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From Financial Overheating to Social Policies: The Tricky Change in the Asian Economic Paradigm Post 1997-98 Crisis

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Abstract: As proved by the failure of most of forecasters in predicting the Asian crisis in 1997, country risk analysis is a difficult task. In the aftermath of the Asian crisis, TAC (Thierry Apoteker Consultant) developed a method, RiskMonitor, based on non-linear early warning models for economic and financial crises, in order to predict economic development in emerging countries. RiskMonitor is used in the present paper to look at how the five Asian countries hit by the 1997-98 crisis (South Korea, Thailand, Indonesia, Malaysia, and the Philippines), reacted to the event, when taken as a "group" and individually. The study shows that pre- and post-crisis situations differ as regards the nature of the risk at stake (moving from financial to political one), and that the five countries have adjusted in different ways to the turmoil.

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1 INTRODUCTION

In an international environment characterized by low growth and high uncertainties, the perceived risks of economic or financial crises in the Asian countries hit by the 1997-98 turmoil (South Korea, Thailand, Indonesia, Malaysia, and the Philippines) are rather low. Significant changes in economic policies and in the management of structural development issues have occurred, and the economic variables that are now allowing these countries to adjust to changing international circumstances are very different from the ones in the mid-90s.

This paper is an attempt to analyse these changes and identify the nature of current and future challenges faced by these countries. The methodology is based on the definition and examination of fundamental economic balances that characterize the performances of these five countries. The macroeconomic balances or equilibria have been defined in the context of an early warning model for economic and financial crises in developing countries. Even though "crises" are brutal and non-recurrent events, the ability of a given model to provide trustable predictions for such events allows to have a deep insight into the development mechanisms at work in emerging economies. The use of such a model enables to improve the understanding of the key changes that have occurred since 1998, while simultaneously pointing towards new areas of risk.

The paper is structured around three sections: the first one gives an overview of the methodology used in TAC's non-linear early warning model. The second section applies the methodology to the five countries that were affected by the crisis of 1997-98 in order to highlight the significant transformation in the economic development paradigm in the region, while simultaneously indicating the differences between the five countries. Finally, the third section tries to identify both the short-term and the medium-term risk factors that are associated with this new paradigm.

2 A NON-LINEAR TOOL DESIGNED TO ASSESS THE RISK OF UPCOMING CRISIS IN EMERGING ECONOMIES

2.1 Background on country risk analysis

During the period 1970-1990, country risk was a matter of sovereign risk and so a matter of game theory. Evaluation of this sovereign risk was simply done using a combination of two macroeconomic variables : a measure of the total external debt and a measure of the current account deficit. Economists usually used total external debt over exports for the first indicator and current account over exports for the second.

The capital flows liberalization of the 1990's, radically changed this traditional view of sovereign risk. Because of this new financial landscape, country risk is viewed as a complex combination of macroeconomic and microeconomic factors and not only as a financial balance. Then, country risk ratings must take into account much more indicators than before, and this complexity has led to many 'failures' of traditional risk rating system to correctly predict crisis with a sufficient time-lag to induce either macroeconomic corrective measures, or corporate adjustments to such risks (it is revealing indeed that none of the crises that occurred since the early 90s have been predicted by the leading rating agencies like Moody's or Standard & Poor's).

A significant amount of academic and applied economic research has been focusing on finding new ways to integrate the large number of parameters or possible sources of difficulties (see bibliography). As the number of variables grows, the number of possible valid combinations between them grows too.

Immediately after the Asian crisis, TAC undertook a research based on the following objectives:

- Finding better Ratings
- Providing an analytical framework that helps understanding the nature and unfolding of country crises
- Using non-linear methods to detect thresholds effects
- Using only Official Data available
- Using exactly the same method over 45 developing countries

The results of this research was the design of a new non-linear tool for predicting four types of different crises (default, liquidity, exchange rate, and cyclical crises) with an 8-quarter advance on the events themselves. This tool is called RiskMonitor.

2.2 Principles of methodology

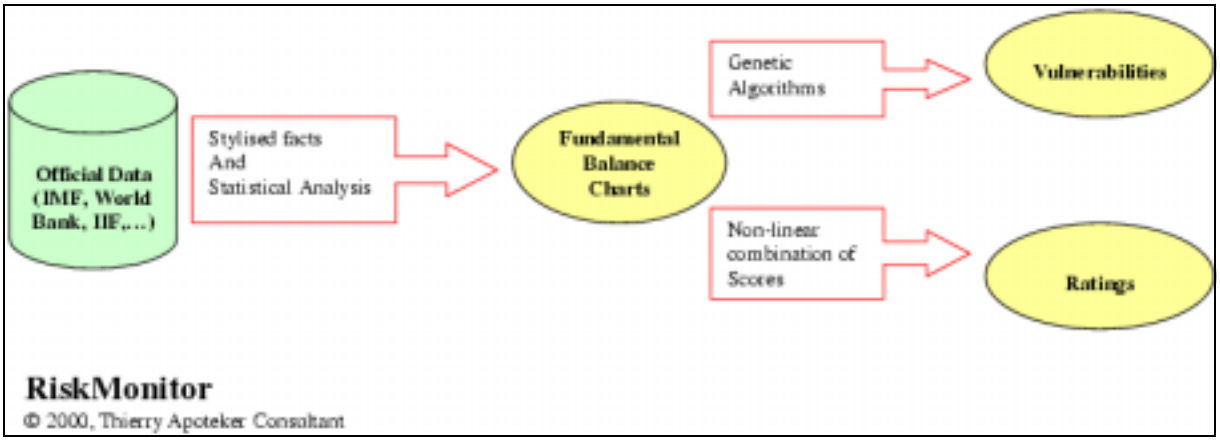
RiskMonitor provides a quantitative as well as graphic comparison of 45 major developing countries based on T-A-C proprietary non-linear methodology, through three complementary steps:
the Fundamental Balances (and associated scores),

the Ratings,

the Vulnerabilities (to unexpected events).

Chart 1 shows the basic construction scheme of RiskMonitor.

Chart 1 : RiskMonitor Scheme



Starting from official data, using stylised facts and statistical analysis of historical data, five fundamental macroeconomic or macro-financial balances are defined and graphically represented:

the Growth Balance,

the Financing Balance,

the Foreign Exchange Balance,

the Cyclical Balance,

the Banking System Balance.

Each of these Fundamental Balances is a combination of two variables, with each variable being associated with a risk threshold that has been statistically determined to maximize the quality of the output signal in terms of crisis prediction. The position of any country in any one of the Fundamental Balance can be quantified by applying a continuous non-linear algebraic function, with the resulting score dependent on the distance of the country from the risk threshold.

The Growth Balance (G1) measures the ability of a country to record adequate economic growth without involving excessive imbalance in the external financing. It crosses a growth indicator with an external equilibrium. The growth indicator is represented by a GDP per capita with an accelerator effect. The external equilibrium a current account as a percentage of adjusted exports (exports are here *adjusted* by the estimated share of exports that is imported).

The Financing Balance (G2) measures the quality of the external financing of a country and the risks associated to external debt. The financing stability includes foreign direct investments, foreign exchange reserves and short-term debt outstanding over adjusted exports. External debt burden is observed using two indicators, a standard debt service, and a "maximum potential service" where it is assumed that the disappearance of international

confidence in the country could lead to the suspension of all short-term foreign currency credit lines used by the country (so-called "worst case scenario").

