The Fallout of 9/11 on Asian Economies: Policy Options

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As a result of the September 11, 2001 terrorist attacks on the United States, the immediate reaction of various economists around the globe was that the Asian economies, in particular the Southeast Asian economies, would deepen, leaving no room for an early rebound from the 1997 financial crisis. However, as events developed, the global as well as the regional economic developments gave way for greater optimism towards the immediate economic prospects of these countries. The disruption of the economy following the attacks turned out to be less disruptive than originally thought as statistics show distinct signs of improvement in the global economic situation. In the regional front, most regional stock markets rallied and consumer confidence improved, boosting domestic demand. The result of the unprecedented fiscal measures and monetary stimulus such as cuts in interest rates, income tax cuts, and post-attack government spending led to the mild rebound strengthening to more or less a full-blown economic recovery since the later part of 2002.The trend continues even at a faster pace. In nutshell, the completion of completion of initiated reform agenda and maintenance of strong economic fundamentals will provide necessary policy options for the countries in the event of uncertainty in the global recovery.

INTRODUCTION

The world has turned into a global village following the adoption of outward oriented liberal economic policies by many countries. This process of globalisation is further enhanced by the unrelenting financial innovations and rapid developments of technology in the area of information and communication. As a consequence, countries now have become increasingly integrated and more dependent on each other. This growing degree of dependence has been

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increasingly making economies more vulnerable to external shocks. Any disturbance in one part of the world, could more or less simultaneously affect the other parts.

Turbulence in financial market is not a new phenomenon and in all probability, will continue to occur with increased integration of world financial markets. Such contagion effect could be best exemplified by the financial crisis of 1997 in Southeast Asia. While policy-makers could do much to minimise peaks and troughs of business cycle of boom, recession, depression and recovery through prudent and timely policy interventions in reducing the possibility of the occurrence of a recession, careful analysis of financial crises and recessions with their causes, effects and remedies, leads to the fact that free market economy is not exempted from these irregular business cycle swings. Policymakers are often urged to strengthen macro-economic discipline and to improve the soundness of the financial system as preventive measures. However, in many cases, despite pre-emptive measures; due to unforeseen circumstances, economies may still experience recession as a consequence of global economic slowdown. The adverse impact brought forth by the incidence that occurred on September 11, 2001 in the United States is one such unforeseen event.

As the countries both in the South and East Asia are being increasingly integrated to the global economy, more prone are these economies to the business cycles of the industrial economies. These economies are not left behind in facing new challenges especially during times of synchronized downturns in major industrial countries. As such a major challenge that these economies face is in finding ways to shield the negative impact of the global economic downturn while maintaining the level of integration so as to reap the benefits of upswings, which should help them to move into higher growth paths.

The impact of the global slowdown on most of the Asian economies would depend mainly on the degree of economic integration, particularly trade linkages with the industrial countries. The fact that the volume of world trade in goods and services decelerated to negative 0.2 percent in 2001 from 12.4 percent in 2000 reflects the impact of the global slowdown accentuated by the September 11, crisis on highly trade dependent countries. As such the intensity of policy response would also depend on the degree of economic integration to the global economy. If you take the example of highly trade dependent countries in the Southeast Asia like Singapore and Malaysia, they have been adversely affected to the farthest extent than less trade dependent countries like Myanmar and Nepal. (Table1)

In particular, countries with strong trade linkages with the US, the Euro area and Japan have been severely affected as a consequence also of the September11, 2001 episode. To mitigate the impact of the external slowdown, highly trade dependant countries need more speedy and intense policy responses. Standard policy responses to this kind of external shocks, such as stimulus macroeconomic policies to boost aggregate demand, have been well documented in the literature. However, the availability and effectiveness of standard policy options depend on the existing domestic macroeconomic environment and the degree of structural rigidities in individual economies. Therefore, standard policy options may not be applicable uniformly across all countries. Individual country positions during the slowdown need to be assessed prior to prescribing specific policy responses. This requires a detailed analysis of individual country positions at the time of the slowdown. *The assessment and analysis of this paper are focused on the period 2000-2002 and a special focus is laid on the resultant effects of the terrorist attacks in the United States on September 11, 2001.*

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

	1997	1998	1999	2000	2001	2002**
Indonesia	47.5	86.2	57.9	69.0	63.5	51.1
Korea	58.9	70.2	64.5	72.6	68.5	62.6
Malaysia	151.3	174.5	189.5	200.1	183.8	182
Mongolia	96.9	101.5	112.9	113.0	115.4	109.5
Myanmar	1.7	1.4	1.0	1.0	1.0	n.a.
Nepal*	41.4	38.7	36.0	41.7	41.7	36.6
Philippines	74.8	90.6	83.3	90.6	83.7	92.8
Singapore	265.0	250.9	266.1	287.3	271.0	277.5
Sri Lanka	67.8	67.4	77.4	70.1	66.5	63.9
Taiwan	79.1	78.6	81.8	90.8	79.4	86.3
Thailand	74.1	83.4	85.3	106.9	107.9	105.6

Source: Computed from IFS data and EIU data for Taiwan
* *Nepal Rastra Bank*
** *Key Indicators 2003, Vol 34, Asian Development Bank*

GLOBAL ECONOMIC SETTING[1]

Prior to September 11, the world economy was already experiencing sluggish economic growth with the south east Asian countries still in the midst of recovery following the crisis that erupted in the early 1997.[2] Policy-makers in the three major economies of the world, viz., the US, Euro area and Japan had become increasingly confronted with mostly negative developments in the economic front in the form of deteriorating corporate profits, falling stock prices, rising unemployment, and faltering investor confidence. There was a shift of focus from inflationary pressures to a foreseen recession and short-term interest rates began to fall in many economies. The optimistic view therein, that the US economic activity would rebound in the third quarter of 2001 had faded by mid-year as did subsequent hopes for a modest US rebound in late 2001. Moreover, in the second

[1] This study is based exclusively on the various issues of the World Economic Outlook, IMF, Asian Development Outlook, ADB , Consensus Forecast and Asia pacific Consensus Forecast, Consensus Economics, and SEACEN Outlook.

[2] The timely adoption of appropriate policy measures by the respective crisis-led countries helped their economy to recover though at a slower pace.

quarter of 2001, economic conditions in Japan deteriorated significantly, and the pace of economic activity in the Euro area had also slowed substantially. This situation was unique in the context of a global economic slowdown as these three major world economies which together account for roughly 45.0 percent of the world's output and absorb nearly 50.0 percent of total exports from the Asia and the Pacific region was simultaneous in a process of experiencing recession. The global economy too became vulnerable through an erosion of the financial position of consumers, corporations, and governments. Sentiments were also affected by the global slowdown, leading to abrupt reductions in private spending.

The US economy considered as the growth engine of the world economy had already slowed to 1.9 percent economic growth in the last quarter of 2000. It further slowed to 1.3 percent and 0.2 percent respectively in the first two quarters of 2001 before declining to 1.3 percent in the third quarter of 2001, as investment and exports continued to contract while domestic consumption slowed to 2.5 percent growth in the second quarter of 2001 the smallest expansion in four years. Even though the real GDP growth rate recovered in the fourth quarter, subsequent financial and accounting scandals and lower corporate profits weighed heavily on the US growth to reach 2.4 percent in 2002.

The Euro area was expected to be relatively unaffected by the information, communications and technology (ICT) correction in the US. However, real GDP growth, which was quite strong in the first quarter of 2001, declined during the second and third quarters. This was due to the slowing growth of exports both to the US and Asia and to the weakening domestic demand as high oil prices, slowing job growth, and declining equity values (especially in the telecommunication sector) impacted profits and real incomes. Private consumption growth slowed from 2.0 percent in the first quarter of 2001 to 1.7 percent in the second and remained stagnant at 1.7 percent in the third quarter also. The unemployment rate remained stable at 8.3 percent throughout the second and third quarters of 2001and increased slightly to reach 8.4 percent in 2002.

