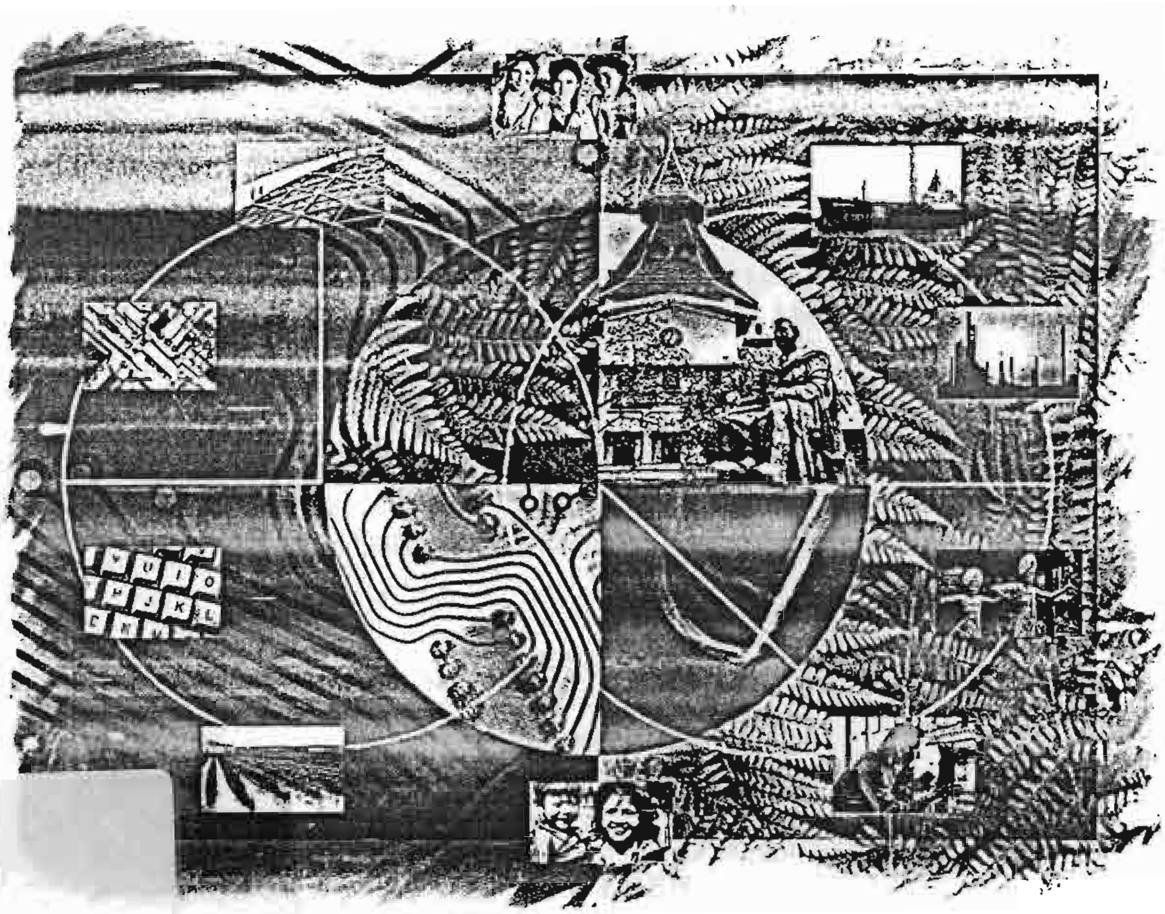
COUNTRY PAPERS

Bangkok, Thailand
October 28-29, 2002

International Conference on

ECONOMIC RECOVERY and REFORMS



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Indonesia

Economic Recovery and Reform in Indonesia

Hadi Soesastro
CSIS, Jakarta (Indonesia)

ABSTRACT

Amongst the crisis-hit countries in Asia, Indonesia was hit hardest. A great deal has been written about the origin and the unfolding of the crisis in Indonesia. The deterioration of its economic "fundamentals" was not immediately obvious as the economy continued to grow by about 7 percent in the first half of 1997, exports remain strong, the current account deficit was manageable, and the budget exhibited a surplus. Yet, the economy had became very vulnerable to external shocks. Short term debt had accumulated rapidly since the beginning of the 1990s, in part to finance long term projects. The banking system, which expanded rapidly following a major deregulation in 1988, had been under lax supervision. Economic liberalization and deregulation, which began in the mid 1980s, slowed down in the early 1990s. Certain sectors of the economy were re-regulated and a number of activities, in manufacturing and services, were given protection or other favorable treatment because of their close links to the power center. However, the depth of the crisis cannot be explained by these factors alone. In fact, it was the mishandling of the crisis that led to free fall of the economy and the currency (*Rupiah*) in the beginning of 1998. This was followed by the fall of the Soeharto regime that was in power for more than 30 years. The collapse of the regime resulted in an equally deep political crisis. In the four years since Soeharto's fall in May 1998, Indonesia has three presidents.

Given the depth of the economic and financial crisis, coupled, with the political crisis, Indonesia's recovery process had been slow, difficult, and frustrating. With each new government, a new recovery program was introduced, but its implementation was poor due to lack of economic leadership and administrative capacity as well as continuous political interference. The involvement of the IMF has been critical to the setting of the recovery and reform agenda, especially with the changes of government. However, IMF's tendency to "micro-manage" Indonesia's IMF-supported program has added to the difficulties in implementing it.

The Indonesian economy began its recovery in 2000. The economy grew by 4.8 percent, driven to a large extent by domestic consumption and export growth. This recovery, however, was not sustained. Economic growth slowed down to 3.5 percent in 2001. This performance was better than many other Southeast Asian countries. Malaysia, Singapore and Thailand were adversely affected by the slowdown of the US and the global economy, especially since September 11. However, these economies will recover more swiftly with a recovery of the US and the global economy. Indonesia, on the other hand, has to overcome a number of systemic problems internal to its economy and polity. Its slow "recovery without reform" is not sustainable. The banking system remains weak and, in fact, faces the danger of another crisis. The government's budget is experiencing a temporary relief as a result of higher oil prices and the successful rescheduling of public external debt through the Paris Club. The challenge of fiscal sustainability remains great.

Reforms are also necessary to enhance the economy's international competitiveness. The weak currency has been a factor in its international competitiveness, but this cannot be relied upon indefinitely. The competition from China and other economies in the region is real. Increased productivity, moving up to higher value-added production, and a further diversification of the economy requires new investments, especially from abroad. This also requires further reforms and the maintenance of political stability.

Indonesia's recovery and reform agenda has been formulated since the IMF was invited to help support the program. The agenda has not been without criticism, and over the years modifications have been made. Some lessons have been learnt. But the lessons drawn need to take into consideration the overall political environment, which at times had been favorable but at other times had caused severe obstruction.

INTRODUCTION

Amongst the crisis-hit countries in Asia, Indonesia was hit hardest. A great deal has been written about the origin and the unfolding of the crisis in Indonesia. The deterioration of its economic "fundamentals" was not immediately obvious as the economy continued to grow by about 7 percent in the first half of 1997, exports remained strong, the current account deficit was manageable, and the budget exhibited a surplus. Yet, the economy had became very vulnerable to external shocks. Short term debt had accumulated rapidly since the beginning of the 1990s, in part to finance long term projects. The banking system, which expanded rapidly following a major deregulation in 1988, had been under lax supervision. Economic liberalization and deregulation, which began in the mid 1980s, slowed down in the early 1990s. Certain sectors of the economy were re-regulated and a number of activities, in manufacturing and services, were given protection or other favorable treatment because of their close links to the power center. However, the depth of the crisis cannot be explained by these factors alone. In fact, it was the mishandling of the crisis that led to the free fall of the economy and the currency (rupiah) in the beginning of 1998. This was followed by the fall of Soeharto who had been in power for more than 30 years. The collapse of the regime resulted in an equally deep political crisis. In the four years since Soeharto's fall in May 1998, Indonesia has had three presidents.

Given the depth of the economic and financial crisis, coupled, with the political crisis, Indonesia's recovery process has been slow, difficult, and frustrating. With each new government, a new recovery program was introduced, but its implementation was poor due to lack of economic leadership and administrative capacity as well as continuous political interference. The involvement of the IMF has been critical to the setting of the recovery and reform agenda, especially with the changes of government. However, IMF's tendency to "micro-manage" Indonesia's IMF-supported programs has added to the difficulties in implementing them.

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Reforms are also necessary to enhance the economy's international competitiveness. The weak currency has been a factor in its international competitiveness, but this cannot be relied upon indefinitely. The competition from China and other economies in the region is real. Increased productivity, moving up to higher value-added production, and a further diversification of the economy requires new investments, especially from abroad. This also requires further reforms and the maintenance of political stability.

Indonesia's recovery and reform agenda has been strengthened through the IMF-supported program. The agenda has not been without criticism, and over the years modifications have been made. Some lessons have been learnt. But the lessons drawn need to take into consideration the overall political environment, which at times had been favorable but at other times had caused severe obstruction.

This paper begins with a discussion of the overall process of recovery and reform in the context of Indonesia's changing political landscape, affecting the implementation of the recovery and reform programs as well as relations with the IMF. This will be followed by an examination of the evolving programs and policies and the difficulties of implementing them. The final section looks at the overall macroeconomic performance under the recovery program over the last five years.

THE PROCESS

Initial Handling of the Crisis

The Indonesian crisis, which perhaps could be dated to 21 July 1997 when its currency fell by 7%, has been characterized by the extreme depreciation of the rupiah. In the following months the rupiah continued to slide. By 22 January 1998 the currency fell to a record low of about Rp 17,000/$, which amounted to a devaluation of more than 80% since it was floated on 14 August 1997.

The initial debate in the country centered on the link between currency depreciation and "economic fundamentals." One view suggested that Indonesia's economic fundamentals were as sound as they had ever been, and more sound than those of Thailand. Thus the large depreciation must have been caused by other factors. Yet, "contagion" alone cannot account for this. The financial health of the economy, or the lack of it, which was largely overlooked when assessing a country's economic fundamentals, was thought to play a critical role in the crisis. Some argued that "political fundamentals", including good governance, are equally important. The currency crisis as it unfolded came to be seen largely as a symptom of a much deeper crisis of confidence in the government.

The other view argued that the large depreciation must mean that Indonesia's economic fundamentals were much less sound than was generally believed, and that the public was not sufficiently informed about the real state of the economy. In fact, both views appear to converge in identifying the steps necessary to overcome the crisis, namely to increase transparency in both public and corporate governance, and to resume the reform process that seemed to have come to a halt. Indeed, concerns had been raised since about 1992 or so that the country was experiencing "deregulation fatigue". The crisis was thus seen as a blessing in disguise, in that it might produce a new sense of urgency that would revive the drive for economic reforms.

Pressures on the rupiah began to be felt following the decision by the Thai government to float the bath on 2 July 1997. On 11 July Bank Indonesia (BI), Indonesia's central bank, widened its intervention band to avoid having to sell foreign exchange to speculators in defense of the rupiah. On 13 August the upper limit of the intervention band was exceeded despite further interventions by BI. The next day, concerned that it may squander its foreign reserves, BI decided to let the rupiah float freely. The rupiah continued to weaken, and BI responded by tightening liquidity in its efforts to keep inflation under control and to stem the tide of large shifts into dollar holdings by residents. This policy was ineffective because the rupiah continued to slide. This tight money policy was widely criticized, including by President Soeharto himself. The monetary authorities gave in to these pressures but as a precaution BI put a limit on forward transactions in the foreign exchange market.

In mid September the Finance Minister outlined for the first time the government's program to overcome the crisis. It had five main objectives: (a) stabilization of the rupiah; (b) fiscal consolidation; (c) reduction of the current account deficit; (d) strengthening the banking sector; and (e) strengthening the private corporate sector. A number of measures were outlined to achieve these objectives. Among the measures were cancellation of a number of budget-financed (large) projects and the reduction of subsidies on fuel. On the banking sector, the government proposed the mergers of state banks and private banks and the liquidation of insolvent banks. Private companies were advised not to expand their activities, especially if they relied on foreign funding. The government also put an end to the 49% foreign ownership limit on Indonesian stocks.

Following this policy announcement the currency stabilized, but only briefly. By the beginning of October the rupiah had already depreciated by about 35%. Similarly, the Jakarta Stock Exchange index had fallen by 44%. There were reports that private companies were having difficulties to meet their external debt service obligations. This led the Cabinet to decide on 8 October to seek assistance from the International Monetary Fund (IMF). In his initial statement the Finance Minister explained that the government sought technical assistance from the IMF to strengthen the financial system. The possibility of financial support would be explored only as a precaution. It was somewhat obvious that President Soeharto was hesitant to draw in the IMF. However, during the process of exploration with the IMF it was felt that an IMF standby loan, backed by an economic program, was becoming necessary to restore confidence.

In comparative perspective, Indonesia had drawn in the IMF to help overcome the crisis ate an earlier stage than Thailand had done or Korea was to do. It had not drawn down its reserves. An agreement was reached with the IMF on 31 October 1997, in the form of a letter of intent (LOI) signed by the Finance Minister and the Governor of BI. The program to overcome the crisis and towards economic recovery, accommodating IMF's conditionality, were contained in the Memorandum of Economic and Financial Policies (MEFP) that was attached to the LOI. The program was to be implemented over a three-year period.

The program was built around three main pillars. First, a strong macroeconomic framework designed to achieve an orderly adjustment in the external current account, and incorporating substantial fiscal adjustment as well as a tight monetary stance. Second, a comprehensive strategy to restructure the financial sector, including early closure of insolvent institutions (banks). Third, a broad range of structural measures that also improve governance. The program was clearly aimed at restoring macroeconomic stability and confidence. Stimulating or revitalizing the economy was not the essence of the program. Indeed it was only much later that the problem of corporate debt and the revitalization of the economy were taken into consideration.
The first pillar was simply a continuation of the policies that were already introduced by the government since August. However, a much tighter budget appeared to have been demanded by the IMF. A budget surplus of 1% of GDP was aimed for. The justification for this stance was to support the required external adjustment, finance the costs of restructuring the financial sector, and bring down the government debt/GDP ratio.

Within the second pillar, the following day after the announcement of the program the government closed a total of 16 banks. This was a very controversial decision and may have caused an irreparable damage. As there was no deposit guarantee in place, the decision was a big shock to the public. This had led to waves of severe bank runs that forced the government to provide emergency liquidity to save the banks. This rescue operations turn out to be very costly for the government, and for the country. The media had reported that the IMF realized that it had given the wrong advise. However, liquidation of banks was already in the government's own agenda. On 2 September BI had already issued a decree regarding procedures for the liquidation of banks. However, nobody, including banks, appeared to have taken notice of this decree.

The third pillar was the structural reforms. In its design, the recovery program included a strong structural reform component. It was felt that the program, whose main aim was to restore confidence, would not have credibility if it did not have this third pillar. The Indonesian side in the negotiations, supported by the World Bank, could be the party that insisted on including this component in the program. The IMF was said to be reluctant to do so as it had no experience in managing it. Indeed, it is these structural reform measures that become the IMF's Achilles heel in its involvement in Indonesia. It one of the major causes of the mishandling of the crisis, resulting in the very deep and protracted crisis.

1997 - 1999: Difficult Recovery, Difficult Reform

Unlike the Thai and other previous IMF-supported programs, Indonesia's program has a strong structural reform component. Subsequently it became an integral part of IMF's approach, although the current Managing Director, Horst Koehler, has de-emphasized it. However, in the Indonesian case, it cannot be easily taken out from the program as progress in implementing an economic recovery program is constantly threatened by entrenched vested interests, corruption and poor governance, as well as lack of institutions and administrative capacity.

It should be noted that at the time of the Indonesian program any such agreement with the IMF was only announced, as the official document was not made available to the public. It was not long there after, following a lot of criticisms, that the IMF agreed to henceforth make such agreements public. As stated in the MEFP structural reforms were aimed at promoting greater transparency in policy making and competition to support ongoing restructuring of the economy. In regard to this the government intended to speed up its structural reform program through further trade and investment liberalization, and deregulation and privatization. Indeed, the public and the media focused their attention on the structural reform component of the program, and generally found that it did not go far enough. Nevertheless, it helped restore confidence, which proved to be short-lived.

As mentioned before, on 1 November the government announced the closure of 16 banks. Panic broke lose, leading to large withdrawals by depositors even from banks that were generally believed to be healthy. Public confidence in domestic private banks was shattered, literally overnight. Meanwhile, in cooperation with the Bank of Tokyo and the Monetary Authority of Singapore, BI began to intervene in the market to stabilize the rupiah. The government also issued a series of policy measures to implement the deregulation component of the program.

By the third week of November the crisis had hit Korea, resulting in renewed volatility in regional currency markets. The concerted intervention in support of the rupiah was terminated as it was felt that it could no longer be effective under those circumstances. In addition, President Soeharto showed great reluctance to implement the program. The September decision to cancel the implementation of large projects was reversed for 15 projects that were linked to the Palace. One of the 16 liquidated banks that was owned by Soeharto's son was allowed to continue to operate under a different name. In the midst of the crisis Soeharto gave approval for the first private petroleum refinery plant, costing $3.2 billion, to be built by a consortium that included his son.

The various policies introduced by the President who tried to reassert his authority created even greater uncertainties. In early January 1998 the President presented a draft budget to the Parliament that was different from the one that was outlined in the IMF-supported program. The market reacted negatively, causing the rupiah to plummet. The final straw came when the international media reported the alleged unhappiness of the IMF with the way Indonesia implemented the program (*Washington Post*, 8 January 1998). The rupiah hit the "psychological level" of Rp 10,000/$ (compared to Rp 5,000/$ at the end of December 1997), leading to an outbreak of panic buying. Supermarkets were emptied in no time. The IMF team had to come back to Indonesia to "rescue the rescue program".

Within a few days a new agreement was reached. It was a "strengthened" program that was signed by the President himself on 15 January 1998. It came to the surprise of many that Soeharto was willing to sign the agreement covering a program that included the commitment to bring all off-budget resources (controlled largely by Soeharto) into the budget, to again cancel infrastructure projects that were recently reinstated, to discontinue any government support given to the National Car Project (of Soeharto's other son), as well as to discontinue any budgetary or extra-budgetary support to the state-owned aircraft industry, IPTN, which was the pet project of Soeharto's favorite minister, Habibie. The press interview given by Soeharto following the signing of the agreement did little to convince the public that he was serious in implementing the program. If anything, it became all the more clear that Soeharto had his own plans, that was soon to become more apparent.

Soeharto established a Council for Economic and Financial Stabilization, chaired by himself, to undermine his economic team in the Cabinet. On 22 January 1998 the rupiah fell to its historic low of $17,000/$, following the nomination of Habibie as a vice presidential candidate by Soeharto's party, Golkar. The President used the collapse of the rupiah to discredit the IMF-supported program. Then in mid February, almost out of the blue, he indicated an interest in adopting the concept of a currency board system (CBS). In spite of the opposition by the Governor of BI to this idea, on 1 March, in his accountability speech to the People's Consultative Assembly (MPR), President Soeharto proposed a course of action that he called "IMF plus", which included the possible adoption of the CBS. In the second week of March, President Soeharto was re-elected for a seventh term. Subsequently the IMF announced that it was postponing the release of the second trance of its financial assistance because of concerns about Indonesia's commitment to the recovery and reform program, resulting in serious slippage in implementation. The slippage included: monetary policy being too loose; questionable personnel changes within BI, failure to lift the monopoly of Bulog, the state logistics agency; and circumvention of the agreement to abolish the plywood and clove cartels (under the control of a Soeharto crony and son, respectively). During the period of standoff with the IMF the economy continued to deteriorate rapidly. The condition was most serious in regard to the financial position of the domestic banking system.

A new Cabinet was announced on 14 March. Its first big task was to re-establish relations with the IMF. On 17 March an IMF team returned to Indonesia. A supplementary MEFP was submitted on 10 April following successful negotiations under the Coordinating Minister for the Economy, Ginanjar Kartasasmita. This was the first MEFP that addressed to debt problems of private corporations. But Soeharto's days were numbered. Riots began to break out and demonstrations demanding him to step down were on the rise. The announcement on 4 May of a 71% increase in fuel prices and a 20% increase in electricity prices provoked an escalation of social unrest. It culminated in a two-days rioting that left Jakarta devastated. As efforts to shore up his power were unsuccessful, President Soeharto stepped down on 21 May. He handed his power over to his Vice President, Habibie.

On the next day Habibie announced his Cabinet. Ginandjar Kartasasmita was retained as Coordinating Minister for the Economy. On 29 July 1998 under Ginandjar's leadership a new IMF-supported program was drafted. In comparison to the old program, it contained a strategy for corporate restructuring and a more elaborate bank restructuring program.

Table 1 List of Indonesia's IMF Supported Programs
31 October 1997 - 7 June 2002

Date	Agreement	Signatory (ies)	IMF Review
31/10/1997	MEFP	MoF, Gov.BI a)	
15/01/1998	'Strengthened ' MEFP	Pres. Soeharto	
10/04/1998	Supplementary MEFP	Coord. Minister b)	completed
Soeharto's Seventh Term			
24/06/1998	Supplementary MEFP	Coord. Minister b)	completed
Habibie Government			
29/07/1998	New MEFP*)	Coord. Minister b)	
11/09/1998	Supplementary MEFP	Coord. Minister b)	completed
19/10/1998	Supplementary MEFP	Coord. Minister b)	completed
13/11/1998	Supplementary MEFP	Coord. Minister b)	completed
16/03/1999	Supplementary MEFP	Coord. Minister b)	completed
14/05/1999	Supplementary MEFP	Coord. Minister b)	completed
22/07/1999	Supplementary MEFP	Coord. Minister b)	**suspended**
Wahid Government			
20/01/2000	New MEFP+)	MoF, Gov.BI, Coord. Minister c)	
17/05/2000	Supplementary MEFP	MoF, Gov.BI, Coord. Minister c)	completed
31/07/2000	Supplementary MEFP	MoF, Gov.BI, Coord. Minister d)	completed
(New Wahid Cabinet)			
07/11/2000	Supplementary MEFP	Gov.BI, Coord. Min. e)	**suspended**
Megawati Government			
27/08/2001	Extended MEFP")	MoF, Gov.BI, Coord. Minister f)	completed
13/12/2001	Extended MEFP")	MoF, Gov.BI, Coord. Minister f)	completed
09/04/2001	Supplementary MEFP	MoF, Gov.Bi, Coord. Minister f)	completed
07/06/2001	Supplementary MEFP	MoF, Gov. BI, Coord. Minister f)	???

*)Second Arrangement; +)Third Arrangement; ")based on Third Arrangement.
a) Mari'e Muhammad and Soedradjad Djiwandono
b) Ginandjar Kartasasmita
c) Bambang Soedibjo, Sjahril Sabirin, Kwik Kian Gie
d) Bambang Soedibjo, Anwar Nasution, Kwik Kian Gie
e) Rizal Ramli, Anwar Nasution
f) Boediono, Sjahril Sabirin, Dorodjatun Kuntjoro-Jakti

For the next one year, six successful reviews of the program took place (see Table 1). But the Habibie government was entangled in a serious scandal of political financing (the Bank Bali scandal) to help win his election as president. The scandal perhaps involved Habibie himself, a number of his ministers, the GOLKAR party, and allegedly also the Governor of BI. The Governor of BI was taken to court, sentenced, but following an appeal he was later acquitted, while some ministers have been sentenced, but others have not been investigated at all). The government refusal to publicize the audit on Bank Bali by PricewaterhouseCoopers, as demanded by the IMF led to a second standoff with the IMF, resulting in a suspension of the program in September 1999.

At the General Session of the People's Consultative Assembly in October 1999, Habibie's "accountability report" was rejected by 355 votes to 322. He decided to withdraw from the presidential race. Although Megawati came out as the "winner" in general elections in June, because her party, PDI-P, won the largest votes, she lost against Abdurrahman Wahid, who joined the presidential race at the eleventh hour. There was the hope that from then Indonesia will be on its way towards sustained recovery.

Since 2000: Slow Recovery without Reforms

The honeymoon period following the election of Abdurrahman Wahid as President under a more democratic system was only a brief one. It basically ended with the announcement of the National Unity Cabinet. Wahid's cabinet was a great disappointment to many. Firstly, it did not reflect the spirit of "reformasi" (reform) because it was not free from individuals that were associated with the *status quo* forces. Secondly, it was regarded as a "political" cabinet rather than a cabinet that can deliver the reforms because it incorporated all major political parties with diverse interests and agendas. Thirdly, the capability of the economic team was highly questioned as it consisted of politicians from different parties (and some military officers) with no technocratic background.

Abdurrahman Wahid, known as Gus Dur, was fully aware of these shortcomings. He had consciously made a political "trade off" between effective government on the one hand and national unity and reconciliation on the other hand. Gus Dur was of the view, even before assuming the Presidency, that national unity and reconciliation should be given highest priority. He was deeply concerned with the political polarization in the country. This had motivated him to run for the Presidency himself in order to prevent a deepening rift within the nation between the nationalists, represented by Megawati, and the Muslims that are organized into different groups and factions that initially rallied behind Habibie.

The economic situation of the country remained dire. The President, however, was least interested in the economy. There was the hope that he would grow in his job and would begin to attend to the economic problems of the country. When installing the National Economic Council (*Dewan Ekonomi Nasional*) at the beginning of December 1999, President Wahid stated that the Council's main task was to advice him on economic matters, specifically to provide him with a "second opinion". He further stated that this was deemed necessary because his cabinet was the result of "horse trading" with various political parties. Gus Dur did not personally know a number of the candidates but accepted them under that guarantee. It was clear from the outset that those ministers would have difficulties working together unless there was strong leadership from the President himself or from the coordinating ministers.

Soon the media was full of reports about the lack of cooperation and coordination among members of the economic team. The media exposed the struggle between two ministers simply as a struggle between two political camps. However, observers believed that the struggle was one for the control over financial resources by competing political parties. Gus Dur was given 100 days by opinion leaders to prove that his "political" cabinet could deliver. Initially it was widely believed that this kind of pressure would have no constitutional implications. He was legitimately elected by the People's Consultative Assembly (MPR), and constitutionally only the MPR can unseat him. However, as a reaction to the earlier period, the MPR session was to meet every year Instead of every five years, and the MPR could ask for an accountability report by the President every year. The first annual session was scheduled for August 2000. There was, thus, an implicit "threat" of the possibility of a constitutionally legitimate change of government before the end of the term of the president. There was the hope that this could provide an incentive for the Wahid Administration to shape up.

After returning from his trip to Europe, Gus Dur decided to take charge of the economy himself. Despite the assistance given by his two economic councils, the National Economic Council (or *DEN*) and the National Council for Business Development (or *DPUN*), the President failed to exercise economic leadership. With a weak economic team in the cabinet, it was the executing agencies that held the key to the successful implementation of policies to revive the economy. In resolving the crisis the previous government had established new institutions, which included the Indonesian Banking Restructuring Agency (IBRA), the Indonesian Debt Restructuring Agency (INDRA), and the Jakarta Initiative Task Fore (JITF). Together with Bank Indonesia, the Ministry of Finance, the State Minister for Investment and State Enterprises, all those "crisis institutions" were to be involved in the gigantic task of *credit restructuring*, which was one of the main tasks towards the recovery of economic activities. Coordination amongst these institutions and agencies was at best very weak and of an *ad-hoc* nature.

Since the Habibie Administration there was a lot of political interventions towards those "crisis" institutions, IBRA in particular, as these institutions are where possibilities exist for mobilizing financial resources for political funding. The Bank Bali scandal was a clear case in point. There was also intervention towards state banks to conceal huge non-performing loans of politically connected companies. For the very first few days of the Wahid Administration there were also attempts by certain political groups to gain control over IBRA, the institutions that is in control of a lot of "nationalized" assets. To prevent this from happening, the strengthening of IBRA was stipulated in the new three-year IMF-supported program, agreed upon on 21 January 2000.

The new program canceled the 29 July 1998 program and would extent to December 2002. As will be elaborated upon later, this new program incorporated a medium-term agenda with four components, namely a medium-term macroeconomic framework, restructuring policies, rebuilding economic institutions, and improving natural resource management. The medium-term macroeconomic framework was to outline the recovery while maintaining price stability. The targets were set for a 5 to 6 percent growth over the medium term with inflation below 5 percent. Other targets included gross international reserves at about six months of imports, and a gradual reduction of public debt to GDP from more than 100% in 2000 to 65% by the year 2004. The new government was reluctant to adopt even a slightly expansionary fiscal policy. This stance was taken to limit foreign borrowing (including development assistance).

Implementation of the new IMF-supported program was extremely slow. In April Gus Dur reshuffled the Cabinet. The public responded negatively to this decision, suspecting that the new ministers were to become Gus Dur's instruments in his drive to mobilize financial resources for political purposes. In addition, it also became apparent that the Wahid government was not serious in dealing with the KKN (*korupsi, kolusi, nepotisme* or coruption, collusion, and nepotism) issues. In fact, it was itself already entangled in such issues. By June 2000, there were three cases of KKN that had links with the President. One of this was the Bulog scandal (Bulog-gate), which eventually led to his removal from office.

IMF loan disbursements were delayed because of the above as well as the poor implementation of the new program by the economic team, which was basically opposed to an involvement by the IMF. However, public pressures began to mount for the government to be serious about its recovery and reform program. In May and again in July, the government issued a supplementary program, and again in July. The August session of the MPR began with the possibility that some of its members would mount a serious effort to impeach the President. His "progress report" was poorly received. In response to the criticism the President agreed to delegate much of the authority for day-to-day administration to the vice president, Megawati. On 29August he also streamlined his Cabinet and installed a new economic team, headed by Rizal Ramli, who was openly critical of the IMF.

Nevertheless on 7 September the new economic team issued a new Letter of Intent and a supplementary MEFP which was to become the basis for further IMF support. The document stipulated a 10 Point Economic Recovery Program, which was known to be drafted by the new Coordinating Minister himself. This was to give "ownership" to the program, which until then was largely prepared and drafted by the IMF team. This 10 Point Program consisted of the following:

- Maintain macroeconomic stability with the support of IMF/World Bank/ADB.
- Reduce unemployment by creating jobs in all regions.
- Improve agricultural productivity and farmer welfare.
- Increase non-oil export revenues, particularly in manufacturing and agro-industry.

- Promote domestic and foreign equity investment.
- Expedite banking and corporate restructuring.
- Accelerate privatization of state-owned enterprises.
- Initiate comprehensive small and medium scale enterprises (SME) development program.
- Ensure sustainable development of natural resources.
- Implement economic decentralization through an orderly and phased transition.

Many of the points in this new program were never translated into plans of action. In November the government and the IMF met to discuss the (third) review of the program, which was the first review under the new economic team. Implementation of the program was deemed to be too slow. Ramli complained that the IMF was pressing too hard. He argued that it was difficult to implement every reform, while the country was going through a complex transition to democracy. In December the IMF suspended the further disbursement of its funds. In February 2001 Rizal Ramli went to Washington, DC for talks with the IMF. It failed to break the deadlock. Rather surprisingly, on 23 February the World Bank announced that it was sharply reducing its assistance to Indonesia under the new program. Restoration of higher funding levels was made conditional upon economic reforms and improved governance.

The suspension was a major blow to Indonesia's foreign credibility. However, as stated by Dick (2001), it "served the government's political agenda bv showing the government as standing up to foreign pressures." Although the IMF had become as much hostage to the government as vice-versa, it did not give in. Yet, in securing its objectives, the IMF was drawn more closely into the political process. In a sense, the IMF was the remaining voice for policy discipline. Dick (2001) argued that it remained an open question whether continuing IMF tutelage is a good or a bad thing. There is a kind of "moral hazard" in the nature of the support program. It "creates perverse incentives for the government to act irresponsibly in public, while making excuses and apparent concessions in private." It is not unusual that the government would evade responsibility by portraying the IMF as imposing harsh or unrealistic discipline.

In April the IMF sent another high-level-mission to Jakarta to get the relationship moving. But this mission slipped quietly out of Jakarta. The IMF insisted that the government revised the state budget because of the danger that the budget deficit would be blown out by the growing economic and political instability to a level of 6% of GDP. Relations between the President and the Parliament had become very tense. The President was not willing to respond to the two Memoranda from the Parliament in relation to his involvement in the so-called Bulog-gate. In his effort to deflect his critics, the President made a plan to hand over "constitutional duties" to the vice president. However, Megawati rejected the plan. On 30 May the Parliament called for a special session of the MPR. That was the beginning of Gus Dur's ending.

A special session of the MPR was initially scheduled for 1 August. President Wahid made it known that he would not attend the session because he regarded it as unconstitutional. On 22 July he wrote a letter to the MPR board stating the above. In response to this, the special session was brought forward to 23 July. In the evening of 22 July the President declared a state of emergency, which allowed him to dissolve the Parliament, and with that the MPR would no longer exist. The decree was ignored by the MPR, and on 23 July a Supreme Court decision stated that the decree had no constitutional basis. There was little support left for President Wahid. He was dismissed by the MPR for refusing to make himself accountable and for issuing the decree. The MPR elected Megawati as Indonesia's fifth President, the third in just 40 months after the fall of Soeharto in May 1998.

It took Megawati about three weeks to form her Cabinet. There was a lot of praise for the economic team in the Cabinet. Indeed, they moved swiftly to mend relations with the IMF. On 27 August the government produced a MEFP, which was built upon the MEFP of 20 January 2000 (the 3rd Program) as the basis for renewed IMF support. This led to the disbursement of a $400 million loan. Another "extended MEFP" was issued on 13 December, with a request to the IMF to extend the program to December 2003. Two supplementary MEFPs were issued in April and June 2002. A review that was to be completed before the end of September 2002 was not concluded. This suggests the limited capacity of the government to implement the program. Is this mainly because of the nature of the program or because of the weak economic and overall leadership of the country? Meanwhile there were increased calls for the government to terminate the program with the IMF when it ends in December 2003. A small group has demanded that the program be ended in December 2002.

The Megawati government has entered its second year. Megawati has passed her first year in office albeit not with flying colors. The media and public opinion have been rather harsh in evaluating the performance of her government in its first year. The general view is that the government has failed to implement the necessary reforms. This is particularly the case with legal reform. Political reform and economic reform have been slow. The economic recovery program was kept on track largely through the IMF-supported program. Yet, the ability of the IMF to act as the "police" in maintaining policy discipline may be waning, perhaps more rapid than generally anticipated.

Although the economy grew by about 3.5 percent in 2001, this is not good enough for Indonesia in view of the need to create job opportunities for the 2.5 million people entering the work force each year. Observers are of the view that a 3 to 3.5 percent growth rate is the "natural" growth rate for the Indonesian economy, this natural rate being the result of population growth. It cannot be regarded as an achievement of the government.

The Indonesian economy can be said to be recovering if it can grow again by 6 percent or more per annum. However, this higher growth rate must be accompanied by its sustainability and improved social justice and greater equity. That is why Indonesia's agenda for economic recovery must include wide-ranging reform measures, covering improved economic governance and the establishment of new economic institutions. This is not an easy task.

In the meantime, efforts to rehabilitate the failed banking and financial system have not been all that successful despite their high cost, particularly to the government. The burden to rescue failed banks and to recapitalize others is carried by the government through its budget that is already very tight. And this burden will be felt for many years to come. It is the government that bears the costs of the financial crisis of 1997/98 which largely originated with the private sector. The domestic debt of the government increased from virtually nothing at the onset of the crisis to about 50 percent of GDP.

In addition, private debt restructuring has been extremely slow. Many private companies have been trying to get out of the problem by being bailed out by the government. A few, politically connected business groups have been rather successful in soliciting the government's helping hand. However, this too resulted in higher contingent liabilities on the part of the government.

Private assets that fell into the hands of the government in exchange for the government's assistance to banks are being handled by the Indonesian Banking Restructuring Agency (IBRA). It is the policy of the government to dispose of these assets as quick as possible. The process has been extremely slow and frustrating. Apart from problems non-cooperation by previous owners, the agency itself suffers from a deficit of competence and transparency, perhaps also honesty, and the inherent difficulties of restructuring. But equally problematic has been the problem of political interference. The sale of these private assets is one source of funding political activities. The Bank Bali scandal during the Habibie presidency exemplifies this problem.

The government's policy to finance up to a significant portion of the budget deficit with domestically mobilized resources is a good way to force IBRA to expedite the process of assets disposal as well as to accelerate the program of privatization. Both asset sales and privatization are expected to finance about 70 percent of the budget deficit, the remaining 30 percent being financed through foreign assistance.

The tight budget has also been helped by the willingness of donor governments to reschedule public external debt service payments. This rescheduling exercise through the Paris Club has been repeated for three times and in all likelihood will have to be repeated again in the years to come to give Indonesia the necessary breathing space to overcome the bunching of debt, both external and domestic, in 2003 to 2006.

Central government development outlays have significantly decreased in the last few years. This is also caused by fiscal decentralization as part of the implementation of regional autonomy. It is as yet unclear as to how local governments will allocate their spending for infrastructure, education and health, expenditures that have impacts on the country's future growth potentials.

In the first few years, there are likely to be problems in the implementation of regional autonomy. Capacity in the regions is still weak, but problems in the implementation are caused to a large extent also by the absence of clear implementation regulations. In addition, local governments are trying to maximize local revenues in the short term by introducing new taxes and other user charges. Many of these new taxes and user charges do not make sense and result in high economic cost. Efforts are being made by the central government to control this but with mixed results. There is also the problem of the sharing of revenues from natural resources between the central and regional governments. Disputes on this matter have caused problems for investors in particular in mining and forestry. The weak government at the center is not helpful to resolving this problem.

Perhaps, the bright side of the picture is that the country has been spared from major political upheavals since Megawati assumed the presidency. There is "quasi" stability. There is political guarantee, reiterated recently by the Chairman of the People's Consultative Assembly (MPR), Amien Rais, that Megawati would stay through 2004.

The government has not been at the forefront in promoting the country's reform agenda. Neither is the parliament. In fact, the parliament has been blocking a number of efforts by the government. Megawati's government appears to suffer from a serious paralysis. She herself is not a champion of the reform. In the political field, she is on the conservative side. In the economic field, she lacks the ability to comprehend the scope and depth of Indonesia's economic problems.

The "muddling through" scenario is still as valid for Indonesia today as it was a few years ago. There are still no political breakthroughs and none is expected to happen in the foreseeable future. Indonesia and the leadership are still in a state of drift. In the short term perhaps even this "quasi" stability is not bad. However, the longer term prospects are worrying if such "quasi" stability continues for an extended period. This stability is characterized by the absence of political upheavals but there is only little movements, especially in pursuing the country's reform agenda.

THE PROGRAMS AND POLICIES

Indonesia's recovery program, as formulated in its first IMF-supported program, is built around three main pillars: First, a strong macroeconomic framework. Second, a comprehensive strategy to restructure the financial sector. Third, a broad range of structural reforms. Subsequently, a fourth element has been included, namely measures to restructure corporate sector debt.

Macroeconomic Policies

Fiscal Policy. The government's fiscal policy was initially very tight, aimed at a surplus of 1% of GDP. To achieve this objective, the government began with a program to adjust administered prices of petroleum products and electricity, with a view to eliminating subsidies for these products. Other measures included the introduction of local sales tax on gasoline, increased revenues from the luxury sales tax, and increased revenues through land and building tax. However, most importantly was the plan to improve tax administration in general and the structure of the tax system. In addition, it finally took steps to consolidate all off-budget funds into the budget.

The target of a 1% surplus in the 1998/99 budget was abandoned due to the sharp depreciation of the rupiah and the deterioration of the economy. Additional measures to strengthen the budget were introduced. These included the increase in excises on alcohol and tobacco, and the removal of all VAT exemptions. As described earlier, the government canceled 12 major infrastructure projects, many of which were to be undertaken by Soeharto's cronies or children.

Continued sharp deterioration in economic conditions in the first quarter of 1998 greatly endangered the budgetary position. It was estimated that the budget deficit could increased to 6% of GDP. Additional measures were introduced to limit the deficit to about 3% of GDP. This level was determined by the possibility of additional foreign financing. The further deepening of the crisis, following the social turmoil and political changes, put severe pressures on the budget, especially since the government introduced a social safety net (SSN)program to alleviate the impact of the crisis on the poor. The overall cost of the SSN program was initially set at about 7.5% of GDP. There were few options left to reduce the deficit, except for further cuts in infrastructure projects.

By July 1998 the new government under Habibie formulated a new program. In view of the above developments, the IMF allowed Indonesia to run a fiscal deficit of up to 8.5% of GDP to provide room for increased social spending. However, as it turned out, the social impact of the crisis was less severe than initially estimated. This high level of deficit was never reached. In addition, implementation of many development programs was slow, mainly due to administrative delays. During the first five months of the fiscal year, the budget recorded a small surplus. Increased criticisms by the public on the implementation of the SSN programs led the government to develop an internal government oversight mechanism to ensure accountability as well as schemes to cooperate with local governments and civil society. The actual budget deficit in 1998/99 was only 2.1% of GDP. It failed to deliver the planned stimulus.

The 1999/2000 budget was projected to experience a deficit of almost 6% of GDP. This deficit was to be financed not only from external resources but also from bank asset recoveries. A "high quality fiscal stimulus" was to be achieved through better targeting and monitoring of public expenditures. With the assistance of the IMF, the government began to outline structural fiscal reforms, including fiscal decentralization. The latter was to response to the decentralization program that was approved by Parliament and would begin as soon as in 2001. Due to development spending shortfalls, the fiscal deficit for 1999/2000 was much lower than projected.

In 2000, the budget year was moved to coincide with the calendar year. The 2000 budget was drafted by the new Wahid government. This budget was based on five principles, namely: (a) to strike a careful balance between supporting the economic recovery and starting the process of reducing government debt; (b) to continue to avoid domestic bank financing; (c) to initiate a range of structural tax reforms; (d) to start the process of gradually reducing untargeted subsidies; and (e) to begin to restore public sector wages. A budget deficit of 5% of GDP was expected, which was to be financed about equally from foreign sources and domestic sources (asset recovery and privatization). In the end, higher oil prices helped to reduce the pressures on the budget.

Given the high level of debt, especially domestic debt, that had been building up during the crisis, the 2001 budget was designed to restore fiscal sustainability over the medium term. One major component of the policy measures to achieve this goal is the reduction and restructuring of subsidies, a politically sensitive and difficult issue to handle for the government, particularly in the new political environment. The original 2001 budget deficit was set at 3.7% of GDP. The Megawati government that adopts a conservative fiscal policy stance, as its predecessors, was able to contain the budget deficit within that target. As part of its medium-term fiscal consolidation strategy, the 2002 budget targeted a further reduction in the deficit to 2.5% of GDP. Domestic budget financing was targeted at 1.4% of GDP. The draft budget for 2003, recently submitted to the Parliament proposed a budget deficit of 1.5% of GDP. Fiscal sustainability continues to be a serious challenge in the years to come due to the high level of public debt and the pressures of fiscal decentralization..

Monetary Policy. From the outset the government was determined to adopt a tight monetary stance, essentially to support the exchange rate. The wisdom of achieving exchange rate stability as an objective for monetary policy (by using interest rates) has been questioned. The ceiling on base money, which is a main performance criterion in the program, would be adjusted automatically in line with the net international reserves position. Monetary policy remained focused on controlling inflation. The implementation of this policy, however, was hampered by problems in the banking system. As a consequence of the closure of 16 banks discussed earlier, the public had shifted sizable amounts of deposits to state and foreign banks. This led to a bifurcation of the banking system: a large number of banks faced liquidity shortages and were unable to obtain sufficient funds in the interbank market (even at interest rates of up to 75%), while a smaller group of banks became very liquid and were trading amongst themselves at a low rate (of 15%). This had complicated the task of monetary policy. Bank Indonesia (BI) had to provide liquidity support to distressed banks, while withdrawing funds from banks with excess liquidity. The IMF had voiced its concern about monetary loosening. By the end of 1997, as discussed earlier, interest rates were further increased but the rupiah continued to fall.

The liquidity support to banks led to an expansion of central bank credits. In response, monetary policy was further tightened to bring the exchange rate to a more appropriate level and to reduce inflation.

From mid 1998 BI introduced a new system to strengthen monetary management. The system whereby interest rates on SBIs (central bank paper) are set administratively was replaced by an auction system. This will also promote the emergence of a market-determined term structure of interest rates. By late 1998, the Habibie government was becoming more concerned about the impact of high interest rates on the banking system and the corporate sector. The mood was to introduce a more "flexible" monetary policy, to reduce interest rates but at the first sign of inflation or weakening of the exchange rate a tightening of monetary policy would be reintroduced. During the last quarter of 1998, the base money was allowed to grow by 6%. The rise of base money above the target in February 1999, largely due to uncertainty about the bank restructuring program, led to a new round of tightening. For fiscal year 1999/2000 as a whole, the base money increase was set at 9.5%.

BI which had become an independent institution since mid 1999 focused its monetary policy on the control of inflation, more precisely on the so-called "core" inflation. It faced continued pressures to reduce interest rates, and often tried to accommodate those pressures. On the other hand, it did not try to tighten monetary policy further when there were increased inflationary pressures resulting from sources beyond its control, such as adjustment of administered prices or confidence problems. The issue of independence of the central bank remains controversial, and the unresolved revision of the Central Bank Law is another main factor that weakens BI monetary management. It should also be mentioned that for an extended period BI was headed by a Governor that was sentenced by the court but refused to resign, and more then half of its directors had tendered their resignation but remained in place so long as their replacement cannot be decided upon given that revision of the Law remains a pending issue.

At the end of December 2001 the government admitted that it was unable to keep base money growth within the target. This was blamed on prolonged political instability and uncertainty over the direction of economic policies. Furthermore, the impact of upward adjustments in administered prices has added to the higher inflation since mid-2000. The policy of the Megawati government is to restore single digit inflation by the end of 2002. To this end, BI will gradually reduce base money growth to 12-14% by the end of 2002 from about 20% at the end of 2001. By mid-2002, inflation had been brought down, and interest rates began to fall. It remains to be seen whether this would help stimulate the economy that has experienced a weakening, both due to internal conditions and external developments.

Financial Sector Restructuring

The critical importance of financial sector restructuring for the success of the recovery program has been realized from the outset. The main challenge was to be able to overcome the problem of high nonperforming loans (NPLs) of the banking system. There was, in fact, great underestimation of the extent of NPLs in both private national and state banks.

A four-part restructuring program was undertaken. The first measure taken was to close insolvent banks. This led to the closure of 16 banks on 1 November 1997. The second was to require weak, but viable, banks to formulate and implement rehabilitation plans. The third was to resolve the specific problems of state and regional development banks. A plan to merge state banks was also announced on 1 November. The fourth part was to improve institutional, legal, and regulatory framework for banking operations. On the latter, prudential regulation enforcement, a key task in strengthening the financial sector, has been attempted through the establishment of a graduated system of penalties for noncompliance. This could culminate in the withdrawal of banking license. To strengthen the institutional infrastructure for banking, the following measures were taken: (a) revise the legal framework for banking operations; (b) improve transparency and disclosure in banking; (c) level the playing field for foreign investors in banking; and (d) eliminate all restrictions on bank lending.

At the end of January 1998 the government announced its long awaited rehabilitation program for the banking sector. The program has two elements. The first is the government's full (blanket) guarantee to all depositors and creditors of locally incorporated banks. The second is the creation of the Indonesian Banking Restructuring Agency (IBRA) that is to become the key player in the restructuring of the banking sector.

The cost of the guarantee is huge, although it becomes real only in the case of a default. This effectively means that BI assumes the risk of the banking sector. At the announcement, the intention was to have the guarantee in place for at least two years and in due time it will be replaced by a deposit insurance system. Four years after its introduction the system is still in place and no replacement is being seriously prepared. IBRA also has a limited lifespan and will be terminated in 2004. IBRA's two main functions are to supervise banks that are in need of restructuring and to act as the management agency for assets that it acquires in the process of bank restructuring. The cost of IBRA turns out to be high as well.

A total of 54 banks, representing 40% of banking assets, were immediately brought under IBRA's supervision. In April1998 the government announced the suspension of seven relative insignificant banks while a further seven banks that could continue operate were placed under IBRA's management. The latter includes some of the largest national private banks, which comprise 20% of the banking system assets and account for 75% of the total liquidity support provided by BI to the banking system. The liquidity support given exceeded 500% of equity. The transfer of banks to IBRA was crucial for stopping the flow of liquidity support to banks and for BI to regain monetary control. However, the transfer to IBRA is only the first step in restructuring the banking sector. Its real task is to restructure the banks. This is an enormous task for such a new institution.

In the May riots, BCA, the largest national private bank, became the target of looting due to its close connections with Soeharto. This was followed by a huge depositors run, creating enormous problems not only for the bank but for the financial system as well. BI had to provide substantial liquidity support and the bank was placed under IBRA's management.

In June 1998, the 128 private banks were grouped into three categories: 32 banks were placed in category A (having CARs of more than 4%); 62 in category B (with CARs of between -25% and 4%), and 34 in category C (with CARs below -25%). Those in category C faced the prospect of being forced to close or merge with other banks unless they could raise their CAR above -25%. Restructuring of state banks has been conducted in a separate program. This too has been slow. Recapitalization of two large state banks, BRI and BNI, was completed only in July 2000.

The total cost of bank restructuring, which includes the cost of recapitalizing banks to an 8% CAR (capital adequacy ratio) and of repaying Bank Indonesia for the liquidity support provided to banks taken over by IBRA, was estimated in the April1998 IMF-supported program to amount to about 15% of GDP. This is financed by issuing government bonds. It turned out later to be much costlier and reached the order of 50% of GDP.

Throughout 1998 the conditions of banks continued to deteriorate. A comprehensive strategy was drawn to arrest this situation. Weak banks will be addressed through a combination of mergers, recapitalizations and freezings. Deposits of a frozen bank will immediately be transferred to a designated recipient bank. The bad loans of banks will be transferred to an Asset Management Unit (AMU) within IBRA. In all cases, depositors and creditors will be fully guaranteed. All bank are to achieve minimum CARs of 4% by end-1998, 8% by end-1999, and 10% by end-2000.

The bank recapitalization program did not go smoothly. By mid-November 1998, only 27 of the 54 banks under the control of IBRA was audited. There was considerable opposition to the program. Bank's owners, on their part, feared that they would loss control of the banks. There was also concern that the costly recapitalization will transfer wealth from the general public to the wealthy elite who are the principal shareholders of the banks. Essentially, the government lacked a clear and coherent program for bank recapitalization. Details of the bank restructuring program were announced in March 1999. The government closed down a further 38 banks (in category B and C), took over 7 banks (category B), and recapitalize 9 banks (category B). The recapitalization was undertaken jointly, roughly 80% by government and 20% by the original owners. Delays in the restructuring of the banks had greatly increased the cost of the exercise.

It was in January 2000 when BI publicized its estimate that the total amount of government bonds needed to recapitalize the banks would amount to about 51% of GDP. The bonds comprise two parts: (a) those needed to replace the loans made by BI to failed or taken over banks; and (b) additional bonds needed to restore a CAR to 8% by end of 2001.

IBRA was under great stress to sell off assets and restructure debt as quickly as possible. The chairman of IBRA has been replaced several times, in some cases clearly based on political consideration. This has been another cause for IBRA's disappointing performance. As discussed earlier, IBRA was to raise Rp 17 trillion in FY 1999/2000 and Rp 16.3 trillion in FY 2000 from asset sales and the earnings of its performing assets.

IBRA has faced enormous difficulties to work out the debt of some of the largest debtors. Despite its special legal powers given by the Parliament since late 1999, it was unable to deal with recalcitrant debtors and shareholders. In mid-2000 the government announced a plan to establish a Committee for Resolving the Cases of Recalcitrant Debtors. All IBRA's non-cooperative debtors and shareholders will be referred to the Committee for resolution. The Committee was established on 17 July. The Committee will also decide on cases to be brought to court. However, IBRA does not have a good record in this regard. Of the 60 or so cases that it had brought to court it lost in almost all cases. There continued to be heavy political interference towards

IBRA's activities. A new governance framework was proposed in July 2000 to ensure IBRA's independence in carrying out its mandate. A new governing board, composed of independent professionals, will be at the center of this framework. The final governance framework included an Oversight Committee, rather than a governing board.

As part of the asset recovery effort, on 7 March 2002 the government embarked on a strategy to resolve the long-standing problem of shareholder settlement agreements with former bank owners. After delays, by September 2002 a number of these debtors have made an agreement with IBRA to accelerate the settlements of their debt.

With the program of bank recapitalization essentially completed, IBRA's task has become much more demanding. Its new focus, as described in the July 2000 Letter of Intent (LOI) to the IMF, is to drive asset sales and debt restructuring, return assets to the private sector quickly, and achieve budgetary collection targets. The role of IBRA has become crucial to fiscal sustainability. It was able to meet the budgetary targets in FY 1999/2000 and FY 2000 as well as FY 2001. IBRA's target for 2002 is a net cash recovery of up to Rp 35 trillion. However, the challenge appears to become greater as attractive assets have been sold off and the economic prospects remain far from bright.

Nationalist sentiments and interference by various political interests have made the sale of assets a difficult and frustrating one. The sale of BCA was successful but the process took about 2 years to complete. The sale of another private bank, Bank Niaga, is another big headache for IBRA. Allegations that IBRA has attempted to bribe members of Parliament to smoothen the process of the Bank Niaga sale may end up in a failure to sell the bank.

Many issues regarding policies on and the handling of the banking sector during the crisis will continue to preoccupy analysts for many years to come. Was there a better way for BI to rescue banks in the wake of the large bank runs? What needed to have been in place before the closure of the 16 banks in November 1997? Should a new, single institution like IBRA be given the responsibility to manage such a huge task?

Structural Reforms

As discussed earlier, structural reform programs have become an important part of the IMF-supported recovery program. Fundamental structural reforms that were identified included further liberalization of foreign trade and investment, dismantling monopolies and price controls, greater private sector participation in the provision of infrastructure, and expansion of the government's privatization program.

Liberalization of Trade and Investment. This part of the structural reforms is essentially a continuation of the policies that have been put in place since the early 1990s. On tariff reduction, the program extends the tariff reduction schedule issued in May 1995 and June 1996. However, specific attention was given to certain sectors that continued to be protected because of pressures from vested interests, such as petrochemical products and iron and steel. Agricultural trade was also liberalized. The import monopoly of Bulog on wheat and wheat flour, soybeans, and garlic was eliminated. Export taxes and various types of export restrictions on a number of commodities were eliminated as well. The joint plywood marketing body, controlled by a Soeharto crony, was abolished.

All import restrictions on all new and used ships were abolished. They were initially introduced to protect Habibie's ship building project. There was also mentioning about the discriminatory treatment in favor of the National Car Project, owned by a Soeharto son. The domestic trade of agricultural products was fully liberalized. This included clove trade, which was monopolized by a Soeharto son. The administrative retail price for cement was also eliminated.

In March 1988 a number of commitments were made to reduce tariffs to an end date in 2003. Since then liberalization of trade and investment was no longer a major component of the program.

