

The *Asia Economic Monitor* (AEM) is a semiannual review of emerging East Asia's growth, financial vulnerability, and emerging policy issues. It covers the 10 Association of Southeast Asian Nations members; People's Republic of China; Hong Kong, China; Republic of Korea; and Taipei, China.

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## Highlights

### Economic Performance in the First Half of 2006

- Emerging East Asia's economic growth likely accelerated in the first half of 2006. In the first quarter of the year, the region posted average GDP growth of 8.1%—higher than the previous quarter's 7.7% figure; available indicators suggest that GDP continued to grow at a brisk pace in the second quarter as well.
- Faster export growth—driven by an increasingly broad-based expansion among industrial economies and by a rebound in the global demand for IT products—benefited economies across the region.
- As for domestic sources of growth, while a rapid increase in investment added significant stimulus to the PRC's strong growth, investment generally increased in ASEAN and the NIEs but contributed much more modestly to the expansion.
- Higher energy prices continued to create or accentuate inflationary pressures across the region: in the PRC and NIEs, inflation remained relatively subdued—though it has inched up in recent months, while in many ASEAN economies, it was either trending up strongly or remained at elevated levels.
- Even as the region maintained strong growth, most stock markets, after soaring through mid-May, suffered from a global correction in risk appetite and plummeted over the following month, erasing much of the year's gains and adding volatility to regional currencies.
- Balance of payments positions were stronger across emerging East Asia, as current account balances improved and capital inflows increased. Coupled with official interventions in exchange markets, this led to a build-up of foreign exchange reserves.
- Despite the mid-May market jitters, financial vulnerability indicators suggest improved resilience of most emerging East Asian economies to possible financial shocks; in some economies, however, banks' exposure to real estate is rising.

### Outlook, Risks, and Policy Issues

- Looking ahead, sustained and broad-based economic expansion in major industrial countries and the rebound in the global IT industry should augur well for the emerging East Asian economic outlook. Nonetheless, continued global monetary tightening and elevated energy prices could somewhat cloud the external economic environment.

*Continued overleaf*

## Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AEM	Asia Economic Monitor
AMC	asset management company
ARIC	Asia Regional Information Center
ASEAN	Association of Southeast Asian Nations
ASEAN5	Indonesia, Malaysia, Philippines, Singapore, Thailand
bbl	barrel
bp	basis point
BOJ	Bank of Japan
BOT	Bank of Thailand
CAR	capital adequacy ratio
CBC	Central Bank of China (Taipei, China)
CLI	composite leading indicator
ECB	European Central Bank
GDP	gross domestic product
IMF	International Monetary Fund
IT	information technology
JCI	Jakarta Composite Index
KLCI	Kuala Lumpur Composite Index
Korea	Republic of Korea
KOSPI	Korean Stock Price Index
Lao PDR	Lao People's Democratic Republic
LEERS	Linked Exchange Rate System
M2	broad money
mbd	million bbl/day
NPL	nonperforming loan
NYMEX	New York Mercantile Exchange
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
OREI	Office of Regional Economic Integration
PCOMP	Philippine Composite Index
PRC	People's Republic of China
ROA	return on assets
SET	Stock Exchange of Thailand
STI	Straits Times Index
TWSE	Taiwan Stock Exchange Index
US	United States
US FED	US Federal Reserve
VAT	value-added tax
WHO	World Health Organization
WTO	World Trade Organization
y-o-y	year-on-year

Note: "\$" denotes US dollars unless otherwise specified.

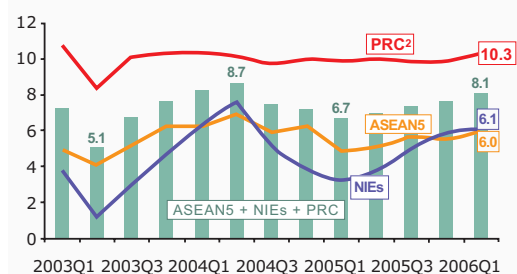
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- On balance, the current assessment is that in 2006 emerging East Asia is likely to post an average GDP growth of 7.5%—higher than in 2005. In 2007, the region's average growth is forecast to slow, in part because of easing growth in US, Japan, and PRC, yet remain a healthy 6.9%.
- In the PRC, growth is expected to be 10.1% this year and 9.0% in 2007. A domestic demand recovery in Korea should push average GDP growth in the NIEs up to 5.1% this year, which will then likely slow to 4.7% in 2007. GDP growth in ASEAN is expected to be 5.5% this year, rising slightly to 5.7% in 2007 mainly as a result of country-specific factors that will boost domestic demand, such as a recovery from the effects of the August 2005 mini-financial crisis in Indonesia.
- This favorable outlook is subject to two types of risks: (i) near-term cyclical risks and (ii) deeper, structural, low probability but high impact risks.
- A sharp fall in external demand, correction of an overheating PRC economy, higher-than-expected energy prices, and a significant deterioration in global financial conditions constitute the first risk category, while a sudden and disruptive adjustment of the global payments imbalances and an outbreak of an avian flu pandemic belong to the second.
- Against the backdrop of the prospects for robust growth and higher inflation, emerging East Asia's policy options for managing near-term risks comprise a combination of further monetary tightening—through interest rate hikes or currency appreciation, or both, and in some cases, additional efforts to narrow fiscal deficits and reduce public debt. For example, in the PRC, both interest rate hikes to cool domestic demand and currency appreciation to address external imbalances are appropriate. At the same time, increasing exposure of banks to real estate in some economies needs close monitoring and appropriate measures to reduce risks.
- To address deeper vulnerabilities, the region's policy priorities should be to (i) boost domestic demand—consumption in the PRC and investment in most other economies, (ii) increase exchange rate flexibility, (iii) improve the region's energy efficiency, and (iv) prepare for the possibility of an avian flu pandemic.

# Emerging East Asia's Growth and Restructuring—A Regional Update

## Economic Performance in the First Half of 2006

Figure 1: **Regional GDP Growth<sup>1</sup>** (y-o-y, %)



<sup>1</sup>Weighted by gross national income (atlas method, current \$).

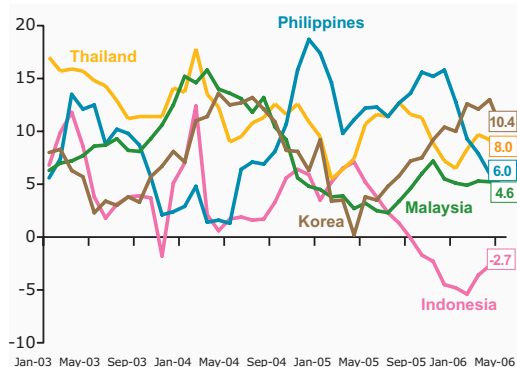
<sup>2</sup>PRC estimates based on OREI staff calculations.

Source: Asian Development Bank.

## GDP Growth

Economic growth in emerging East Asia<sup>1</sup> likely accelerated in the first half of 2006, continuing the positive trend from the second half of last year. Taken together, the nine large economies in the region<sup>2</sup> saw gross domestic product (GDP) expand by 8.1% in the first quarter of 2006 (2006Q1), up from 7.7% in 2005Q4 (Figure 1). The People's Republic of China (PRC) continued to anchor the expansion, growing 10.3% in 2006Q1. GDP growth also accelerated to 6.1% for the three newly-industrialized economies (NIEs), and to 6.0% for the five large economies of the Association of Southeast Asian Nations (ASEAN).

Figure 2: **Industrial Production Growth<sup>1</sup>** (y-o-y, %)

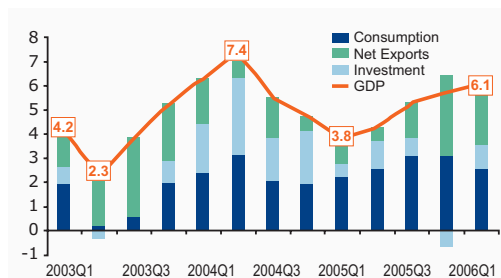


<sup>1</sup>3-month moving average.

Source: ARIC Indicators.

Industrial production was strong in several of the region's economies during the first half of 2006. Singapore and the NIEs all saw much stronger industrial growth in early 2006 than in 2005, with the Republic of Korea (Korea) posting 10.4% growth in May (Figure 2). Elsewhere, industrial growth was mixed: steady in Malaysia (4.6%), falling in the Philippines (6.0%) and Thailand (8.0%), and still negative in Indonesia (-2.7%). In the PRC, industrial production grew 17.9% during May 2006 after holding steady at 16.0–16.5% since May 2005.

Figure 3: **Contributions to Regional<sup>1</sup> GDP Growth** (y-o-y, %)



<sup>1</sup>Regional = ASEAN5 + NIEs.

Source: ARIC Indicators and OREI staff calculations.

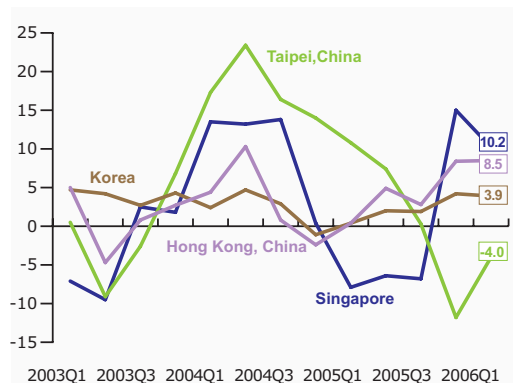
In terms of demand, a revival of investment and increased exports elevated GDP growth in 2006Q1. Excluding the PRC, investment rebounded in 2006Q1 from a small decline in 2005Q4 (Figure 3). In contrast, consumption growth eased somewhat in 2006Q1, but still provided strong support to overall expansion. Exports further strengthened in 2006Q1, continuing the rebound from softer external demand in the first half of 2005.

Fixed investment improved or held steady in several economies in 2006Q1. Fixed investment growth during the period stabilized at 3.9% in Korea and 8.5% in Hong

<sup>1</sup>Emerging East Asia includes the 10 members of the Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam); People's Republic of China; Hong Kong, China; Republic of Korea; and Taipei, China.

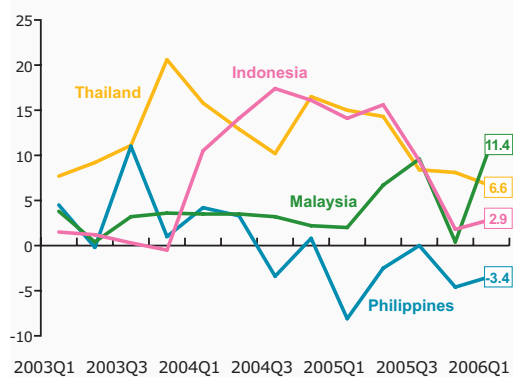
<sup>2</sup>The nine large regional economies for which quarterly data are available are People's Republic of China, three newly-industrialized economies (Hong Kong, China; Republic of Korea; and Taipei, China)—NIEs, and the five large ASEAN economies (Indonesia, Malaysia, Philippines, Singapore, and Thailand)—ASEAN5. These economies account for about 99% of the aggregate regional economy.

Figure 4A: **Fixed Investment Growth** (y-o-y, %)



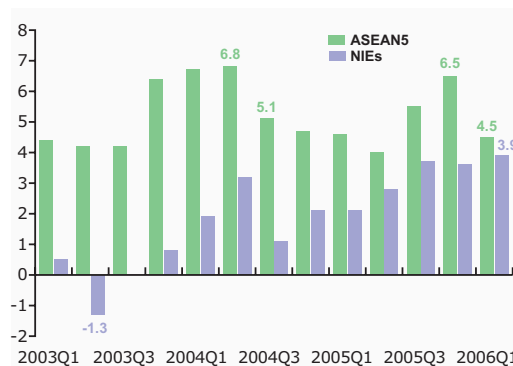
Source: ARIC Indicators and OREI staff calculations.

Figure 4B: **Fixed Investment Growth** (y-o-y, %)



Source: ARIC Indicators and OREI staff calculations.

Figure 5: **Consumption Growth** (y-o-y, %)



Source: ARIC Indicators and OREI staff calculations.

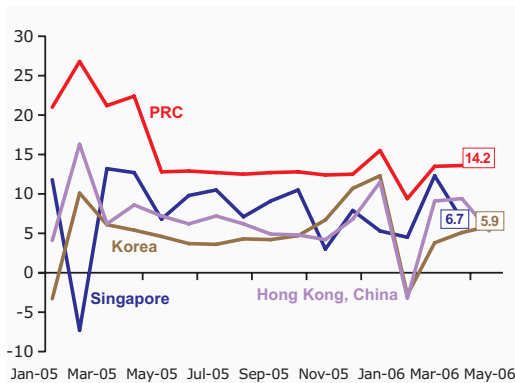
Kong, China following slow 2005 growth (Figure 4A). In Singapore, fixed investment grew 10.2% in 2006Q1, showing continued volatility. After a surge in growth in 2004 and early 2005, fixed investment in Taipei, China plunged 11.8% in 2005Q4, but the decline slowed to -4.0% in 2006Q1. Like Singapore, Malaysia’s fixed investment rebounded strongly, with a 2006Q1 increase of 11.4%, as global demand solidified for information technology (IT) products—a key Malaysian export (Figure 4B). Indonesia, however, saw only a mild rise in investment growth, to 2.9%, after the financial turbulence last year triggered a sharp slowdown in the second half. Similarly, investment growth continued to ease in Thailand, to 6.6%, in part due to political uncertainty. Continued political uncertainty also affected Philippine investment, which has experienced a prolonged contraction. Investment has been much stronger and sustained in the PRC than elsewhere in the region. Monthly growth of real fixed asset investment edged up to an average 27.7% in 2006Q1 from 25.7% in 2005Q4.

Growth in consumption fell slightly in 2006Q1, after a strong 6.5% growth in ASEAN5 at the end of 2005, and despite the slight increase in the NIEs (Figure 5). In ASEAN5, especially Indonesia, there was a surge in public consumption from 2005Q4 to 2006Q1. Strong consumer credit growth in Malaysia and continued growth in Philippine remittances maintained the robust and stable growth in the two economies. Among the NIEs; Hong Kong, China saw public consumption in 2006Q1 emerge from a prolonged contraction. In Korea, private consumption continued to recover as the workout of the 2003 household debt problem progressed.

Evidence from retail sales data suggests that slowing consumption growth in ASEAN5 in 2006Q1 may have continued in recent months (Figure 6). Although the seasonal distortion caused by holiday sales makes trends over 2005Q4–2006Q1 difficult to interpret in the NIEs, consumption growth appears to be strengthening, at least in Hong Kong, China. In the PRC, monthly retail sales growth averaged 13.2% monthly in the first 5 months of 2006.

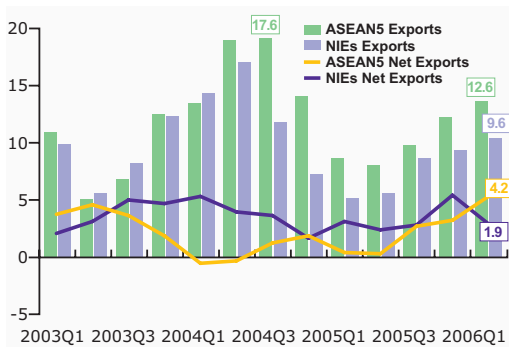
Exports continued to strengthen for both the NIEs and ASEAN5 in 2006Q1, contributing strongly to the region’s economic expansion (Figure 7). But ASEAN5 also saw a softening in domestic demand growth in 2006Q1. This

Figure 6: **Retail Sales Growth** (y-o-y, %)



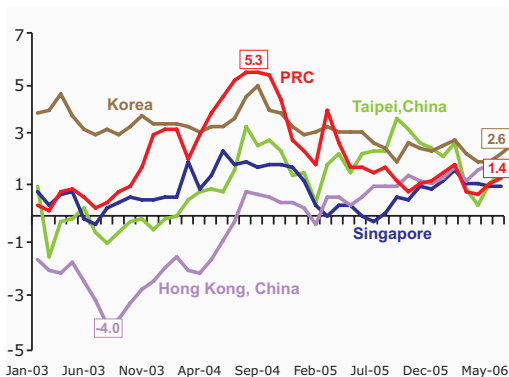
Source: CEIC.

Figure 7: **External Contributions to Growth** (y-o-y, %)



Source: ARIC Indicators and OREI staff calculations.

Figure 8A: **Low Inflation<sup>1</sup> Economies—Headline Rates** (y-o-y, %)



<sup>1</sup> Low inflation is defined as below 3% average inflation from Jan 2005 to most recent month where data are available. Sources: OREI staff calculations based on data from ARIC Indicators, Hong Kong Monetary Authority, and Central Bank of China (Taipei, China).

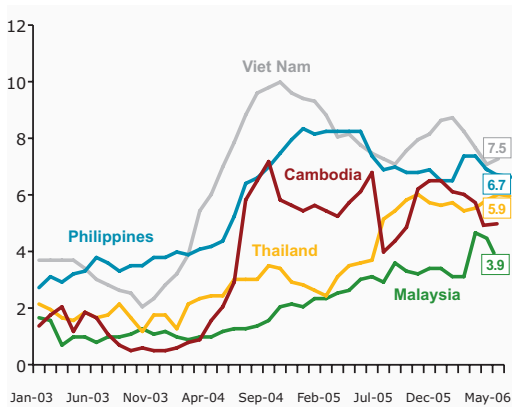
restrained import growth and thus boosted net exports for the third straight quarter—contributing 4.2 percentage points (or more than two-thirds) of total GDP growth in 2006Q1. In contrast, rebounding domestic demand in the NIEs accelerated import growth, eroding the contribution of net exports to 1.9 percentage points (or about one-third) of total GDP growth in 2006Q1. Trade data show that these trends—rising net exports in ASEAN5 and falling net exports in the NIEs—continued through the first half of 2006. The trade surplus in the PRC grew by 39% in US dollar terms in 2006Q1, indicating that net exports provided strong support to economic expansion. The PRC trade surplus grew at an even higher 63% in April–June 2006 over the same period last year, meaning the contribution of net exports to GDP growth was probably significant in 2006Q2 as well.

## Inflation

The sustained global increase in oil and other commodity prices—accelerating in 2005 and into the first half of 2006—continued to build inflationary pressures throughout the region. The extent to which these pressures fed inflation varied across economies with the region’s average inflation rate at 3.0% for the first 5 months of 2006, about the same rate as in 2005. This was mainly because inflation temporarily eased in the early months of 2006 but then began to trend higher. In the PRC and NIEs, inflation remained relatively subdued but inched up in recent months. In many ASEAN economies, it was either trending up strongly or remained at elevated levels. In several economies, such as Malaysia and Thailand, higher inflation accompanied higher economic growth in the first half of 2006. In others, such as the Philippines and Viet Nam, inflation fell in early 2006 from previous peaks, but remained high despite the gradual recovery in agriculture, particularly food production, since the poor harvests in 2004–05.

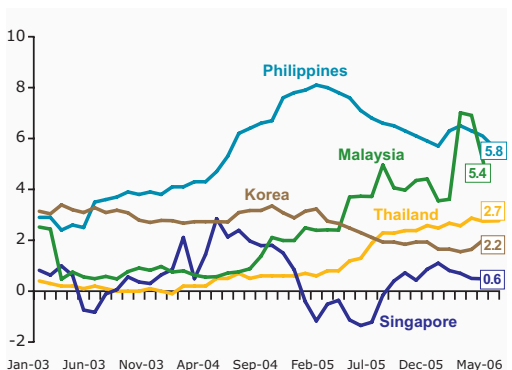
After dipping early in the year, inflation inched up in PRC; Hong Kong, China; Korea; and Taipei, China; but stayed below 3.0% (Figure 8A). The gradual decline of Korea’s inflation since 2004Q3 was helped by the won appreciation, which mitigated the impact of rising import prices. In the PRC, despite rapid demand growth, inflation has been contained thus far in 2006 by energy price controls, excess capacity in

Figure 8B: **Moderate Inflation<sup>1</sup> Economies—Headline Rates** (y-o-y, %)



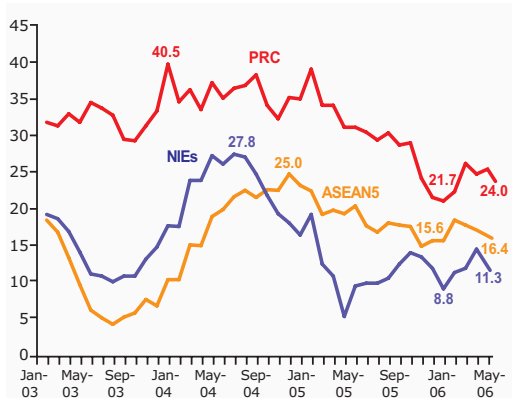
<sup>1</sup> Moderate inflation is defined as above 3% or above average inflation from Jan 2005 to most recent month where data are available.  
Sources: OREI staff calculations based on data from ARIC Indicators.