In Japan, the economic growth was modest and was expected to sustain. However, economic activities weakened sharply in the first quarter of 2001 (See Table 2). The unexpected severity of the global information, communications and technology (ICT) sector slowdown adversely affected the economy with a double-digit contraction in export and private investment demand throughout the year, after a strong performance in the last quarter of 2000. Consumption which sustained quarter-on-quarter growth of 2.0 percent in the second quarter, slowed down to less than 1.0 percent in the third quarter with demand weakening, industrial production on a downward trend throughout 2001, contracting by 11.7 percent in August 2001 from a year earlier. The unemployment rate reached a postwar high of 5.1 percent as at the end of the third quarter of 2001. The unemployment rate further aggravated to reach 5.4 in 2002.[3]

Inflationary pressure built throughout much of the first half of 2001, eased somewhat in the US and Europe in the third quarter. In the US, consumer prise eased to 2.6 percent in September 2001 from a year earlier, while in Europe, annual inflation measured by Consumer Price Index (CPI) eased from 3.0 percent in June to 2.5 percent in September 2001. However, in Japan, prices continued to drop by 0.8 percent in September 2001 from a year earlier.

Even before 11 September terrorist attacks, the global slowdown was turning out to be deeper, longer, and more synchronised than originally thought. Any hope of recovery was dashed following the 11 September incidents. The incident saw an even sharper and simultaneous decline in economic growth across major economies.

ASSESSMENT OF THE IMPACT OF THE SEPTEMBER EVENT

Direct Impact on the US Economy

As noted above, the unprecedented terrorist attack of 11 September on Pentagon and the World Trade Centre in the United States came at a time of weakening global economy. The incident directly disrupted the US economic activity and significantly increased uncertainty over future economic conditions. In addition, the level of consumers' confidence in the US, which had already weakened even before the 11 September terrorist attack, was further undermined after the attacks. The 11 September attack pushed further the already slowing US economy. It has had a strong negative effect on the confidence of both the businessmen and the consumers, which resulted in an 11.0 percent contraction in private investment, and private growth slowing to 1.0 percent, the lowest in eight years.

The terrorist attacks resulted in a heavy loss of innocent lives and a huge destruction of property. In addition, because of the size and the nature of the attack, the effects were expected to last for quite some time. The loss of property from the terrorist attack of 11 September 2001 was estimated at about $16 billion. This amount worked out just above 0.15 percent of US annual GDP (US Bureau of

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[3] The weakening consumer and business sentiments towards the end of 2001 was an indication towards a long period of recession. This triggered further losses on the Nikkei 225 Index, and caused problems for the banks in their balance sheet, which since end-September 2001, were required to value stock holdings at market prices. This could in the longer run cause repatriation of Japanese bank holdings from other countries or reduce the activities of Japanese banks from the emerging Asian economies. However, the Japanese government took aggressive policy measures towards financial sector reforms in 2001 and is moving ahead towards eliminating non-performing loans by end 2004.

Economic Analysis, 2001)[4]. Although the human toll as well as the property damage may have had a limited macroeconomic impact, the short-term losses through specific industries could be beyond what has been anticipated.

As a consequence of the terrorist attacks, the US airline sector had lost around 20.0 percent of its relative value, while this percentage worked out at around 15.0 percent for Europe and Japan. Other service industries, viz., hotels, tourism, travel agency, restaurants, etc. besides airlines have also been hit hard by the attack. Relative equity values for hotels and leisure facilities were off by around 15.0 percent in the US and Europe, although in Japan they gained a little which possibly reflects that Japan has more limited need for air travel.

The terrorist attacks also resulted in a series of temporary disruptions to the network of the present mode of the economy. In the US, consumption fell significantly during September 2001, as most people stayed indoors. For example, television viewers surged by almost 50.0 percent immediately after the attacks and on an average crowd at the shopping malls fell by about 5.0 percent or more.

Table 2. Direct Cost of September 11 Attacks
(In billions of US dollar)

Losses	Costs
Structure, Equipment and Software	
Private	14.0
State and local government*	1.5
Federal government	0.7
Sub-total	*16.2*
Other Insurance Losses	
Life and related costs	2.6
Workers compensation	1.8
Homeowners and other	0.6
General government	0.2
Sub-total	*5.2*
Total	*21.4*

* Largely New York City subways.
Source: US Bureau of Economic Analysis (2001Q.b).

The closure of the US stock exchanges for four days and other financial disruption also reduced revenues. Stock prices in the US were generally seen to be falling and investors as well as consumer confidence was at the lowest level, the expectation for future earnings was low and as such the stock prices were subsided drastically. In conjunction to this atmosphere of increased uncertainty and heightened recession fears in the wake of the attacks on the US, stock markets

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4 As reported in the IMF World Economic Outlook, December 2001.

underwent steep corrections in September, experiencing significant volatility. The Dow Jones Industrial Average, which was down by 11.0 percent throughout September 2001 compared to end-December 2000, fell by 14.3 percent over a period of one week, which means a drop of 23.6 percent since end-December 2000. The initial magnitude of the reduction in US demand following the attack and its spill over effects to Europe and Japan were somewhat underestimated and the extent to which world trade would be reduced was not anticipated. The subsequent US-led military operations in Afghanistan, and the anthrax scares had also introduced an extra element of risk and uncertainty. This further slowed the already weakening global economy.

Table 3. Macro economic Indicators of the Three Major Economies

	2000	2001				2002+
	Q4	Q1	Q2	Q3	Q4	Q1
			(Percent)			
Euro Area						
Real GDP growth rate	2.8	2.4	1.6	1.4	0.6	0.9
Unemployment rate	8.5	8.4	8.3	8.3	8.4	8.4
Consumer price inflation rate	2.6	2.6	3	2.5*	2.2*	2.3*
Japan						
Real GDP growth rate	2.4	1	-1.2	-0.5	-1.2	0.2
Unemployment rate	4.8	4.9	5.1	5.1	5.1	5.4
Consumer price inflation rate	-0.6	-0.5	-0.7	-0.8	-1	0.9.
United States						
Real GDP growth rate	1.9	1.3	0.3	-1.3	1.7	2.4
Unemployment rate	4	4.2	4.5	4.8	5.6	5.8
Consumer price inflation rate	3.4	2.9	3.2	2.6**	1.6***	1.3

* Refers to harmonised Index of Consumer Prices (HICP)
** Unadjusted CPI for the 12-month period ended in September.
*** Unadjusted CPI for the 12-month period ended in December.
Sources: ADO 2001 Update/ ADB
European Central Bank, September 2001, Monthly bulletin (online), available:
+WEO/IMF Sept. 2003
www.ecb.int/pub/pdf/mb200204en.pdf; Government of Japan (online), available: www.stat.go.jp/english/19.htm; US Government, (online), available: www.fedstats.gov

Impact of the 11 September Event on the Asian Economies

The terrorist attacks that affected the US economy directly generated a significant impact on Asian economies as a whole. These economies, some in the midst of recovery from the Asian financial crisis of 1997 were already adversely affected by a sharp fall in external demand even before the attack. There are a few avenues through which the effects of the deteriorating global economic downturn were transmitted to developing Asia. Firstly, in the short-run, global commerce was affected severely. The general worsening of confidence dampened the global trade further, placing additional downward pressure on export volume and commodity prices. In fact, the commodity prices were sharply lowered after the attacks. This could adversely affect trade in goods over a long period by increased transaction costs, although the magnitude of this effect was not expected to be very large. Secondly, trade in services, especially tourism and banking sector showed immediate signs of being badly affected. In the longer-run, these sectors will continue to be badly hit by increased uncertainty.