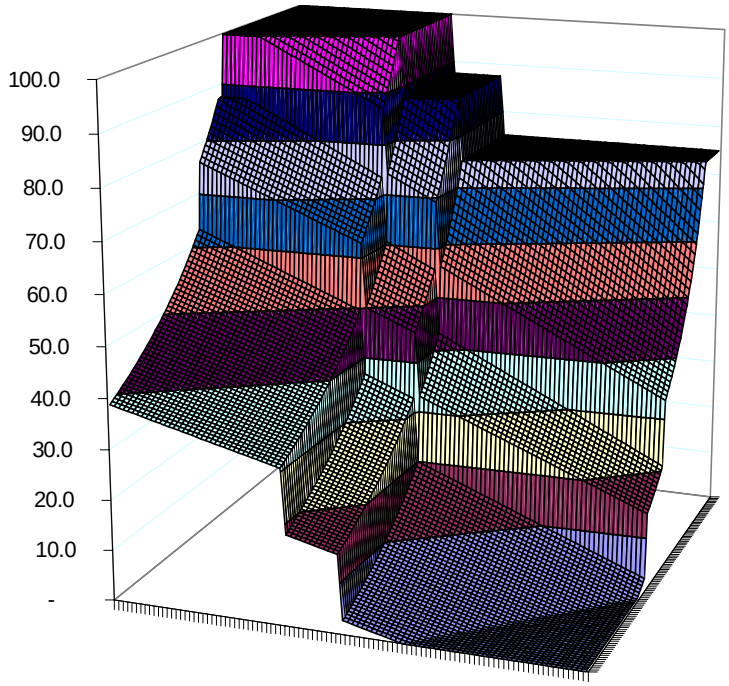
The Foreign Exchange Balance (G3) aims at giving a more accurate and short-term measurement of the financial component of country risk. In fact, financial difficulties, all the more so crises, are almost always preceded by significant imbalances on the foreign exchange market. The indicators used in this Balance include a comprehensive but relative measure of "true" foreign exchange reserves, and a complex real exchange rate (measured against currencies of countries competing for the same products on the same export markets). Because of the very powerful predicting ability of this single Fundamental Balance, more than one risk threshold are used for each indicator.

The Cyclical Balance (G4) provides a measurement of the cyclical position of the economy in terms of country risk analysis, and enables to measure both the quality of the domestic economic policy and the nature of the most sensitive risks. One of the two indicators used here is related to monetary policy, and the second is a leading indicator of domestic economic momentum.

The Banking System Balance (G5) enables to measure the risks associated with the global imbalances in the banking sector in terms of systemic risk. Such systemic risks are appreciated through an indicator of macroeconomic financial leverage (measure of possible over-indebtedness by domestic agents), crossed with an indicator of dependence (of domestic banking institutions) to international refinancing.

Chart 2 illustrates the non-linear score function (vertical axis) associated with the values taken by each of the two indicators (two horizontal axes) that are used in the Foreign Exchange Balance.

Chart 2 : Non-linear Score function for the Foreign Exchange Balance



The next step of the method is the construction of Risk Ratings. These Ratings constitute the core results in terms of early warning signals. Four such Ratings are constructed, each one highlighting the different nature of accumulated tensions.

The **Development Risk** measures the risk of a crisis erupting because of a country's inability to register a satisfactory development path, and is associated with likely political and social tensions.
The **Solvency Risk** measures the risk of a crisis triggered by excessive foreign debt and unsustainable financing paths.
The **Short-Term Financial Risk** measures the risk of a significant shock initiated by short-term imbalances in the main financial variables (exchange rates or/and interest rates, banking system, asset markets).
The **Short-Term Economic Risk** measures the risk of crisis because of excessive cyclical imbalances, with the associated consequences on the banking and corporate situation.

The Risk Ratings are computed as weighted geometric means of the scores for each Fundamental Balances, with different weights attributed to each Rating. All Ratings are in a range of values between 0 (lowest risk) and 100 (highest risk). Threshold are then defined to find optimal regions of relatively equivalent risk level, related to probability of occurrence of any of the four types of crisis included (default, liquidity, exchange rate, cyclical) on an 8-quarter horizon. These "regions of risks" are defined by the following letters:

A : low risk
B : medium low risk
C : medium high risk
D : high risk

K : very high risk (probability of a crisis within the next eight quarters above 70%)

The last step of the method aims at providing a complementary measure to the quantitative information brought by Risks Ratings, by relying exclusively on a combinatorial approach of positions taken by any country during the past five years in any of the five Fundamental Balances. The idea is that the non-linear nature of crisis eruption and country risk materialization implicitly suggests that even if a country's Ratings are satisfactory, the combination of positions taken during the recent past could be brutally affected if something unexpected happens (be it domestic events, including political, or international economic or financial events unrelated to the specific situation of the country). In other words, the Vulnerability measures aims at assessing the unexpected side of country risk sudden changes, by identifying patterns of conditions (each condition is defined as a position in a given Fundamental Balance at a given moment of time) which were most often associated to full-blown crisis occurrences. These patterns of conditions were identified through the application of a Genetic Algorithm to a large number of countries and crises since 1980.

The measure is expressed as a percentage of the total number of conditions associated to the given crisis that a country already meets or fulfils. A measure above 60% should be taken as a sign of increased vulnerability, and a reading of 100% indicates that any significant unexpected event, domestic or international, can rapidly trigger a full-blown crisis, whatever the Risk Ratings are.

2.3 Results of the method

RiskMonitor has been initially tested on 45 countries over the period 1970-1998. As for any signalling tool, the quality of results can be appreciated through two sets of measures: the signal-to-noise ratio (what is the actual event in the following eight quarters if there is a signal of crisis, i.e. a K" reading on any one of the four Ratings), and the cover ratio (how many crisis have occurred with the different signals). It is easy to understand that the definition of the various thresholds (both on Fundamental Balances and on the levels of the Risk Ratings themselves) as well as the weights in the construction of the Ratings, must find a delicate balance between the highest signal-to-noise ratio and the highest cover ratio. Indeed, a 100% signal-to-noise is possible (i.e. every time there is a "K" reading, there is a crisis in the next 8 quarters, no "signal mistake" at all), but a large number of crises will not then be detected (low cover ratio). Conversely, it is possible to have a high cover ratio (most of the crises occurred when a crisis signal was present), but at the expense of the signal-to-noise ratio (large number of false signals for crises that do not occur).

RiskMonitor results are presented in tables 1 and 2 below:

Table 1 : Signal-to-Noise ratio, 1970-98

Observation / *signal*	Crisis	No Crisis	Total
Crisis	71%	29%	100%
Uncertain	39%	61%	100%
No Crisis	26%	74%	100%

Table 2 : Cover Ratio

Observation signal	Crisis	No Crisis
Crisis	55%	20%
Uncertain	33%	47%
No Crisis	12%	33%
Total	100%	100%

3 APPLICATION FOR MACROECONOMIC DIAGNOSIS: PATH CHANGES AND AVERAGE POSITIONS FOR THE 5 ASIAN COUNTRIES HIT BY THE 1997-98 CRISIS

3.1 The global or average picture: from the build-up of crisis factors to exit of troubles

In this section, an attempt is made to describe the overall positions and path changes for the five countries taken as a whole. Obviously, this does not suggest that the five countries were affected by the same difficulties or imbalances, neither that they are following the same exit paths. These differences will be analysed later in the paper, but it is a useful introduction to see how the "region" as a whole performed during the period preceding the crises, and during the years post-crisis.

The analysis is conducted by looking at each Fundamental Balance. The "region's" characteristics are computed as simple arithmetic average of the five countries' performances (South Korea, Indonesia, Thailand, Malaysia and the Philippines), and is referred to, in the text and charts, as A5 (Asian Five).