Figure 9: **Core Inflation Rates** (y-o-y, %)



Note: Official figures, except Malaysia (ex. food, fuel, utilities) and Singapore (ex. food, private transport).  
Sources: OREI staff calculations from Bloomberg data, Bank of Thailand, and Bangko Sentral ng Pilipinas.

Figure 10A: **Merchandise Export Growth<sup>1</sup>** (\$ value, y-o-y, %)



<sup>1</sup> 3-month moving average.  
Sources: ARIC Indicators and CEIC.

manufacturing, and good harvests. In Hong Kong, China; and Taipei, China, inflation rose from previously very low levels.

Among moderate inflation economies, inflation fell from the December 2005 level in Cambodia and Viet Nam (Figure 8B). Indonesia also saw inflation easing to (a still high) 15.5% in June 2006 after surging to 17.9% in October 2005 after fuel subsidies were lowered. In Thailand, which earlier removed fuel subsidies, inflation remained high in June 2006. A 20% hike in fuel prices in Malaysia spiked headline inflation in February 2006. In the Philippines, higher fuel prices and an increase in value-added tax (VAT)—to 12%—drove inflation higher early in the year.

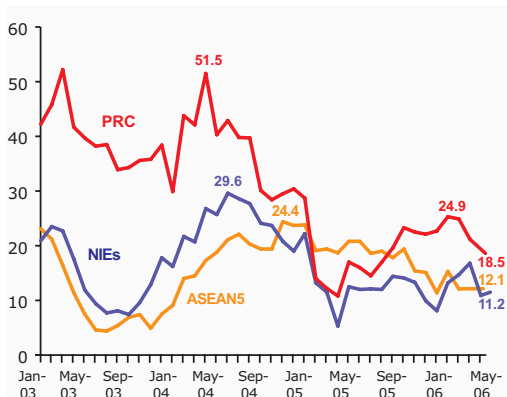
The extent of the pass-through effect of rising energy costs into core inflation varied across the region (Figure 9). The effects were relatively large in the Philippines—where higher fuel costs are quickly transmitted into higher utility prices—but subsequently began to appear elsewhere in the region. In Malaysia, the February 2006 fuel price hike quickly led to higher transportation costs. In Thailand, core inflation edged up to 2.7% but remained within the central bank’s target range.

## Balance of Payments

In the first half of 2006, a regional export rebound was underway across emerging East Asia, with growth stronger relative to late 2005. In turn, balance of payments surpluses increased, as current and capital account balances improved. Coupled with official interventions in exchange markets, this led to a build-up of foreign exchange reserves.

Aggregate regional merchandise exports grew at an average 18.0% in the first 5 months of 2006, compared with 16.3% in the last 3 months of 2005. This was anchored by a reacceleration of exports in the PRC, after a sharp decline in late 2005 (Figure 10A). For ASEAN5, a relatively broad-based, modest rebound—from an average 15.6% export growth in 2005Q4—benefited from the improved global IT demand, high commodity prices, and the 2005 quotas placed on PRC textile exports. For the NIEs, export growth rose in early 2006, propelled by stronger global IT demand and a recovery in import demand from the PRC—the NIEs’ largest export market.

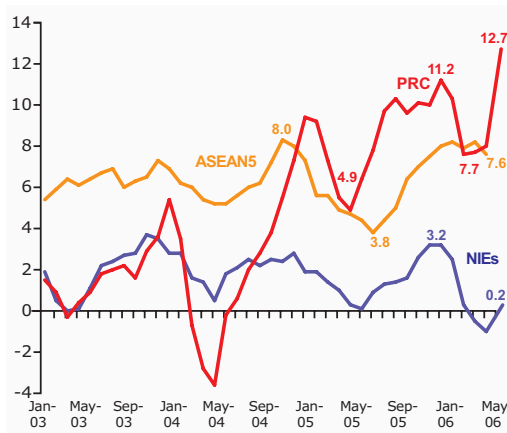
Figure 10B: **Merchandise Import Growth**<sup>1</sup>  
(\$ value, y-o-y, %)



<sup>1</sup>3-month moving average.  
Sources: ARIC Indicators and CEIC.

Emerging East Asia’s merchandise imports grew by an average of 15.7% in the first 4 months of 2006, compared with 15.3% in the last 3 months of 2005. On average, PRC monthly imports grew 22.0% in the first half of 2006, about the same pace as in 2005Q4 (Figure 10B). Import trends in the NIEs, in turn, largely followed export trends, except that import growth rebounded more strongly through March 2006. Aggregate NIEs import growth fell in April and May because of a sharp drop in import growth in Hong Kong, China. In contrast, import growth in Korea and Taipei,China continued to strengthen through May 2006. For ASEAN5 economies, import growth continued to slow in early 2006 because of the negative or sharply lower import growth in Indonesia and Thailand, due to fading economic momentum. However, for Malaysia and Singapore, strong export and investment growth drove import growth higher in the first 4 months of 2006.

Figure 11: **Trade Balance**<sup>1</sup> (\$ billions)



<sup>1</sup>3-month moving average.  
Sources: ARIC Indicators and CEIC.

Although variable seasonality makes trends difficult to interpret, in the first half of 2006 the PRC and ASEAN5 economies showed generally higher trade surpluses than a year earlier, whereas trade balances in the NIEs were weaker (Figure 11). The service and transfers components have remained relatively stable, while net income moved into surplus in 2005 due to higher interest earnings on reserves. Thus, it appears likely that the current account continued to strengthen in the first half of 2006 alongside the trade balance.

The aggregate current account surplus of ASEAN5 increased relative to GDP—from 8.0% in 2005Q4 to 9.4% in 2006Q1 (Table 1A). In Singapore the increase was slight—from 30.4% of GDP in 2005Q4 to 30.8% in 2006Q1. In Malaysia, it rose from 12.9% in 2005Q4 to 15.4% in 2006Q1. During the same period, Thailand’s current account surplus widened to 3.4% of GDP, Indonesia’s to 4.1%, and the Philippines’ to 4.4%.

In the NIEs, aggregate current account balances narrowed in 2006Q1 relative to 2005Q4 (Table 1B). There was a reversal in Korea’s current account balance, from 2.5% in 2005Q4 to -0.6% in 2006Q1, as the trade surplus narrowed and the services deficit increased along with stronger domestic demand. In Hong Kong, China, the current account surplus also narrowed but remained large at 10.2% of GDP. In Taipei,China, it fell from 10.5% of GDP in 2005Q4 to 7.1% in 2006Q1.

Table 1A: **Balance of Payments—ASEAN5**  
 (% of GDP)

	2005Q1	2005Q2	2005Q3	2005Q4	2006Q1
<b>Current Account</b>	6.3	4.5	7.4	8.0	9.4
Trade balance	8.5	7.3	10.4	11.9	11.8
Net Services	-1.2	-1.2	-1.5	-2.3	-1.6
Net Income	-2.1	-2.8	-2.9	-3.0	-2.0
Net Transfers	1.1	1.2	1.4	1.3	1.1
Capital Account	0.0	0.0	0.0	0.1	0.0
<b>Financial Account</b>	-1.1	1.4	-4.0	-8.5	-1.4
Net Direct Investment	2.2	4.2	2.8	1.9	4.0
Net Portfolio Investment	1.0	-1.4	0.5	-2.3	4.5
Net Other Investment	-4.3	-1.3	-7.3	-8.1	-9.9
Net Errors & Omissions	0.0	-1.0	-1.0	0.1	-0.3
<b>Overall Balance</b>	5.1	4.9	2.3	-0.4	7.7

Sources: Bank Indonesia, Bangko Sentral ng Pilipinas, *International Financial Statistics Online* (International Monetary Fund), and CEIC.

 Table 1B: **Balance of Payments—NIEs**  
 (% of GDP)

	2005Q1	2005Q2	2005Q3	2005Q4	2006Q1
<b>Current Account</b>	4.7	2.6	2.8	6.0	3.0
Trade balance	3.1	2.7	3.2	4.3	1.5
Net Services	0.9	0.4	0.2	1.6	0.9
Net Income	1.5	0.2	0.0	0.8	1.3
Net Transfers	-0.7	-0.7	-0.7	-0.6	-0.7
Capital Account	-0.3	-0.3	-0.2	-0.2	-0.2
<b>Financial Account</b>	1.6	1.4	-2.5	-4.6	-1.3
Net Direct Investment	-0.6	0.2	-1.4	1.3	0.6
Net Portfolio Investment	-4.1	-3.9	-2.4	2.0	-0.8
Net Other Investment	6.4	5.1	1.3	-7.9	-1.2
Net Errors & Omissions	1.2	-1.1	0.9	0.8	1.4
<b>Overall Balance</b>	7.2	2.7	1.0	2.1	2.8

Sources: *International Financial Statistics Online* (International Monetary Fund) and CEIC.



As trade and current account balances were strengthening overall in emerging East Asia in the first half of 2006, financial balances in 2006Q1 were generally stronger relative to 2005Q4 in ASEAN5 and the NIEs. This reflected a partial reversal in 2006Q1 of the general increase in financial outflows from the region, excluding the PRC, in the second half of last year. Fluctuations in the financial account over the last half of 2005 and the first half of 2006 were grounded in changing trends in portfolio and other investment flows. Rising short-term US interest rates reduced the profitability of carry trades and raised expectations that US long-term interest rates would also rise. This reduced inflows into the region in 2005Q3–Q4. Yet, by early 2006, the increase in US long-term rates failed to materialize. Thus, the search for yield brought financial flows back to the region’s asset markets, sharply reducing financial account deficits. These trends translated into larger balance of payments surpluses in the region, especially in ASEAN5 and the PRC (Table 2). After accumulating \$207 billion in official foreign reserves in 2005, the PRC absorbed another \$56 billion through March 2006. Reserve accumulation elsewhere in the region—that had slowed in 2005—also accelerated slightly in response to the strong inflows. These trends continued until mid-May 2006, when the region—together with other emerging markets—underwent a financial market correction.

Table 2: **Foreign Exchange Reserves**  
(excluding gold)

Country/Region	(% change, y-o-y)		Value (\$ billions)			
	Dec 04	Dec 05	Dec 04	Dec 05	Mar 06	Jun 06
Brunei Darussalam	4.9	-4.1	0.5	0.5	...	...
Cambodia	15.7	1.0	0.9	1.0	1.0	...
PRC	50.6	33.7	614.5	821.5	877.6	...
Hong Kong, China	4.4	0.57	123.5	124.2	125.9	126.5
Indonesia	0.0	-5.6	35.0	33.0	38.2	38.1
Korea, Rep. Of	28.2	5.7	199.0	210.3	217.3	224.3
Lao PDR	7.0	1.3	0.2	0.2	0.2	...
Malaysia	49.1	5.7	66.4	70.2	73.4	78.5
Myanmar	22.2	14.7	0.7	0.8	...	...
Philippines	-3.9	21.4	13.1	15.9	17.8	18.2
Singapore	17.2	3.2	112.2	115.8	121.4	128.7
Taipei, China	17.0	6.4	241.7	257.3	257.1	260.4
Thailand	18.5	4.2	48.7	50.7	53.7	56.4
Viet Nam	13.1	25.8	7.0	9.1	...	...
<b>Emerging East Asia</b>	29.9	16.9	1,463.5	1,710.2	...	...

... = not available

Sources: *International Financial Statistics Online* (International Monetary Fund) and Institute of International Finance.

Figure 12A: **Composite Stock Price Indexes<sup>1</sup>**  
**—NIEs and PRC**

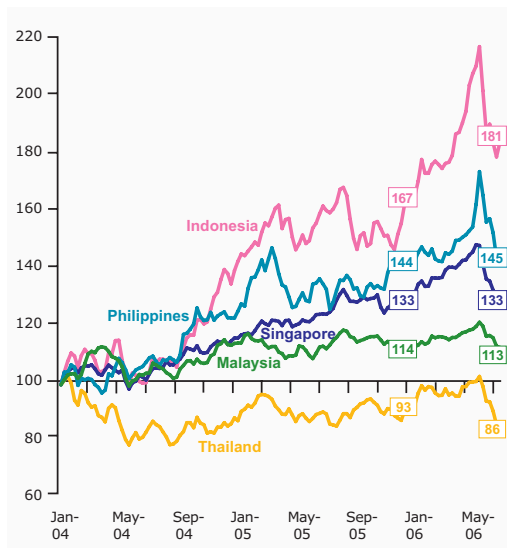
(weekly average, first week of Jan 2004 = 100, local index)



<sup>1</sup>Weekly averages of Hang Seng (HK, China), PCOMP (Philippines), KOSPI (Korea), STI (Singapore). The PRC index is based on the Shanghai and Shenzhen composite, weighted by market capitalization. Source: OREI staff calculations from Bloomberg data.

Figure 12B: **Composite Stock Price Indexes<sup>1</sup>**  
**—ASEANS**

(weekly average, first week of Jan 2004 = 100, local index)



<sup>1</sup>Weekly averages of JCI (Indonesia), KLCI (Malaysia), TWSE (Taipei,China), SET (Thailand). Source: OREI staff calculations from Bloomberg data.

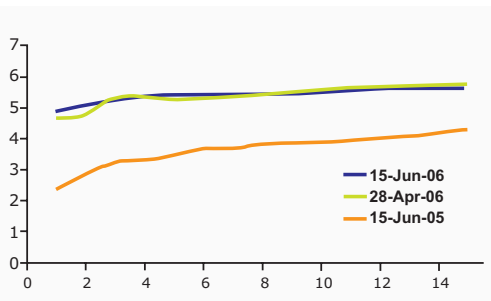
## Financial and Exchange Markets

Regional financial markets were volatile in the first half of 2006, with asset prices and exchange rates rising through mid-May, only to suffer a sharp correction from mid-May through mid-June. Before the downturn, stock market gains on the year ranged from 5.9% in Korea to 34.2% in the PRC (Figures 12A, 12B). But after United States (US) core inflation began to climb more than expected and the US Federal Reserve seemed to lean toward further upward rate adjustments, global investors suddenly adjusted their risk appetite. The correction affected all stock markets in the region except the PRC, where financial regulatory reforms triggered a burst of enthusiasm in May 2006. Some markets were affected more than others. Overall, through June 2006, Korean equities lost 10.0% after the large gains in 2005, while Thailand’s market lost 7.4%. In contrast, stock markets in Hong Kong, China; Indonesia; and PRC registered gains in the first half of this year—ranging from 4.8% to 37.6%. Other stock markets were about even on the year.

The adjustment seemed generally more severe in equity markets as local investors moved into local fixed-income assets. In Thailand, for example, the yield curve—which shifted up from June 2005 to April 2006 as policy rates moved up in tandem with US rates—did not change significantly from late April to mid-June 2006 (Figure 13A). This was mimicked in several markets, such as Korea, although rate hikes were less than those in Thailand. Moreover, in some cases, such as in Taipei,China; long-term rates increased slightly in June 2006, whereas in others (such as Singapore) they fell.

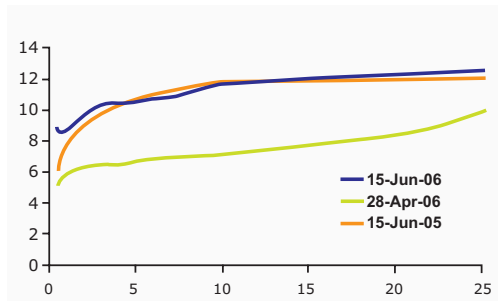
The trend in the Philippines was different. The yield curve shifted markedly downward from June 2005 through April 2006 as spreads compressed across maturities (Figure 13B). Global trends were one cause, but so was reduced political uncertainty and improved fiscal performance. The trend, however, sharply reversed by mid-June 2006 and the curve shifted upward as risk aversion increased. In the PRC, bonds enjoyed the same strong demand as stocks as long-term rates fell even while short-term rates rose—the result of monetary tightening. Thus, the yield curve flattened appreciably.

Figure 13A: **Thailand Benchmark Yields** (% per annum)



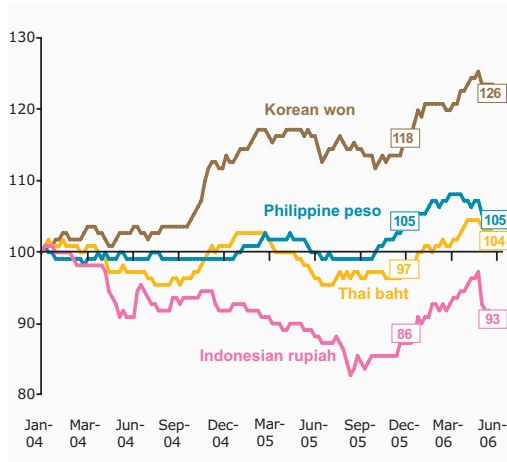
Source: Bloomberg.

Figure 13B: **Philippines Benchmark Yields** (% per annum)



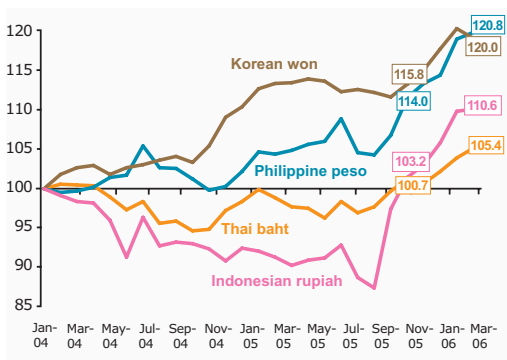
Source: Bloomberg.

Figure 14: **Exchange Rate Indexes** (weekly average, first week of Jan 2004 = 100, \$/local currency<sup>1</sup>)



<sup>1</sup>An increase is an appreciation.  
Source: OREI staff calculations from Bloomberg data.

Figure 15: **Real Effective Exchange Rate** (Jan 2004 = 100, \$/local currency<sup>1</sup>)



<sup>1</sup>An increase is an appreciation.  
Source: OREI staff calculations from Bloomberg data.

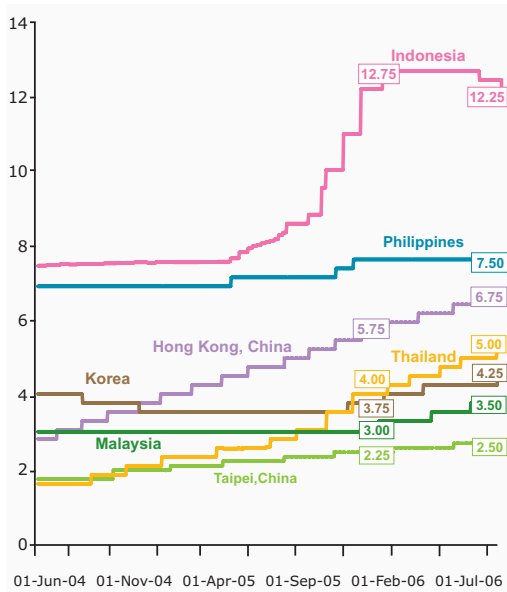
External and regional financial market developments affected currency markets across the region. Pressures for appreciation increased in late 2005 and early 2006, reflecting the improved current account balances and the increased portfolio inflows in the capital account. The extent to which exchange rates appreciated was influenced by country-specific market conditions and exchange rate policies. Through mid-May 2006, currency appreciation against the US dollar ranged from 0.8% in the PRC to 12.7% in Indonesia, with the average hovering about 6% (Figure 14). The market correction in mid-May did not completely reverse this broad trend, with most currencies appreciating on balance between 3–7% over the first half of 2006. The key exceptions were the Philippine peso and Viet Nam dong, which depreciated slightly.

Through March 2006, some regional currencies appreciated in real terms far more than they did in nominal terms (Figure 15). This was especially true in Indonesia and the Philippines, partly reflecting the relatively strong pass-through of high energy costs to domestic inflation. Korea and, to a lesser extent, Thailand, also experienced strong real currency appreciation.

## Monetary and Fiscal Policy

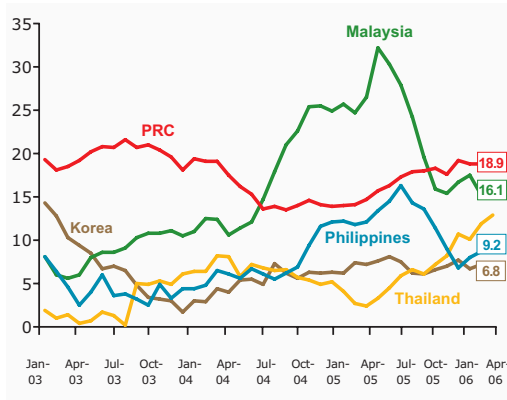
Given the rising global short-term interest rates and the gradual build-up of domestic inflationary pressures, most regional monetary authorities tightened monetary policy during the first half of 2006 (Figure 16). The major exception was Indonesia, which cut its policy rate by 25 basis points (bp) to 12.5% in early May 2006 during a period of relative stability,

Figure 16: **Policy Rates**<sup>1</sup> (% per annum)



<sup>1</sup>Hong Kong, China: Discount Base; Malaysia: Overnight Policy Rate; Philippines: Reverse Repo Rate; Thailand: 14-day Repo Rate; Korea: Overnight Call Rate; Taipei, China: Official Discount Rate. Sources: Bloomberg and CEIC.