Secondly capital flows fell as risk premiums rose. As such, business was affected negatively by reduction in revenue and access to the capital at the same time. In the longer-run, this could even lead to a failure of weak companies. Although these trends were already evident, after 11 September terrorist attack, the availability and terms of financing have become even tighter both for the governments and private sector. Another prominent channel of transmission operated through financial market linkages. Portfolio investment inflows were already lowered before the attacks but many emerging economies that experienced steep stock-market corrections immediately following them have had only partial recoveries.

In summary, the extent to which the emerging Asian economies were affected depended on: (a) how much they are dependent on global trade. For example, for those economies with high merchandise exports to GDP ratio, the impact of the delayed recovery in global trade may mean a longer period of significant lower growth; and, (b) how vulnerable these economies are to heightened political uncertainty.

Financial Markets and Capital Flows

The immediate impact of the terrorist attack of 11 September on Asian countries was severe. The financial market developments across the region, with a few exceptions, was heavily influenced by the downward and post volatility trends in US stock markets, cutting of the Federal Reserves interest rate and to some extent increased uncertainty and risk aversions of market participants. The initial reaction in the equity and financial markets was where regional Asian stock prices fell sharply immediately after the 11 September attacks. For example, The Peoples' Republic of China's (PRC) Shanghai A Share Index, which was opened to local investors in February 2001 and which rose quite rapidly through May suffered a sharp correction. Although the US, European and the Japanese bourses recovered well, most major markets have not been able to do so; some emerging economies within this region faced a surge of private capital outflows, attributing mainly to the outflows of portfolio investment combined with weak FDIs mainly due to higher uncertainty and risk aversion. Furthermore, since economic activities slowed down considerably, demand for foreign credit also slipped down; however some countries made larger net repayments regarding private credits as existing loans continued to be repaid. The crisis-affected economies of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand experienced net private capital outflows in 2001, having just had some capital inflows after the financial crisis; but the net outflows were still below the levels experienced in 1998 and 1999. However, in contrast, the private capital inflows in the PRC improved, attributable mainly to the increased foreign direct investment.

Trade

The volume of world trade in goods and services decelerated to negative 0.2 percent in 2001 from 12.4 percent in 2000. The severe disruption of trade was very significant in most Asian countries as economic performance of the newly industrialised economies within the region that account for over 35.0 percent of GDP in emerging Asia are very dependent on exports of goods and services. One of the most significant sectors that experienced contraction was the global ICT sector in which many emerging economies are highly dependent. The global price of semiconductor, its production and sales weakened in 2001, led by the collapse in the market for memory chips. Sales of final products, particularly computers were badly affected. Also as manufacturers[5] tend to dominate the external trade of most of the Asian economies, the high share of electronic exports in total exports and the sharp contraction in their prices suggested further weakening of the manufacturers' terms of trade from the already depressed level. The external environment also affected commodity prices, thereby changing the terms of trade of these economies in the region. The prices of most commodities fell immediately after the attack.

World oil prices declined to around \$18 per barrel by late November from \$25 prior to the attacks and the peak of over \$30 reached in 2000. However, after fluctuating at around \$20 per barrel through early November, oil prices softened further in response to OPEC's difficulties in co-ordinating global production cuts, particularly among non-OPEC producers. Most significant was the Russian commitments that fell short of the 200,000 barrels per day cut envisaged by the OPEC.[6] Nonetheless, oil prices showed upward trend in early March 2002 only to

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[5] The aftermath of 11 September negatively affected exporters through both direct and indirect linkages. The direct relationship between the price and volume of commodity production is ambiguous, depending on whether lower prices reflect lower demand or more supply. A decrease in demand as seen after 11 September episode would reduce output; an increase in supply, in contrast, would raise it. The indirect effects reflect the impact of changes in the terms of trade on real incomes and spending, and are unambiguous. It is obvious that deterioration in the terms of trade will reduce spending in the producing country on both the domestic and imported goods. Domestic output will fall unless some other factors, such as policy shocks, adjust it more than what is offset in the private demand. However, these indirect effects are likely to occur with some lags, as domestic spending exhibit inertia in response to changes in income. In term of trade, Hong Kong, China, Pakistan and Singapore were to be most affected.

[6] Prices clearly depend on the willingness of exporters to agree on production limits. Even if agreement is reached to a certain level, the scope for a significant increase in price is always limited by the weak global demand and also the incentives for producers to circumvent agreed limits if price rise.

renewed concerns about the stability of supply in the Middle East as well as of a stronger outlook for global recovery. This put Brent Crude spot price at US $ 23.79 a barrel by 15 March 2002.

The effect of the terrorist attack was also felt on the prices of non-fuel commodities. The aggregate index of non-fuel prices dropped by a further 6.0 percent from September to November 2001. The decline in commodity prices and oil has had a contrasting effect on Asian economies. Those who are net importers may have benefited which may have led to increasing real incomes, paving a way for monetary easing in response to global downturn. However, for net exporters, lower prices caused deterioration in terms of trade and lower real income.

Tourism

The 11 September attacks had an immediate and significant global impact on tourism. According to the World Travel and Tourism Council (WTTC), tourism contribution to World GDP in 2001 registered a contraction of about 1.0 percent against the previous projected growth of 3.0 percent. Although the big losses in tourism were borne by US and Europe, the impact spilled over to the Asian economies also. Particularly tourism in the South East Asia contracted by 1.8 percent in 2001.

Sector-wise, tourism and airlines were the two major sectors that have been most affected by the 11 September attacks. The effect was seen to be most significant in those economies with large tourism sectors, viz., Cambodia, Maldives, Nepal and Thailand. As expected, the effect on tourism varied highly across countries, depending on the share of tourism in the economy ranging from 0.9 percent of GDP in Mongolia to more than 7.0 percent in Malaysia (Table 4). In addition to this, a dropout in tourism arrival heavily affected a countdown on related industries such as hotels, restaurants, travel agencies, etc., with a very high

Table 4. Tourism Receipts As Percent of GDP, 2001

Indonesia	3.6
Korea, Republic of	1.5*
Malaysia	7.8
Mongolia	0.9
Myanmar (Burma)	n.a.
Nepal	2.9
Philippines	2.4
Singapore**	6.0
Sri Lanka	1.3
Taipei, China***	1.4
Thailand	5.8*

* Refer year 2000 data

** Refer to travel credit as percent of GDP

*** Refer to general merchandise: export fob as percent of GDP

Source: SEACEN member Central Banks
Asian Development Bank

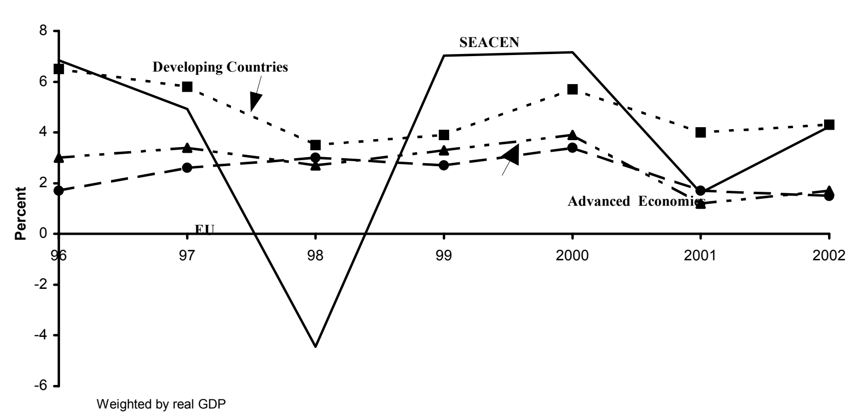
cumulative impact. Tourism is a big source of foreign exchange earnings. In Thailand alone, Net travel receipts account ranges for about 50.0 percent of its current account surplus, while the figures for Malaysia, Indonesia and the Philippines is 31.0 percent, 22.0 percent and 14.0 percent, respectively. Another immediate impact of the attack was on the airline industry. The sudden fall in the volume of passengers and the increase in the insurance costs after the attacks worsened the already ailing industry. In most of the cases, increase in insurance costs was passed on to the consumers in the form of surcharge. In other cases, such as in Korea and Singapore, the respective governments had offered subsidies to varying extents.