The observation of the five Fundamental Balances for the A5 countries is indeed very revealing: taken as a whole, A5 did not exhibit major signs of over-indebtedness (Financing Balance), and the crisis was not a result of sustained insufficient growth accompanied by massive current account deficits, the key elements that were found in most country crises before, notably in Latin America and Africa.

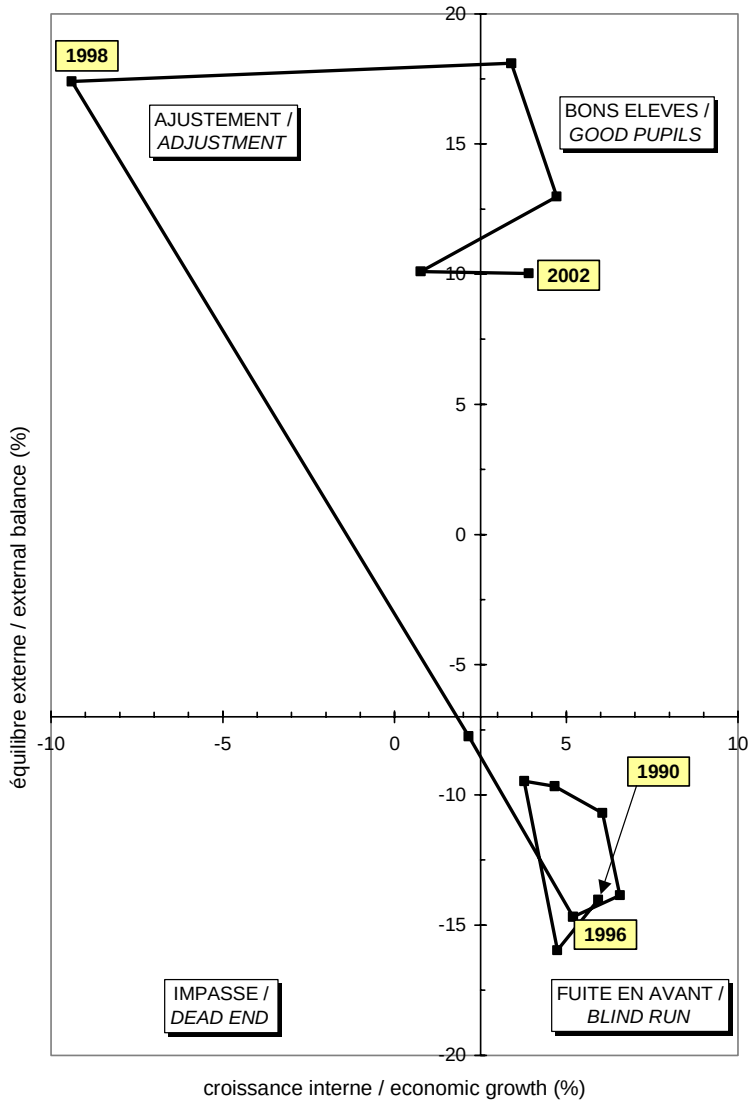
The reading of the five Fundamental Balances can help in summarizing the logics of the build-up to the crisis, the shock itself, and the exit from it in subsequent years, taking the 5 countries as a whole:

Prior to the crisis, the A5 countries were registering an unsustainable combination of sustained *blind run* in the Growth Balance (high growth, but too large current account deficits that need to be financed), very unstable sources of finance (Financing Balance), *unsustainable overvaluation* in the Foreign Exchange Balance (overvalued exchange rates with insufficient foreign currency reserves), a *speculative bubble* situation in the Cyclical Balance (ample money creation not absorbed by a matching real economic momentum), and a *systemic risk* situation in the Banking System Balance. The first signs of strains that emerged in the corporate and financial sectors in Thailand in the first half of 1997 were then enough to trigger the successive devaluations, themselves fostering the banking crises and a partial paralysis of financing mechanisms, amplified by the massive retrenchment of short-term

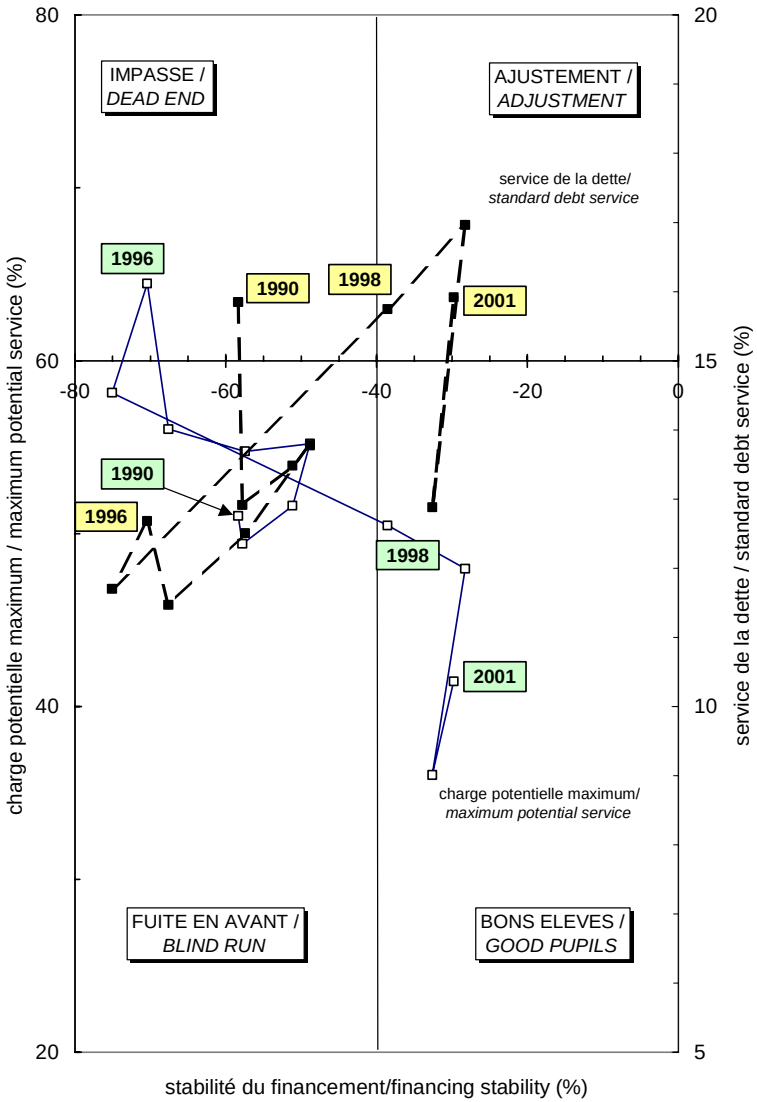
capital providers; added to the high credit leverage, this pushed the economies into the most severe economic crisis of the last decades.