As discussed earlier, the structural programs listed above were one of the causes for Soeharto's silent (and occasionally open) opposition to the IMF-supported program. His reluctance to implement many of those commitments, which characterized the mishandling of the crisis, has led to the deep crisis. Rather than helping to restore confidence, the IMF-supported programs resulted in a further erosion of confidence because of the failure to implement and to deliver.

The circumstances that led to the inclusion of the structural reform programs have been discussed earlier. A policy question which will be raised again and again in the future assessment of the Indonesian case is whether the structural conditionalities should have been introduced only after the initial crisis had been resolved.

Deregulation and Privatization. Some measures to promote domestic competition have been included in the above discussion. Most important is the phasing out of import and marketing monopolies and price controls on agricultural commodities except for rice and sugar.

A comprehensive program was drafted to review public sector expenditures, including of state-owned enterprises and strategic industries. This was to be become the basis for an accelerated program of privatization. In particular, promoting competition will be undertaken by accelerating privatization and expanding the role of the private sector in the provision of infrastructure.

The initial step was to sell shares in some state enterprises that were already listed on the stock exchange and were operating in a competitive environment, including PT

Telkom (domestic telecommunications), PT Indosat (international telecommunications) and PT Semen Gresik (cement production). The next batch of privatization would include enterprises in plantations, infrastructure, mining and manufacturing, including Pelindo II (ports infrastructure and management), PT Perkebunan Nusantara IV (palm oil plantation) and PT Jasa Marga (toll roads).

A masterplan for the restructuring and privatization of all state enterprises over the medium term was released in late 1998. It provides for the review of the regulatory framework in the key privatized sectors. The privatization program on the basis of the masterplan began to implemented in 1999/2000, with a modest target of receipts of $1.5 billion, or 1% of GDP. A special audit was undertaken on the three most important state enterprises, Pertamina (oil), PLN (electricity) and Bulog (logistics agency). Both the restructuring of the oil sector and the power sector was outlined in the March 1999 Supplementary MEFP to the IMF. The audits were completed in June 1999.

The economic team in the Wahid government appeared to be less enthusiastic about the privatization program. They proposed to review the program, but at the same time expected that the privatization revenue would amount to Rp 8.6 trillion during 1999/2000, much higher than the original target set by the earlier government. The new government has updated the masterplan to promote "fast-track privatization" for enterprises in competitive industries. The privatization transaction for FY 2000 was set at Rp 6.5 trillion. The change in mood on the part of the government could have been caused by necessity. As this government was determined to reduce external financing of the budget deficit, it had to resort to domestic resources mobilization. Privatization is one important source for this.

Priority was given by the Wahid government to the rapid restructuring and privatization of the telecommunications sector and the energy sector. With a new cabinet installed in August 2000, the Ministry for Investment and State-Owned Enterprises was abolished and a new Ministerial Board was established to over see the privatization program.

Under the Megawati government no new initiatives on privatization have thus far been made. In FY 2001, proceeds from privatization was far below the target. Privatization appears to have come to a halt.

Other Reforms. In the course of implementing the series of recovery programs, a few other reforms were undertaken. Amongst the important ones were the reforms to overhaul the bankruptcy system and the establishment of a commercial court. The Parliament ratified a revised bankruptcy law on 24 July 1988. However, the operation of the commercial courts needs significant improvement to gain credibility. In the course of the development many strange decisions have been made by the commercial court. There is the allegation that the new commercial courts are not free from bribery, as shown in the notorious Manulife case.

Another major initiative was the introduction of competition policy and the enactment of the Law regarding Prohibition of Monopoly Practices and Unhealthy Competition (Competition Law) in March 1999. A Commission for Business Supervision was set up in 2000. It is still too early to judge about the performance of this Commission. However, if it continues to strengthen its capacity to perform its role, the Commission will become one of the important new economic institutions in the country.

The bankruptcy law, commercial court, competition law and the competition commission as discussed above have all been created by the IMF-supported program. In a sense, they can be regarded as being introduced due to IMF conditionality. A policy question has been raised as to whether their creation in a haste could result in their being discredited as something that is imposed from the outside and cannot be implemented successfully in Indonesia. The Commercial Court gives an illustration at its best of the relevance of this question.

MACROECONOMIC PERFORMANCE: FINAL NOTES

This final section attempts to describe macroeconomic developments during the immediate years of the crisis (1997 and 1998) and the following years, so as to be able to make an assessment of the impact of the recovery and reform programs introduced since October 1997. A few microeconomic results have been discussed in the previous section.

As can be seen from Table 2, GDP growth declined from 7.8% in 1996 to 4.7% in 1997. The economy was still growing at 7% in the first semester of 1997. The deepening of the crisis and the political and social unrest in 1998 led to a severe contraction of the economy. It has been said that such a situation has not been experienced by any other economy in recent history.

Growth in 1999 was less than 1%, driven largely by household consumption. In 2000, the economy showed a strong sign of recovery. The peaceful general elections in June 1999, the first democratic elections in 40 years, and the election of Abdurrahman Wahid as President created a turn-around on the general sentiments of the people. Exports picked up. Investment was growing for the first time since the crisis by a strong 22%. It mainly consisted of domestic investments. By and large, foreign investors kept a wait and see attitude. Indeed, it was unfortunate that the encouraging prospect was short-lived. The earlier session has highlighted the problems during the Wahid presidency.

Table 2. Annual Growth of GDP By Expenditure
(at 1993 constant prices)

	1996	1997	1998	1999	2000	2001
Consumption	8.65	6.97	-7.11	4.26	3.89	6.15
Household consumption	9.72	7.82	-6.17	4.63	3.63	5.94
Government consumption	0.65	0.06	-15.37	0.69	6.49	8.24
Gross fixed capital formation	14.51	8.57	-33.01	-18.20	21.92	3.96
Export of goods and services	7.56	7.80	11.18	-31.80	26.48	1.88
Less import of goods and services	6.86	14.72	-5.29	-40.68	21.09	8.05
Gross Domestic Product	**7.82**	**4.70**	**-13.13**	**0.79**	**4.90**	**3.32**

Source : Central Board of Statistics

The change in sentiment was reflected in the 2001 growth figures. Household consumption remained strong, but investment grew by a mere 4 %. As the world was experiencing a slow down, Indonesia's exports was also affected.

As can be seen from Table3, the recovery in 2000 was experienced in all sectors, including manufacturing, which performed better than in 1997. The continued weak rupiah was an important competitive factor in 2000. There was a slowdown in all sectors in 2001, but the mining sector again experienced a contraction. Security problems in the mining regions, and the proliferation of illegal mining, as well as the impact of the regional autonomy project have all resulted in declining mining activities. Some investors have closed down their mines and other have left the country.

Table 3. Annual Growth of GDP By Industry of Origin

(at 1993 constant prices)

	1996	1997	1998	1999	2000	2001
Agriculture	3.14	1.00	-1.33	2.16	1.70	0.63
Mining and Quarrying	6.30	2.12	-2.76	-1.62	5.06	-0.64
Manufacturing Industry	11.59	5.25	-11.44	3.92	6.10	4.32
Electricity, Gas & Clean Water	13.63	12.37	3.03	8.27	8.78	8.43
Construction	12.76	7.36	-36.44	-1.91	5.50	3.96
Trade, Hotel & Restaurant	8.16	5.83	-18.22	-0.06	5.58	5.11
Transportation & Communication	8.68	7.01	-15.13	-0.75	9.38	7.51
Fin., Leasing & Business Services	6.04	5.93	-26.63	-7.19	4.34	2.99
Services	3.40	3.62	-3.85	1.94	2.20	1.97
Gross Domestic Product	**7.82**	**4.70**	**-13.13**	**0.79**	**4.90**	**3.32**

Source : Central Board of Statistics

Table 4. Monetary Indicators

	1996	1997	1998	1999	2000	2001
Consumer Price Inflation						
(Average annual rate in %, 1996=0)		6.63	10.31	77.63	2.07	9.18
12.55						
Exchange Rate						
(Average market rate, Rupiah per US$)	2348	2953	9875	7809	8527	10410
Money Supply Growth :						
Base Money (Mo)	33.08	33.95	63.00	35.50	23.41	1.74
M1	21.66	22.24	29.17	23.16	30.13	9.58
Currency	8.07	26.40	45.63	40.97	24.02	5.49
Demand Deposits	30.54	19.99	19.80	10.83	35.51	12.89
Quasi Money		32.11	23.50	71.72	9.53	12.13
13.93						
M2	29.64	23.22	62.35	11.92	15.60	12.99
Commercial Banks' Outstanding Credit Growth	24.76	29.09	28.90	-53.81	19.48	14.35
Deposit Rate						
(Average 1 month deposit rate, % p.a.)	16.92	23.01	51.67	23.97	11.16	14.54
Lending Rate (% p.a.)						
Working Capital	19.21	21.98	32.27	28.89	18.43	19.19
Investment	16.42	17.34	23.16	22.93	16.59	17.9

Source : Bank Indonesia and Central Board of Statistics (various editions)

Table 4 shows developments in the monetary field. The above story seems to be confirmed by developments of credit growth, which almost reached 20% in 2000. It has since weakened again. Inflation, which hit a record high of 78% in 1998 was brought down drastically to 2% in 1999. It went up again in 2000 and 2001, partly because of upward adjustments in domestic fuel prices, electricity, transportation charges. Political instability nearing the end of the Wahid government also contributed to this.

The currency, which began to strengthen in 1998 continued to decline in the years that followed. By the end of 2001, the exchange rate stabilized at about Rp 10,000/$. It then strengthened at the beginning of 2002 to around Rp 8,400/$ for a while, but since mid-2002 tended to stabilize at about Rp 9,000/$.

Developments in the base money, and problems encountered by the monetary authority to control base money growth was discussed earlier. Efforts at controling base money growth became more successful in 2001. Interest rates increased in 2001 after experiencing significant reductions in 2000. Problems of monetary management remain a major challenge for the government and BI.

The significant increase in the country's outstanding debt can be seen from Table 5. The earlier discussion has examined the reasons for the increase. Total government debt increased from $54 billion in 1997 to $141 billion in June 2001. This was caused mainly by the increase in domestic debt, as discussed previously. Domestic debt increased from zero in 1997 to $69 billion in June 2001, whereas external debt increased from $55 billion to $72 billion. Total government debt reached above 100% of GDP since 1998, but was about 95% in June 2001. The target of the recovery program is to reduce government debt to 65% of GDP in 2004. Total private debt remained high, but lower in June 2001 compared to pre-crisis (1996), because of the dramatic reduction in domestic debt. External debt was highest in 1998 but has since declined.

The cost of the crisis and the way it was handled can be said to be borne by the government. However, as the interest on bonds is being paid through the budget, in the end the burden is with the people. It is only logical that the people demands that the government implement a recovery program with a strong reform component.

Table 5. Debt Indicators

(Outstanding Debt US$ bill)

	1996	1997	1998	1999	2000	Jun-01
Total government Debt	**55.2**	**53.9**	**77.3**	**139.7**	**151.9**	**140.7**
Domestic	0.0	0.0	10.0	63.8	77.0	68.7
External	55.2	53.9	67.3	75.9	72.0	
Total private debt	**182.2**	**154.4**	**128.4**	**134.8**	**126.8**	**129.7**
Domestic	127.3	72.2	44.8	62.6	60.0	62.8
External	54.9	82.2	83.6	72.2	66.9	
Total Debt	**237.4**	**208.3**	**205.7**	**274.5**	**278.7**	**270.4**
Domestic	127.3	72.2	54.8	126.4	137.0	131.5
External	110.1	136.1	150.9	148.1	138.9	
(As percent of GDP)						
Total government Debt	**27.0**	**48.7**	**112.2**	**106.1**	**111.5**	**94.8**
Domestic	0.0	0.0	14.5	48.5	56.5	46.3
External	27.0	48.7	97.7	57.7	48.5	
Total private debt	**89.1**	**139.6**	**186.3**	**102.4**	**93.1**	**87.4**
Domestic	62.3	65.3	65.0	47.6	44.1	42.3
External	26.8	74.3	121.3	54.9	45.1	
Total Debt	**116.1**	**188.4**	**298.4**	**208.6**	**204.6**	**182.2**
Domestic	62.3	65.3	79.5	96.0	100.6	88.6
External	53.8	123.1	219.0	112.5	93.6	

Source : Feridhanusetyawan, Pangestu and Roesad (2001)

The above discussion has shown that the Indonesian economy has began to loose steam in 2001 the economy grew by about 3.3%, driven mainly by domestic consumption. Indeed it was a better performance than in some other Asian economies. However, as stated before, this is not good enough for Indonesia in view of the need to create job opportunities for the 2.5 million people entering the work force each year. The Indonesian economy can be said to be recovering if it can grow again by 6 percent or more per annum. However, this higher growth rate must be accompanied by its sustainability and improved social justice and greater equity. That is why Indonesia's agenda for economic recovery must include wide-ranging reform measures, covering improved economic governance and the establishment of new economic institutions. This is not an easy task.

The previous examination has shown that efforts to rehabilitate the failed banking and financial system have not been all that successful despite their high cost, particularly to the government. The burden to rescue failed banks and to recapitalize others is carried by the government through its budget that is already very tight. And this burden will be felt for many years to come. It is the government that bears the costs of the financial crisis of 1997/98 which largely originated with the private sector.

In addition, private debt restructuring has been extremely slow. Many private companies have been trying to get out of the problem by being bailed out by the government. A few, politically connected business groups have been rather successful in soliciting the government's helping hand. However, this too resulted in higher contingent liabilities on the part of the government.

Private assets that fell into the hands of the government in exchange for the government's assistance to banks are being handled IBRA. It is the policy of the government to dispose of these assets as quick as possible. The process has been extremely slow and frustrating. Apart from problems of non-cooperation by previous owners, the agency itself suffers from a deficit of competence and transparency, perhaps also honesty, and the inherent difficulties of restructuring. But equally problematic has been the problem of political interference. The sale of these private assets is one source of funding political activities. The Bank Bali scandal during the Habibie presidency exemplifies this problem.

The government's policy to finance up to a significant portion of the budget deficit with domestically mobilized resources is a good way to force IBRA to expedite the process of assets disposal as well as to accelerate the program of privatization. Both asset sales and privatization are expected to finance about 70 percent of the budget deficit, the remaining 30 percent being financed through foreign assistance.

The tight budget has also been helped by the willingness of donor governments to reschedule public external debt service payments. This rescheduling exercise through the Paris Club has been repeated for three times and in all likelihood will have to be repeated again in the years to come to give Indonesia the necessary breathing space to overcome the bunching of debt, both external and domestic, in 2003 to 2006.

Central government development outlays have significantly decreased in the last few years. This is also caused by fiscal decentralization as part of the implementation of regional autonomy. It is as yet unclear as to how local governments will allocate their spending for infrastructure, education and health, expenditures that have impacts on the country's future growth potentials.

In the first few years, there are likely to be problems in the implementation of regional autonomy. Capacity in the regions is still weak, but problems in the implementation are caused to a large extent also by the absence of clear implementation regulations. In addition, local governments are trying to maximize local revenues in the short term by introducing new taxes and other user charges. Many of these new taxes and user charges do not make sense and result in a high cost economy. Efforts are being made by the central government to control this but with mixed results. There is also the problem of the sharing of revenues from natural resources between the central and regional governments. Disputes on this matter have caused problems for investors in particular in mining and forestry. The weak government at the center is not helpful to resolving this problem.

These problems do affect the country's investment climate. But the country will learn how to overcome them by going through the bad experience and learning from the mistakes. They can be costly, but perhaps that is the cost to pay. External pressures, such as in the Manulife case, are sometimes necessary.

Notwithstanding the above, there also is a positive side of developments in the Indonesian economy. This refers to the so-called "healthy" sector of the economy. This sector has not been affected by the financial crisis and has grown faster since the crisis. It consists of medium-sized enterprises that have not relied on bank credits for their investments. It also consists of a whole array of small scale activities. However, it also consists of a wide range of export-oriented manufacturing activities. The increase in investment since 2000 has been accounted for by a large number of new small investments within this sector as well as expansions of existing large investments, including foreign direct investment (FDI). In the medium to long term the health of this "healthy" sector of the economy depends on the overall economic and political environment in the country. But for now, it is a major engine for growth and helps the economy to be afloat.

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International Conference on Economic Recovery and Reforms

Japan

Implications of the Japan's Lost Decade to Asia Perspectives from Japanese Trade and Investment Relationships*

Shigeyuki Abe
Center for Southeast Asian Studies
Kyoto University

ABSTRACT

Japan has been struggling to get out the decade long depression. Koizumi government changed its stance of economic policy from the former governments to emphasize reforms rather than fiscal expansion. In this paper a short history of the current Japan's depression will be explored first. Specific problems of recent economic policies will be discussed next. Bad debt problems, industrial re-structuring, inflation targeting issues, record high unemployment situation, changing Japan models, and etc. are such issues. Lastly, Japan's role in Asia will be discussed.

* Prepared for the International Conference on Economic Recovery and Reforms, October 28-29, 2002, Imperial Queen's Park Hotel, Bangkok, hosted by Faculty of Economics, Thammasat University, and the Bank of Thailand.

1. Introduction

In the 1980s, *Japan Bashing* was a key term to explain the relationship between Japan and the United States. Japanese exports to the United States were so strong that the United States constantly bashed Japan to open her market[1]. One could see the products of Toyota, Nissan, Honda, Sony, Panasonic, and other Japanese firms in every corner of the world. In Japan's heyday, eight of the ten largest banks in the world were Japanese. This resulted in the enforcement of BIS regulations. This enforcement has been plaguing Japanese banks ever since and has resulted in a credit crunch. During the era of Japan bashing, both countries acted harshly and sometimes confronted each other emotionally. These worrisome and yet happy days did not last long. *Japan Passing* became the new term to represent the situation during the following decade. The United States started to neglect Japan and to consult more with other Asian countries, particularly China. When President Clinton entered office, this trend intensified and the new key term became *Japan Passing*. Japan seemed to become invisible. In fact, in one of Clinton's speeches to congress, Japan was not mentioned at all, while China was mentioned six times and other countries mentioned include North Korea, South Korea, and Russia[2].

Japan is now in the midst of the *Lost Decade*. The *Lost Decade* used to be a term reserved for Latin America. But no matter how hard Japan has tried to escape the current depression syndrome, there seems to be no way out. Depression in Japan has been affecting Asia negatively. Thus, Japan must be currently regarded as a kind of *virus*. It has been exporting its depression.

Although Japan has endured the trauma of going from being the leader of Asia to the virus of Asia, she is now on the verge of rebounding from hardship to attain

[1] Prior to this the relationship between Japan and the United States was characterized by the following phrase, "If the United States coughs, Japan will catch cold," or "If the United States catch cold, Japan will suffer from pneumonia."
[2] Tetsuya Tsukushi, "From Bashing to Passing to Nothing", News23 TODAY'S COLUMN Jan.30(Thu), 1997.

new heights in the future. The real question is how soon this can be achieved. Where Japan will go from here will inevitably have important impacts upon other Asian countries because the economic ties have become much tighter than they were before.

In order to assess all these matters, we will briefly review the economic growth history of Japan in the next section. We will analyze also how the Japan system has been formulated. Since Japan has large impacts on China and other Asian countries through her trade and investment, we will review the trade and investment relations in this section. In section 3, although the recent Asian crisis is often explained by volatile international capital markets, we will look at it from an alternative perspective, i.e., real side stories. We then discuss the current status of the Japanese economy in section 4. In the concluding section, we will touch upon possible policies that Japan might adopt to once again lead Asia and the world.

2. History of Japanese Economic Growth

Postwar Period

When Japan was defeated in World War II, her industrial production decreased to about a half of its prewar level, exports to one fifth, and imports to one half. With 13.1 million jobless, grave shortages of energy and food, and high inflation, Japan endured the hardship and successively democratized the country in accord with the orders of the SCAT, or the U. S. occupation forces. *Zaibatsu* were dissolved, drastic land reform was implemented, and labor democratization was promoted. At the start, though, the United States and its allies intended to leave Japan as poor as the other Asian countries which Japan had invaded. Fortunately for Japan, this policy stance changed 180 degrees when the Korean War broke out. With special procurement demand from the United States, Japan started to enjoy an economic boom.

High Growth Period

During the period 1955 to 1970 Japan achieved an annual growth rate of about 10 percent in real terms (Fig.1). During this High Economic Growth Period, many Japanese management characteristics were formed, such as seniority wage, lifetime employment, company labor union, just-in-time *kanban* system, TQC, industrial policy, sub-contracting system, and government-private sector collaboration. In the days of high economic growth with abundant labor, this system functioned nicely[3]. Japan engaged in a vertical trade system, importing raw materials and processing them to export manufactured goods. Cheap oil prices and a fixed exchange rate (at 360 yen to the dollar) worked out very well for Japan. Government interventions were often made and the private sector reacted even better than expected.

Nixon Shock and Two Oil Crises

In the 1970s, Japan encountered the Nixon shock and then the two oil shocks. In the early years of the 1970s, the U.S. economy weakened. Then President Nixon suspended the convertibility of the dollar into gold in 1971. He also initiated a new relationship between the United States and China. The combined effect of these two acts is called "the Nixon shock." Also, the exchange rate system shifted from fixed to floating in 1973. During this period, Japan suffered not only from trade frictions internationally but also from environmental pollution problems domestically. These problems generated growing pressure to change Japan's industrial structure. The first oil crisis was a devastating blow to Japan, and Japan was forced to change its structure from one centered on heavy industry and chemicals to one centered upon energy saving. Japan managed to remain competitive by effectively cutting energy consumption, conserving resources and electric power, and further up-grading their structures to more technology and knowledge based ones.

[3] Noguchi criticized the traditional Japanese bureaucrat driven system as 1940 system. See Yukio Noguchi, "The 1940 System :Japan Still under the Wartime Economy," *American Economic Review*, May 1998.

It was around this period that the auto and the electrical machinery industries made a quantum leap forward and played a leading role in propelling the economy.

Plaza Accord, Trade and FDI

After overcoming the crises of the 1970s, Japan became more efficient and more competitive. In 1985 Japan faced a sharp yen appreciation when the Plaza Accord came into effect. Transformation of industrial structure was again necessary. The yen rose from 240 to 120 per dollar in just one year. In response, Japanese firms sought to rationalize their operations. Some of them moved their production facilities to overseas markets. Meanwhile, foreign made goods poured into Japan, made affordable by the strong yen. This accelerated the emergence of a more horizontal division of labor between Japan and low-cost countries.

Since 1985, Japan's trade structure has undergone profound changes. While the share of goods shipped to the United States and the EU has declined, those going to East Asian countries have increased. In terms of categories of goods, while the share of durable consumer goods (notably, automotive vehicles) has decreased, those of capital goods (about 60%) and parts of machinery and transportation equipment (about a third) have risen. The share of capital goods and parts of machinery and transportation equipment shipped to East Asian countries in their worldwide exports has increased, and parts of machinery and transportation equipment exported to these countries accounted for a little less than 50%. (Figure 2)

Japanese imports from East Asian countries have been rising since 1990, and have accounted for about one third of Japan's total imports in recent years. In terms of categories of goods, the share of industrial supplies (petroleum, etc.) in the total imports which had accounted for nearly 60% in the second half of the 1980s dropped to about 40% by 2001, while those of capital goods and parts of machinery and transportation equipment have risen. (Figure 3)

As the production by Japanese transplants in overseas markets has expanded, Japan's exports of finished goods, notably, durable consumer goods (*export substitute effects*) have decreased, while there has been an increase in exports of parts of machinery and transportation equipment and capital goods which are necessary for overseas production (*export-inducing effect*).

Thus, Japan's trading pattern is now more horizontal. This is a departure from the earlier vertical trade pattern, when Japan imported raw materials and exported only industrial products. Intra-industry trade has been expanding.

Regional ties have been tightening since 1985. With the development of regional trading arrangements trade intensities underwent substantial changes. Japan has been growing less dependent on the United States and European markets and trading more with Asia (Figure 3). For China the trade intensity is strong with Japan, 2.89, and with Asian NIEs, 3.02. It is 2.08 with ASEAN4. In case of Japan the intensity is 1.77 with China, 2.67 with Asian NIEs, 2.82 with ASEAN4 while it is 1.61 with the United States Both Japan and China have stronger ties with Asian countries. It should be noted at this juncture that both Singapore and Hong Kong are hubs of the Asian trade. Their trade intensities with Asian neighboring nations are larger than those of any other pairs. This has quite an implication for regional trading zones. (Table 1)

Prior to the Plaza Accord, FDI from Japan was directed mostly toward the United States and Europe. Since 1985 the direction has shifted more to Asian countries. The participation of newly industrializing economies, especially Asian ones, has intensified competition in the manufactured-goods markets, while industrialized countries have shifted their industrial and export structures more to the knowledge-intensive industries such as high-tech and software. (Figure 4-7)

Bubbles

Japan took all possible measures to revive its economy and this in turn contributed to the creation of a bubble economy. As Japan encountered international difficulties, the government tried to help the private sector by pumping public works and other projects into the economy, which resulted in ever-increasing public debt. It was natural for private enterprises and individuals at that time to invest in real assets. When the bubble burst, this brought massive non performing loan (NPL) problems.

Since the bursting of the bubble, the Japanese economy has never come back to a normal growth pattern. Japan obviously mismanaged its economy by adopting a succession of wrong policies in the recent past.

View from per capita GDP

To sum up the above brief historical overview, let us look at changes in Japan's per capita GDP. Japan's industrial growth can be described as a process of constant upgrading of its industrial structure in order to catch-up to the United States and Europe. In 1955 per capita nominal GDP of Japan was just one tenth that of the United States. By 1987 Japan's per capita GDP had surpassed that of the United States. Japan attained the world's highest per capita GDP in 1996, reaching a level more than 20 percent higher than the United States (Figure 8). This achievement was made possible by productivity increases.

Total Factor Productivity

Behind this growth in per capita income was a constant increase of technological development, which can be measured by TFP (total factor productivity)[4]. Figure 9 shows a growth in the TFP – namely, qualitative improvement of labor and capital

[4] The calculation of the TFP is from METI, *White Paper on International Trade*, 2000.

inputs in addition to a qualitative increase in capital input, technological advance, and the expansion of economies of scale. This has contributed to the growth of the Japanese economy. A sharp fall in the percentage contribution of capital and changes that occurred in the TFP were factors that braked the forward momentum of the Japanese economy from the rapid growth of the 1960s to a slower and more stable growth during the 1970s and beyond. Growth in the TFP slowed sharply during the 1990s, due in part to a cyclical downturn in the economy. This explains the nature of the *Lost Decade* very well.

Figure 9 traces the technological advance that has underpinned the economic growth of Japan. During the rapid economic growth period, technology introduced from overseas contributed to the growth. Original technological innovations accounted for only a small part of this technological advance. Technological advances made by Japan largely consisted of developing refined applications of imported technology. In the 1980s, however, R&D activities undertaken by Japanese firms began to pick up, and their technology exports also increased.

Trade Issues in Retrospect

The worldwide recession that occurred in the 1970s triggered a movement toward protectionism, and the number of import restrictions and antidumping lawsuits increased sharply in many countries[5]. Particularly, trade friction involving Japan, the United States, and the EU--which together account for 60% of the world's GDP and more than a half of the world's exports--intensified.

Trade frictions involving Japan's exports started with the exports of textile goods in the 1960s. But by the 1970s the focus had shifted to higher value-added products, such as steel, color TV sets, and automotive vehicles, in line with the greater sophistication of Japan's industrial structure. Such frictions arise inevitably

[5] For example, Edward J. Lincoln, Japan: Facing Economic Maturity, Washington D.C.: The Brookings Institution, 1988.

as the export structure and domestic industrial structure of different countries become more alike and as the number of areas of competition grows larger. Japanese exports of highly specialized products to Western countries had been surging, even when the recipient markets were struggling with a recession. This poured oil on the flames of protectionist sentiment in the recipient countries. To put the matter another way, during the high growth period Japanese manufacturers engaged in "cut throat" competition domestically, and they adopted the same tactics in exporting their products in the United States and Europe.

By the 1980s, the trade imbalance of many countries had widened. Trade frictions no longer involved only individual goods. The economic structure as a whole became the issue. The United States attempted to impose Super 301 under the new trade policy of 1985, and trade frictions started to escalate. Japan continued to record current-account surpluses and became the world's largest net creditor country. Japan, as a country running the world's largest trade surpluses, was asked to increase imports and to recycle funds to needy countries. In an effort to deepen mutual understanding between the two countries, Japan and the United States held Structural Impediments Initiative (SII) talks, followed by a Framework Talk. In my opinion, these were not really trade talks, but rather discussions of international industrial policy, or exercises in policy coordination. On repeated occasions Japan and the United States exchanged views on matters relating to one another's savings and investment structure and non-tariff trade barriers.

3. Asian Crises: Real Side View[6]

[I'm not sure "Real side view" communicates effectively what you have in mind]

In July 1997 Thai currency (baht) fell down suddenly. The immediate reason was the sudden outflow of short term capital, which exhausted the international reserve at the Bank of Thailand. Thailand kept domestic interest rates high and kept the dollar peg system in order to invite foreign investments. Foreign investors moved their capital to earn secured high interest. But when the prospect of baht devaluation became likely, a sudden outflow resulted, which in turn triggered a fall in the baht. The movement of Asian currencies before and after the crisis is shown in Figure 10.

We should note, however, that there's a real side view of the Asian currency crisis. The world wide depression pulled down the Southeast Asian economies, especially Thailand. These countries' dependence on electronics products is very high and this particular depression attacked their economies directly. Under such circumstances, China, India and Vietnam started to intrude into labor intensive product markets. In early 1994 China's Yuen was devalued and this made China even more competitive. The relative competitiveness of Southeast Asian countries fell. Thailand in particular recorded substantial balance of payment deficits in 1995 and 1996 (more than 8 percent of GDP). Thus, Thailand's economy revealed its fragility to world currency speculators.

Another negative factor was that the short-term funds did not go into real production. Instead it was invested in real estate, i.e., the construction of office buildings, residential apartments, and golf courses. Non banks played an intermediary role to funnel the funds to this sector. This, of course, created bubbles. When the bubbles burst, these non banks suffered from accumulated bad

[6] This section is based upon Shigeyuki Abe, "Asian Currency Crisis 1997 and Japan", a paper presented at the Western Economic Association Annual Meeting, Bangkok.

debts. Stock prices of these firms plummeted, and this affected other stock prices.

Since this was commonly known, speculators naturally thought that Thailand could not maintain the dollar peg system.

Competition in Asia is tough, not only in semiconductors but also for many other products. Southeast Asian countries are competing with each other. During the 20 years of the industrialization process, each country has possessed similar industrial and export structures. Electronics products in particular became the most important export items. Thus, when the Thai baht was devalued, other countries were forced to devalue their currencies to remain competitive.

Figure 11 shows Asian countries exports of SITC 2digit products to Japan for the period between 1988 to 1995. From these figures we can safely argue that most of the Asian countries have similar export structures. For SITC 74 (other industrial machinery and parts), 75 (office machines and computers), 76 (telecommunication and sound recording apparatus), 77 (electrical machinery), Korea, Singapore, Philippines, Thailand and Malaysia have been expanding their trade. China seems to be pursuing a similar but somewhat different path, while Indonesia is clearly different.

We now move to a further breakdown of SITC. As an illustration, I take Taiwan, Korea, Thailand, Malaysia, and China and their performance in exporting their products of SITC 7511 to 7868 to Japan for the years 1988, 1992, and 1995. In 1988, for most of the products, exports of China, Taiwan and Korea surpassed those of Malaysia and Thailand. There were almost no China exports. We see emerging exports from Thailand and Malaysia, but the products are different for these countries. For example, Malaysia showed its strength in SITC 7764 (ICs) and 7622 (radio receivers), while Thailand in 7527 (PC storage units) and 7599 (parts for PCs). China did not export many of these products. In 1992, changes can be observed. Exports from Taiwan and Korea shrank substantially in most of the products. Malaysia increased its exports to Japan in products like 7622 (radio receivers), 7638 (sound recording), and 7649 (parts of radio, sound recorder, telecommunication etc.), all of which were already caught up by China. Thailand drastically increased exports of SITC 7599 (parts of office machines), and 7649, the latter was caught by China, 7752 (refrigerators). Malaysia and Thailand competed with each other in 7764 (ICs). (Figure 12)

In 1995, Taiwan and Korea were gone. China suddenly emerged as the top competitor. The catching up process was acute. And yet there's differentiation of products between Thailand and Malaysia except products like 7611(TV), 7638 (video), 7764 (Integrated Circuits).

By adopting this perspective, we can argue that in using FDI to building the same kind of industrial structure throughout Asia, and engaging in fierce competition, Japan was basically repeating the pattern of behavior it displayed in the earlier trade frictions.

4. The Current Status of Japanese Economy

As I outlined above, the growth of Japan after World War II left serious problems before us. Like other Asian countries, Japan now faces growing globalization. In this situation, Japan has three fundamental problems. First is the aging population. Second is the enormous public debt. Third is the continuing depression, or the *Lost Decade*.

Let me start with statistics.

National Debt

Figure 13 shows the fiscal balance of Japan changing over time. As you can see, the fiscal balance became negative only after the first oil shock. The balance did not return to positive territory until 1988. Then the bubble collapsed in 1990 and once again the fiscal balance deteriorated. The end result of these successive government deficits is an accumulated national debt.

Figure 14 shows the growth of national debt. Until 1982 the level of the national debt remained under 100 trillion yen, or 20% of GDP. Currently it reaches almost 80% of GDP. These figures are only for central government national bonds outstanding. If we include other debts and local government ones, the ratio is now over 120% of GDP. Japan is most heavily indebted of all OECD countries. (Figure 15)

This simply implies that the government is reaching the limits of what can be done with fiscal expansionary policy. Koizumi has declared his intention to limit the amount of government issue to 30 trillion yen this fiscal year. The question remaining is how to use fiscal expansionary measures most effectively.

Deflation

Deflation is another serious problem that Japan is currently facing. Prices of all kinds, including interest rates, are low. Land prices have suffered the most deflation, as shown in Figure 16. As one can see, inflation of land prices was more than 40% in 1988. In 1992 land prices recorded negative growth for the first time. And since then, there has been no reversal of the movement.

The Nikkei Stock Price Index, GDP deflator, and import price index are shown in Figure 17. All of them show a deflationary trend but the trend of Nikkei Stock Price Index is worst of all.

Another important price is the interest rate. The call rate is shown in Figure 18. As is shown there, the current level is a historical low of 0.002. This means that Japanese monetary authority has no remaining capacity to use interest rate management as a policy tool.

Aging

Furthermore, a declining birth rate and an aging society present a long-term challenge to Japan's economy. According to estimates by the Ministry of Welfare, by 2050 only 55 percent of the population will be of working age, while the aged population will have increased to 33 percent. Together with the national debt problem, inter-generational distribution of income will be the real issue from now on. The burden of Japan's young population will become almost intolerable by 2050. This limits the scope of government macro policies even for the short run. (Figure 19-20)

Unemployment

Unemployment has been increasing. We can regard this as a process of restructuring, but it is worrisome that new graduates cannot find jobs. (Figure 21)

Policies Taken

Thus, both monetary and fiscal policies are reaching an impasse. Recently, however, the Japanese government has tried to improve the current status. The relevant policies are tabulated in the Figure 22 and Table 2

5. Conclusion: Future Course of Japan and Asia

IT and Globalization

The current structural problems in Japan arise from adjusting to a new environment. They manifest the dynamism of the Japanese economy itself. The progress of information and telecommunications technology and the globalization of market economies has had a substantial impact on Japanese firms. The after-effects of the bursting of the bubble can also be recognized as a structural problem. Such significant changes in the business environment can make an existing economic system obsolete and reduce the profitability of the corporate sector.

Even excellent Japanese companies, major contributors to the export driven Japanese growth in the past, such as Sony, Panasonic, and Toshiba, recorded deficits and made drastic employment reduction schemes last year (Table 3). Fortunately, in the second quarter of 2002 most of these firms have shown sufficient recoveries. In the 1990s, with the improvement in productivity induced by the expansion of IT-related investment, the United States enjoyed a prolonged period of expansion and price stability, although we can observe such distortions as excessive consumption due to higher stock prices and a rising current account deficit. In Japan, too, it seems that the kind of mega-change which occurs only once or twice in a hundred years may already be underway.

The Important Role of the Private Sector

To get out of the current depression, Japan needs to adjust to new environments and thus needs structural reform. The government announced *Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2002* in June 2002. This proposes concrete measures to address such issues such as economic revitalization, tax reform, and a review of government expenditure. We need to recognize that no matter what the government does, the propelling force is the private sector. In the area of finance, too, the main force in enhancing the financial intermediary function is the profit incentive of financial institutions and investors. Tax reform, deregulation, and the review of pension and medical systems currently being promoted by the government are indeed very important, but these should be combined with vital private sector activities.

As we discussed earlier, the Japanese economy has, over the years, overcome various hardships in the economic environment such as the Nixon shock, two oil shocks, and the Plaza Accord. All these severely changed the terms of trade in ways which caused Japan to suffer difficulties in exporting goods. In each of these adjustment phases, Japan experienced drastic restructuring, successfully achieving the exit of many weak enterprises. On the other hand, as a result of the efforts and ideas that arose from the need to overcome such 'pains,' Japan started to produce higher value-added products that satisfied the needs of the times. In turn, Japan became strong in energy-saving products, diversification of life styles, and environmental concerns. Still so far, Japan has readjusted only in the manufacturing sector.

The 1990s have often been called the "*Lost Decade*," but it is probable that in recent years Japan has in fact been undergoing structural change of great magnitude. In fact, reorganization and cooperation on a large scale have been occurring both in the industrial and financial sectors. Many elements of Japan's heritage--such as cross shareholdings, keiretsu relationships, and long-term employment--are being reviewed in response to recent changes in the economic environment. Corporate governance is steadily changing.

Japan and Asia

(1) Competition

Japan is surely going to change. Hopefully, it will get out of the depression. More importantly, the relationship Japan has with China and other Asian countries will become even tighter, year by year. Until the recent past Japan led the ladder of industries. But in the near future Japan might simply quit competing in some areas, or compete even more fiercely in others. There used to be a division of labor between Japan and other Asian countries. Japan produced more sophisticated industrial products and other Asian countries specialized in more labor intensive medium quality goods. But the world is changing.

With the IT revolution and rapid accumulation of both physical and human capital, many Asian countries have become capable of competiting head to head with Japan. This phenomenon is exemplified by the current market share of leading electronic products. According to the *Nihon Keizai Shinbun*, August 13, 2002, China now produces 54.1 percent of DVD players in the world, while Japan produces only 7.7 percent (2002 projection). China produces 27.8 percent of mobile phones; Japan, 12.9 percent. For desktop PCs, China produces 29.6 percent; Japan, only 2.3 percent. China produces 43.7percent of air conditioners; Japan only 15.2 percent. (Figure 23)

Of course, there are some products where Japan leads in production such as notebook PCs (18.8%), large LCDs (28.9%), and digital cameras (51%). All these products used to be more or less Japanese monopolies. Japan needs to develop more and more front runner products. Otherwise, in the end, Japan will have nothing to export. In an encouraging trend, Japan is now beginning to earn money by developing technology herself. Figure 24 depicts the export-import ratio of patents trade. If this figure is larger than one, it means Japan earns more than she pays abroad. The trend is steadily sloping upward.

Although Japan is not particular known for innovations in technology, Japan has had its successes in the past. Japan introduced a nylon-producing technology in 1951. Transistor technology followed in 1954, and a domestically-built rocket was launched and polyester textile manufacturing technology was introduced in 1957. Home use VCRs appeared in 1976, super LSI in 1978, and optical CDs in 1982. Current and future technological advancement is expected around nano technology and in other areas.

(2) Japanese involvement in Asia

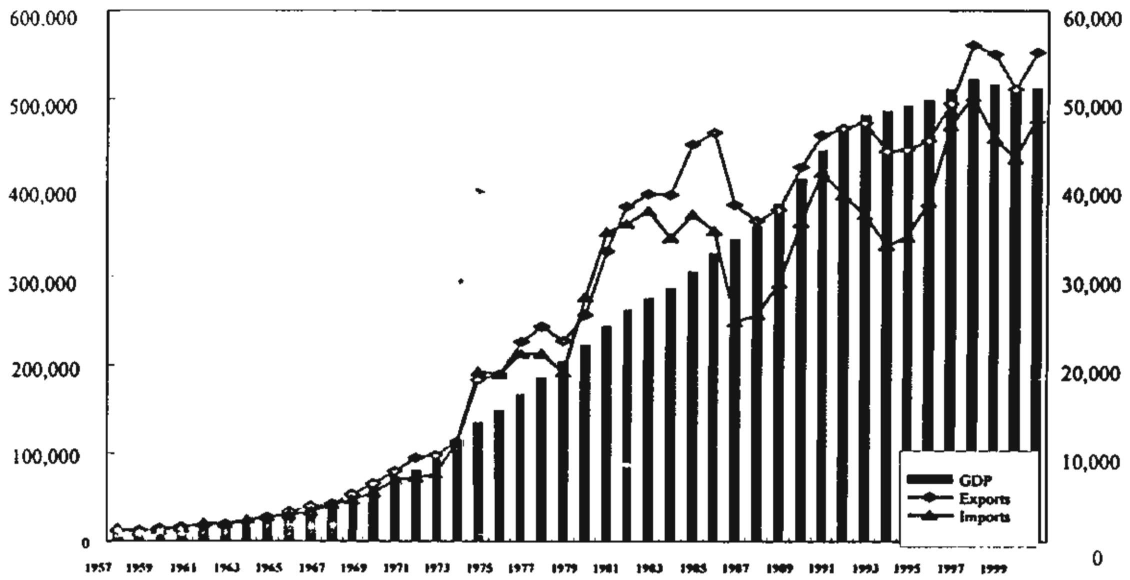
Even in the midst of the Lost Decade, at the time of the Asian currency crisis Japan suggested to create Asian Monetary Fund, to which the U. S. opposed. Japan gave up the idea and proposed the so-called *Miyazawa Plan*, by which Japan offered as much as 30 billion US dollars to Asia, 15 billion of which was allocated for medium to long-term financial support while the rest was for short-term financial support.

Japan became the biggest ODA donor in the world in 1989. Japan has been offering ODA worldwide, but has concentrated her ODA in Asia. Figures 25 and 26 show the recent trend in ODA and the top ten recipients in the past few years. See Table 4 also.

(3) Increasing Imports of Manufactures

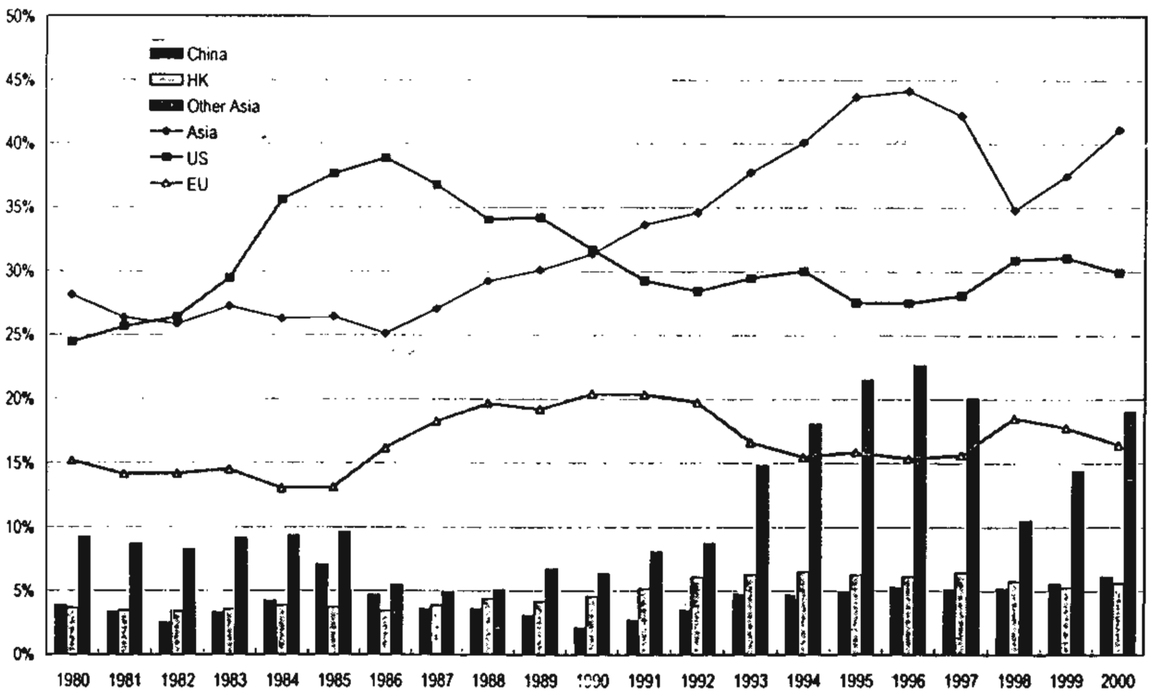
Japan has transformed its trade patterns from those of a vertical division of labor to a horizontal division of labor. Figure 27 shows the path of deepening intra-industry trade, demonstrating that Japan has become a big consumption market for Asian exporters. Although ASEAN climbed up from 30 % level in 1992 to more than 50% and the world average in 2000, China enjoyed a very high ratio from the beginning. And yet, the ratio has been constantly rising. This is a rosy sign for both Japanese consumers and Asian producers.

Figure 1. Japan's growth path



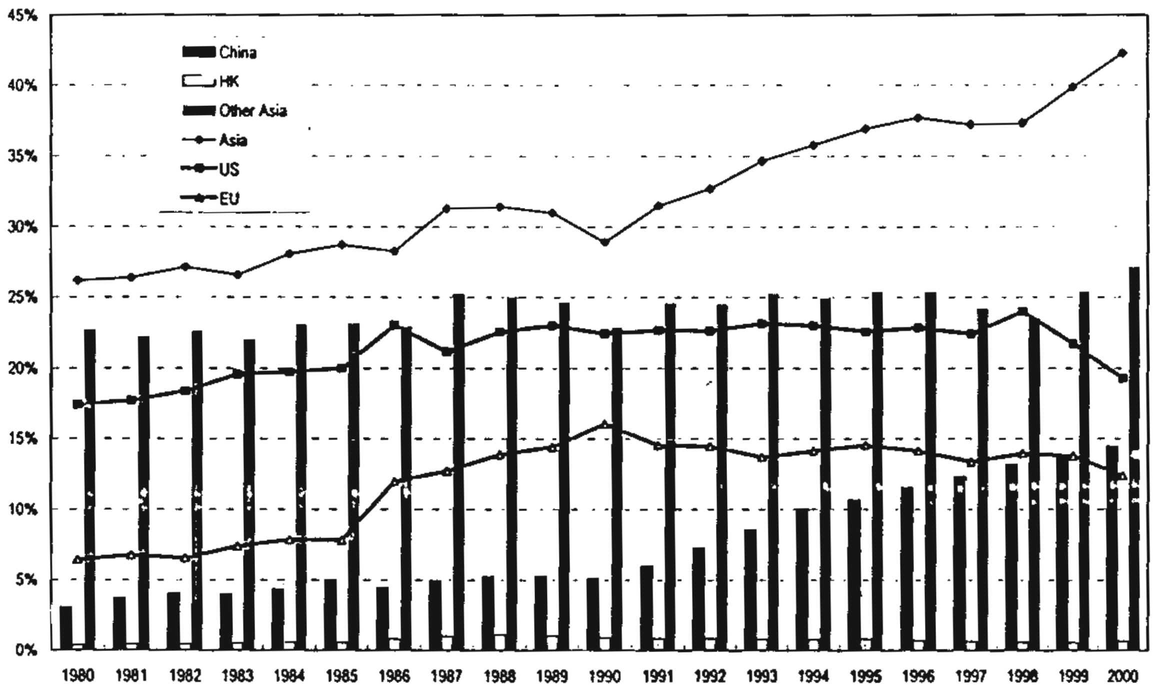
Source: IMF, *International Financial Statistics*

Figure 2 Export Destination



Source: IMF, *Direction of Trade*

Figure 3 Imports by Region



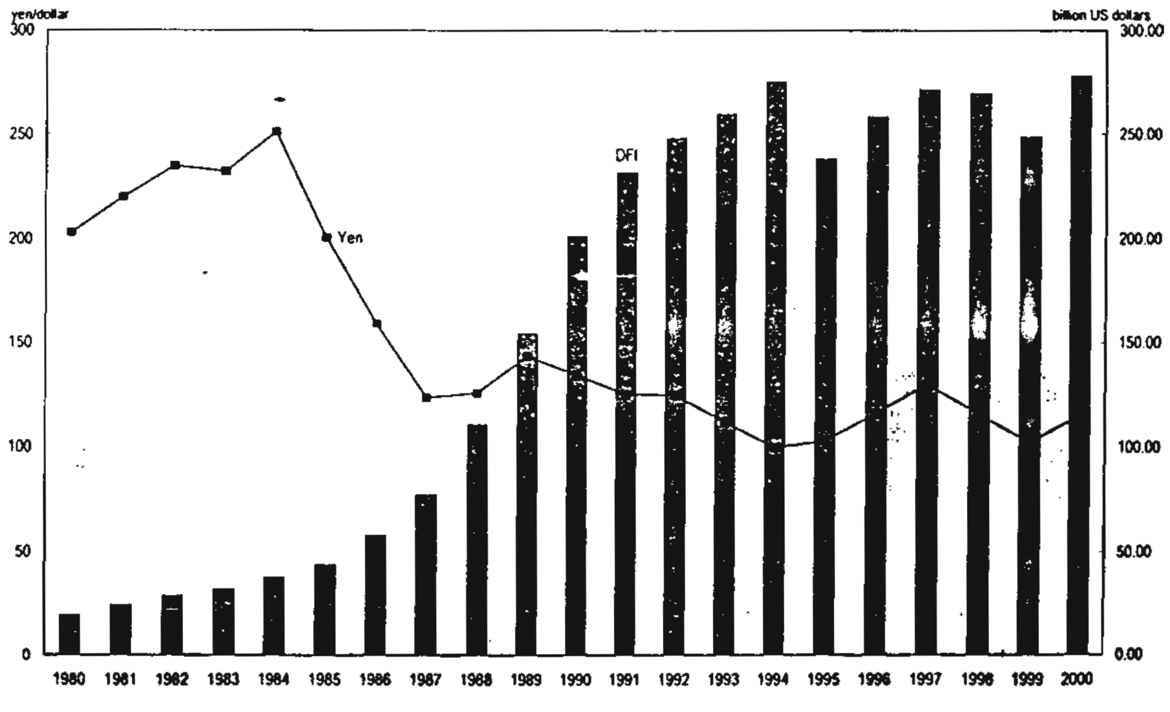
Source: *IMF, Direction of Trade*

Table 1 Trade Intensity

	US	Japan	EU	East Asia	Asian NIEs	Chinese	Hong Kong	ASEAN4	China	AFTA
US	0.00	1.55	0.61	1.03	1.19	1.47	0.68	1.09	0.57	1.05
Japan	1.61	0.00	0.46	2.50	2.67	3.63	2.05	2.83	1.77	2.51
EU	0.51	0.34	1.73	0.30	0.30	0.31	0.29	0.29	0.30	0.29
East Asia	1.18	2.21	0.41	2.30	2.20	1.40	3.52	2.33	2.54	2.38
Asian NIEs	1.16	1.61	0.40	2.48	1.60	1.13	2.90	3.01	4.22	2.40
Chinese Taipei	1.27	2.07	0.42	2.33	2.98	0.00	7.65	2.19	0.79	2.18
Hong Kong	1.21	1.04	0.43	2.73	0.59	0.50	0.00	1.01	9.79	1.09
ASEAN4	1.14	2.93	0.42	2.27	2.81	2.41	1.50	2.06	1.10	3.63
China	1.27	2.89	0.42	1.92	3.02	1.02	7.00	0.99	0.00	1.09
AFTA	1.05	2.47	0.42	2.42	2.38	2.12	1.89	3.93	1.09	4.08

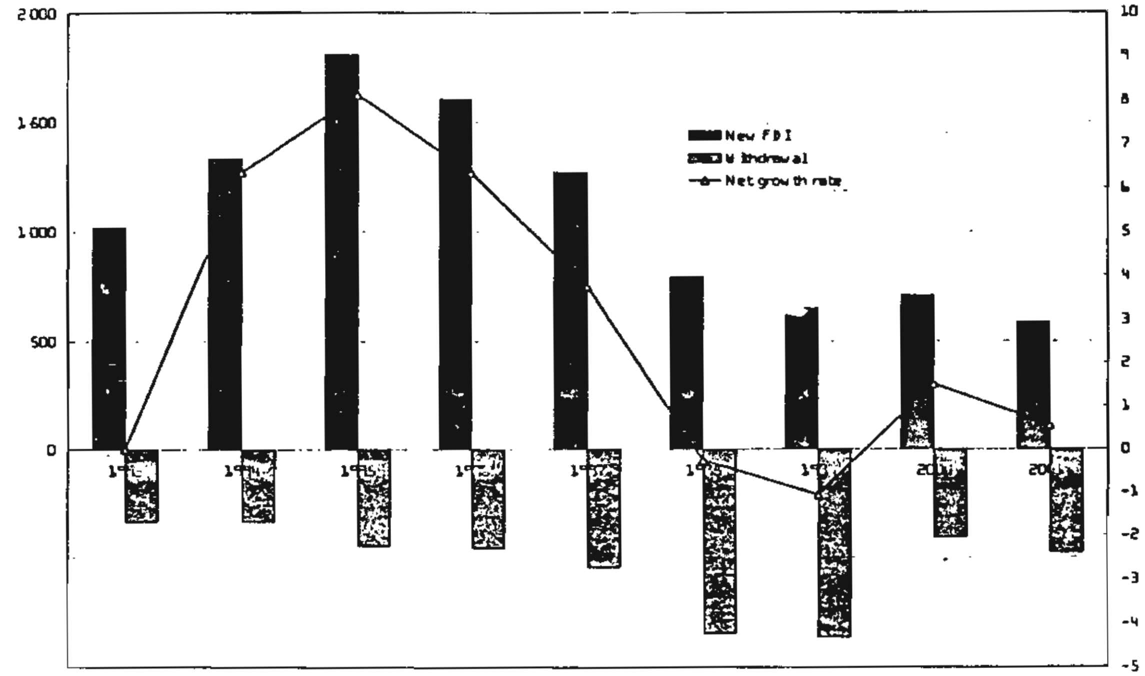
Source: Calculated using the data by IMF, *Direction of Trade*

Figure 4 Yen rate and growth of FDI



Source: IMF, International Financial Statistics; METI, *White Paper of International Trade, 2002.*