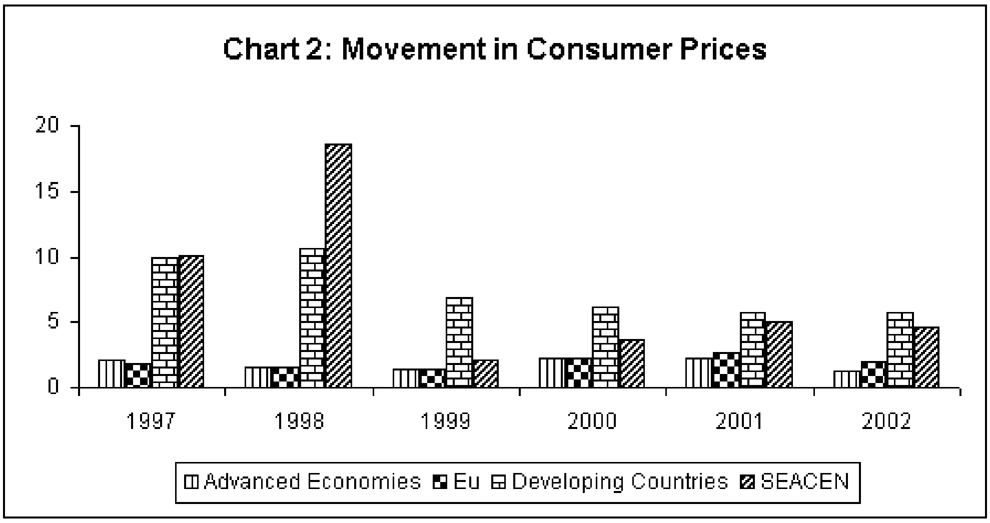
Impact of the September Event on SEACEN Economies

Considering the overall economic growth, in 2001, the *SEACEN* economies as a whole postulated a growth of 1.6 percent compared to 7.2 percent growth in 2000, while inflation edged up to 5.0 percent from 3.5 percent a year ago. (See, chart 1 and 2) However the inflation was still at the lower single digit. The aggregate merchandise exports of these countries fell down in 2001 (See, chart 3). In comparison, real GDP growth in the emerging Asia slowed down to 4.1 percent in 2001 from 7.1 percent in 2000.

The developing Asian economies that depend heavily on electronic exports suffered a contraction of about 10.0 percent. The south Asian economies in 2001 experienced a nominal growth of 0.5 percent in merchandise exports as against a growth of 17.3 percent in the year 2000. However, the exports of the People's Republic of China (PRC) and south Asian economies whose economies are more diversified and traditional expanded but at a much slower rate than that in 2000. The Central Asian economies, together with Mongolia also experienced a decline of 0.6 percent in merchandise export growth, mainly due to the contraction in the global commodity demand.

Chart 1: Rate of Growth of Real GDP





As a result of the terrorist attacks of 11 September, the macroeconomic policies of virtually all-emerging Asian economies, have become more accommodative. In addition to this, most also took relevant fiscal policy stances to counter the effects of global slowdown. For example, Singapore perhaps one of the most affected economies because of its limited domestic sector, had undertaken a very little monetary or fiscal stimulus prior to 11 September terrorist attack but in the wake of the attack, the authorities resorted to additional fiscal stimulus packages of about 7.0 percent of GDP in October 2001. Malaysia too announced a second fiscal stimulus package of 1.3 percent of GDP in October 2001. Korea resorted to a mix of fiscal and monetary policies. However in countries, such as the Philippines, fiscal constraints have limited the usage of additional fiscal stimulus.

It is therefore seen that those countries, which are more closely tied-up with the global economy, were affected more adversely. Singapore, which is the most open economy amongst the member countries, witnessed its GDP shrink by 2.4 percent in 2001 as against a growth of 9.4 percent in 2000. Similarly, Taiwan's economic growth shrank by 2.2 percent. The GDP growth in Malaysia, the Republic of Korea and Thailand also slowed down to 0.4 percent, 3.1 percent and1.9 percent respectively in 2001 while those of Indonesia, Mongolia and Nepal also decelerated to 3.3 percent, 1.1 percent and 4.6 percent respectively. Sri Lanka, on the other hand experienced a contraction of 1.4 percent, due to exacerbated drought and security problems. Philippines experienced only a modest slowdown in economic growth of 3.2 percent compared with 4.4 percent in 2000, in spite of a decline in exports by 16.2 percent, mainly attributable to the robustness of its agriculture sector, which remained resilient in the face of the external shocks.

Chart 3: SEACEN Trade Developments
Average Growth Rate of Merchandise exports and Imports
Current Account (% of GDP)

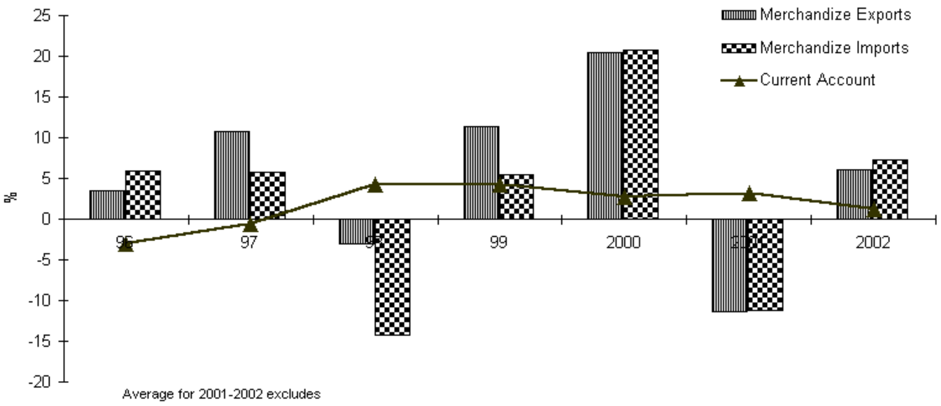
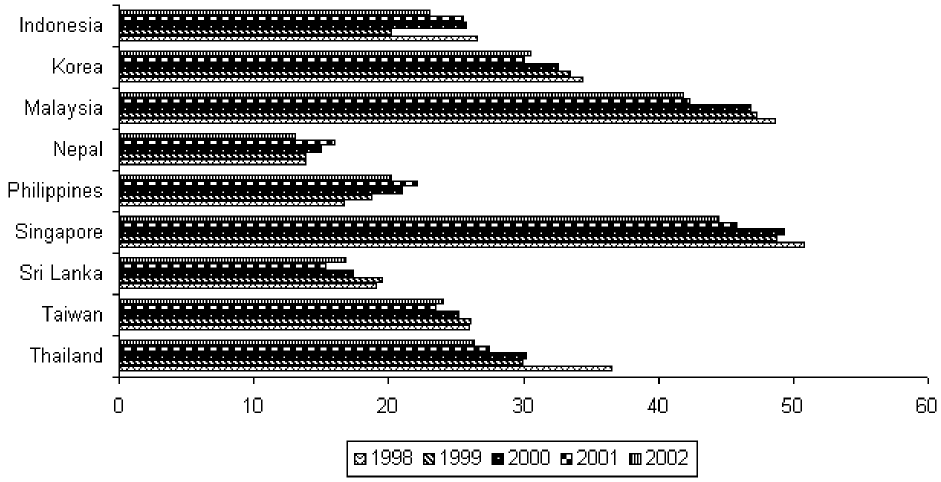


Chart 4: Gross Domestic Savings (Percentage of GDP) of Selected SEACEN Countries



The global slowdown had the most severe impact on the manufacturing sector in the south east Asian region. Singapore's manufacturing sector shrank by 12.0 percent as against an average growth of more than 14.0 percent in the previous two years. Likewise, in Malaysia, the manufacturing sector shrank by 5.0 percent in 2001 as against an average growth of more than 17.0 percent in the previous two years. Meanwhile, the manufacturing sector in Korea grew only by 2.0 percent as against an average growth of more than 18.0 percent in the previous two years, and in the Philippines, its manufacturing sector witnessed a decelerating growth in spite of a very mild slowdown in its GDP growth.

