ANZ COUNTRY RISK REPORT

CONTENTS

About this report

This report is divided into two sections. The first part examines country risk issues in individual countries and draws on the detailed country risk work undertaken by Economics@ANZ. The second part examines economic developments on a regional basis with a series of charts and brief commentary.

The separate Country Updates document provides a brief update of recent developments and the economic outlook in individual East Asian countries, with a table of economic statistics for each one.

Economics@ANZ

18 December 2003

EAST ASIA: COUNTRY RISK ISSUES

Country	Politics	Economy	Balance of Payments	Other
China	Sudden and unexpected change of policy direction. Pressures are created by the contradictions inherent in freeing up the economy while maintaining a communist political system. There could be a loss of continuity. Potential for significant unrest, due to regional and sectoral disparities, poverty, corruption, job losses and inadequacies of socialist welfare system.	Low growth. Even 8% is not sufficient to reduce unemployment and satisfy the aspirations of the populace. Unbalanced growth. Inefficient resource allocation produces both bottlenecks and excess capacity. Ongoing restructuring of state-owned businesses crystallises economic problems eg unemployment, unfunded pensions, bad debts, unsold stock. Poor health of major state-owned banks. Government's off-budget debt ("special bonds") and contingent liabilities (state banks, pensions). WTO commitments. More rapid reform and opening of the economy carries risk as well as opportunity.	Management of an eventual transition to an open capital account and flexible exchange rate regime. Consequent currency volatility could impact on trade and investment flows and even de-stabilise other regional currencies. Rapid growth of exports is causing tensions, both in market countries and with competitor countries. Disillusionment on the part of foreign investors. Issues include poor profits, opaque legal system, and arbitrary decision-making by officials.	Tensions created by liberalising the economy but not reforming the political system. This could ultimately produce violent outcomes.
Hong Kong	Disagreements with Beijing over the administration of Hong Kong. Business has tended to shrug off this issue but interference could conceivably undermine Hong Kong's great advantage over mainland cities – its fair and transparent legal system.	Hong Kong's high cost structure - may undermine its role as the services hub for the region. Competing cities such as Shanghai and Shenzhen are attracting investment Emergence of a structural budget deficit could eventually undermine the attributes which made Hong Kong special – low taxes, good infrastructure, and pegged exchange rate.	High costs and fixed exchange rate have reduced competitiveness. However, continuation of HK$ peg is a vital underpinning of investor confidence.	The impact of SARS, which was much greater in Hong Kong than elsewhere, illustrates a particular vulnerability of a small, densely-populated, service-based economy.

EAST ASIA: COUNTRY RISK ISSUES (continued)

Country	Politics	Economy	Balance of Payments	Other
Indonesia	Uncertainty ahead of legislative and presidential elections in April and July 2004 respectively. The lead-up is likely to be fraught with political jostling for support and strategic alliance building adding to uncertainty as the country treads new ground in terms of a direct vote for the presidency. Economic reform likely to take a backseat in the run-up to elections. Political and economic stability threatened by violent unrest with possible triggers being religion, separatism and repression.	Pace of economic reform is hindered by strong vested interest against change. Corruption, corporate governance concerns and security issues continue to impede long-term investment. High unemployment, which is estimated at around 40% of the workforce compared with an official estimate of around 8%. Weak foreign direct investment and fiscal consolidation make it difficult for the economy to expand at a rate to make serious inroads to reducing unemployment.	Although it has improved, foreign debt as a % of GDP remains high. Debt service obligations have improved but remain high at around 17-20% of exports of goods and services.	
Malaysia	There was a smooth political transition at end-October 2003, but new Prime Minister Ahmad Badawi must quickly establish his political authority to reduce the possibility of a divisive and damaging power struggle within UMNO. Close state control over many aspects of the economy and strong links between business and politics. The media is also under state control, while the independence of the judiciary has been eroded over the past few years.	Malaysia is highly exposed to the world economy and economic prospects would deteriorate rapidly if the current global economic recovery falters. Large federal government deficit (official projection is 5.4% of GDP in 2003), but the overall public sector deficit is much smaller (official projection for 2003 is 1.5% of GDP). There are encouraging early signs, however, that Abdullah Badawi recognises the need to shift from 'crony capitalism' to a business environment that is transparent and based on an open tendering. He has also expressed scepticism about large infrastructure projects, a policy hallmark of Dr Mahathir, and a railway project awarded to a business ally of the former prime minister shortly before he left office, has been postponed.	Relatively low value-added in the large export sector. Adherence to fixed exchange rate against the US dollar significantly restricts the flexibility of economic policy. Malaysia is likely to move to a float at some stage, and the change will need to be managed carefully. Low levels of foreign investment, indicative of the competitive challenge posed by China.	Malaysia would be vulnerable if there was serious political unrest in Indonesia which produced a large-scale exodus from the archipelago.