The adjustment that took place right after the currency meltdown of July-October 1997 can also be clearly seen in our five Fundamental Balances, with large and rapid changes in all of them, underlying critical moves in economic fundamentals. The A5 thus experienced a very deep recession associated with a spectacular improvement in their current account balance (in surplus after many years of deficit), which propelled the path in a pronounced *adjustment* in the Growth Balance. The short-term capital outflows caused by the crisis enabled the *financing stability* to improve rapidly, as well as the *maximum potential service* indicator, highlighting the much reduced financial vulnerability after the crisis. Conversely, the more "structural" indicator of external solvency, the *standard debt service*, deteriorated significantly, mostly because of higher amortization payments, and the difference in currency structure of debt on the one hand (heavily in dollars or other major currencies), and of GDP (heavily in local currencies) on the other. This explains the opposite movement in the two paths of the Financing Balance. The improvement is also rapid and sharp in the Foreign Exchange Balance, with the five countries switching from the *overvaluation* area to the *undervaluation* one, on the ground of currency devaluation, thus experiencing strong competitiveness gains. At the same time, falling foreign exchange reserves explains why the path went through the *liquidity risk* zone at the beginning of the crisis. The Cyclical Balance saw relatively limited changes: plummeting imports were compensated by depreciated exchange rates (hence a stable *real economic pressure*), while monetary expansion took place to support the banking system hit by the crisis: the *monetary pressure* increases consequently. Indeed, as can be seen in the Banking System Balance, the banks of the A5 had to face a reversal in *foreign financing*, with international banks stopping lending to them, and the path moving away from the *systemic risk* zone. Overall the crisis triggered important changes in all five Balances, which led the A5 in a very different post-crisis situation, where the nature of the risk itself has evolved.

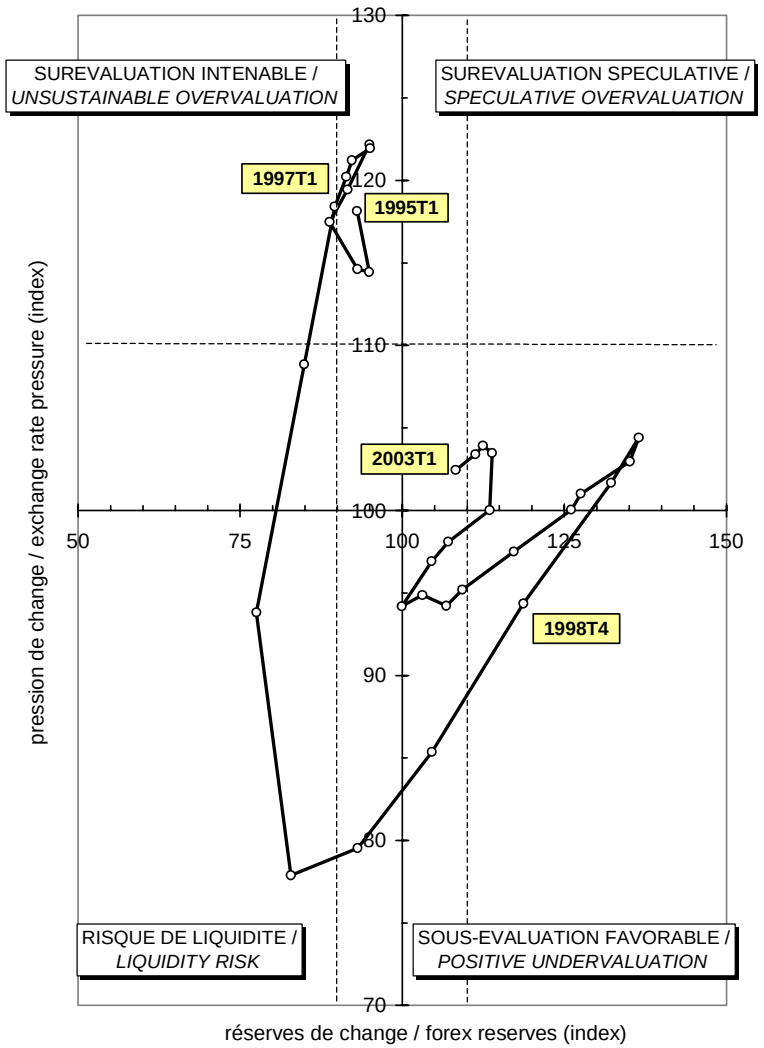
1 - Equilibre de Croissance / Growth Balance
A5



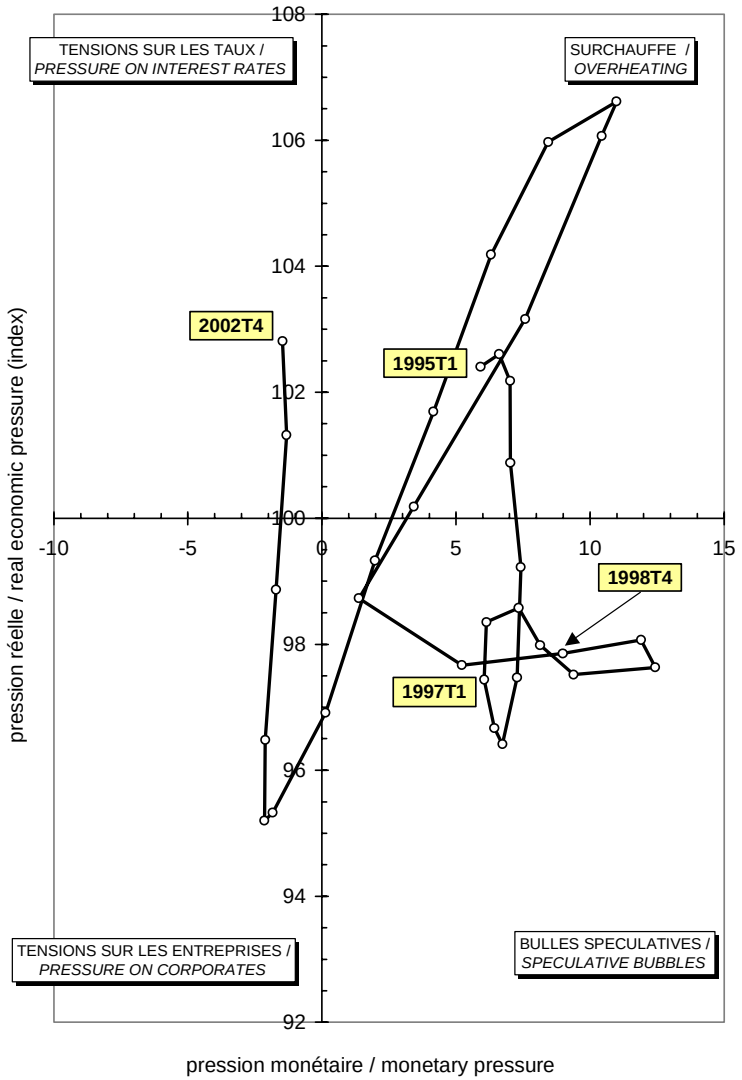
2 - Equilibre de Financement / Financing Balance
A5