Figure 17: **Liquidity Growth**<sup>1</sup> (y-o-y, %)



<sup>1</sup>Liquidity = M2. Sources: ARIC Indicators and Bloomberg.

after hiking the policy rate by more than 500 bp in 2005 in response to third quarter financial market turbulence. It then made a second cut to 12.25% in early July, when markets had stabilized in the wake of the correction. Another exception was the Philippines, which held rates steady through June 2006, as they were well above US rates. In contrast, Hong Kong, China and Thailand basically matched US rate hikes. Other economies made fewer upward adjustments. The PRC raised its policy rate (1-year working capital rate) by 27 bp in late April 2006 and followed it by raising reserve requirements for banks.

Through mid-May 2006, currency appreciation partially mitigated the pressure to tighten monetary policy rates arising from imported inflation. Still, despite currency appreciation and tighter policy rates, growth in liquidity accelerated in several countries through April 2006, especially PRC; Hong Kong, China; and Thailand (Figure 17). In contrast, liquidity growth was more modest or slowed in Korea and Malaysia. In some cases, the effects of higher policy rates on liquidity conditions were partially offset by imperfectly sterilized exchange market interventions.

Against a backdrop of generally strong economic expansion, gradually rising inflation, and tightening monetary policies, authorities left fiscal policies generally unchanged in 2006, although some continued to cut deficits. The main exceptions were the modest programmed increases in the deficit in PRC; Taipei, China; and Viet Nam. In contrast, Malaysia and the Philippines aimed to further reduce fiscal deficits in 2006, while in Indonesia; Hong Kong, China; and Thailand; for example, there were no major changes in fiscal policy stances (Table 3).

Generally, the trend of withdrawing fiscal stimulus and strengthening public finances—begun in 2002—is expected to continue this year. Although central government debt continues to rise in Korea, it remains relatively low, as it does also in Thailand (Table 4). Though still high in Indonesia, central government debt has fallen sharply over the past several years. In the Philippines, after rising over 2000–04, central government debt fell in 2005, aided by a narrowing fiscal deficit. Debt remains somewhat high in Malaysia as well, but most of it is denominated in ringgit. Overall, fiscal consolidation in the region has been rewarded with better financing

conditions, low sovereign—and hence corporate—spreads and improved investor confidence. Moreover, fiscal positions—in terms of both revenues and debt levels—are becoming healthier. Externally held debt, in particular, is low and maturity profiles are stronger than just a few years ago.

Table 3: **Fiscal Balance of Central Government** (% of GDP)

	2003	2004	2005	2006
PRC	-2.2	-1.3	-1.2	-1.4
Hong Kong, China	-3.3	-0.3	0.3	0.4
Indonesia	-1.7	-1.1	-0.5	-0.7
Malaysia	-5.3	-4.3	-3.8	-3.5
Philippines	-4.7	-3.9	-2.7	-2.1
Singapore <sup>1,2</sup>	-1.1	-0.1	0.2	-1.4
Taipei, China <sup>1</sup>	-3.0	-2.1	-1.8	-2.5
Thailand <sup>1</sup>	0.6	0.3	0.2	0.5
Viet Nam	-4.3	-2.0	-2.3	-3.0

<sup>1</sup> Fiscal year.

<sup>2</sup> Excludes investment income and interest income.

Sources: *Asian Development Outlook 2006* (Asian Development Bank), official sources, and OREI staff calculations.

Table 4: **Gross Central Government Debt** (% of GDP)

	Indonesia	Korea	Malaysia	Philippines	Thailand
2000	97.9	17.4	36.6	64.6	23.5
2001	84.5	18.2	43.6	65.7	24.8
2002	72.3	18.5	45.6	71.0	31.0
2003	65.4	21.9	47.8	77.7	27.5
2004	61.3	25.2	48.1	78.5	27.8
2005	52.7	29.6	46.2	71.8	26.1

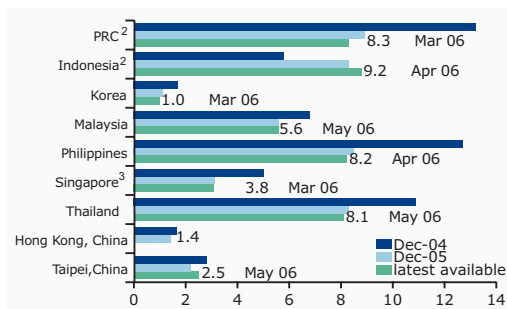
Source: ARIC Indicators.

## Assessment of Financial Vulnerability

In the twelve months to June 2006, financial vulnerability in emerging East Asian economies generally declined, suggesting an improved resilience to financial shocks across the region. After the 1997–98 Asian financial crisis, the financial sectors in emerging East Asian economies recovered steadily as a result of structural changes and workouts initiated by the banking and corporate sectors, and a major policy thrust toward strengthening regulatory frameworks. Banks across the region have improved their financial positions, with nonperforming loan (NPL) ratios falling, bank profitability improving, and capital adequacy ratios (CARs) exceeding the 8% international norm since 2000 across the region. Reforms in banking sectors also included upgrading of the regulatory environment with heightened supervision of banks and nonbank financial institutions. Raising competition in the financial sector, strengthening corporate governance, and developing local capital markets and equity financing were also part of the policy mix. At the same time, corporations helped increase economic efficiency and improve debt-servicing capabilities by introducing effective cost-cutting measures and major restructuring plans.

### Nonperforming Loans

Figure 18: **NPLs<sup>1</sup> of Commercial Banks**  
(% of total commercial bank loans)



<sup>1</sup>Data on NPLs exclude those transferred to AMCs. NPLs are on a 3-month accrual basis in Malaysia, and 3-months or more in Korea and Thailand.

<sup>2</sup>Banking sector NPLs.

<sup>3</sup>Local commercial bank NPLs as % of nonbank loans.

Sources: ARIC Indicators, Monetary Authority of Singapore, China Banking Regulatory Commission, Hong Kong Monetary Authority, Central Bank of China (Taipei, China), and CEIC.

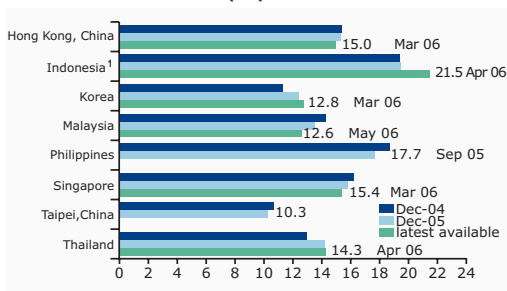
NPLs have steadily declined as a percentage of total commercial bank loans in five of the nine emerging East Asian economies where latest data are available (Figure 18). For these economies, NPL ratios are now below 10%. The PRC recorded the largest decline in NPLs since December 2005—from 8.9% to 8.3% in March 2006—while Malaysia’s NPL ratio remained at 5.6% in May 2006. However, the ratio increased in Indonesia—from 8.3% in December 2005 to 9.2% in April 2006—due to rising interest rates that induced increased credit risks. In Korea; Hong Kong, China; and Taipei, China, the NPL ratio remained well below 3%.

In general, the continued decline in NPL ratios across the region was primarily due to workouts of distressed loans. These included transfers to public or private bank-owned asset management companies (AMC) for resolution, along

with improved risk management, which helped reduce new NPLs from more recent lending. The workout process has largely been completed in Malaysia and Thailand, while in the PRC, where the decline in NPL ratio was largely due to public recapitalization programs and the transfer of NPLs to AMCs, 15 transactions amounting to \$11.4 billion were announced between September 2005 and February 2006. Although several more transfers are expected to be completed over the rest of 2006, a risk remains that NPLs in the PRC may start rising again partly due to an increasing exposure of banks to real estate, combined with a persistent lack of clear guidelines for lending and still poor credit assessment capacity of domestic banks.

In the Philippines, the Special Purpose Vehicle law was extended for 18 months in April 2006, and the Philippine central bank (Bangko Sentral ng Pilipinas) expects this to reduce the NPL ratio below 7% by the end of the year. In Thailand, the Bank of Thailand (BOT) hopes to reduce the NPL ratio to 5% by the end of 2006 and to 2% by the end of 2007. To achieve this ambitious target, the BOT mandated the Bangkok Commercial Asset Management Company as key bidder for domestic problem loans—following its merger with the Thai Asset Management Corporation. In Taipei, China, the NPL ratio has remained low, as government regulations make it difficult for banks with high NPL ratios to apply for new business licenses or set up new branches. An increase in the size of outstanding bank loans was partly responsible for the decline in NPL ratios for most of emerging East Asia, with the exception of the Philippines, where total loans outstanding fell.

Figure 19: **Capital Adequacy Ratios of Commercial Banks (%)**



<sup>1</sup>Refers to CAR of banking system.  
Sources: ARIC Indicators, Monetary Authority of Singapore, Hong Kong Monetary Authority, Central Bank of China (Taipei, China), and CEIC.

## Capital Adequacy Ratios and Bank Profitability

The average CARs of emerging East Asian commercial banks are well above the 8% international norm (Figure 19). Malaysia’s CAR declined from 13.5% in December 2005 to 12.6% in May 2006, as bank credit expanded and authorities continued to implement tighter prudential regulations. Slight increases, however, occurred in the CARs in Korea and Thailand. While CARs usually increase as economic fundamentals improve, prudential regulation is tightened, risk management improves, and bank profits increase, high CARs in Indonesia and the Philippines can be

mainly attributed to a lack of profitable lending opportunities. In these countries, in fact, as interest rates rise, banks usually prefer holding low-risk government securities, which increases the risk of portfolio losses from falling bond prices. In Indonesia, in particular, where credit growth remained low, the average CAR increased substantially to 21.5% in April 2006, partly due to a decline in commercial bank assets.

During the 12 months through December 2005, banking sector profitability among emerging East Asian economies either improved or remained stable, with the exceptions of Indonesia and Taipei,China (Table 5). In the Philippines, return on assets (ROA) increased from 1.0% in December 2004 to 1.1% in December 2005, as banks profited from improvement in loan quality and an expansion in investments. In Singapore and Thailand, the ROA remained at 1.2% and 1.3%, respectively, at the end of 2005. In contrast to these trends, the ROA of the Indonesian banking sector declined to 2.6% in December 2005, partly due to narrowing interest margins—reflecting a rise in deposit rates—and the introduction of tighter classification standards for loans. The ROA also marginally declined in Taipei,China, approaching the level of a zero return, mainly due to substantial write-offs of nonperforming cash and credit card loans, totaling \$2.2 billion. As a result, banks in Taipei,China are now more conservative in new lending and have become very aggressive

Table 5: **Banking Sector Profitability**<sup>1</sup> (%)

	2002	2003	2004	2005	2006 <sup>2</sup>
Hong Kong, China	1.4	1.4	1.6	1.7	n.a.
Indonesia	1.9	2.5	3.5	2.6	2.6
Korea	0.6	0.1	0.9	1.0	n.a.
Malaysia	1.3	1.3	1.4	1.4	n.a.
Philippines	0.8	1.2	1.0	1.1	1.2
Singapore	0.8	1.1	1.2	1.2	1.2
Taipei,China	-0.5	0.2	0.6	0.3	n.a.
Thailand	0.3	0.7	1.3	1.3	n.a.

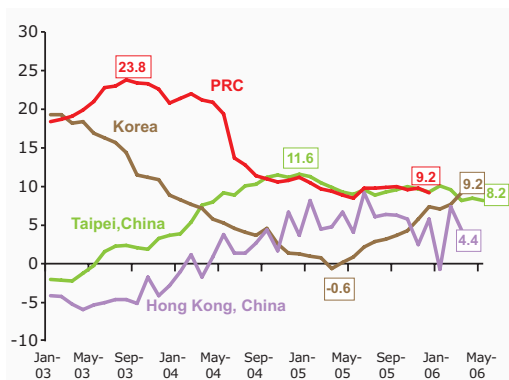
<sup>1</sup>Rate of return on assets for all commercial banks (Indonesia, Korea, Philippines, and Thailand); banking system (Malaysia); domestic banks (Singapore and Taipei,China); and retail banks (Hong Kong, China).

<sup>2</sup>As of April 2006 for Indonesia and March 2006 for the Philippines and Singapore.

Sources: Hong Kong Monetary Authority, Bank Indonesia, Financial Supervisory Service (Republic of Korea), Bank Negara Malaysia, Bangko Sentral ng Pilipinas (Philippines), Monetary Authority of Singapore, Central Bank of China (Taipei,China), and Bank of Thailand.

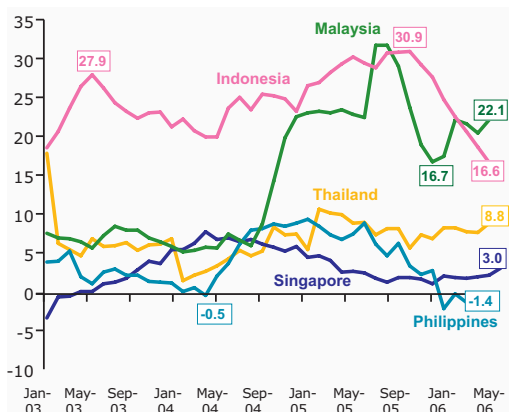


Figure 20A: **Nominal Bank Credit<sup>1</sup> Growth—PRC and NIEs (y-o-y %)**



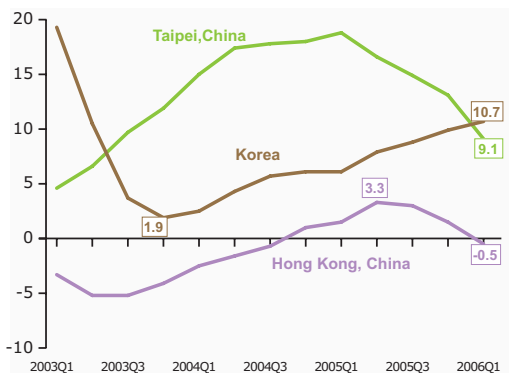
<sup>1</sup>Claims on the private sector: deposit money banks. Sources: OREI staff calculations based on ARIC Indicators, *International Financial Statistics* (International Monetary Fund) and Central Bank of China (Taipei,China).

Figure 20B: **Nominal Bank Credit<sup>1</sup> Growth—ASEANS (y-o-y %)**



<sup>1</sup>Claims on the private sector: deposit money banks. Source: OREI staff calculations based on ARIC Indicators.

Figure 21A: **Growth of Household Credit—NIEs (y-o-y, %)**



Sources: Bank of Korea, Hong Kong Monetary Authority, and CEIC.

in managing NPLs. Latest available data suggest that in 2006Q1 the average ROA of commercial banks remained about the same as 2005 in Indonesia, Philippines, and Singapore.

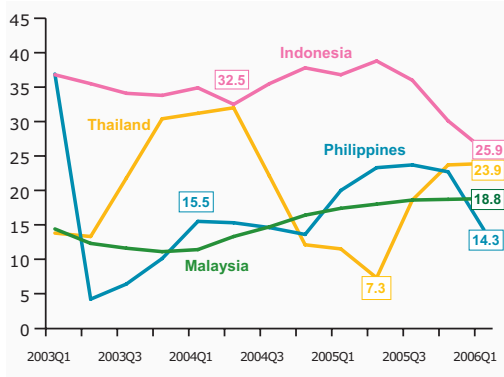
## Bank Lending

In the 12 months to May 2006, nominal bank credit to the private sector continued to grow in most emerging East Asian economies (Figures 20A, 20B). In Indonesia, Malaysia, and Philippines, however, growth decelerated substantially since the last quarter of 2005. In particular, nominal credit growth softened in Indonesia from 30.9% in September 2005 to 16.6% in April 2006, while it remained negative in the Philippines from December 2005 to February 2006, due to sluggish credit demand from the corporate sector and banks' cautious lending (given prevailing NPL levels). In the PRC, credit growth remained stable throughout 2005. Household credit growth generally remained high, especially in Thailand, Malaysia, and Korea, as domestic banks used more aggressive marketing strategies (Figures 21A, 21B).

Still, prudential regulations were mostly strengthened across the region. To limit potential problems arising from excessive credit growth, Malaysian authorities, for example, have adopted minimum payment and income requirements for credit cards, and plan to establish a Credit Counseling and Debt Management Agency later this year. Household credit growth also remained relatively high in Indonesia (25.9% in 2006Q1), despite relatively unfavorable underlying economic conditions and the decelerating trend that began in 2005Q3.

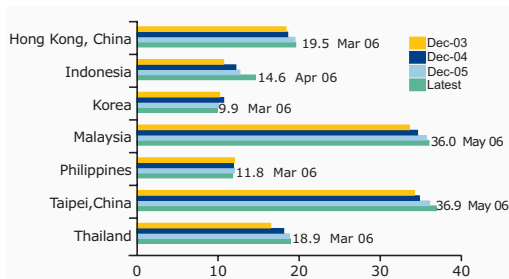
The relatively modest real estate exposure of emerging East Asian banks is another indicator of banks' improved asset quality (Figure 22). But the first months of 2006 saw a marginal increase in the share of real estate loans to total bank lending in several economies across the region. The largest increase was in Indonesia, where the ratio rose from 12.8% at the end of 2005 to 14.6% at the end of April 2006. In Korea, while households are still recovering from the build up of credit card debt, property prices are rising fast in some locations. Thus, with rising bank loans for household mortgages and small business loans backed by real estate collateral, the situation merits close monitoring.

Figure 21B: **Growth of Household Credit—ASEAN4** (y-o-y, %)



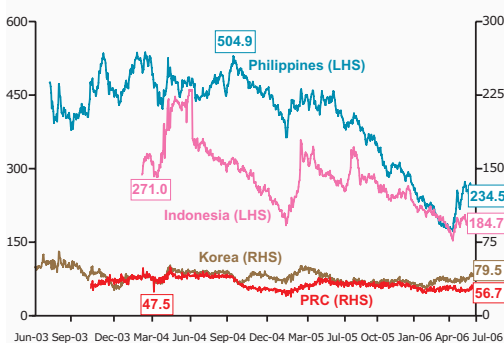
Sources: Bank Indonesia, Bank Negara Malaysia, Banko Sentral ng Pilipinas, and Bank of Thailand.

Figure 22: **Real Estate Loans—NIEs** (% of total loans)



Sources: Bank Indonesia, Financial Supervisory Service (Korea), Bank Negara Malaysia, Banko Sentral ng Pilipinas, Bank of Thailand, Hong Kong Monetary Authority, and CEIC.

Figure 23: **Sovereign Spreads** (10-year yields against US 10-year benchmark, basis points)



Source: Bloomberg.

## External Vulnerability Indicators

The ratio of total external debt to gross foreign exchange reserves has generally declined or remained stable throughout the region, although significant differences exist across economies (Table 6). As of 2006Q1, the ratio was 3.5 in Indonesia, 3.1 in Philippines, 2.1 in Singapore, 1.1 in Thailand, 0.9 in Korea, 0.7 in Malaysia, and 0.3 in PRC.

However, the ratio of short-term external debt to gross international reserves generally remained stable in all emerging East Asian economies for which data are available (Table 7). The ratios in 2006Q1 were 0.2 in the PRC and Malaysia; 0.3 in Korea and Philippines; and 0.4 in Thailand.

Available data on total debt service as a percent of total exports of goods and services show the ratio continued to decline in Malaysia and the Philippines in 2005, but increased slightly in Korea and Thailand (Table 8). Indonesia's debt service ratio, however, increased substantially to 38.6%.

While sovereign spreads for US dollar bonds issued in Korea and the PRC remained relatively stable, spreads in the Philippines and Indonesia have been declining from 2005Q2 through April 2006, reflecting a general return of investor interest (Figure 23). Since May 2006, however, spreads began to widen again in these two countries, signaling resurgent risk aversion among investors to emerging markets. Also since May 2006, spreads have increased somewhat in Korea but declined in the PRC, suggesting the need for close monitoring of international sentiment.

Increasing long-term yields among emerging East Asian economies represents a risk to the banking sector, as higher yields reduce bond and asset valuations on balance sheet. Latest available data show that commercial banks in Indonesia, Korea, Malaysia, and Thailand have a combined \$170.7 billion worth of local currency sovereign bonds on their balance sheets.

**Table 6: Ratio of Total External Debt to Gross Foreign Exchange Reserves**

	2002	2003	2004	2005	2006Q1
PRC	0.6	0.5	0.4	0.3	0.3
Hong Kong, China	3.1	3.1	3.5	3.6	3.6
Indonesia	4.2	3.9	3.9	4.0	3.5
Korea	1.2	1.0	0.9	0.9	0.9
Malaysia	1.4	1.1	0.8	0.7	0.7
Philippines	4.0	4.2	4.2	3.4	3.1
Singapore	2.0	1.8	2.0	2.0	2.1
Taipei,China	0.3	0.3	0.3	0.3	n.a.
Thailand	1.6	1.3	1.1	1.0	1.1

Sources: OREI staff calculations based on ARIC Indicators and data from the Joint BIS-IMF-OECD-World Bank statistics database, Institute of International Finance, and CEIC.