Figure 5 FDI



Source: MOF

Figure 6 FDI by Region

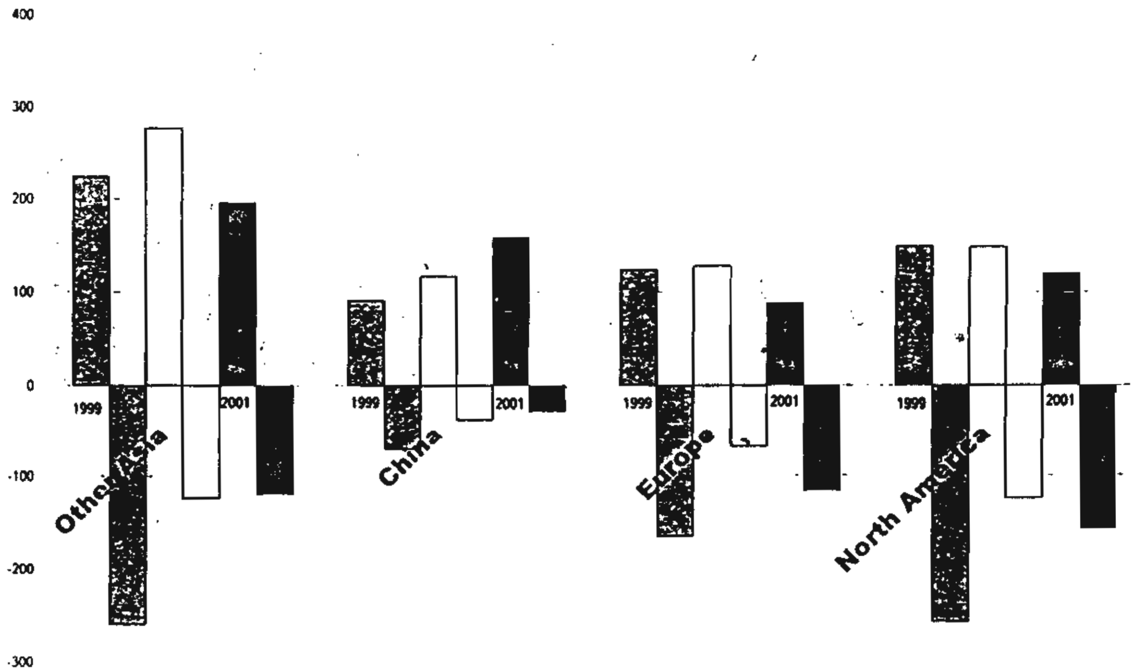


Figure 7 FDI by Industry

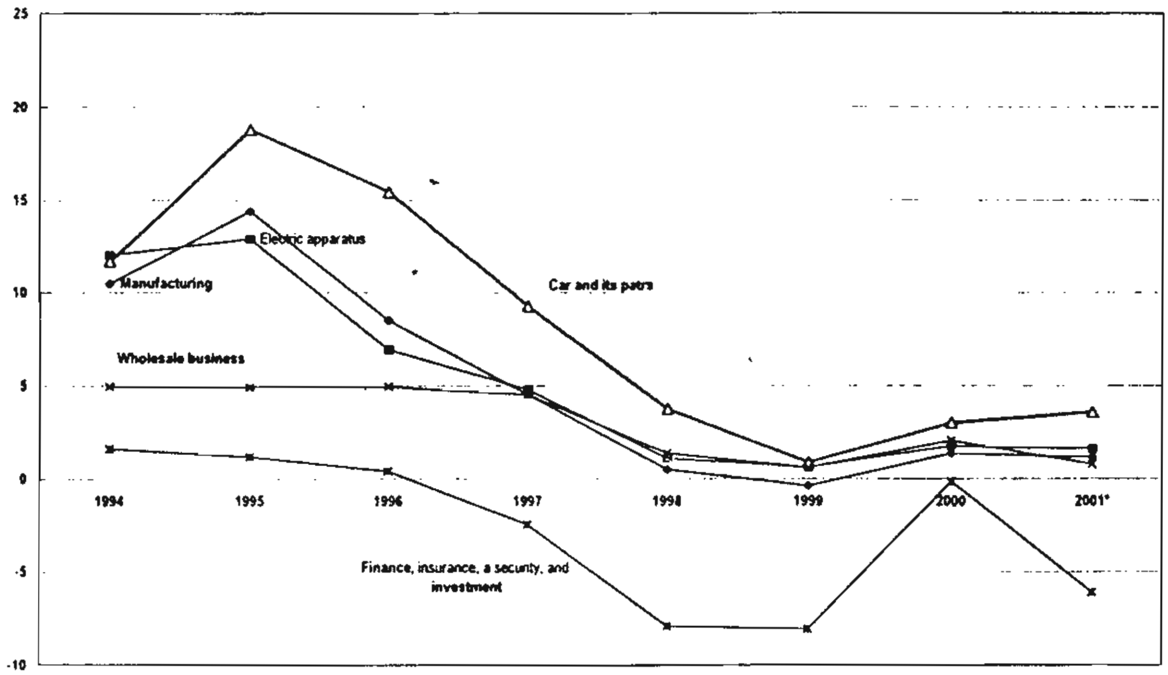
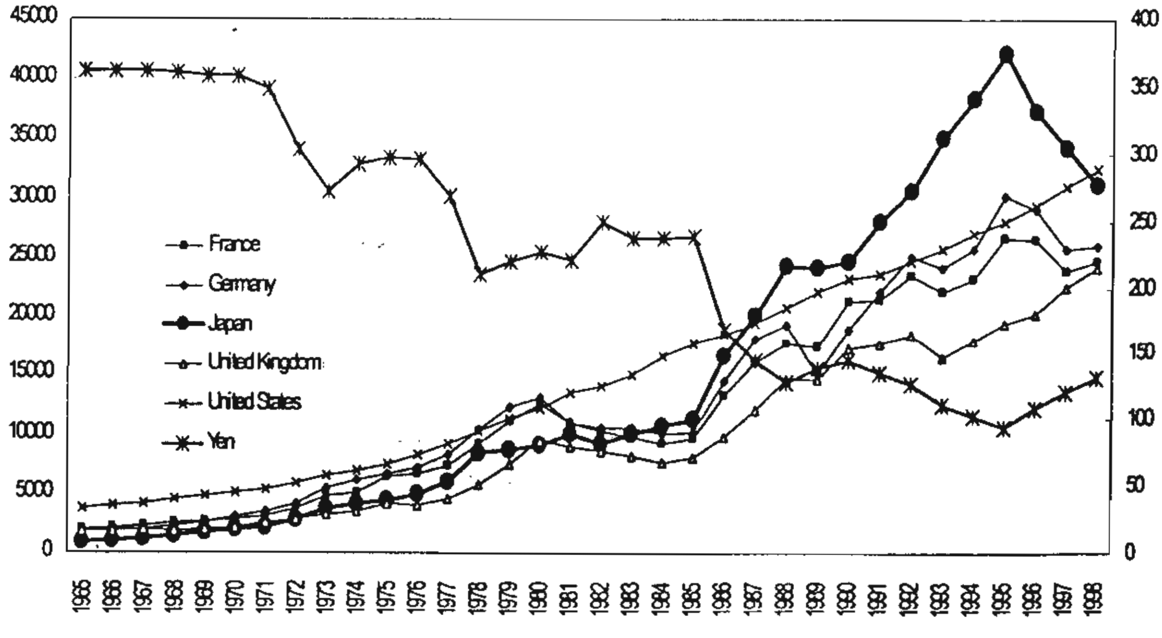
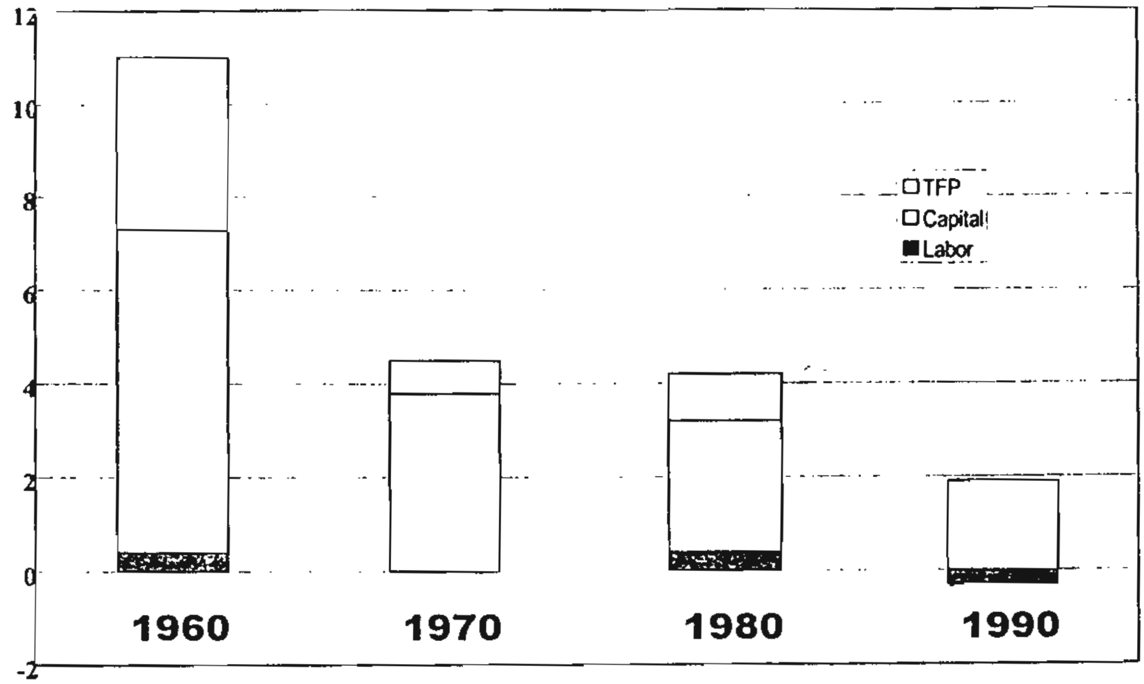


Figure 8 GDP per capita: industrial countries



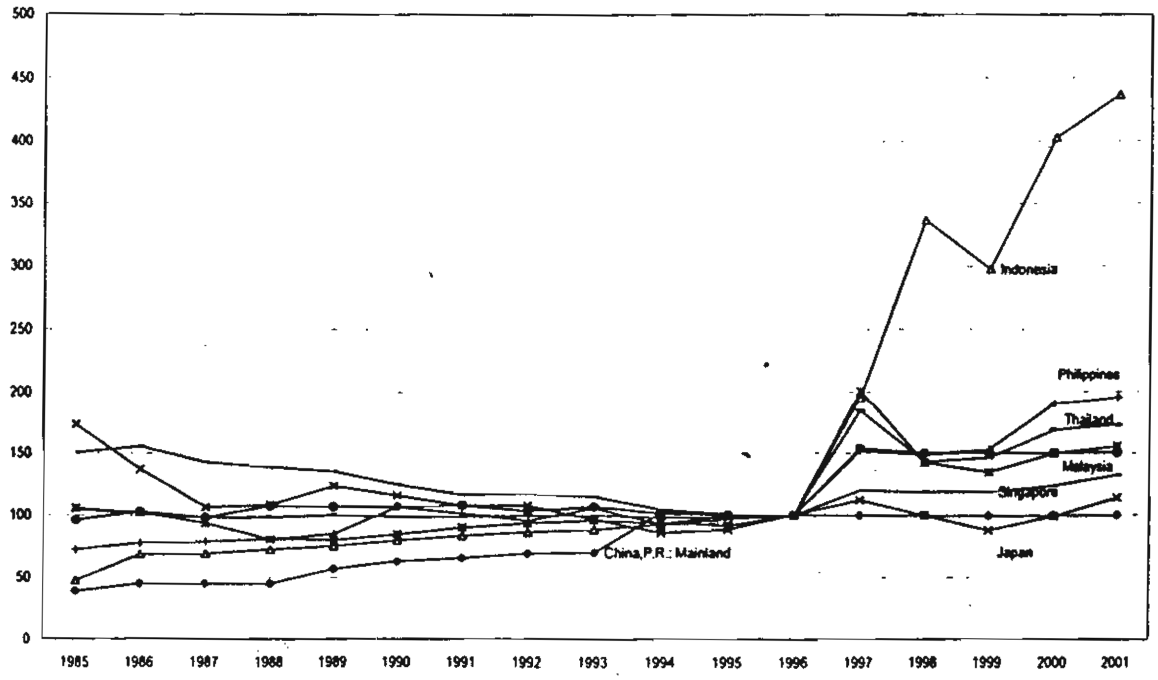
Source: IMF, *Direction of Trade*

Figure 9 Total factor productivity



Source: METI, *White Paper on International Trade, 2000*

Figure 10 Asian Crisis: Exchange Rates



Source: IMF, *International Financial Statisitcs*

Figure 11 Asian Crisis: Real Side Story (1)

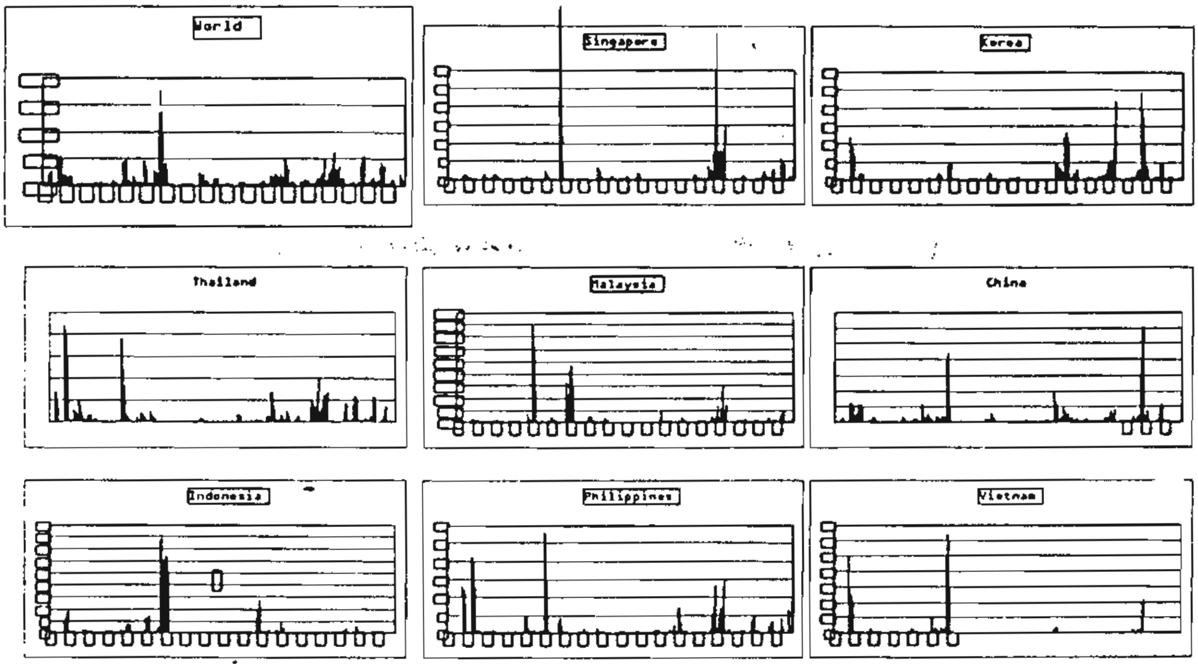
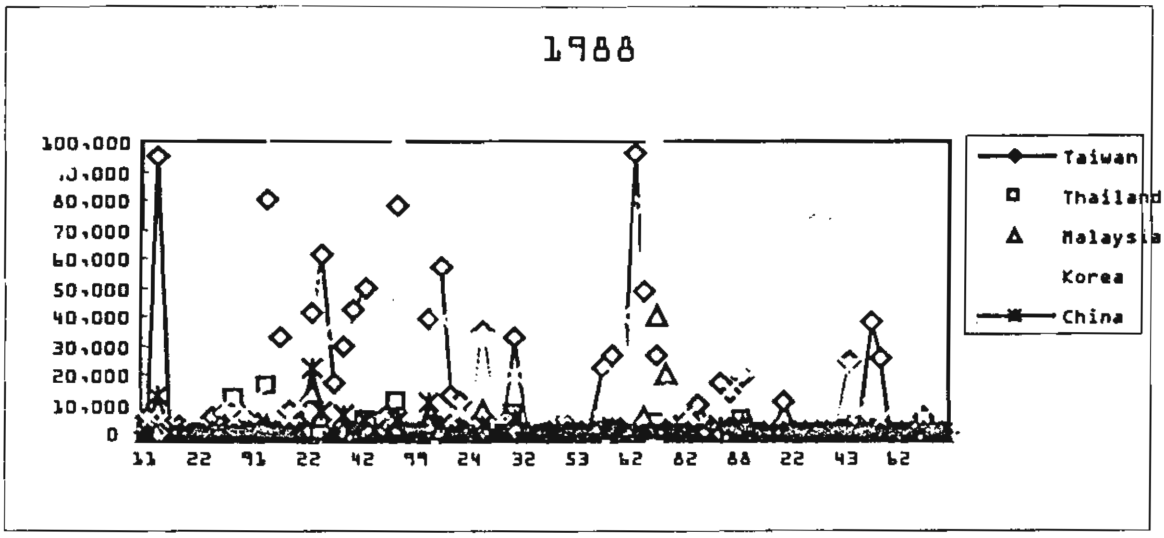


Figure 12 Asian Crisis: Real Side Story (2)



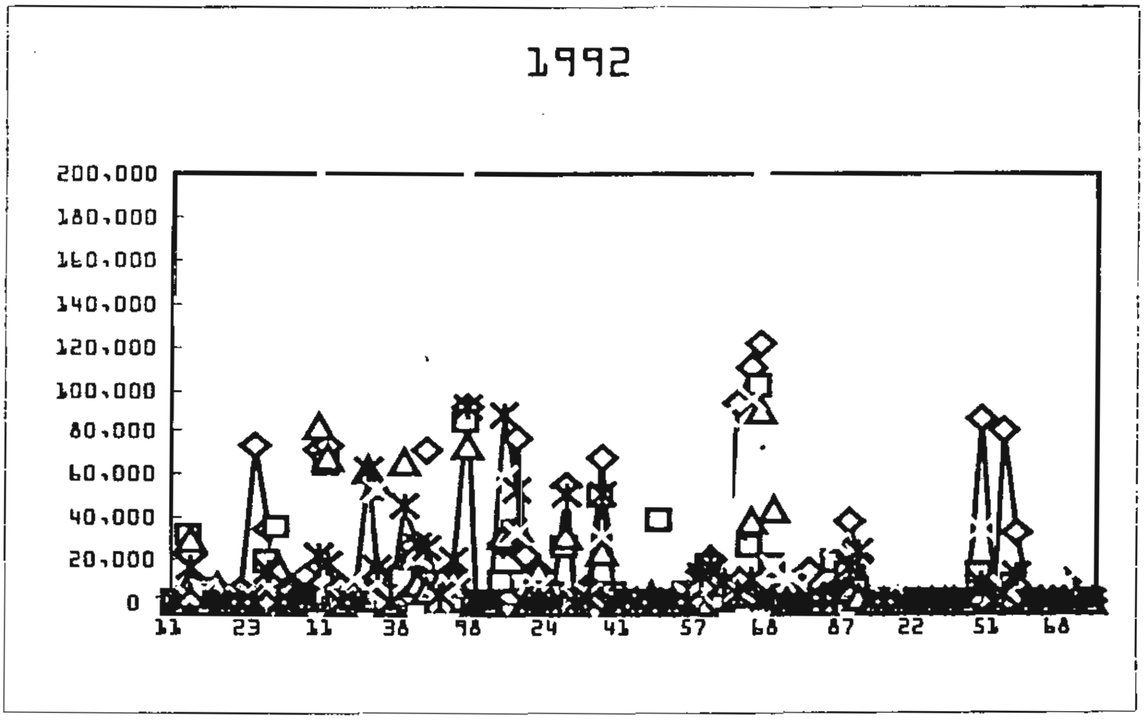


Figure 13 Fiscal Balance

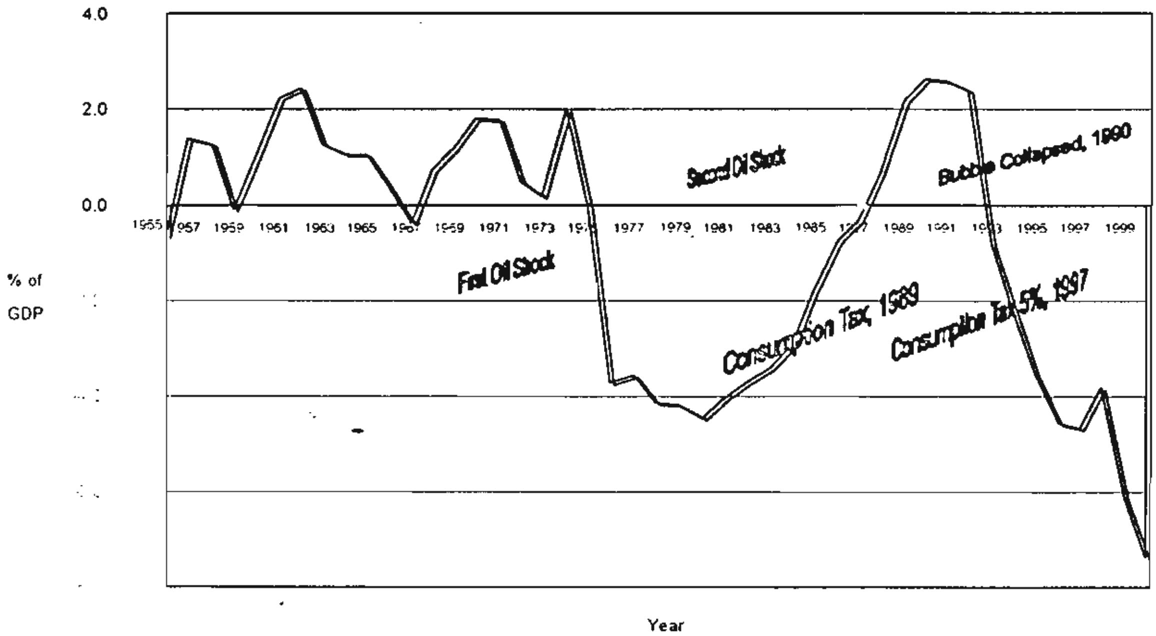
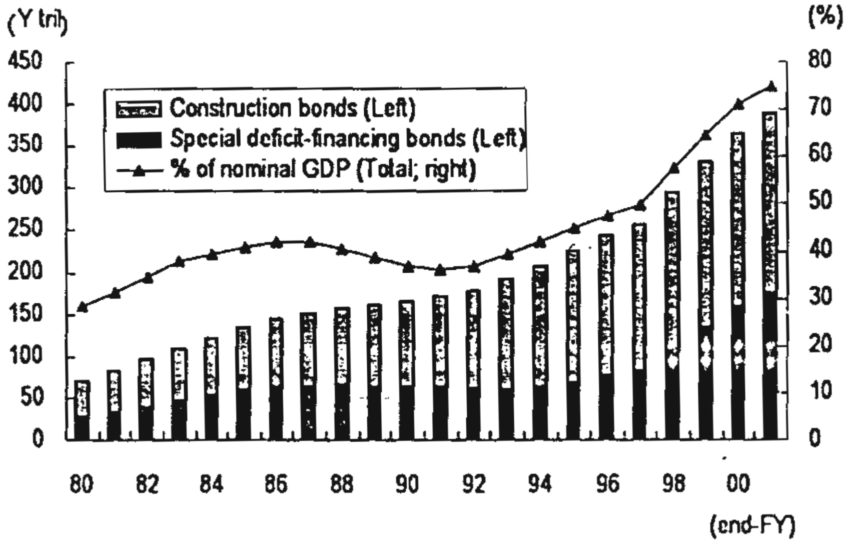
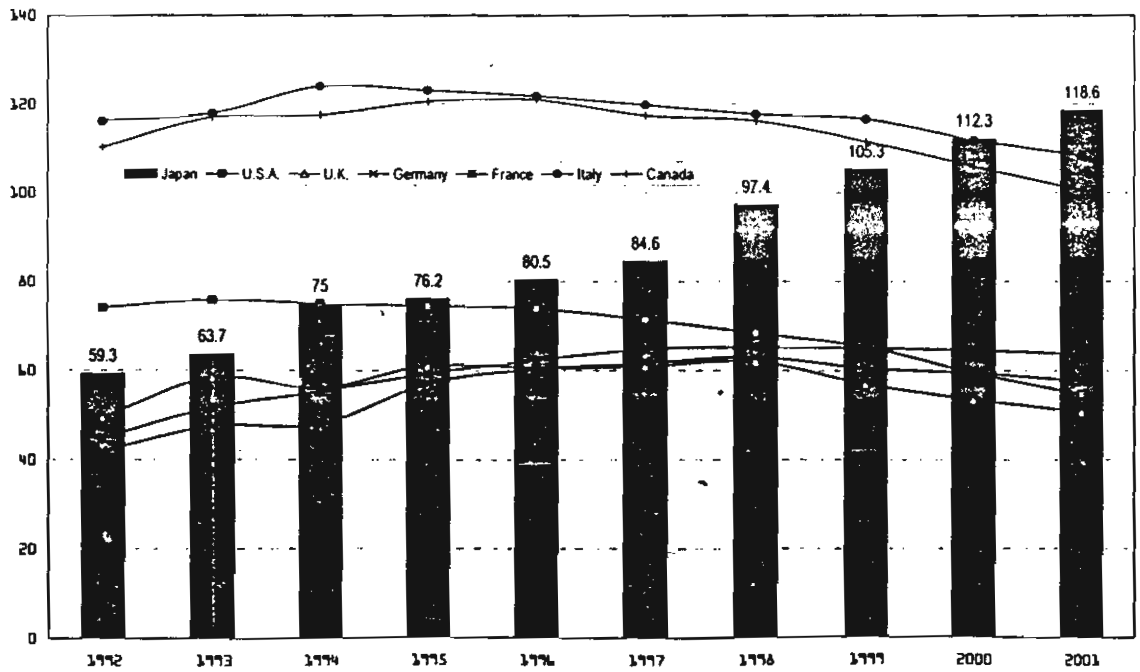


Figure 14 National Debt



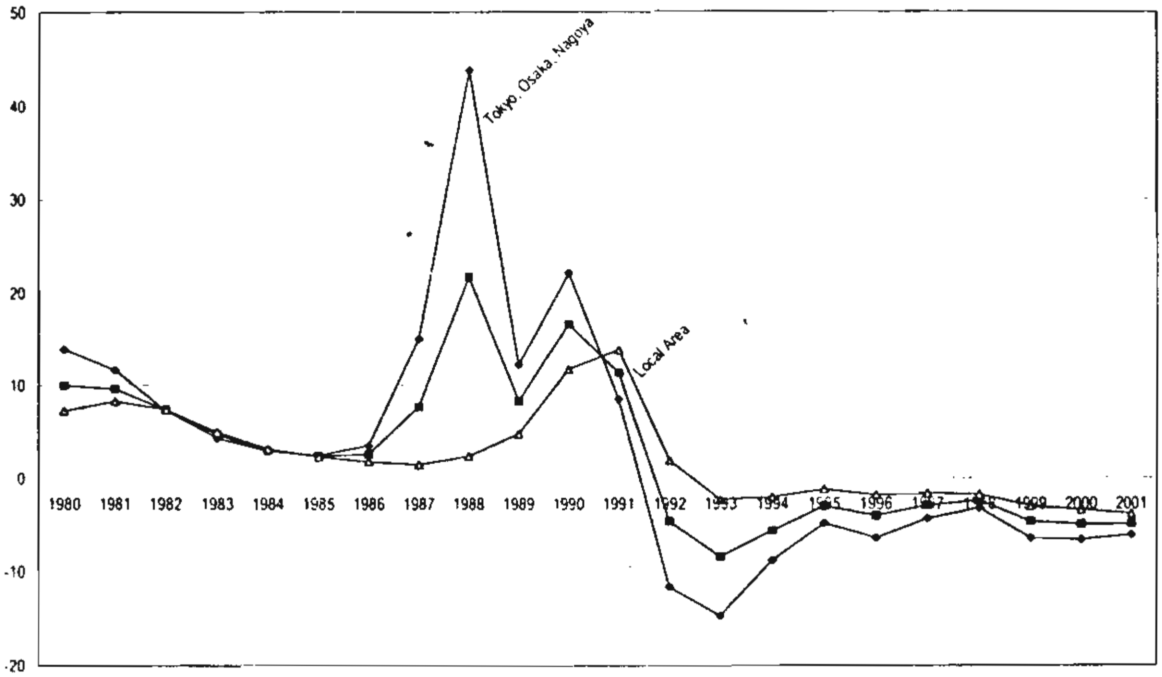
Sources: MOF; CAO.
Note: FY80-99: Actual; FY00-01; Government estimation.

Figure 15 National Debt: International Comparison



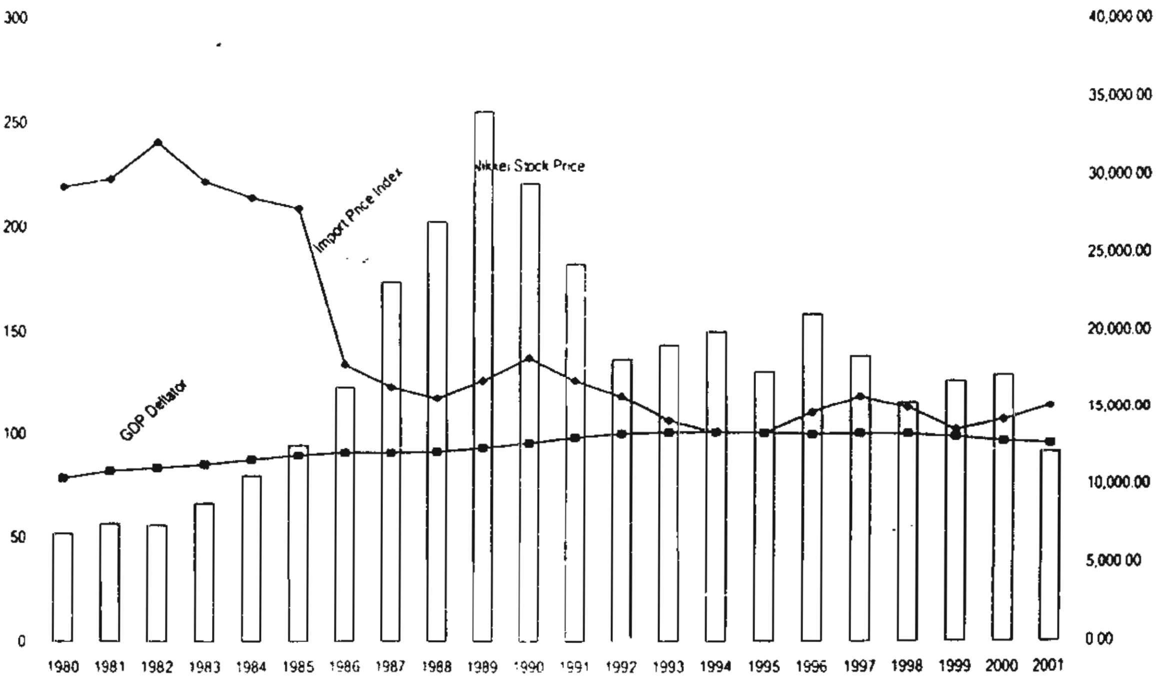
Source: OECD

Figure 16 Land Prices



Source: Nikkei NEEDS

Figure 17 Deflation



Source: Nikkei NEEDS

Figure 18 Call Rates

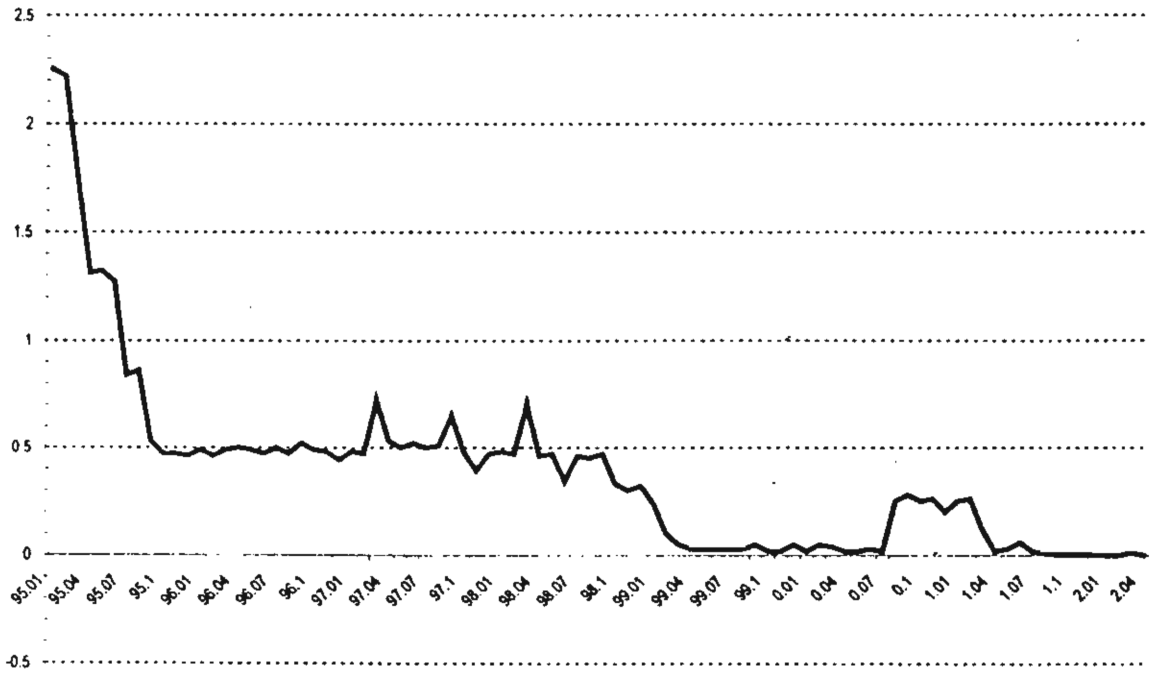
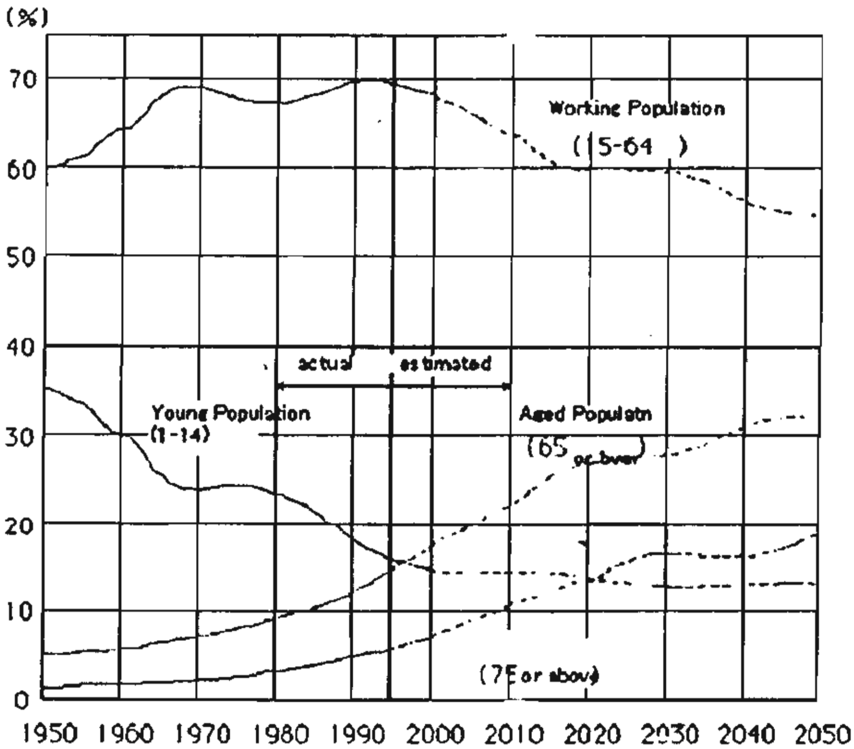


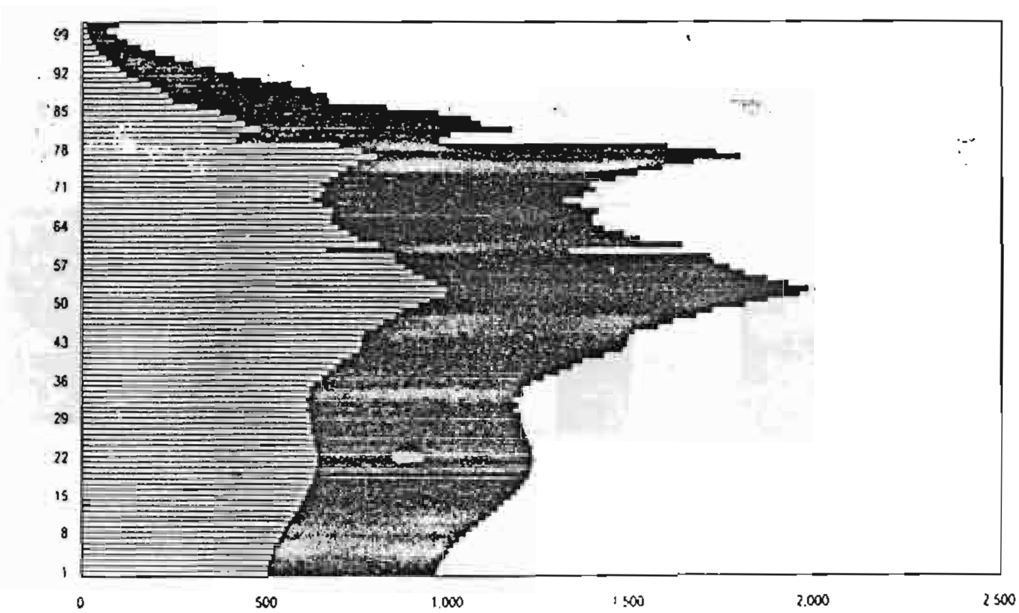
Figure 19 Aging



Source: Ministry of Welfare and Labor

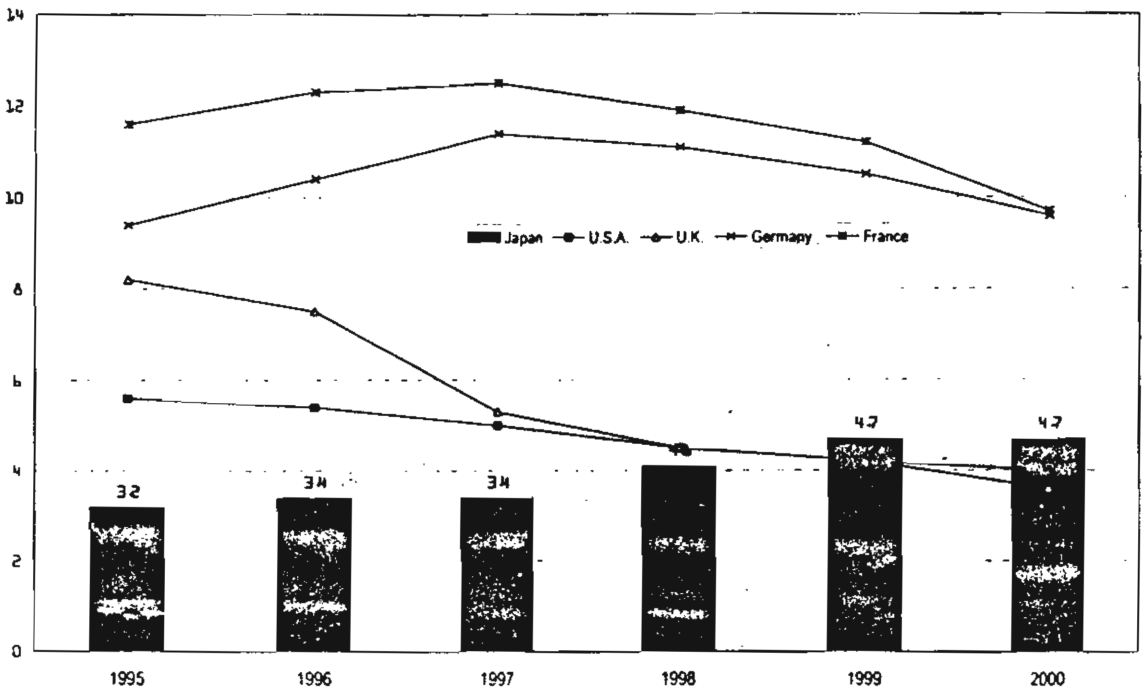
Figure 20 Population Pyramid

Population Pyramid, 2025



Source: Ministry of Welfare and Labor

Figure 21 Unemployment



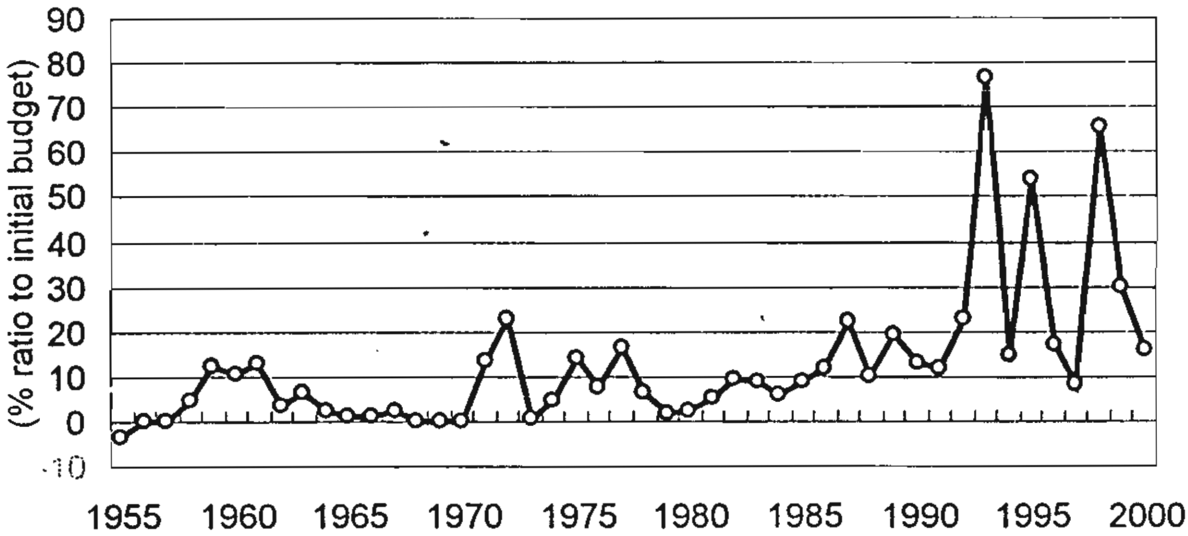
Source: OECD

Table 2 Major Economic Policies in the 1990s

Date	Measures	Overall Size of Project	Prime Minister
Aug.,1992	General economic measures	10.7	Miyazawa Kiichi
Apr.,1993	To promote general economic measures	13.2	Miyazawa Kiichi
Sep.,1993	Emergency economic measures	6	Hosokawa Morihiro
Feb.,1994	General economic measures	15.3	Hosokawa Morihiro
Apr.,1995	Emergency economic measures and against yen appreciation	-	MurayamaTomiichi
Sep.,1995	To fully carry out the economic measures and recovery	14.2	MurayamaTomiichi
Apr.,1998	General economic measures	More Than 16	Hashimoto Ryutaro
Nov.,1998	Emergency economic measures	More than 17(27including tax reduction)	Obuchi Keizo
Nov.,1999	New economic measures	17(18including elderly care program)	Obuchi Keizo
Oct.,2000	New measures for the rebirth of Japan	11	Mori Yoshiro
Apr.,2001	Emergency economic measures	-	Mori Yoshiro
Jun.,2001	Fundamental principle on economy and finance	-	Koizumi Junichiro

Source: *Economic White Paper*

Figure 22 Public Works



Sources: MOF; Daiwa Institute of Research (DIR).

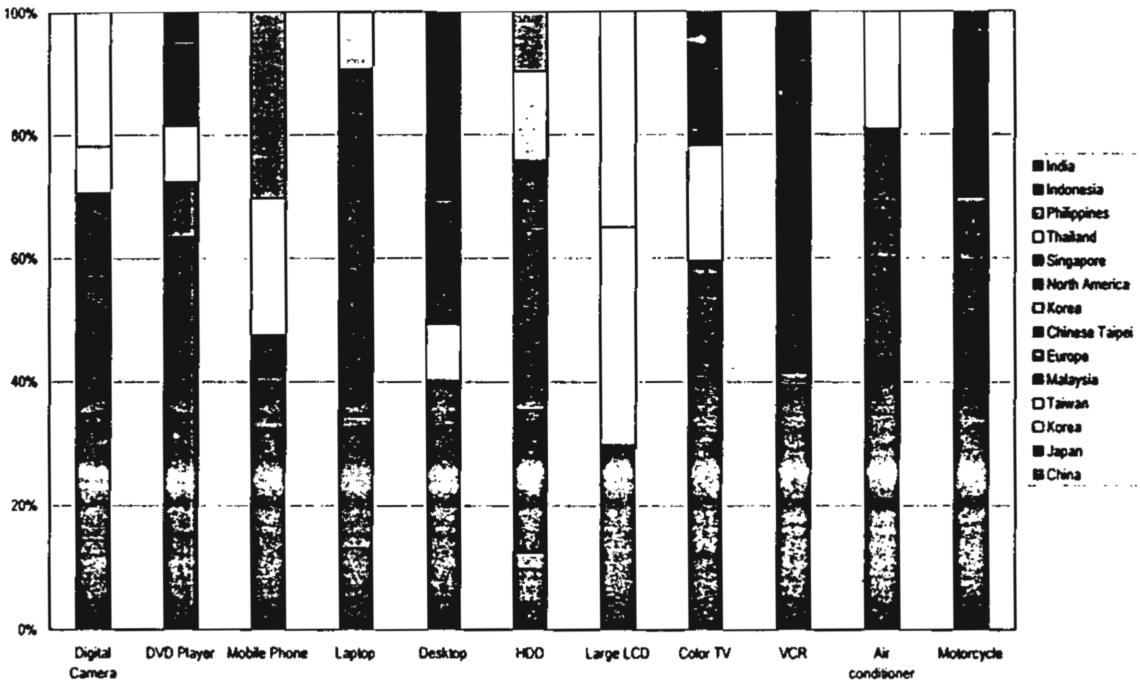
Notes: 1) Based on central government general account.

2) Negative values are cases when initial budget was cut

Table 3 Employment Reduction Plan

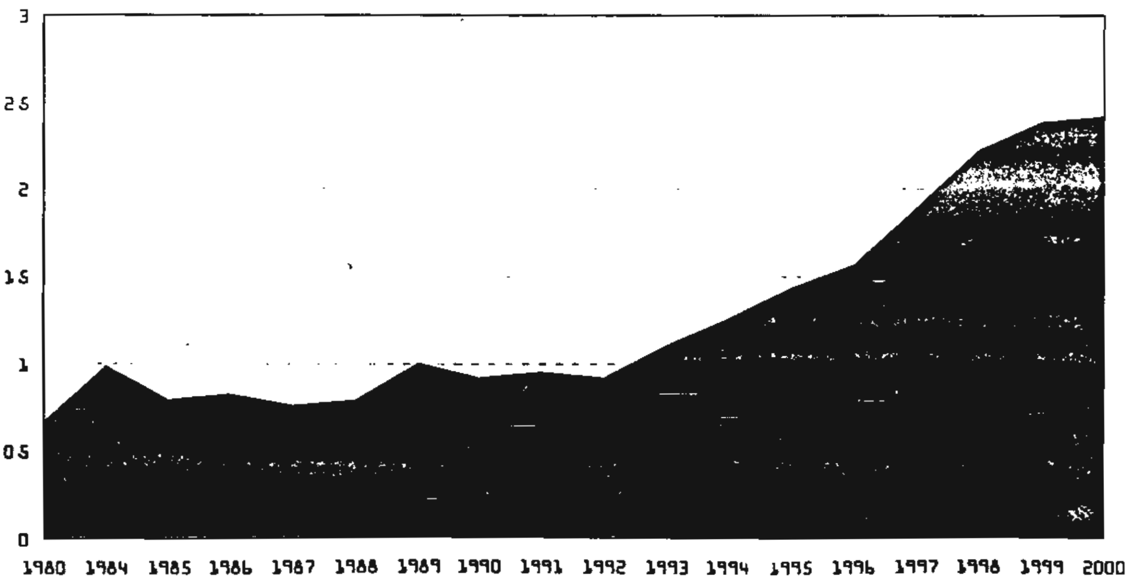
Employment Reduction Plan							
					NetProfit 2001(100mil yen)		
	Home	%	Foreign		Total	Midyear	Yearend
Hitachi	10,200	4%	4,500	6%	14,700	970	1400
Toshiba	17,000	12%	1,800	4%	18,800	1100	1150
Fujitsu	5,000	5%	11,400	16%	16,400	2100	2200
NEC	2,500	2%	1,500	5%	4,000	30	?
Matsushit					6,000	450	?
Kyocera	All contract employee		10,000		10,000	180	500
Oki	2,200	10%	0	0%	2,200	30	?

Figure 23 China: Emerging Power



Source: *Nihon Keizai Shinbun*, August 13, 2002

Figure 24 Technology Transfer



Source: Ministry of General Affairs

Figure 25 ODA

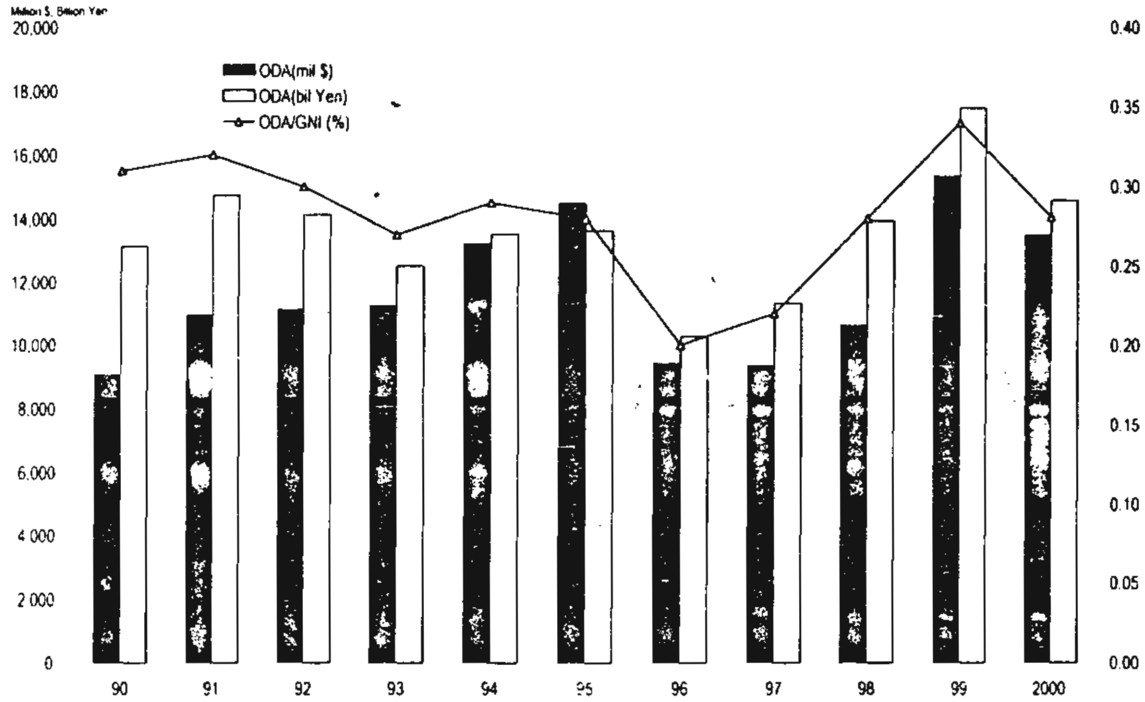


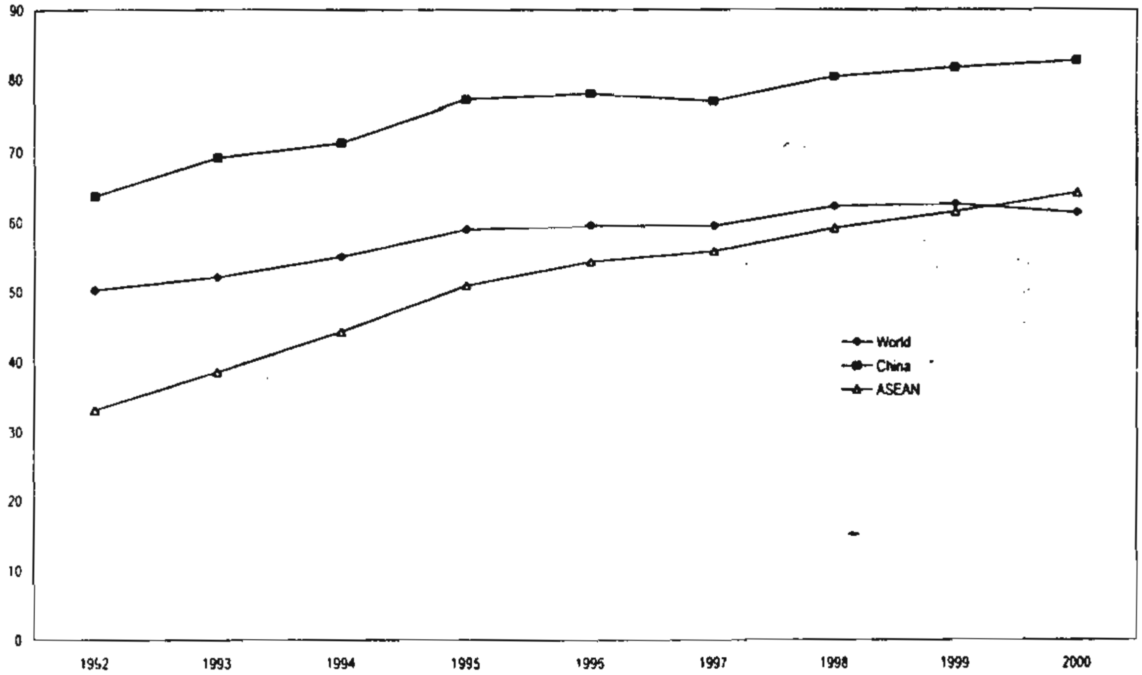
Table 4 Top 10 ODA Recipients

Million US dollars, %

Rank	1998			1999			2000		
	Country	Amount	Share	Country	Amount	Share	Country	Amount	Share
1	**China**	**1,158.16**	**13.46**	Indonesia	1,605.83	15.30	Indonesia	970.10	10.06
2	Indonesia	828.47	9.63	**China**	**1,225.97**	**11.68**	Vietnam	923.68	9.58
3	Thailand	558.42	6.49	Thailand	880.26	8.39	**China**	**769.19**	**7.98**
4	India	504.95	5.87	Vietnam	679.98	6.48	Thailand	635.25	6.59
5	Pakistan	491.54	5.71	India	634.02	6.04	India	368.16	3.82
6	Vietnam	388.61	4.52	Philippines	412.98	3.93	Philippines	304.48	3.16
7	Philippines	297.55	3.46	Peru	189.12	1.80	Pakistan	280.36	2.91
8	Sri Lanka	197.85	2.30	Pakistan	169.74	1.62	Tanzania	217.14	2.25
9	Bangladesh	189.05	2.20	Brazil	149.36	1.42	Bangladesh	201.62	2.09
10	Malaysia	179.10	2.08	Syria	136.17	1.30	Peru	191.68	1.99
Sum of top 10		4,793.70	55.70		6,083.45	57.95		4,861.64	50.43
Developing Coutries Total		8,605.90	100.00		10,497.56	100.00		9,640.10	100.00

Source: Ministry of Foreign Affairs, *White Paper on ODA*, 2001

Figure 26 Ratio of Manufacture Imports



International Conference on
Economic Recovery and Reforms

Malaysia

Economic Recovery and Reforms: The Malaysian Experience

Ragayah Haji Mat Zin
Isntitute of Malaysian and International Studies (IKMAS)
Universiti Kebangsaan Malaysia

ABSTRACT

Initially, Malaysia implemented IMF-style responses to the Asian financial crisis 1997-1998 but when these exacerbated the economic downturn, the government introduced counter-cyclical measures and announced the National Economic Recovery Plan (NERP) to provide a comprehensive and action-oriented framework to expedite economic recovery. The NERP has six interrelated and complementary objectives, which included the short-term focus of stabilising the ringgit, restoring market confidence, and maintaining financial stability. These were complemented with structural reform objectives of strengthening economic fundamentals, continuing the equity and socio-economic agenda, and restoring adversely affected sectors.