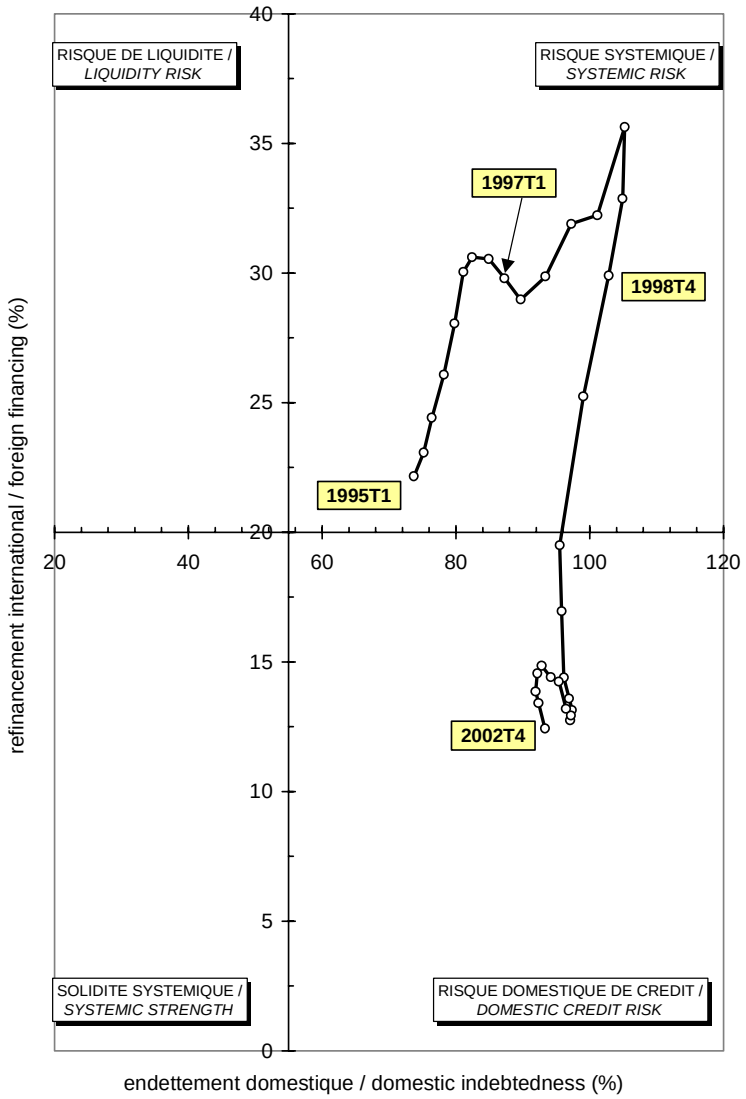
3 - Equilibre de Change / Foreign Exchange Balance
A5



4 - Equilibre Conjoncturel / Cyclical Balance
A5



5 - Equilibre Bancaire / Banking System Balance
A5



The five Asian countries in the post-crisis period experience strong current account surplus as shown in the Growth Balance. However, the *economic growth* indicator is now oscillating around the risk threshold, underlining that the countries have not managed to go back to their high pre-crisis GDP growth rates. In countries where population growth is still high, this lack in growth momentum highlights increasing political and social tensions despite absent financing problems. Similarly, the Financing Balance indicates that, due to the now above-threshold *financing stability*, the five countries are less vulnerable to financial shocks, though the structural debt situation has worsened (while remaining under control) and rising debt service raise management issues. The *positive undervaluation* and resulting foreign exchange gains underpinned by the crisis have been short-lived: with very large external surpluses and progressively restored confidence, the A5 path in the Foreign Exchange Balance moved away from the *liquidity risk* as soon as 1998Q3, the increase in official reserves being amplified on the *forex reserves* index by the simultaneous reduction in international interbank credits. This rapid exit coincided with nominal appreciation of all five currencies compared to their troughs at the worst of the crisis, rapidly erasing the competitive advantage taken by the depreciation of 1997. It is also important to note that part of this return to a neutral currency valuation is due to the Chinese deflation and stability of the Chinese currency vis-à-vis the dollar. The current position is undoubtedly far better than just before the crisis, but leaves open the question of competitiveness in presence of world deflationary forces and increased competition for market shares by all developing countries. The post-crisis period in our Cyclical Balance reflects the global economic cycle (1999-2000 growth followed by the 2001 recession especially strong in the electronic sector), domestic demand momentum now taking place at lower and constant *monetary pressure*. The path has also moved out from the most dangerous *systemic risk* zone in our Banking System Balance, but the current situation of the five Asian countries highlights a still high economic leverage and strong link between cyclical evolutions and the banking system, which can constrain economic growth. Thus, as seen in all five Balances, the five Asian countries have moved from a situation where financial risks were the highest to one where external financing is not an issue any longer but where political and social risks have grown up, putting more pressure on governments and on their management of potential tensions.

3.2 The country by country approach: nuances to the average picture

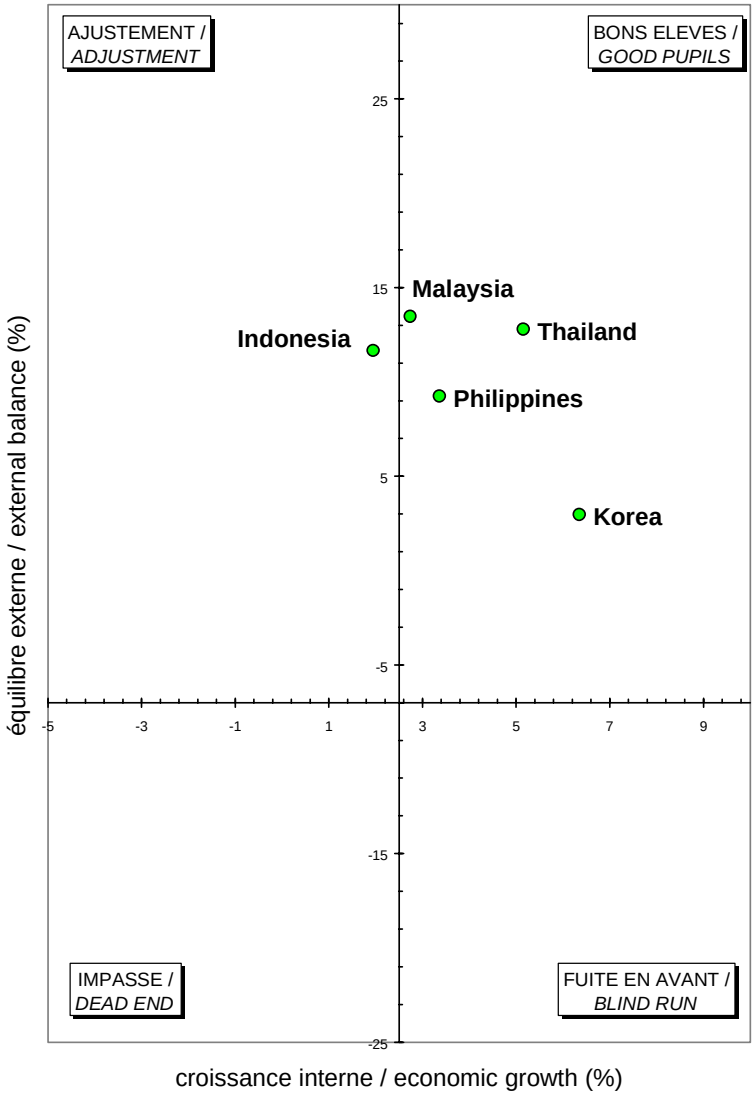
Despite the regional contagion and relative homogeneity in initial causes and unfolding of the crisis, the five Asian countries have registered very significant differences in macroeconomic performances during the post-crisis period. A rapid examination of the latest positions of each country in the five Fundamental Balances, enables to make the following comments:

At one end of the spectrum lies Indonesia, with a combination of positions within the five Balances certainly better than before the crisis, but not yet very favourable. Indeed, Indonesia has not been able to register rapid economic growth and has remained in the *adjustment* area of the Growth Balance every year since 1998. In TAC's system, this is a very powerful determinant of social and political tensions, that added to the specific regime change induced by the fall of President Suharto in the wake of the crisis. In parallel, the flows of foreign direct investments have turned negative (non-residents liquidating their assets and shifting the funds abroad), here again almost continuously since the eruption of the crisis. Added to the "discovery" of previously unreported external debt by private borrowers, this was instrumental in leaving Indonesia in the *dead end* area in the Financing Balance. In other