On the external front, the slowdown of the growth in the south *SEACEN* region in 2001 was also a direct outcome of a sharp fall in its exports. As a result of a slowdown in the global economy, world trade[7] in 2001 decelerated, thereby reducing the demand for the region's exports particularly for ICT and affected especially countries like Korea, Malaysia, Philippines and Singapore whose major chunk of the exports are electronic goods and depend heavily on the US market.

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

The economies in the region poised a diverse experience regarding domestic demand in 2001. In Malaysia, Singapore and Thailand, the growth in the domestic demand was generally seen to have declined but it went up in Korea, stayed somewhat unchanged in the Philippines and decelerated sharply in Indonesia. Since exports declined sharply, economic growth in these economies in 2001 was mainly the reason of the growth in domestic demand, which although was slower in many countries of the region, remained positive.

The weakening exports and decelerating growth however helped to contain inflation in most of the *SEACEN* countries with an exception of Indonesia. Singapore, which had a low inflation at 1.3 percent in 2000, experienced a mild deceleration, whereas in Malaysia, inflation rate was maintained at about 1.4 percent throughout 2001. However, in Korea and Thailand, inflation edged up somewhat in the beginning of 2001, but gradually declined since then to reach 4.1 percent and 1.6 percent respectively. In the Philippines, annual inflation accelerated to 6.1 percent in 2001 from 4.4 percent in 2000 whereas in Indonesia inflation in 2001 reached double digit at 11.5 percent from 3.7 percent in 2000.

The equity markets in the *SEACEN* countries although poised a declining trend till the third quarter of 2001, rebounded significantly towards the fourth quarter. In local currency term, these gains have ranged from 23.0 percent in Malaysia to 73.0 percent in Korea. The main factors attributable to the surge in the regional stock prices were the upswing in the US stock market after falling sharply as a result of 11 September terrorist attack and a better than expected growth among many of the economies in the region in addition to the declining interest rates.

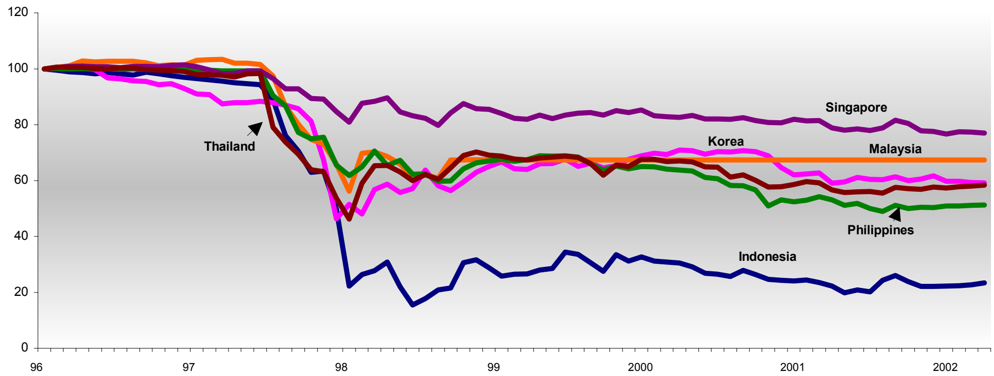
However, most of the economies in the region posted a decline in stock market capitalization in spite of the surge in the stock prices during the fourth quarter in

7 The World Bank's estimates puts forth a decline in the world trade by 1.0 percent in 2001 as against a growth of 13.0 percent in 2000.

2001. The market capitalization of these economies ranged from about 11.0 percent in Thailand to about 35.0 percent in Indonesia in terms of dollar values. The decline in market capitalization as a percent of GDP in 2001 was about 32.0 percent for Indonesia, 15.0 percent for Singapore, 24.0 percent for Malaysia and 6.0 percent for Thailand. However, in the Philippines, it increased though mildly, attributing mainly to the contraction in the dollar value of the country's GDP in 2001.

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

Chart 5: Bilateral U.S Dollar Exchange Rates of Selected SEACEN Countries
(U.S dollare per currency unit, January 1996=100)



The real effective exchange rates of several of these economies, with an exception of Singapore[8] started to appreciate gradually. This appreciation since 11 September 2001 is roughly about 2.5 percent for Indonesia, about 5.0 percent for Korea, about 6.0 percent for Malaysia, about 8.0 percent for Thailand and about 9.0 percent for the Philippines. Although the real effective exchange rates are still lower than the pre-crisis level, the continued real appreciation of the currencies could erode the export competitiveness of the economies.

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

Policy Responses and Assessment Undertaken by SEACEN Countries

However, it is clear that *SEACEN* countries recognize that a crisis may be eminent following the 11 September terrorist attacks with the implementation of some very tangible response to precipitate a fast response. The *SEACEN* countries were concerned about the spill over effects to the economy and many of the policy response were geared towards re-establishing confidence. It is also to be noted that the attack came at a time when the crisis-affected Asian countries were in the midst of recovery.

The major challenge faced by the *SEACEN* countries was how to strike a balance between the gain in output and the deterioration in the external payments position. The *SEACEN* economies with comfortable external payments and fiscal positions and low inflation were in a better position to relax their fiscal policy and reduce interest rates. For example, Malaysia and Singapore adopted aggressive stimulus measures. Malaysia expanded the fiscal deficit, relative to GDP, with supplementary spending and in Singapore substantial off-budget fiscal stimulus was introduced in the face of rapidly slowing economic conditions, while the other governments pursued less active counter cyclical policies. However, monetary policy across the SEACEN region was mixed as monetary authorities, with varying tools, worked out competing objectives. For example, monetary policy was relatively accommodative in Malaysia, Korea, Philippines, Singapore and Taiwan while in Indonesia and Thailand, it was relatively tight.

For Indonesia, it was hard on the part of the Indonesian government to formulate appropriated monetary as well as fiscal policy in response to the external shock of 2001. Inflation has been on the rise from about 9.4 percent in 2000 to 12.6 percent in 2001, constraining the policy makers from reducing the interest rates. In addition, interest rates have to remain high because of weak exchange rate, and the need to attract financing for public debt. The short- term interest rate was increased from about 15.0 percent in December 2000 to 18.0 percent in February 2002. Although the fiscal deficits were not very large in recent years, Indonesia had the highest public debt to GDP ratio amongst the SEACEN countries. In addition, shortfall in revenue collection limited the country from any probability of further fiscal expansion in 2001. As such, to counter the external shock, the Government had to take on various austerity measures in 2001 viz., hiking domestic energy prices, increasing the tax on interest income from bank deposits, increasing sales tax on agricultural products, and cutting down on public spending. In spite of these austerity measures, fiscal deficit of the central Government for 2001 turned out to be larger than in the previous year.

Although Korea had planned to run a small fiscal deficit in 2001 as against a surplus of 1.1 percent of GDP in 2000, the actual government expenditures fell short of the budget target, while the total revenues surpassed the original target. This has resulted in a budget surplus of about 1.3 percent of GDP, thereby nullifying the original intentions, which was mainly the result of various problems faced in implementing the fiscal policy. As such, monetary policy is seen to have played a decisive role in responding to the external shock in Korea. As a result of a significant cut in the interest rate by the Central Bank, the three-month inter-bank lending rates fell from 6.9 percent in December 2000 to 4.0 percent in December 2001 to 4.4 percent in February 2002. The reductions in the interest rate were helped along by the gradual decline in inflation from more than 5.0 percent in the second quarter of 2001 to 4.1 percent in the last quarter to 2.7percent in 2002.