EAST ASIA: COUNTRY RISK ISSUES (continued)

Country	Politics	Economy	Balance of Payments	Other
Philippines	Potential for policy reversal, driven by political expediency, corruption or judicial activism. Terrorism and other security risks. Violent acts have been perpetrated by groups with diverse political and criminal agendas. Leadership vacuum. The president and her potential rivals are pre-occupied with manoeuvring for the May 2004 election.	Further widening of the budget deficit. After some reduction was achieved during 2003, there is a risk of a pre-election splurge in coming months. Vulnerability to drought and storms. Agriculture comprises 20% of the economy and was badly affected by the 1998 *El Nino*.	Exports heavily dependent on electronic goods and thus vulnerable to global weakness in this sector. Competiton for foreign investment. Electronics may lose ground to China; call centres and back-office services to India. Higher oil prices. Philippines is dependent on imported oil.	
Singapore	Political system stifles efforts to promote more entrepreneurial culture required to diversify economic structure.	Heavy reliance on electronics, although efforts are being made to diversify the manufacturing base. Increasing competition from trade and investment in the region, particularly from China and Malaysia. A less flexible workforce in terms of job aspirations and remuneration and employers' reluctance to recruit older workers are some structural issues that are difficult to redress.	Over-dependence on electronics, which accounts for around 60% of non-oil domestic exports.	Regional tensions and terrorist activity in SE Asia, on the one hand, and heavy investment by multinationals in Singapore and the country's pro-US stance, on the other, cloud the economic and investment environment. Singapore's high trade intensity makes it more vulnerable than its neighbours.

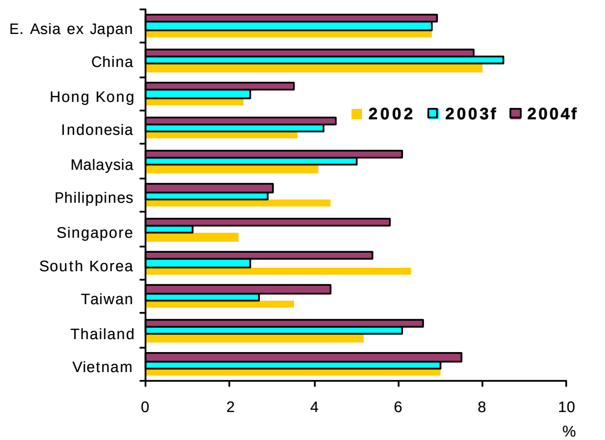
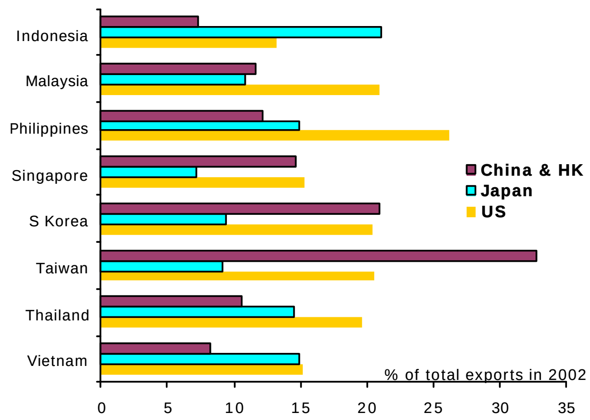
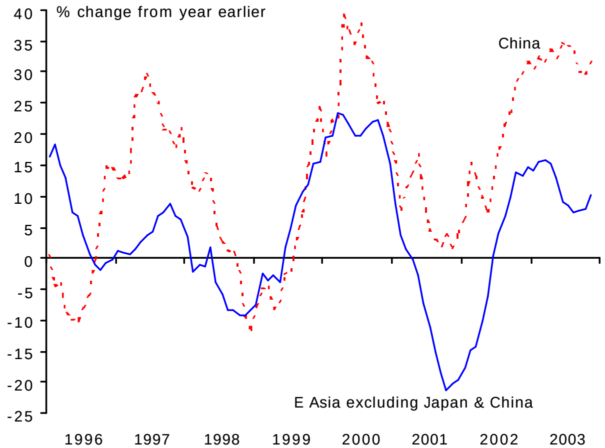
EAST ASIA: COUNTRY RISK ISSUES (continued)