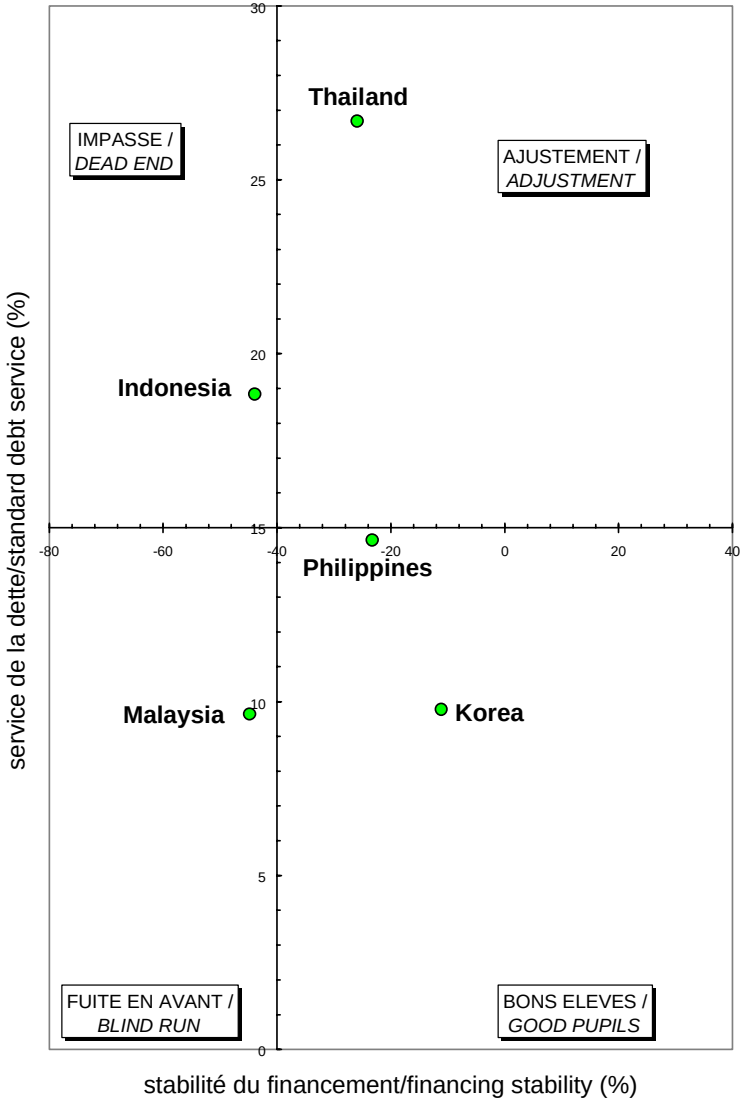
words, the key "structural" imbalances have shifted significantly after 1997, from excessive external deficits to insufficient growth, from speculative capital to excessive debt burden, but still remained negative. The Cyclical Balance is hampered by the difficulties of the banking and financial system, as well as by the very slow corporate restructuring taking place. The most visible improvements are concentrated on the Foreign Exchange Balance (with a neutral competitiveness associated with ample reserves), and on the Banking System Balance (with a more rapid move than in the other Asian countries towards a *systemic strength*. For the latter, it has to be recognized that the improvement in the macro leverage is related as much to the inability of banks to extend credit, as to a real balance sheet transformation.

At the other end of the spectrum lies Korea. Indeed, the 1997 shock triggered a more lasting move into the areas of *good pupils* for both the Growth and the Financing Balances. The "structural" ability of the country to grow without significant hindrances from external factors has been re-established, notwithstanding the dependence of cyclical developments to the international conditions. This is also indicated by the Cyclical Balance, which tends to suggest that the recent "blip" in GDP growth early in 2003 is only temporary, and related to such "exceptional" factors as the SARS impact, the tensions with North Korea and the corporate scandals. However, Korea's positions in the Foreign Exchange and the Banking System Balances warrant a note of caution for the short-term risks: indeed, the Won appears to be now overvalued by about 15%, the highest level within the five countries, and the level of reserves, very high in nominal terms (USD 122 bn at the end of March 2003), is just neutral when confronted with the domestic liquidity (M2) expansion and the pick-up in international bank lending. The *domestic credit risk* of the Banking System Balance confirm that the microeconomic de-leverage has been obtained mostly through a re-shuffling of subsidiaries (and a cleaning of intra-group accounts) and an increase in equity, but not through any significant reduction in debt incurred by the domestic economic agents (with a relative, but limited, switch between corporate lending and consumer lending, the boom in the latter being now translated into a spectacular increase in household defaults on their credit cards).

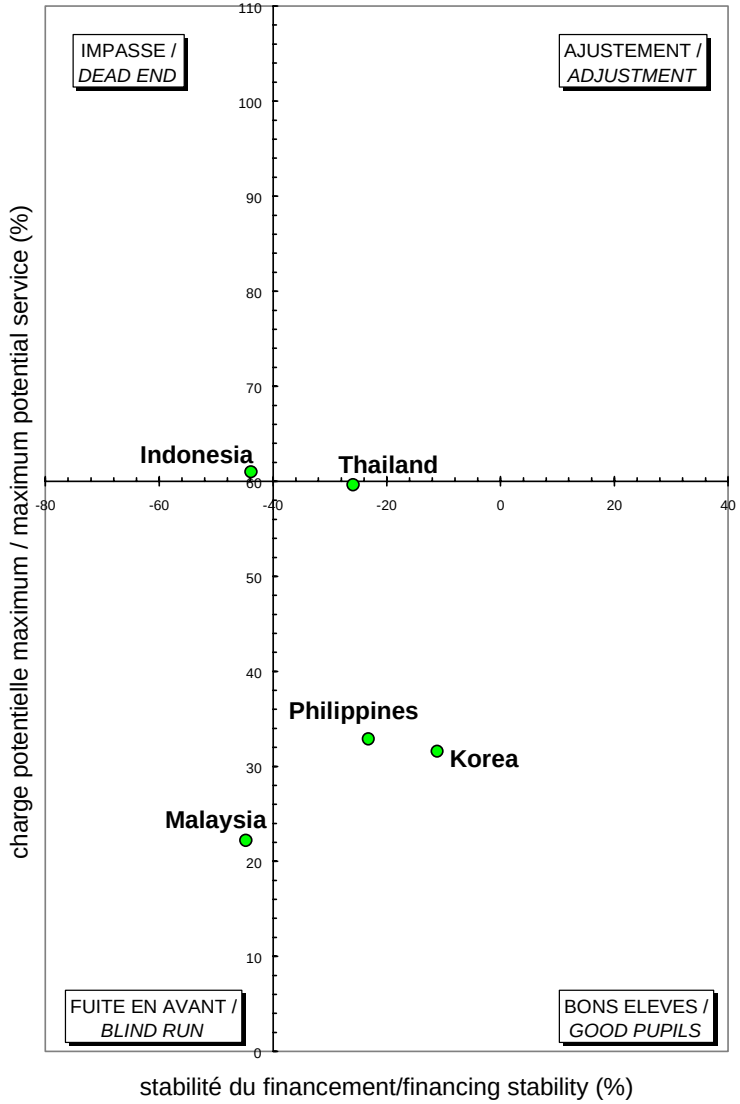
1 - Equilibre de Croissance / Growth Balance