**Table 7: Ratio of Short Term External Debt to Gross Foreign Exchange Reserves**

	2002	2003	2004	2005	2006Q1
PRC	0.2	0.2	0.2	0.2	0.2
Indonesia	0.4	0.4	0.5	0.6	n.a.
Korea	0.4	0.3	0.3	0.3	0.3
Malaysia	0.2	0.2	0.2	0.2	0.2
Philippines	0.4	0.5	0.4	0.4	0.3
Taipei,China	0.2	0.2	0.3	0.3	n.a.
Thailand	0.3	0.3	0.3	0.3	0.4

Sources: OREI staff calculations based on ARIC Indicators and data from the Joint BIS-IMF-OECD-World Bank statistics database, Institute of International Finance, and CEIC.

**Table 8: Debt Service Ratio** (% exports of goods and services)

	2001	2002	2003	2004	2005
PRC	8.0	7.3	7.5	7.5	n.a.
Indonesia	36.0	32.1	29.8	31.2	38.6
Korea	14.4	7.8	6.5	5.6	5.8
Malaysia	6.8	6.6	6.2	4.4	4.0
Philippines	15.8	16.4	16.9	13.8	13.3
Thailand	20.8	19.6	16.0	8.5	9.8

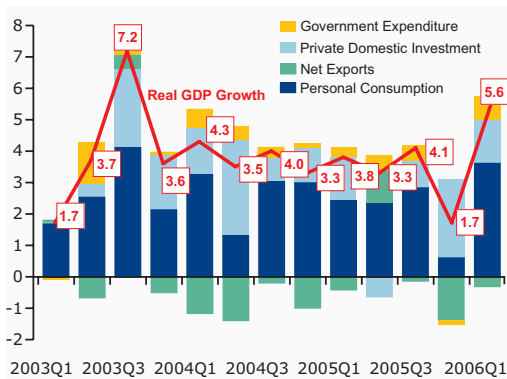
Source: *Asian Development Outlook 2006* (Asian Development Bank).

## Outlook, Risks, and Policy Issues

### External Economic Environment

The evolving global economic environment facing emerging East Asia remains broadly favorable. On balance, the external economic environment is expected to support regional economies much as it did in 2005. Strong growth of external demand is a key positive element, with major export markets likely to sustain or strengthen their expansions, thus boosting external demand for the region’s exports. However, two mitigating elements increase the complexity of the external environment. First, energy prices will likely remain elevated, at least through mid-2007, leading to sustained inflationary pressures throughout the period. Second, monetary authorities in major industrial countries are expected to continue raising short-term interest rates. For export-oriented economies with generally robust external balances, strong public finances, and resilient financial sectors, these conditions tend to play to their strengths. This is especially true to the extent that rising energy prices are a consequence of a strong global economic expansion, which enhances external demand even as it adds to costs.

Figure 24: **Contributions to Growth—US**  
(seasonally adjusted, annualized, % change)

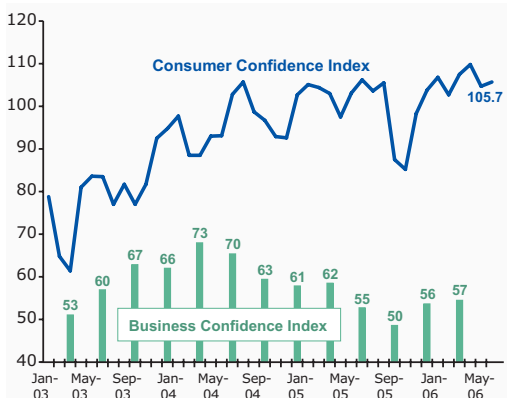


Source: US Bureau of Economic Analysis.

The outlook for external demand hinges to a large extent on prospects for the US, Europe, and Japan, which together account for about 40% of total exports from emerging East Asia, or about two-thirds of its extra-regional exports. The outlook for the remainder of 2006 and 2007 is for (i) a strong but moderating US economic expansion, (ii) an accelerating expansion in the euro area, and (iii) a strengthening of the economic recovery in Japan. Looking through a different prism, the stronger demand for global IT products should improve the export and growth prospects for several emerging economies.

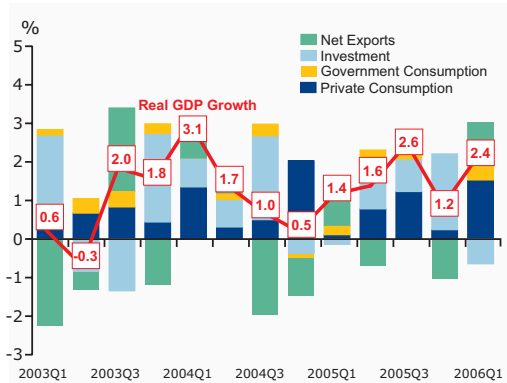
The US economy is running near capacity: the labor market is tightening, core inflation is rising, and import growth is strong. Consumption bounced back in 2006Q1, pulling GDP growth to a seasonally adjusted annualized rate of 5.6% (Figure 24). Still, growth momentum is likely to ease because of the cumulative effects of higher oil prices, higher interest rates, and the lagged effects of a narrowing government deficit—

Figure 25: **US Consumer and Business Confidence Indexes**



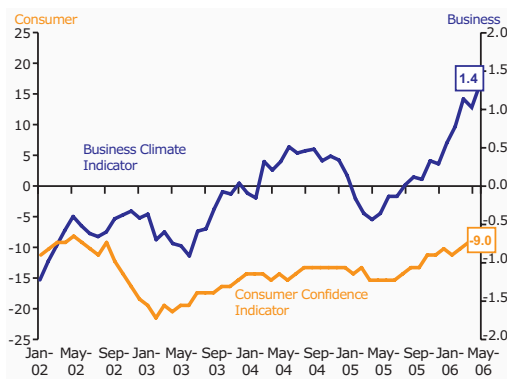
Notes: 1. Consumer confidence (1985=100).  
 2. A business confidence index above 50 means there are more positive than negative responses.  
 3. Consumer confidence is monthly, business confidence is quarterly.  
 Source: Bloomberg.

Figure 26: **Contributions to Growth—euro area** (seasonally adjusted, annualized, % change)



Source: Eurostat.

Figure 27: **Euro Area Consumer Confidence and Business Climate Indicators**



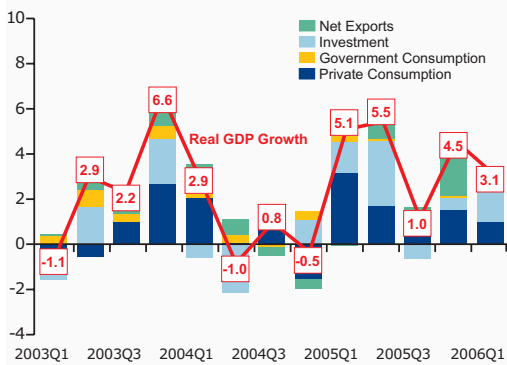
Source: Bloomberg.

from 4.7% of GDP in 2004 to 3.8% in 2005. The June 2006 FED Beige Book Report showed signs of a cooling residential real estate market and moderating consumption growth, coinciding with indicators of easing momentum in services and a small drop in consumer confidence (Figure 25).<sup>3</sup> Yet, the labor market is tightening—with unemployment down to a seasonally adjusted 4.6% in June 2006 from 5.0% a year earlier. And, 3-month core inflation jumped from a seasonally adjusted annualized rate of 2.0% in February to 3.8% in May. Further, there are signs of stronger activity in the corporate sector, commercial real estate, and energy markets. These trends point to the possibility of stronger investment, as does an increase in factory orders for business equipment in May and the upturn in business confidence. Higher import growth and a wider trade deficit would likely accompany a shift from consumption-led to more investment-led growth in 2006. Overall, the economy is expected to move toward its 3.0–3.3% potential rate of growth in 2006 and 2007.

At an earlier point in its business cycle, the euro area is undergoing a surge in economic momentum: unemployment is falling, inflation is rising, and import growth is accelerating. Stronger consumption, in particular, led GDP growth higher in 2006Q1 (Figure 26). There is an improvement in consumer confidence and a marked surge in business sentiment (Figure 27). The June business climate indicator was at its highest level since 2000 in the euro area. In Germany, which accounts for a third of the euro area economy, business confidence in June reached its highest level since 1991. Supported by still accommodative monetary conditions, growth in domestic demand is gathering momentum, despite the drag of higher oil prices and slightly tighter fiscal policies. Unemployment in the euro area fell to 7.9% in May 2006 compared with 8.8% a year earlier. Moreover, inflation crept up to 2.5% in May and June from 2.2% in March, and has remained above the European Central Bank (ECB) target for more than a year. However, excluding energy, inflation was 1.5% for May 2006. With rising domestic demand, import growth should rise, a favorable trend for trade-dependent emerging East Asia. Euro area GDP growth is forecast to strengthen to about 2.0% rate over 2006–07.

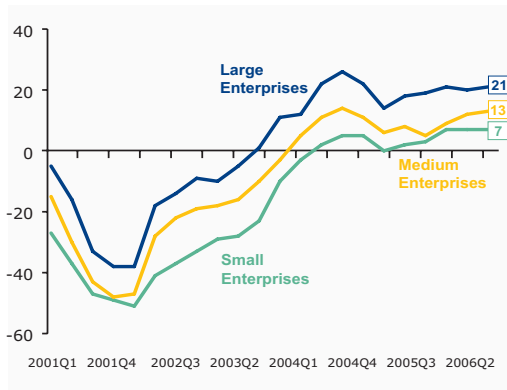
<sup>3</sup>The Institute for Supply Management’s index of non-manufacturing business activity slipped from 60.1 in May 2006 to 57.0 in June, though remaining above 50, which indicates a slowing but sustained expansion of activity in the services sector. The manufacturing index dipped from 54.4 to 53.8 from May to June.

Figure 28: **Contributions to Growth—Japan**  
(seasonally adjusted, annualized, % change)



Source: Cabinet Office, Government of Japan.

Figure 29: **Japan Tankan Survey—Business Conditions Indicators** (Manufacturing)



Source: Bloomberg.

Figure 30: **New US IT Orders**<sup>1</sup> (\$ billion)



<sup>1</sup>6-month moving average.

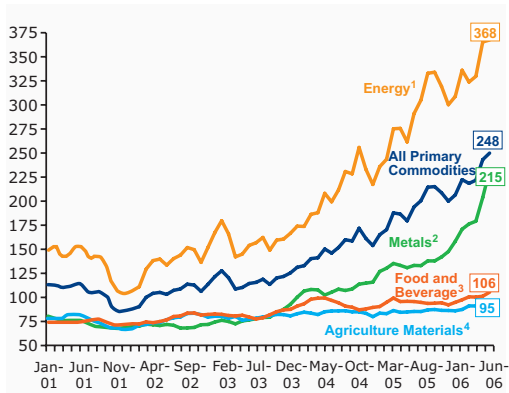
Source: Bloomberg.

As with the euro area, the Japanese economic recovery is strengthening, the labor market is tightening, and deflation is fading. The economic recovery was sustained in 2006Q1 by a stronger contribution from domestic demand (Figure 28). And with sustained external demand, rising income and profits, and accommodative monetary conditions, confidence is rising and business conditions are improving (Figure 29). The latest Tankan Survey indicates that corporations are boosting planned capital spending. With strong above-trend growth, the unemployment rate fell to 4.0% in May 2006 from 4.4% a year earlier. At the same time, inflation is crawling more firmly into positive territory, with the headline consumer price index rising 0.6% in June 2006, up from 0.3% in May. However, excluding fresh food, inflation was at 0.3%, led by fuel price increases. With improving domestic demand, import growth is strong (23% in April), although this is in part a consequence of higher import prices. In its fourth year of recovery, the economy is expected to grow by 2.9% in 2006, before settling to a more sustainable pace of 2.4% in 2007.

The favorable growth outlook for the US, euro area, and Japan is complemented by a stronger global IT industry (Figure 30). Increased IT demand has already helped export and overall GDP growth in the region in the first half of 2006. With the general deepening and broadening of economic expansions in developed markets, trade prospects globally are broadly favorable. The World Trade Organization (WTO) forecasts that world trade volume for goods will expand by 7% in 2006 compared with 6% in 2005.

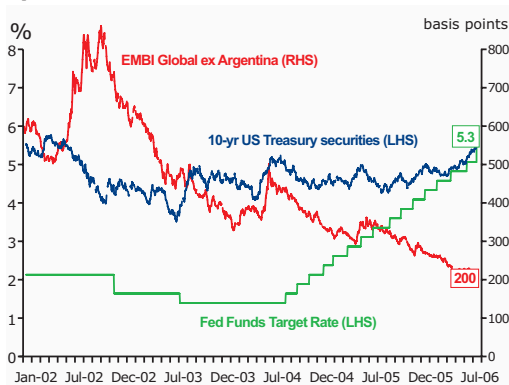
Against these positive prospects for export markets, there are two mitigating elements of the external environment—elevated energy prices and tightening global monetary conditions. After rising rapidly in 2002–05, energy prices continued to climb in 2006. Through June, they rose a further 18%, while metals prices climbed 34% (Figure 31). With robust global demand continuing to press against tight supply, concerns about supply stability will likely keep oil prices both high—around \$70/bbl—and volatile over 2006–07 (Box 1). This trend has not yet severely disrupted regional economies or strained their external finances. Yet, several economies must deal with rising inflation rates. Moreover, the region is generally vulnerable to higher energy costs because of its poor energy efficiency.

Figure 31: **Primary Commodity Price Indexes** (1995 = 100)



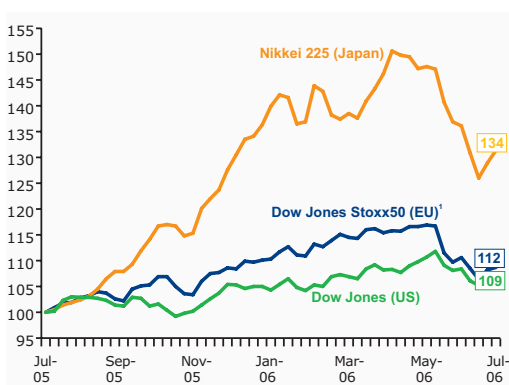
<sup>1</sup> Crude oil, natural gas, coal.  
<sup>2</sup> Copper, aluminum, iron, tin, nickel, zinc, lead, uranium.  
<sup>3</sup> Cereal, vegetable oils, meat, seafood, sugar, bananas, oranges, coffee, tea, cocoa.  
<sup>4</sup> Timber, cotton, wool, rubber, hides.  
 Source: International Monetary Fund website.

Figure 32: **US Interest Rates and Sovereign Spreads**



Sources: US Federal Reserve and JP Morgan.

Figure 33: **G3 Stock Market Indexes** (weekly average, 1 July 2005 = 100)



<sup>1</sup> capitalization-weighted index of 50 European blue chips.  
 Source: OREI staff calculations from Bloomberg data.

Even as the export outlook remains favorable, rising commodity prices are adding to global inflationary pressures, suggesting that global monetary conditions will continue to tighten. Policy rate hikes began earliest in the US, but most major central banks were withdrawing liquidity by early 2006. After the evenly-paced increase in the US Federal Reserve (FED) funds target rate to 5.25% on 29 June 2006, the US FED signaled that future adjustments would be determined by economic developments, but that inflation risks remain a concern. For the ECB, which raised its policy rate by 25 bp to 2.75% in early June 2006, inflation risks remain a concern, but future decisions will likely weigh these risks against the resilience of the economic recovery. Similarly, the Bank of Japan (BOJ), which ended quantitative easing while maintaining the “zero interest rate” policy in March 2006, changed the guideline for the uncollateralized call rate to 0.25% on 14 July, thus lifting the “zero interest rate” policy. For the BOJ, evaluating the market’s response to the rate hike and monitoring both economic activity and inflation trends will be important in the months ahead.

Diverging from past experience of US monetary tightening—and despite a rise in global short-term interest rates through June 2006—long-term yields have remained relatively low, resulting in a flattening of the yield curve (Figure 32). In June 2006, the yield on 10-year US Treasury bonds was at 5.14%, up about 100 bp from a year earlier, despite a 200 bp rise in short-term rates. Like the spreads between long and short maturities, corporate and sovereign risk premiums were compressed, continuing a multi-year trend.

Accompanied by low volatility in asset prices, these unusually benign financial conditions were tested from mid-May through mid-June this year by a market correction stemming from increasing concern about US inflation. Like most emerging East Asian stock markets, the US and other major equity markets saw sharp losses that erased much or all of this year’s gains (Figure 33). However, after dropping sharply since 2002, sovereign spreads rose only modestly during the correction—primarily where fundamentals were perceived as weak. To the extent that improved financial resiliency and public sector finances are the source of risk premium compression—rather than high global liquidity—low sovereign spreads and favorable financial conditions should persist over 2006–07.

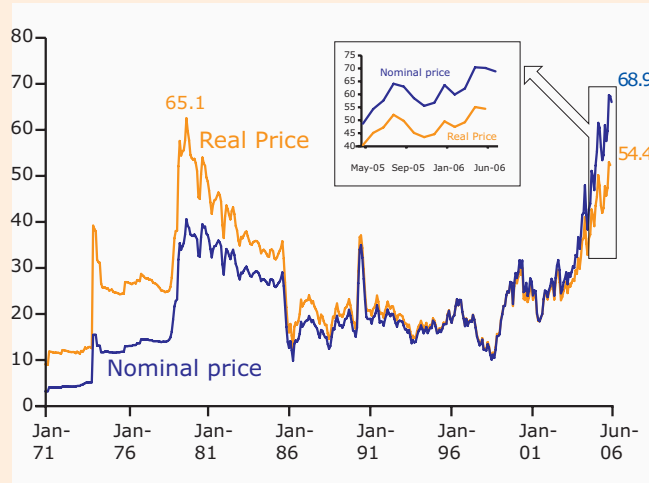
**Box 1: High and Volatile Oil Prices: A Need for Improving Energy Efficiency**

Oil prices began to climb in mid-2003 after remaining below \$25 per barrel (bbl)—apart from spikes—for 17 years. Prices rose by 33% in 2004, 42% in 2005, and 20% in the first half of 2006. These are historic highs in nominal terms, although about 16% below the highs of 1979–1980 in real terms (Figure B1.1). During much of this ascent, 6-month futures were priced higher than 12-month futures, suggesting that oil prices were expected to decline (Figure B1.2). However, in late 2005, near-term prices fell below longer-term prices, meaning the market expects a longer period of elevated oil prices. Since then, the differential has stayed near zero.

Rapidly growing demand, limited spare capacity, geopolitical uncertainties in oil-producing regions, supply disruptions, and increased interest from portfolio investors in global oil markets have worked in tandem to generate both high and volatile oil prices.

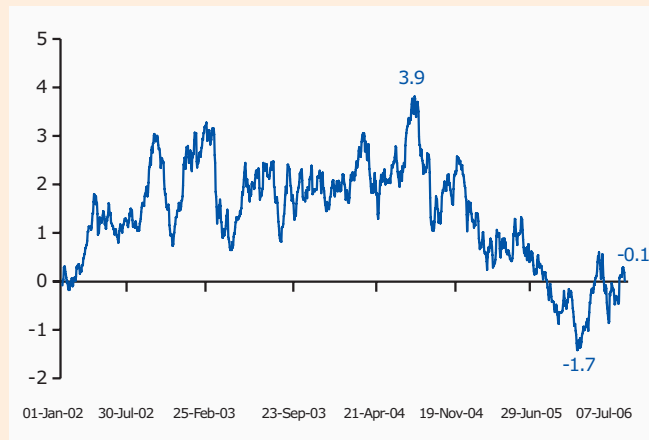
From the demand side, world GDP growth historically outpaced energy consumption growth (Figure B1.3). The gap was widest in the early 1990s and the late 1990s. However, growth in energy consumption accelerated with the recovery from the global slowdown in 2001, surpassing

**Figure B1.1: Brent Crude Oil Prices, January 1971–June 2006 (\$/barrel)**



Note: Real Brent price deflated using producer’s price index of all commodities with Dec 2001 as base year.  
Sources: *International Financial Statistics Online* (International Monetary Fund), Bloomberg, and US Bureau of Labor Statistics.