Country	Politics	Economy	Balance of Payments	Other
South Korea	North Korea poses a significant military and economic threat to South Korea. This is heightened by the unpredictable nature of the North. Weak presidential leadership and the dominance of the opposition in parliament are likely to dampen the pace of economic reform.	Corporate and banking sector restructuring undermined by strong nationalist sentiment, fresh scandals, difficulty in dismantling *chaebols* which has, in turn, reinforced concerns over corporate governance and transparency issues. Escalation of labour unrest. Significant increase in strike action has disrupted production and is in danger of damaging prospects for manufacturing investment as competition from low-cost production bases (eg. China) intensify.Sharp acceleration in consumer borrowing in recent years has raised concerns about an adverse impact on financial institutions of a significant deterioration in economic conditions.	Exports face strong competitive pressures from Japan. Over the medium term, China will increasingly become a major competitive threat.	
Taiwan	Potential military conflict with China. Low risk, but China maintains it has the right to intervene if Taiwan declares independence, is invaded by a foreign power, or is threatened by "internal chaos". Intimidation is likely ahead of March 2004 elections. Corruption, entrenched by links between politics, business and crime. Often-stormy political scene hampers much-needed reform legislation.	"Hollowing out" of the economy as Taiwanese firms invest in China. Probably exaggerated, as economic integration with China will help diversify Taiwan's economy. Banking collapse. The sector is fragmented and under-capitalised with high levels of NPLs. (Legislation to improve effectiveness of asset management company has been stalled.)		International relations constrained by implications of "One China" policy and ascendancy of PRC.

EAST ASIA: COUNTRY RISK ISSUES (continued)

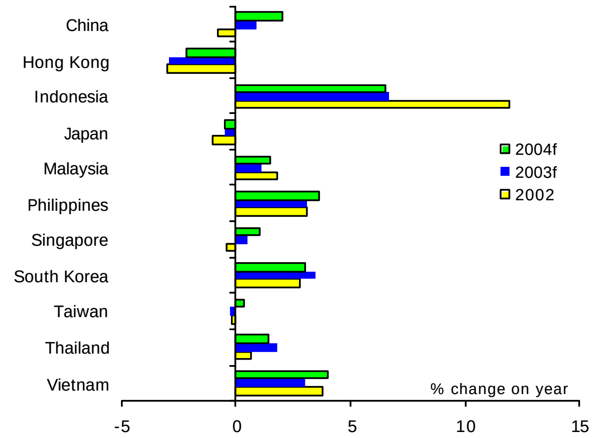
Country	Politics	Economy	Balance of Payments	Other
Thailand	Prime Minister Thaksin's popularity is being boosted by strong economic recovery. Democracy is maturing, but political institutions remain weak. Prime Minister Thaksin's government is authoritarian and sensitive to criticism.	The government's record of economic growth is impressive, but several other aspects of economic management are poor. The attitude towards foreign investment is ambivalent, with the government's recognition of the contribution that such investment makes to economic development at odds with its nationalistic sentiment. Privatisation has stalled, private banks are still burdened with high levels of NPLs, corporate sector restructuring has been slow, and aggressive new lending by state-owned financial institutions is causing concern. Regional disparities in economic development, particularly between Bangkok and the poor but populous north-east.	Thailand's external debt position has improved significantly since the crisis in 1997, with a lower level of total debt and much smaller short-term component. However, the burden of debt remains more onerous than in most other E Asian countries.	
Vietnam	Bureaucracy and corruption are hampering economic reform and are detrimental to foreign investment and the development of the private sector.	Poor infrastructure. The IMF has reiterated that commercially-based decision-making in the state-owned enterprise and banking sectors is a key requirement to sustain solid economic growth. Economic reform must be speeded up if plans for WTO membership by 2005 are to be realised.	Pronounced deterioration in the current account deficit. Disillusioned foreign investors. For some, Vietnam's disadvantages (corruption, inconsistent bureaucracy, poor legal system, inadequate infrastructure etc) have overcome is labour cost advantages.	Uncertainties/tensions concerning the mismatch between the economic and political reform process.