Specifically, the government imposed selective exchange controls on 1 September 1998 and fixed the exchange rate at US1=RM3.80 the next day. The Government also introduced pre-emptive measures to strengthen the resilience of the financial sector. These include strengthening the resilience of the banking sector through a merger programme; the establishment of Danaharta, the national asset management company to address the rise of NPLs as well as Danamodal, an interim funding vehicle to address the erosion of capital in some banking institutions; and the Corporate Debt Restructuring Committee to resolve the debt problems of larger corporations.

1. Introduction

Before the devaluation of the baht in July 1997 that triggered the East Asian financial crisis Malaysia was enjoying an enviable average growth rate of 9.7% per annum in the four years prior to the crisis. In the beginning most analysts expected it to be contained within a few months. However, the crisis turned out to be unprecedented in terms of the speed and severity of the contagion effect that also spread to countries outside of East Asia. In Malaysia, as in other East Asian countries, what started as a currency crisis quickly deteriorated into an economic and social crisis.

By most indicators the Malaysian economy was fundamentally strong on the eve of the crisis. Real gross domestic product (GDP) grew at about 8.5% in the first half of 1997 while the Government continued to register fiscal surpluses and, more importantly, the level of external debt was low at 43.2% of gross national product (GNP). Bank Negara Malaysia (1999a:569) states that the current account deficit was reduced to 5% of GNP in 1996 from 10% in 1995 and was expected to improve further. Inflation reached its lowest level, 2.1%, in July 1997. Measures were also taken to slow down the pace of bank landing so as to make domestic demand more compatible with the level of output, and to contain the development of any asset bubble.

Despite its relatively sound economic fundamentals, Malaysia was not spared from the crisis. The contagion effect spread to Malaysia soon after the sharp depreciation of the Thai baht on 2 July 1997 as herd behaviour caused market participants to view Malaysia as having the same common problems as those faced by her neighbours. By the end of August 1998, the speculative attack on the ringgit had caused it to be depreciated by 40% against the United States dollar compared to its level at the end of June 1997. The Kuala Lumpur Stock Exchange Composite Index (KLSE CI) fell by 79.3% from a high of 1271.57 points in February 1997 to a low of 262.70 points on 1

September 1998. The effects were then transmitted to the banking and corporate sector, resulting in the economy experiencing a recession for the first time in 13 years by the second quarter of 1998.

How did Malaysia manage the economy during the crisis and what steps have been taken to revive the economy? What reforms have been put into place in order to strengthen the economy, particularly the financial and corporate sector, to become more resilient in facing future challenges in the turbulent era of globalisation. The objective of the present paper is therefore to trace the path of economic recovery in Malaysia after the crisis as well as examine the essential reforms made at the macro and micro levels. In this regard, the paper will concentrate mostly on the restructuring of the banking and corporate sectors. For this purpose, the next section will enumerate the various stages of Malaysia's policy responses to the crisis while Section 3 will describe macroeconomic impact of the crisis and measures on the Malaysian economy. The progress of controls and reforms will be addressed in Section 4. Section 5 will conclude the study.

2. Policy Response to the Crisis[1]

While measures were already put in place before the crisis to address potential vulnerabilities, they were insufficient to reverse the financial panic and speculative pressure that ensued. The Malaysian government's response to the crisis changed at various stages reflecting the different assessment and policy orientations (Ishak Shari and Abdul Rahman Embong 1998: 3-4).

[1] This section is mainly based on Bank Negara Malaysia (1999a)

2.1 Initial Policy Response

At the initial stages, using the IMF/World Bank approach, the Central bank attempted to stabilize the ringgit by intervening in the foreign exchange markets and raising domestic interest rates. However, these interventions were very costly as propping the ringgit led to a depletion of the country's foreign exchange reserves while raising the domestic interest rates had the negative effect of exacerbating the economic downturn. As the crisis appeared to be prolonged, interest rates were subsequently reduced to about pre-crisis levels so as not to adversely affect the real sector. However, after September 1997 interest rates were adjusted upwards (but not as high as prescribed by the IMF) to ensure depositors obtained a positive rate of return on their savings to be in line with the increase in expected inflation. To curb speculation in the currency and stock markets and to allow rates in Malaysia to reflect domestic conditions, banking institutions were required to observe a US$2 million limit on outstanding non-commercial related ringgit offer side swap transactions with foreign customers.

When both the ringgit and share prices were pushed to successive lows in a progressively volatile external environment, it was recognized that stronger macroeconomic adjustments were required. Hence, a set of austerity measures was announced in early September 1997 to further reduce the level of aggregate demand and contain the current account deficit. These measures included a 2% cut across the board in Government spending; rationalisation of the purchase of imported goods by public agencies, including the armed forces; and deferment of several large privatised projects (Bank Negara Malaysia 1998). These measures were reinforced with further measures announced in the 1998 Budget in October 1997, which included deferment of projects with total cost amounting to RM65.6 billion and establishing the RM 1 billion fund for small- and medium-scale industries (SMIs). When the regional instability persisted into December, the government introduced a stronger and comprehensive package of policies including a further sharp cutback in Federal

Government expenditure by 18% in 1998; deferment of selected projects; intensive promotion of exports, tourism and the utilisation of locally-produced goods; and a freeze on reverse investment which amounted to RM10.5 billion in 1996.

The government also instituted measures to further strengthen prudential standards of the banking system. These included the recognition of a loan as non-performing when its servicing had been in arrears for three months instead of six; increasing the minimum general provision from 1.0% to 1.5% and greater disclosure in financial statements. Measures were also taken to reduce credit growth and exposure to the less productive sectors in the form of voluntary credit plans whereby the financial institutions undertook to reduce overall credit growth to 25% by the end of 1997, 20% by end-March 1998 and 15% by end-1998. At the same time, the banking institutions had to ensure that in allocating credit, priority would be given to borrowers engaged in productive and export-oriented activities. Priority was given to rationalise and consolidate finance companies into fewer but stronger financial institutions and there was a push for greater corporate transparency and disclosure.

2.2 A Change in Policy Direction

As the crisis deepened, counter-cyclical measures were introduced to head off an impending recession. Fiscal policy was selectively relaxed beginning March 1998 and monetary policy was eased in early August 1998 when inflationary pressures became subdued. By April-May 1998, when it was obvious that the economy was contracting, Malaysia went against the IMF advice and allocated additional fiscal expenditures totalling RM3 billion. The fiscal measures included selective increase in infrastructure spending, setting-up of funds for SMIs, higher allocation on social sector development as well as reducing taxes (Bank Negara Malaysia 1999b). The government also implemented several programs under the National Economic Recovery Plan to help the poor weather the adverse conditions, which include the following: the 20% cut in the 1998 budget has been compensated by an additional allocation of RM3.7 billion (about 18% of the total social sector budget). This amount is to assist the vulnerable groups hit by the crisis, including funds for small farmers, micro-credit for small businesses, extension of community and rural health facilities, and development of skills training and higher education. The World Bank disbursed a USD 300 million loan in June 1998 to mitigate the adverse effects of the economic adjustment on the more vulnerable segments of society and in 1999 approved USD404 million to fund social programs such as low cost housing. The Islamic Development Bank also approved a loan of USD99 million. Malaysia had also obtained funding from bilateral sources such as loans under the New Miyazawa Initiative. Moreover, the government has not reduced the original budget allocated for poverty alleviation while ministries involved in providing the social services, such as the Ministry of Health and Ministry of National Unity, had smaller 1998 budget cuts. The government has also taken measures to increase opportunities for employment and self-employment by encouraging organized and systematic petty trading, farming and setting up of small businesses. Measures to contain inflation, such as removal of imperfections and distortions in the marketing of essential commodities, importing from cheaper sources and others, were executed.

In an attempt to protect itself against international financial volatility, the government imposed selective exchange controls on 1 September 1998. These were necessary as the risks of further instability persisted more than a year into the crisis, despite Malaysia's strong macroeconomic fundamentals and restructuring program. Unlike other regional currencies, the ringgit was significantly traded in the region, especially in Singapore. The substantial onshore-offshore interest rate differential attracted ringgit funds abroad, for example in Singapore where the ringgit deposit rates were as high as 20-30%. Hence, Malaysia was facing the dilemma of a trade-off between an accommodative monetary policy to avoid a contraction in the economy, and the need to check further deterioration in the exchange rate.

Specifically, the controls were aimed at bringing about stability and to enable monetary policy to be based on domestic conditions. The main selective exchange control measures include (see Bank Negara Malaysia 1999a: 292):

- Control on the transfer of funds in the External Accounts to immobilize trading of ringgit offshore;
- Control on ringgit loans to non-residents;
- Imposition of the 12-month holding rule on the repatriation of funds in External Accounts (replaced by repatriation levy on portfolio funds on 15 February 1999 which was subsequently liberalized further on 21 September 1999);
- Limiting the amount of ringgit that could be imported or exported and the amount of foreign currency that could be exported.

The ringgit exchange rate was fixed at US$1 = RM3.80 the next day. This move enabled the authorities to reduce the interest rate. For example, the base lending rate (BLR) of commercial banks, which rose from 10.33% at the end of 1997 to 12.27% at the end of June 1998 was reduced to a maximum rate of 8.05% as at 10 November, 1998. This move has benefited the banking institutions and private sector from enhanced liquidity and lower interest rates (Ishak Shari and Abdul Rahman Embong 1998), thus stimulating an expansion in domestic demand.

The selective exchange control measures had the specific target of eliminating access to ringgit by speculators by reducing the offshore market in ringgit and limiting the supply of ringgit to speculators. They also aimed at stabilising short-term capital flows and carefully designed to have minimal impact on economic activities. Thus, rules that governed trade transactions and foreign direct investment were left unchanged. Current account convertibility continued to be maintained. The only requirement was for trade settlements to be carried out in foreign currencies. As such, the exchange controls affect only short-term flows. As conditions stabilised and improved, modifications were made where on 15 February 1999, a "repatriation levy" replaced the 12-month holding rule. For funds brought into the country prior to this date, the principal amount was allowed to be repatriated subject to a graduated levy. For funds brought in from this date onwards, the principal amount was freely allowed to be repatriated, but the profits were subject to a graduated levy system, which was simplified to a flat 10% levy on 21 September 1999.

2.3 National Economic Recovery Plan

In late July 1998, the National Economic Action Council (NEAC), which was set up to deal with the crisis and revive the economy, announced the National Economic Recovery Plan (NERP) to provide a comprehensive and action-oriented framework to expedite economic recovery. The NERP has six interrelated and complementary objectives, which included the short-term focus of stabilising the ringgit, restoring market confidence, and maintaining financial stability. These were complemented with structural reform objectives of strengthening economic fundamentals, continuing the equity and socio-economic agenda, and restoring adversely affected sectors.

Related to these six objectives, the NERP contains 40 courses of action and more than 580 detailed recommendations (see NEAC 1998). Four areas of action were proposed in order to stabilise the ringgit and these includes the appropriate choice of exchange rate regime, increase external reserves, reduce over-dependence on the US dollar and adopt a balance interest rate policy. The market confidence-building measures recommended are improve transparency and the regulatory environment, establish rules for assisting industries and companies, increase the consistency of government policies, adopt liberal market-based policies, improve public relations and improve the dissemination of economic information. The actions identified to bring stability in the financial markets are preserving the integrity of the banking system, establishing an agency to insure deposits at commercial and savings banks as well as to close or merge insolvent thrift institutions, recapitalising the banking sector, monitoring closely overall credit expansion, improving the capital market and developing the private debt securities market.

The fourth NERP objective of strengthening economic fundamentals involves issues that are structural in nature, and the measures recommended are aimed at instituting structural reforms to build a more dynamic and resilient economy. Towards this end, the actions to be taken involve increasing the quality of investments, improving the balance of payments, maintaining a balance public sector financial position, appropriate monetary policy and price stability, and increasing labour competitiveness. The actions to be taken in continuing the equity and socio-economic agenda include ameliorating the hardship from poverty, addressing Bumiputera equity ownership, expanding employment opportunities, meeting the challenge of expanding tertiary education, addressing graduate unemployment and controlling the influx of foreign workers. With respect to the final aim of restoring adversely affected sectors, the sectors involved are the primary commodities and resource-based industries, mining and petroleum, manufacturing, information technology and the Multimedia Super Corridor, motor industry, construction, property, infrastructure, transport, freight forwarding, tourism, banking as well as insurance and reinsurance.

The NERP also recommended the easing of monetary and fiscal policies. As a continued effort to revive the economy, the 1999 Budget presented in October 1998 continued with an expansionary fiscal stance. The government development expenditure was raised by about 23% to RM19,378 million while the operating expenditure increased by 4.2% to RM46,563 million. Of the additional allocation for development expenditure in 1998, RM1,000 million was directed for social development projects to address and ameliorate the effects of the economic crisis on the lower income groups.

In early 1999, the economy showed signs of an initial stage of recovery after one year of economic contraction. Macroeconomic policy management focused on strengthening the recovery process and on expediting measures to address structural issues, both in the economic and financial sectors. In terms of Government spending, priority was given to projects that address structural and socio-economic issues (education and skills training, health services, low-cost housing, and agriculture and rural development), as well as revival of selected infrastructure projects to increase efficiency of the economy. An important criterion of the stimulus package was that it should result in minimal leakage abroad to ensure no build-up of risks in the balance of payments (Bank Negara Malaysia, 2000). Projects should also have strong linkages to ensure maximum stimulus to economic growth and have short gestation periods while meeting socio-economic objectives.

Monetary policy has become accommodative since early August 1998 when interest rates and the statutory reserve ratio (SRR) were brought down to reinforce the expansionary fiscal policy. The central bank lowered the 3-month intervention rate in three successive steps in August from 11% to 9.5%. The SRR was reduced from 8% to 6% on 1 September and further to 4% on 16 September so as to ensure sufficient liquidity in the banking system and to lower the cost of funds. Due to uncertainty, banking institutions had become excessively cautious in their lending decisions, causing a sharp slowdown in credit. To avoid a credit crunch situation, banking institutions with adequate capacity were encouraged to attain a minimum loan growth of 8% for 1998 with the proviso that financial discipline must be exercised in making lending decisions. The intervention rate was reduced further in successive steps to reach 5.5% by August 1999.

The Government also introduced pre-emptive measures to strengthen the resilience of the financial sector to ensure the continued efficient functioning of the banking sector and promote market confidence in the face of deteriorating economic conditions.

These measures were multi-pronged, aimed at strengthening all aspects of the financial system. They included strengthening the resilience of the banking sector through a merger programme; the establishment of Pengurusan Danaharta Nasional Berhad (Danaharta), the national asset management company, on 20 June 1998 to address the rise of NPLs as well as Danamodal, a special purpose vehicle to address the erosion of capital in some banking institutions; and the Corporate Debt Restructuring Committee (CRDC) to resolve the debt problems of larger corporation[2]. A series of measures was also implemented with respect to operations in the capital market in order to improve market transparency and corporate governance, including removing restrictions on submissions for new listings while strengthening rules, securities laws and procedures of the KLSE.

In addition to Danaharta, Danamodal and CDRC, the Government has also established or expanded several special funds to provide credit to priority areas at reasonable rates in order to avoid the adverse effects of excessively high interest rates on small businesses. These funds included the Fund for Food (RM1 billion), Fund for Small and Medium Industries (RM1.5 billion), Export Credit Refinancing Facility (RM3 billion), Special Scheme for Low and Medium Cost Houses (RM2 billion) and Rehabilitation Fund for Small and Medium Industries (RM750 million).

2.4 Measures to Resolve Financial and Corporate Sector Distress

Since the crisis had exposed the vulnerability of the finance companies, a merger programme for finance companies was announced in January 1998 to consolidate and rationalise the industry. While this was consistent with the longer-term objective of creating a core of domestic banking institutions to meet the challenges of increased liberalisation, it also represented part of the overall pre-emptive strategy to increase

[2] Elaborations on these three vehicles will be given in Section 2.4 below.

the resilience of the finance companies to withstand risks arising from the economic slowdown (Bank Negara Malaysia 1999b). The merger exercise was market-driven with Bank Negara Malaysia facilitating the process. Upon completion in 1999, the number of finance companies would be reduced by more than half of the original 39.

As the crisis deepened and prolonged, the banking institutions were being more preoccupied with preserving their balance sheet and managing the deterioration of their asset quality and loan portfolio instead of generating new businesses. The rising incidence of the NPLs also caused them to be overly cautious in their lending, resulting in many viable businesses failing to secure financing. Under the NERP's third objective of maintaining financial market stability, the Government created Danaharta. This is an asset management company established to remove the NPL distraction from the banking institutions to enable them to concentrate more on their credit operations, to facilitate an orderly payment/write-down of debts and disposal of assets as well as to restructure or liquidate ailing companies with outstanding loans of RM50 million or less. Given the non-performing nature of its assets, Danaharta does not expect to generate profits from its operations, but aims to minimise costs by maximising the recovery value of its NPLs.

Danaharta was set up at great speed because the Companies Act did not provide for the rapid acquisition and disposal or smooth management of assets and affairs of a distressed company. It is expected to have a life span of 7-10 years. The Danaharta Act and the amendments to the National Land Code passed in September 1998 provided the legal framework to engage in these activities. With this, "Danaharta is empowered to acquire assets with certainty of title while preserving existing registered interests over the assets, to foreclose on assets and sell through public auctions, public tender offers or private treaty and without consent of the borrower (provided the sale is at market value and a 30-day notice is given)"(Thillainathan 2000).

While Danaharta would not purchase the entire NPLs in the banking system, it would ensure that the residual NPLs remains at manageable levels at all times. Danaharta's acquisition process is divided into secured loans, unsecured loans and other credit facilities such as foreign currency loans and off-balance sheet facilities. Priority is accorded to weaker financial institutions, including those institutions seeking recapitalisation from Danamodal Nasional Berhad (Danamodal) before proceeding to acquire NPLs from other financial institutions. Danaharta also manages loans of selected financial institutions so as to facilitate strategic mergers between identified financial institutions and to preserve the strength of the acquiring institutions.

For loans which are secured by properties, Danaharta appoints independent professional valuers to perform detailed valuation of individual properties. For loans which are secured by quoted shares, the fair value of the loans is determined based on the characteristics of the company whereby premiums are attached to larger stakes that offer influence or control over the company. In the case of loans secured by unquoted shares, acceptable valuation techniques are used. A uniform discount of 90% to the principal outstanding is applied in general to unsecured loans. In terms of profit sharing, it is stipulated that any excess in recovery value over and above Danaharta's acquisition cost plus direct costs will be shared between the selling financial institution and Danaharta on a 80:20 basis. However, the financial institution's share of the upside will be limited to the shortfall value plus a holding cost of 8% per annum. For larger loans where valuation is either onerous or inconclusive, a risk-sharing arrangement with the selling financial institution is done on a case-by-case basis.

For loans acquired from financial institutions, Danaharta pays cash and/or issues zero-coupon, Government-guaranteed, tradeable bonds with yields approximating those of Malaysian Government Securities with similar tenor. These bonds are issued on a monthly basis with an initial tenor of five years and a rollover option exercisable at

Danaharta's discretion for up to an additional five years. For loans acquired from development finance institutions, Islamic loans and unsecured loans, cash payments are made. It is estimated that Danaharta would require RM15 billion to finance its activities.

The asset management approach is divided into loan management and asset management, and which approach is taken depend on the viability of the loans acquired. For viable loans, Danaharta will take the loan management approach whereby it will rehabilitate or restructure the loans including rescheduling the payments and debt equity conversion. For non-viable loans, Danaharta will take the asset management approach whereby it will manage the borrower through the appointment of Special Administrators or manage the collateral either through the rehabilitation of the collateral or foreclosure if all other options have been exhausted (Bank Negara Malaysia, 1999).

Danamodal was incorporated on 10 August 1998 as a fully-owned subsidiary of the central bank to serve as an interim funding vehicle for banking institutions to meet their capital adequacy requirements. The rationale for the its establishment are:

- To ensure that the banking sector recapitalisation process is commercially driven and that investment decisions are made according to market-based principles
- Delays in addressing recapitalisation and Non-Performing Loans issues will create a drag effect on the financial system and economic recovery
- Direct capital injection by the Government into the banking institutions is not desirable and would lead to conflict of interest position in the future.

Danamodal is to revitalise the financial services industry by the recapitalisation of, and active management of its investment in, the banking institutions within the framework defined by the central bank in an independent, fair and transparent manner. Revitalisation will be measured by institutions being competitive and well capitalised and showing sustainable levels of profitability, and having good corporate governance. Danamodal's financial objective is to operate profitably over its lifetime, but successful revitalisation will be given higher priority than maximising returns. To achieve these objectives, Danamodal will intervene as required by influencing corporate governance structure and process and helping to set the management agenda. As a strategic shareholder in the recapitalised banking institutions, Danamodal is in a position to facilitate the consolidation and rationalisation process and act as a catalyst to guide mergers. Danamodal will exit or divest its stake when the restructuring and financial criteria have been accomplished. Under the worst case scenario, the total funding requirement of Danamodal has been estimated to be RM16 billion to ensure that the risk-weighted capital ratio (RWCR) of all banking institutions to be at least 9%. These funds are to be raised in the form of equity, hybrid instruments, or debt in both the domestic and international markets.

Danaharta and Danamodal were complimented with the setting up of the CRDC in July 1998 to facilitate the restructuring of large corporate debts (exceeding RM50 million) and ensuring viable corporations continued to receive financing. The CRDC provided a platform for both the borrowers and creditors to work out feasible debt restructuring schemes without resorting to debilitating legal proceedings. Bank Negara Malaysia (1999) stated the objectives of CDRC are:

- To minimise losses to creditors, shareholdrs and other stakeholders through voluntary co-ordinated workouts
- Preserve viable businesses that are affected by the current economic conditions
- To introduce and implement a comprehensive framework for debt restructuring.

Many companies have opted to this friendlier arrangement to resolve their debt problems instead of going to court to defend against the creditors. CRDC acts as an advisor and mediator between the debtors and the creditors on the restructuring exercise. Once an application to CRDC is made by either the creditor or the debtor, the appointed independent consultant will come up with the restructuring programme for the debtor. CRDC will then evaluate the application and consider its viability and acceptability to the bankers and shareholders of the companies involved. If all parties are agreeable to the structure of the proposal, the proposal will be implemented (see CRDC 2002).

The CRDC framework relies on co-operation, persuasion and collegiate approach to reconcile the interests of the financial institutions and the borrower. The four basic principles of the framework are:

- Financial institutions must be supportive and not precipitate insolvency
- Decision-making is on the basis of sharing reliable information amongst all parties involved in the workout
- Financial institutions must co-operate to reach a collective view on whether a company should be given financial support based on specified terms
- Losses should be jointly borne in a fair manner to specified categories.

In other words, the restructuring efforts would be conducted on a voluntary basis, based on market-driven principles to ensure that there would be a win-win situation for both the borrowers and the creditor banking institutions.

Danaharta, Danamodal and CDRC are interdependendent and complimentary, representing a comprehensive and coherent plans towards strengthening the banking sector, as shown in **Chart 1**. As such, their functions were co-ordinated to ensure that they operated in a cohesive and structured manner to achieve the desired objectives.

This was undertaken by the Steering Committee, chaired by the Governor of the central bank, to oversee and monitor the policies, operations and progress of these three bodies.

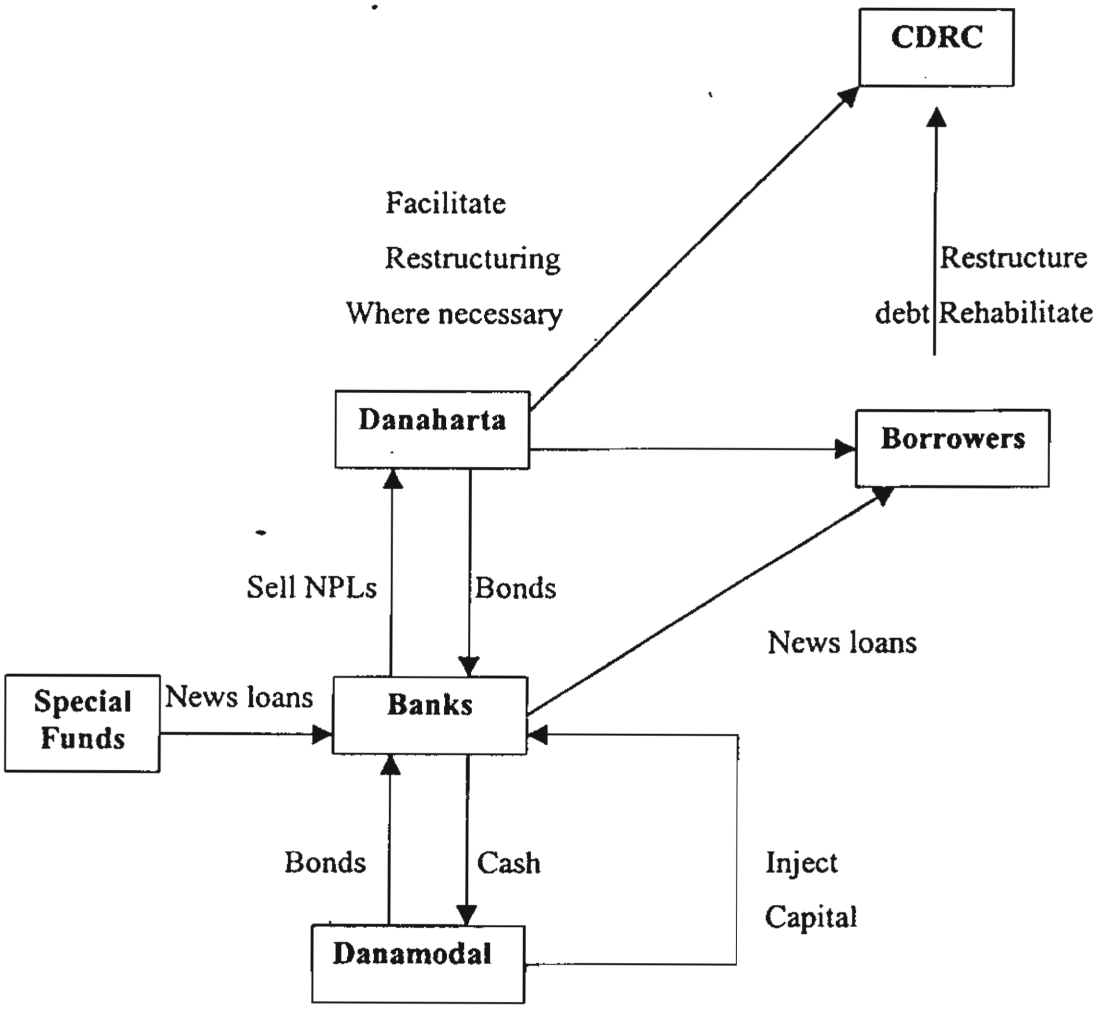


Chart 1
Overview of Danaharta, Danamodal and CDRC

Source: Bank Negara Malaysia (1999a)

In order to enable banking institutions to concentrate more on their credit operations rather than being overly preoccupied with managing the deterioration of their asset quality, the central bank reverted to the earlier definition of NPLs (loans that were defaulted for at least six instead of three months). The purpose was to ensure that the real sector of the economy continues to receive financing and to provide borrowers with the opportunity to regularise their accounts. Banking institutions, however, can retain shorter NPL classification periods based on their individual internal policies.

A series of measures was also implemented in relation to the operations in the capital market so as to improve market transparency and corporate governance, including removing restrictions on submissions for new listings while strengthening rules, securities laws and procedures of the KLSE. The measures were also targeted at protecting the local stock market from the adverse effects of the trading of Malaysian shares on a stock market that is not a recognised stock exchange. In essence, the regulatory supervision by domestic regulators was strengthened, including enhancing the operational ability to curb market abuses and boost enforcement powers of the Securities Commission and the exchange and clearing house.

3. Macroeconomic Impact of the Crisis and Measures

Table 1 shows that Malaysia had achieved an impressive record of growth prior to the financial crisis of 1997-98. The real (in 1987 prices) gross domestic product (GDP) grew at over 9% per annum during the first half of the 1990s, reaching a peak of 10% in 1996. In fact the crisis had only a moderate impact on the Malaysian GDP in 1997, when the economy still manage to grow at 7.3%. However, with the deepening of the economic turmoil, Malaysia experienced the full impact of the crisis in 1998 when the economy contracted by 7.4%, for the first time since 1985. Nevertheless, The economy made a speedy recovery and achieved a growth rate of 6.1% in 1999 and 8.3% in 2000. Unfortunately, the dampening of the US economy, the continuing recession in the Japanese economy (two of Malaysia's leading trade partners) plus the event of 11 September 2001 impacted negatively on Malaysia so much so that the growth rate which has been revised downwards to 2.0 plunged further to register only 0.4% for 2001. Growth has been forecasted to be at 3.5% for this year. Per capita GDP which peaked at RM9065 (1987 prices) in 1997 fell to RM8245 in 1998 and climbed to RM8493 in 1999 and RM8899 in 2000.

Table 1 also reflects that the high growth rate of the economy that preceded the crisis was associated with the intensive growth of the manufacturing and the construction sectors. The two sectors together with non-government services sector accelerated at double-digit growth. In contrast, the primary sector, was experiencing negative growth in the years before the crisis except for 1996 and 1997. The sectoral growth rates indicate that the construction sector was the worst hit, plunging by 23.0% in 1998 and 5.6% in 1999, and growing only at 3.1% in 2000. Consequently, its share of the GDP fell from 4.8% in 1997 to 4.0% in 1998, 3.6% in 1999 and 3.4% in 2000. Although the manufacturing sector also contracted sharply in 1998 by 13.4%, it recovered quickly and managed to register a growth rate of 13.5% in 1999 and 17.0% in 2000. As such, the share of the manufacturing sector which reached 29.9% in 1997 fell slightly to 27.9% in 1998, but rose to 30.0% in 1999 and 32.6% in 2000.

With industrialisation and the rise in employment opportunities, the unemployment rate contracted to 2.4% on the eve of the crisis. Actually, Malaysia was experiencing full employment throughout the 1990s. The labour market became so tight that some sub-sectors have to resort to imported labour from abroad, namely from Indonesia, Bangladesh and the Philippines. The crisis resulted in workers been retrenched from certain sub-sectors, particularly construction. However, some 74,610 vacancies were registered in selected sub-sectors enabling those retrenched workers to be re-deployed to other sectors still experiencing labour shortage, such as some sub-sectors in the manufacturing and services sectors as well as the agriculture sector. Quite a number of the foreign workers have returned to their respective countries. Hence, unemployment rate has been rising to 3.3% in 1998 and 3.4 % in 1999 but moderated to 3.1% in 2000. Preliminary figure shows that it has risen again to 3.7% in 2001. Table 1 also shows that the share of employment in the primary (agriculture, forestry and fishing) and the secondary (mining and quarrying, manufacturing and construction) sectors contracted in 1998 and 1999. On the other hand, the share of employment in the services sector went up. However, the total employment in the manufacturing sector went up by 6.7% in 1999, indicating a rapid recovery in this sector.

Table 2, which shows more macroeconomic and financial indicators, confirms that the economic recovery in Malaysia had begun in the first half of 1999 when the second quarter GDP growth rate registered 4.1% and went on to record 6.1% for the whole year. The current account balance as a percentage of GNP, which was negative for several years prior to the crisis) has turned positive since December 1998, reaching a peak of 17.1% in 1999. Although it has come down since then, it remains at a substantial level. External debt has also trimmed to about half of the GNP in 2000, but has risen since then. Net international reserves peaked in June 1999 at US31.1 billion or equivalent to 6.7 months of retained imports and remained at almost the same level since then. However, it has come down a little in terms of months of retained imports. The 3-month interbank rate contracted to just over 3% from its high of 11.2% in June 1998 while the base lending rate (BLR) dropped to 7.2% in June 1999 and 6.39% in 2001. The annual growth rate of banking system loans plunged from 28.2% in June 1997 to 0.1% in 1999 while the RWCR remained above 12% since June 1999, which far exceeded the internationally prescribed ratio of 8%.

The retrenchment of workers according to sectors for 1996-1998 is shown in **Table 3**. Between 1996 and 1997, there was a 143% increase in retrenchment which jumped to 345% between 1997 and 1998. A total of 83,865 workers lost their jobs in 1998. Almost 54% of the total retrenched were from the manufacturing sector while 11.1%

were from the construction sector. Another 12.4% were from the wholesale and retail trade, hotels and restaurants sector. The group most vulnerable to the crisis are migrant workers. While official statistics indicate that 3,246 have been retrenched in the first five months of 1998, an estimated 80% of the 768,400 employed in the construction sector were migrant workers. Given the dramatic decline in the level of construction activity, the reported figure would grossly under-estimate migrant worker retrenchments. Most of them have incurred labor brokerage costs and their debts could not be honored due to the abrupt retrenchment, repatriation and loss of income, which might result in an eventual entrapment of a vicious debt and poverty cycle. On the other hand, many of the retrenched locals might return to their villages to find jobs in the agricultural sector or register in the Training Scheme for Retrenched Workers program offered by the Human Resources Development Council to upgrade their skill and improve their income-earning potential. The Ministry of Human Resource has established a RM5 million retraining programme to upgrade the skills of the workers in assisting the retrenched workers to find new jobs. In easing the financial burden and moderating the retrenchment level, firms in selected sectors were exempted to pay the levy to the Human Resource Development Fund (HRDF)[3] for a certain period.

While the initial official expectation of inflation was 7-8% in 1998 (private sector estimates had been more pessimistic at 8-12%), it turned out to be better than expected at 5.3%, rising from 2.7% in 1997 (see **Table 4**). However, it is particularly alarming tonote the disproportionate rise in the index for food, which recorded a rise of 8.9%, since its weight in the Consumer Price Index (CPI) was 34.9% in 1998. Similarly, the index for medical care and health expenses also rose above the CPI of 5.3%, that is, by 6.2%. The rise in the cost of medical fees is mainly due to the 30% rise in the cost of imported drugs, which account for over 60% of drugs used in the country. Fortunately, this item has only a small weight of 1.9% in the CPI. With the

[3] HRDF was established in 1993 to conduct courses to retrain and upgrade the skills of employees.

implementation of the various Government policies, the CPI managed to be brought down to 2.8% in 1999, 1.6% in 2000 and 1.4% in 2001, particularly the index on food following the campaign on "zero inflation" and consumption of Malaysian-made goods. The Government also intensified efforts to promote measures to increase domestic food production as well as services related to the food industry.(Bank Negara Malaysia 2001:35).

The impact of ringgit depreciation on the Producer Price Index (PPI, 1989=100) was much faster compared to the CPI. The PPI, which measures prices of intermediate and final goods charged by domestic producers, increased by 10.7% in 1998 compared to 2.7% in 1997. The large increase in prices was largely due to the higher import prices following the weaker ringgit and higher local production cost. However, lower import prices (-0.6%) and lower local production costs (-3.9%) contributed to the decline in the PPI by 3.3% in 1999. The PPI rose by 3.1 percent in 2000 mainly due to the higher crude oil price. Due to the weak commodity prices in 2001, the PPI fell by 5.0% to reflect the lower prices charged by local producers.

The property prices as reflected by the Malaysian House Price Index (MHPI, 1990=100) declined by 9.4% in 1998 (compared to a rise of 1.9% in 1997). It has further declined by 2.3% in 1999 (an improvement compared to the 12% decline in the first half of 1999) reflecting an improvement in property prices following the measures taken by the government. These include the Home Ownership Campaign (12 December 1998 to 12 January 1999) and the Second Home Ownership Campaign (29 October to 7 December 1999), stimulating foreign demand for high-end properties and restricting the development of new residential properties and shop houses where the individual units cost more than RM250,000. In 2000, property prices increased as reflected in the rise of the MHPI by 4.7%, but with the exception of certain choice locations, particularly in the Klang Valley, property price levels remained below the peak levels that prevailed in 1997 (Bank Negara Malaysia 2001:37). The situation worsened thereafter when the MPHI only crept up by 0.9% for the first half of 2001.

4. Progress of Controls and Reforms

4.1 Changes made to the exchange control measures

Malaysia's imposition of the exchange control measures was controversial. However, conditions and circumstances were in Malaysia's favour then which increased the prospects for their success. According to Bank Negara Malaysia (1999a), capital controls have historically been imposed by countries facing acute balance of payments constraints, imposing restrictions on almost all transactions with non-residents, including current account transactions, due to weak external reserve position. In contrast, Malaysia has maintained free movement of all current account transactions and Malaysia had strong reserves position as corrective measures had turned the current account balance into surplus of 14% GNP in 1998. Secondly, capital controls were imposed in many of the countries when they were facing capital flight. In contrast, Malaysia has generally not experienced significant capital outflows of the type and magnitude experienced by countries facing acute balance of payments and international reserve constraints. Thirdly, external reserves of the country were intact, unencumbered and rising (see Table 2). At the same time, Malaysia was blessed with low inflationary rate as well as low external debt.

Critics dispute the effectiveness of the controls since markets in the region had stabilised, often saying that Malaysia "closed the stable door only after the horse has bolted". However, the central bank emphasised that the controls were aimed at containing the internationalisation of the ringgit to prevent speculative activities, not to be used as a substitute for sound and transparent domestic economic policies. Thus, after the imposition of the controls, inflows reflected export proceeds or purchase of ringgit assets and outflows represented import payments and sales of ringgit assets. As the controls were showing positive results, the controls began to be relaxed, beginning in February 1999 when rules on the minimum holding period on portfolio investments were partially relaxed. On 1 September 1999, the one-year rule on portfolio investments expired, enabling funds which were in Malaysia prior to 1 September 1998 to freely leave the country. Yet, contrary to expectations, the outflows were relatively small given the positive economic prospects. By 2001, the capital controls imposed on foreign portfolio investments had all been removed when the 10% exit levy on repatriation of portfolio profits within one year was withdrawn on 2 May 2001 (Malaysia 2001), but the new capital controls imposed on Malaysians still remains in place. Before the crisis, only those Malaysians with domestic borrowings had to have the prior approval of the Bank Negara Malaysia to invest overseas whereas after the crisis even those Malaysians without any domestic borrowings require the central bank's approval to invest abroad.

The exchange controls were sufficient to provide a greater degree of independence for the conduct of monetary policy to support the recovery process while the greater stability in the currency, stock markets and the financial system also revived consumer and investor confidence. The fixed exchange rate provided businesses with a degree of predictability under which they could plan their businesses. At the same time, policymakers had some "breathing space" to expedite economic and financial reform (Bank Negara Malaysia 1999b). It also enabled the recovery to be achieved without massive fiscal cost going into massive debt and the nation did not suffer widespread unemployment or social dislocation.

4.2 Progress of the merger programme

As at 15 March 1999, eight finance companies had been merged while 14 would be merged in the same year. Some banking institutions suffered severe losses during the crisis primarily from high levels of NPLs. In order to prevent further deterioration in the financial health of these banks, the central bank assumed control over the operations of four banking institutions, two of which merged with stronger entities later. Another was resolved through open tender exercise while the fourth was resolved through capital injection by Danamodal. Moreover, two of the larger domestic commercial banks were merged with stronger commercial banks. To ensure that the mergers would not weaken the strength of the acquiring banks, distressed assets of the weaker institutions were removed to subsidiaries of Danaharta.

By 31 December 2000, the merger programme for domestic banking institutions that was initiated in 1999 was successfully implemented, with 50 out of 54 domestic banking institutions consolidated into 10 banking groups and 94% of the total assets of the domestic banking sector rationalised and consolidated (Bank Negara Malaysia 2001). Under the merger exercise, each of the ten banking group should have a minimum capital base of RM2 billion or an asset base of RM25 billion. This exercise, which concluded in 2000, succeeded in consolidating the fragmented domestic banking sector without causing disruptions to the provision of banking services. In 2001, the focus of the domestic banking groups was to complete the business integration processes and rationalisation exercises. By the end of 2001, all banking groups had conducted their branch rationalisation exercise and five banking groups had rationalised their workforce. All the staff rationalisation exercise were conducted on a voluntary basis. Affected staff were granted the opportunity for various options of redeployment to other suitable business divisions, or to opt for the voluntary separation scheme with adequate compensation. As a result of the rationalisation exercise during the year, 187 branches were closed, whilst 55 branches were relocated and a total of 4,240 staff left the banking industry (Bank Negara Malaysia 2002).

4.3 Progress of financial and corporate restructuring by Danaharta

Substantial progress has been made in both bank and corporate restructuring. According to Thillainathan (2000), the ability of the Malaysia Government to act quickly and effectively on bank restructuring was significantly enhanced by the existence of a strong legal framework for Bank Negara Malaysia. It has already most of the specific powers necessary to deal with banking crisis. For example, it has the power to investigate, prosecute, take over the management of banks and impose a moratorium on their operations. It also has the power to acquire the shares of financial institutions and require a capital increase of a bank's capital impaired by losses. Because Bank Negara's powers are explicit and clear, they deter legal challenges during the implementation of the restructuring programme. The progress in the acquisition and management of NPLs by Danaharta is reflected in **Table 5**. It can be seen that Danaharta had acquired (19.1 billion) and managed (26.4 billion) RM45.5 billion (2,666 accounts) in NPLs from various financial institutions by 31 December 1999. According to Bank Negara Malaysia (2000), the book value of the loans removed from the banking system amounted to RM34 billion, representing approximately 42% of NPLs in the banking system. The removal of these NPLs from the banking sector has reduced the residual NPL level to 6.6% (based on 6-month classification) from the peak of 9% as at the end of November 1998. A total of RM10.3 billion nominal value zero-coupon bonds have been issued as consideration for the loan acquisitions, which is lower than the RM15 billion budgeted earlier.

The total loans acquired and managed rose to RM47.49 billion (2,835 accounts) by the end of 2000 (of which RM20.39 billion was acquired). The book value of the loans removed from the banking system was equivalent to 44% of the NPLs in the banking system. The removal of NPLs by Danaharta succeeded in reducing the NPLs in the banking system to manageable levels. The weighted average discount rate for the acquired NPLs was about 55% compared to 56% the previous year. Three tranches of zero-coupon bonds as consideration for the NPLs acquired were issued, bringing the total nominal value of bonds issued to RM11.1 billion as on 31 December 2000.

As at 31 December 2001, the total loans acquired and managed increased marginally to RM47.72 (of which RM19.82 billion was acquired) from 2,902 accounts. Six months later, as at 30 June 2002, it again rose slightly to RM47.76 (2,905 accounts) with the same amount being acquired. This is because Danaharta completed its loan acquisition phase in 2000 and did not make any direct purchase from the banking institutions in 2001. Over this period, the weighted average discount on all acquisitions fell to 54% up to the end of June 2002. Danaharta expects to resolve the remaining NPLs of RM12.4 billion (in gross value terms) by the end of 2001.

Table 6 illustrates Danaharta's loan management progress. As of 31 December 1999, Danaharta had within its portfolio 2,666 accounts relating to 2,345 borrowers and had initiated recovery measures with 88% of these borrowers in terms of value or 71% in terms of number. A total of RM17.6 billion or 38% of the loans and assets under its management has been restructured or disposed (as in the case of foreign loan assets), with an average recovery rate of 80.2%. Danaharta, being an asset management vehicle, has chosen the recovery measure that maximizes the recovery value of the assets. The preference is to restructure the loans wherever possible, and only resort to foreclosure and sale of collateral as a last resort. Loan restructuring has shown to give a higher recovery rate than outright foreclosure.

As at 31 December 2000, the number of accounts within its portfolio increased to 2,835 accounts relating to 2,507 borrowers, with a total gross value of RM47.49 billion. Danaharta had initiated recovery measures with 98% of these borrowers in terms of value or 91% in number. Danaharta concentrated on its loan and assets management process, applying various techniques on its loans and assets, such as active restructuring and rescheduling for viable loans; foreclosure, appointment of

Special Administrators and Schemes of Arrangement for non-viable loans. By year-end, Danaharta has successfully restructured RM35.8 billion of loans (representing approximately 74% of loans under its portfolio), with expected recoveries of RM23.8 billion. This translates into a 66% recovery rate over the outstanding loans (see **Table 7**).A year later, total loan rights acquired and managed by Danaharta amounted to RM47.7 billion, of which RM39.8 billion were from the banking system, accounting for approximately 40% of the total NPLs of the banking sector. By 31 December 2001, Danaharta has dealt with RM47.7 billion (99.9%) of the total loans acquired and managed under its portfolio. From the total adjusted loan outstanding already dealt with, Danaharta expects to receive total recovery of RM28.5 billion, resulting is a recovery rate of 56% (inclusive of interest).

The composition of Danaharta's assets would change over time from unresolved NPLs to various assets groups and ultimately into cash. As Danaharta moved from its establishment phase to management phase, its composition of NPLs also change from being unresolved to NPLs that have been processed where recovery proceeds have been received or pending implementation. Based on the current pace of resolution, Danaharta is on track to achieve its targeted unwinding by 2005.

4.4 Danamodal and Progress of Banking Sector Reform

In the case of recapitalisation exercise by Danamodal, initially it had RM10.835 billion funding (of which RM3 billion is capital). By 15 March 1999, it had injected RM6.15 billion as fresh capital into 10 banking institutions in the form of Exchangeable Subordinated Capital Loans. This total capital injection had decreased to RM5.3 billion at the end of 1999 upon repayments by five banking institutions. The recapitalisation by Danamodal had helped to strengthen the RWCR position of these institutions from 9.9% as at end-September 1998 to 12.3% as at end-December 1999 (Bank Negara Malaysia 2000).

Danamodal has made no additional capital injection during the year 2000. Following the improved economic environment and in tandem with the merger programme for domestic banking institutions, 8 banking institutions have repaid their loans to Danamodal amounting to RM3.4 billion, bringing the outstanding amount of capital injection to RM3.7 billion as at 31 January 2001. During the course of consolidation, Danamodal has played an active role in spearheading the merger negotiations for those banking institutions where Danamodal was the major shareholders. As a result of the merger process, two banking institutions repaid their loans to Danamodal. Where Danamodal continues to hold stakes in banking institutions, Danamodal would assess all viable options in order to maximize recoveries from the capital investment and give financial flexibility for Danamodal to redeem its bond amounting to RM11 billion when they mature in the year 2003. Due consideration would however be accorded to ensure that the financial strength of the banking institutions or bank holding companies would not be unduly weakened by the capital repayment (Bank Negara Malaysia 2001).

As the capital position of the banking institutions has continued to strengthen, no further capital injection was made since December 1999. In August 2001, Danamodal concluded the sales and purchase agreement on the disposal of its investment in one finance company. With the completion of the sale, Danamodal's outstanding investment in the banking sector has shrank to RM2.1 billion from RM7.1 billion since its inception (Bank Negara Malaysia 2002). Danamodal expects to recover the entire remaining investment over time.

4.5 Progress of Financial and Corporate Restructuring by Corporate Debt Restructuring Committee (CRDC)

As at 15 March 1999, CDRC had received 48 applications for debt restructuring, involving debt of RM22.7 billion. Two restructuring plans have been implemented and 26 Creditor Committees had been formed to oversee the restructuring efforts inception (Bank Negara Malaysia 1999). By 29 February 2000, the CRDC had successfully completed the restructuring of 19 cases with debts totalling RM14.1 billion, whilst 10 cases had been referred to Danaharta. As the economy improved, not many new applications were submitted to CRDC since late 1999. CRDC expected to complete the debt restructuring of 26 cases involving debts amounting to RM16.4 billion that was still outstanding by the third quarter of 2000. In addition to corporate restructuring, CRDC was also involved in the restructuring of transportation, telecommunication and steel industries comprising nine companies to ensure that the restructured companies operating within the industry would become feasible and viable (Bank Negara Malaysia 2000).

During the course of debt restructuring, various techniques were applied such as debt to equity conversion, debt to private debt securities conversion, participation of white knights and reduction in the paid-up capital of the borrowers. The cumulative progress of CDRC as at 31 December 2001 since its inception is illustrated in **Table 8**. A total of 37 cases have been successfully finalised, resolving debts amounting to RM34.5 billion, equivalent to 51% of the total referred to CDRDC. Withdrawn or rejected 23 cases with debts of RM10.1 billion or 15% of the total. Therefore, as at 31 December 2001, CDRC has 12 outstanding cases to be resolved with total debts of RM18.04 billion, representing 27% of the total.

The progress of corporate debt restructuring under the purview of CDRC has been relatively slower given the following factors:-

i) Larger number of creditors involved in the debt restructuring exercise;
ii) The need to obtain 100% consensus from the parties involved; and

iii) The lacklustre performance of the capital markets in recent months, resulting in difficulties for some borrowers to implement their debt restructuring schemes.

To benefit and strengthen the economy in the long run, CDRC also played a pivotal role in driving the restructuring of the public transportation industry. The debt restructuring scheme for the public transportation industry has been finalized and will be implemented in the near term. CDRC has also completed its study on the restructuring of the steel and telecommunication industries and the options to address the various issues concerning the industries are being considered.

One potential area of vulnerability that needed to be addressed was the resolution of the large corporate debts and its impact of the health of the banking sector. To facilitate this process, the corporate debt restructuring framework under the CRDC was revamped to accelerate the pace of corporate debt restructuring in Malaysia. Borrowers and creditors were subject to more stringent and definitive timelines in the debt restructuring process to ensure that they complete the resolution process within the shortest timeframe. Operational restructuring was undertaken together with financial restructuring to ensure the viability of the debt restructuring scheme. Significant progress has been achieved following this revised framework, with resolution of a number of debt restructuring cases, including the debts of three large corporates. CDRC had targeted to resolve 10 cases with total debts of RM 10.2 billion between 1 August 2001 and 31 December 2001. As at 31 December 2001, CDRC has successfully resolved eight of these cases, with debts accounting for 83.5% of the total targeted amount of debts to be addressed. In total, CDRC has successfully resolved 11 cases in the year 2001, involving debts amounting to RM 11.9 billion has targeted to complete the restructuring of the remaining cases by July 2002.

The debt restructuring process by CDRC is expected to be accelerated with changes that were made to the debt restructuring framework during 2001. The changes included the setting of specific timeline to ensure effective implementation of the restructuring and enhanced disclosure and reporting requirements to improve corporate governance. More importantly, borrowers must undertake operational restructuring alongside debt restructuring because debt restructuring on its own may not bring about long term solution for the problems faced by the large corporates, to ensure the viability of the company over the longer term. The criteria for the acceptance of loans under CDRC was also amended to borrowers with aggregate borrowing of RM100 million with exposure to at least five creditors banks compared to a minimum amount of RM50 million and two creditor banks previously.

As at 8 March 2002, 12 cases with debts totaling RM18.8 billion remained outstanding. This included one case that was previously resolved but had to be revised. For cases in which the creditors and borrowers are unable to reach a consensus on the terms of the restructuring exercise, the cases would be removed from the purview of CDRC. Any further negotiations between the creditors and borrowers will be conducted outside the auspices of CDRC. To date, CDRC has rejected or discharged 12 cases from its purview. CDRC is on course in its target to ensure that all workout proposals of borrowers under its purview are approved and implemented by end-July 2002.

5. Concluding Remarks

The process of bank and corporate restructuring has proceeded steadily with Danaharta and the CDRC having done a good job within the parameters under which they operate. Thillainathan (2000) attributed the substantial restructuring to the following factors. First, there was political will. Second, the scale of the restructuring problem was more manageable. Third, the domestic resources available to finance the restructuring was plentiful and finally, the required legal infrastructure to correct the failing economy was already in place or quickly put in place. A main issue with the restructuring is that it was more government-financed and government-facilitated and less market-based. While this was justified during the crisis, there should be increased reliance on market-based approach to restructuring as the economy got stronger.

The development of the financial sector should be aligned with the envisaged direction for the development of the economy. This objective is incorporated in the formulation of the Financial Sector Masterplan (FSMP) by the central bank that was launched in March 2001. The FSMP outlines the medium and longer term agenda to build a financial sector that is responsive to the changing economic requirements and that is resilient, efficient and competitive. The recommendations that were outlined in the FSMP focused on enhancing domestic capacity and capability before progressing towards more competitive environment in the second phase and finally towards greater international integration. The FSMP identified three key objectives in its implementation phases. Firstly, to enhance domestic capacity by building the capabilities of domestic banking institutions and increased deregulation in certain areas to increase competition; secondly to promote financial stability through strong, risk-adjusted regulations and supervision; and finally, to meet the socio-economic objectives of Malaysia, which includes increasing the level of consumer activism.

Other developments in the financial system include the introduction of various capital market measures to promote efficiency, transparency, resilience and competitiveness of the capital market. Additional measures were concurrently introduced to improve corporate governance and minority shareholder position. The key measures include first, the launching of the Capital Market Master Plan (CMP) by the Securities Commission on 22 February 2001. The CMP seeks to ensure that the capital market is able to play its role in supporting national economic growth needs and aspirations, meeting the challenges of globalisation and tapping value-added opportunities within areas of comparative and competitive advantage. The second measure relates to the consolidation of the stockbroking industry, where the 53 stockbroking companies which existed as at end-August 2001 are expected to be reduced to 36. The Kuala Lumpur Stock Exchange introduced the new Listing Requirements to further enhance efficiency in capital market activities, corporate governance and transparency as well as strengthen investor protection and promote investor confidence. Both the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) and the Commodity and Monetary Authority of Malaysia (COMMEX) have been integrated to become the Malaysian Derivatives Exchange (MDEX) in order to attain economies of scale, offer a wider range of products to investors and enhance cost efficiency.