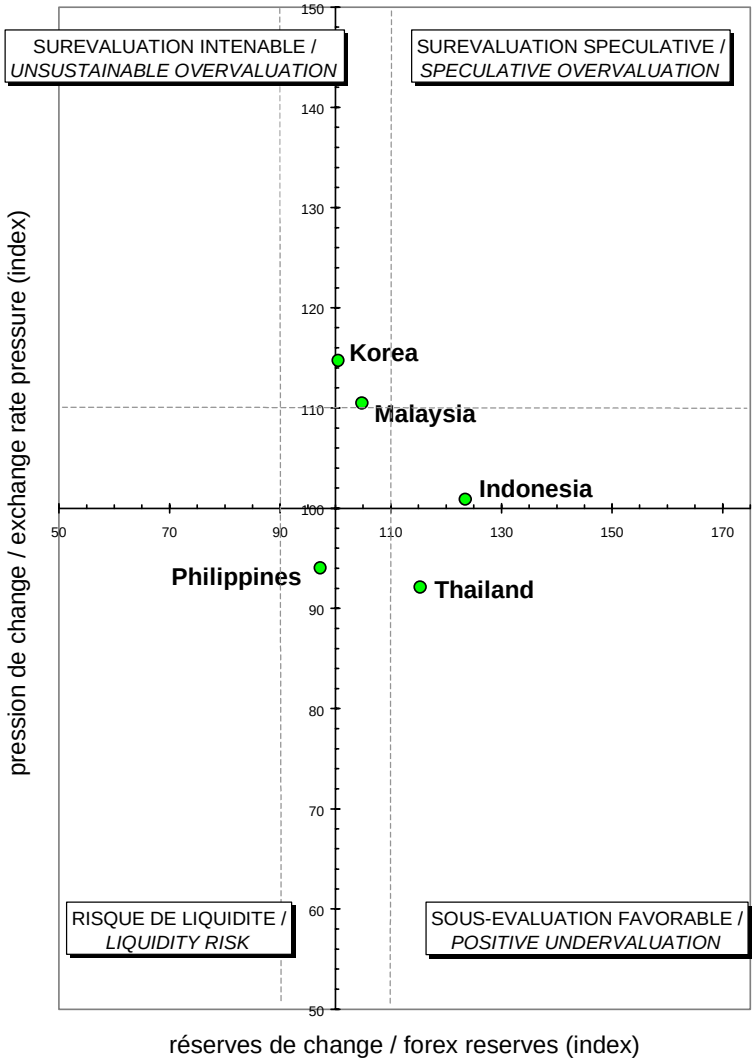
2 - Equilibre de Financement / Financing Balance
service de la dette / debt service



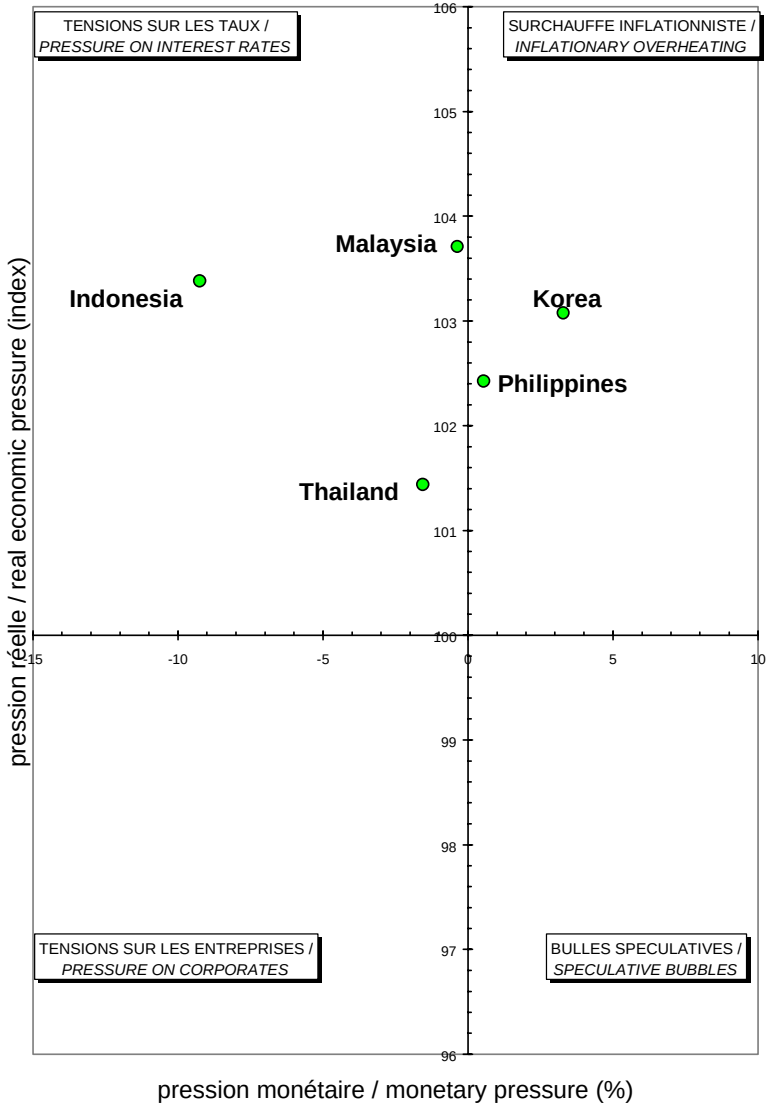
2 - Equilibre de Financement / Financing Balance
charge potentielle maximum / maximum potential service



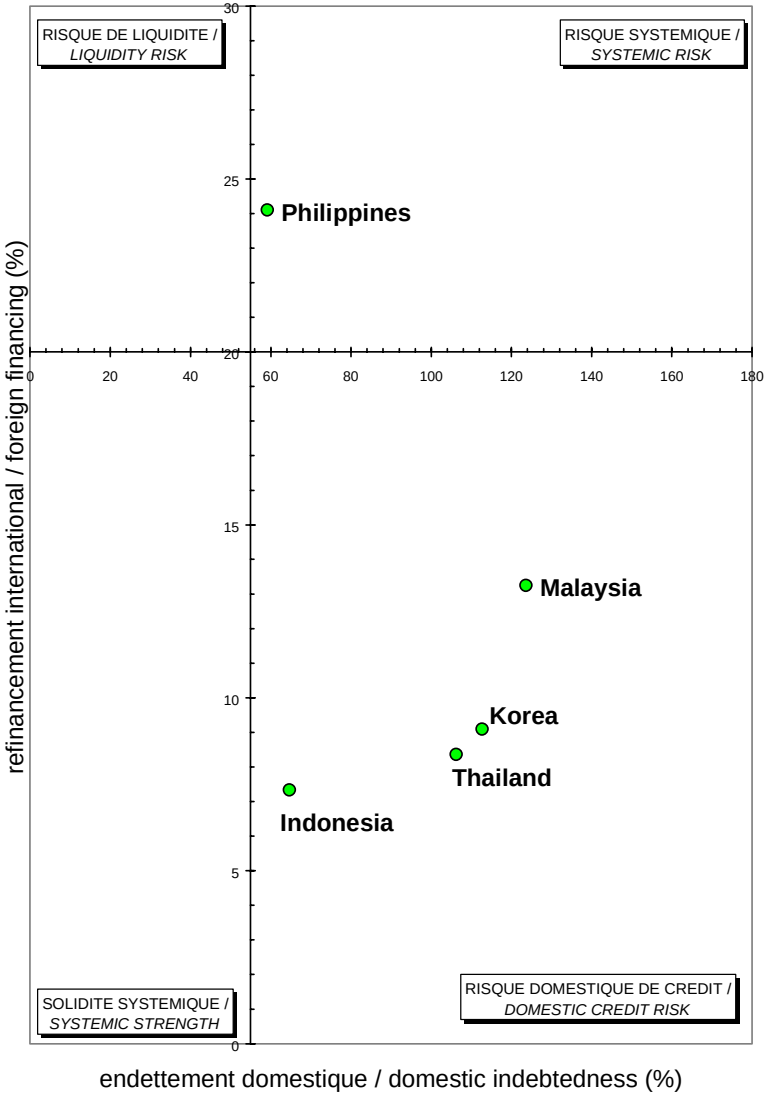
3 - Equilibre de Change / Foreign Exchange Balance