**Figure B1.2: 6-month Minus 12-month Futures Oil Price, NYMEX (\$/bbl)**



Source: Bloomberg.

world GDP growth in 2002. On average, while global oil demand grew at about 1 million bbl per day (mbd) in the 1990s, it grew by 1.5 mbd between 2002 and 2005. Much of this came from rapid economic growth of the PRC and other large

emerging economies. PRC demand increased from 2 mbd in 1990 to 7 mbd in 2005. With emerging economies now accounting for a larger share of the world economy, energy demand is growing faster relative to the global economy.<sup>1</sup>

However, although growth in global oil consumption slowed from 4% in 2004 to 1.3% in 2005—and is expected to remain somewhat subdued at 1.5% in 2006<sup>2</sup>—oil prices have continued to rise. This suggests that other factors besides energy demand are also at work in keeping energy prices high.

Part of the explanation is that the prolonged period of relatively low oil prices over 1986–2002 induced limited investment in exploration or other upstream activities with high costs and long gestation periods. As a result, global spare capacity for crude oil production

<sup>1</sup>Emerging East Asia’s consumption of world energy more than doubled from 8.4% in 1980 to 21.2% in 2005. Energy consumption in non-Organisation for Economic Co-operation and Development (OECD) economies is expected to account for 75% of the growth in world energy consumption and, in 2015, to surpass that of OECD economies. *International Energy Outlook 2006*, Energy Information Administration, US Department of Energy.

<sup>2</sup> Energy Information Administration. 2006. *Oil Market Report*. Washington, DC, May.



has fallen over the last decade. For example, excess production capacity among Organization of the Petroleum Exporting Countries (OPEC) fell from about 10 mbd in 1985 to 2.8 mbd in the first four months of 2006.

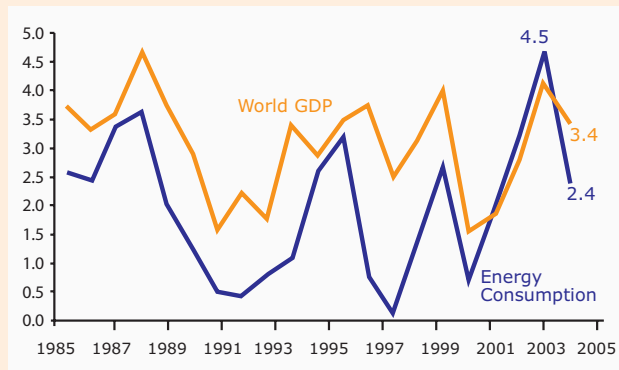
Further feeding high energy prices is a refinery mismatch. On one hand, the proportion of oil reserves of the more easily-refined light sweet crude is falling. On the other, upgrading refineries for the more complex process of maximizing light petroleum products (such as gasoline and diesel) extracted from heavy sour crude oil is lagging.<sup>3</sup> Underinvestment in upgrading refining capacity over the past 15 years has created a mismatch that further increases prices of gasoline and diesel. An indirect indication of the capacity constraint is the rapid rise in the difference in profit margins between the two refining processes, which averaged more than \$10/bbl in 2005 compared with about \$3/bbl during 1995–2000. If the refineries of all European members of the Organisation for Economic Co-operation and Development (OECD) were upgraded to full-conversion facilities, an additional 2 mbd of light petroleum products could be produced.<sup>4</sup>

In the short-term, both the demand and supply of energy are relatively inelastic. Yet, if oil prices remain elevated, adjustments will occur over time—as happened after the

two oil price shocks in the 1970s. Consumers learn ways to conserve energy, or use it more efficiently, while supply increases as investments in oil exploration, refining capacity, and transport infrastructure become more profitable.<sup>5</sup>

Still, in the near term, limited or declining spare capacity is a major factor that would keep oil prices high. Currently, the market is also particularly sensitive to political disturbances and geopolitical risks in oil-producing regions, as well as other temporary disturbances to supply, such as hurricanes Katrina and Rita in late 2005, which damaged major production and refining facilities in the US.

Figure B1.3: World GDP Growth vs. Energy Consumption Growth (%)



Note: Growth rate of 2005 GDP is ADB estimate. Sources: *Statistical Review of World Energy 2006*, BP, and *World Development Indicators* (World Bank).

Moreover, because of rising energy prices portfolio funds have leapt into global energy markets (especially

given the low yields of more traditional financial assets). Institutional investors have increased the share of their investments in oil—the so-called paper barrel.<sup>6</sup> And, as with other tradable assets, speculative factors drive short-term oil price movements, adding to price volatility.

Most of the economies in emerging East Asia are net importers of energy and relatively energy inefficient (in part because of large manufacturing bases). With economies potentially vulnerable to energy supply shocks, the region’s policymakers are focusing increasingly on

energy policies. On the supply side, beyond stockpiling of strategic reserves, stable and transparent investment regimes are needed, conducive to private sector involvement in high-risk exploration and development of new energy sources, especially renewable energy. On the demand side, greater energy efficiency is required—using market prices as incentives to avoid waste.

<sup>3</sup>Heavy sour crude oil has a higher wax and sulfur content than light sweet crude oil.

<sup>4</sup>Energy Information Administration. op cit.

<sup>5</sup>There are reports that the world’s largest oil company, Saudi Aramco, recently launched its biggest expansion program in many years (in Saudi Arabia). The PRC is also examining more closely domestic oil exploration and building refining capacity to meet its growing oil demand.

<sup>6</sup>In April 2006, the first exchange-traded fund allowing US investors to put money directly on the price of crude, the US Oil Fund, was launched on the American Stock Exchange.

## Regional Economic Outlook for 2006–2007

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In 2005, despite slowing external demand, rising global interest rates, and sharply higher energy costs, emerging East Asian economies maintained a strong average GDP growth rate of 7.2% (Table 9). Through the first half of 2006, the region continued to adjust admirably to higher energy costs, persistent inflationary pressures, tighter monetary conditions, and increased financial volatility. Moreover, there was a revival of external demand during the first half of 2006 and several economies exhibit strengthening domestic demand. These factors should help emerging East Asia to maintain strong GDP growth. For the third consecutive year, emerging East Asia is thus forecast to post an average GDP growth of over 7% in 2006 before slowing marginally in 2007.

The outlook for the PRC economy is key to the region's strong growth prospects. PRC economic growth should rise further from its rapid 9.9% expansion in 2005 to 10.1% in 2006 before easing to 9.0% in 2007. This projection is based on expectations that policy tightening will begin to show its effects during the second half of 2006. This would alleviate pressures on the economy from overheating in sectors such as construction and real estate. At the same time, PRC imports should rebound somewhat from the exceptionally low growth in 2005, which was caused, in part, by delayed commodity imports as producers drew down inventories in an effort to avoid rising costs of imported materials. Stronger PRC imports will provide sustained support to the rest of the region, particularly the NIEs. Sustained demand from the PRC, the global rebound in IT, and stronger domestic demand should propel overall economic growth higher among NIEs—from 4.5% in 2005 to 5.1% in 2006, before slowing somewhat in 2007. In Hong Kong, China, growth should slow from the very rapid 2004–05 pace, but remain elevated as a result of close economic ties with the PRC. ASEAN economies are expected to maintain a steady GDP growth of 5.5% in 2006, reflecting the stable external outlook, with slight variations up or down across economies. Despite slowing external demand, growth of the ASEAN economies should edge up in 2007 based on country-specific factors such as the recovery from the August 2005 mini-crisis in Indonesia, strong remittance growth in the

Table 9: Annual GDP Growth Rates (%)

	Average							ADB Forecasts	
	1996–2004	2000	2001	2002	2003	2004	2005	2006	2007
<b>Emerging East Asia</b> <sup>1,2</sup>	6.2	7.8	4.4	6.8	6.7	7.9	7.2	7.5	6.9
<b>ASEAN</b> <sup>2</sup>	3.8	6.6	1.8	4.7	5.3	6.4	5.5	5.5	5.7
Brunei Darussalam	0.8	2.8	3.0	2.8	3.2	1.7	3.6	...	...
Cambodia	6.9	8.4	5.5	5.2	7.0	7.7	8.4	6.3	6.4
Indonesia <sup>3</sup>	2.6	4.9	3.6	4.5	4.8	5.1	5.6	5.4	6.0
Lao PDR	6.1	5.8	5.8	5.9	5.8	6.9	7.2	7.3	6.5
Malaysia	4.7	8.9	0.3	4.4	5.5	7.2	5.2	5.5	5.8
Myanmar <sup>4</sup>	10.4	13.7	11.3	12.0	13.8	13.6	12.2	...	...
Philippines	4.1	6.0	1.8	4.4	4.9	6.2	5.0	5.0	5.3
Singapore	5.0	10.0	-2.3	4.0	2.9	8.7	6.4	6.1	4.6
Thailand	2.7	4.8	2.2	5.3	7.0	6.2	4.5	4.7	5.5
Viet Nam	7.1	6.8	6.9	7.1	7.3	7.8	8.4	7.8	8.0
<b>NIEs</b>	4.4	7.9	1.4	5.3	3.2	5.7	4.5	5.1	4.7
Hong Kong, China	3.6	10.0	0.6	1.8	3.2	8.6	7.3	6.5	5.2
Rep. of Korea	4.6	8.5	3.8	7.0	3.1	4.7	4.0	5.1	4.9
Taipei, China	4.5	5.8	-2.2	4.2	3.4	6.1	4.1	4.4	4.0
<b>PRC</b>	9.0	8.4	8.3	9.1	10.0	10.1	9.9	10.1	9.0
<b>Japan</b>	1.1	2.9	0.4	0.1	1.8	2.3	2.6	2.9	2.4
<b>US</b>	3.0	3.7	0.8	1.6	2.7	4.2	3.5	3.3	3.1
<b>Euro area</b>	1.9	3.9	1.9	0.9	0.8	2.1	1.3	2.1	2.0

<sup>1</sup>Aggregates are weighted according to gross national income levels (atlas method, current US dollars) from *World Development Indicators* (World Bank).

<sup>2</sup>Excludes Brunei Darussalam and Myanmar for all years as weights are unavailable.

<sup>3</sup>For Indonesia, GDP growth rates from 1996–2000 are based on 1993 prices, while growth rates from 2001 onward are based on 2000 prices.

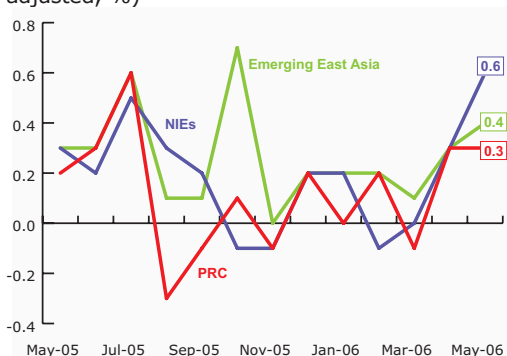
<sup>4</sup>For FY April–March.

Sources: Asian Development Bank; Prime Minister's Office, Brunei Darussalam (*Brunei Economic Bulletin*); Eurostat website (euro area); Economic and Social Research (Japan); Bureau of Economic Analysis (US).

Philippines, and reduced political uncertainty in Thailand. (For outlooks, risks, and policy issues for individual economies, see Part IV.)

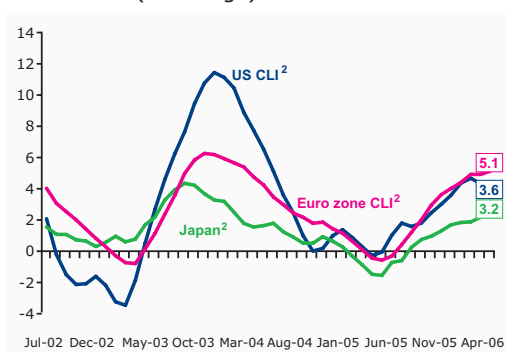
With headline and core inflation already rising in recent months in several emerging East Asian economies, the outlook is for higher inflation on average in 2006 than last year. Reinforcing this expectation is evidence of higher inflation momentum in the region (Figure 34). Although still relatively low in the PRC and the NIEs—especially compared with ASEAN—the seasonally-adjusted series show inflation

Figure 34: **Inflation Rates**<sup>1</sup> (m-o-m, seasonally adjusted, %)



<sup>1</sup> Weighted by gross national income (atlas method, current \$).  
Source: OREI staff calculations based on ARIC Indicators.

Figure 35: **OECD Composite Leading Indicators**<sup>1</sup> (% change)



<sup>1</sup> Composite leading indicators (CLIs) are constructed to signal turning points in growth cycles of aggregate economic activity.  
<sup>2</sup> 6-month, annualized, trend restored.  
Source: OECD website.

accelerating somewhat in April 2006. For emerging East Asia overall, annual inflation is expected to rise from 3.0% in 2005 to 3.5% in 2006, increasing in the PRC from 1.8% to 2.3%, in the NIEs from 2.4% to 2.6%, and in the ASEAN economies from 6.3% to 7.3%.

## Risks to the Outlook

The forecast of a strong regional expansion over the near term is contingent on the assumption that no serious adverse shocks occur over the forecast period. Yet, there are several risks to this outlook. These risks can be grouped into two broad categories. The first includes near-term, cyclical risks: (i) a sharp fall in external demand; (ii) vulnerabilities due to an overheating PRC economy; (iii) higher-than-expected energy prices; and (iv) a significant deterioration in global financial conditions. The second category includes those that have a relatively low probability of occurring in the near term but would seriously disrupt the region's economies if they occur: (v) a sudden and disruptive adjustment of the global payments imbalance; and (vi) an avian flu pandemic.

The risk of a sharp slowdown in external demand hinges on whether or not the US economy would slow much more than expected. The last US recession was accompanied by a drop in external demand for emerging East Asia, which contributed to the sharp economic slowdown in the region in 2001. Up until now, rapid growth of household wealth underpinned the US expansion by spurring consumption growth. However, the US real estate market is beginning to cool. If that would be hastened by, for example, rising US interest rates, consumption growth and thus the US economy could slow more sharply than expected. The OECD composite leading indicator for the US shows that the risk of such a downturn has recently increased (Figure 35). However, there is no such indication in the euro area or Japan, which are strengthening and rebalancing sources of global growth. A more balanced global expansion implies that while a sharper-than-expected US slowdown would reduce growth projections in the region, it need not derail the expansion.

The 2006–07 growth forecast for the PRC is based on expectations that, with more assertive monetary tightening

by the authorities, the economy will slow to a sustainable but still strong growth rate. However, given current indications of an overheating economy, such as overinvestment and rapidly rising real estate prices in selected areas, there is a risk that the economy may slow more sharply. Given its importance as an export market to the rest of the region, this could trigger a broader slowdown.

Against the backdrop of rising inflation in the region, a spike in oil prices could significantly exacerbate inflationary pressures—especially if it is sustained or perceived as permanent. Given that fuel prices have already increased, further hikes would be onerous to producers and consumers alike. Even if the spike turns out to be short-lived, it could be difficult to absorb on top of already high prices. To the extent that governments try to insulate economies by limiting pass-through effects, there could be adverse fiscal impacts.

A sharp deterioration in global financial conditions could occur, for example, if the US FED continued to raise short-term rates faster than expected. They could also arise from a sudden upward adjustment in long-term US interest rates—a much steeper US yield curve. Or there could be a more severe correction in emerging financial markets that markedly impact risk premiums. In general, the scope for regional monetary authorities to mitigate the impact of higher interest rates might well be limited if the adjustment is accompanied by significant turbulence. If authorities respond by tightening monetary policy more than anticipated, investment spending could weaken, and the region could face some intense financial headwinds.

The possibility of a sudden and disorderly unwinding of the global payments imbalance is relatively remote over the forecast period. However, to the extent that a globally-shared approach to resolving the current payments imbalance is not emerging, there is an increasing concern over the medium-term stability of global financial markets. If, for example, a financial shock hits the US, the consequences for emerging East Asia could be large. Immediate effects on the region's financial markets might not be severe, but they would likely require authorities to manage significant capital inflows and pressures on their currencies to appreciate. Inflows could be so large as to make sterilized intervention impractical.

Nonetheless, although potential capital losses on official reserves could be large—especially if currencies appreciate against both the US dollar and the euro—the direct financial impact of a rapid reduction of the US current account deficit might well be manageable. But the secondary effect—plunging US imports—would not. The sudden evaporation of a large external market would impose a significant adjustment cost on the region’s economies.

The final risk—an avian flu pandemic—is also a remote possibility, but with potentially severe consequences. The structure of the poultry industry in much of the region—with many small-scale, backyard flocks—makes the region more vulnerable to the disease. The potential costs are outlined in the December 2005 edition of the *Asia Economic Monitor* and the *Asian Development Outlook 2006*. Since then, the disease has spread significantly, and cases of human-to-human contagion are suspected in Indonesia. However, efforts have been stepped up at the international, regional, and national levels to put effective mitigation and control measures in place (Box 2).

## Policy Issues

Given the outlook for robust external demand, sustained regional economic growth, and the risks outlined above, near-term economic policies in emerging East Asia should focus mainly on managing persistently high energy costs and the associated inflationary pressures. Inflation needs to be managed within the context of expectations that global interest rates will rise further. This in turn has consequences for both the conduct of monetary policies and the management of external balances. At the same time, structural policies are needed to address the risks arising from the heavy reliance on external demand, increased vulnerability to global energy market shocks, and the threat of an avian flu pandemic.

In terms of monetary policy, while a tightening bias remains a generally appropriate policy stance for most emerging East Asian economies for maintaining price stability, the appropriate speed and degree of adjustment will depend on several internal and external conditions. A critical factor for monetary authorities is the extent to which rising global

**Box 2: Impact of Avian Flu—an Update**

By end-June 2006, a total of 54 countries had reported avian flu outbreaks in wild birds or poultry,<sup>1</sup> with 38 new cases in the first half of the year. The disease spreads primarily through poultry trade but also through migration of wild birds. Even cats were found to be infected with the disease in Germany, Austria, and most recently, in Indonesia.

In July 2006, the World Health Organization (WHO) reported that there were 229 confirmed human cases worldwide since 2003, with 131 fatalities (Table B2). In emerging East Asia, confirmed human infections increased by 33% since December 2005; while 79% of those resulted in death.

Indonesia had 35 new human avian flu cases, the most in the region. Most worrying was a cluster of seven fatalities among extended family members in the Karo district of North Sumatra who were in close contact with each other, but only some of whom were in contact with infected birds. This raises the possibility that the virus mutated, allowing human to human transmission. Eleven new human infections were reported in the PRC, seven of which were fatal. In Cambodia, two human deaths were confirmed, with chickens and ducks in neighboring areas testing positive for the avian flu virus. In February 2006, Malaysia reported its first poultry outbreak since 2004, in Setapak City. Poultry

infections were subsequently detected in other areas too. Myanmar reported its first poultry outbreaks in Mandalay and Sagoing provinces in March 2006 leading to the culling of 660,000 poultry. On a more positive note, in Viet Nam and Thailand, where human deaths occurred due to avian flu in 2003 and 2004, no new cases have been reported since January 2006.

Backyard poultry, the livelihood for many rural Asian families, and urban wet markets, where birds are openly slaughtered and displayed, increase the probability

Encouragingly, however, efforts are underway at the global, regional, and national levels to combat the disease. At the global level, an International Ministerial Pledging Conference was held in Beijing, PRC in January 2006, where almost \$1.9 billion was pledged to support programs to combat the disease. ADB, for example, pledged \$400 million in loans and \$69 million in grants for regional projects. WHO published a “Pandemic Flu Draft Protocol for Rapid Response and Containment,” also in January, mapping out a strategy that would reduce the threat of a pandemic. In May, the Food and Agriculture Organization held an international scientific conference on avian flu that confirmed the role of migrating birds in transporting the virus over long distances, resulting in a \$6.8 million plan to survey the migratory behavior of wild birds. Also in May, delegates to the World Health Assembly agreed to advance implementation of the International Health Regulations directly related to avian flu and to the threat of a pandemic. And in June, a high-level avian flu conference was held in Vienna, Austria to assess the current situation, the preparations made in case a pandemic occurs, and to follow up pledges and commitments made at the Beijing conference.

Within the region, the first East Asia Summit held in Kuala Lumpur, Malaysia in December 2005 issued a declaration on Avian Flu Prevention, Control, and Response. WHO

**Table B2: Confirmed Human Cases of Avian Flu A/(H5N1) Reported to WHO as of 4 July 2006**

	2003	2004	2005	2006	Total (A)
Emerging East Asia (I) cases	3	46	95	48	192
fatalities	3	32	41	38	114
Cambodia cases	0	0	4	2	6
fatalities	0	0	4	2	6
PRC cases	0	0	8	11	19
fatalities	0	0	5	7	12
Indonesia cases	0	0	17	35	52
fatalities	0	0	11	29	40
Thailand cases	0	17	5	0	22
fatalities	0	12	2	0	14
Viet Nam cases	3	29	61	0	93
fatalities	3	20	19	0	42
Other regions (II) cases	0	0	0	37	37
fatalities	0	0	0	17	17
Total (I)+(II) cases	3	46	95	85	229
fatalities	3	32	41	55	131
fatalities (%)	100	70	43	65	57

Notes:  
 1. Total number of cases includes number of fatalities.  
 2. WHO reports only laboratory-confirmed cases.  
 Source: World Health Organization.

of humans coming into contact with the disease. Inadequate health infrastructure, especially in rural areas, is also a problem because it increases the risks of an outbreak going undetected and rapidly getting out of control.