With all these reforms and measures, Malaysia should be stronger and more resilient in meeting the vagaries of the global business cycle. Although critics indicate that what have been done may not be sufficient in certain aspects, particularly the existence of moral hazard in the banking industry enhancing corporate governance and transparency, they have said that Malaysia was successful in containing its bad-debt situation, and hence preventing an erosion of consumer and corporate confidence. These need to be dealt with as the country faces bigger challenges ahead, particularly the rise of China and the implementation of AFTA and WTO agreements.

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Table 1
Composition and Growth Rate of the Gross Domestic Product and Employment Share By Industry of Origin (In 1987 Prices)

GDP Share (Employment Share)	1993	1994	1995	1996	1997	1998	1999	2000	2001[1]
Agriculture, Forestry and Fishing	12.9 (22.6)	11.6 (19.6)	10.3 (19.0)	9.8 (17.7)	9.2 (16.7)	9.6 (16.3)	9.1 (16.0)	8.5 (15.2)	8.4 (14.8)
Mining and Quarrying	7.5 (0.5)	7.3 (0.5)	8.2 (0.5)	7.7 (0.5)	7.3 (0.5)	7.9 (0.5)	7.2 (0.5)	6.9 (0.4)	6.8 (0.4)
Manufacturing	26.2 (23.4)	26.7 (25.1)	27.1 (25.7)	29.1 (26.5)	29.9 (26.9)	27.9 (26.5)	29.9 (26.4)	33.4 (27.6)	32.8 (27.4)
Construction	3.8 (7.3)	4.0 (7.9)	4.4 (8.9)	4.7 (9.4)	4.8 (9.9)	4.0 (9.4)	3.6 (8.5)	3.3 (8.1)	3.4 (8.2)
Services (Non-Govt.) (Govt.)	50.6 (46.2) 42.7 (34.6) 7.9 (11.6)	51.1 (46.9) 43.4 (35.4) 7.7 (11.5)	51.2 (45.9) 44.1 (35.1) 7.1 (10.8)	50.7 (45.9) 44.2 (35.6) 6.5 (10.3)	51.9 (46.0) 45.3 (36.1) 6.6 (9.9)	55.7 (47.3) 48.4 (37.1) 7.3 (10.2)	55.1 (48.6) 47.8 (37.8) 7.3 (10.8)	53.4 (48.7) 46.5 (38.1) 6.9 (10.6)	54.6 (49.2) 47.4 (38.6) 7.2 (10.6)
Import Duties – Imputed Bank Service Charges	-1.0	-0.7	-1.2	-2.0	-3.1	-5.1	-4.9	-5.4	-6.0
Unemployment :%	3.0	2.9	2.8	2.5	2.4	3.2	3.4	3.1	3.9
Per Capita GDP (RM)	7235	7548	8050	8646	9065	8245	8493	8899	9167
Average Growth Rate (%)									
Agriculture, Forestry and Fishing	-3.1	-1.9	-2.5	4.5	0.7	-2.8	0.4	0.6	1.2
Mining and Quarrying	-4.0	6.0	22.9	2.9	1.9	0.4	-2.6	3.1	0.9
Manufacturing	14.6	11.4	11.4	18.2	10.1	-13.4	13.5	21.0	0.2
Construction	10.8	15.1	21.1	16.2	10.6	-24.0	-4.4	1.0	4.9
Non-Government Services	16.0	11.1	11.9	10.2	10.5	-0.5	4.4	5.3	4.0
Government Services	7.2	5.4	1.4	1.7	8.6	1.1	7.7	1.4	7.1
Total	**9.9**	**9.2**	**9.8**	**10.0**	**7.3**	**-7.4**	**6.1**	**8.3**	**2.0**
Average Per Capita Growth Rate (%)	5.9	4.3	6.7	7.4	4.8	-9.0	3.0	4.8	3.0
Per Capita Income (Nominal) (RM) (US$)	8299 3073	9042 3447	10072 4016	11228 4446	12314 4377	12135 3093	12305 3238	13,361 3516	13,333 3508
Population (Million)	**19.2**	**20.1**	**20.7**	**21.2**	**21.6**	**22.1**	**22.7**	**23.3**	**23.8**

Note 1: Estimate by the Ministry of Finance.

Source: Ragayah and Saadiah (2002)

Table 2
Malaysia: Key Macroeconomic and Financial Indicators

Indicators	June 1997	Dec. 1997	June 1998	Dec. 1998	June 1999	1999	2000	2001[p]	2002[f]
Real GDP growth (annual, %)	8.4[1]	5.6[2]	-5.2[1]	-10.3[2]	4.1[1]	6.1	8.3	0.4	3.5
Gross national Savings (% of GNP)	n.a.	39.4	n.a,	41.9	n.a.	41.1	39.5	34.9	33.8
CPI growth (%)	2.2	2.9	6.2	5.3	2.1	2.8	1.6	1.4	1.8
Unemployment rate (quarterly, %)	2.3	2.0	3.3	3.4	3.3	3.4	3.1	3.7	3.6
Federal Government Overall Balance (% of GDP)	n.a.	2.5	n.a.	-1.9	n.a.	-1.8	-3.2	-5.8	-5.5
Current account balance (% of GNP)	n.a.	-5.9	n.a,	13.7	n.a.	17.1	10.2	8.9	7.9
External debt (% of GNP)	43.2	64.0	64.7	60.2	57.7	57.6	50.5	55.4	-
Net international reserves									
RM billion	70.7	59.1	58.2	99.4	118.3	117.2	113.5	117.2	-
US billion	28.0	21.7	20.5	26.2	31.1	30.8	29.9	30.8	-
Months of retained imports	4.3	3.4	3.8	5.7	6.7	5.9	4.5	5.1	-
M3 growth (%)	21.8	18.5	7.3	2.7	7.7	8.3	5.0	2.8	-
3-month interbank rate (%)	7.5	8.7	11.2	6.5	3.3	3.18	3.25	3.27	-
BLR (commercial banks, %)	9.5	10.3	12.3	8.0	7.2	6.79	6.78	6.39	-
Banking system loans (annual growth, %)	28.2	26.5	10.2	1.3	1.6	0.1	5.5	3.6	-
RWCR of banking system	12.0	10.5	11.2	11.8	12.7	12.4	12.4	12.8	-
Net NPL of banking system (% of total loans) (6-month classification)	2.2	4.7[3]	8.9[3]	7.5	7.9	6.4	6.3	8.1	-

Notes: p = preliminary; f = forecast; n.a. = not available; [1] Refers to 2nd quarter, [2] Refers to 4th quarter [3] 3-month classification.
Source: Bank Negara Malaysia 1999a for June 1997-June 1999; 2001, 2002 for 1999-2001.

Table 3
Retrenchment of Workers According to Sector, 1996-1998

Year	Total	% Change
1996	7,773	
1997	18,863	143
1998	83,865	345
		% of Total
1998		
Agriculture	5,108	6.1
Mining	877	1.1
Manufacturing	45,151	53.8
Construction	9,334	11.1
Electricity, gas and water	1	0.0
Transport, storage and communications	2,007	2.4
Wholesale and retail trade, hotels and restaurants	10,434	12.4
Finance, insurance, real estate and business services	6,596	7.9
Social services	4,242	5.1
Others[1]	115	0.1
Total	**83,865**	**100.0**

Note: [1] Includes unclassified sectors.
Source: Malaysia 1999.

Table 4
Malaysia: Inflation Indicators Annual Growth Rate (%), 1997-2001

	Weights	1997	1998	1999	2000	2001
		Annual Change (%)				
Consumer Price Index (1994=100)	100.0	2.7	5.3	2.8	1.6	1.4
Of which :						
Food	34.9 (33.8)	4.1	8.9	4.6	1.9	0.7
Beverages and tobacco	3.6 (3.1)	1.3	4.3	7.9	2.8	4.8
Clothing and footwear	3.6 (3.4)	-0.5	0.4	-2.0	-1.7	-2.6
Gross rent, fuel and power	21.1 (22.4)	3.2	4.4	1.6	1.5	1.4
Furniture, furnishings and household equipment and operation	5.6 (5.3)	0.1	3.9	1.3	0.0	0.1
Medical care and health expenses	1.9 (1.8)	3.6	6.2	3.1	2.0	2.9
Transport and communication	17.9 (18.8)	0.6	-0.1	0.5	2.1	3.6
Recreation, entertainment, education and cultural services	5.8 (5.9)	0.4	3.3	2.6	0.5	-0.1
Miscellaneous goods and services	5.6 (5.5)	4.6	7.1	1.5	0.9	0.7
Consumer Price Index by Region:						
Peninsular Malaysia CPI	100.0 (81.6)	2.8	5.5	2.9	1.7	1.5
Sabah CPI	100.0 (8.9)	2.0	4.3	2.4	0.6	0.6
Sarawak CPI	100.0 (9.5)	1.7	4.2	1.6	1.5	0.8
Producer Price Index (1989=100)	100.0 (100.0)	2.7	10.7	-3.3	3.1	-5.0
of which						
Local Production	79.3	2.5	11.2	-3.9	3.6	-6.1
Imports	20.7	2.8	9.2	-0.6	1.1	-0.3
House Price Index (1990=100)		1.9	-9.4	2.3	4.7	0.9[1]
of which						
Klang Valley		4.4	-11.2	-10.2	12.4	0.4
Johor Bahru		0.1	-21.9	-8.7	2.8	-2.3
Penang Island		1.3	-11.5	-8.2	8.3	-3.7

Notes: [1] January-June
Weights in parentheses are for 2000-2001.
Source: Bank Negara Malaysia (2000, 2002).

Table 5
NPLs Acquired and Managed by Danaharta

	31 December 1999			31 December 2000			31 December 2001			30 June 2002		
	Gross Value (RM mil)	Value Paid (RM mil)	Discount %	Gross Value (RM mil)	Value Paid (RM mil)	Discount %	Gross Value (RM mil)	Value Paid (RM mil)	Discount %	Gross Value (RM mil)	Value Paid (RM mil)	Discount %
NPL acquired form :												
Commercial Banks	11,062.4	4,020.4	64	11,542.1	4,461.1	61	11,417.1	4,434.8	61	11,412.0	4,434.4	61
Finance Companies	3,938.7	1,938.5	51	4,312.4	2,049.5	52	3866.9	1,889.4	51	3867.0	1889.5	51
Merchant Banks	3,024.3	1,677.3	45	3,211.9	1,811.8	44	3,211.9	1,811.8	44	3211.8	1811.7	44
Development Finance Inst.	935.7	565.6	40	1,161.2	749.2	35	1,161.2	749.2	35	1161.2	749.1	35
Offshore Banks	123.1	104.7	15	123.1	104.7	15	123.1	104.7	15	123.1	104.7	15
Others	42.7	42.7	0	42.7	42.7	0	42.7	42.7	0	42.7	42.7	0
TOTAL	19,127.0	8,349.1	56	20,393.4	9,219.0	55	19,822.9	9,032.7	54	19,817.8	9032.1	54
NPLs under Management :	26,393.7			27,094.5			27,896.0			27,944.1		

Sources: Danaharta, Operations Reports: Six months ended 31 December 1999, 2000, 2001 and Six months ended 30 June 2002.

Loan Management Progress

No		31 December 1999			31 December 2000			31 December 2001		
		RM Billion	%	%	RM Billion	%	%	RM Billion	%	%
1.	Restructured/Approved For Restructuring	17.6	38		35.83	74		47.72	100	
a.	Performing	3.14		18			9			
b.	Fully Settled	1.66		8						
c.	Workout Proposal Approved	12.59		74						
d.	Plain Loan Restructuring						19			24
e.	Special Administrators						8			11
f.	Settlement						18			14
g.	Scheme of Arrangement						16			18
h.	Foreclosure						20			21
i.	Legal Action						5			4
j.	Others						5			8
2.	Proposal Evaluated Pending Finalization	2.51	6			3				
3.	Proposal Submitted Pending Evaluation	15.81	35			10				
4.	Recovery Initiated Pending submission of Proposal	4.14	9			11				
5.	Recovery to be Initiated	5.68	12			2				
	TOTAL	45.52	100	100	47.49	100	100	48.03	100	100

Sources: Danaharta, Operations Reports: Six months ended 31 December 1999, 2000, 2001.

Notes:

1. **Plain Loan Restructuring (PLR)** refers to restructuring which may include rescheduled loans,.partial cash settlement or asset disposal.
2. **Settlement** refers to cases where loans are disposed outright, or full and final settlement has been agreed and payment has been received or its pending
3. **Scheme of arrangement (SOA)** refers to a scheme under section 176 of the Companies Act 1965, a voluntary scheme of arrangement or a scheme under the CDRC.
4. **SA-scheme approved (SA)** refers to a Special Administrator scheme
5. **Foreclosure** refers to foreclosure of property under section 57 of the Pengurusan Danaharta Nasional Berhad Act 1998, and foreclosure of share collateral.
6. **Others** refer to cases of partial resolution, involving primarily redemption of collateral to reduce the amount outstanding pending final resolution.
7. **Legal action** refers mainly to accounts where all other recovery methods have been exhausted.

Table 7

Expected Recovery from Loans Restructured and Loans Approved for Restructuring

	31 December 1999			31 December 2000			31 December 2001		
	Loan Outstanding	Expected Recovery	Recovery Rate (%)	Loan Outstanding	Expected Recovery	Recovery Rate (%)	Loan Outstanding	Expected Recovery	Recovery Rate (%)
Performing Loans	3.14	3.14	100	2.57	2.57	100			
Plain Loan Structuring	4.38	3.88	88.5	7.06	6.54	93	11.60	8.04	69
Settlement	3.57	2.57	72.0	6.34	4.86	77	6.87	5.19	76
Scheme of Arrangement	1.73	1.41	81.3	6.08	5.07	83	9.15	6.95	76
SA –Scheme Approved	0.37	0.19	50.7	2.50	1.54	62	5.55	2.46	44
Foreclosure	1.85	0.89	47.8	7.63	2.12	28	11.58	3.37	29
Others				2.02	1.10	55	4.14	2.50	60
Legal Action				1.63			2.05	-	-
SA Pending Approval	2.56								
	17.61	12.08	68.6	35.83	23.80	66	50.94	28.51	56

Sources: Danaharta, Operations Reports: Six months ended 31 December 1999, 2000, 2001.

Table 8
Cumulative Progress of CDRC as at 31 December 2001

	31.12.2001			
	RM mil	%	No of cases	%
Cases discharged				
- Withdrawn cases	7,427	11	13	11.6
- Rejected cases	2,642	4	10	15.1
Subtotal	**10,069**	**15**	**23**	**26.7**
Cases accepted				
- Outstanding	18,038	27	12	14.0
- Revised	1,747	3	3	3.5
- Resolved	34,489	51	37	43.0
- Transferred to Danaharta	2,470	4	11	12.8
Subtotal	**56,744**	**85**	**63**	**73.3**
Total referred to CDRC	66,813	100	86	100.0

Source: CRDC 2002.

International Conference on
Economic Recovery and Reforms

The Philippines

Bank Performance and Rate of Economic Recovery: The Philippine Case

Edita A. Tan*
School of Economics
University of the Philippines

ABSTRACT

The paper sees imprudent lending by a weak banking system as an important and common cause of the East Asian crisis. The crisis-hit economies' banking systems had not put in place prudential rules and practices and their organization was subjugated to power politics and big business control. Many of their member banks engaged in imprudent connected lending which later turned up as non-performing loans, NPL. These have real and financial costs. Bad investments produce smaller or even zero value added thus slowing down growth. Banks' fund supply falls when loans do not get repaid. NPL also reduce banks' interest income and raise their collection and other transactions costs. The health of the Philippine banking system is analyzed in terms of aggregate and cross-section performance indicators such as sources and uses of funds, NPL/loan ratio, NPL/equity ratio and capital/asset ratio. Performance, as gauged from these ratios, varied widely across banks. NPL ratio ranged from 8% to 69%. Six banks had serious NPL ratio exceeding 20% and NPL/equity ratio much exceeding unity. Bank performance is not explained by size or state-private ownership. Two of the problematic banks were large state banks and four were private of varied sizes. The problematic banks composed a relatively small segment of the system so that their insolvency did not cause a systemic bank run. A core group of fairly strong private banks had existed and withstood the turmoil of the past three decades including the 1983-1985 economic crisis, the 1989-1991 recession and the Asian crisis. They had acquired a reputation of good banking. It appears that their presence had preserved the people's confidence in banking so that a systemic bank-run was avoided. Depositors did not react in a herding manner, they were discriminating in their response to the crisis and to the news of specific bank failure. NPL has contributed to the slow recovery of the economy as the banks are unable to increase credit and lower interest cost.

* The paper was prepared for presentation in the International Conference on "Economic Recovery and Reforms" in Bangkok, October 28-29, 2002.

The crisis-hit economies of Asia are recovering and exhibiting positive growth rates. However, the rate of recovery in most cases has been slow with the prospect for resuming their high pre-crisis growth path uncertain. All the affected economies are experiencing great difficulties in solving structural defects of their financial systems and the large non-performing loans of their major banks. We see the crisis as the expected consequence of very inefficient allocation of financial resources by financial systems that had not as yet instituted many of the basic elements of the Basle financial architecture. The architecture includes regular use of international accounting and auditing standards, legal framework for protecting property rights and enforcing financial obligations, prudential rules for banks and appropriate role and powers of central banks. Among Asian economies, only the Philippines, Malaysia and Singapore had adopted and applied international accounting standards before the crisis. At the same time, the crisis-hit economies' important financial institutions particularly banks were subjugated to the dictates of the governing power in politics and/or business. Connected banking of various forms was practiced by connected banks. In Indonesia, the Suharto government exercised direct influence on the state banks which dominated the system. In Korea, the chaebols had financial institutional arms. In Thailand, Malaysia and the Philippines, big business conglomerates also included banks and other financial institutions which functioned as their financial arm. The connected banks tended to make bad loans to the investment projects of their affiliate businesses. In many cases the projects were not chosen on the basis of their marginal rate of return and risk. The capital inflow into their economies merely increased the supply of resources of the connected financial institutions and powerful business groups. Foreign capital which was seen as a sign of approval by the international financial community was welcomed by their governments. That the massive foreign capital inflow overvalued the currency and penalized exports was generally ignored. By supporting the currency, the capital flow stabilized the nominal exchange rate and over-rated the expected rate of return on domestic assets. This further encouraged capital inflow, at least for a time.

The imprudent lending by connected banks meant fund allocation to bad investments which later on manifested themselves as non-performing loans. The reckoning of the true state of the economy instigated a capital flow reversal that resulted in very large devaluation of the currency and the crisis. The devaluation inflated the liability of the financial institutions and other sectors that borrowed from abroad. This worsened the ability of firms to pay their loans thus worsening the NPL problem. The banks which borrowed abroad likewise incurred losses. The NPL reduced the banks' supply of loanable funds, profits and net worth. The NPL also diminished their reputation or goodwill making them less attractive to depositors. Solving the NPL problem has proved difficult for all the affected Asian economies. Stiglitz (2001) discussed a number of issues related to NPL. There are management problems of how to minimize the cost of disposing NPL. Viable projects have to be distinguished from non-viable ones with the intent of saving the former and preventing fire sales for the latter. The assets have to be correctly valued. The agent for managing NPL has to be chosen, should it be a government agent, an independent private group or the affected bank itself. There are also refinancing issues - which banks to close, which to be refinanced and where to obtain the funds. The recession has reduced both tax and private saving sources for refinance. Foreign capital still hesitates to come back to the affected economies. The third issue relates to moral hazard that government assistance and policies might foster.

The needed financial reforms are proving to be difficult and slow to implement. Putting in place the Basle financial architecture is a slow process as it starts with learning and putting into extensive practice international accounting and auditing standards, legislating corporate and banking legal structure including developing judicial capability for enforcing and settling financial conflicts, reorienting central banking and strengthening its capability for enforcing prudential banking rules and practices. Solving defective and non-competitive structure of the banking system and large NPL has been a difficult and complex challenge. It has taken Korea four years to finally solve the insolvency of its banking system. Japan, Thailand and Indonesia have not settled the NPL of their major banks. The Philippines has settled only one of four insolvency bank cases.

The paper analyzes the financial turmoil, especially the NPL problem, that the Philippines experienced following the Asian crisis. It is noted that at the onset of the crisis, the Philippines appeared to be in a relatively strong position to withstand contagion for it had already undertaken major structural reforms in the banking sector. The experience with a deep crisis in 1983-1985 of a similar depth and causes as the 1997-1999 Indonesian crisis had prodded the government to adopt major reforms. The crises in both countries involved the toppling of an authoritarian and rapacious president. Major reforms in trade and industry, the public sector and the banking system had been undertaken by the new Philippine administrations over the 1986- 1995 period. The banking system had been tremendously strengthened. Most indicators in 1995-1996 were favorable. The NPL ratio was only 2.8%, the banks' asset/capital ratio was 12%, the current account to GDP ratio was -4%, the national budget had a small surplus. However, the statistics did not reveal the imprudent connected lending that a number of banks had made. The unproductive investments which they financed later revealed themselves as NPL. The large devaluation that accompanied the crisis worsened the NPL problem as the firms which borrowed abroad suffered losses from the inflation of their foreign liability. At the same time interest rate rose as the central bank adopted a deflationary policy and as the short-term capital flow reversed its direction and reduced the level of domestic credit. The NPL ratio doubled the following year and has continued to rise since 1996 reaching 18.4% in May 2001 (Philippine Daily Inquirer, July 8, 2002). The NPL are pulling down the rate of recovery. While GDP growth quickly turned positive from -0.6% to 3.3% in 1997-1998 to 1998-1999 it has remained at less than 4% since then. The downturn in Japan and the US, the country's most important trading partners, contributes to the economic slack. The banking system has stagnated with its loans growing at virtually zero rate. The stock market fared even worse with prices and value of transactions continuing to fall.

The paper traces the movement of key financial variables during the post-Marcos period from 1986 to 2001. We looked into the response of the financial market to the structural reforms undertaken during the period and how imprudent bank lending had crept up again. A cross-section analysis of banks shows significant variation in their performance. There were prudent banks and very imprudent ones. The economy was fortunate to have a core group of private banks that have behaved prudently through various political regimes. They sustained the banking system by preventing a mass bank run through the two crises. The paper also discussed central bank policies relating to the crisis and the remaining weaknesses of prudential rules.

The paper is organized as follows: Section 2 briefly analyzes the real cost of imprudent lending. Section 3 gives a brief history of structural reforms and their impact on intermediation activities of banks. Section 4 looks at the performance of individual banks and assesses the health of the banking system as whole. It also illustrates cases of imprudent lending by specific banks. Section 5 gives the dimension of the NPL problem and its implications on the recovery of the banking sector and its competitiveness. The concluding remarks in the last section discusses policy issues.

Section 2 - The Real Cost of Imprudent Lending and Speculative Portfolio Investment

Inefficient lending and financing imply inefficient allocation of real resources. Imprudent lending of connected banks has real counterparts in bad investments. The real impact on the economy is seen in Figure 1 below. Consider an aggregate investment opportunity curve AB with a competitive domestic saving-investment equilibrium at point X, with a rate of return = marginal rate of time preference equal at r(1). Let us assume a liberalized capital market with foreign interest rates being lower than domestic rate. Capital inflow would push the level of domestic investment to point Y where the marginal rate of return equals foreign interest rate r_f All is still well and the economy realizes consumption in year 2 at C_{23}, from C_{22}. In a competitive system, capital inflow will stop at this level. Sovereign guarantees and irrational exuberance on the part of foreign investors may lead to a larger capital inflow than the optimal level. The misallocation would be exacerbated if the capital flow is channeled to connected banks and their businesses. Their privileged access to funds leads to a concentration of fund in their businesses, hence a lower marginal rate of return. This tendency is observed in the crisis-hit economies particularly Korea and Indonesia. It is also the case in Japan.

Financing bad investments inevitably results in NPL and slower economic growth. Bad investments would not generate sufficient income to pay for the user cost of capital - interest costs and depreciation or even the amortization of principal. From the national accounting framework, bad investments contribute little or zero to GDP growth. The negative impact of inefficient financing may not manifest itself in the short-run during which the positive multiplier effect of the investments is operating. The multiplier effect may be prolonged when the current growth of income further attracts new investments. But in the long-run, the low or negative returns on investment will manifest themselves as NPL. The Japanese and Korean recessions are the long-run reckoning of the cumulating bad investments in the past.

The presence of foreign capital complicates the results as the distribution of losses may be biased against domestic investors. It appears that the burden or cost of the currency crisis was born largely by the domestic party to the foreign transactions and less by the foreign sources of the capital. There are four types of capital flows - FDI, long term loans, short-term loans and portfolio investments. Clearly profits and loses are directly borne by the FDI source. Because of implicit sovereign guarantees on loans, asymmetric stock market information and asymmetric currency hedge, domestic agents tend to bear most of the risk or burden of losses from foreign capital inflows. Consider stock price changes. Stock price changes may arise from changes in corporate performance or from speculative attacks. An increase in the profitability of a corporation raises its stock price, losses have the opposite effect. The stock holder gains or losses from the real changes. Price changes due to speculative attack in the market results in wealth redistribution between buyers and sellers. The huge portfolio inflow into the rather small and underdeveloped stock markets of the crisis-hit economies resulted in large losses for many domestic financial investors. The large foreign institutional investors have a comparative advantage in obtaining information and economies of scale in diversifying their portfolios. They manage very large funds. It is likely, therefore that they gained at the cost of domestic investors. Or if they lost, their losses would not have been as much as the losses of the small domestic investors. In the case of the short-term loans, the foreign lenders lost less since their loans were denominated in foreign currency. The domestic borrowers were left to bear the currency losses that inflated their foreign liabilities. They also faced higher interest rates for their loan repayment.

Banks are profit-making firms. They borrow to lend and they generally borrow short at some interest cost and lend long at a higher interest rate. The interest rate differential provides them with a margin of profit. The balance sheet of a bank consists of assets, principally loans, liabilities from funds borrowed in the form of deposits and other liabilities and equity. The supply of loanable funds comes from funds flowing in from new deposits and other liabilities and repayment of loans. When a loan turns bad, its amortization and interest income stop. Fund supply falls. The problem worsens if the bank's reputation suffers because of the presence of NPL for it will be less able to attract new deposits or retain outstanding deposits.

Section 3 - The Philippine Experience

There were marked differences in the economic performance and the conditions prevailing at the onset of the crisis between the Philippines and the three crisis-hit economies - Korea, Thailand and Indonesia. The Philippine had had a much inferior economic performance with lower and more volatile growth rates which made it less attractive to foreign capital. Capital inflow was not as massive as in the other economies. (Table 1) Political uncertainty and poor governance had prevailed through two decades of the Marcos dictatorship, from 1965 to 1985. The regime was as repressive as it was rapacious, taking capture of both public and privately owned resources and businesses. The people power revolution toppled the dictatorship in

February 1986 but the achievement was followed by great hardship. The new government of Cory Aquino was challenged by a series of coup attempts from Marcos followers with the last one in December 1989 almost succeeding. The economy inherited large foreign debts and insolvent government financial institutions (GFI). It had to recover from a deep recession when GDP annual growth dropped by -7.3% in two successive years from 1983 to 1985. The recovery from the 1983-85 crisis was fast and appeared strong until it was reversed by the 1989 coup attempt. It created political uncertainty which was exacerbated by major calamities - a strong earthquake and the eruption of Mt. Pinatubo, and the Gulf War. Again a recession set in with growth dipping from 6.2% to 3.0% to -0.6% over the 1988-1991 period. Recovery was slower this time and before growth could stabilize at its long-run level of 5-6%, the Asian financial crisis spread to the country, once again pulling down growth rate to a negative level, -0.6% in 1997-1998. Growth turned positive the next year but it has remained at a relatively low level, 3.3%, 3.9% and 3.7% in the next three years. The country's growth fundamentals particularly the saving rate and the population rate have not been very strong, averaging less than 20% and 2.3%, respectively, in the 1990s.

The last recession was not as deep as had happened in the neighbors. When the Asian crisis started, there was much optimism that the economy would be able to avoid its contagion. Macro fundamentals and financial indicators were encouraging.[1] Moreover, the country had already undertaken substantial and fairly comprehensive structural reforms covering trade and industry, industrial organization, and banking. The historically high and highly differentiated tariff rates were drastically lowered and simplified and almost all non-tariff barriers were abolished. The more than 300 government corporations created during the Marcos dictatorship were privatized. Some important monopolies, especially in transportation and communications, were dismantled. Major banking reforms were undertaken.

[1] Tan, E. wrote in 1999 that the Philippine crisis could have been prevented if the central bank and the national government did not follow the IMF prescription of adopting recessionary monetary and fiscal policies which exacerbated the effects of the capital flow reversal. At the time of writing, the NPL problem had not yet emerged.

The banking reforms were instigated by the very palpable fraudulent financial transactions made during the Marcos regime that left the country with a large external debt, unproductive investments and large NPL in the then dominant government financial institutions, GFI. The GFI included the Development Bank of the Philippines (DBP), the Philippine National Bank (PNB), the Government Service Insurance System (GSIS) for state employees and the Social Security System (SSS) for private employees. The two banks were the largest in the banking system and the GSIS and SSS, the largest in the insurance industry. Marcos directly made demands on the GFI to provide financing for his and his cronies' projects, hence the term "behest loans". Many of the behest loans were never intended to finance projects but were simply ways of appropriating funds. The practice became known as "front-ending" i.e., propose a project with little or no collateral upon the behest of the President, pocket the loan proceeds and invest a small fraction for show. The state banks' loanable funds were largely sourced from the central bank's rediscount window and foreign borrowing. Government agencies, including the central bank, were the main foreign borrowers then. The funds indirectly financed capital flight estimated to have reached $10billion in 1986, the equivalent of a year's export at the time. The GFI loans inevitably ended up as NPL. There remained many failed businesses. At the time of reckoning under the new government of Cory Aquino, the NPL ratio of PNB was 35%, GSIS, 50%, DBP, 65%.[2] Their NPL comprised the bulk of the system's NPL. Additionally, many small private unit banks consisting of rural banks and individual development banks which had been dependent on central bank rediscounting window also acquired relatively large NPL. The policy then was for the central bank to rediscount their loan papers at minimal interest rates. The window provided a good opportunity for financial capture so that many small rural and development banks were established in order to have access to it. A few crony private commercial banks which also obtained favorable central bank credit also failed.

[2]The SSS was headed by a man of strong will and integrity who negated the President's behest. SSS was the only GFI that preserved its solvency during the Marcos years.

It is noteworthy that in this profligate environment, a core group of private commercial banks separated themselves from the abusive system and functioned as regular banking intermediaries. The group had developed a fairly solid reputation of good banking and formed a segment that was large enough to preserve confidence in the banking system, thus preventing a massive bank run. The insolvency of the state and crony banks did not endanger collapse of the system for being dependent on central bank funding, they had little deposits to run away with. In 1985 the loan deposit ratio was 850% for state banks, 230% for rural banks and 110% for private commercial banks. Government deposits comprised the bulk of the GFI deposits. Since they undertook marginal intermediation functions they were perhaps viewed by the public as merely a source of privileged credit. While they did not cause a bank run, their bad loans entailed real losses to the economy for the funds could have been allocated to productive investments.

A series of major banking reforms were undertaken over the 1986-1995 period. The Cory government was faced with the choice of closing the insolvent state banks or restructuring their portfolio to their net worth. The latter was chosen with a proviso that henceforth they were to mobilize their own funds and no longer rely on central bank credit. Central bank development lending and currency swaps were stopped. The Asset Privatization Trust was created to take over and manage the GFI's NPL. The resources and net worth of DBP and PNB were reduced by the removal of the NPL. This decision had the important result of reducing the relative importance of state banks; their share in the total assets of the banking system fell from 19.9% in 1985 to 3.2% in 1987; their total resources dropped from P77 billion to P25 billion. Entry of domestic banks and branching was relaxed.

The Ramos administration completed the reforms though the sequence may be questioned. It fully liberalized currency and capital transactions quite early. (1992). In 1993, the central bank was made independent of the executive by limiting the representation of cabinet members in the Monetary Board from 5 to 2 out of 7. The new central bank called Bangko Sentral ng Pilipinas, BSP was to be responsible mainly for maintaining price and exchange stability. Its economic development role, which had been abandoned earlier, was officially removed by the law. In 1994, foreign bank entry and branching were relaxed. Previously only four foreign banks which obtained their licenses in the 1950s and 1960s had been allowed to operate. They could not expand their branches beyond a handful located in Metro Manila. The new law allowed 100% foreign equity in banks which in the beginning were to be limited to 10. Foreign banks could establish more branches, merge with domestic banks and have controlling interest in any of them. Bangko Sentral was concerned about the large number of banks and their small sizes. It raised minimum equity levels for different bank categories several times: universal banks from P1 billion in 1990 to P2.5 billion in 1995, to P5 billion in 1999. The corresponding figures for other commercial banks are P500 million, P1.25 billion and P2.4 billion.

The reforms had many positive impact: entry of a large number of foreign banks and branches, an acceleration in intermediation activities, reduction in deposit-loan margins and introduction of modern technology in bank services and clearing. (Table 2) The number of foreign bank branches increased by 7 between 1995 to 2000. In addition to the branches are 5 subsidiaries of foreign banks. M2/GNP[3] ratio which stagnated at around 20% from the mid 1960s to 1985 began to rise and reached 43.3% in 1997. The recent crisis reversed its upward trend and pulled it down to 39.4% in 2001. The financial asset/GNP ratio rose from 70.9% in 1986 to 134.1% in 1997; it also fell afterwards dipping to 106.3% in 2001. The insolvent small rural banks and private development banks were closed down, and the rest encouraged to merge or be taken over by larger and solvent commercial banks and thrift banks. Bank capital grew at two-digit rate over the 1986-1997 period. The number of banks fell slightly so their average equity rose while their branch network expanded. The intermediation margin decline initially in 1986-1990 but the 1990's financial turmoil has disrupted positive developments in the system. Unite and Sullivan (2002) found the margin declined only in the conglomerated banks in1990-1998.

[3] $M_2 = M_1$ + saving deposits + time deposits. Deposit substitutes comprise less than 5% of total deposits and when added to the M_2 equals M_3. The M_2 and M_0 definitions are not as expansive as those in the US which has more diversified liquid assets.

President Ramos (1992-1998) was able to foster political stability and a sense of a competent government. This encouraged capital inflow. From a low base of only $81 in 1986, net inflow rose quite rapidly starting in 1989. (Table 3) Large-scale capital inflow started only in 1994 as the net inflow rose from $4.4billion to $11.1billion in 1995 to 1996. Previously, the net inflow comprised mostly of medium and long term loans and FDI. In 1996, the latter comprised only 30% of the total inflow. The short-term flows in 1996 consisted of portfolio investments, short-term loans by non-bank and bank borrowing (reported as commercial bank net foreign account). The net foreign assets of banks (NFA) jumped from $1.6 billion to $4.2 billion. Portfolio investments were first reported in 1996 at $2.101 billion. The reversal in 1997 and 1998 in the short-term accounts was drastic - from a positive $7.714 billion to -$.416 billion, then to -$5.820 billion and -$2.038 in 1998 to 1999. Bank borrowing comprised the bulk of the short-term flows. They included foreign currency deposits (FCD) by residents and foreigners. Previously FCD could not be lent out but beginning in 1992, banks were allowed to lend them, partly in domestic currency. These loans entailed currency risk on top of the ordinary credit risk. The drastic reversal of the short-term flows had had its expected impact - currency depreciation, reduced fund supply, high interest rate and inflation of liabilities of the foreign currency borrowers, all hurtful to the banks, their borrowers and the real sector.

The capital inflow substantially increased bank lending. Table 2 shows that the growth rate of commercial bank loans outstanding accelerated during the 1992 to 1996 period and drastically decelerated afterwards; in 1994-1995, growth was 40.7%, in 1995-1996, 61.9% and in 1996-1997, 26.5%. Growth was negative in 1997-1998, and only .4% in 1998-1999, high at 7.2% in 1999-2000 but fall to -1.5% in 2000 -2001. Portfolio investments from abroad intensified the rising activities in the stock market. Table 2 shows a rapid rise in the value of transactions and stock price during the 1990-1996 period. The value of transactions jumped by 77% and the price level by 22% in 1996 to 1997. The reversal of the portfolio flow had the expected negative effect on the stock market with both the value of transactions and prices falling substantially. The stock market, like the banking system has not recovered until now (July 2002)

Section 4 - Non-Performing Loans Across Banks

Non-performing loan and non-performing asset ratios (NPL/total loans and NPA/total assets) are used here to gauge the health of banks. Bangko Sentral uses a rather strict definition of non-performing loans (NPL), i.e., loans whose principal and/or interest has not been paid 30 days or more after its due date (BSPa). The NPL ratio was quite low in 1996, 2.8%, but has continuously increased since then. It nearly doubled to 4.9% in 1996-1997, then again in the following year when it reached 10.3% in 1998. The ratio was 16.9% at the end of year 2001 and is now 18.4%. The current rate is still low relative to the other last Asian economies though its continuing rise is worrisome. The NPL ratios were about 80% in Korea, 40% in

Thailand but only 10% in Malaysia (Dekle and Fletzer 2002)

It is helpful to see the problem at the micro level, i.e., at individual banks. We find the NPL problem to be non-systemic but isolated in specific banks. The wide variation in the condition of banks including their NPL ratio seems to reflect differences in behavior particularly in their business identity and objectives. Some banks seem to see themselves primarily as banking enterprises that aim to develop and survive as banks. Such banks would have a long time horizon of operation, cultivating a reputation as reliable trustees of the people's saving and wealth. This core group of banks had withstood three decades of economic and political turmoil. They did not join the political banks in the capture of central bank development funds and other privileges. The presence of these banks had exerted a great stabilizing influence on the banking system, preserving depositors' trust in the system and preventing a systemic bank run. Nevertheless the core banks also suffered from the crisis, they also incurred high NPL though these are sufficiently covered by their networth.

The annual growth of deposits and outstanding loans averaged 23.8%% and 33.1% respectively in 1990-1996. (Table 2) In these years, all the commercial banks had capital-asset ratio greater than the Basle level of 8%, ranging from 10.0% to 15.0% (Table 4) The banks, however, had varying profitability rates as reflected in surplus to equity ratio and surplus to asset ratio which ranged, respectively, 12.5% to 39% and 4% to 12%. It is noted that the banks that became insolvent after the crisis did not show inferior surplus ratios. Ordinary balance sheet and income statements were unable to indicate quality of a bank assets and liabilities. The latter are not distinguished by currency and so do not indicate currency risk.

The bad loans made during the credit bubble of the first half of the 1990s manifested themselves as NPL after a lag of three- to- five years. The NPL ratio in end of 2001 ranged from 8.9% (China Trust) to 69% (Westmont Bank). (Table 4) Bank size and ownership structure do not seem to explain the NPL ratio for there were large and small banks and private and state banks that incurred high NPL ratio. The solvent banks include the same mix. Three small private banks became insolvent: Westmont Bank (United Overseas Bank, Philippines), Urban Bank and Orient Bank. The Philippine National Bank (PNB), with NPL ratio of 46%[4] was the sixth largest bank with equity of P186 billion. It was a state bank until 1996 when it was partially privatized. Then in 1998 its controlling interest was acquired by Lucio Tan, a crony of President Estrada. (He took over in July 1998 and was deposed in December 2000.) The Land Bank of the Philippines, a state bank and the fifth largest in the commercial banking system, had NPL ratio of 25.1%. The Equitable-PCI Bank, a large private bank had NPL ratio of 32.9%. Equitable Bank and Philippine Commercial and Industrial Bank were fairly strong banks that never had a problem until their politically assisted merger in 1998.

Anecdotal stories give some insights into the irregular lending made by the problem banks. The anecdotes were culled from business reports in major newspapers since

[4]The Banko Sentral website gives PNB's NPL ratio at 46% but the bank's published information gives a figure of 53% (Philippine Daily Inquirer, July 22, 2002).

official reports were unavailable. The reports show different forms of imprudent transactions including DOSRI loans (to directors, other officers and related individuals of the bank), politically connected loans and more ordinary frauds committed by bank officials.

1. PNB has had a checkered history of connected banking and insolvency. It is the oldest state bank founded in 1916 under the US colonial government to service the financial transactions of the government. It issued the Philippine currency which was convertible to the US dollar at P2/$1. From the 1950 to 1985 it had functioned as a development financing arm of the national government. As a state bank it was a depository of government funds. It had been a source of privileged credit for the country's political and business elite. (Hutchscroft 1998). It appears that the bank had ingrained a habit of privileged or connected banking which its partial privatization in 1989, 1992 and 1998 failed to remove. PNB shares were first sold to the public in 1989 and again in 1992. The bank had rightly assumed central bank guarantee against closure because of its size and (partial) government ownership. It was not closed down in 1986 when it was found insolvent. It is not being closed down even if its NPL has exceeded its equity by 160%

In the first year of Estrada administration (1998) Lucio Tan, his crony, acquired controlling interest in the bank but with the government retaining about 16% of its equity. It is not clear how much Tan actually invested in the bank. Just before his acquisition, the bank issued new stocks. The bank lent to its Employees Retirement Fund in order to buy a block of the new issues. Through the President's help, Tan obtained the voting rights of the Retirement Fund shares which he used to gain controlling interest. (Torrijos, PDI May 23-24, 2001, Business World, June 4, 2000) Until 1996, the bank's condition appeared relatively strong. Its equity to asset ratio was 11%, its deposits and loans were growing at 21% and 24% annually on average from 1990-1996. These rates were comparable to the growth rates of the other large banks such as Metro, Bank of the Philippine Islands and RCBC. (Table 4). It reported profits until 1997, then losses afterwards. In year 2001, the bank declared losses of

P11 billion that reduced its equity by almost half. The losses have not been explained how these were incurred. They could be through front-ended DOSRI loans, a sophisticated form of looting. Tan's acquired Philippine National Airline was reported to owe PNB P9 billion (Villamor and Lucas, PDI). The central bank and the Philippine Deposit Insurance Corporation (PDIC) provided it with emergency loans of P15billion and P10 billion, respectively. The bank has remained open but its level of intermediation has been drastically limited by its NPL problem.

2. Three private commercial banks were declared in difficulty by the Bangko Sentral: Orient Bank, Westmont Bank and Urban Bank. Orient bank was placed on receivership after it was found to have reported investments in fictitious companies and made DOSRI loans that turned bad. It was closed down immediately with the case now in court. Westmont Bank made heavy investments in its sister investment company, the Westmont Investment Corporation which concentrated lending in property. The bank obtained emergency loans from the Bangko Sentral while negotiating its sale to United Overseas Bank of Singapore. The bank has been allowed to remain open pending the negotiation which had dragged on for four years. The Singapore bank was reported to have finalized Westmont Bank's full takeover. (Business World, July 4, 2002).

3. Urban Bank's trouble began when it bailed out its affiliate, Urbancorp, by buying more than P4.5billion of its loan receivables which BSP later considered to be 'garbage' receivables. Urbancorp used Urban Bank funds to invest in property. The property investments include Urban Bank Plaza, high-rise buildings in Fort Bonifacio, and Puerto Azul, a resort built during Marcos time that was already bankrupt at the time of Urban Bank purchase. (Dancel, PDI, May 8, 2001) Apparently Urban Bank had special relations with GFI. Land Bank's Provident Fund kept P400 Million deposits in Urban Bank and lent it P600 Million, half of it when Urban Bank was already in difficulty. The SSS Retirement Plan had P171 Million exposure to UB and owns 15% of its equity. The GSIS originally financed the Panlilio Group that invested in Puerto Azul. The loan had reached P14 billion (C.

Batino Business World May 5, 2000.) Note UB gave Puerto Azul P450 Million loan a day before UB declared a bank holiday. High government officials who were reported to be large depository clients of UB were allowed to withdraw their deposits a few days before the bank holiday. Despite all these doubtful transactions Bangko Sentral gave the bank an emergency loan of P30 billion. UB is still on receivership.

4. The SSS and the GSIS made loans and investments at the behest of President Estrada. (Dumlao, PDI June 11, 13, 2001, Business World, November 2, 1999) SSS' investment in Belle Corporation, the developer of Tagaytay Highlands, a luxury resort/real estate. It is illustrative of how SSS funds were misused to funnel funds to the President and his cronies. SSS was pressed to invest P745 Million in shares of stock of Belle Corporation. SSS' recorded purchase price was higher than the prevailing market price with the difference allegedly given to the President. In December 1998, SSS recorded a purchase of 149 million shares at P3.10 when it was trading at P2.10. On March 20, 2000, SSS held 476 million shares at average acquisition cost of P.69 though its closing price was P.59. The acquisition-market price differential in the two transactions amounted to P150 Million and P47.6 Million, respectively, or a total of P197.6 Million. This was the alleged commission of the President. Moreover, SSS was pressed to extend P375 million loan to the company. In 1999, SSS reported losses for the first time in its 44 year history. It had to borrow from the Land Bank, the Philippine Health Insurance and First Metro Investment Corporation, the first two being government institutions. SSS admitted it lost P813 million of its P50 billion investments in publicly listed stocks. In 2000, 28% of the investments were still locked in 24 corporations awaiting better prices. In the meantime they earn zero or minimal returns and have large paper losses. SSS and GSIS funds are also being eroded by high administrative cost. Scandalously high salaries and perks have been reported.

5. Both GSIS and SSS were pressured to provide funds to Equitable Bank to help it acquire Philippine Commercial and Industrial Bank (PCI). (Gaylican, PDI August 14, 1999) Equitable Bank and PCI were fairly strong banks that survived

and grew until their politically assisted merger in 1998. The assistance appears to be in exchange for money laundering services. Evidence in the impeachment proceedings against Presidetnt Estrada showed Equitable-PCI acted as a conduit of his loot from jueteng and other sources. The Bangko Sentral provided the merged bank with an emergency loan of P30 billion when it suffered a liquidity problem during the impeachment proceedings against President Estrada. There were increased withdrawals of deposits during the hearings when evidence of laundering of the President's deposits was being presented. The loan has been repaid and the bank has resumed normal operation.

6. Some banks including the more solid ones made large loans to projects of questionable social value. The Mondragon Leisure Resorts Corp. obtained a loan for P4.5billion for a tourist and gaming resort project in the abandoned U.S. Clark Airbase in Pampanga Province. (The 1986 Constitution prohibits foreign military basis in the country.) The airbase was badly damaged by the Pinatubo Volcano and its surrounding area is still covered by lahar or volcanic ash. Its only attractive feature is the presence of the abandoned US airport infrastructure. Pampanga has no natural scenic resources and the volcano is still active and can erupt again anytime. But four banks provided Mondragon with a colossal loan -Far East Bank, Asian Banking Corp., United Coconut Planters Bank and Metropolitan Bank and Trust Company. Three of these banks - FEBT, UCPB and Metro - are important banks in size and reputation. It appears that the company had intended to front-end the loan, i.e., immediately appropriate the loan proceeds and make token investment in the loan project. The company did not even pay the rental of the land and the gaming share to the government. According to the Clark Development Corporation President Rufo Colayco, Mondragon spent only about P2.0 billion of the loan proceeds. (G. Cabacungan, PDI, Jan. 8,1999) There were rumors the money was invested abroad. Another case that got to the papers was a P7 billion syndicated loan to Uniwide Retail Store. Important banks provided large loans - Equitable for P1.73 billion, RCBC for P1.34 billion, UCPB for P995 million, PNB for P611 million and Land Bank for P588 million. Six other banks

gave the balance. We have no report on how large property developments such as the Rockwell, the Fort Bonifacio, the Enrile Enterprises, the Villar Metropolis and the Amari Land Fill were financed. They must have absorbed a large fraction of domestic credit and account for a large share of the banking system's non-performing assets. Bangko Sentral reports that the bulk of the NPL came from only 161 large loans. (BSPa) The media recently reported a Senator owing PNB P300 million and the Lopez group that owns Rockwell a total of P30 billion to various creditors.

Section 5 - Perspective of NPL

As stated earlier, the problem banks did not form a large enough segment to cause a system-wide bank run and banking collapse. Confidence in the banking system was preserved as the anomalies were blamed on a small number of banks. By identifying the failing banks and discussing their problems, the news media helped put their relative importance in perspective, isolating them from the rest of the other banks. For this reason the threat of a bank run did not materialize. However, the high level of the NPL and their distribution across banks have implications on the future development of the banking system and its competitiveness.

The value of NPL was 7.9% of GNP and the NPA, 12.9% in 2001. (NPA = NPL + acquired assets from NPL.) (Table 5) It is reasonable to assume that actual losses in output would be a fraction of the NPL and NPA since some of the assets are possibly viable and majority have some market value. Some repayment of the NPL may be expected. The NPL are concentrated in 11 commercial banks which hold 51% of the banking system's NPL and 30% of its assets.[5] The problem banks comprise a minority in terms of numbers, 11 out of 44 commercial banks. Of the 11 troubled banks only four have not resolved their NPL problem - PNB, Orient Bank, Urban Bank and Land Bank. PNB's NPL to equity ratio was 260% at end of 2001. Its new President (Lorenzo Tan) reported in the papers that the bank is being rehabilitated and

[5] Table 4 does not include Urban Bank and Orient Bank which were closed down soon after their insolvency was confirmed by Bangko Sentral.

would start earning profits in four years time. Details on the rehabilitation plan were not spelled out in the papers. Its emergency loan of P25billion from the Bangko Sentral and the Philippine Deposit Insurance Company has not been repaid but is being extended in order to support the bank's rehabilitation. Two relatively large banks - Land Bank and UCPB also have equity to NPL ratios of 135% and 258% respectively. As a state bank, Land Bank might be viewed as possessing central bank guarantee against closure. Moreover, it can depend on a steady flow of deposits from government agencies and continue operating even with the heavy NPL burden. Government deposits comprised more than 69% of its total deposits in 2001. These guarantees will allow the bank to continue making imprudent lending. About six other banks with relatively high NPL ratio have been able to survive and function normally. All except UCPB have NPL/equity ratio of less than 1.0.

As discussed above, the NPL reduced the supply of funds, raised the cost of lending and reduced the profit rates of banks. The slowdown of the economy after the crisis had exacerbated the problem by also decreasing the level of saving and other excess funds that banks could intermediate. Table 2 thus shows how much the growth rate of deposits and loans have fallen since the crisis. The growth rate of loans outstanding of commercial banks dipped from 26.5% in 1996-1997 to -4.8% in 1997-1998. Loans had hardly recovered from the 1996-1997 crisis when their growth swung from .4% to 7.2% to -1.5% during the 1998-2001 period. Deposits performed better than loans, growing more steadily at 6.8% on average after the crisis. Expectedly the better performing banks or those with relatively low NPL ratio attracted more deposits and provided more loans than the problematic banks. Three banks stand out in terms of deposit growth - the Bank of the Philippine Islands, Banco de Oro and China Trust. Their NPL ratios were, respectively 15.1%, 11.2% and 8.9%, much lower than the average rate of 18.4%. But Metro Bank and Prudential Bank which have relatively high NPL ratios of 18.1% and 25.8%, respectively experienced high deposit growth of 16%. Metro Bank is the largest domestic bank that caters to Chinese Filipino businesses. Its NPL/Equity ratio was 62%. Prudential Bank NPL arose from an isolated case of fraud by its officials. It is owned by the Catholic hierarchy of Manila. It has a relatively low NPL/Equity ratio of -56%.

The cross section data presented above lead us to conclude that the banking system has stabilized and that majority of the commercial banks have been able to manage their NPL. The NPL will, however, continue to drag down the growth of the system's intermediation activities. They will continue to slow down the flow of loanable funds from loan repayment and increase intermediation cost. Moreover, the variation across banks of the NPL ratio will dampen competition across them. Those with heavy NPL will not be able to compete well with those with low NPL ratio. The former would have a slower rate of repayment flow, higher cost and lower profit rate. As happened in the post- 1983-1985 crisis, rearrangement of the relative position or importance of the banks may be expected. The strong ones willl tend to attract more depositors, give more loans and offer better terms. This may results in a higher concentration ratio unless entry of new banks and new branches is able to counter the advantage of the existing strong banks.

Section 6 - Bangko Sentral Policy

The discussion raises several policy issues relating to a) prudential rules on disclosure and effective supervision and monitoring that set prompt signals of anomalous transactions, b) moral hazard fostered by BSP bailouts c) personal responsibility of bank officials for their portfolio decisions, and d) rationale for GFI. The anomalous transactions described above definitely reflect weaknesses of prudential rules and BSP-PDIC supervision. The anomalous transactions that reached billions escaped BSP supervisors. BSP failed to take note of the giant loans especially those going into property development, gaming and shopping centers. It did not question the large deposits that were flowing into selected and known crony banks. BSP has not instituted an electronics monitoring system which would allow it to promptly track irregular transactions. It inspects banks once a year at pre-announced schedule allowing them to produce good accounts. BSP looked into end of the year financial reports which can be beautified. Little can be read from balance sheet data since they do not reflect irregular transactions.

BSP has no definite stand on bailouts. Its bailout was selective favoring state banks and large connected banks – PNB, Equitable-PCI, Urban Bank. This practice fosters moral hazard of the worst kind encouraging corrupt officials and finance managers to connive to raid financial institution. While it condemned the so called garbage loans of Orient Bank and Urban Bank it was silent about the garbage loans of PNB and Land Bank. It continues to support the clearly bankrupt PNB and places no sanction on the high NPL of Land Bank. It is in fact insolvent with its NPL also exceeding its equity.

There is no clear accountability by bank officials for their portfolio decisions. Federico Pascual of GSIS and Renato Arellano of SSS admitted to succumbing to the pressure by President Estrada to provide loans to his cronies. They were entrusted with the pension funds of employees and ought to be accountable to them. The officers of PNB and Land Bank should be held responsible for their banks' high NPL. Narvasa, a former Supreme Court justice, was PNB board chair when many of its NPL were granted. His closeness to the President is reflected in his lawyering for him in the impeachment trial. The officers of Equitable-PCI agreed to service fraudulent deposits and other transactions of President Estrada. The officials of Urban Bank, Orient Bank and Westmont Bank clearly violated prudent banking principles. All the guilty bank officials have not been prosecuted. In fact no financial institution official has even been brought to court.

Finally there is the question of the economic value of having GFI and the partial privatization of PNB. The GFI no longer have a special role in the financial system since much of development financing has been abandoned. PNB and Land Bank are classified as extended or universal commercial banks and Land Bank's special access to government deposits sustains its lax lending decisions. The GSIS and SSS do not provide better service than private insurance. Because of the low rate of return on their investments and high administrative cost their pension funds earn below market interest rate. The government's minority interest in PNB, reported at 16%, allows it to appoint some of its directors.. Directorship in semi-government corporation is a lucrative privilege that the executive uses to grant favor all sorts of reasons. It is a source of corruption and an obstruction of efficient management. Partial state control confounds the objectives of the institution and blurs the accountability of its officers. To whom is a government appointed officer accountable - to the President or to the equity holders? President Arroyo has recently announced the government's retaking controlling interest in PNB. This is definitely a wrong move unless the intent is to refurbish its position until it can be sold and fully privatized at a fair price.