4 - Equilibre Conjoncturel / Cyclical Balance



5 - Equilibre Bancaire / Banking System Balance



In-between these two countries lie the other three members of the so-called A5, with conclusions blurred by the mixed signals provided by RiskMonitor and indeed very different situations between them. Thailand, the Philippines and Malaysia are all in the *good pupils* area for the Growth Balance, but rather close to the risk threshold for the last two (riskier for the Philippines, because they have been only twice in this area since 1994). Their performances are even more apart in the Financing Balance, with a drying-up of FDI more visible for Malaysia (*blind run*), an unfavourable amortization schedule for Thailand (in the *adjustment* area, but likely to move back closer to the risk threshold as soon as 2003-04 considering the expected schedule of repayments), and a position rather close to the two risk thresholds (*financing stability* and *standard debt service*) for the Philippines. The positions on the Foreign Exchange Balance also reveals some fragilities for the three countries, but in a different manner: a more pronounced *liquidity risk* for the Philippines, notwithstanding a still competitive exchange rate; conversely, a slight overvaluation for the Malaysian Ringitt (but possibly corrected with the recent dollar depreciation against which the currency is pegged); and finally, a better position for Thailand, in the *positive undervaluation* area, but possibly corrected by the appreciation against the dollar in the recent period. The performances are more aligned in the Cyclical Balance, with a rather favourable position for all three countries, but are again very different in the Banking System Balance: indeed, the Philippines have moved back into the *systemic risk* area, at a time when non-performing loans are still at high levels. Thailand and Malaysia have clearly exited this more risky area, but are still characterized by very large macro-leverage effects in the economy.

4 CURRENT SITUATION: WHAT CAN BE SAID IN TERMS OF RISK

As was seen in the previous section, though a general common move can be seen in the five Asian countries hit by the crisis in 1997-98, each of them also have its own specificities, which explains different reaction to the crisis and post-crisis periods. Apart from what the quantitative system tells us, qualitative elements are obviously useful to better understand these differences.

South Korea has demonstrated a very strong adjustment to the shock caused by the crisis, its industrial sector going through major adaptation and restructuring, which enabled maintained competitiveness and stronger economic rebound. The country has also relied on research and development to keep up with its previous economic growth momentum and to insure productivity gains. In that sense, the 1997-98 crisis appears more like a “repeat” of previous “leaps” taken by the country in its very successful development strategy, with a major industrial transformation imposed by a macroeconomic disruption. Finally, the coincidence of the crisis and of general elections helped alleviate the political pressures by putting in charge a team with a popular mandate right at the moment when tough decisions were needed. This positive approach is however tempered by the geopolitical threat caused by North Korea, as well as by domestic factors that may impair growth (recent economic overheating, foreign exchange overvaluation, corporate scandals).

In both Indonesia and the Philippines, the relative stable political background of South Korea is absent. The political leadership immediately after the crisis was held partly responsible for the poor management of the events, and no popular mandate was given. In both countries today, the current leadership has not been elected, but pushed into power by a vacuum at the top, vacuum itself related to very strong political tensions, and putting the military forces as a

key arbiter in the two countries. In both countries, the way out of the crisis has taken longer and is not fully finished yet, with many structural reforms still pending. Growing terrorism threats added to high income inequalities, strong political patronage and high corruption are further shaking the political power and make both countries more fragile as regards the "pure" political risk. Though none of the two countries are currently in a critical situation, the longer-term perspective is more clouded.

Malaysia and Thailand are somewhat in between: they are less industrialized than South Korea but they are politically more stable than Indonesia and the Philippines, all the more so that the political leadership in both countries has clearly played a "supportive" nationalistic stance. Both countries are open economies and thus remain highly dependent on the global environment and on foreign direct investments (FDIs) to support their growth. In a context of loss in competitiveness (increased labour costs, not compensated by productivity gains) and greater competition from China, both countries face new challenges to attract FDIs and to develop their economies further to rely less on the export sector for their economic growth.

These brief qualitative comments can then complement the current quantitative measures of risk for the five countries as provided by RiskMonitor (combination of positions in the five Fundamental Balances, as of August 2003):

Table 3: Ratings and Vulnerabilities for the A5

Ratings	Development Risk	Solvency Risk	Short-term Financial Risk	Short-term Cyclical Risk
Indonesia	C	C	B	B
Korea	B	B	C	C
Malaysia	B	B	C	C
Philippines	B	B	B	B
Thailand	B	B	A	A

Vulnerabilities	Transfer Risk	Liquidity Crisis	Exchange Rate Crisis	Cyclical Shock
Indonesia	80	33	43	60
Korea	20	8	43	0
Malaysia	0	0	0	0
Philippines	0	0	0	0
Thailand	0	8	0	0

A synthetic table using both Vulnerability and Rating measures can be useful to summarize the results:

Table 4: Synthetic summary of Risk measures

Risk Ratings Vulnerability	A or B	B or C	D	K
<50	***VERY LOW RISK*** Thailand	***LOW RISK*** South Korea Malaysia Philippines	***HIGH RISK***	***CRITICAL RISK***
>50	***LOW RISK***	***MODERATE RISK*** Indonesia	***VERY HIGH RISK***	***CRITICAL RISK***

Overall, the probability of one of the four crises analysed through RiskMonitor (default, liquidity, exchange rate, cyclical) in the next eight quarters remain low for the whole group of countries. Indonesia is still in the worst position, and Thailand is the country exhibiting the best combination of Fundamental Balances.

5 CONCLUSION

The "East Asian miracle" was not a mirage, and macroeconomic performances as well as risks of significant crisis have improved, even though at a diversified pace and to a different extent. The examination of five economic Balances that have had a very good track record in providing early warning signals of upcoming crises suggest that the financial excesses that have characterized the first part of the 90s have by and large disappeared. The probability of sudden financial explosions is low or very low in all five countries.

However, the same Balances clearly show that the 'key' risk issues have been profoundly transformed. The ability of the Asian countries to adjust to changes in their environment (mostly external conditions in industrialized nations) is now based on the "flexibility" of the domestic growth rate of the economy. Activity, and therefore employment, have become the major "adjustment variables", a positive development when seen from a foreign banker's short-term perspective, but a more questionable change when taking into account the lack of (or the limited extent of) social safety nets, the dire need for infrastructure improvement, at least in some of the countries (Indonesia, Philippines, Thailand), and the somehow fragile political situation (at least again in the Philippines and Indonesia, but also to a certain extent in Malaysia). Similarly, corporate governance has somewhat improved, and banks have become more cautious in extending loans to companies, but this has not led to a significant macro-deleveraging, shifting the financial risks from companies to households, and again highlighting the new social and political dimension of present country risks in the five countries. This "new nature of risk" is amplified by the international developments worldwide (terrorism, religious fundamentalism, "rogue" States, unilateralism by major powers), as well as by the new economic challenges that the A5 have, one way or another, to face (competition from China, volatile currencies, question on the multilateral trade organization).

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