The Malaysian government opted for a substantial fiscal expansion as the interest rate was cut by 50 basis points only once in late September 2001. In 2001, inflation remained low and stable at 1.4 percent reaching to 1.8 in 2002 and the short-term interest rate was maintained at 3.0 percent. As Malaysia's stock of public debt was at about 35.0 percent of GDP, a number deemed low by international standard, the country had larger scope for fiscal expansion. As the economic slowdown in 2001 had warranted for a substantial fiscal stimulus, the original budget for 2001 was supplemented by two additional spending packages mainly on public works and infrastructure development. Hence, Malaysia ran a fiscal deficit of more than 5.0 percent of GDP for a second year in succession.

In the Philippines, there was a substantial reduction in interest rates. The three-month inter-bank lending rate was brought down to about 7.8 percent in February 2002 from 15.9 percent in December 2001. The reduction in interest rate was as well helped by the gradual decline in inflation. However, since the national government's debt was already 4.1 percent of GDP in 2000, the authorities did not institute major fiscal stimulus measures. In addition, since the country's public debt had hovered around 70.0 percent of GDP, there had been a consensus that the country needed to gradually reduce the fiscal deficit, consolidate the fiscal position, thereby restoring the already lost fiscal credibility. As such, the underpinning policy measures taken by the government was directed towards fiscal restraint rather than fiscal expansion. The fiscal deficit in the Philippines contracted mildly to below 4.0 percent of GNP in 2001. This is an important accomplishment in face of the deterioration of fiscal performance in the latter part of 2000.

In Singapore too, interest rates and inflation were low. The already low inflation of about 1.0 percent gradually yielded to mild deflation of 0.4 percent in 2002. The three-month inter-bank lending rate gradually declined from 2.8 percent in December 2000 to less than 1.0 percent in February 2002. Singapore's fiscal stimulus measures mainly consisted of tax rebates and reductions, rather than expenditure increases. The measures considered were rebates on corporate and personal income, and property taxes, as well as on rentals on public properties used for commercial and industrial purposes.

In response to the external shock, Thailand made a significant cut in its interest rate and as a result, the three-month inter bank lending rate gradually came down from 5.0 percent in December 2000 to 2.3 percent in 2002. Prior to the attack, the weakening condition of Thai bhat and the fear of capital outflows had led Thailand to raise official interest rate in mid-2001. Similarly, tax cuts and special schemes at spurring activities in the rural economy, small and medium enterprises, and the tourism sector were the main components of the stimulus packages in the fiscal front. Thailand's public debt level in 2001 stood at about 58.0 percent of its GDP. The rate of increment of public debt in the recent years has been fast on the rise from less than 15.0 percent of GDP in 1996. Hence, such trends seen in public debts raise issues whether expansionary fiscal policy is sustainable in the long run.

OUTSTANDING ISSUES OF CONCERN

The process of globalisation of the world economy that started in the 1990s has a much significant role in increasing the degree of dependence between the inter-economies and the same has been responsible for increasingly making economies more vulnerable to the external shock. The experience of financial crisis of 1997 in South East Asia has clearly demonstrated that market economy enhanced by the unrelenting financial innovations and rapid development in new technology is not exempted from the irregular business cycle swings. The fact that the world economy non the less the South Asian economies is much dependent on the performance of the three major economies, namely, the US, the Euro area, and Japan is once again demonstrated by the 11 September terrorist attacks on the US.[9] In a globalizing world, the external environment plays a key role. The slowdown in the global economy in 2001, which sharply reduced export demand of the south Asian economies and caused deterioration in external trade activities, deepened sharply following the 11 September terrorist attacks. As a consequence, the economic contraction in the region was widespread even to the extent in recording a negative growth rates with higher inflation in some of the countries in the region. Such adverse developments in the region in 2001 clearly demonstrated the vulnerability of these economies to external shocks and the need for measures to strengthen the resilience of the economy.

With investment and exports expected to be among the engines of growth, the region's dependency on the global economic rebound is considerably high. While domestic conditions play crucial role in creating conducive environment for investment, global economic conditions would also be important. Global economic slowdown will induce foreign investors to withdraw investment worldwide. As such the investor's confidence is always prejudiced by the unfavourable global as well as the regional environments. The prolonged weakness in investment could slow down the economic activity and trade globally, and an increased transaction costs on international trade could also reduce the US propensity to import goods for a given level of aggregate demand. In addition, the weakening of non-oil

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9 The three major world economies together account for roughly 45.0 percent of the world's output and absorb nearly 50.0 percent of total exports from the Asia and the Pacific region.

primary commodity prices may hurt some south east Asian countries such as Mongolia that rely on commodity exports.

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

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

In the medium term, there is also some uncertainty regarding world oil price hike. A hike in oil prices will significantly harm the Asian economies as was experienced due to ongoing unrest in Middle East, Palestine- Israel confrontation and political upheaval in Venezuela etc. Also, the risk of an extended period of global economic malaise is accentuated by the possibility of a prolonged period of turbulence caused by acts of terrorism or even by the military operations led by the US in attacking Iraq and elsewhere. Countries like Nepal and Philippines in the region that rely on worker remittances could be hurt by such political turmoil in the Middle East

It is evident that fluctuations of the exchange rates among the dollar, the yen, and the euro can exacerbate trade deficits of emerging market economies, precipitating balance of payment crisis. A country that has dollar denominated liabilities but that earns yen or euros from its exports could see its ability to service its debts suffer if the dollar appreciates relative to the other currencies. The rise of the dollar in the 1980 hurt Latin American economies, the fall of the yen in the mid- 1990s hurt the economies of Southeast Asia, and the decline of the euro exacerbated Argentina's trade deficit. Hence the emerging market economies should act on the assumption that the major exchange rates will be volatile. That implies a further reason to avoid debt that is denominated in dollars or any other single currency[10]. A country that borrows abroad might protect itself from currency fluctuations by borrowing in mix currencies.

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

The capital adequacy ratio of the banking sector in most of the *SEACEN* countries has shown signs of improvement. The banking sector profitability, as measured by the average return on equity, has also shown improvements in many of the countries in the region. For example, the average return on equity ranges from 4.4 percent in the Philippines to 15.8 percent in Korea.

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

The situation of AMCs in Korea and Malaysia is a little different. About 7.0 percent of the banking sector's NPLs in Korea had been transferred to the Korea Asset Management Corporation (KAMCO) by December 2001 and it was able to dispose about 58.0 percent of the NPLs by January 2002. In Malaysia, about 40.0 percent of the banking sector's NPLs had been transferred to its Asset Management Company, Danaharta, of which about 88.0 percent was disposed by the year-end. The reason behind a high aggregate NPLs ratio can be accounted for the slow progress in the operational restructuring of the corporate sectors in most of the countries in the region. In recent years, these countries have made some progress in financial restructuring of their corporate sectors through debt rescheduling, debt-equity swaps, debt forgiveness and indexation of interest payments to earnings. However, progress made especially in the operational sides has been very slow. In many cases, changes in the management have not come into effect even in corporate restructuring. In addition, banks as well as AMCs are observed to be reluctant in taking tough measures such as selling off non-performing assets or converting debt into equity and also in forcing corporations to close non-viable

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

businesses, sell over-valued assets and undertake other means of operational restructuring.

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

Another possible area of vulnerability is the possibility of growing public debts. With the slower growth and larger fiscal spending, growing public debts is seen as emerging risk. However as the economies in the region recover, pressure on public debt burden and future contingent liabilities would be reduced to a large degree.

There is also the fear that amidst weakening economic conditions, erratic movements in the stock market and political uncertainty have constrained the structural reforms, and focus will be more on pursuing short-term stability instead of carrying out the much needed structural reforms

THE NEPALESE SCENARIO

As a landlocked and relatively closed economy, the impact of the slowdown in industrial countries was seen to be lower for Nepal compared to most other countries in the Southeast Asian region. The ratio of total merchandise trade to GDP was 42 per cent of GDP in 2001. Nepal recorded a GDP growth of 5.5 per cent during the fiscal year 2000/01. However, the impact of the global slowdown, particularly the events of September 11, affected the performance for the fiscal year 2001/02. GDP growth slowed down to negative 0.6 per cent during the period. Tourism as well as exports of ready-made garments, carpets, pashmina shawl and woollen carpets have been affected severely.