<sup>1</sup>FAO/AIDE News. *Update on the Avian Influenza Situation*, no. 40. Food and Agriculture Organization, June 2006.

published a Regional Flu Pandemic Preparedness Plan (2006–2008) in January 2006 to complement national efforts. In May, the APEC ministerial meeting announced an Action Plan to help its members detect and respond to avian flu outbreaks. And in June, ASEAN+3 officials held a 3-day meeting in Myanmar focusing on bird flu.

At the national level, too, initiatives are being taken to combat the disease. Indonesia has a strategy involving vaccination, animal and human health surveillance, and

depopulation of infected areas. In the Karo district, the government decreed strict avian flu monitoring and culling of all poultry within one-kilometer of each confirmed case of the disease. The Ministry of Health and Ministry of Agriculture are also preparing National Preparedness Plans. The PRC has taken several steps, including the prohibition of human anti-flu drugs in poultry (which could allow drug-resistant strains of the virus to evolve). In June 2006, the PRC and WHO established a WHO Collaborating Centre for Surveillance, Research

and Training on Emerging Infectious Diseases in Guangzhou. And in the same month, the Ministry of Agriculture issued an emergency order to monitor areas below the flight paths of migratory birds, lakes, and other sites where avian flu appeared. The Hong Kong Hospital Authority requires hospitals to report pneumonia cases of those who traveled in affected countries before falling ill. And Viet Nam has established production zones to relocate farms and to provide farm sanitation.

energy prices pass through into domestic—especially core—inflation. Effective management of these inflationary pressures—and liquidity conditions in general—hinges on the degree of exchange rate flexibility allowed, and the degree of sterilization. Other factors that will affect policy choices include the degree of trade and financial openness, the sensitivity of capital flows to short-term interest rate differentials, and the pace of monetary tightening by major central banks around the world.

Box 3 highlights monetary policy options available for emerging East Asian economies in responding to potential shocks to the economy. In open economies, monetary conditions are influenced jointly by interest rate and exchange rate movements. In some cases, the latter is a more powerful instrument than the former. In other words, the greater the degree of exchange rate flexibility allowed, the greater the scope for decoupling domestic interest rate policy from global interest rate trends. Monetary authorities across the region tend to follow US FED policy rate changes, to a greater or lesser extent. The more the exchange rate adjusts against the US dollar in response to a given shock, the less authorities need to rely on domestic interest rate adjustment.

The appropriate mix of interest rate changes and exchange rate adjustments would depend upon a host of macroeconomic conditions specific to each economy: the balance of payments position, the cyclical phase of the economy, and the underlying nature of the inflationary pressures. However, where pressure



**Box 3: Monetary Policy Options for Emerging East Asia**

The period since the second half of 2004 has seen an unwinding of the very stimulatory monetary policies pursued by the United States (US) Federal Reserve (FED). The US FED funds target rate has risen from an historic low of 1.00% in 2003–2004 to its current rate of 5.25%—through a series of seventeen 25-basis point (bp) increases. While emerging East Asia’s economies have broadly followed the global monetary policy cycle, only in Hong Kong, China have policy rate adjustments kept up with the US—because of the linked exchange rate system. There has been a declining interest rate differential between other emerging East Asia’s policy rates and the US FED funds rate.

While the policy interest rate is the primary tool for conducting monetary policy in larger industrial economies like the US—as trade is smaller relative to total output—for smaller open economies, exchange rates play a more central role in impacting domestic inflation (a pass-through from imported prices) and output (the impact on net exports). For instance, even if a country’s interest rates do not keep up with world rates, to the extent that its currency appreciates, monetary conditions might effectively be relatively tight (relative to a base year). Therefore, in order to obtain a better measure of the overall

monetary policy stance, it is important to assess both interest rates and exchange rates.

This is the central idea behind a monetary conditions index (MCI) which defines the combination of interest rate and exchange rate that is consistent with a particular monetary policy stance. The weight of each variable in the MCI depends on the relative impact on inflation. The actual computation of the MCI is more involved, as the weights for the exchange rate and interest rate ideally need to be derived formally from a structural model of the economy. Table B3 provides a rough indication of the impact

of appreciation of most emerging East Asian currencies (in trade-weighted terms) since mid-2004 thus suggests that the overall monetary condition is tighter than is indicated by the change in policy interest rates. This is particularly true for Korea, which has seen a significant appreciation of its trade-weighted exchange rate since mid-2004, as it is for Singapore.

Given that the actual monetary condition is determined by both the interest rate and the exchange rate, the key policy question is—assuming monetary policies need to be altered—what is the appropriate mix between changes in interest rates and exchange rates?

The answer depends on the monetary policy and exchange rate framework. For example, if a small economy operates a fixed exchange rate and is open to international capital flows, it effectively forsakes monetary policy autonomy and hence its

policy rates have to change more or less in step with the partner country rates. Hong Kong, China is a case in point.

Monetary authorities in most emerging East Asian economies, however, have shifted toward either formal or informal inflation targeting in recent years with

**Table B3: Effect on Inflation of Changes in Interest and Exchange Rates** (in basis points)

	Effect of a 1 basis point change in interest rate	Effect of a 1% change in exchange rate	Interest rate equivalent (in bp) of a 1% change in exchange rate
Hong Kong, China	1.08	49	45
Korea	0.56	21	38
Malaysia	0.21	14	68
Singapore	0.36	43	119
Taipei, China	0.29	14	48
Thailand	0.43	14	33
Average	0.49	26	59
Japan	1.37	4	3

Source: CLSA Asia-Pacific Markets, The Infotax, 1 July 2006.

of a one basis point change in interest rates and a 1% change in exchange rates on domestic inflation. For example, while a 1% change in the effective exchange rate in Japan is equivalent to only a 3bp change in interest rate, it is equivalent to an average of almost 60bp change in several emerging East Asian economies. The general

increasingly flexible exchange rates. An inflation-targeting monetary authority in a relatively small, open economy must consider exchange rate movements when choosing the appropriate interest rate to attain the desired monetary stance.

But there is a second consideration. For each policy interest rate, there is a specific currency value that places the foreign exchange market in equilibrium (when supply and demand for the currency are equal). Thus, there is an optimum combination of exchange rate and interest rate that allows the inflation target to be met without exerting undue pressure—either to appreciate or depreciate—on the exchange rate.<sup>1</sup>

Suppose an inflation-targeting authority faces increasing inflationary pressures and decides to raise the policy interest rate to tighten monetary conditions. This will attract capital inflows and thus cause a fully floating exchange rate to appreciate—resulting in tighter monetary conditions and reducing the required interest rate adjustment. But suppose the monetary authority wants to limit

the exchange rate adjustment, then the interest rate must bear a higher weight of the required change. This then induces larger capital inflows than otherwise and builds even greater pressure for the currency to appreciate. In this case, authorities must intervene in the exchange market to buy up the excess foreign currency and then sterilize the effect this has on the domestic monetary base (and it must be done continuously to maintain the desired monetary stance). To the extent that these interventions are not perfectly sterilized, monetary policy will tend to be looser than intended and inflationary pressures can persist, requiring further tightening through interest rate hikes.

Consider the case in which the inflation-targeting monetary authority is faced with both an increase in inflationary pressure and an increase in foreign currency inflows—as happened during the first quarter of 2006 in much of emerging East Asia. In this case, increased foreign demand for local currency would likely lead to currency appreciation, under a floating rate regime, and result in tighter monetary conditions. Depending on the relative size of the two external shocks, the

currency appreciation might be sufficient to reestablish low and stable inflation with no (or minimal) adjustment to the interest rate required. If there should be no exchange rate adjustment under a fixed rate regime, the change in policy rate would be required. But the interest rate increase induces capital inflows and resulting additional appreciation pressures would force the authorities to scale up ongoing exchange market intervention requiring further sterilization efforts.

These examples show that, for a relatively small and open economy, a flexible exchange rate can be a shock absorber to partially insulate the domestic economy from external shocks by minimizing the size of the policy rate adjustment needed to attain the inflation target. In short, the greater the exchange rate flexibility, the easier it is to maintain autonomy in monetary policy.

The same logic would also apply to a large economy, like the PRC, in order to alleviate the strains on liquidity growth arising from reserve accumulation. Greater exchange rate flexibility can also assist in resolving some of the global payments imbalances.

exists for currency appreciation, appropriate exchange rate adjustment can reduce the need for hikes in the policy interest rate. In the PRC, for example, achieving the necessary degree of monetary tightening will likely require both increases in deposit and lending rates to cool domestic demand and further currency appreciation to support monetary policy tightening as well as alleviate external imbalances. For Korea, where the current account surplus is narrowing and the policy rate has been raised twice this year, most recently in June, further fine-tuning of monetary conditions needs to proceed with caution. Thailand—which has tightened monetary policy

<sup>1</sup>This discussion is based on background papers prepared by OREI.

significantly—will need to balance sustained inflationary pressures against a weaker expansion in domestic demand. In contrast, against decelerating but still high inflation and weaker external balances, the focus in the Philippines and Indonesia will have to be on maintaining stability of both internal and external balances. This may mean continuing to lower the elevated rates in Indonesia without igniting inflation and exacerbating external conditions.

Fiscal conditions and policy options vary greatly across the region. In Korea and Singapore, where public finances are generally strong, the focus could turn to addressing such long-term priorities as preparing for an aging population and sustaining economic growth through enhanced research and development. In contrast, in the PRC, a critical need is to shift the public spending focus toward high priority and quality investments in environmental protection, energy efficiency, social protection, human capital, and rural development without adding to economic overheating. In the Philippines and Indonesia, where fiscal vulnerabilities remain despite recent improvements, reducing inefficiencies and prioritizing development needs can help guard against macroeconomic instability. As the smaller ASEAN economies implement fiscal reforms, improving the efficiency of fiscal administration is an important challenge, especially in tax collection and management of still relatively low level of expenditures. In Myanmar, however, fiscal sustainability is threatened by the persistent monetization of the fiscal deficit.

To address external imbalances and reduce vulnerability to external shocks, the region should enhance domestic demand. In the PRC, efforts to stimulate consumption—especially in rural areas or through social sector reforms such as pension reforms—are appropriate. Excluding the PRC, unexploited investment opportunities—both in the private sector and public sector-led infrastructure projects—remain large in several emerging East Asian economies. Appropriate structural reforms and policies that improve domestic business climates and stimulate investment would be valuable.

This could include adopting initiatives aimed at strengthening the efficiency of domestic financial institutions, particularly banks, as well as developing efficient domestic capital markets—particularly bond markets. While bank balance

sheets in emerging East Asia have strengthened significantly in recent years, continued efforts to improve profitability and to reduce financial vulnerabilities are essential to withstand ongoing challenges. Banks across the region need to continue strengthening their resilience to shocks—as less benign macroeconomic and market conditions may emerge in the months ahead. Such efforts are needed even more as banks—beginning this year—start implementing the Basel II capital adequacy framework, which aims to improve measurement and management of risk by adjusting and refining traditional capital adequacy measures. Addressing corporate sector vulnerabilities and improving corporate governance is also critically important. Implementing effective mechanisms to channel regional savings into regional investment would also help reduce external payments imbalances and support sustained economic growth across the region.

It is also important for emerging East Asian economies to improve energy efficiency and reduce dependence on external sources of energy. This can be achieved by (i) promoting the adoption of technologies using renewable energy sources; (ii) providing market incentives to reduce energy consumption; (iii) removing subsidies and price controls; (iv) introducing regulatory and administrative measures to ensure the use of energy-friendly production and construction standards; and (v) increasing public awareness on the relevance of enhancing energy efficiency and conservation. While the adoption of domestic energy policies will depend on each economy's degree of energy self-sufficiency, it is imperative to strengthen regional cooperation on energy policy—a shared approach and collective action can better address common concerns.

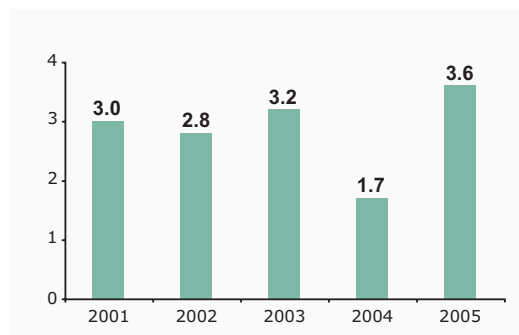
Enhancing the region's capability to manage a possible avian flu pandemic is another policy priority for emerging East Asian economies. Implementing initiatives to combat the recent, renewed spread of the disease is essential. Authorities should introduce a proper mix of containment programs at the country-specific and regional level aimed at strengthening surveillance and disease control mechanisms, providing timely and accurate information on the incidence and spread of the disease—including updates of flu outbreaks and cases of human infection—and developing contingency plans in coordination with the private sector to minimize the social and economic consequences of a pandemic outbreak.

## Brunei Darussalam

*Sustained oil demand should result in economic growth this year at about the same pace as the estimated 3.6% in 2005. To diversify the economy, the government is stepping up efforts to encourage private-sector initiatives.*

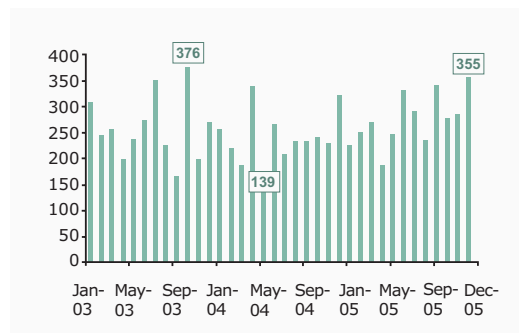
**Economic Outlook:** With the oil and gas sector contributing about 40% of GDP and 90% of exports, sustained oil demand is expected to drive modest but steady 3.6% economic growth in 2006—about the same pace as in 2005. Robust oil revenues are expected to spur domestic demand, especially investment in construction and trade. Higher export earnings are strengthening both government revenues and the current account surplus—which was estimated at about 70% of GDP in 2004. Inflation will likely remain low at about the 2005 level of 1%, in part because of the exchange-rate peg to the Singapore dollar and generally low inflation among main trading partners such as Japan and Korea.

### GDP Growth (%)



Sources: Prime Minister’s Office and *Brunei Darussalam Statistical Yearbook*.

### Trade Balance (\$ million)



Source: *Direction of Trade Statistics*, May 2006 (International Monetary Fund).

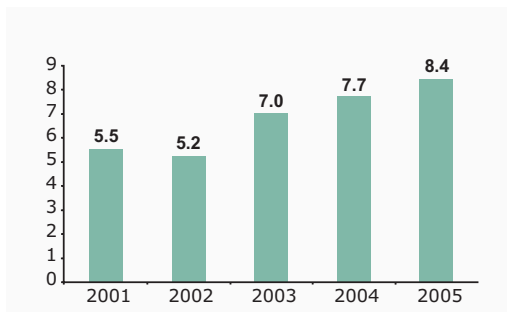
**Risks:** According to some recent independent forecasts, the country faces a possible depletion of oil reserves as early as the next decade. Thus, economic growth is constrained by the limited capacity to either increase oil production or diversify the economy, which currently restricts the country’s absorption of windfalls from oil. Another risk would be a prolonged downturn in the global economy, significantly reducing oil prices and demand, and causing public expenditure—currently about 50% of GDP—to be curtailed.

**Policy Issues:** Given the country’s currency board system—under which the Brunei dollar is pegged to the Singapore dollar—monetary policy is not an option and fiscal policy remains the main policy lever. With huge oil revenues boosting private and government income, the fiscal surplus climbed from about 10% of GDP in 2003 to an estimated 20% in 2005. Despite the sharp increase, the government resisted calls for higher current expenditures, reducing the risk of an inflationary surge in domestic demand and increasing public savings against future needs. Continuing this policy would reduce external vulnerabilities, while the government tackles the challenge of diversifying the economy by: (i) negotiating economic partnership agreements (for example with Japan) and strengthening regional ties (Brunei Darussalam joined ADB in April 2006); (ii) encouraging SMEs and several private-sector initiatives, such as the “e-Brunei” project that will use current information and communications technology to improve the business environment; and (iii) floating the first Islamic Bond, in March 2006, to promote development of the financial sector.

## Cambodia

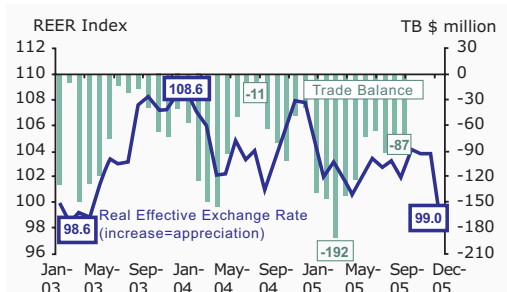
GDP growth is expected to slow to 6.3% this year after the 2005 peak of 8.4%. The country could build resilience to economic shocks by diversifying sources of growth beyond garments. While the fiscal outlook is improving, reducing inflation remains a challenge.

### GDP Growth (%)



Sources: Ministry of Economy and Finance; National Institute of Statistics of Cambodia website; and *Asian Development Outlook 2006* (Asian Development Bank).

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100

REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: ARIC Indicators and *Direction of Trade Statistics*, May 2006 (International Monetary Fund).

### Fiscal and Monetary Indicators

	2002	2003	2004	2005
Central government fiscal balance (% of GDP)	-6.4	-6.9	-4.3	-3.1
Riel/\$ (y-o-y, % change)	0.2	-1.6	-1.0	-1.9
Current account balance (% of GDP)	-8.8	-10.1	-9.9	-10.2

Source: *Asian Development Outlook 2006* (Asian Development Bank).

**Economic Outlook:** The high and accelerating growth of the past 3 years may not be sustainable, as intensified global competition will make it difficult for the garments sector to continue its rapid expansion. Preliminary data show that economic growth slowed in early 2006, with agricultural production leveling off after a 2005 rebound from the 2004 drought. GDP growth is expected to ease to 6.3% in 2006 from last year's exceptionally high 8.4%. Average inflation reached a 7-year peak of 5.8% in 2005, mainly due to an upsurge in food and oil prices. Data for early 2006 show inflation slightly decelerating to an average of 5.6% in the first 5 months of 2006.

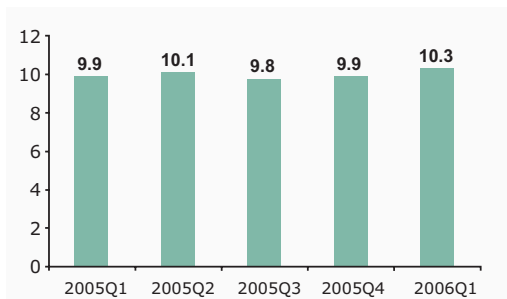
**Risks:** High export concentration in garments, especially to the US and the EU, exposes the economy to abrupt adjustments in external prices and foreign trade policies. A severe drop in demand for garments thus remains a major risk to sustained economic growth, suggesting the need to diversify into other sectors. Given its proximity to Thailand and Viet Nam, the risk of contagion from an avian flu outbreak persists. This is aggravated by inadequate government funds to prepare for a possible pandemic and the need to design an effective campaign to inform the population how to detect and contain the disease.

**Policy Issues:** Rolling back inflation remains a major challenge, especially as high dollarization reduces the effectiveness of monetary policy. To mitigate erosion of the riel's purchasing power, the National Bank of Cambodia is focusing on maintaining exchange-rate stability and keeping credit growth to programmed levels. On the fiscal side, efforts to improve revenue collection are showing results, with total revenues increasing to 11.6% of GDP in 2005 from 10.0% in 2000. Better revenue collection, coupled with initiatives to streamline expenditure, reduced the fiscal deficit to 3.1% of GDP in 2005, maintaining a trend that started in 2003. However, sustaining this trend remains a challenge given the need for large investment to improve social and economic infrastructure. To enhance export performance, the government introduced policies to facilitate trade by reducing administrative requirements needed to process international transactions. A strong push to pass market-friendly enterprise and investment laws remains a key factor in building an economic environment conducive to greater private-sector participation and increased economic diversification.

## PRC

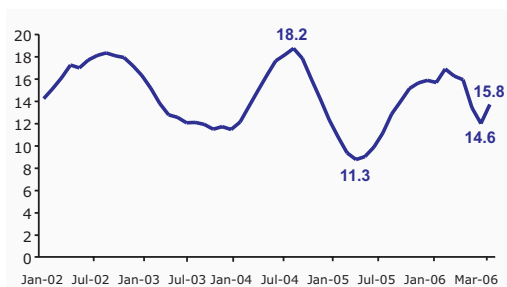
GDP growth is expected to accelerate further to 10.1% in 2006. Interest rate hikes, faster yuan appreciation against the US dollar, and further liberalization of capital outflows would help government efforts to restrain growth in liquidity and fixed investment.