Much effort still has to be exerted to improve prudential rules and supervision of banks and the full privatization of GFI. Recent reforms are aimed largely at disclosure. Bangko Sentral now requires banks to make quarterly balance sheet reports. The Quarter 4, 2001 report contains risk indicators such as NPL and NPA ratios and sources of deposits, whether government or non-government. The information is however contained in the website to which only a very small proportion of the population largely in Metro Manila has assess. A new law on money laundering (2001) sets an extraordinary large deposit transaction of P4 million or $80,000 level for automatic reporting to the central bank. Few Filipinos have this wealth or business. BSP must make a thorough review of how it can effectively monitor large loans. As in the first crisis, it is the large privileged borrowers that caused the bank problems. The single borrower limit of 20% of equity will not prevent insolvency if the loans are really bad. A bank may lend to only 5 bad borrowers to wipe out its equity.

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Tables and Figures

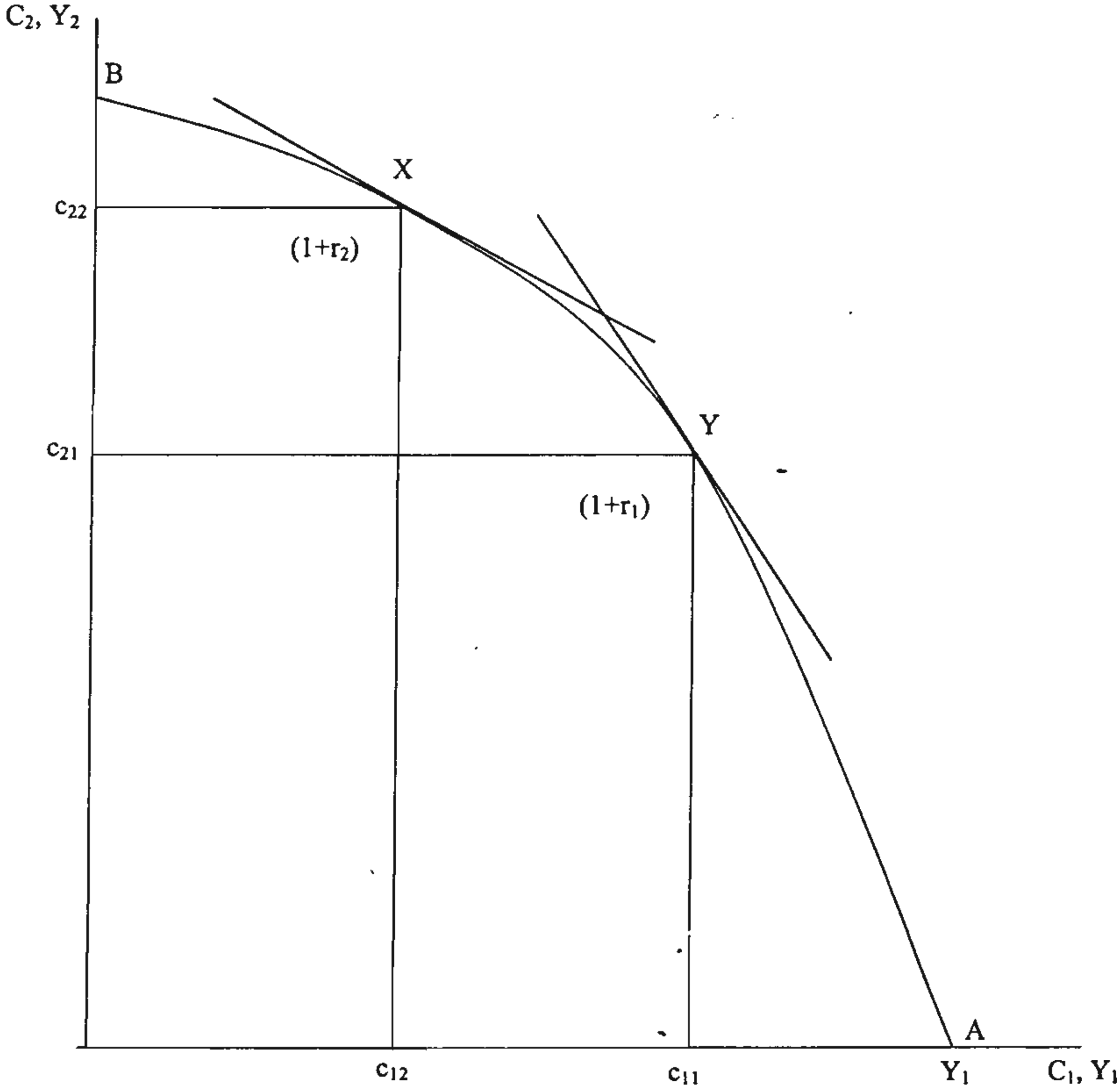

Figure 1

Table 1 Macro Fundamentals and Economic Growth

Year	Annual Growth Rate			Inflation Rate (%)	%ρ in nominal ER (%)	Index of Real ER 1990=100	S/GDP	I/GDP	CA/GDP	Fiscal deficits/GDP
	GDP	GNP	Export							
1984	-7.3	-9.1	7.7	44.6	30.1	83.6	23.9	20.3		-1.9
1985	-7.3	-7.0	-14.1	25.0	50.3	77.4	18.8	14.3		-2.0
1986	3.4	3.6	4.5	8.0	11.4	96.6	19.0	15.2	3.1	-5.1
1987	4.3	5.1	18.1	3.8	9.6	102.7	21.0	17.5	-1.4	-2.4
1988	6.8	7.2	23.7	8.8	2.4	104.8	21.1	18.7	-1.0	-2.9
1989	6.2	6.2	10.5	12.2	2.8	97.9	21.3	21.6	-6.7	-1.6
1990	3.0	4.8	4.7	13.2	12.0	100.0	18.7	24.2	-5.8	-0.7
1991	-0.6	0.5	8.0	18.5	13.0	99.3	16.6	20.2	-1.9	-1.6
1992	0.3	1.6	11.1	8.6	-7.2	91.1	14.1	21.3	-1.6	-3.1
1993	2.1	2.1	15.8	7.0	6.3	93.2	13.8	24.0	-5.5	-1.4
1994	4.4	5.3	18.5	8.3	-2.6	87.0	14.9	24.1	-4.5	1.1
1995	4.7	4.9	29.4	8.0	-2.7	82.2	14.5	22.5	-4.3	0.8
1996	5.8	7.2	17.7	9.1	1.9	75.3	15.6	24.0	-4.6	0.8
1997	5.2	5.3	22.8	5.9	12.6	78.8	15.2	24.8	-5.1	0.3
1998	-0.6	0.4	16.9	9.7	38.8	99.3	12.4	20.3	-4.5	-0.9
1999	3.3	3.7		6.7	-4.4	93.8	14.3	18.8	-4.6	-2.7
2000	3.9	4.2	9.0	4.4	13.1	102.7	16.5	17.8	-5.1	-3.0
2001	3.7		16.2	6.1	15.3	111.0	17.5	17.6	-4.5	-4.2

Note: % ρ the average if monthly nominal peso/US dollar rate

Source: Bangko Sentral ng Pilipinas: Statistical Bulletin, 1990, 1997; Selected Philippine Economic Indicators, December 1998, March 2002; www.bsp.gov.ph.statistics/sipbs. Real Exchange Rate Index from Romeo Bautista (2002) "Exchange Rate Policy in Philippine Development" processed.

Table 2 Selected Financial Indicators of the Banking System

Year	Annual Growth Rate				Ratios (%)				Index of Stock Market Transactions, 1990=100		
	Total assets of financial system	Loans outstanding of KB	Deposits KB	Capital KB	(capital/ Assets) % KB	M_2/GNP (%)	FCD/M_2 (%)	Total Financial Assets/ GNP(%)	Value transacted	Composite price	%ρ Price
1986	-23.0	-3.8	-1.8	28.1	12.1	23.6		70.9			94.3
1987	8.2	14.4	7.5	11.8	12.5	23.8		67.8			130.9
1988	16.0	35.7	26.6	18.7	12.5	25.1		66.9			4.4
1989	22.0	15.7	27.0	11.1	11.3	27.7		70.4			43.0
1990	25.4	33.7	23.1	30.0	11.5	27.7		74.7	100.0	100.0	-16.0
1991	14.2	9.3	18.5	23.9	11.7	27.4		73.8	137.8	176.7	76.7
1992	17.9	19.5	18.3	23.7	12.3	27.8		79.1	269.2	194.8	10.2
1993	24.8	38.2	29.0	17.7	11.6	31.7		90.6	637.1	496.5	154.9
1994	24.6	28.4	24.3	28.7	12.0	34.7		94.8	1273.7	426.6	-14.1
1995	28.4	40.7	26.2	36.9	12.8	38.3	20.7	104.6	1325.0	397.2	-6.9
1996	28.7	61.9	27.0	25.7	12.1	38.7	31.7	116.6	2338.8	485.6	22.2
1997	28.5	26.5	29.5	27.5	11.8	41.7	43.3	134.1	2049.7	286.2	-41.1
1998	1.6	-4.8	4.8	7.6	12.7	42.2	52.4	122.9	1429.0	301.5	5.3
1999	8.6	0.4	9.4	10.2	13.0	43.3	52.1	119.4	2730.8	332.6	10.3
2000	8.7	7.2	8.6	2.0	13.0	40.8	58.6	116.5	2419.2	236.8	-28.9
2001	0.9	-1.5	4.5	1.7	13.2	39.4	58.6	106.3	558.0	204.0	-13.8

Source: Bangko Sentral ng Pilipinas: Statistical Bulletin, 1990, 1997; Selected Philippine Economic Indicators, December 1998, March 2002; www.bsp.gov.ph.statistics/sipbs.

Table 3 Capital Flows and Gross International Reserves (GIR)

	Net Flows									
Year	MT & LT Loans	Bonds & Securities	Investments (4)+(5)	FDI	Portfolio	S T Loans	Change in KBNFA	Short-Term Flows (9)-(1)-(4)	Total (1)+(2)+(3)+(6)+(7)	GIR
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1986	732		114			–824			22[2]	2.5
1987	159		326			80			565	2.0
1988	(519)		986			–303			164	2.1
1989	381		843			–89			1135	2.4
1990	674		480			19	603		1776	2.0
1991	835		654			349	40		1878	4.5
1992	633		737			660	289		1850	5.3
1993	2455		812			–148	–299		2820	5.9
1994	1313		1558			1002	674		4547	7.1
1995	1276		1609			–56	1574		4403	7.8
1996	2841	–37	3517	520	2101	540	2414	7714	11075	11.7
1997	4824	–676	762	1249	–406	495	1188	520	6593	8.8
1998	2850	–1082	1672	2016	206	–1521	–963	-3910	956	10.8
1999[1]	2898	–439	1022	1244	604	–1163	–214	-2038	2104	15.1
2000	na	na	2054	1348	–113	na	na		na	15.0
2001	na	na	1719	1953	1399	na	na		na	15.7

Note: MT, LT, ST are medium term, long term and short term and short term loans; KB are commercial banks; NFA is net foreign assets. Net investment flow = FDI + Portfolio net flows.
[1]1999 data is for January to July.
[2]Figure given in the source does not equal the flows

Source: BSP, Statistical Bulletin, 1997, BSP Selected Philippine Economic Indicators.

Table 4 Selected Indicators of Condition of Individual Banks, 1990-2001

Panel A										
		Average growth rates 1990-1996				Ratios: 1996				
Banks		Total Deposit	Total Loans	Bills Payable	Investments	Total deposits	Loans	Total Capital Accounts	Surplus	Surplus
						Total liabilities	Total assets	Total assets	Capital stock	Total assets
1. PNB		0.21	0.24	0.33	0.39	0.83	0.50	0.11	0.86	0.05
2. Equitable		0.20	0.40	0.52	-0.11	0.68	0.54	0.13	0.69	0.04
PCI		0.26	0.45	0.22	0.33	0.80	0.68	0.14	1.55	0.08
3. UCPB		0.22	0.37	0.36	0.17	0.73	0.66	0.14	5.79	0.12
4. Bank of Commerce		0.25	0.45	-0.14	0.60	0.81	0.68	0.12	0.39	0.03
5. PB Communication		0.28	0.35	0.57	0.24	0.68	0.58	0.10	1.68	0.06
6. Prudential Bank		0.11	0.32	-0.13	0.19	0.90	0.50	0.13	3.58	0.10
7. Allied Bank		0.30	0.43	0.84	0.43	0.69	0.62	0.11	12.53	0.10
8. Metro Bank		0.26	0.43	0.64	0.01	0.74	0.59	0.14	0.51	0.05
9. RCBC		0.30	0.40	0.29	0.20	0.76	0.67	0.10	0.61	0.03
10. Bank of Phil. Islands		0.20	0.36	0.29	0.18	0.83	0.57	0.15	2.16	0.10
11. China Banking		0.23	0.35	0.45	0.47	0.72	0.63	0.15	3.90	0.08
12. Security Bank		0.31	0.61	0.47	-0.17	0.77	0.60	0.10	0.93	0.05
13. Union Bank		0.32	0.53	0.53	0.24	0.49	0.55	0.13	0.39	0.04

Panel B

Banks	NPL ratio 2001	Average growth rates 1997-2001: Total Deposit	Total Loans	Bills Payable	Investments	Ratios: 2001: Total deposit / Total liabilities	Loans / Total assets	Total capitak accounts / Total assets	Surplus / Capital stock	Surplus / Total assets	NPL / Capital Account
1. United Overseas	69.7	0.04	-0.16	-0.22	2.55	0.86	0.44	0.11			1.35
2. PNB	46.0	-0.12	-0.14	-0.03	0.07	0.72	0.41	0.07	-0.48	-0.06	2.57
3. Equitable/PCI*	32.9	-0.08	-0.04	-0.20	0.34	0.72	0.43	0.18	0.11	0.02	0.78
4. UCPB	32.3	0.09	-0.05	-0.16	0.15	0.89	0.48	5.30	2.72	0.04	2.58
5. Bank of Commerce	31.7	0.16	0.07	0.40	0.46	0.82	0.47	0.16	0.38	0.04	0.93
6. PB Communication	29.6	0.07	-0.07	0.02	0.40	0.85	0.42	0.16	0.05	0.01	0.78
7. Prudential Bank	25.8	0.16	0.08	-0.01	0.24	0.92	0.39	0.18	2.80	0.08	0.56
8. Land Bank of the Phils.	25.1	0.10	0.03	0.11	0.22	0.79	0.43	0.08	0.66	0.03	0.15
9. Allied Bank	19.8	0.08	-0.03	-0.19	0.30	0.88	0.38	0.13	17.77	0.09	0.62
10. Metro Bank	18.1	0.16	0.05	-0.03	0.36	0.87	0.45	0.13	0.46	0.04	0.84
11. Phil. Veterans Bank	16.9	0.07	-0.10	-0.56	0.14	0.83	0.23	0.26	0.35	0.06	0.15
12. RCBC	16.7	0.12	0.02	-0.05	0.38	0.80	0.50	0.10	0.84	0.04	0.60
13. Bank of Phil. Islands	15.0	0.22	0.13	-0.19	0.37	0.93	0.42	0.14	2.08	0.10	0.39
14. Phil. Trust	14.8	0.11	0.05		0.21	0.87	0.48	0.12	1.45	0.07	0.59
15. China Banking	13.7	0.10	0.004	-0.22	0.25	0.87	0.46	0.16	3.19	0.10	0.40
16. Security Bank	11.7	2.50	1.20	0.09	0.58	0.69	0.48	0.14	0.79	0.06	0.12
17. DBP	11.6	0.20	0.04	0.08	0.08	0.25	0.51	0.12	0.19	0.02	0.49
18. Banco de Oro	11.2	0.15	0.13	0.22	0.31	0.85	0.51	0.15	0.43	0.04	0.38
19. Union Bank	11.0	0.03	-0.17	-0.17	0.22	0.67	0.26	0.24	0.80	0.10	2.78
20. Chinatrust	8.9	0.31	0.17	0.54	1.53	0.83	0.55	0.19	0.56	0.07	0.25

Note: * Equitable/PCI merged in 1999 (average growth from 1999-2001 only)

Sources: Philippine Fact Book, various years and www.bsp.gov.ph.statistics/sipbs.

Table 5 Non Performing Loans and Assets of the Banking System and Commercial Banks
December 2001

	(%)
NPL/Total Loans, Banking System	16.9
NPA/Total Assets, Banking System	14.6
NPL/Total Loans, Commercial Banks	17.3
NPA/Total Assets, Commercial Banks	14.3
NPL/Total Loans, Universal Banks	18.8
NPA/Total Assets, Universal Banks	15.3
NPL/GNP, Banking System	7.9
NPA/GNP, Banking System	12.9
NPL/Total Loans, Foreign Banks	4.8
NPL/Total Loans, Thrift Banks	17.0
NPL/Total Loans, Rural and Cooperative Banks	6.8
NPL/GNP Problem Banks	4.1
Total Assets/Total Assets, Problem Banks/Banking System	29.9
NPLPB/NPL, Problem Banks/Banking system	51.3

Note:
Problem banks or the commercial banks are those with NPL ratio > 19%
NPL= non performing loans defined as loans whose principal and or interest is unpaid for 30 days or more
NPA= non performing loans + acquired assets from non-performing loans
½ of NPL accounts belonged to just 162 borrowers, manufacturing accounted for 34.9%, real estate 14.5% (BSP Status Report on Philippine Financial system, Second Semester 2002)

Source: Internet: http//www.bsp.gov.ph/Statistics/sipbs
BSP, Philippine Selected Economic Indicators, March 2002

Table 6 Now — Solidity, Fragility Reassessed at 1998 Yearend, More Stability, Less Fragility

Contributing Factors to Banking Crisis	Singapore	Hong Kong	Philippines	Korea	Malaysia	Thailand	Indonesia
Macroeconomic volatility	Stabilizing	Stabilizing	Stabilizing	Stabilizing	Stabilizing	Stabilizing	Yes
High rapidly rising credit/GDP ratio	High, steady	High, steady	Low, steady	High, steady	High, steady	High, steady	High, steady
High property exposure asset inflation	Yes, stabilizing	Yes, stabilizing	Yes, stabilizing	No	Yes, stabilizing	Yes, stabilizing	Yes, stabilizing
High forex loans or forex liabilities?	No	Deposit	Yes	Yes	Some, Labuan	Yes	Yes
Financial liberalization destabilizing	No	No	No	No	No	No	No
Government-directed lending	Some	No	Some	Some	Some	Some	Some
Related-party lending	No	No	Some	Some	Some	Some	Yes
Weak regulations, acctg., disclosures	Strong	Strong	Strong	Improving	Forbearance	Improving	Improving
Weak regulatory supervision compliance	No	No	Some	Improving	Forbearance	Delays, forbearance	Yes
Weak capital or loan reserve levels	No	No	Low reserves	Govt. support	Govt. support	Govt. support	Yes
Fragility for individuals banks?	No	No	Some	Govt. support	Govt. support	Govt. support	Yes
Weak or under-regulated non-banks?	No	No	Some	Some	Ongoing recap	Some	Yes
Current fragility score (previous score), 1 = best, 24 = worst	4(7)	4(8)	10(14)	11(22)	11(15)	13(22)	18(20)
Overall solidity or fragility	Solid	Solid	Fairly solid	Some fragility	Some fragility	Some fragility	Fragile

Source: Goldman Sachs, Investment Research, Asia Banks, January 1999

International Conference on
Economic Recovery and Reforms

South Korea

Economic Trends and Outlook, Recovery and Reforms of the Korean Economy

Ehung Gi Baek*

* **Sangmyung University**

ABSTRACT

Korea achieved a strong recovery from the crisis. However, the economic slowdown, which began in August 2000, continued its downward trend for a year. Since then, some of the recently announced economic indicators such as industrial production and shipments showed signs of recovery. Current business cycle status of the Korean economy is now in the boom stage of the ascending business cycle phase. We also show that the Korean economy is expected to grow by 6% this year. Addtionally this report explains reform policies as follows: Financial sector restructuring, corporate sector restructuring, labor market reform, and public sector reform. We evaluate two of important reform policies regarding banking sector in this section, increased concentration ratio in banking industry and inappropriate usage of public funds. Finally, this report contains some of the remaining issues such as presidential elecion in December, fire-day workweek system, introduction of FLC, and new capital adequacy ratio and reduction of NPLs.

* email: egbaek@sangmyung.ac.kr

I. Introduction

Korea achieved a strong recovery from the crisis and 1998 recession, with output increasing 10.9% in 1999 and 9.3% in 2000 (Table 1). However, the economic slowdown, which began in August 2000, continued its downward trend for a year. Since then, some of the recently announced economic indicators such as industrial production and shipments showed signs of recovery. The volume of the current account surplus narrowed significantly from the third quarter of 2001 reflecting the economic recovery, while consumer prices slowed down markedly. Current business cycle status of the Korean economy is now in the boom stage of the ascending business cycle phase. It is the second boom stage after the 1997 crisis which is shown in Table 2. In spite of apprehension of a double-dip recession, the Korean economy is expected to grow by 6% this year.

This country report describes recent trend of the Korean economy since the 1997 economic crisis in section II. However, it mainly focuses on the trends of 2001 and 2002. We also review 2002 economic outlook of the Korean economy in the same section, where we are interested in if the Korean economy can demonstrate strong recovery in this year. Section III explains important restructuring processes and reform policies implemented to cope with economic distresses caused by the crisis. We evaluate some of the economic performances accomplished during the post-crisis period in section IV. Finally, this report will contain some of the remaining issues to be settled and necessary policy instruments which should be designed or thrusted with bigger efforts in section V.

II. Recent Economic Trend

1. Recovery from the crisis

Average growth rate during the period of 1999-2001 is 7.7 percent, which tells that the speed of economic growth during this period fully recovered the speed before the crisis of 1997. It implies that the recovery of the Korean economy was made in terms of economic growth not in terms of production level. A hypothesized GDP is created using extrapolation based on the average growth rate between 1981 and 1996. Comparison of the actual GDP and the hypothesized GDP in Figure 1 shows that there is a persistent gap between the two GDP series. This observation supports the claim that the crisis gave permanent shocks rather than temporary shocks to the economy.

To demonstrate how much pressure the financial market is undergoing, we construct a measure of financial market pressure index. The index is generated by financial variables such as exchange rate, interest rate, and foreign reserves.[1] It is $\frac{1}{\sigma_e} \times \Delta e + \frac{1}{\sigma_i} \times \Delta i - \frac{1}{\sigma_R} \Delta R$ where Δe, ΔI, and ΔR are percentage change in exchange rate, change in interest rate and percentage change in foreign reserves year-on-year base and all σs are their corresponding standard deviations. The index in Figure 2 clearly shows that the financial market escapes danger of crisis completely as of June 2002.[2]

Now let us take a look at the goods and service market. Figure 3 shows increasing rates of GDP, private consumption (CP), fixed investment (IF), commodity exports (XG), and commodity imports (MG). While commodity export is primarily

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[1] Refer to Eichengreen, Rose and Wyplosz (1995).

[2] Mean and standard deviation of the index between January 1991 and October 1997 are –0.43 and 1.20 respectively. It is confirmed that the index is marked beyond the critical value, mean+2× standard deviation, between November 1997 and June 1998. It proves that the Korean economy got

determined by the business conditions of foreign countries and the real exchange rate, other four variables reflect the domestic business conditions. The movements of these variables are consistent with the trend of financial market. GDP rebounded from a negative growth rate in the first quarter of 1999. Such a recovery is basically attributable to strong restoration of domestic demand except construction investment. The construction activity did not turn into a positive growth rate until the first quarter of 2000. The upward trend of business cycle rapidly continued until August 2000. In this section, we review recent economic trends of the Korean economy centering around the first half of 2002.

2. Economic Growth

During the first quarter of 2002, GDP expanded by 5.7 percent year-on-year owing to the rapid growth of private consumption and construction investment as well as the shift of exports and facilities investment to an increase (Table 3). Meanwhile, the growth rate of real GNI rose to 7.5 percent in the first quarter owing to improved terms of trade conditions, with the pace of decline in the prices of imported goods, such as information and telecommunication equipment and semiconductors.

The rate of increase of final consumption expenditures rose to 8.1 percent due to burgeoning private consumption. Private consumption increase by 8.4 percent in the first quarter year-on-year as expenditures for durable goods, including passenger cars, air conditioners, and mobile handsets, increased sharply together with a high rate of growth in service-related expenditures.

Fixed investment increased by 6.5 percent owing to the rapid growth of construction investment and the shift of facilities investment to an increase. Despite a continued decline in investment in general machinery and precision

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out of financial difficulty after June 1998.

equipment, the trend of facilities investment reversed to record a 3.2 percent rise, helped by the shift to an increase of investment in electric and electronic equipment, including industrial electricity equipment and telecommunications equipment. Construction investment recorded brisk growth of 10.1 percent, encouraged by a sharp rise in investment in residential buildings, including apartment complexes and commercial structures such as shopping districts, which more than offset a drop in construction investment in infrastructure.

Exports of goods and services, in real terms, increased by 2.1 percent owing to brisk exports of semiconductors, communications equipment, and automobiles. Meanwhile, imports of goods and services, in real terms, soared by 6.3 percent due to rise in consumer goods as well as a hefty rise in the number of Koreans traveling abroad.

Breaking down economic activity by sector as seen from Table 4, the construction, electricity, gas and piped water services, and agricultural and fishery industries posted high growth rates. That of manufacturing also rose slightly from the previous quarter. The construction industry grew by 8.9 percent, a similar level to the previous quarter as building construction in the private sector, led by residential structures, such as apartment units, showed strong growth.

Despite a reduction in gas and water infrastructure projects, the growth rate of the electricity, gas and water industry climbed to 7.7 percent, boosted by a sharp rise in the consumption of electric power in the production and service sectors. The growth rate of the service industry widened from 4.7 percent in the previous quarter to 7.6 percent. Driven by favorable performance in private tutoring institutes, medical health, movie and entertainment service businesses, the social and personal service industry expanded by 11.6 percent.

The growth rate of the transportation, storage, and communication industry went up to 8.6 percent, boosted by a speedier rate of increase in the transportation business, following an expansion of the quantity of goods transported and steady growth in the communication business in the wake of increased use of mobile communications. Mainly owing to an increase in commission income at securities companies and the favorable real estate brokerage business, the growth rate of the financing, insurance, real estate, and business service sector rose sharply from the previous quarter's 5.5 percent to 9.2 percent.

Despite the sluggishness of the lodging business, the wholesale and retail, restaurant, and hotel industries expanded by 5.8 percent, similar to the previous quarter' growth, thanks to brisk transactions involving consumer goods for domestic consumption, construction materials, and imported products. The agriculture, forestry, and fishing industry registered high growth of 7.2 percent due to handsome growth in the livestock sector, encompassing beef cattle, poultry farming, and pig raising, following expanded meat consumption which offset the slackness of cultivation centered on vegetables. In the meantime, the growth rate of the manufacturing industry edged up from the previous quarter's 2.1 percent to 3.5 percent, owing to a rise in the production of semiconductors, communication equipment, automobiles, and nonmetallic mineral.

3. Wages and Prices

Per capital nominal wages rose by 7.7 percent year-on-year during the first two months of 2002, up from the previous quarter in Table 5. Broken down by type of remuneration, the rate of increase of regular payments accelerated significantly, whereas the scale of the decline in the rate of overtime payments expanded sharply and the growth rate of special cash payments slowed down. By industry, wages in construction shifted to a sharp rise, and the rates of increase of wages in the manufacturing; transportation, storage and communication; financing, insurance and real estate sectors accelerated.

Consumer and producer prices are in Table 6 and 7. Consumer prices maintained downwardly stable movements through the first quarter following on from the latter half of the preceding year. But they shifted to an increase in April 2002. During the first quarter, consumer prices rose by 1.6 percent compared with the last month of the previous quarter, driven upward by a rise in prices of agricultural products due to seasonal factors, the increased prices of petroleum products following the hike of international oil prices, as well as the continuous rise in housing rents. As the scale of their increase was narrower than usual, however, the year-on-year rate of increase slowed to a level of around 2.5 percent. From April, prices of petroleum products and housing rents continued to rise, and prices of agricultural goods, led by those of fruit and vegetables, maintained an upward trend. Accordingly, the year-on-year rate of increase accelerated to 2.5 percent in April and further to 3.0 percent in May.

Viewing the trend of consumer prices by sector since the first quarter of this year in comparison to the last month of the previous quarter, prices of agricultural, livestock, and marine products showed a high rate of increase during January and February due to seasonal factors, including supply shortages during the winter season and the spike of demand for the Lunar New Year holidays. The scale of their rise, however, was narrower than usual. Prices of agricultural, livestock, and marine products showed a downward trend briefly in March owing to the expanded supply of vegetables. But they marked a sharp rise again in both April and May due to sluggish shipments of fruit and vegetables following frequent storms of yellow dust and heavy rainfall. Industrial product prices, which had marked a downward trend in the latter half of the previous year, shifted upward early this year, helped by increased prices for petroleum products in the wake of higher international oil prices. This upward trend was sustained until May. Mainly owing to the cut in some public service charges, including those for piped natural gas and mobile phone use, service prices dropped temporarily in February. But overall service prices maintained a rising trend this year due to the continued rise in housing rents and personal service charges.

Led by housing rents and personal service charges, core inflation, which stripped out non-cereal agricultural products and petroleum fractions from the CPI, kept on upward trend during the first quarter compared with the last month of the previous quarter. But the scale of the rise was smaller in most years. Accordingly, year-on-year core inflation stood at the 3.0 per cent level, substantially below that in the latter half of the previous year.

Producer prices, which had been on a decline since the latter half of the previous year, rose by 1.7 percent during the first quarter of this year compared with the last month of the previous quarter, affected by the KRW's depreciation, the increased prices of some raw materials, and the reduced supplies of some agricultural products as a result of seasonal factors. However, their year-on-year rate of increase was negative by a small margin thanks to a fall in producer prices in the latter half of the previous year. From April, however, their year-on-year rate of increase shifted to an upturn as prices of petrochemical products continued to rise following a hike in international oil prices and prices of agricultural, forest, and marine products soared owing to poor production amid unfavorable weather conditions.

Viewing the trend of producer prices by sector from the first quarter of this year compared with the last month of the previous quarter, those of agricultural, forest, and marine products rose sharply in the first quarter due to seasonal factors, including supply shortages during the winter season and the spike of demand for the Lunar New Year holidays. These prices dropped temporarily in April, affected by an increase in shipments of vegetables, but rose again in May due to inactive shipments of vegetables and fruit following adverse unfavorable weather conditions. Manufacturing industry product prices climbed during the first quarter owing to the depreciation of the KRW against the U.S. dollar, a hike in prices of some imported raw materials, including crude oil and wool, and higher international prices of petrochemical products and reinforcing bars. They continued to rise in both April and May, headed by those of petrochemical products. Service prices, which had shown stable movements during the fourth quarter of the previous year, rose sharply during the first quarter owning to a rise in construction-related service charges and higher office rental charges. In both April and May, their rising trend continued centering on service charges in the transportation and communication sector, including railroad fares, express and cross-country bus fares, expressway tolls, and public phone charges.

4. Balance of Payments: Current Account

The surplus on the goods account expanded to 3.3 billion dollars during the first quarter from the previous quarter's 2.2 billion dollars (Table 8). On the other hand, the deficit on the service account widened slightly from the previous quarter. As a result, the surplus on the current account increased slightly from the previous quarter to 1.7 billion dollars. However, the current account in April was in equilibrium as the growth rate of imports exceeded that of exports and the external payment of dividends increased.

5. Real Estate Prices

Table 9 shows the recent trend of real estate prices. The upward trend of real estate prices, such as housing prices and housing rents, accelerated during the first quarter, centering especially on Seoul, Seoul metropolitan area, and some large cities, reflecting the burgeoning seasonal demand in spring. Land prices, which had held relatively stable during the previous year, showed a rise in Seoul and Seoul metropolitan area, affected by a rise in housing prices and the lifting of restrictions on development in the green belts. However, the upward pace of housing prices and housing rents slowed down markedly with the close of the season favored for moving house and a series of government measures to stabilize real estate prices. In May, when few people wish to move house, the rising pace abated further.

6. Financial Market

Figure 4 shows three market interest rates, i.e. overnight call rate, yield on three-year treasury bonds, and yield on three-year corporate bonds. During the first quarter of 2002, the overnight call rate showed stable movements at around the 4.0 percent level at which the BOK maintained its call rate target. However, yields on Treasury bonds and corporate bonds, which had maintained an upward trend since the previous October, showed a stable downward trend early this year due to uncertainties surrounding the pace of economic recovery and prospects for an improvement in the demand and supply conjuncture in the bond market. In early March, their yields shifted upward on the improved showing of economic indicators both at home and abroad. Accordingly, yields on Treasury bonds and corporate bonds (AA-grade) edged up from 5.91 per cent and 7.04 percent respectively at the end of last year to 6.39 percent and 7.07 percent.

The overnight call rate in April hovered around 4.0 percent, the call rate target set by the BOK. This target was, however, raised slightly to 4.25 percent in May in order to preempt possible excessive liquidity and call market rates edged up correspondingly. In contrast, yields on Treasury and corporate bonds showed a downward trend mainly owing to the protracted bearishness of the stock market, the apprehension that the recovery of the U.S. economy might be delayed, and an improved interplay of demand and supply situation in the bond market. They slid to 6.14 percent and 6.90 percent, respectively, as of the end of May.

The Korean composite stock price index (KOSPI) continued its upward trend early this year owing to expanded buying of stocks by foreign investors, but it experienced a series of sharp ups and downs from mid-January according to a correction phase following the surge of stock prices during a short-term period and the trend of U.S. stock price movements. (See Figure5 of KOSPI) After the Lunar New Year holidays, however, it returned to an upward trend, boosted by the impending settlement of the negotiations for the sale of Hynix Semiconductor, and the bullish U.S. stock markets. Accordingly, KOSPI soared by about 30 percent from 693.70 points at the end of the previous year to 895.58 points at the end of March. The KOSDAQ index showed similar movements, posting 92.73 points at the end of March, up from 72.21 points from the end of the previous year.

In April, the KOSPI registered a peak for the year so far of 937.61 points on April 18, but after that it plunged sharply owing to the spread of a mood of caution following the rapid rise of stock prices within a brief period and the unease of the U.S. stock markets. With the beginning of May, it rebounded briefly, before resuming its downward trend. Consequently, the KOSPI and KOSDAQ index fell to 796.40 points and 69.78 points, respectively, at the end of May.

The Korean won, which had appreciated against the U.S. dollar in early March due to the strengthening of the yen, shifted to a depreciating trend as the Japanese yen weakened in mid-March and foreign stock investment funds posted a net outflow from the foreign exchange market. The won softened to 1,332.0 won per dollar, its lowest exchange value for the year so far in mid-April.

However, the Korean won subsequently appreciated sharply against the U.S. dollar, closing May at 1226.3 won per U.S. dollar, thanks to the weakening of the U.S. dollar against major currencies in international financial markets from mid-April, the expansion of foreign currency supply with an inflow of foreign stock investment funds in May and expectations of the won's further appreciation on the recovery of the Korean domestic economy.

Meanwhile, the Korean won weakened steeply against the Japanese yen in early March, trading at 1,027 won per 100 yen in international financial markets. From mid-March, however, the won regained some of its lost ground due to the shift of the yen to a depreciation, posting a rate of 998.0 won per 100 yen. As the U.S. dollar weakened against major currencies in international financial markets in April and the appreciation of the yen against the dollar outpaced that of the yen against the dollar outpaced that of the won, the Korean currency depreciated slightly, posting 1,008.31 won per 100 yen at the end of April. In May, as the strengthening of the won against the U.S. dollar was greater than that of the yen, the won again appreciated slightly in yen terms to register 998.50 won per 100 yen at the end of the month.

The growth of banks' deposit-taking accelerated greatly during the first quarter of this year as short-term deposits surged amid the expanded supply of liquidity through the government and private sectors credit. (Table 10) However, deposit-taking by banks' trust accounts fell sharply as the downward trend of placements in New Pension Trusts deepened on expectations of lower yields on the operation of these assets and the withdrawal of funds from maturing Tax-Free Household Trusts continued. On the other hand, deposit-taking by investment trust companies shifted to a sharp rise as deposits in MMFs surged with the return of funds, which had been shifted out of these products at the year-end, and brisk sales of stock beneficial certificates on the back of the bullish stock market. Deposit-taking by merchant banking corporations also increased, affected by the return of funds that had been temporarily withdrawn for the year-end closing and the movement of short-term operational funds at financial institutions into bills issued and CMAs.

During April and May, deposits at banks increased owing to the continuous supply of private sector credit which offset the liquidity absorption by the government sector, including the payment of corporate and value added taxes. The pace of the decrease in deposit-taking by banks' trust accounts, however, slowed down remarkably with a sharp reduction in the retirement of funds from maturing New Pension Trusts and Tax-Free Household Trusts and the brisk sale of Specified Money Trusts, led by those whose funds are assigned to CP. Deposit-taking by investment trust companies decreased as the inflow of funds to stock-linked products was inactive owing to a continued stock price correction phase as well as seasonal factors, such as tax payments. That by merchant banking corporations meanwhile suffered a reduction affected by the massive withdrawal of corporate funds for the payment of taxes.

7. Monetary Aggregates

During the first quarter of 2002, the growth rates of M2 and MCT+ accelerated to 14.6 percent and 13.7 percent, respectively. (Table 10) This mainly reflected expanded fiscal spending and a sharp rise in private sector credit through bank loans, such as the continuous growth of loans to households and small and medium enterprises, whose effects more than offset the monetary absorption by the government sector, which expanded sharply owing to increased collections of value added tax. The growth rate of M3 also rose by 12.1 percent as liquidity supply through banks increased and deposit-taking by investment trust companies shifted to a rise. The growth rate of reserve money rose to 10.5 percent, in response to a surge in currency in circulation in order to the demand for cash on the occasion of the Lunar New Year holidays.

During April and May, M2 growth slipped as funds migrated from bank deposits to the market for the purchase of financial debentures while the monetary absorption by the government sector soared owing to the increased tax revenues, including those from composite income tax, and to sales of government-held stocks in Korea Telecom.

8. Corporate Finance

Information of corporate fund raising is listed in Table 12 during the period of 2001 and 2002. Bank lending during the first quarter increased sharply due to the lending of funds gathered from the redemption of borrowings by large companies at the year-end, a sharp rise in loans to small and medium enterprises, which needed short-term working capital to meet payment of value added tax, the rising demand for funds on the occasion of the Lunar New Year holidays, and the economic recovery. The net issuance of CP also shifted to a rise mainly owing to the re-issuance of paper, which had been retired briefly at the year-end, as well as to the increasing appetite for it on the part of investment trust companies on the wake of their brisk sales of MMFs. The scale of the net redemption of corporate bonds meanwhile dwindled as the volume of maturing issues fell and institutional investors' appetite for them rose owing to the easing of worries over possible corporate credit risk.

During April and May, bank lending maintained a continuous upward trend as loans to small and medium enterprises increased owing to the rising demand for short-term working capital by smaller companies and banks' efforts to expand their lending, even though loans to large companies declined slightly due to their improved cash flow. The net issuance of CP also continued to rise in response to expanded CP purchases by Specified Money Trusts at banks and by mutual credits. However, the net redemption volume of corporate bonds expanded as companies declined to roll over maturing issues in order to improve their financial structure.

9. Economic Prospects for 2002

The world economy in the second half will continue to recover at a gradual pace although uncertainties over the U.S. economy are running high. The U.S. economy has shown some signs of financial market instability, triggered by recent sharp falls in stock prices and the depreciation of the dollar. However, it is not expected to suffer a double dip at this point. Major forecasting agencies see the U.S. economy exhibiting growth at the 2 per cent level in 2002 despite the spreading uncertainties. But if U.S. financial market instability deepens, due to revelations of corporate accounting irregularities involving creative accounting practices or a worsening of Central and South American economies, the spreading of negative effects such as a weakening of consumer confidence is inevitable and the pace of economic rebound would be slowed down subsequently.

The Japanese economy, having shown some easing of the protracted in the early part of this year, is expected to get back on track in line with an expansion of export increase amid the global economic recovery. For the year 2002 as a whole, however, it will continue to exhibit negative growth. The euro region will continue to stage its economic revival slowly but steadily, backed by increased consumption. The Japanese yen will continue to maintain the strong trend exhibited since April. This judgment is predicated on the large current account deficit of the U.S., dampened investor confidence in the U.S. economy, expectations of a Japanese economic rebound and so forth.

International oil prices are projected to remain stable in the second half of the year. International oil prices had surged up until mid-May 2002 before shifting to a decline. Now they are moving at around the 25 dollar/barrel level. In the second half, the demand for crude oil is increasing, amid the economic recovery worldwide. However, oil prices are predicted to maintain a similar level to their second quarter average (25 dollars per barrel based on Brent crude) or to edge up only slightly as non-OPEC oil producers attempt to expand their production and stocks of petroleum are maintained at a stable level. Prices of other raw materials, centering on those for industrial use, will continue to rise gradually in response to the global economic turnaround.

Household and corporate sentiment is expected to be generally positive, but not as favorable as in the first half due to growing uncertainties about overseas economic conditions in the U.S. in particular. The CSI on consumer expectations and the BSI on prospects for business conditions recorded a slight decline recently, but this outlook remains positive. Labor-management unease will re-emerge in the second half of the year. Collective negotiations on wages, which had been delayed due to the World Cup, will be concentrated in the second half of the year. Conflicts of interest may deepen, concerning the implementation of the five-day workweek. In addition, the social atmosphere may be relaxed in the run-up to the presidential elections.

Major domestic forecasting institutes recently revised their economic forecasts announced at the beginning of this year.[3] Table 13 summarizes the economic forecast by KDI announced in July 2002. Under the major assumptions described above, the Korean economy is expected to rise up to lower 6 percent as domestic demand maintains its steady growth trend while export growth accelerates with the world economic recovery. Private consumption is expected to increase to the 7 percent range this year, however, the effects of expansion of consumer credit, increase in asset prices, improvement in terms of trade, among others, are expected to decrease within the second half, resulting the growth trend to slightly slow down. Equipment investment is expected to increase sluggishly compared to the previous quarter, however, in the second half of this year, as a rebound to last year's stagnation, the growth rate is expected to rise significantly recording in the range of 10 percent. But construction investment growth is forecasted to slow down slightly in the second half, registering an annual growth rate of 9-10 percent. Export in the second half of this year, due to the recovery of the world economy and as a rebound to last year's stagnation, is expected to increase to 10 percent range. Import is expected to increase to 14-15 percent due to the expansion of the economic growth trends and appreciation of the KRW exchange rate.

[3] KDI announces their revised outlook regularly quarter through quarterly journal, *KDI Economic Outlook*. We cite the KDI economic outlook in this section.

Current account is forecasted to remain at 4-5 billion dollars in surplus despite expansion in exports because appreciation of the KRW results a significant increase in imports in the second half of this year. Consumer price due to increase in domestic demand and increase in wages, has been under sustained inflation pressure. However, consumer price is forecasted to remain at 2.8 percent due to the KRW appreciation. Due to the instability of the U.S. financial market resulting increasing uncertainty in the international financial market, such factors may negatively affect the Korean economy. On the other hand, due to the insecurities of the U.S. financial market and improvement of Koreas credibility, the capital inflow into the domestic economy might increase, resulting potentially faster economic growth than expected.

III. Economic Reform and Restructuring Process

Causes of the 1997 crisis were largely investigated and many policy recommendations were given according to those investigations. Major reform policies were applied to corporate sector and financial sector. The reforms included measures to boost competition, strengthen corporate governance and resolve problems in the financial sector by the use of public money to address the non-performing loan problem and to re-capitalize financial institutions. The goal of the Korean economic reforms was to create a market based economy. The Korean government believed that such policy actions would lay the foundation for the expansion by boosting investor confidence, encouraging large capital inflows and helping to normalize financial market conditions. The paper will discuss the most important policy actions and instruments given to treat the main causes of the crisis.[4]

[4] MOFE (2001, 2002a) and OECD(2001) provide excellent survey of the Korean Economy after the crisis. For the future policy direction, refer to MOFE (2002b) and Lee (2002).

1. Financial Sector Restructuring

A. Banks and Non-Bank Financial Institutions

Authorities closed or suspended a number of non-viable financial institutions, including 16 merchant banks, five commercial banks, six securities brokerages, and four insurance companies. As of January 20, 1999, 86 financial institutions have been closed or suspended of operation. Of the 25 commercial banks, 13 banks satisfied the BIS ratio requirement of eight percent at the end of 1997. Having reviewed the rehabilitation plans submitted by the remaining 12 unsound banks, the Financial Supervisory Commission (FSC) classified them into two categories: "disapproved" and "conditionally approved". Five banks whose rehabilitation plans were rejected by the FSC were "disapproved", and seven banks were "conditionally approved" and ordered to fulfill the corrective actions imposed by the FSC.

The five non-viable banks were liquidated through purchases and acquisitions (P&A) in July 1998 and their assets were transferred to acquiring banks selected on the basis of financial soundness (BIS ratio of 10 percent or higher), long-term business strategies, and comparative advantages. (Table 14) The seven viable banks dubbed "conditionally approved" by the FSC took corrective actions imposed by the commission to further improve their soundness. In particular, Hanvit Bank - the merger creation of the Sangup Bank and Hanil Bank - was established in early 1999. In addition, Chohung Bank, Kangwon Bank, and Hyundai Merchant Banking Corporation announced the merger by the end of March 1999. Chungbuk Bank was also ordered to merge with the three banks at the beginning of February 1999.

The remaining two "conditionally approved" banks not involved in the merger deals are taking rehabilitation actions that include disposal of non-performing loans, recapitalization, and streamlining of business operations. Most important of all, Korea First Bank, one of the two nationalized banks, was finally auctioned off to Newbridge Capital Consortium of the United States on the last day of 1998. Similar deal for Seoul Bank is in the concluding stage of the negotiations with competitive international bidders.

Of the 13 healthy banks, Kookmin Bank and Korea Long Term Credit Bank (KLTCB) merged into Kookmin Bank, while Hana Bank and Boram Bank also merged into Hana Bank in early 1999. The FSC gave similar treatment to the restructuring of non-bank financial institutions. Self-rehabilitation measures under the initiative of major shareholders are being implemented, with the FSC closely monitoring the progress. Should the self-rehabilitation measures prove inadequate, the institution shall be subject to either corrective actions or closure. As of January 20, 1999, 43 non-bank financial institutions had their licenses revoked, and 38 were suspended.

B. Public Support for Financial Restructuring

Ridding the banking sector of NPLs is an important part of the financial sector restructuring. The FSC estimation of bad loans held by the Korean banks at the end of June 1998 totaled KRW 136.0 trillion, of which KRW 72.5 trillion worth are the less problematic "precautionary" portion, defined as those that fell in arrears for three to six months. Hence, the problematic NPL portion is a smaller part of the bad loans, or some KRW 63.5 trillion. Disposing of the NPLs is a staggering task; however, actual amount of cash involved in the implementation is only a fraction of the total amount of the NPLs. The strategy is as follows: Korea Asset Management Corporation (KAMCO) modeled after the U.S. Resolution Trust Corporation (RTC) would purchase the NPL from the bank at market value which is only a fraction of the book value. But KAMCO does not pay for the purchase in cash but in kind with its own issuance of bonds. The Korean government guarantees the KAMCO bonds and agrees to pay for the interest at maturity in cash. The banks welcome such arrangement, since government-guaranteed bond holding raises the BIS capital ratio.

The same strategy is employed in the recapitalization of the banks. Korea Deposit Insurance Corporation (KDIC) modeled after the United States' FDIC pays for the capital subscription of the bank not in cash but in kind with the issuance of its own bonds. The Korean government guarantees the KDIC bonds and agrees to pay for the interest at maturity in cash. The bank welcomes the receipt of the government-guaranteed bond, since such bond also raises the BIS capital ratio.

In both of these NPL disposal and recapitalization operations, the amount of cash transaction is brought to a minimum. At the same time, the amount of fiscal support can also be minimized. KAMCO has the power and plans to resell its purchased NPLs to retrieve the cost of the purchase and minimize the eventual burden on the public. Likewise, KDIC also plans to sell its acquired equities of the banks to the private sector foreign or domestic, not only to minimize the eventual burden on the public but also to reprivatize the acquired bank.

By the end of 1998, KAMCO issued KRW 19.9 trillion worth of government-guaranteed bonds to purchase KRW 44 trillion worth of NPLs from the banking sector. KDIC by the same time also issued KRW 21 trillion worth of its government-guaranteed bonds for recapitalization and depositor protection. Hence, KAMCO and KDIC together financed a total of KRW 40.9 trillion for the financial sector restructuring by the end of 1998. With additional KRW 23.1 trillion financing in 1999, the total financing to will amount to KRW 64 trillion.

KAMCO plans to sell KRW 16 trillion worth of NPLs in 1999. Eventually it plans to dispose of 98 percent of the purchased NPLs to redeem 91 percent of the cost of NPL purchase. To prevent moral hazard in the financial industry, cost redemption will be closely monitored by the Financial Supervisory Service (FSS), the newly created executive body of the FSC. Furthermore, should the financial sector restructuring require more financing for unexpected reasons, necessary financing will be mobilized by KAMCO's sale of acquired assets and issuance of asset-backed securities (ABS) and KDIC's sale of acquired equities.

C. Capital Market Liberalization and Foreign Direct Investment Promotion

Capital market liberalization and promotion of FDI are also important aspects of the restructuring. Measures taken by the Korean government to liberalize the capital market and promote FDI since the outbreak of the crisis reflect not just the changes in policy matrix, but more fundamentally the change in the government's philosophy. Complete removal of foreign equity ownership ceiling in May 1998, complete freedom for foreign investors to make hostile M&A from May 1998, complete freedom for foreigners to invest in local bonds and short-term money market instruments, complete liberalization of foreign exchange transactions from April 1999 - the list goes on.

The Korean government's renewed zeal for attracting FDI is another case in point. The new Foreign Investment Promotion Act, drafted and legislated after months of intense deliberation, abolishes and replaces the old legal framework on FDI. The new FDI policy of "promotion and support" annuls the old "regulation and management" approach. Newly set up Korea Investment Service Center (KISC) at Korea Trade Investment Promotion Agency (KOTRA) now provides convenient one-stop service to all prospective foreign investors. Local autonomies now have greater discretion in attracting FDI in their own jurisdictions. Extensive tax exemptions are given. High-tech industry FDI, for instance, is given full exemption of corporate and income taxes for the first 7 years and additional 3 years of corporate and income tax break at 50% reduction. Local autonomies can give additional breaks on local taxes at discretion. The goal is to make Korea the most investor-friendly destination for FDI in the world. Having attracted record $8.9 billion in FDI in 1998, the government is confident that 1999 inducement would reach target $15 billion.

D. Liberalization of Foreign Exchange Transactions

Implementing full liberalization measure, the new Foreign Exchange Transaction Act replaces the old Foreign Exchange Management Act. The new law that goes into effect in April 1999 liberalizes corporate overseas borrowing, and establishes futures market. In addition, Korea will see a significant expansion of financial derivatives market. The Korea Futures Exchange (KFE) is preparing for its inauguration in April 1999. Improved credit ratings of Korean financial institutions and deregulation of foreign exchange transactions will facilitate the growth of financial derivatives market.

The liberalization of foreign exchange transactions, however, also raises new challenges. Rapid, borderless transaction of short-term capital may destabilize the foreign exchange market and render the Korean won more susceptible to speculative attacks. As a result, the government devised various measures to counter potential market instability. Reinforcement of prudential regulations and supervision of financial institutions are one measure. On January 1, 1999, the Financial Supervisory Service was inaugurated to consolidate financial sector supervisory authorities and strengthen the supervision function.

2. Corporate Sector Restructuring

The corporate sector restructuring has been led by the creditor banks under the Five Principles of Corporate Restructuring agreed between the government and the business leaders in early 1998. The government assisted the private sector initiative by providing the legal and institutional framework of the five principles - enhancement of corporate governance, prohibition of cross-guarantees between business affiliates, improvement of corporate financial structure, business concentration on core competence, and responsibility reinforcement of governing shareholders and management.

A. Enhancement of Corporate Governance

To reinforce management transparency and accountability, top thirty chaebols and all listed companies were required in February 1998 to organize "independent audit committee" represented by minority shareholders and creditors. In addition, to rectify the practice of illicit control of the firm through proxy equity participation, the system of outside director was adopted. Appointed by the shareholders meeting from among revered personalities, the outside director represents the interests of minority shareholders and the public interest at large. All listed companies are required to appoint outside directors, and by October 1998 all 752 listed companies appointed 764 outside directors.

To enhance the credibility of corporate accounting, the firms are required from the fiscal year 1999 to adopt strengthened accounting standards and to publish combined financial statements. Fighting another corporate ailment that may lead to simultaneous dilapidation of involved affiliates and render inefficiency and discrimination, the Fair Trade Commission (FTC) investigated unfair inter-affiliate transactions of chaebols, and fined the top five chaebols a total of KRW 91.3 billion penalty. To strengthen the FTC"s supervisory function, the Commission secured the legal authorization of a two-year power to request financial informations from the financial institutions.

B. Chaebol Restructuring

Top five chaebols and their creditors reached agreement on debt reduction and other restructuring measures in early 1998 and verbalized the agenda for chaebol reform as follows: (i) Adoption of combined financial statements from the fiscal year 1999, (ii) compliance with international standards of accounting, (iii) reinforcement of voting rights of minority shareholders, (iv) mandatory appointment of outside directors, (v) establishment of external auditors committee, (vi) prohibition of cross-subsidiary debt guarantees from April 1998, (vii) resolution of all existing cross-debt guarantees by 2000.

Another element of the corporate restructuring involves business swaps between top five chaebols to streamline over-investment and enhance efficiency in such key industries as semiconductors, petrochemicals, aerospace, rolling stock, power plant equipment, vessel engines, and refining. In December 1998, the top five reached agreement on much of the deals and are currently working on closing the rest of the deals.

Following the December 7th agreement, the "Big Five" signed financial pacts with their creditor banks that called for dramatically reducing the number of their subsidiaries from 272 at the end of 1998 to 136 by the end of 2000. In addition, the top five chaebols pledged to slash their debt-to-equity ratios and improve their financial structure by asset sales, recapitalization, and $ 28.8 billion foreign capital inducement.

All five chaebols have already eliminated all cross-debt guarantees within each group. Chaebols pledged to enhance management transparency by shifting the management control to the board of directors, appointing outside directors and independent auditors for their affiliates, and preparing for filing group-wide combined financial statements.

C. Non-Viable Firm Exit

In May 1998, creditor banks established a formal review committee to assess the viability of 313 client firms showing signs of financial weaknesses. Upon completion of their evaluation, creditor banks listed 55 firms as non-viable, of which 20 are affiliated with top five chaebols, and 32 with top sixty-four. The outstanding loans to the 55 non-viable firms were approximately KRW 5 trillion.