Table 5. Key Economic Indicators

	1998	1999	2000	2001	2002
GDP Growth (%)	2.9	4.5	6.1	5.5	-0.6
Export Growth (% of GDP)	10.4	10.4	13.1	13.6	11.1
Openness (trade as a % of GDP)	38.7	36.0	41.7	41.7	36.6
Inflation (%)	8.3	11.4	3.5	2.4	2.9
Debt Service Ratio*	4.7	5.0	4.7	4.4	4.9
Government Budgetary Deficit (% of GDP)	-5.9	-5.3	-4.7	-5.9	-5.4

* *In relation to exports of goods and services (excluding re-exports) and private transfers*
Source: NRB

The fiscal deficit remained at 4.7 per cent of GDP during the fiscal year 2000/01 despite adopting a structural adjustment program with a number of fiscal reform measures. Both higher expenditure growth and slower revenue growth contributed to the higher deficit. With persistent fiscal imbalances due to structural problems in tax administration, monetary policy was the preferred option to support domestic activities.

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

The Nepal Rastra Bank also introduced several reforms in the financial sector. A new Nepal Rastra Bank Act and the Loan Recovery Act 2002 have been enacted. It has implemented the financial sector reform as a part of the overall economic liberalization process. Compared to the private sector banks, the government-owned banks have weaker health, reflecting the major problem in the financial sector. The restructuring of the government -owned banks and strengthening their management has become the prime strategy of the financial sector reform. Under the Debt Recovery Act, Debt Recovery Tribunal (DRT) has been set up to create a sound banking environment through reduced non performing asset. Also an assets management company is being established. However, in spite of all these, persistent fiscal deficits over the years indicate the need for continuous efforts to implement structural reforms in fiscal management as well.

Increasing defense related expenditure due to the internal conflict exerts more pressure on the fiscal deficit. Addressing structural rigidities in the fiscal sector should be the key to achieving macroeconomic balance, which will provide more policy options for Nepal to reduce its external vulnerability.

POLICY ISSUES AND CHALLENGES

However, it must be pointed out that the *SEACEN* economies in particular the crisis-inflicted economies because of recent reforms after the 1997 financial crisis, are in a better position to handle any exchange rate as well as the financial market corrections. It is to be noted that as far as *SEACEN* economies are concerned, the slowdown after the 11 September crisis is characterised as more of an ICT sector correction that deepened into a global cyclical slowdown. This is in contrast to the corrections to domestic demand and substantial capital outflows suffered by many emerging Asian economies during the 1997/98 financial crisis. Hence, the basic weakness is seen as one that stems from trade rather than capital flows or lack of economic fundamentals.

Monetary and Fiscal Policies

In general, monetary polices were considerably relaxed after the attack and this was in line with the developments in the United States. Fiscal policy was also eased substantially and in many cases, supplementary budget spending was proposed. However, as far as monetary policy is concerned, with interest rate already at a very low level, there may have not been much room left for monetary simulation. There was also the fear of possible deflation as in the case of Japan's zero interest policy if monetary policy was used to the extreme. However monetary policy still played a major role in stabilizing the economy.

Prior to the 11 September attacks, in some of the crisis-affected countries, a large part of the public debt had already been incurred as a result of financial restructuring. In spite of this, fiscal policies still remain a very viable policy option as with weak external environment, expansionary fiscal policy can have desirable supply-side effects. The worrying factor is the rising of sovereign debt as the slowdown of the economy and the increased government spending could lead to the deterioration of the balance sheet of the public sector. However, it must be emphasized that sovereign debt rating for most countries in the south Asian region, remain reasonably good. Most of these countries are able to maintain a current account surplus and this is important for those countries like Indonesia and the Philippines, which have a large external debt burden. In addition, the level of reserves is at a comfortable level after years of experiencing current account surpluses. Furthermore, the risk of debt crisis, similar to that in Argentina is ruled out, as there is a favourable expectation of sufficient domestic liquidity due to the high domestic savings.[11] There is also very little new risk as debt levels are manageable; hence the need for a "Ponzi" type of financing therefore does not exist. However, there is a fear of overreaction of fiscal policy. It must be emphasised that in the longer run, "expansionary policies", whether it is fiscal or monetary must still be assessed against the risks to long-term sustainability. In the case of fiscal policy, persistent deficit spending could affect on the structure of public finances, such as a permanently higher tax level, as well as the economic costs of an eventual policy reversal.[12] However, fiscal policy looked appropriate in the situation despite the very open economy, "leakage" is minimized as the marginal propensity to import out of government expenditure is offset by voluntary import compression and lower income. It is also important to encourage capital inflow since financing persistent budget deficits without international capital, may result in a rise in real interest rates, rising deficits and larger issuance of bonds (Rojas-Suárez, 1992). It should be noted that one reason for the faster than expected economic recovery after the 11 September is that macroeconomic policies were conducted with greater clarity and coherence.

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[11] Rating and Investment Information, Inc, Japan, R&I Asian Focus, Sovereign Rating Outlook for Asia in 2002, Growing Public Debt Emerges as new risk December 20, 2001.

[12] Monthly Report, ECB, April 2002

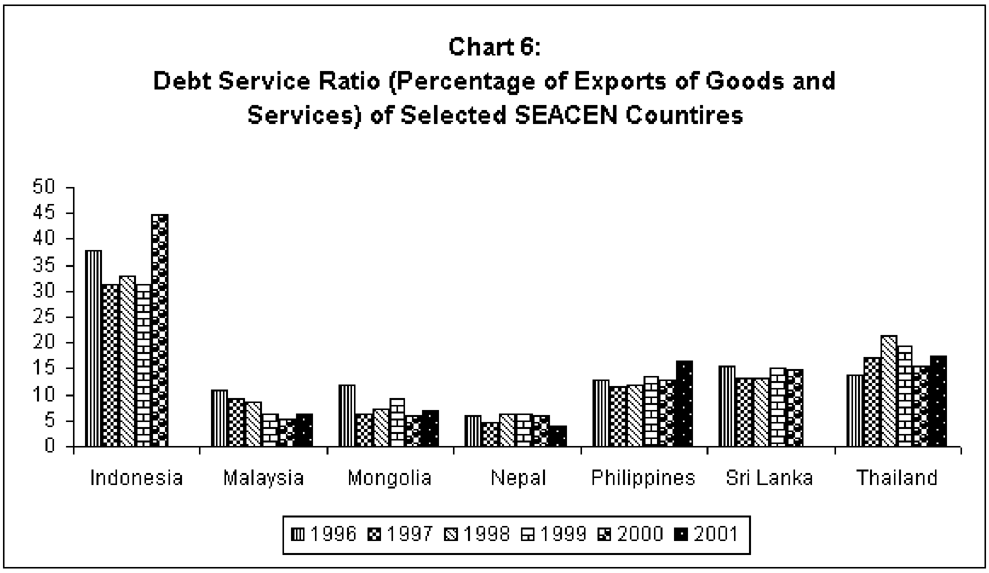

*Table 6. The Standard & Poor's Sovereign rating of Selected SEACEN Countries**

	Long-Term Rating	Outlook
Indonesia	B-	Negative
Korea	A+	Stable
Malaysia	A	Stable
Mongolia	B	Positive
Philippines	BBB+	Stable
Singapore	AAA	Stable
Taiwan	AA	Negative
Thailand	A-	Stable

* *On April 2002*
Source: Standard & Poor

Trade Ties

An obvious linkage is through the trade as many south Asian countries have a high trade ratio to the US and the US forms the single biggest market for many of these countries. A longer run strategy is to strengthen the multilateral trade ties[13]. Investment in the area of information, infrastructure, technology innovation and skill development must continue to be encouraged[14]. Singapore, due to the slowdown of high-tech exports, as a result of decline in high-tech investment by the US, has diversified into biotechnology products. Since countries in the region

[13] US Department of State, International Information Programs, Excerpt from Joint Statement of Thirteenth APE Ministerial, 18 October 2001.