EAST ASIA: REGIONAL ECONOMIC DEVELOPMENTS

Real GDP Growth	Growing importance of the Chinese market	Exports
		
The economies most severely affected by the SARS crisis, namely, China, Hong Kong, Singapore and Taiwan, rebounded in the third quarter. Malaysia and the Philippines posted stronger growth and South Korea emerged from recession. Growth prospects for 2004 are being underpinned by stronger external demand from the US and Japan, the region's main export markets. East Asia excluding China and Japan is forecast to expand by 5.1% in 2004 from an estimated 3.7% in 2003. The slightly slower, albeit healthy, pace of growth projected for China is expected to keep non-Japan East Asian growth steady at 6.9% for 2004 (6.8% in 2003).	China and Hong Kong collectively has emerged as one of the main trading partners of the East Asian economies. In the case of South Korea and Taiwan, China and Hong Kong was the leading market in 2002, with Hong Kong's thriving re-export trade and growing demand for goods from China fuelling the rapid absorption of exports.	Export growth was adversely affected in mid 2003 by the spread of SARS and the detrimental impact that the Iraq war had on consumer and business confidence and the economic outlook. Export growth is now picking up again with strong demand from China, faster-than-expected economic recovery in the US, and several quarters of positive GDP growth in Japan.

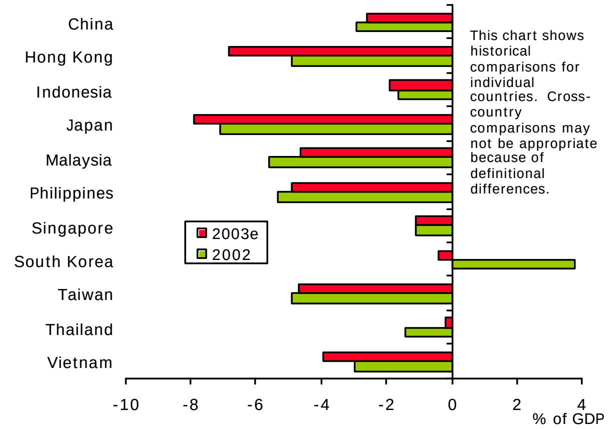
EAST ASIA: REGIONAL ECONOMIC DEVELOPMENTS (continued)

Inflation



Average annual inflation in Indonesia improved markedly from 11.9% in 2002 to 6.7% during January-November 2003, thanks largely to currency appreciation and relatively stable food prices. Consumer prices are above year-earlier levels in Singapore and China after a period of deflation in 2002, while inflation in Thailand and South Korea was higher in 2003. The outlook is mixed, with inflation in China, Malaysia, Philippines, Singapore, Taiwan and Vietnam expected to edge up in 2004.

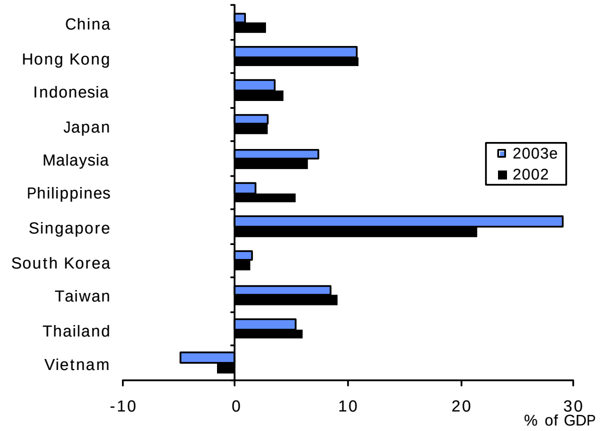
Large budget deficits in most countries



Sources: Economist Intelligence Unit, national statistics

Budget deficits are expected to have been incurred in all East Asian countries in 2003. The biggest change was in South Korea where a budget surplus of almost 4% of GDP in 2002 was succeeded by a small deficit estimated to have been equivalent to 0.4% of GDP in 2003. There was also a clear deterioration in Hong Kong, while Japan continues to incur the largest deficits which is reflected in a sharp rise in the ratio of gross public sector debt to GDP from 100% in 1997 to over 150% in 2003.