Creditor banks denied new credit and cross-subsidy bailout to dismiss these 55 non-viable firms out of the market. Legal proceedings for corporate rehabilitation and bankruptcy filing were simplified in February 1998 to facilitate market exit of non-viable firms and to ensure better representation of creditor banks in the resolution process.

D. Corporate Workout Programs

Procedural simplification for market exit also has important implications for corporate workouts, in that the presence of expeditious exit scheme better induces more efficient negotiations for the workouts programs between the creditor banks and the firms.

The IBRD has been actively participating in the Korean workout programs. The Bank provided Korea with expertise and the Technical Assistance Loan of $ 33 million to employ outside experts as advisors for the design and implementation of corporate workout programs.

E. Workout Programs for SMEs

Corporate workout is extended to small and medium enterprises as well. Creditor banks have evaluated the financial status of approximately 22,000 SMEs with outstanding loans of one billion won or more. Approximately 13,000 firms listed as viable were selected as candidates for workout programs. So far, creditor banks concluded workout programs with more than 11,800 SMEs.

3. Labor Market Reform[5]

Korea achieved substantial progress in labor market reform since the inauguration of the Tripartite Commission and revision of Labor Standard Act (LSA) which legalized layoffs for managerial reasons. The landmark achievement of labor market flexibility rallied corporate sector restructuring and enhanced corporate competitiveness. The labor dispute at Hyundai Motors and its subsequent resolution in August 1998 showed an example of the social acceptance of the new

[5] Martin and Torres (2000) argued that Korea should not reduce the momentum of labour market

principle of labor flexibility.

The same social acceptance of the new labor reality was again ascertained in the subsequent labor disputes between the nine financially troubled commercial banks and their labor unions. The two sides reached the agreement to reduce the workforce by 32 percent for managerial reasons. When the government later took stern actions against illegal strikes at Mando Machinery, one of the largest auto parts producers, it received no serious social resistance.

Social adjustment to the new labor practice is complemented by the government's effort to reinforce the social safety net. In 1999, the government is spending KRW 7.7 trillion up from KRW 5.7 trillion in 1998 on various programs of unemployment protection. Employment insurance system has also been augmented to cover all regular, temporary, and daily employees.

4. Public Sector Reform

Public sector reform is an urgent issue. Poor productivity and rampant inefficiency in the public sector beg thorough-going reform. State-owned enterprises (SOEs), in particular, require drastic overhaul by means of privatization and/or management reform is necessary. Twenty public institutions of the 109 SOEs have already been privatized in 1998. More such actions are planned ahead.

The 89 subsidiaries of the 30 parent SOEs are also subject to privatization or management reform: Future status of the 21 subsidiaries of those SOEs for immediate privatization in 1999 will be determined by the new acquiring private management. Of the remaining 68 subsidiaries, 31 will be privatized either immediately or in time, while 37 will be restructured or consolidated.

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and social policy reforms despite her impressive recovery from the 1997 crisis.

Downsizing of the government is also an important feature of the public sector reform to raise efficiency. The government streamlined its organizational structure in February 1998. It plans to reduce its employees by 11 percent, or approximately 18,000 out of 162,000 employees, by the end of 2000. 9,084 jobs were eliminated in 1998. 6,400 more will be cut in 1999, and 3,400 more in 2000.

Local autonomies have also streamlined their organizations. By September 1998, 35,070 jobs, or 12 percent of the total, have been eliminated. In conjunction with the government reform, the quasi-government sector, including public institutions and various government-affiliated associations, has also been streamlined.

Elimination of excessive regulations is another important task in the public sector reform. The Regulation Reform Committee (RRC) has abolished 4,465 regulations, some 40 percent of the 11,125 total. 23 laws were abolished, and 248 laws revised. These numbers speak for the government's strong commitment to drastically reducing unnecessary regulations. Abolition of unnecessary regulations is also conducive to enhancing transparency in corporate, financial, and public sectors. At the same time, the ongoing reforms will make Korea's regulatory system more in line with the frameworks of the WTO and the OECD.

Above all the long-term goal of the Korean economy is to build a knowledge-based Korea rich in human resources and intellectual capital that leads the world at the forefront of human creativity. To do this, reform and restructuring can only be accelerated in many respects.

IV. Policy Evaluation

With the new framework established by the reforms, the Korean economy benefited from buoyant world demand in 1999 and 2000. Particularly performance of the information and communications technology sector was outstanding. It is partly due to the KRW depreciation. We evaluate two of important reform policies regarding banking sector in this section, increased concentration ratio (CR) in banking industry and inappropriate usage of public funds.

1. Increased CR in Banking Industry

Banking sector restructuring since the currency crisis had reduced the number of Korean banks to 14 as of the end of 2001, from 30 at the end of 1997, through the market exits of ailing banks and mergers between banks. This sharp reduction within such a short period is generally considered as having been an inevitable step toward heightening the international competitiveness of the Korean banking industry by bringing about the resolutions of financially troubled banks and enlarging domestic banks' scales. However, now that the number of banks has been halved in less than four years, and that several mega-banks have come into being, it seems right time to check the possibility of this increased concentration in the Korean banking industry causing adverse side effects, for example, on competition in the market.

In general, the degree of market concentration indicates the possibility of a monopoly or a restriction of competition taking place in a certain market or industry, and this is measured by the CR and the Herfindahl-Hirshman Index (HHI). Kim W.J. (2002) demonstrated that the Korean banking industry was, by and large, a competitive market before the currency crisis according to the CR and HHI measurements for the bank deposit and bank loan market.

Triggered by the recent banking sector restructuring, however, it has become "moderately concentrated," following the definition shown in the guidelines of the U.S. Department of Justice. This result suggests that there is little possibility that problems such as monopoly in the banking industry many arise in the domestic banking market for now. It also suggests, however, the possibility of the Korean banking market turning into "a highly concentrated banking market" cannot be ruled out if mergers, especially those centering on large banks, continue. In fact, it is widely argued that additional mergers between banks are necessary to further enhance international competitiveness, in that it is desirable to build up market power for the sake of effectiveness.

However, given Korea's relatively unfavorable competitive conditions, for instance, its higher entry barriers compared with those in financially advanced nations, these research results raise concerns that further concentration in the Korean banking sector might lead to side effects such as increased burdens for consumers of bank services, restrictions on the effectiveness of monetary policy and the heightening of systemic risk.

Thus, it is desirable to maintain competition in the domestic market at an appropriate level by strengthening competitiveness through mergers between small and medium-sized banks, rather than led by larger banks. Also, considering the fact that the Korean banks' relatively lower international competitiveness stems not only from the small scales of their businesses but also from internal hurdles including their lack of managerial independence and shortage of expert staff, it seems necessary to enhance banks' international competitiveness by improvements in governance structures and resolutions of non-performing loans, quite apart from the enlargement of their scales.

In terms of legal and institutional arrangements, guidelines for bank mergers should be set up which are different from the existing ones for corporate mergers, so as to reflect the peculiar nature of the banking industry. Prudential supervision should also be strengthened to prevent the failures of banks which are larger than ever before.

2. Public Funds Usage

The Korean government pumped approximately KRW 156.3 trillion in public funds into ailing financial institutions between November 1997 and May 2002 to revive a financial system as shown in Table 15.[6] Had these public funds not been made available, the effects on the Korean economy could have been catastrophic. These public funds were raised by issuing government-backed KDIC and KAMCO bonds (KRW 102.1 trillion), recycling retrieved public funds (KRW 32.2 trillion), and dipping into the government budget (KRW 22 trillion). The effects of these public fund expenditures were maximized by prompt and effective use. By the end of May 2002, public funds spent on financial restructuring were allocated as follows: equity investment (KRW 60.2 trillion); financial contributions and deposit insurance payments (KRW 42.5 trillion); non-performing loan purchases (KRW 38.7 trillion); and the purchase of other assets (KRW 14.9 trillion).

Not only the financial institutions that received public funds directly, but every Korean citizen has benefited from these expenditures. This public fund spending allowed Korea to eliminate structural defects the economy accumulated over a period of years and resulted in a more sound and transparent financial sector. The resulting financial market stability has expedited economic recovery especially in the areas of production and employment.

Consequently, within just four short years, Korea has successfully overcome a financial crisis to regain an A-level credit rating. It is worth noting that during the course of financial restructuring, the notion that large financial institutions are not exempt from market forces has taken root.

[6] K. Kim (2002) explains mixed results of financial restructuring including the issue of public funds in detail.

V. Remaining Issues

1. Presidential Election in December

There will be a presidential election in December 2002. There are all three elections including this one in this year. The government should take extra caution to prevent distorted policy-making, particularly with regard to economic restructuring and law enforcement, by political considerations related to the coming election. Also the privatization schedule of government-owned banks should be carried out as planned and non-bank financial institutions should be privatized as soon as possible regardless of the coming presidential election.

2. Five-Day Workweek System

In accordance with the ever-changing business environments, the shortening of working hours is being discussed in earnest. Representatives of labor unions assert that the five-day workweek system which is currently carried out from July 2002 in banking sector, would reduce unemployment and maintain hiring status, while management insists that labor productivity must be improved in proportion to the shortened working hours. Opinion for the necessity of introducing the five-day workweek has gained recognition nationwide since debate has recently centered on the improvement of workers' quality of life, the need for employees to develop their job skills, employment creation, and so forth.

The Tripartite Committee comprising of representatives from labor, management, and the government attained substantial consensus as to the basic principle on the shortening of working hours in October 2000. The main contents of the basic agreement are as follows. Shorten legal working hours to 40 hours a week and reduce total working hours to 2,000 hours in one year. Improve the holiday and paid leave system to meet global standard. Shorten working hour in stages, according to the type and size of the business. The issues of disagreement center on the upper limit monthly and annual paid leave, whether or not wages should be cut along with shortened working hours, and the timely implementation of the five-day workweek system. It is anticipated that public sector organizations will be the first to adopt the five-day workweek system. Its implementation in the private sector will be phased in thereafter, according to the type of business.

Baek and Oh (2001) investigated the short-run production effect of the reduction of legal working hours on the Korean economy by industry. Main result shows that the short-run production effect on the Korean economy is negative in all industry. Especially manufacturing industry is most severely affected by the reduction of legal working hours. The government announced a revision of the Labor Standard Act in accordance with the five-day workweek system because the Tripartite Committee recently did not reach an agreement on the shortening of working hours

3. Introduction of FLC

It is obvious that the Korea's financial system cannot establish a sound footing as long as the degree of credit risk and instability in the corporate sector remain high. As a result of regulatory reforms for financial institutions in the wake of the 1997 financial crisis, the operating principle of Korean banks has changed from relationship-based banking to arm's-length banking. The key to this change was the introduction of forward-looking criteria (FLC) for loan classification. The FLC-based regulatory framework was adopted to push ahead with financial and corporate restructuring simultaneously. Regulators were keenly aware that the financial and corporate sectors are inextricably linked making it necessary to reform the two sectors at the same time. This point was well illustrated by the banks' performance in 1999 and 2000. During the two years, banks recorded large losses, despite a strong recovery of the Korean economy, due to high provisioning against further increases in non-performing loans.

Simply put, FLC require banks to assess a loan on the basis of the borrowers' future capacity to repay, instead of their past repayment records. Under the system, banks are driven to take an arm's-length approach to customers in a sharp departure from their past practice of lending based on personal relationships. In the meantime, the introduction of FLC emerged as a positive development, generating greater risk awareness among bank officials and investors, although the credit conditions of some firms deteriorated.

Experts agree that a rigid implementation of FLC contributed a great deal to putting the nation's financial sector in better shape. It allowed the government to launch the second-stage financial sector-restructuring program in 2000, under which dozens of marginal firms were weeded out. In the initial period, financial regulators took the initiative in forcing nonviable companies out of the market. But the FLC allowed banks to carry out corporate restructuring on their own without the intervention of the regulatory authorities. It is true that this market-based system of corporate and financial restructuring has yet to take firm root in Korea. Yet it is also true it has allowed banks to reduce their credit risks by pulling the plug on nonviable companies and thereby improving their balance sheets.

4. New Capital Adequacy Ratio and Reduction of NPLs

The Government revised the capital adequacy ratio, so called the BIS ratio, effective January 1, 2002, to more properly reflect the market risk that arises from the movements in interest rates or exchange rates. The new BIS ratio is calculated based on the classification of assets into the trading book and the banking book, rather than looking at total asset as whole. Specifically, the new BIS ratio takes into account market risk against the assets in the trading book. There is no change regarding the banking book.

One reason for the change is that banks are recently more exposed to market risk, due to banks' expanding investment in stocks, bonds, derivatives, and so forth. Nevertheless, until now, only credit risk was considered when estimating the risk of asset holdings. Under the new regulation, it is required to hold an adequate amount of equity capital to cover the market risk.

This ratio is applied to banks with assets in the trading book of more than one trillion won, or 10 percent of the total assets as recorded in the consolidated financial statement. As of end-September 2001, 10 banks, including Choheung, Hanvit, Kookmin, and Hana, are subject to the new ratio. However, the minimum equity capital ratio remains at 8%.

Based on steadfast efforts to clean up their balance sheets, local banks reduced the total amount of loans classified as substandard or below to 18.1 trillion won as of the end of March this year, lowering the ratio of non-performing loans to total outstanding loans to 3.1 percent from 3.4 percent at the end of 2001. The lowered problem-loan ratio led to an improvement in the capital adequacy ratio as well, with the BIS-required average capital adequacy ratio of the nation's 15 commercial banks standing at 10.81 percent in the first quarter of the year, well above the government-set threshold of 10 percent. The banks did not experience any huge falls in their BIS ratios according to the new criteria as well, proving that their competitiveness as global financial institutions has been largely enhanced.

Under the new capital adequacy criteria set by the BIS, which added the factor of market risk to the existing criteria for calculating the capital adequacy ratio, the newly calculated BIS ratio of eight banks recorded an average 11.42 percent, down only 0.08 percentage points from the 11.50 percent based on the previous BIS capital adequacy ratio which considered credit risk only. On the back of reduced problem loans and improved business conditions, 22 local banks earned a total of KRW 5.2 trillion in their 2001 fiscal year ending in March this year.

The flow-on effect of the U.S. economic rebound on Korea's economy, combined with the low interest rate policy, is positive for Korean banks. Those banking systems and banks that have undertaken earnest reform since the Asian financial crisis of 1997 and 1998 are in the best position to reap the benefits of the economic upturn. The government expects local banks' net profit for the year to reach as high as KRW 7-8 trillion. Reflecting the improved balance sheets of Korean banks, and the upgrade in Korea's sovereign rating, major international rating agencies - Standard & Poor's, Moody's Investors Service and Fitch Ratings - have all raised their ratings on Korean banks.

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Tables and Figures

Table 1 Trend of Economic Growth Rate

(Unit: %)

1981-1989	1990-1996	1997	1998	1999	2000	2001	1999-2001
8.6	7.6	5.0	-6.9	10.9	9.3	3.0	7.7

Source: Bank of Korea

Table 2 Reference Cycle

(Unit: year.month; months)

	Trough	Peak	Trough	Duration (Months)		
				T→P	P→T	T→T
Cycle 1	72.3	74.2	75.6	23	16	39
Cycle 2	75.6	79.2	80.9	44	19	63
Cycle 3	80.9	84.2	85.9	41	19	60
Cycle 4	85.9	88.1	89.7	28	18	46
Cycle 5	89.7	92.1	93.1	30	12	42
Cycle 6	93.1	96.3	98.8	38	29	67
Cycle 7	98.8	00.8[e]	01.8[e]	24	12	36
Average				32	18	50

Note: 'e' denotes estimate by the cycle of coincident composite index.
Source: National Statistical Office

Table 3 Growth Rates by Component of Expenditure

(Unit: %)

	2000	2001					2002
		Q1	Q2	Q3	Q4	Year	Q1
GDP	9.3	3.7	2.9	1.9	3.7	3.0	5.7
GNI	3.6	0.5	1.3	-0.1	3.4	1.3	7.5
Final consumption expenditure	6.7	1.2	3.5	4.3	5.6	3.7	8.1
Private consumption	7.9	1.5	4.1	4.8	6.6	4.2	8.4
Government consumption	0.1	-0.7	-0.1	1.0	0.3	0.2	5.5
Gross fixed capital formation	11.4	-4.0	-4.8	-3.1	4.9	-1.7	6.5
Equipment	35.3	-8.4	-11.2	-15.7	-3.1	-9.8	3.2
Construction	-4.1	1.5	1.1	8.2	10.7	5.8	10.1
Exports of goods and services	20.5	9.0	0.7	-4.1	-1.1	1.0	2.1
Imports of goods and services	20.0	0.2	-7.2	-5.5	1.1	-2.8	6.3

Table 4 Growth Rates by Sector of Economic Activity

(Unit: %)

	2000	2001					2002
		Q1	Q2	Q3	Q4	Year	Q1
Agriculture, Forestry & Fishing	2.0	-4.1	3.5	1.3	1.5	1.4	7.2
Manufacturing	15.9	4.5	2.2	-1.7	2.1	1.7	3.5
Electricity, Gas & Water	14.0	7.5	4.7	4.3	6.0	5.7	7.7
Construction	-3.1	2.4	1.5	7.6	9.5	5.6	8.9
Services	9.5	3.9	4.0	3.8	4.7	4.1	7.6
Wholesale and retail trade restaurants and hotels	9.8	3.4	3.8	3.8	5.1	4.0	5.8
Transport, storage and communication	17.9	8.2	6.8	7.7	6.8	7.3	8.6
Finance, insurance, real estate and business services	4.9	4.4	4.2	4.2	5.5	4.6	9.2
Community, social and personal services	5.1	3.9	5.8	10.0	9.8	7.3	11.6
Government & Private Non-profit Services	0.3	1.2	1.0	0.8	0.6	0.9	1.0

Table 5 Rates of Increase of Nominal Wages

(Unit: %)

	2000	2001					2002
		Q1	Q2	Q3	Q4	Year	1-2
Nominal wages per worker	8.0	8.5	4.6	4.6	5.2	5.6	7.7
Regular Payment	7.3	7.7	6.8	5.7	6.0	6.5	12.1
Overtime Payment	13.7	7.5	-1.7	-3.2	-0.2	0.3	-9.6
Special Cash Payment	8.1	11.5	-0.2	4.4	4.6	5.0	1.4
Manufacturing	8.5	11.2	5.5	4.6	4.7	6.3	5.5
Construction	8.8	-2.1	4.6	-0.4	-2.3	-0.3	15.3
Transport, storage, communications	12.4	2.9	-0.2	1.9	2.9	1.8	3.7
Electricity, gas and water	7.0	19.9	13.0	5.2	23.8	15.5	-4.1
Finance, insurance and real estate	6.5	7.2	3.9	5.7	6.1	5.7	9.1

Note: Comparison with the same period of the previous year.

Table 6 Rates of Increase of Consumer Prices

(Unit: %)

	2000	2001					2002		
		Q1	Q2	Q3	Q4	Year	Q1	4	5
Consumer Prices	2.8 (2.3)	2.5 (3.6)	0.6 (5.0)	0.5 (4.2)	-0.4 (3.4)	3.2 (4.1)	1.6 (2.5)	0.6 (2.5)	0.4 (3.0)
Agricultural, livestock, and marine products	-2.3	9.4	0.2	3.6	-3.5	9.5	5.7	0.7	1.2
Industrial products	2.4	0.6	0.6	-0.3	-0.9	0.0	1.1	1.0	0.4
Services	4.3	2.3	0.8	0.3	0.7	4.0	1.0	0.3	0.3
Core Inflation	2.9 (1.9)	1.8 (3.3)	0.7 (3.9)	0.5 (3.7)	0.6 (3.6)	3.6 (3.6)	1.2 (2.9)	0.3 (3.0)	0.3 (3.0)

Note: Comparison is with the last month of the preceding period. Figures in parentheses refer to rates of increase over the corresponding period of previous year.

Table 7 Rates of Increase of Producer Prices

(Unit: %)

	2000	2001					2002		
		Q1	Q2	Q3	Q4	Year	Q1	4	5
Producer Prices	1.7 (2.0)	1.1 (2.5)	0.2 (3.1)	-0.5 (2.0)	-1.4 (0.0)	-0.7 (1.9)	1.7 (-0.2)	1.0 (0.7)	0.7 (1.5)
Agricultural, forest and marine products	-7.9	9.7	0.4	-3.1	-0.7	6.1	5.9	-1.2	5.4
Manufacturing industry products	2.2	0.2	0.2	-0.7	-2.1	-2.3	1.7	1.2	0.6
Electric power, water, and gas supply	7.9	2.6	1.1	0.0	-0.3	3.5	-2.7	0.0	0.0
Services	2.0	1.0	-0.2	0.6	0.2	1.6	1.4	0.8	0.3

Note: Comparison is with the last month of the preceding period. Figures in parentheses refer to rates of increase over the corresponding period of previous year.

Table 8 Balance of Payments: Current Account

(Unit: billion dollars)

	2000	2001					2002	
		Q1	Q2	Q3	Q4	Year	Q1	4
Current Account	12.2	2.8	3.8	1.0	1.1	8.6	1.7	0.0
Goods	16.9	3.3	5.0	2.9	2.2	13.4	3.3	1.2
Services	-2.9	-0.2	-0.6	-1.4	-1.2	-3.5	-1.4	-0.4
Income	-2.4	-0.4	-0.5	-0.1	0.2	-0.9	0.0	-0.7
Current transfers	0.7	0.1	-0.1	-0.3	0.0	-0.4	-0.1	0.0

Table 9 Rates of Increase of Real Estate Prices

(Unit: %)

	2000	2001					2002	
		Q1	Q2	Q3	Q4	Year	Q1	4
Housing Prices	0.4	0.8	2.2	4.8	1.7	9.9	7.6	0.6
(Apartment in Seoul)	4.2	2.2	4.8	8.6	2.6	19.3	15.0	0.5
Housing rents	11.1	4.9	3.2	6.4	1.1	16.4	7.3	0.3
(Apartment in Seoul)	12.1	6.8	5.2	9.7	0.1	23.4	11.2	-0.1
Land Prices	0.7	0.1	0.4	0.3	0.5	1.3	1.8	-

Table 10 Growth of Deposits at Financial Institutions

(Change during the period; Unit: billion won)

	2001				2002		
	Q1	Q2	Q3	Q4	Q1	4	5
Deposit money banks [1]	5,477	21,893	25,725	4,611	2,9005	-1,244	6,577
Money-in-trust	3,506	-2,752	-424	2,465	-5,299	-173	-225
Investment trust companies	17,866	-8,838	26,029	-21,187	15,046	-4,018	3,645
Merchant banking corp.	-581	-42	43	-1,091	1,956	-329	-150

Note: 1) Bank deposits + CD + RP + Cover bills.

Table 11 Monetary Aggregate Trends

(Unit: %)

	2001				2002		
	Q1	Q2	Q3	Q4	Q1	4	5
M3	8.2	8.3	10.3	11.5	12.1	-	-
M2	21.4	15.3	12.9	13.7	14.6	15.7	14.5
MCT+	13.5	11.2	12.3	13.6	13.7	15.4	14.6
Reserve Money	11.7	10.6	8.87	14.6	15.0	17.0	17.8
	(28,703)	(28,227)	(29,215)	(31,147)	(32,966)	(33,120)	(33,343)

Notes: 1) percentage changes compared with the same period of the previous year.

2) Figures in parentheses indicate daily averages during the period (billion won).

Table 12 Corporate Fund Raising

(Change during the period; Unit: billion won)

	2001				2002		
	Q1	Q2	Q3	Q4	Q1	4	5
Bank Loans [1]	3,275	3,748	6,293	-267	12,718	4,315	4,465
Large enterprises	2,104	-2,390	-431	-2,682	3,450	-219	-378
Small and medium enterprises	1,171	6,139	6,724	2,415	9,268	4,534	4,845
Net bond issuance [2]	5,410	5,955	3,843	-6,389	-2,736	-1,160	-165
Net CP issuance [3]	6,955	189	3,356	-2,400	4,901	3,462	4,668
Stock issuance [4]	448	893	1,015	2,282	652	137	342

Notes: 1) Excluding changes to bank accounts in connection with the disposal of bad loans and debt for equity swaps, but including CLO.

2) Issuance by general companies, excluding those under court management, court receivership and workout programs.

3) Based on the amount CP discounted by securities firms, bank trust accounts, and merchant banking corporations.

4) Based on companies listed on the Korea Stock Exchange and registered with the KOSDAQ, but excluding financial institutions.

Table 13 Korea's Economic Outlook

(Unit: %)

	2001P	2002				
		Q1P	Q2	Q3	Q4	year
GDP	3.0	5.7	6.1	6.3	6.4	6.1
Total Consumption	3.7	8.0	6.4	6.0	5.3	6.4
Gross Fixed Investment	-1.7	6.5	5.2	10.0	8.5	7.6
Total Exports	1.0	2.1	10.5	12.8	15.7	10.2
Total Imports	-2.8	6.3	15.3	18.4	19.5	14.9
Current Account ($ bil.)	8.6	1.7	2.0	0.5	0.2	4.4
Goods Trade Balance ($bil.)	13.4	3.3	4.2	2.6	1.9	11.9
Rate of CPI Inflation	4.1	2.5	2.7	2.6	3.5	2.8
Unemployment Rate	3.7	3.6	2.9	2.6	2.8	3.0

Note: 'P' denotes preliminary estimates by the BOK.

Source: KDI, *KDI Economic Outlook*, Vol. 19 No. 2, 2002.

Table 14 Change in Korean Banking Industry after currency crisis

<table>
<tr><th>Name</th><th>1997</th><th>1998.6</th><th>1999.H1</th><th>1999.H2</th><th>2000</th><th>2001.H1</th><th>2001.H2</th></tr>
<tr><td>Sangup</td><td></td><td rowspan="2">Hanvit (1.6)</td><td></td><td></td><td rowspan="5">Woori Holding company (4.1)</td><td></td><td rowspan="5">Woori Holding company</td></tr>
<tr><td>Hanil</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Pyungwha</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Kwangju</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Kyungnam</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Chohung</td><td></td><td rowspan="2">Chohung (5.3)</td><td rowspan="3">Chohung (9.14)</td><td></td><td></td><td></td><td rowspan="3">Chohung</td></tr>
<tr><td>Jeonbuk</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Kangwon</td><td></td><td></td><td></td><td></td><td></td></tr>
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<tr><td>Boram</td><td></td><td></td><td></td><td></td><td></td></tr>
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<tr><td>Suhyup</td><td></td><td></td><td></td><td></td><td></td><td></td><td>Suhyup</td></tr>
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Note: P&A or M&A dates are in parentheses.

Table 15 Public Fund Preparation and Expenditures

(1997 Nov. – 2002 May, unit: trillion won)

Item	Equity investment	Financial contribution	Deposit insurance payments	Purchase of other assets	NPL purchases	Total
Bonds Issue	42.2	15.2	20.0	4.2	20.5	102.1
Recycling Public Fund	3.9	1.2	6.0	4.4	16.7	32.2
Government Budget	14.1	-	0.05	6.3	1.5	22.0
Total	60.2	16.4	26.1	14.9	38.7	156.3

Figure 1 GDP vs. Hypothesized GDP

(Unit: Billion KRW)

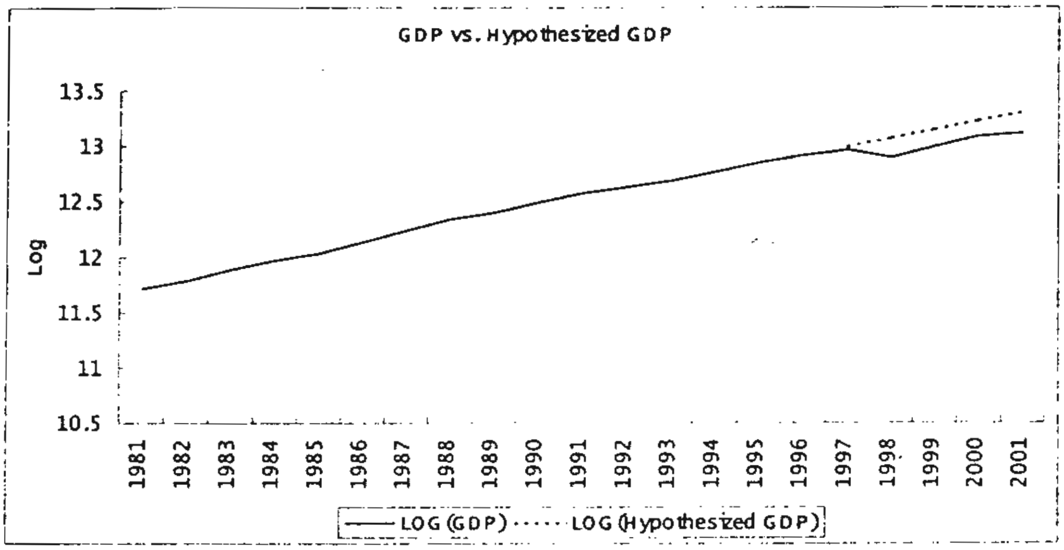
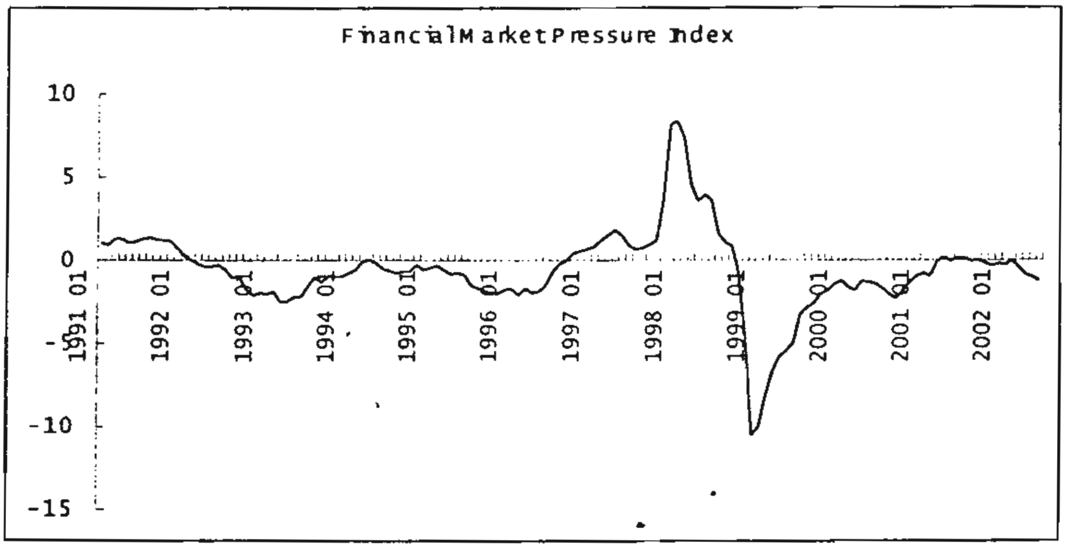


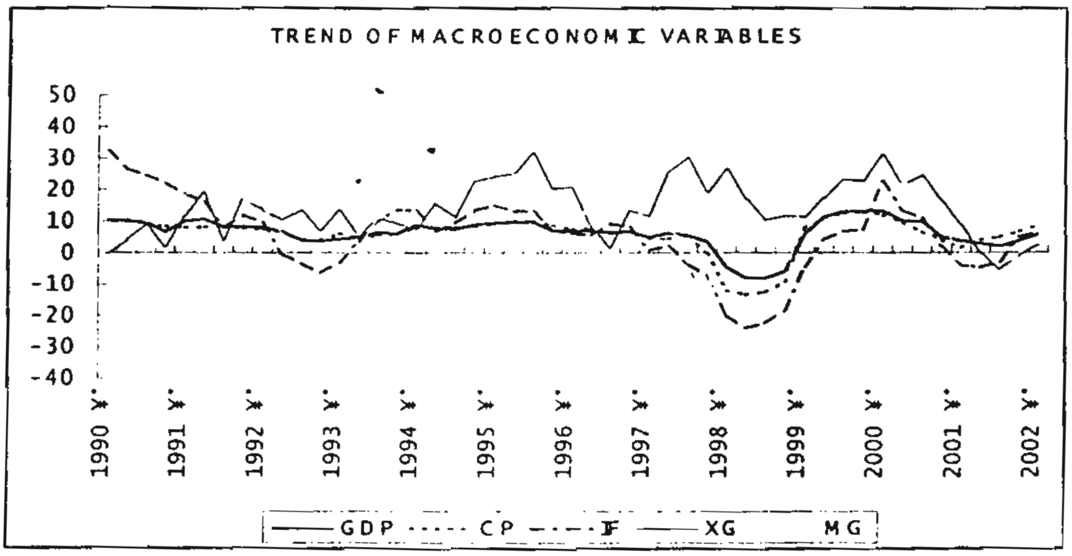
Figure 2 Financial Market Pressure Index



Note: FMPI = $\frac{1}{\sigma_e} \times \Delta e + \frac{1}{\sigma_i} \times \Delta i - \frac{1}{\sigma_R} \Delta R$ where Δe, Δi, and ΔR are percentage change in exchange rate, change in interest rate and percentage change in foreign reserves year-on-year base respectively. All σs are their corresponding standard deviations.

Figure 3 Trends of Macroeconomic Variables

(Unit: %)



Note: CP (Private Consumption), IF (Fixed Investment), XG (Commodity Exports), MG (Commodity Imports)

Figure 4 Market Interest Rates Movements

(Unit: %)

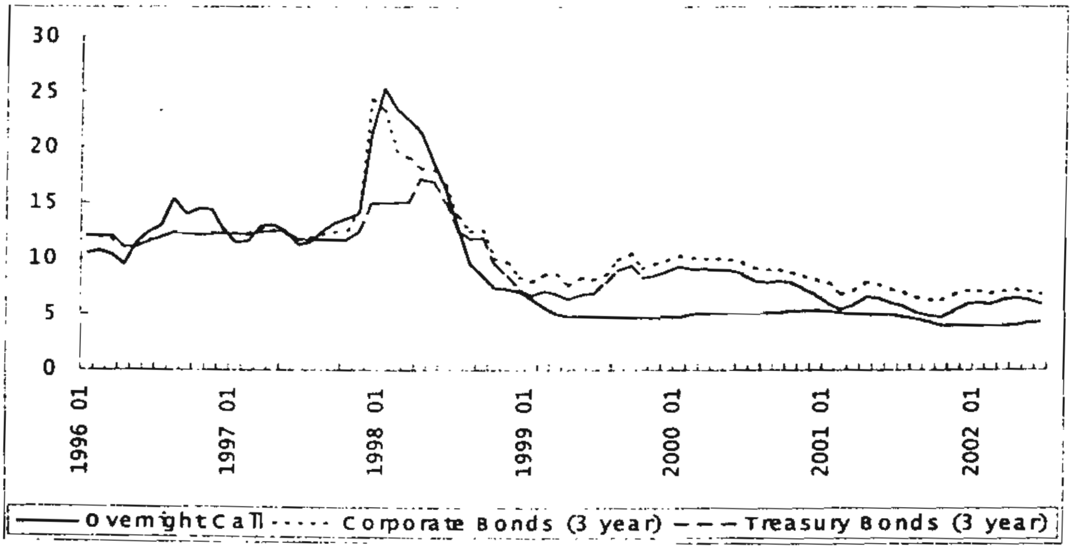


Figure 5 Stock Price Movements

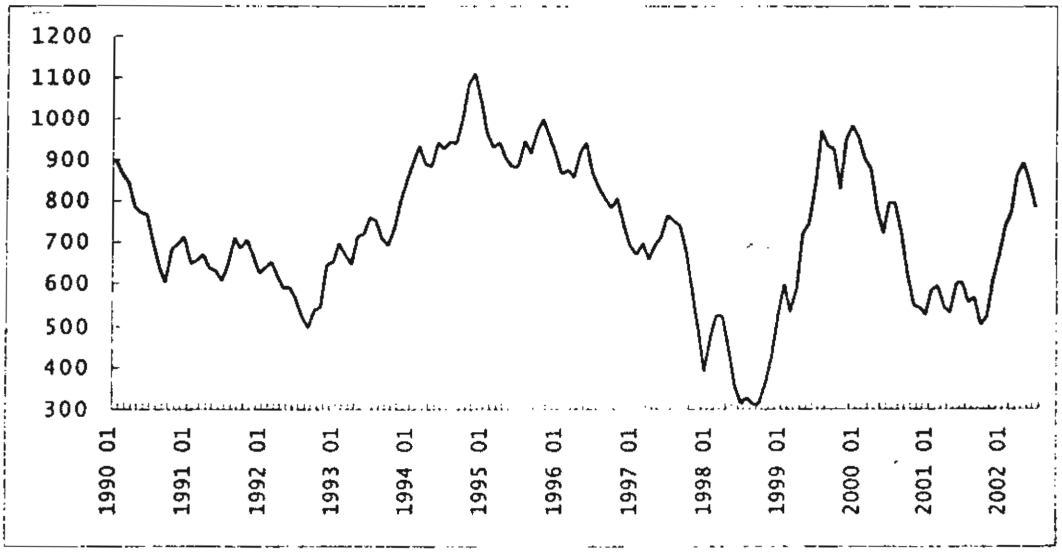
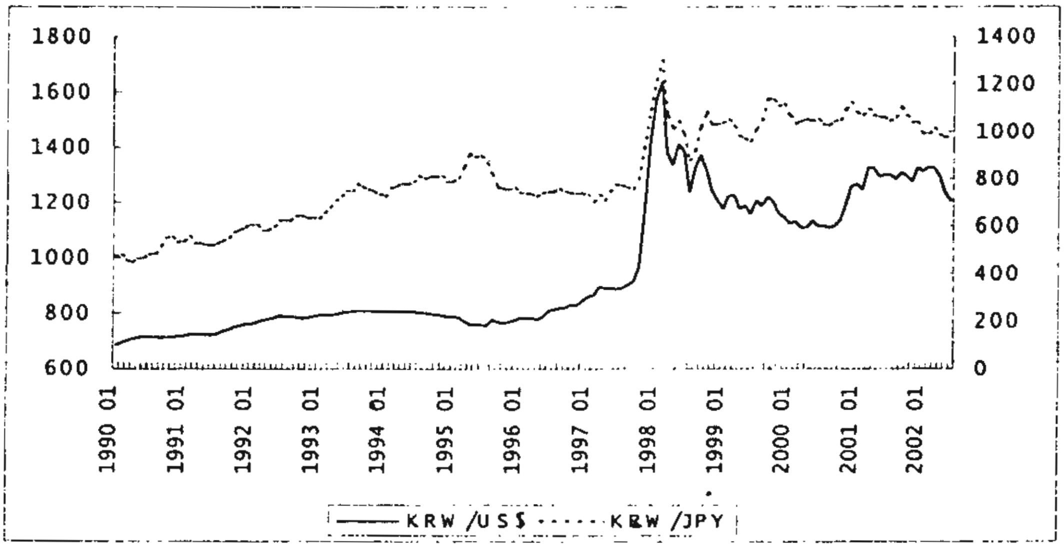


Figure 6 Exchange Rates Trends of the Korean Won



International Conference on
Economic Recovery and Reforms

Sweden

Nordic and Asian Crises in Structural Perspective

Christer Gunnarsson

Lund University, Sweden

ABSTRACT

The economic crisis in the Nordic countries, Finland and Sweden during the early 1990s exhibit many striking similarities with the Asian crisis of 1997/98. In both cases a crisis in the financial sector triggered a chain reaction that involved a dramatic fall in exchange rates, a collapse in the real estate market, falling stock exchange values and a fiscal crisis for the government sector. The question is why countries at seemingly very different levels of economic maturity came to experience such similar developments. Explanations for the Asian crisis have in large degree circled around the issue of inherent structural weaknesses in an Asian development model, notably connoted by the concepts such as crony capitalism and moral hazard. The fact that the Nordic crisis exhibits similar characteristics casts serious doubt on these explanations. In the Nordic case explanations concentrated on the alleged over-size of the public sector.

In this paper it is argued that the fundamental similarity between the two cases is made up by the changes in the global financial system that altered the scope for national polity making in the 1980s. Financial deregulation led to a movement away from a system characterised by a socialisation of savings to a system where savings were increasingly being circulated in private and international and largely unregulated capital markets. In both cases there was a movement away from a rationing system characterised by capital shortage in which government regulation aimed at influencing resource allocation to a system of capital surplus. In both the Nordic and the Asian cases this surplus capacity coincided with an increasing demand for investment capital. In Asia the Plaza Accord of 1985 that gave the ASEAN countries a competitive edge in exports of manufactured goods. In the Nordic countries, notably in the Swedish case, a booming export sector driven by exchange rate depreciation in 1982 triggered an expansion of the demand for credit. When the export sector slowed down in both cases investments relocated towards the domestic sector, to real estate investments and to the public sector. In both cases it was an expansion based on access to cheap credit.

The similarity demonstrates that the "developmental state" was not a typical Asian phenomenon since, in fact, the Nordic welfare state was in large degree built on similar characteristics as the Asian model, the foundation of both being the government control over national savings. When this control eroded in the 1980s it led to similar reactions regardless of development levels. Thus, we conclude that both crises were consequences of a structural change in the financial sector that was to lead to structural effects also in the real economy.

International Conference on
Economic Recovery and Reforms

Thailand

Thailand's Macroeconomic Policy under the Current Administration: A Proposed Alternative

Supote Chunanuntathum*

Thammasat University

ABSTRACT

The country report on Thailand will concentrate on analyzing the recent macroeconomic situation and long-drawn adjustment toward recovery after the financial crisis in July 1997. Short description of the causes of the current economic crisis will first be summarized. The paper will include various recent macroeconomic policies (monetary, fiscal and others) and measures taken by the Thai authorities to counter the on-going economic downturn. Other specific and relevant measures especially on the banking sector's non-performing loans and the use of quasi-fiscal measures as policy tools will also be described along with the normal Thai fiscal policy.

* Faculty of Economics, Thammasat University. The author would like to thank Dr. Bhanupong Nidhiprabha for helpful comments and Mr.Narongchai Thitinanpong for an able research assistance.

1. Introduction

It has now been more than five years since the eruption of the Thai financial crises (the twin crisis of currency and banking including the financial companies) in the middle of 1997. The financial crises have caused, as is now well known, menaced real economic consequences especially in the first two years following the forced domestic currency floating on July 2, 1997. Nevertheless, the Thai economy has been adjusting all along in the responses not only to the previous long-run fundamental current account (and hence balance of payments disequilibrium) with a huge accumulated external debt amounting to US$ 90.54 billion (or 60 percent of GDP) in 1996, the huge financial institution problem loans (still remaining according to the Bank of Thailand at Baht 1.04 trillion or 20.84 percent of total credit outstanding in June 2002), the ever changing external economic conditions, but also the Thai government own macroeconomic policies.

Though much progress have now been made to foster the Thai economy back toward the path of recovery, the current macroeconomic recovery remains frangible with the domestic output still below the potentially full - employment GDP level. The purpose of this short paper is a follow - up of the changing macroeconomic situation of the Thai economy. The emphasis will, however, be on the current short-run or intra-cyclical economic fluctuation and stabilization policies adopted by the Thai government in the past one to two years. The paper begins by investigating the fluctuations of various relevant macroeconomic variables of the Thai economy. This information from the collected data will be described only briefly. Then it will be followed by an analysis of the macroeconomic policy mix adopted by the present administration. The paper describes how the mix develops and changes. An alternative and better macroeconomic policy mix is then proposed if the present policy combination is founed to be inappropriate. The paper also makes a final comment on the intervention policy of the government.

2. Macroeconomic Variables and Relevant Facts

a. Aggregate Production

There are many important macroeconomic variables which indicate that Thai economy is now on the path of recovery. Figure 1 shows the fluctuation of output or GDP after the crisis (1997 - 2002). The total real Thai output fell precipitately from an unsustainably high average economic growth rate of 9.53 percent per year during the economic boom and asset-price bubble period (1988 - 1996) to -1.37 percent in the initial year of the crisis in 1997 and by -10.51 percent in the following year of 1998. The graph also shows that there was a recovery in production of goods and services by 4.43 and 4.64 percent during 1999 - 2000. The growth rate of real GDP was then only 1.8 percent reflecting an overall economic slowdown in 2001, as compared to the 1999 - 2000 period. However, the year-on-year quarterly growth rate of the domestic output has again recovered in the first half of 2002. The year-on-year quarterly real production rebounded to 3.89 and 5.1 percent respectively for the first and second quarter of 2002 as compared to 1.68 and 1.83 percent in 2001.

b. Employment

The employment statistics from the National Statistical Office's labor force surveys indicate a low open unemployment rate of approximately 1.5 percent in the two-year period of 1996 - 1997. But it rose after the economic crisis to peak at 5.3 percent in May 1999 after which the average unemployment rate fluctuated downward to 3.3 percent in 2001. The latest available figure of the unemployment rate for May 2002 is 3.0 percent. Unemployment which is often considered to be a lagging adjusted variable relative to the leading economic recovery of production. Employment has moved along without much lag to real output. Table 1 shows the fluctuation of the unemployment rate during 1996 - 2002-Q1.

c. Components of the Aggregate Demand

Components of the demand also change after the economic crisis. As a result of the forced floating of the value of the foreign exchange against the baht and the contractionary aggregate demand policies, severe domestic retrenchment occurred especially in the immediate 1-2 year period that followed after the midst of 1997. Private consumption fell by an average of about 5.54 percent in the last two quarters of 1997 and then declined further by as much as 11.51 percent in 1998. Private investment plunged even more i.e. by 30.44 percent in 1997 and 52.28 percent in 1998. Private investment recovered after 1999 and grew positively by 17.29 and 5.14 percent respectively in 2000 and 2001. It remains, however, volatile.

Government consumption fell marginally by only 2.83 in the first year of the crisis, 1997. But as a result of the changing government fiscal policy from a surplus (an initial IMF conditionality of a fiscal surplus together with a restrictive monetary policy targeting at the exchange rate) to an allowable fiscal deficit, the government consumption grew by 1.56 to 3.9 percent during 1998-2001. Turning to the public investment. Unlike the government consumption which can hardly be cut back due to its generally fixed current expenditures (wage compensations to state employees and debt repayments), government or public investment, after only a fiscal expenditure drag in 1997, has continued to decline up to 2001. Public investment grew negatively by 28.73, 3.13, 9.93 and 6.60 during 1998 - 2001. This may not be a good sign because public investment in infrastructure and human capital is important to provide a sustained economic development in the long run. Thailand, as a developing economy, still needs such public investment.

When the private and public investment are combined, it is found that the aggregated investment in the economy fell respectively by 20.54, 44.32 and 3.18 in the first three years after the crisis or 1997 - 1999 and then recovered very marginally by 5.46 percent in 2000 and only 0.80 percent in 2001. As for the total consumption expenditure, private and public, it fell 1.57 percent in 1997 and by 9.49 percent in 1998 and then rose by 3 to 5 percent per year during 1999 - 2001. Figure 2 gives the growth rate of private consumption, government consumption and total consumption of the economy. Figure 3 does the same for investment.

Export, as a result of the real depreciation of the domestic currency after its floating and depending also on the growth of the economy in the importing countries, expanded by 7 to 9 percent in 1997 - 1999. It grew very strongly by 17.57 percent in 2000 due basically to a strong economic growth in the trading partner countries. But Thai export fell by 4.23 percent in the following year of 2001, again due basically to the economic downturn in the importing countries especially the United States and Japan. The real value of the baht also contributed to the slow down in the Thai export. Import declined drastically along with severe domestic contraction in the 1997 - 1998 period after which it rose more strongly than export in 1999 - 2000. But, the Thai import also fell, more than the falling export, by 8.29 percent in 2001. Thus, there has been a continuous current account surplus after the crisis. The cumulative current account surplus amounted to U.S. $ 42.33 billion during 1998 - 2001. Despite a smaller current account surplus both absolutely as well as in relation to output, Thailand's overall foreign debt has substantially declined from a peak of approximately U.S. $ 109 billion (or 70.1 percent of GDP) in 1997 to U.S. $ 64.4 billion (or 55.5 percent of GDP) in the first quarter of 2002. Figure 4 shows the current account position as a percentage of GDP and Table 2 shows the external debt situation before and after the economic crisis.

It should also be noted that the Thai economy, as expected from the baht floating, has become relatively more open as measured by an increasing share of the average export plus import - output ratio. The openness of the Thai economy rose from 45.73 percent during 1993 - 1997 to 51.69 percent during 1998 - 2001. Export itself constituted as much as 59.71 percent of output during the period of 1998 - 2001 as compared to 44.39 percent in 1993 - 1997. Even in 2001 where export in the domestic GDP statistics grew negatively at 4.23 percent, the export - output ratio remained higher at 61 percent. Export has become a more dominant part of the aggregate demand and output running counter to the policy debate and resultant desirability of the present Thai Rak Thai (TRT) government for a lesser role of the external real economic forces on the Thai economy. The fact points to a larger role of the external sector or lesser domestic self - sufficiency. The fact also has an important implication for the overall macro - economic management policies which will later be analyzed below. Figure 5 produces the consumption, investment and export share in the GDP.

d. International Terms of Trade

The international terms of trade is exogenous for a small open economy. It is, however, noted that the terms of trade of Thailand fluctuated downward resulting in a deterioration of approximately 27 percent during 1996 - 2002-Q1. Though the fall in the price index of export to import may not be permanent, the substantial decline in a number of years after the crisis can by itself potentially depreciate the value of the baht in the floating exchange rate regime. But in the Thai case the rise in the relative export - import volume, due basically to the supply response under the available excess capacities, has generally more than offset the decline in the relative price. There is, as explained above, a continuous trade (and current) account surplus after the crisis. However, in the 2001 world recession especially in the major Thai trading partners, the trade balance in dollar fell from U.S. $ 5.5 billion in 2000 to U.S. $ 2.5. But the current account remained a surplus of U.S. $ 6.2 billion in that same year.

e. Balance of Payments

Figure 6 shows the situation of the balance of payments during 1991 - 2002-Q2. There has been a net capital outflow made possible basically by a current account surplus after 1997. Net private capital outflow which is also very sensitive to the expected net rate of return differential between the domestic and foreign asset has been negative all along since 1997. However, the overall net annual capital outflow with an exception of 2000 was generally less than the annual current account surplus giving rise to a favorable balance of payments during 1998 - 2001. International reserve has increased while the country's external debt as explained above falls in the process of the macroeconomic fluctuation and adjustment after the crisis.

f. The Assessment of Country Risk

As a result of an improvement in the external liability of the economy as well as the turnaround of the Thai economy to a positive growth path, the market assessment of the country risk has now improved considerably. This can be seen in the calculated spread of the government bond yield denominated in the same currency between Thailand and the United States of America. The positive spread refers to the extra charge (risk premium) expected by the market for the additional risk in buying (investing in) the Thai government sovereign debt relative to the similar U.S. bond. As shown in Figure 7, this risk premium was quite small 0.035 percent prior to the economic crisis in 1997. But, it increased substantially to a height of 7.4 percent in February 1999 after which it fluctuated downward to be approximately 1.5 percent in 2001. The market - assessed risk premium for the Thai sovereign debt still remains higher by about one percentage point than the level before the crisis.

g. Inflation, Real Interest Rate and Real Exchange Rate

Inflation rate, real interest rate and real exchange are the other three variables to be observed before the analysis of the macroeconomic policy management of the current business cycle be analyzed.

Inflation, as shown by the CPI in Figure 8, indicates a temporary and continuous rise from the monthly average of 4.24 percent in the first half of 1997 and before the crisis to a peak of 10.12 percent in June 1998. Thus, there was, as expected, a rapid rise in the price level in the first year after the baht floated in July 1997. After that, the inflation rate fluctuated downward and even turned negative during May to June 1999. Then the general price index rose only 1.54 percent in 2000, 1.65 percent in 2001 and very marginally by 0.39 percent in the first half of 2002. Inflation is not, in fact, an immediate or even an emerging problem for the Thai economy at the present time. This fact has an important implication for the macroeconomic policy management.

Figure 9 also plots the inflation rate together with the interest rate both in nominal and real terms. The fluctuation of the Thai real interest is due to the movement of the inflation rate and the nominal interest rate. In the initial period under the IMF program, the restrictive monetary policy is targeted at the exchange rate stability, while the contractionary fiscal policy is meant to help raduce aggregate demand, with an intention of allowing the switching effect of the floating and much depreciated domestic currency to result eventually for a current account surplus. The nominal interest rate then rose to a historically high (about 20 percent) to dampen inflation which, as explained above, increased to peak at about 10 percent around the middle of 1998. The domestic interest rate adjusted by inflation was, therefore, very high during July 1997 to July 1998, after which it began to fall rapidly. Both inflation and nominal interest rate tended to be much lower and real interest rate was approximately 2 to 4 percent during the negative inflation rate of Mar - October 1999. Short - term interest rate in real terms was less than one percent or even negative during 2000 and the first half of 2001. But when the central bank raised the policy interest rate (14 - repurchase market rate) by a full percentage point from 1.5 percent to 2.5 percent in June 2001, the nominal interest rose pulling, given the inflation rate, the real interest rate upward. And in spite of the monetary authority's decreases of the repurchase market rate by a total of half a percentage to 2 percent on December 25, 2001 and January 21, 2002, the real interest still moves up due to a more than proportionally fall in the domestic inflation rate.

The movement of the nominal and real domestic interest rate is important not only in terms of stimulating domestic spending and some of the recent private investment recovery in certain sector notably housing sector but also helps importantly in the debt restructuring (non - performing loans in the banking sector). In the small open economy with capital account mobility, the domestic interest is also linked to the given world or external interest rates in different currencies. This leads to the international interest - rate differential and expected change in exchange rate and risk premiums or discounts among different assets as important variables, among others, determining the movement of the nominal exchange rate. This nominal exchange rate change and together with price change affect the real exchange rate which in turn will produce impacts on the aggregate demand especially the trade account and hence the growth of output and economic recovery eventually. Figures 10 shows the movement of the nominal and real effective exchange rate for the baht as calculated by the Bank of Thailand. A fall in the rate indicates a real depreciation for the baht and vise - versa for a rise. Figures 11 is also provided to indicate the real value of the baht in terms of the U.S. dollar.

3. Macroeconomic Performance under the Present Administration, 2001-2002

The Thai Rak Thai (TRT) landslide victory in the general election early last year (2001) and the eventual amalgamation of other smaller parties to the TRT has resulted in the absolute one - party dominance both at the parliament and the government usually unseen in the recent history of Thai democracy. It is highly probable that the present government is able to push through most of its own policies and reforms without much difficulty.

The TRT government has assumed the office with a different approach in the economic aspect from the relatively more market - oriented reform of the previous Democrat party - led coalition government. To the TRT own belief and its campaign platform, an economic development should also embrace a number of elements, including, for example, harnessing the hidden entrepreneurial talents of the so - called SMEs and local communities through various state support measures, strengthening the grassroot ability to make an investment and spending decision on production, commerce and finances, an interventionist international trade policy especially against the foreign competition on both import and service trade and attempting to form an economic strategic alliances with Japan, China and India to open up domestic markets and increase leverage vis - a' - vis other major economic powers. The government also attempts to push exporters to move up a value chain closer to the end consumers hoping to capture a marginally more value added along the product chain, as well as forming a regional cartel on rice and rubber, two major Thai agricultural commodity exports.