[14] The World Bank, Issues Brief, Progress over the last 40 years, September 2001.

have either joined or are in the process of joining WTO, the basic terms of reference like tariff etc. should be made compatible to the WTO standard. Furthermore, the member countries should work out in developing the competitiveness of each other based on comparative advantages such as that in the area of forest product, high-tech production, tourism etc. It is obvious that there is a heightened need for other countries in the region to adapt to the increasing competitive challenges from the economic growth of the People's Republic of China

Structural Reforms

At the domestic level, reforms must effectively address the structural factors that contribute to the vulnerability of the financial system. The microeconomic distortion-referring to asymmetric information and moral hazard-that lead to over borrowing and /or over lending must be reduced. This can be achieved by the appropriate pacing and sequencing of liberalization but more with the necessity of implementing institutional reforms prior to easing restrictions on capital flows. The economies in the region would be well served by continuing to move ahead with structural and institutional reforms that bolster domestic sources of growth. This can be achieved by creating a more conducive climate both for domestic and foreign investment and also by fostering a more stable as well as an encouraging environment for consumers

The Southeast Asian region has undergone tremendous reforms but is far from completion. In a constrained setting, policymakers have a dilemma as to the timing of such financial reforms. It must be emphasized that even as priority is to be given to stabilizing the economy, there should not be any delays of structural reforms. Any possible policy slippages and lags in implementation could add further chaos to the entire financial system. As such, in due time, mergers and acquisitions should be encouraged. Besides mergers and acquisitions, strategic alliance between different types of financial institutions aimed at an ultimate universal banking system to improve efficiency and productivity should also be encouraged.

Appropriate reforms could strengthen the banking system. At the same time, there must also be reforms to strengthen the long-term supervision and regulation to develop a strong code of “safe and sound” financial regulations. The long-run aim of improvement in supervision should not be to protect these industries. On the contrary, market forces should be allowed to play their part. International standards in prudential risk management must also be adopted; however, the supervisory authority should not overreact. In addition, the regulatory authority as well as the public should be given access to accurate and timely information. Strict public disclosure on the current condition of financial institutions must be initiated without delay, as bank assets are by nature opaque.

In addition, the domestic capital market- the corporate bond market in particular- must be deepened. This would improve domestic resource mobilization, minimize maturity mismatch, and enhance the ability of the economy to absorb greater capital flows.

Research and Development

Research and development must necessarily led to create, absorb, and adapt new technology for commercial use. In its early stages of development, most of the countries in the region brought technologies form outside the region (emulation or imitation) rather than develop new technologies (innovation). This made some sense for those countries that were relatively late to develop and could take rapid strides simply by importing and assimilating foreign technologies. But these countries now have already drawn themselves to the technological frontier. As the frontier is approached, the opportunities for rapid progress through emulation diminish and the ability to innovate becomes increasingly important.

Unemployment and Social Reforms

The social impact of the slowdown of the economy is a loss of real income directly as a result of unemployment. The relatively slow growth rates in 2001 meant further delays in meaningful improvement of the welfare of the poor - particularly in Indonesia, Nepal, Thailand and the Philippines, where the severity of the economic contractions associated with the crisis partially eroded past progress in reducing poverty to some extent. As social instability is one factor that can prevent the return of investors' confidence, the benefit of adjustment, in particular that of fiscal policy, must trickle down to the poor and middle-income groups.

Outward Looking Policies

In the longer run, even though globalisation can be a source of macroeconomic volatility, policymakers must continue to be alert and responsive to both the opportunities and the challenges of globalisation if the countries are to continue to capitalize on this process. There also exist risks to the globalisation strategy and policies must be formulated to minimize them. Greater volatility is probably the biggest risk that accompanies globalisation. For example, although the positive impact on growth of trade and FDI flows is now widely recognized, the benefits of portfolio capital flows continue to be questioned. As such, policies should be directed towards monitoring and regulating capital flows, developing an appropriate exchange rate regime, minimizing fluctuations in productivity and investment, and strengthening social safety nets.

Concerted Efforts

To some extent, the external shocks associated with the forces of globalisation or crisis can be moderated by regional initiatives and this creates an argument for coordination at the regional level. Frame works for addressing such problems at the regional level have been developed in other parts of the world, providing precedents that countries in the region should follow suit. Interest in the regional option has attracted new attention on Asia in the wake of the 1997 financial crisis and has given rise to discussions for the establishment of an Asian Monetary Fund. Similarly the Chaing Mai initiatives and the SAARC Finance network can be seen as a way of addressing the regional financial pressure. Measures such as the safeguard measures incorporated in the SAFTA agreement are also expected to enable the countries within the SAARC in building and improving the capacity in terms of infrastructure and export promotion with a view to enhance competition and meaningful benefit from intra-regional trade. These initiatives, which forms part of regional cooperation is useful to eliminate the distortions that would otherwise cause such liberalization to heighten volatility and crisis risk.

There have been many proposals as regards to collective efforts at times of economic slowdown Bergsten (1998) proposes the "Concerted Asian Recovery Programme" in which fiscal and monetary stimulus are undertaken simultaneously by various countries. The centrepiece of this proposal is for Japan to take the lead. The World Bank believes that a 1.0 percent GDP increase in fiscal-deficit spending of Japan, Asia NIEs, ASEAN4 and China could generate East Asia's economic growth by as much as 2.0 percentage points of GDP. However, concerted efforts related to economic policy require careful coordination, and experiences have shown that it is virtually impossible to form any kind of consensus on domestic economic policies.

While the long-term solution of a common currency similar to the Euro may be far-fetched, it is fair to say that in some areas, a concerted effort in regional mutual cooperation such as member countries developing joint ventures have resulted in making the regional development more sustainable.

CONCLUSION

Experiences suggests that, although the impact to the global economy, of the slump in external demand is higher for highly integrated economies strong macroeconomic fundamentals to a significant extent can shield the economies from adverse impacts of the external shock. The stronger the macroeconomic fundamentals, the broader the policy options available to minimise the impact of the external shock. The effectiveness of the policy responses would depend on the status of the domestic banking and financial as well as corporate sectors. Policy responses trickle down the economy faster if there are less rigidities in these sectors.

Experience also suggests that the recovery is most advanced in countries where these reforms have been implemented successfully. For example, the recovery is most advanced in Korea, as Korea had already implemented major reforms in financial and corporate sectors successfully. Therefore, completion of initiated reform agenda and maintenance of strong economic fundamentals will provide necessary policy options for the countries in the event of uncertainty in the global recovery.

For countries with macroeconomic imbalances, priority should be given to address structural rigidities that cause macroeconomic imbalances while attempting to use available stimulus polices to cushion the effect of lower external demand in the short term. However, these countries may have to face cyclical fluctuations of the global economy until domestic macroeconomic imbalances and structural rigidities are resolved. Concerted efforts among countries such as reducing trade barriers through multiple trading arrangements could also pave the way to reduce the impact of slowdown in industrial countries by diversification of export markets and products.

ACRONYMS

ADB	Asian Development Bank
AMCs	Asset Management Companies
ASEAN	Association of South-east Asian Nations
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
ICT	Information, Communications and Technology
IFS	International Financial Statistics
IMF	International Monetary Fund
NIEs	Newly Industrialised Economies
NPLs	Non-Performing Loans
OPEC	Organisation of the Petroleum Exporting Countries
PRC	Peoples' Republic of China
SEACEN	The South East Asian Central Banks Research and Training Centre
US	United States
WTO	World Trade Organisation
WWTC	World Travel and Tourism Council

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