### GDP Growth (%)



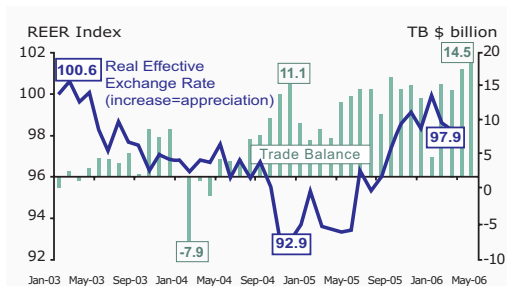
Source: ARIC Indicators.

### Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI.  
Source: OREI staff calculations.

### Trade Balance and Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Source: ARIC Indicators.

Economic Outlook: GDP growth accelerated to 10.3% in 2006Q1. It is expected to ease slightly to 10.1% for all of 2006, as rapid investment and credit growth are restrained by monetary tightening. Though still strong, export growth is decelerating, while import growth is rebounding from a marked slowdown last year, caused by policies that suppressed oil imports, among other factors. The current account surplus is therefore expected to shrink after peaking at 7.0% of GDP in 2005. Inflation, gradually declining since mid-2004 (to 1.4% in May 2006), is likely to remain low despite expected increases in administered energy prices.

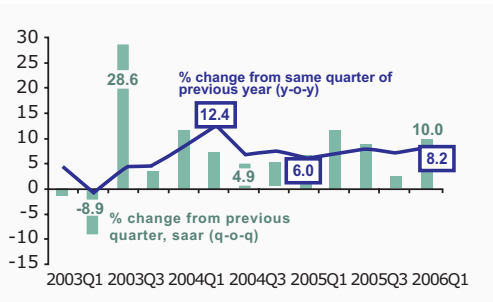
Risks: While the composite leading indicator supports a robust outlook, there are important risks. Externally, a disorderly unwinding of the global payments imbalance could destabilize the economy by sharply curtailing export growth and capital inflows. Higher oil prices could force further price increases. Domestically, there is a risk of the economy overheating. Despite recent progress in reducing NPLs, the rapid growth of corporate and local government debt raises concerns about bad-debt risks among banks. Recent increases in real estate prices are another source of concern. Finally, the threat of avian flu lingers despite several policy measures taken to prevent and mitigate the risk of a pandemic.

Policy Issues: With persistent foreign monetary inflows due to reserve accumulation that was only partly sterilized, M2 grew by 18.4% in June 2006, feeding accelerating investment growth. Foreign exchange reserves increased \$56 billion in 2006Q1, and at this rate could reach the \$1 trillion mark by the end of the year. The authorities responded in April 2006 by raising the 1-year benchmark lending rate by 27 basis points—to 5.85%—the first hike since October 2004. In June, the central bank raised its reserve-requirement ratio for commercial banks in a further attempt to curb lending—raising both deposit and lending rates would help this process. Large trade surpluses, despite the moderate strengthening of the real effective exchange rate since mid-2005, indicate that further yuan appreciation could help manage monetary conditions more effectively. A further liberalization of the capital account, building on recent moves to permit specified domestic institutions to invest abroad, would help slow reserve accumulation. The fiscal situation is manageable, due to consolidation in recent years. However, indications of rising local government liabilities should be closely monitored.

## Hong Kong, China

Although slowing from very high rates of growth over the past two years, a favorable external environment and strong domestic demand should sustain economic growth at a still high 6.5% in 2006. While the financial system remains robust, continued fiscal discipline is required as the population ages.

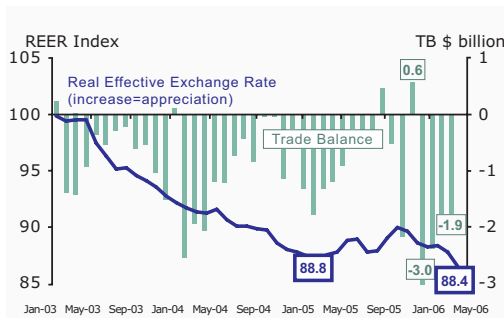
### Quarterly GDP Growth (%)



saar = seasonally adjusted annualized rate.  
Source: Census and Statistics Department of Hong Kong, China.

**Economic Outlook:** The economy performed better than expected in 2006Q1, with GDP growing at 8.2%, as exports expanded at a rapid pace and domestic demand showed a significant recovery. Net exports continued to increase rapidly in 2006Q2, as the PRC economy grew above expectations. At the same time, although increasing interest rates—in tandem with US rate hikes—may have affected asset prices, the impact on the real economy seems to have been negligible. The contribution to growth in 2006Q1 from both private consumption and investment was remarkably high (investment grew at an 8.5% annual pace). Given these trends, GDP is expected to expand by 6.5% for the whole year. Inflation has edged up, increasing to 2.1% in May—compared with 1.0% average inflation for 2005—on the back of rising residential rental costs.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: Census and Statistics Department of Hong Kong, China and OREI staff calculations based on data from the Hong Kong Monetary Authority.

**Risks:** Given its high degree of openness, the economy remains vulnerable to external shocks. As local interest rates generally track closely the US rates under the Linked Exchange Rate System (LERS), a faster-than-expected increase in the US FED fund rates could start having a more direct impact on investment, reducing in turn domestic demand. While monetary policy is effectively tied to the US, the real economy is increasingly linked to the mainland by trade, financial, and tourism flows. Any economic slowdown, even minor, in the PRC, will therefore almost inevitably affect the growth prospects in Hong Kong, China, for the same reason that the strong GDP growth in 2006Q1 is largely determined by trends in the PRC. Domestically, another possible source of risk is the rapid increase in both commercial and residential real estate prices.

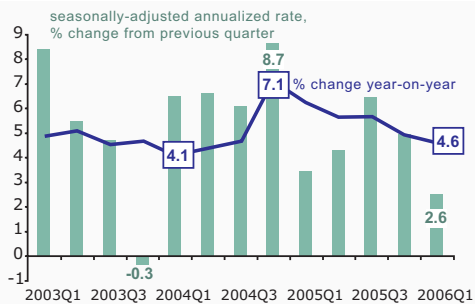
**Policy Issues:** In 2005, the Hong Kong Monetary Authority further refined the LERS by introducing measures designed to build market confidence in the exchange system at a time of increasing uncertainties in the external exchange rate environment. On the fiscal side, after running deficits in most of the years since FY1997/98, the economy posted a consolidated surplus in FY2005/06 (HK\$14.0 billion), the result of strong revenue growth and cuts in government spending. Continued fiscal prudence is appropriate over the medium- to long-term as the population ages and increased demands on the government for related social services will likely stress public finances in the medium to long run—with rising health care costs and a shrinking revenue base as the size of the workforce declines.



## Indonesia

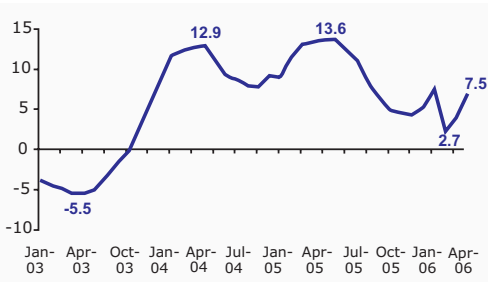
*A revival of market confidence and an expansionary fiscal policy will likely sustain GDP growth at 5.4% this year. While a decline in inflation is encouraging, the capital account remains susceptible to shocks.*

### Quarterly GDP Growth (%)



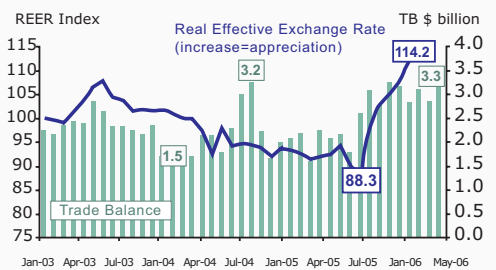
Source: ARIC Indicators.

### Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI.  
Source: OREI staff calculations.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Source: ARIC Indicators.

**Economic Outlook:** Economic momentum slipped further in 2006Q1 as private consumption and investment remained weak. Expanding public expenditures, however, are expected to help sustain economic growth during the rest of the year. Growth in domestic demand is currently constrained by high interest rates, fuel costs, and overall inflation—also as a result of policies used to calm last year’s financial sector turbulence. Still, those policies succeeded in restoring market confidence and economic momentum will likely return later in 2006 or early 2007. Aided by an appreciating rupiah/US dollar exchange rate through April 2006, inflation, though still high, is gradually decelerating after last November’s 18.4% peak.

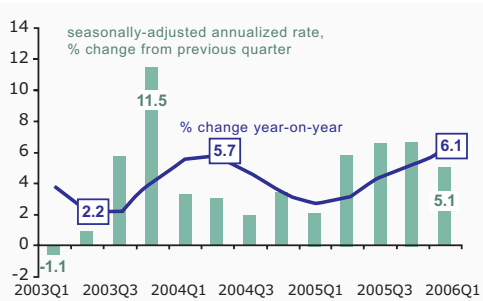
**Risks:** Although inflation is slowing, vulnerability to capital account volatility remains high. Thus a key risk is renewed inflationary pressures, either from further oil price increases, thereby worsening fiscal conditions (remaining subsidies are to be eliminated by end-2006), or a weak rupiah, especially if the depreciating trend against the US dollar—which began in May—continues. Recent deaths from a family cluster in North Sumatra have stoked fears of a human avian flu outbreak. With the highest number of victims in the region, delays in launching serious (particularly local government) prevention schemes, and small budget allocations to combat the disease, concern is rising. The spate of natural disasters has impacted the economy and social services, so any further disruptions could be another source of domestic risk.

**Policy Issues:** After inflation slowed in June, Bank Indonesia further reduced its policy rates in early July to stimulate consumer spending. On the fiscal front, government expenditure will likely expand due to a large carryover from 2005 and increased spending capacity of local governments. However, as debt-servicing requirements remain large, vulnerability to sovereign spread increases persists. This could affect the sustainability of expansionary fiscal policies. Increased labor productivity, an expansion of export markets, and an investment recovery would strengthen economic performance. To spur investment, the government announced a package of tax, regulatory, and other reforms in March 2006. However, institutional weaknesses and administrative bottlenecks pose challenges to its effective implementation.

## Korea

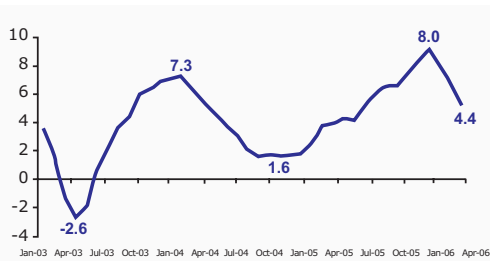
*Sustained momentum in 2006Q1 should boost the pace of GDP growth to 5.1% this year from 4.0% in 2005. Despite rising energy costs, inflation eased slightly from 2.8% in 2005 to 2.6% in June 2006, aided in part by won appreciation.*

### Quarterly GDP Growth (%)



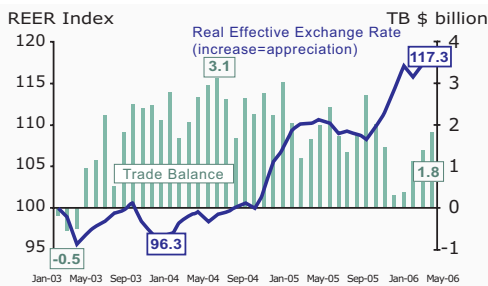
Source: National Statistical Office of Korea.

### Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI.  
Source: National Statistical Office of Korea.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: ARIC Indicators and National Statistics Office of Korea.

**Economic Outlook:** Stronger consumption growth and an improved export performance deepened the economic recovery in 2006Q1. These factors are expected to push GDP growth to 5.1% for the year, despite anemic growth in investment. Given the real won appreciation against the US dollar of about 7% from January through June 2006—following gains of about 26% between 2002 and 2005—and a rapid growth in imports, especially oil, the current account surplus is likely to decline sharply. Although inflation rose to 2.6% in June 2006, and could further increase marginally during the second half of the year—as cigarette taxes and public utility rates are expected to rise—the Bank of Korea recently lowered its inflation forecast for 2006 from 3% to 2.6%.

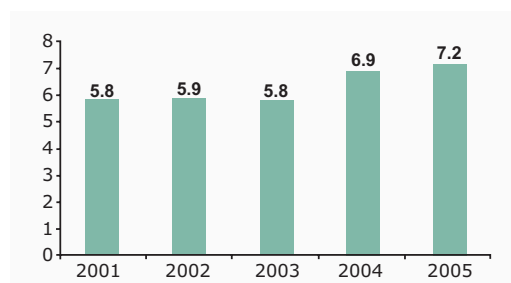
**Risks:** While headline performance has improved, the composite leading indicator suggests a possible loss of momentum. In addition, higher oil prices could reduce profit margins, particularly in the export sector, which is also pressured by a rising won and increasing wages. A disorderly adjustment of the global payments imbalance could exacerbate these trends and erode export demand. Domestically, a possible sharp correction of the real-estate boom could weaken spending by heavily indebted households, reduce construction activity, and increase NPLs in the banking system.

**Policy Issues:** The gradual withdrawal of monetary accommodation continued in early June 2006 with a fourth interest rate hike since October 2005 to 4.25%. Inflation has been maintained within its medium-term target range of 2.5–3.5%, helped by won appreciation that mitigated the pass-through effects of higher imported fuel costs. In addition, further improvement of the fiscal balance, which moved into surplus in 2005, is expected this year. Future policy actions should weigh the possibility of reemerging inflationary pressures—if oil prices continue to climb or the May–June currency weakness persists—against the risk of a softening economic recovery. Structurally, investment is constrained, in part, by problems in corporate governance, recently demonstrated by high profile government cases against both domestic and foreign firms and by labor market rigidities. As property prices are rising rapidly in some locations, bank loans for household mortgages and small business loans backed real estate collateral require close monitoring.

## Lao PDR

Recent trends in main economic indicators point to a solid GDP growth of about 7.3% this year. Tighter controls on bank lending may be required, however, as inflation is edging up, and additional measures to increase revenues are needed to ensure fiscal stability.

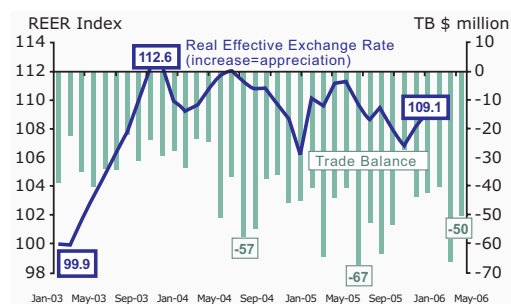
### GDP Growth (%)



Sources: Bank of Lao PDR and *Asian Development Outlook 2006* (Asian Development Bank).

Economic Outlook: With robust mining output and increased electricity sales to neighboring countries in early 2006, the strong economic growth of recent years will likely continue. GDP is forecast to expand by 7.3% in 2006, driven by investment—particularly the construction of the Nam Theun 2 hydropower project and several mining projects. Inflation decelerated to an average 7.2% in 2005, but rose again during the first 2 months of 2006 as food prices increased, reaching 8.5% in February. The kip appreciated by about 6% against the US dollar from January through June 2006 while it has stabilized against the Thai baht, leaving the exchange-rate environment relatively benign.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: ARIC Indicators and *Direction of Trade Statistics*, May 2006 (International Monetary Fund).

Risks: A sharp slowdown in demand for the country’s exports—particularly timber and garments—is a significant external risk. Adverse weather conditions could also hurt agriculture, which is still largely concentrated in rain-dependent rice production. No recent outbreak of avian flu has occurred, and the risk of a pandemic has been lowered because of increased government preparedness. Nevertheless, contagion from neighboring countries remains a threat.

Policy Issues: While inflationary pressures remain a challenge—as a weak transmission process makes conventional monetary tools largely ineffective—the Bank of Lao PDR has set price stability as a clear target and appears determined to reverse the recent inflationary trend by using appropriate monetary policy. The risk of rapid money creation has been reduced while the decision to further control commercial bank lending should help maintain monetary stability. Tax administration has improved through better revenue collection and the authorities were able to contain the fiscal deficit at about 6% of GDP in 2005. A significant boost in revenues still is, however, required. Concrete steps to strengthen central control over revenue collection from the largely administratively decentralized provinces, and speedy implementation of tax measures passed by the National Assembly in 2005, would greatly help fiscal stability. Early expectations of a VAT regime—to be introduced by 2007—boosted economic sentiment, though concerns have recently emerged after the announcement of a delay until 2008. Thus, it is important that the government remains committed to the new VAT, along with other budgetary reforms, to improve the fiscal outlook.

### Fiscal and Monetary Indicators

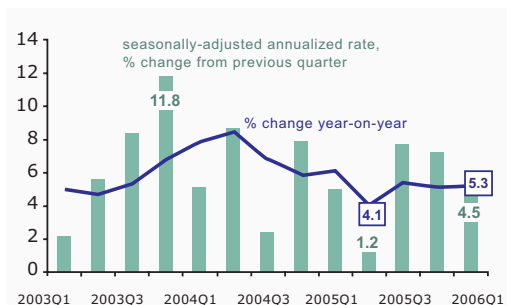
	2002	2003	2004	2005
Central government fiscal balance (% of GDP)	-5.3	-7.9	-5.8	-6.0
Kip/\$ (y-o-y, % change)	-11.0	-5.6	2.6	-1.1
Current account balance (% of GDP)	-2.1	-2.6	-8.6	-8.1

Source: *Asian Development Outlook 2006* (Asian Development Bank).

## Malaysia

Robust export growth should sustain economic expansion at about 5.5% this year. However, risks emanate from global factors that could slow external demand.

### Quarterly GDP Growth (%)



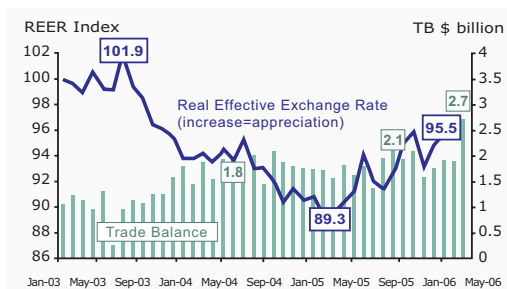
Source: ARIC Indicators.

### Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI.  
Source: OREI staff calculations.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: ARIC Indicators and Bank Negara Malaysia.

Economic Outlook: Despite easing growth momentum from 2005Q4 to 2006Q1, the economy is forecast to expand by 5.5% in 2006. Robust export growth should continue, based on moderating but still strong electronics exports and accelerating exports of commodities. High manufacturing capacity utilization and sharply rising import growth in capital goods will likely accelerate private investment growth throughout 2006. Sustained imports will also narrow the trade surplus. Inflation rose to 4.8% in March 2006—partly because of the February 2006 increase in retail fuel prices, but moderated to 3.9% in May 2006.

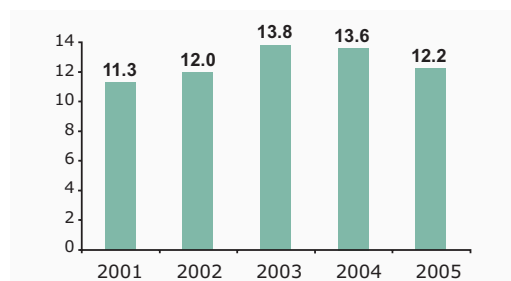
Risks: The composite leading indicator points toward a robust economic expansion. Yet, as a highly export-oriented economy, the country remains vulnerable to weakening external demand due to, for example, an abrupt correction of the global payments imbalance that could erode export performance, destabilize capital flows, and cause capital losses on reserve holdings. A sharp rise in interest rates abroad could also hurt economic growth by forcing a quicker pace of monetary tightening to avoid large capital outflows. Because of continuing avian flu outbreaks around the region, the threat of a pandemic persists, despite effective mitigation policies and the recent absence of any outbreak domestically.

Policy Issues: Indications of broadening economic growth and higher inflation led authorities to begin increasing policy interest rates in November 2005, signaling an end to monetary accommodation, rising by 75 basis points since then to 3.5%. During the January–May period, the ringgit rose by more than 3% against the US dollar—but it has been appreciating in real terms since March 2005. With robust economic growth, increasing inflationary pressure, and rising global interest rates, further policy tightening can be expected. Healthy revenue growth and reduced fuel subsidies should keep fiscal consolidation on track, despite expected increases in spending in line with the country’s medium-term development plan. The plan aims to increase human capital and research and development, to address structural weaknesses constraining private investment, which is a concern as it has continued to decline (as a ratio to GDP) to low levels.