Current account surpluses in most countries

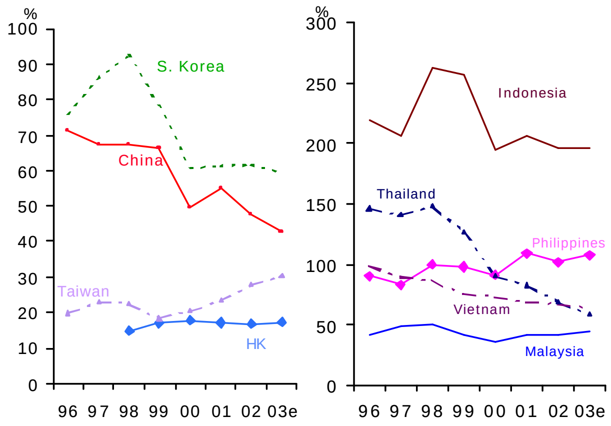


Source : Economist Intelligence Unit

Vietnam's current account reverted to deficit in 2002 and there has been a further deterioration in 2003 with the shortfall expected to widen to approximately 5% of GDP.

EAST ASIA: REGIONAL ECONOMIC DEVELOPMENTS (continued)

Ratio of External Debt to Exports

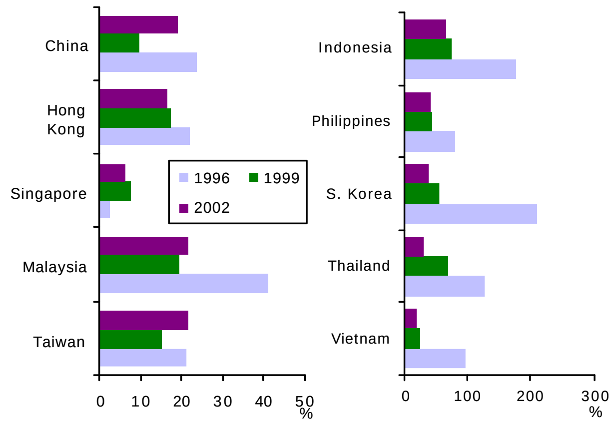


Source: Economist Intelligence Unit

A country's external indebtedness is often gauged by debt-to-GDP or debt-to-exports ratios.

Indonesia is the most highly indebted of the countries considered, with a debt-to-exports ratio estimated at almost 200% in 2003. There has been a significant reduction in the debt-to-exports ratio in South Korea and Thailand over recent years, in contrast to the increases which are apparent in the Philippines and Taiwan.

Ratio of Short Term Debt to Reserves

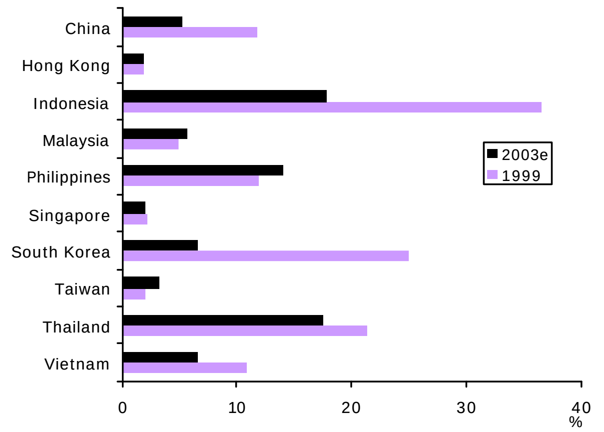


Source: Economist Intelligence Unit

One of the factors that precipitated the "Asian crisis" in 1997 was a build-up of short-term debt (less than 12 months original maturity). In some cases, short-term debt exceeded reserves – clearly potentially dangerous.

China, Malaysia and Taiwan recorded deteriorations in this ratio between 1999 and 2002 after improving from 1996.

Debt Service Ratios



Source: Economist Intelligence Unit

A country's debt service ratio (i.e. the ratio of external debt interest and principal payments to exports of goods and services) is one of the most important criteria used in country risk assessment.

"Crisis" countries namely Thailand, Indonesia and South Korea have recorded improvements in their debt service ratios. In contrast the debt service positions of Malaysia and the Philippines have deteriorated slightly, but remain manageable.