framework for Thailand. The role of fiscal policy appears to be constrained to some extent due to relatively high government debt. At the end of fiscal year in

September 2001, the ratio of public debt to GDP had risen to 57 per cent of GDP from 15 per cent level prior to the financial crisis. The government has now imposed a ceiling of 65 per cent of GDP on public debt. In response to the lower external demand, the government adopted a front loaded fiscal policy, which began in the fourth quarter of 2001 and continued into the first and second quarters of 2002[16]. The fiscal package included a postponement of a VAT rate hike and provision of tax and non-tax incentives to real sector activities. As a result, fiscal deficit is expected to rise to 3.8 per cent of GDP during the fiscal year 2002 from 2.1 per cent in 2001. With signs of global recovery, Thai government recently announced a policy of medium term fiscal consolidation starting from 2003.

On the monetary policy front, Bank of Thailand lowered interest rate to 2.25 and again to 2 per cent in December 2001 and January 2002, respectively, to counter the declining aggregate demand. However, the monetary policy easing was followed by a policy tightening in June 2001, which raised interest rates by 100 basis points to avoid a higher depreciation of the baht due to large repayments of foreign loans by the private sector[17]. Thailand's use of interest rates to achieve exchange rate stability in the wake of large capital outflows is not consistent with measures needed to avert the declining domestic aggregate demand. In particular, during a period of declining aggregate demand, tightening monetary policy aimed at external stability could have adverse implications. Higher interest rates could worsen the situation by discouraging consumption and investment. This also could lead to an overvaluation of the exchange rate, which would have adverse impacts on the recovery in export performance.

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16. Country report submitted to the 37th Conference of the SEACEN Governors in June 2002
17. Country Report to the SEACEN Centre; 2002

However, the reversal of this policy towards the end of 2001 was a move in the right direction in light of the events on September 11. Thailand's recovery could have been more advanced if the stimulus policy package including both monetary and fiscal policy was introduced a little earlier. The economy started to recover from the first quarter 2002 with the global recovery whereas countries like South Korea that implemented stimulus policies promptly witnessed the recovery from the last quarter 2001.

With the recovery in external demand, fiscal consolidation is important for Thailand to maintain macroeconomic balance in the medium term. Thai authorities' commitment to inflation targeting and exchange rate flexibility will improve the resilience of the Thai economy to external shocks.

To help the policy response to take effect, existing structural weaknesses should be removed. In particular, the establishment of the Corporate Debt Restructuring Advisory Council would help cleanup balance sheets of both the financial institutions and the corporate sector through a voluntary process[18]. The establishment of the Thai Asset Management Corporation is also a significant step forward in the right direction. As a result, the ratio of remaining NPLs to total earning assets of the banking system has been continuously reduced from the peak of 47 per cent in 1998 to around 10 per cent in June 2002[12]. Implementation of legal reforms such as the revision of the bankruptcy law and necessary reforms to reinforce the prudential and supervisory framework for financial institutions and enhancing the independence of BOT will further strengthen the corporate and financial sectors in Thailand.

18. Country report submitted to the 37th Conference of the SEACEN Governors in June 2002

5. Summary and Conclusions

Analysis of country experiences suggests that although the impact of the slump in external demand is higher for highly integrated economies to the global economy, strong macroeconomic fundamentals can shield the economies from adverse impacts of the external shock to a significant extent. The stronger the macroeconomic fundamentals the broader the policy options available to minimise the impact of the external shock. For example, Korea, Taiwan and Thailand used a mix of both monetary and fiscal policies. For Singapore and Malaysia, fiscal stimulus was the major policy options available while monetary policy was accommodative due to less flexibility in exchange rate regimes. This group of countries had strong economic fundamentals at the beginning of the slowdown allowing them to use both fiscal and monetary polices. However, country like Singapore, which had deeper integration to the global economy, could not avoid the recession. The policy options would make the length of the recession shorter.

The Philippines and Nepal had the monetary policy option, as these countries were facing some fiscal constraints. Policy strategy was to implement structural reforms, which caused fiscal imbalances while using expansionary monetary policy in response to lower external demand. The Philippines adopted this policy successfully to minimize the impact of the lower external demand to a significant extent.

Indonesia, Sri Lanka and Mongolia encountered macroeconomic imbalances at the beginning of the slowdown which made macroeconomic policy options less available for these countries thus exposing them to the global downturn. Policy priorities for these countries were to implement necessary reforms in fiscal management, financial and corporate sectors that would reduce the vulnerability to these types of external shocks. The impact of the external slowdown is insignificant for Myanmar as it is still a very closed economy for international trade and finance.

The effectiveness of the policy responses would depend on the status of the domestic banking and financial and corporate sectors. Policy responses trickle down the economy faster if there are less rigidities in these sectors. Experience suggests that the recovery is most advanced in countries where these reforms have been implemented successfully. For example, the recovery is most advanced in Korea as it had already implemented major reforms in financial and corporate sectors successfully. Therefore, completion of initiated reform agendas and maintenance of strong economic fundamentals will provide more policy options for member countries in the event of uncertainty in the global recovery.

For countries with macroeconomic imbalances, priority should be given to address structural rigidities that cause these imbalances while attempting to use available stimulus polices to cushion the effect of lower external demand in the short term. However, these countries may have to face cyclical fluctuations of the global economy until domestic macroeconomic imbalances and structural rigidities are resolved.

Concerted efforts among member countries such as reducing trade barriers through multiple trading arrangements could also help reduce the impact of slowdown in industrial countries by diversification of export markets and products.

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