## Myanmar

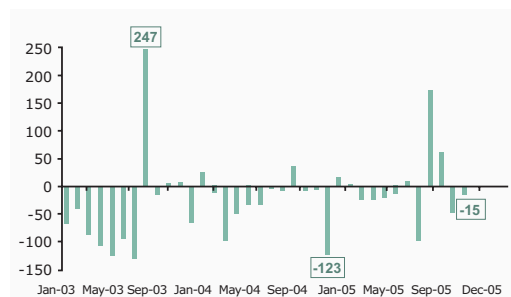
*Gas exports are expected to continue to support GDP growth, but may be tempered by inflationary pressures and unpredictable economic policies.*

### GDP Growth (%)



Source: *Asian Development Outlook 2006* (Asian Development Bank).

### Trade Balance (\$ million)



Source: *Direction of Trade Statistics*, May 2006 (International Monetary Fund).

### Fiscal and Monetary Indicators

	2002	2003	2004
Central government fiscal balance (% of GDP)	-3.6	-4.9	-6.0
Kyat/\$ (y-o-y, % change)	1.5	8.2	7.0

Source: *Asian Development Outlook 2006* (Asian Development Bank).

**Economic Outlook:** Economic trends are difficult to assess, as independent estimates of GDP growth are much lower and inflation estimates higher than official estimates. However, in 2005, export growth in natural gas and continued foreign investor interest in the industry helped support the economy—a trend likely to continue in 2006. There are some prospects for expanding exports to PRC, India, and Thailand, despite continuing pressure caused by the US import ban. Inflation will likely continue to rise sharply this year due to high oil prices and a recent, major salary increase for public-sector employees and military personnel.

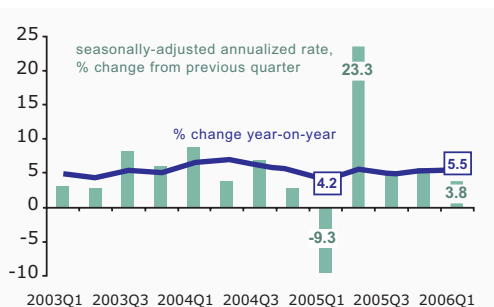
**Risks:** Myanmar suffers from a relatively narrow export base, both in terms of products (gas) and destination (Thailand). Any global shock that reduces energy prices or slows demand for gas could adversely affect the economy. Numerous structural weaknesses—including low productivity in agriculture—increase vulnerability. Avian flu is a significant threat domestically. With about 90 outbreaks in poultry confirmed since March 2006, the sector and related industries are at serious risk. Moreover, with Mandalay—a major trading hub—the focus of the outbreaks, the disease could easily spread. Accelerating inflation and uncertain employment prospects will continue to reduce consumer and investor confidence.

**Policy Issues:** The Central Bank of Myanmar and the country’s commercial banks raised interest rates by two percentage points effective 1 April 2006. However, independent estimates put inflation in double digits. While inflationary pressures are partly due to an increase in demand for staple items, the October 2005 eightfold increase in administered fuel prices—to mitigate the higher cost of subsidies—worsened the situation. And a March 2006 decision to drastically raise salaries of public sector and military personnel between 5-fold and 12-fold also adds tremendous inflationary pressure. New data show that the central bank’s claims on the government increased by 28% in 2005 with a similar trend likely in 2006Q1. Despite a considerable boost in tax revenues in 2004 and 2005, public sector expenditure has grown rapidly, resulting in an estimated fiscal deficit of 3% of GDP in 2005. Substantial efforts to curb inflationary deficit financing, together with greater policy predictability and improved quality of economic information, would enhance the environment for private economic activity. Rationalizing and reducing controls on foreign-exchange markets would also be extremely helpful in reducing distortions that inhibit private economic activity.

## Philippines

Despite the uncertain investment climate, monetary tightening, and high oil prices, the economy remains resilient and growth should be sustained at about a 5.0% pace in 2006. Inflation, however, could still hover around 7%, requiring continued vigilance.

### Quarterly GDP Growth (%)



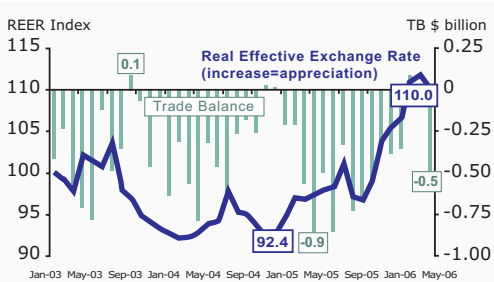
Source: National Statistical Coordination Board of the Philippines.

### Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI.  
Source: OREI staff calculations.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: ARIC Indicators and National Statistics Office of the Philippines.

**Economic Outlook:** Growth in consumption and exports sustained economic expansion in 2006Q1, while investment contracted for a fifth consecutive quarter. GDP growth for 2006 is forecast at 5.0%, supported by continued expansion of remittance-led consumption and by an improvement in IT exports. Investment, however, will likely remain constrained by limited progress in structural reforms, such as in the power sector. Continuing remittance flows and restrained import expansion should keep the current account in surplus, while average inflation from January to June 2006 reached 7.1%, mainly due to higher fuel prices and the recent VAT increases.

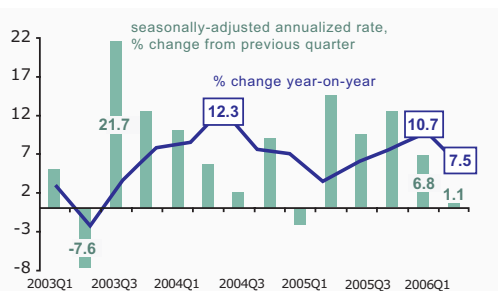
**Risks:** Apart from inflationary pressures arising from further increases in energy prices, risks include a possible slowdown in remittances that would crimp consumer spending and an abrupt correction in global payments imbalances that could reduce export growth and further erode investment. Heightened global financial uncertainty would likely reduce capital inflows, create currency instability, erase recent gains in foreign reserves, and increase the sovereign spread on external debt. Domestically, investor confidence could further decline with continued delays in structural reforms. With the NPL ratio down to 8.2% in April 2006, vulnerabilities in the domestic financial sector have been reduced. The banking sector, however, holds about 28% of the issuance of the public sector, exposing it to volatility in sovereign bond ratings and spreads.

**Policy Issues:** After three successive 25 basis-point hikes in the policy interest rate during 2005, the central bank maintained its policy rates in early 2006 based on evidence that current and expected inflation suggest it is decelerating. Policy rates will likely remain stable in the months ahead. On the fiscal front, higher revenues in 2006Q1 from an expanded VAT and stronger tax collections kept the target deficit of 2.1% of GDP for 2006 on track. Vulnerability can be further reduced through continued efforts to enhance revenues and maintain fiscal prudence.

## Singapore

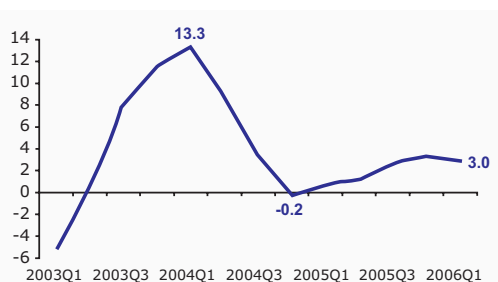
*With sustained global economic expansion, the economy is set to continue its robust performance in 2006, growing by a projected 6.1%. Enhancing competitiveness and increasing economic diversification are key policy challenges for the economy.*

### Quarterly GDP Growth (%)



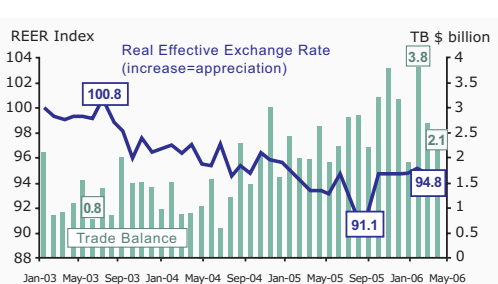
Source: Ministry of Trade and Industry of Singapore.

### Composite Leading Indicator (%)



Note: Annualized two-quarter rate-of-change of trend-restored composite leading indicator.  
Source: OREI staff calculations based on Ministry of Trade and Industry data.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Source: ARIC Indicators.

Economic Outlook: Advance estimates suggest that GDP growth eased in 2006Q2 to 7.5% compared with the 10.7% expansion in 2006Q1. Growth momentum also slowed sharply. The economy moderated as manufacturing growth (10.2%) returned to normal after the exceptional 2006Q1 performance (20.2%). Robust demand for electronics exports and consumer spending sustained growth in the first half of 2006. Despite the very strong performance in the first half of 2006, growth is expected to continue to ease in the second half of the year. With US growth moderating, export momentum is slowing. This, combined with continued weakness in construction, is expected to affect growth. On balance, however, the economy is forecast to expand by 6.1% in 2006. Inflation has slowed in recent months, after peaking at 1.7% in January 2006.

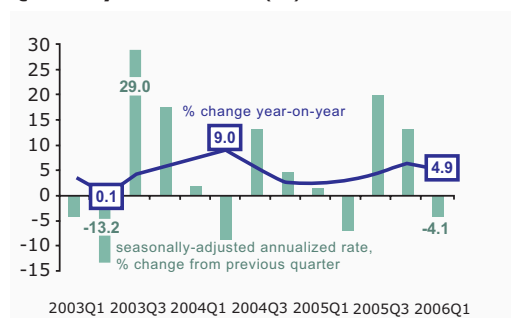
Risks: Although the composite leading indicator weakened recently, the export outlook remains positive due to strong regional leading indicators suggesting that export demand remains firm. Given the openness of the economy, risks could also come from a sudden adjustment to the global payments imbalance or any resultant sharp decline in world economic output.

Policy Issues: The Monetary Authority of Singapore (MAS) is maintaining a policy of gradual appreciation of the Singapore dollar's trade-weighted nominal effective exchange rate. In its April 2006 statement, MAS said its existing policy stance was appropriate to contain inflation, given the recent appreciation against the US dollar (about 5% between end-December 2005 and end-April 2006) and a rise in the domestic Singapore Interbank Offered Rate (from 3.25% at end-December 2005 to 3.55% at end-May 2006). On the fiscal front, after posting a modest surplus in FY2005, the government is expected to run a S\$2.9 billion budget deficit excluding investment and interest income (-1.4% of GDP) in FY2006, largely due to a considerable increase in special transfers—used for economic restructuring and supporting older and lower-skilled workers. The mix between an expansionary fiscal policy and a slightly tight monetary policy seems appropriate for sustaining domestic demand and accommodating government efforts to restructure the economy to adapt to global trends. Over the longer term, a key challenge is to innovate and diversify into new sectors, thus maintaining or enhancing the country's competitive edge. This would also make the economy less dependent on the global IT cycle.

## Taipei,China

Although GDP growth moderated in 2006Q1, the economy should expand by about 4.4% for the year, largely supported by robust external demand. Fixed investment needs to be stimulated to support the nascent recovery in domestic demand.

### Quarterly GDP Growth (%)



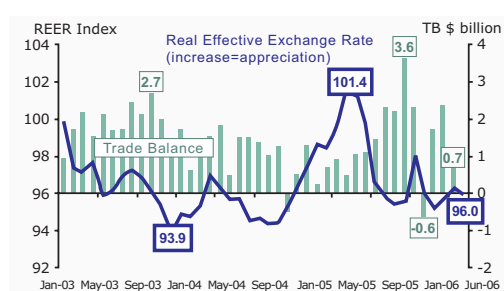
Source: Taiwan Directorate General of Budget Accounting and Statistics.

### Composite Leading Indicator (%)



Note: Annualized two-quarter rate-of-change of trend-restored composite leading indicator.  
Source: Council of Economic Planning of Taipei,China.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: Bank for International Settlements and Ministry of Finance of Taipei,China.

Economic Outlook: GDP growth moderated from 6.4% in 2005Q4 (the fastest pace in six quarters) to 4.9% in 2006Q1. A sustained decline in fixed investment is of some concern, though the rate of decline has slowed significantly from -11.9% in 2005Q4 to -4.0% in 2006Q1. Still, output is expected to expand by 4.4% this year, largely supported by strong external demand, a depreciating real exchange rate, and an accommodative monetary policy. In recent months, however, high oil prices, along with rising food costs, have led to an increase in headline inflation.

Risks: Given the economy's high export orientation, growth prospects inevitably depend on the external environment. A downturn in the electronics cycle, an outbreak of an avian flu pandemic, or an unexpected poor performance of the global economy (and the PRC in particular) would all adversely impact the island's exports and ultimately growth. Political uncertainty affects confidence, a critical factor in stimulating domestic or foreign investment.

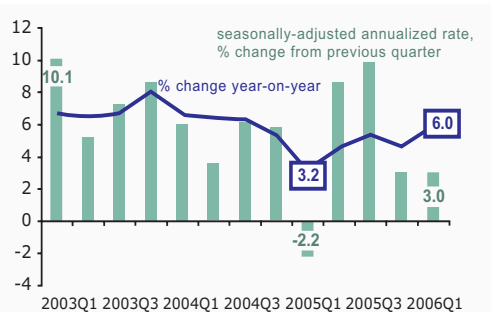
Policy Issues: Since 2004, the Central Bank of China (CBC) has lagged somewhat behind US Federal Reserve policy rate hikes. Until recently, with a nascent recovery in domestic demand, official rates have been barely positive in real terms. However, the CBC hiked the key policy rate on 29 June 2006 by 12.5 basis points, against the backdrop of increased inflationary pressures—from high oil prices, an impending increase in domestic electricity rates, high domestic utilization rates, and low real interest rates—and the desire to return monetary policy to a more neutral stance. Rising public expenditures in recent years, coupled with an increase in public debt, limits the government's ability to use counter-cyclical fiscal policies. Robust GDP growth should enable the government to achieve greater fiscal consolidation and undertake tax reform. Continued liberalization of trade, investment, and tourism with the PRC could also help contribute to strong future growth.



## Thailand

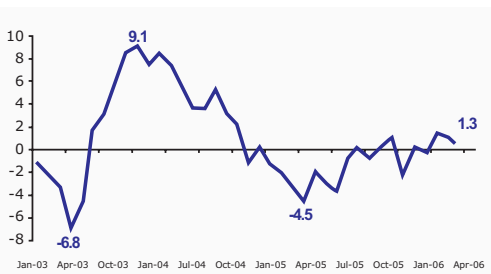
*Sustained 2006Q1 growth suggests that GDP can be expected to expand at 4.7% for the whole of 2006. Persistent oil price increases, creating further inflationary pressures, and political uncertainties present major risks.*

### Quarterly GDP Growth (%)



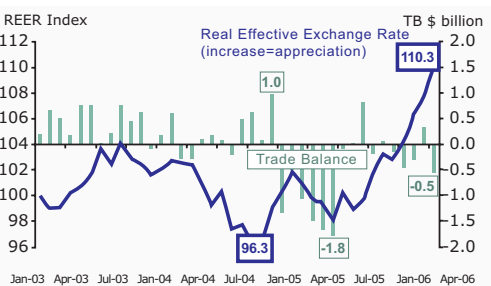
Source: National Economic and Social Development Board of Thailand.

### Composite Leading Indicator (%)



Note: Figure shows the annualized six-month rate of change of the trend restored CLI.  
Source: Bank of Thailand.

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100  
REER = Real Effective Exchange Rate, TB = Trade balance  
Sources: ARIC Indicators and Bank of Thailand.

**Economic Outlook:** In line with a sustained 2006Q1 expansion, GDP growth for the year is projected at 4.7%. Political uncertainties, higher inflation, and interest rate hikes hurt domestic demand in 2006Q2. Growth of exports and imports is mixed, with relatively high growth in February and May 2006. Overall, Thailand posted a trade deficit from January to May 2006. By end-May, foreign reserves were at \$56.0 billion, up nearly \$5.3 billion from December 2005. Inflation, which accelerated in the second half of 2005, averaged 5.7% during 2006Q1 and rose to 6.0% in 2006Q2, reflecting higher fuel prices.

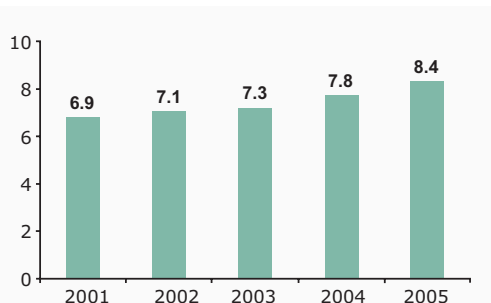
**Risks:** The composite leading indicator supports an outlook for sustained growth. But major risks remain. Thailand imports 90% of its oil, with manufacturing and transport accounting for a major portion of the country's GDP. Soaring oil prices may slow growth and worsen the trade balance. A disorderly correction of the global payments imbalances could affect export demand. With the Bank of Thailand (BOT) matching US Fed policy rate hikes to stabilize capital flows, domestic rates could move up further, jeopardizing an already weak domestic demand. Domestically, persistent political uncertainties could further reduce consumer and business confidence, as they have during the first half of the year. Delays in infrastructure and development spending can also be a downside risk for 2006.

**Policy Issues:** Since August 2004, BOT has gradually raised interest rates to match the US hikes. After increasing policy rates to 5.0% in early June 2006, further policy adjustments must balance efforts to contain inflation and stabilize capital flows against any evidence of a slowing economy. Political uncertainties have also slowed policy implementation. Delays in the infrastructure development program will result in a shortfall in public investment. Political uncertainty also temporarily halted negotiations on bilateral free trade agreements. In March 2006, the Supreme Administrative Court barred privatization of the state-owned electricity utility, EGAT, a key privatization goal. Significant progress in fiscal and structural policies is unlikely until after parliamentary elections are held again in late 2006.

## Viet Nam

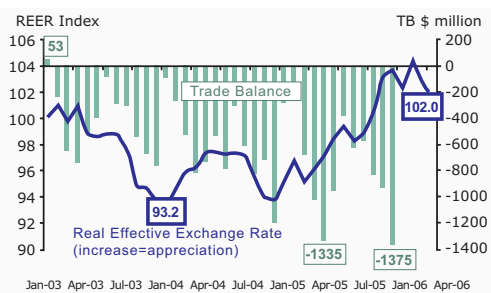
After exceptionally high 8.4% GDP growth in 2005, the economy is likely to expand by a more sustainable 7.8% in 2006. Further monetary tightening could help control credit growth and inflation.

### GDP Growth (%)



Sources: Ministry of Finance and *Asian Development Outlook 2006* (Asian Development Bank).

### Trade Balance & Real Effective Exchange Rate<sup>1</sup>



<sup>1</sup>Jan 2003=100, REER = Real Effective Exchange Rate, TB = Trade balance  
Source: ARIC Indicators and *Direction of Trade Statistics*, May 2006 (International Monetary Fund).

### Fiscal and Monetary Indicators

	2002	2003	2004	2005
Central government fiscal balance (% of GDP)	-3.6	-4.3	-2.0	-2.3
Dong/\$ (y-o-y, % change)	-3.6	-2.4	-0.8	-1.0
Current account balance (% of GDP)	-2.7	-6.4	-5.4	-3.6

Source: *Asian Development Outlook 2006* (Asian Development Bank).

**Economic Outlook:** Authorities announced that GDP expanded by 7.4% during the first half of 2006 compared with 7.6% over the same period last year. The slight easing of growth was due to lower oil production and agricultural output, caused by bad weather and animal disease. Still, growth is expected to accelerate in the coming months, as investment is bolstered by the successful conclusion of bilateral trade negotiations with the US paving the way for a likely quick accession to WTO. Full-year GDP growth is forecast at 7.8%. Inflation averaged 7.9% in the first 6 months of 2006, showing that continued price pressure persists despite a slight decelerating trend. In the first quarter of 2006, preliminary trade balance data shifted marginally into surplus (\$60 million). This is partly due to slowing imports of intermediate goods, which has caused concern about a possible deceleration of domestic production in the months ahead.

**Risks:** With the US a primary destination for exports, a possible slowdown in US demand would adversely affect Viet Nam's economic growth. However, continuing trade expansion with the PRC and other Asian economies—where growth is forecast to remain strong—could mitigate this risk. Internally, poor infrastructure and high utility costs can adversely affect local firms, especially given the imminent entry into WTO. Given the limited exchange rate flexibility, further increases in oil prices would put pressure on inflation. An avian flu pandemic remains a risk with a potentially severe impact on agriculture, tourism, and health. The government is trying to mitigate potential effects of avian flu by upgrading monitoring systems and increasing public awareness to upgrade capacity to react quickly to control the disease.

**Policy Issues:** Last year's monetary tightening—as policy rates rose from 7.50% at end-2004 to 8.25% at end-2005—was unable to stop new credit, which expanded by a whopping 40% in 2005. Authorities are expected to try to curb credit growth this year by increasing interest rates further. The overall budget deficit was prudently managed at 2.3% of GDP in 2005, as oil receipts grew, tax administration improved, and the tax base expanded. Still, off-budget expenditures raise questions of fiscal sustainability. As the government's massive infrastructure plan for 2006–2010 could push inflation above forecasts, improving macroeconomic stability requires close coordination between monetary and fiscal policies. Faster implementation of the equitization process for state-owned enterprises would bolster private sector participation and boost economic growth.