However, when the present government took office in early 2001, the world economy was on the way toward a downturn. There was a substantial fall in the economic growth rate of the Thai major trading partners especially the U.S. where real GDP growth declined substantially from 3.8 pecent in 2000 to 0.3 percent. The Japanese output, with its long - run financial problem, also fell miserably to - 0.2 percent after a spurt of growth by 2.4 percent in 2000. The export component in the Thai GDP then, as shown above, fell by 4.23 percent. This contributed negatively to the growth of GDP by 1.52 percent in 2001. The government, keeping its populist policies under the election campaign promises, began to pursue its fiscal stimulus programs. But the budget for the fiscal year 2001 (October 1, 2000 to September 30, 2001) had been already prepared by the previous government. So, not much could be altered by the present government. The planned budget deficit had been set at baht 105 billion or 2 percent of GDP. The government then decided to resort to finance its additional spendings and subsidies on various programs by means of the quasi - fiscal channels mainly through the state banks. These

September 30, 2001) had been already prepared by the previous government. So, not much could be altered by the present government. The planned budget deficit had been set at baht 105 billion or 2 percent of GDP. The government then decided to resort to finance its additional spendings and subsidies on various programs by means of the quasi - fiscal channels mainly through the state banks. These spending programs include principally the village and urban community fund, debt moratorium for three years on farmers debts (or debt deduction) at the Bank for Agriculture and Agricultural Co - operatives and other state - bank lendings along the government policy lines. Of all these special programs, the village and urban community fund is of short - run macroeconomic importance simply because of its sheer size (baht 80 billion or about 1.6 percent of GDP) and its flexibility in use. The committee at the level of village or the urban local community administers the fund independently under the distant oversight of the national committee. Under the village and urban community fund, 1 million baht revolving investable fund is set up for each village and local urban community to finance selected micro - credit projects for the small scale enterprises throughout the country's approximate 75,000 villages and urban communities. This micro - credit facility has begun to be disbursed since August 2001. Total outstanding disbursement up to the middle of 2000 amounted to approximately baht 60 billion. Funding for the micro - credit program is initially from the Government Savings Bank. But the principal and the interest cost will be eventually reimbursed by the government over a period of 8 years. The total and final financial cost to the government is not yet estimated or known.

To show the extent of the overall fiscal spending injection in the economy, the public - sector balance under the relatively broader concept (GFS basis) is adopted. The main benefit of a public - sector fiscal balance for the immediate analysis of this paper is that the broader and net of inter - sectoral transfer concept includes not only the central government's budgetary balance but also the other forms of balances directly outside the normal budgetary balances of the central government, local government and the non - financial public enterprises. The extra - budgetary balance includes, among other funds, the villege and urban community fund. It does not include other - extra - budgetary stimulus programs notably, the debt deduction for nation - wide farmers. The total cost of this subsidy (interest and debt deduction) program is to be financed annually from the normal government annual budget beginning in 2002. The total cost is estimated to be baht 18,000 million.

The public - sector fiscal balance in Table 3 shows an actual budgetary deficit of baht 110.6 billion or 2.20 percent of GDP in 2001. There was, however, a small surplus in the other combined balances, resulting in an overall deficit for the comprehensive public sector of 1.7 percent of output. But the embarkment of a substantial rise in the intended government spending in the 2002 fiscal year gave rise to a planned budgetary deficit of as much as baht 200,000 million or 3.6 percent of GDP. It includes the new 58 billion baht stimulus budget allocated under the central emergency reserve fund. This fund is to be used for different areas including financing training programs, programs to strengthen local communities and labor - intensive projects in agriculture and tourism and the SMEs production sector. But, as it turned out, this large stimulus is not totally expended. Approximately 20 - 30 percent may have actually been spent and or in the process of disbursement. The government then expects to continue spending the unused portion in the fiscal year of 2003. The government stimulus program from the villege fund is producing a much stronger impact especially in fourth quarter of 2001 and the first quarter of 2002 where the total disbursement amounted to as much as baht 47,373 million or approximately 63.16 percent of the budget. With a rebound of the real economic growth in the first and second quarter of 2002, the central government balance as planned initially has changed. Revenue is reestimated to rise marginally while the 12.42 percent increase in the planned expenditure in 2002 is not all spent in spite of the attempted rapid disbursement of up to 70 percent of the planned 200,000 million baht deficit in the first half of the fiscal year (quarter 4, 2001 to quarter 1, 2002). Approximately 90 percent of the planned government expenditure budget for 2002 is disbursed, which is about 4 - 5 percentage point higher than 2001. The overall actual central government deficit is

The central government actual deficit in the 2002 fiscal year is estimated to have risen by as much as 36.33 percent as compared to the last fiscal year. And even though the government budgetary short - fall (3.2 percent of GDP) is planned to be lower than the planned deficit in 2001 (3.6 percent of GDP), the central government deficit is still expected to be only slightly lower at 2.5 percent of expected output. The present government has clearly adopted a much more expansionary fiscal policy in the current business cycle management. This will likely lead to a further rising public debt. The over - all public debt, including the central government debt, the FIDF or Financial Institutions Development Fund debt resolution associated with the past and on - going restructuring and debt of the non - financial public enterprises, has risen rapidly from 14.5 percent of GDP before the economic crisis to nearly 58 percent in 2001.

Though the actual expansionary fiscal policy stance of the TRT administration especially for the latter part of 2001 and first quarter of 2002 was very clear, the central bank's monetary policy was changing in a somewhat confusing manner in the middle of 2001. The short - run interest rate in the U.S. was raised in 2000 under the FED's policy of tightening in an anticipation of the expected overheating and hence higher inflation. Given the interest rate in Thailand being lower, the interest rate differential in favor of the dollar asset was then generally higher resulting in a net private portfolio capital outflow. There was a balance of payments deficit in 2000 by approximately $ 1.6 billion. This put pressure, under the floating exchange rate regime, on the domestic currency to depreciate and in fact it depreciated from about 37 - 38 baht per dollar in the early of 2000 to around 43 baht toward the end of 2000. But when the world economy entered into a recession in 2001 the world interest rate tended to fall especially very rapidly in the U.S. to reverse its cyclical business downturn after a historically long economic expansion. The interest rate differential between Thailand and abroad became narrower and the net private capital outflow began to fall. The balance of payments deficit was also falling in the first half of 2001 to a negligible low of U.S. $ 0.232 billion. The value of the baht continued to depreciate to an average of 45.50 baht per dollar in the second quarter of 2001. As such, the event of the baht depreciation had been taking place when the present government assumed its office in early 2001. The baht had in fact been adjusting quite nicely and fundamentally right in response not only to the arbitrage outflow but also to the emerging much weaker export market. The exchange rate was playing an important role to shore up the sagging Thai export.

The depreciation of the domestic currency, however, might be of concern to the government. The government has also tended to oppose the falling domestic market interest rate with the belief that the lower interest rate may not be stimulating the economy while a depreciation of the domestic currency causes the baht value of foreign debt to rise and a lower market interest rate hurts depositors' interest income and hence their consumption. But, there is another important part which is not well considered by the government which is logically related to the household inter - temporal consumption behavior. A higher interest rate lowers to - day household consumption for a possible higher future consumption. Lower interest rate then should help to stimulate domestic investment and consumption. There are much evidences now. Lower interest level also make the on - going restructuring of the remaining huge corporate debt overhang less difficult. Nevertheless, the government has long signaled that it opposes the lower market determined interest rate as well as a continuous decline in the value of the baht as seen during the period of 2000 and the first half of 2001.

Thus, placating the government, the monetary authority under the change of a new leadership made a decision to raise the 14 - day repurchase rate (a monetary policy instrument which is akin to U.S. FED - fund rate) from 1.5 to 2.5 percent in early June 2001. The reason given by the independent Bank of Thailand was, however, different. The increase was justified in its own perception to the distorted structure of the local interest rates among domestic foreign banks and Thai banks. The foreign banks borrowed from the inter - bank market and relent it to their customers at a higher interest rate creating a disadvantage to the Thai banks. A rise in the repurchase rate would then help to correct this perceived distortion. It, of course, importantly also reduced the gap between the foreign and domestic short term interest rate. Hence, it made the net capital outflow less attractive. The baht then appreciated both nominally and in real terms. The appreciation did not help the dollar export situation which was already showing sign of weakness from the early 2001. The episode indicated an opportunity loss to allow the exchange rate under the managed exchange rate regime to work itself out to a marginally increase in the Thai export and hence helping to lessen the slow down of the Thai economy in 2001. This was a short period of an inconsistent macroeconomic policy management. While fiscal policy was exceptionally expansionary, the central bank engineered the interest rate policy toward the exchange rate stability causing the baht to appreciate amidst a situation of the declining external demand due to the downturn of the current business cycle.

Nevertheless, the central bank changed its monetary policy direction by reducing the repurchase rate by 0.25 percentage point twice on December 25, 2001 and January 21, 2002. The 14 - day repurchase rate was down from 2.5 percent to 2.0 percent per annum and it has still remained at that level. This has, therefore, indicated that the monetary authority is taking a monetary policy stance in support of the present government's expansionary fiscal policy to revive the growth of the economy. With a return to the balance of payments surplus after the middle of 2001, the central bank has been adopting a sterilized foreign exchange intervention to keep the monetary base rather stable and the nominal baht from appreciating too much which can jeopardize export growtn. This is clearly depicted in Figure 12.

4. Some Concluding Remarks

After 6 years (1997 - 2002) of a continuous actual government budget deficit especially with the ever largest deficit (inclusive of quasi - fiscal activities) spending in 2002 of approximately 2.7 percent of GDP and the already agreed fiscalization of the total expected loss of 1.4 trillion baht of the Financial

Institutions Development Fund in the Thai financial crises, the public debt which stood at 58 percent of GDP in 2001, will certainly rise further. This means that the government future debt service will have to increase. Given the relatively fixed current expenditure and the rising public debt services, the government will face an increasing inflexibility in using the discretionary fiscal stance. Since the government investment expenditure in the Thai government budget has usually been relatively more discretionary than the above two categories of relatively fixed expenditure, it has already been taken the cut during this economic crisis. This, in turn, should not be good for the country's future economic growth and development.

A rising public debt is, therefore, having an implication on the current macroeconomic policy mix. It is proposed that the budget deficit be reduced (preferably through tax reforms, increase in efficiency of government spending, as well as efficient corporatization and privatization of public enterprises) and the role of monetary policy and exchange rate management to support more growth with stability be adopted. Since the Bank of Thailand has also taken a relatively more and clear burden on the FIDF's debt, this part of the public debt management should also be managed such that it will not hinder the role of the monetary policy and exchange rate to support future economic growth. Though the difficulty of an appropriate and timely coordination of different macroeconomic policies should not be underestimated the present situation of a very low inflation should allow a more expansionary monetary policy. The private sector's spending can be stimulated through a low interest rate policy. A large and continuous budget deficit through the domestic bond financing can potentially cause the interest rate to rise or not falling enough crowding out private spending as well as net export through the nominal and hence real exchange appreciation.

Furthermore, though the revolving villege and urban community fund is a one - shot injection program, there are other intervention programs which cover a span of many more years. Many of these populist interventions are not well thought out and run against the concept of economic rationality. The government has paid a relatively less attention to the prudential and correct rule of marginal cost and benefit of public spending. The idea of setting up a government agency to curve imports through creating both tariff and non - tariff barriers also suggest a return to protectionism.

Moreover, the operation of the international rice and rubber cartel are likely to be unsuccessful in the long run causing an additional cost to the treasury at a time when a large public debt service is already an emerging constraint on the government investment spending.

Table 1
Unemployment Rate, February 1996 – May 2002

1996	Feb	2.0
	May	2.0
	Aug	1.1
1997	Feb	2.2
	May	N.A.
	Aug	0.9
1998	Feb	4.6
	May	5.0
	Aug	3.4
	Nov	4.4
1999	Feb	5.2
	May	5.3
	Aug	3.0
	Nov	3.3
2000	Feb	4.3
	May	4.1
	Aug	2.4
	Nov	3.6
2001	Feb	4.2
	May	4.2
	Aug	2.1
	Nov	2.4
2002	Feb	2.8
	May	3.0

Source : National Statistical Office, as published in Bank of Thailand, Economic and Financial Statistics, June 2002.

Remark: Since 1996,the concept of "Labor Force" was revised to cover persons with the age of 15 years and over,as opposed to the original concept of 13 years and over.

Table 2
Thailand's External Debts and International Reserve to Short-term Debt, 1995-2002 Q2

	External Debts			Debt / GDP (%)	International reserve per Short-term debt (%)	Debt service ratio (%)		
	Long-Term	Short-Term	Total			Public sector	Private sector	Total
1995	48,434.0	52,398.0	100,832.0	60.0	70.7	2.8	8.6	11.4
1996	60,999.0	47,743.0	108,742.0	59.7	81.1	2.5	9.8	12.3
1997	70,982.0	38,294.0	109,276.0	70.1	70.4	2.7	13	15.7
1998	76,641.0	28,421.0	105,062.0	93.2	103.9	3.3	18.1	21.4
1999-Q1	76,590.0	25,610.0	102,200.0	86.4	116.9	3.9	17.8	21.7
1999-Q2	75,810.0	23,550.0	99,360.0	82.5	133.5	3.6	15.5	19.1
1999-Q3	75,916.0	21,471.0	97,387.0	78.9	150.7	5.4	18.8	24.2
1999-Q4	75,512.0	19,539.0	95,051.0	77.6	178.0	2.9	10.2	13.1
2000-Q1	73,602.0	17,952.0	91,554.0	73.9	179.8	5	11.1	16.1
2000-Q2	70,111.0	17,066.0	87,177.0	69.8	188.3	3.5	11.8	15.3
2000-Q3	68,467.0	15,240.0	83,707.0	67.4	211.6	3.8	13.1	16.9
2000-Q4	65,021.0	14,694.0	79,715.0	65.1	222.3	3.9	9.7	13.6
2001-Q1	61,261.0	14,545.0	75,806.0	63.5	222.0	6.8	14.2	21
2001-Q2	59,141.0	15,158.0	74,299.0	63.9	208.5	7.4	9.6	17
2001-Q3	58,158.0	14,617.0	72,775.0	63.4	223.3	9.1	15	24.1
2001-Q4	54,122.0	13,389.0	67,511.0	58.8	246.8	8.9	11.9	20.8
2002-Q1	51,248.0	13,166.0	64,414.0	55.5	255.3	10.4	11.5	21.9
2002-Q2	51,711.0	13,389.0	65,100.0	-	274.8	7.2	6.8	14

Source : Bank of Thailand, Economic and Financial Statistics, June 2002..

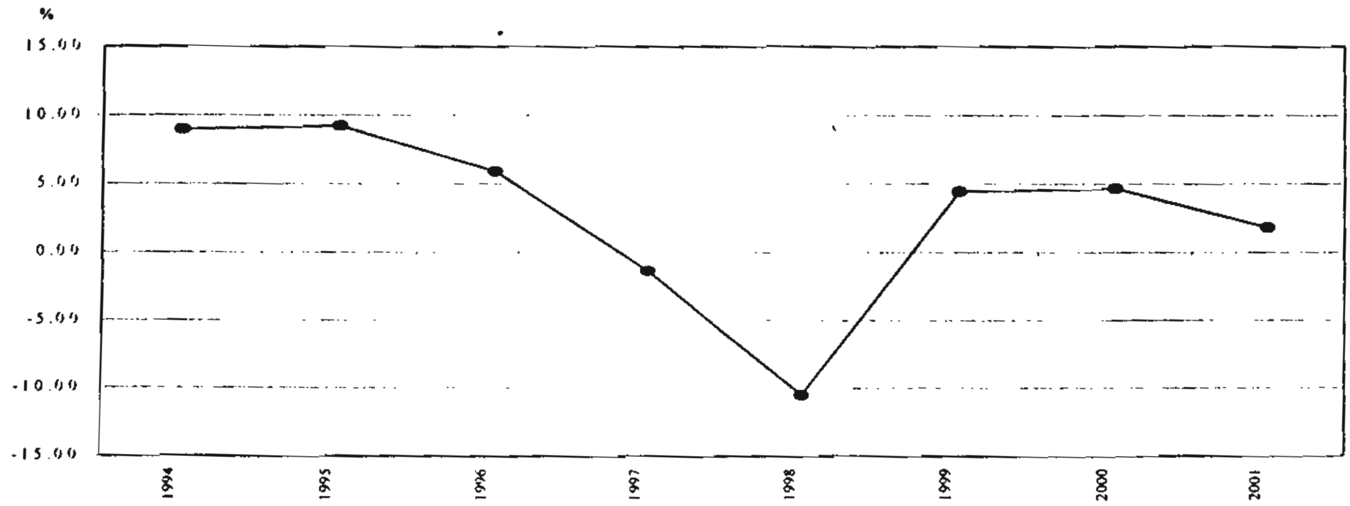
Table 3
Public - Sector Fiscal Balance (GFS Basis), Fiscal Year 2001 -2003

Fiscal Year	2001		2002 e		2003 e	
	Millions of Baht	% of GDP	Millions of Baht	% of GDP	Millions Of Baht	% of GDP
Central Government						
1. Revenue	765,396.9	15.1	833,232.0	15.9	797,000.0	14.4
2. Expenditure from Budget	875,986.8	17.3	975,849.9	18.7	967,559.0	17.5
3. Budgetary Balance (1-2)	-110589.9	-2.2	-142617.9	-2.7	-170559.0	-3.1
4. Non - Budgetary Balance Other than External Loans	25,537.3	0.5	-	-	-	-
5. Expenditure from External Loans	36,610.4	0.7	21,530.1	0.4	26,000.0	0.5
6. Extra - Budgetary Balance	18,802.0	0.4	23,914.3	0.5	59,949.9	1.1
7. Central Government Balance (3+4-5+6)	-102861	-2	-140233.7	-2.7	-136609.1	-2.5
Local Governments						
8. Revenue	144,186.8	2.8	171,975.1	3.3	196,803.0	3.6
9. Expenditure	141,721.8	2.8	169,107.7	3.2	193,028.0	3.5
10. Local Government Balance (8-9)	2,465.0	0.0	2,867.4	0.1	3,775.0	0.1
Non-Financial State Enterprises						
11. Retained Income	168,263.0	3.3	127,163.0	2.4	105,186.1	1.9
12. Capital Expenditure	152,271.0	3.0	139,472.0	2.7	120,945.9	2.2
13. Non-Financial State Enterprises Balance (11-12)	15,992.0	0.3	-12309	-0.2	-15759.9	-0.3
14. Overall Public Sector Balance (7+10+13)	-84404.0	-1.7	-149675.3	-2.9	-148593.9	-2.7

Source : Fiscal Policy Office, Ministry of Finance, August 2002
e = Estimated Value

Figure 1
Thailand's Real Economic Growth Rate

A) Yearly Data : 1994 to 2001



B) Quarterly Data : First Quarter 1994 to Second Quarter 2002

Figure 2
Growth Rate of Consumption Expenditure, 1996 - 2001

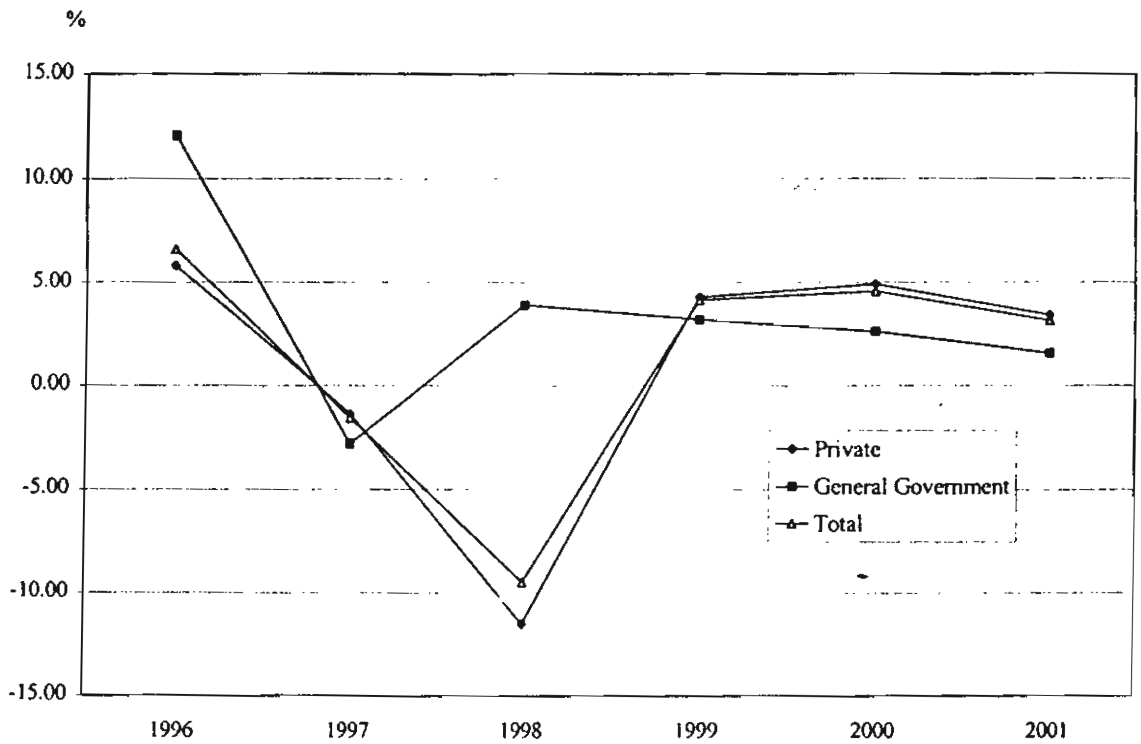


Figure 3
Growth Rate of Investment, 1996 – 2001

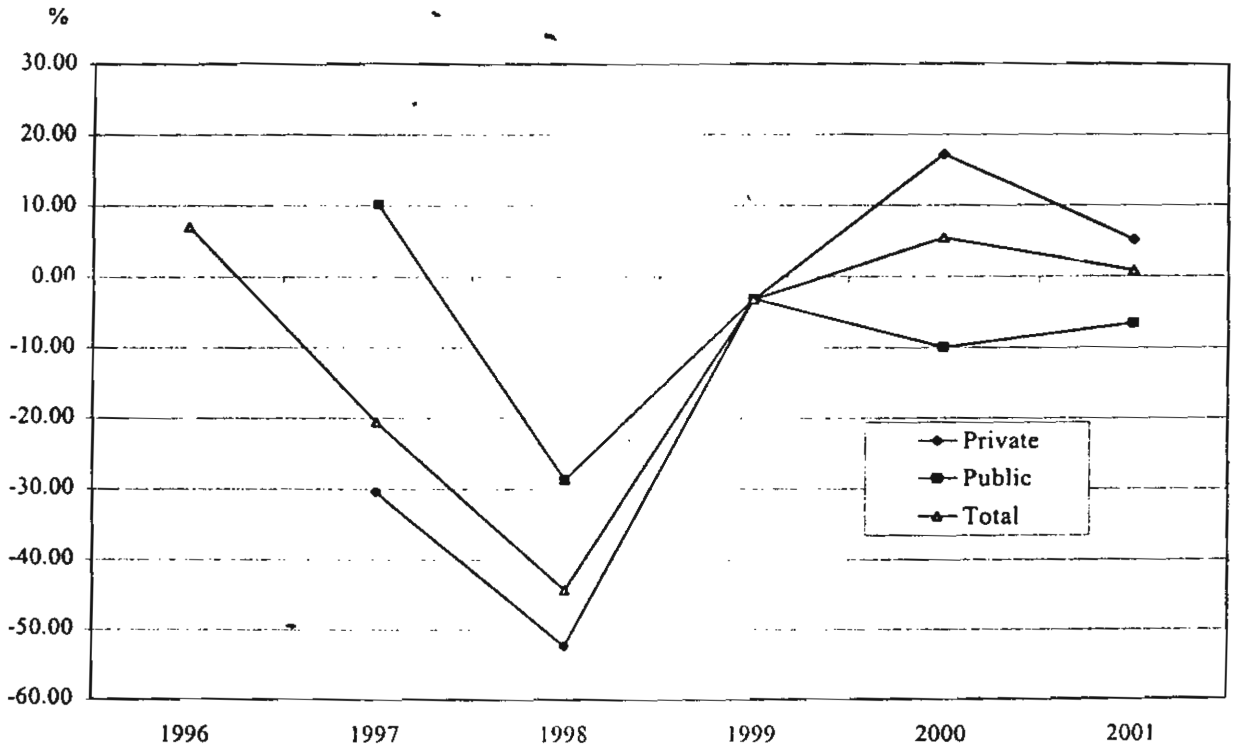


Figure 4
Thailand's Current Account Position as a Percentage of GDP,
1999 - 2001

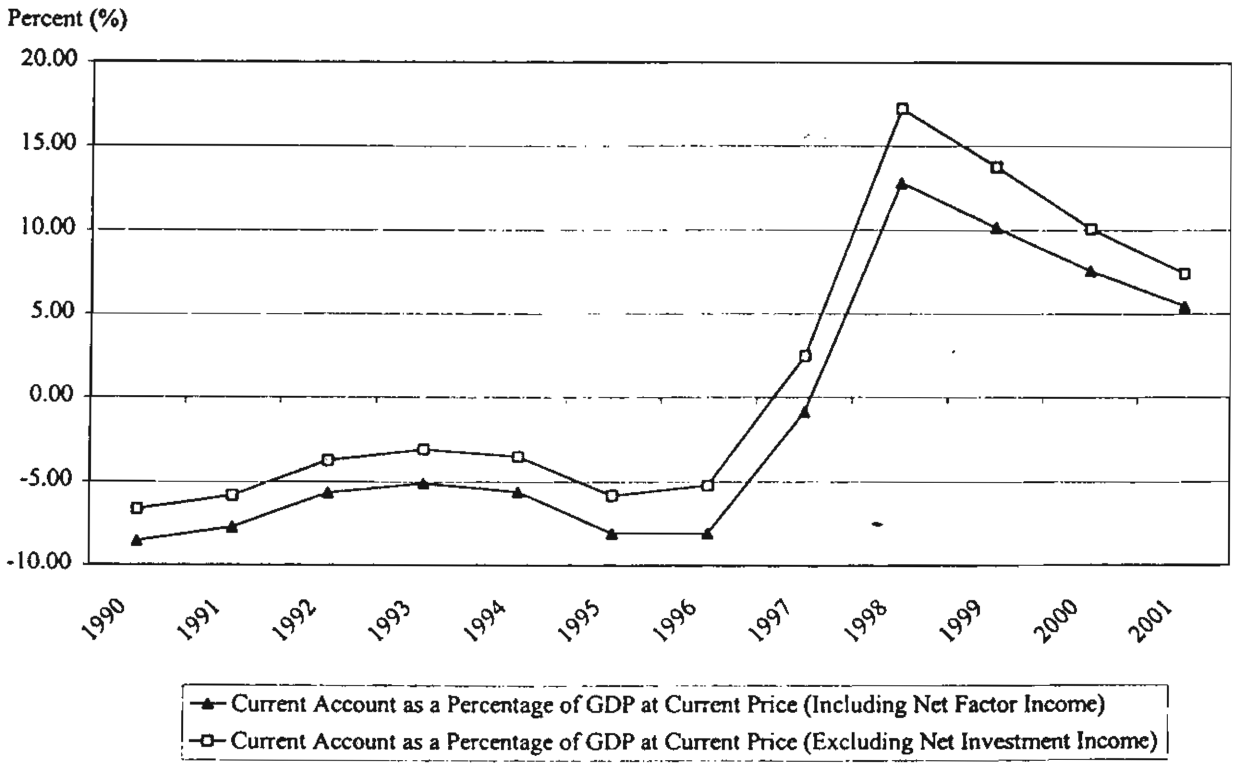
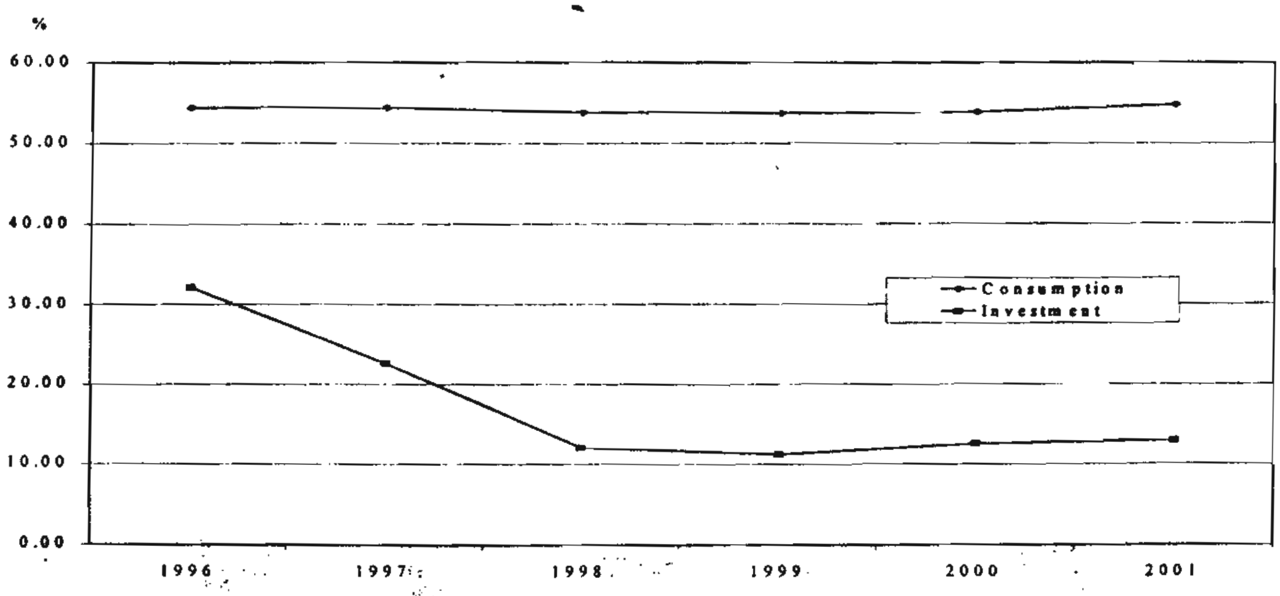


Figure 5
Consumption, Investment and Export as a percentage of GDP,
1996 - 2001

A) Private Sector



B) Public Sector

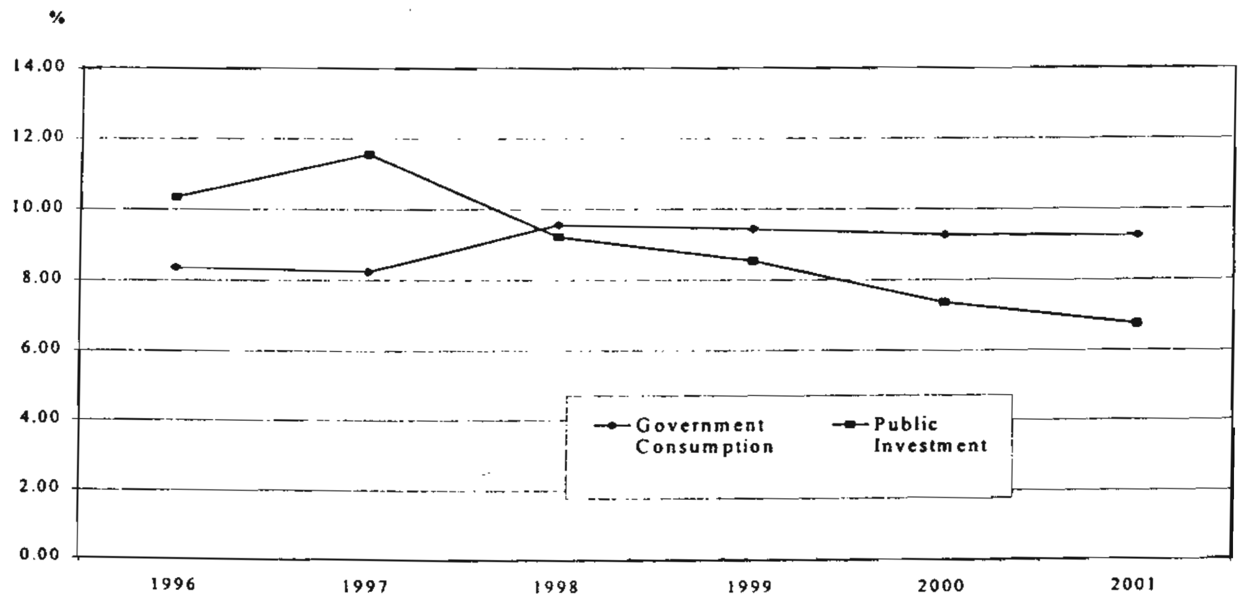


Figure 5 (Continued)

C) Whole Thai Economy

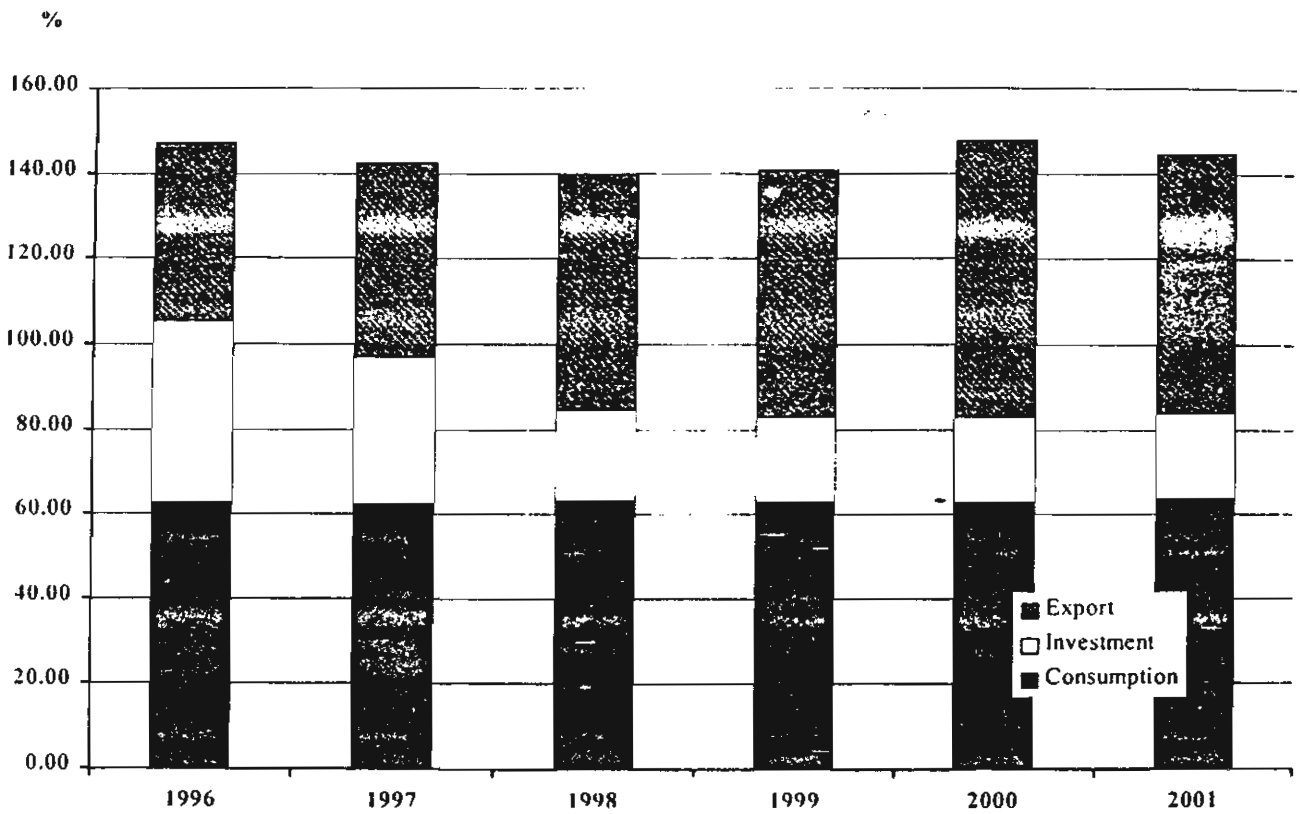


Figure 6
Balance of Payments (US$), 1991 - 2002 Q2

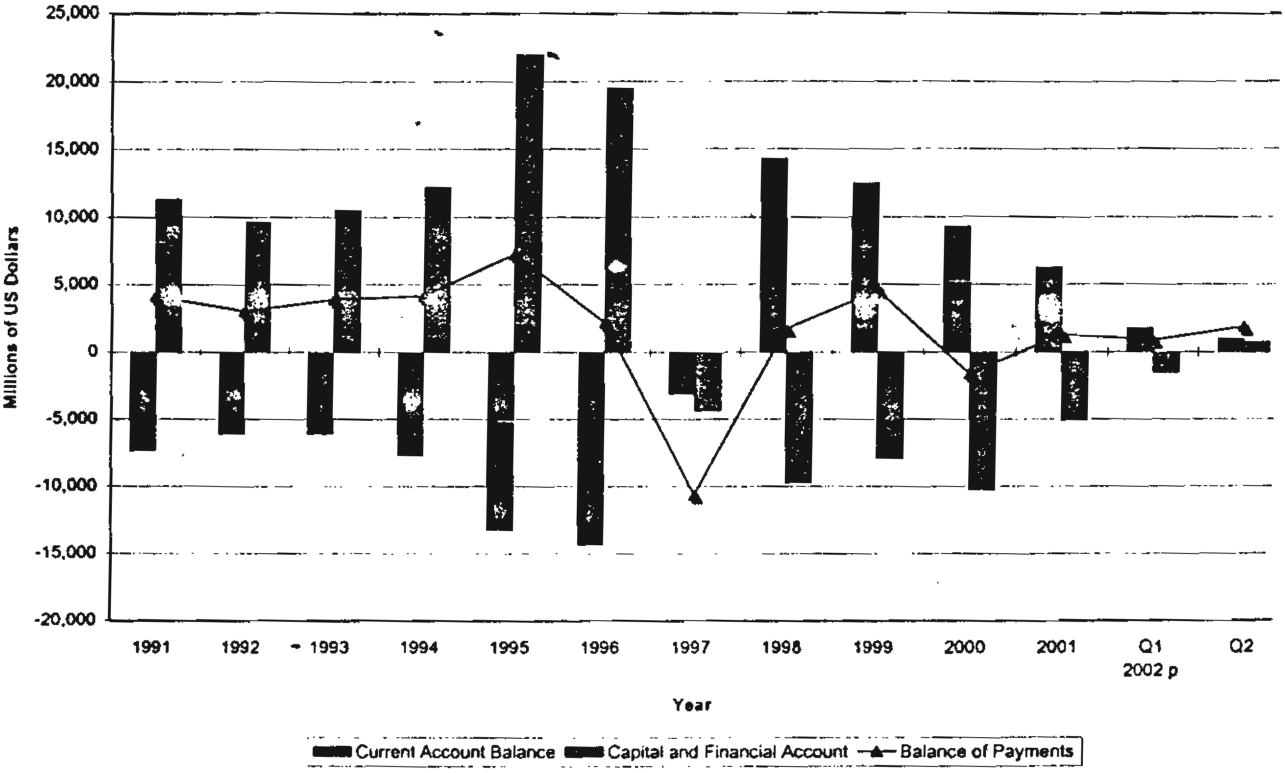
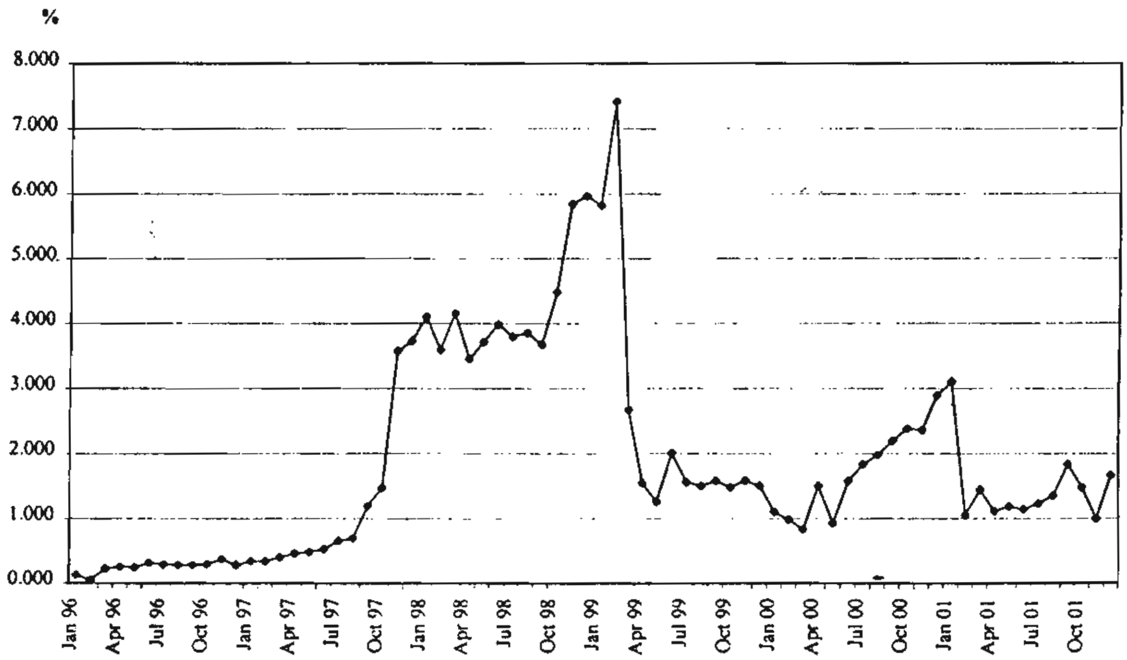


Figure 7
Estimates of Country Risk Premiums for Thailand,
January 1996 to December 2001



Source of Data : Datastream

Figure 9
Inflation Rate (CPI), Nominal and Real Interest Rate,
January 1997 – June 2002

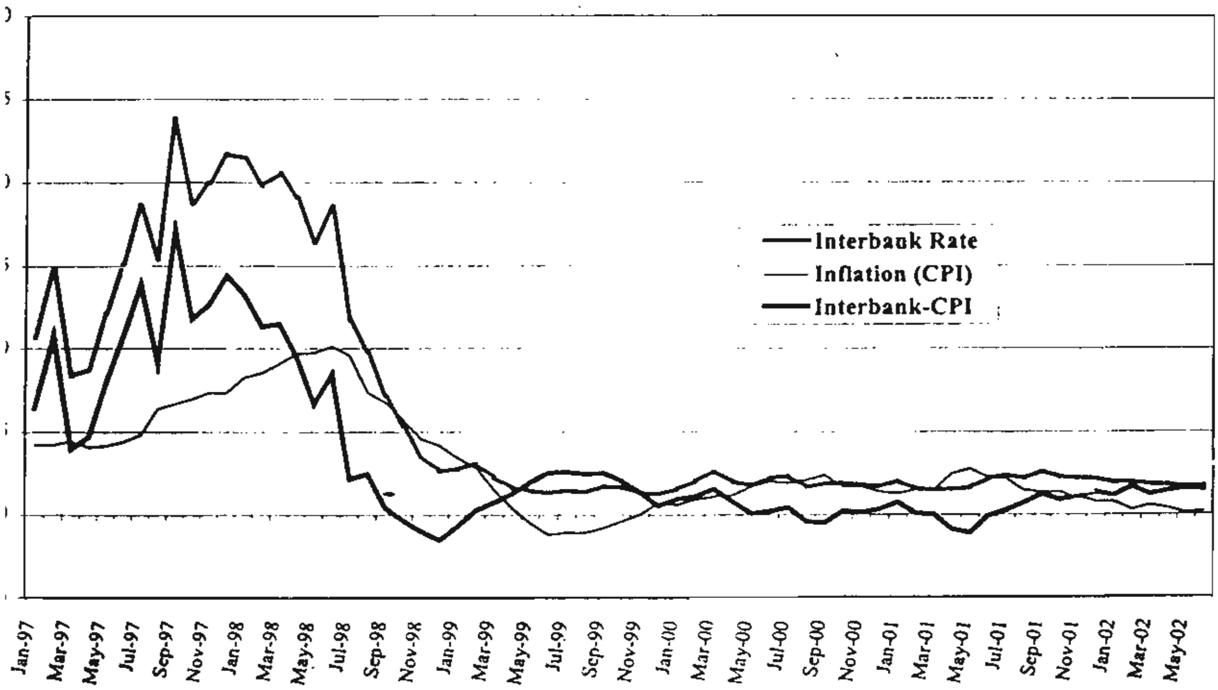
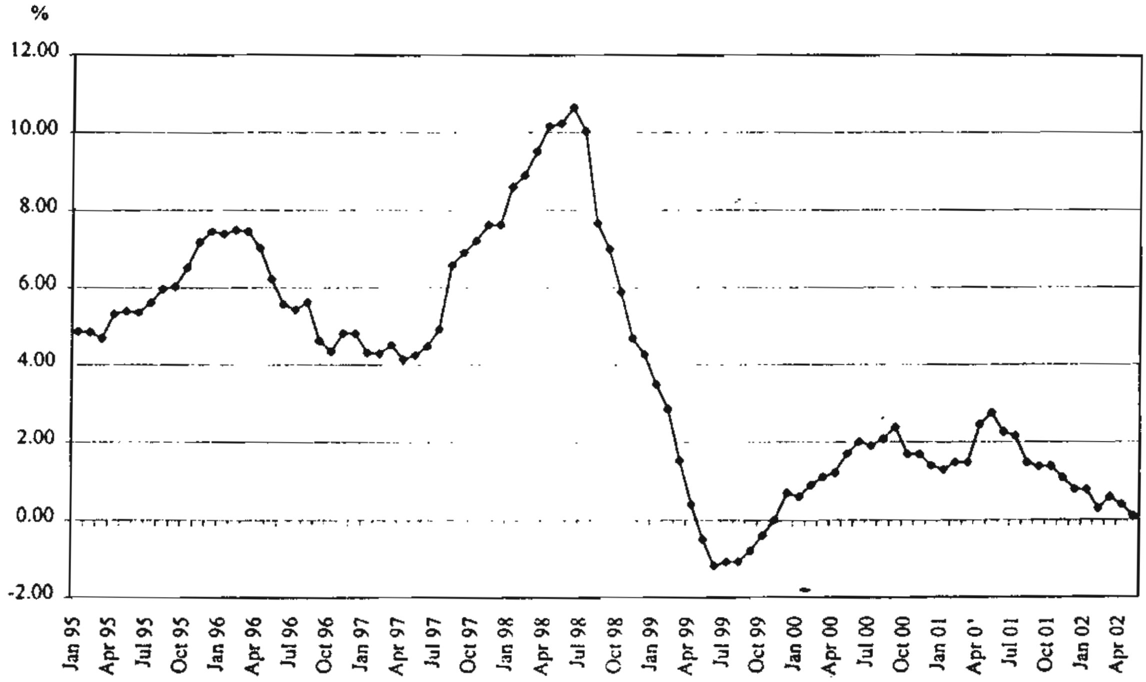


Figure 8
Thailand's Inflation Rate (CPI), January 1995 to May 2002



Source of Data : Bank of Thailand

Figure 10
Nominal and Real Effective Exchange Rate of Baht in Terms of Foreign Currencies,
January 1995 – May 2002

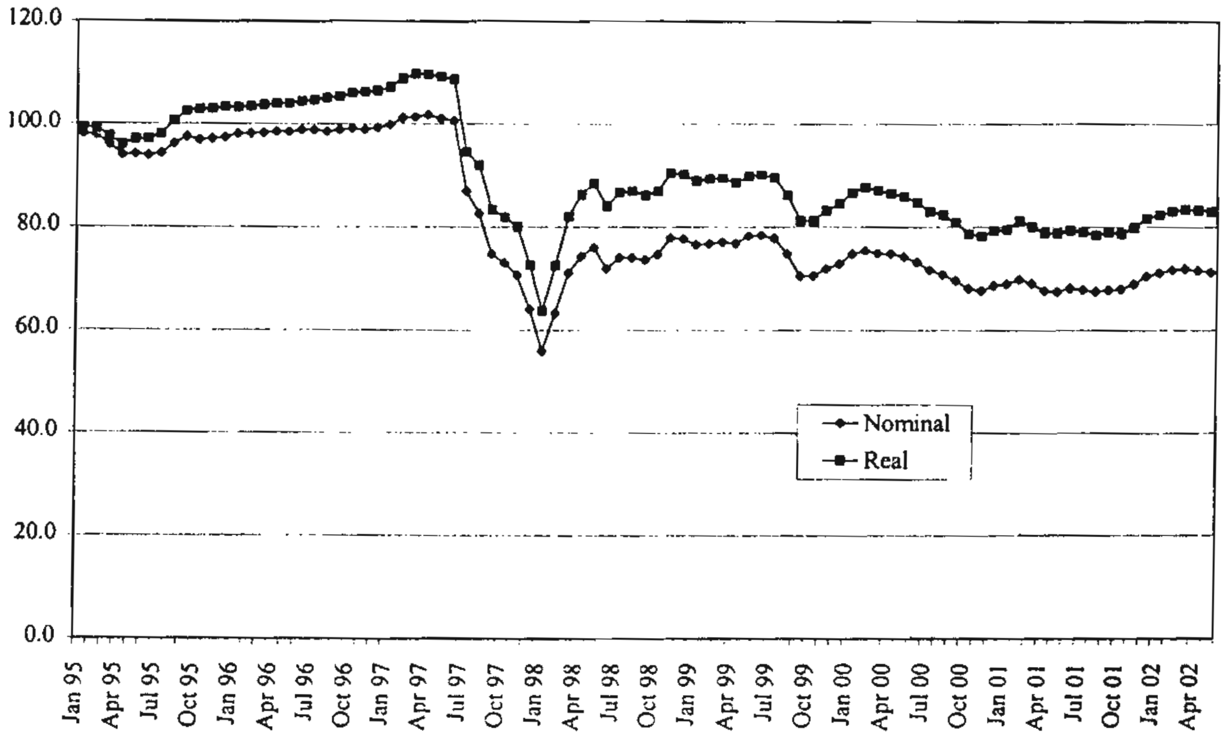
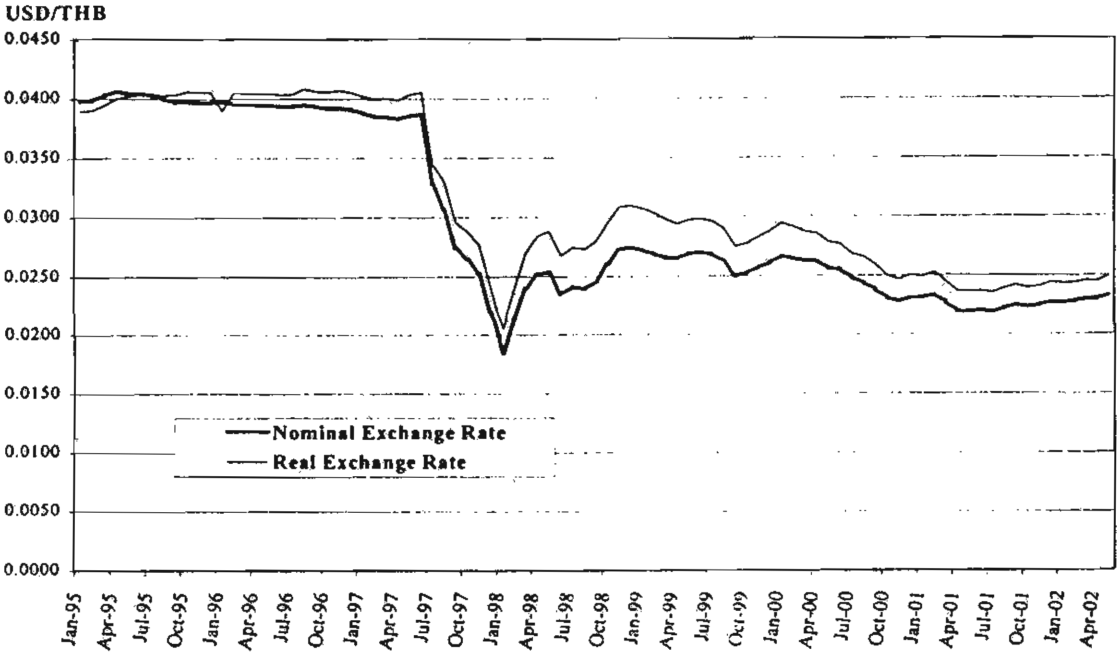


Figure 11
Nominal and Real Exchange Rate of Baht in Terms of U.S. Dollar, January 1995 - May 2002

A) CPI Base



B) PPI Base

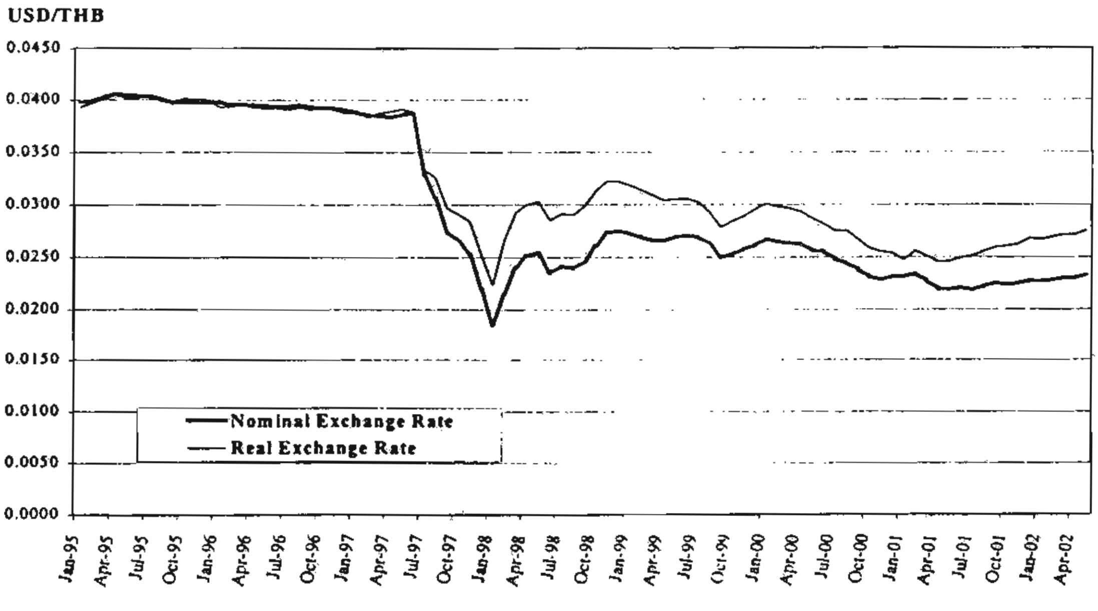


Figure 12
Net Foreign Assets, Net Domestic Assets and Monetary Base,
January 1990 – March 2002