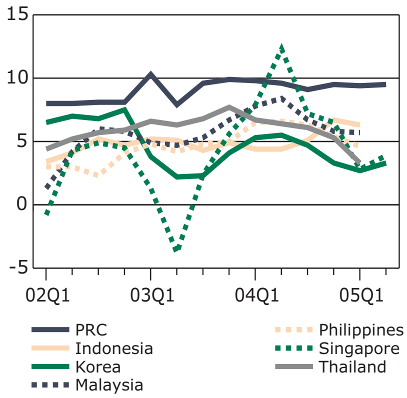
East Asia's Growth and Restructuring—A Regional Update

Recent Economic Performance

Figure 1: **Real GDP Growth**
(y-o-y, %)



Source: ARIC Indicators.

Real Sector Developments

The gradual deceleration in East Asia's[1] gross domestic product (GDP) growth that began in the middle of 2004 has continued this year. The seven big economies in the region for which quarterly GDP data are available—People's Republic of China (PRC), Indonesia, Republic of Korea (Korea), Malaysia, Philippines, Singapore, and Thailand—taken together posted a 6.8% year-on-year GDP growth in the first quarter of this year, compared with 7.3% in the fourth quarter of 2004 and 7.6% for last year as a whole (Figure 1).[2]

The factors that have contributed to slower regional growth over the past year include higher oil prices, softness in the information technology (IT) cycle that began in the second half of last year, the loss of economic momentum in major industrial markets, and, from a technical standpoint, a return to trend growth following the post-SARS (severe acute respiratory syndrome) bounce until the first half of 2004. Nonetheless, there were variations in the performance of countries within the region.

GDP growth in the PRC remained robust at 9.5% in the second quarter of 2005, similar to the first quarter rate, but slightly lower than at the beginning of 2004 when the rate of economic expansion was close to 10%. Indonesia's growth was 6.4% in the first quarter, marginally lower than the postcrisis record rate of 6.7% achieved in the previous quarter. The impact of the devastating tsunami at end-December 2004 was mainly limited to a part of Aceh and had only a modest overall effect on the economy. Malaysia's economy expanded by 5.7% in the first quarter, similar to the 5.8% rate in the final quarter of 2004.

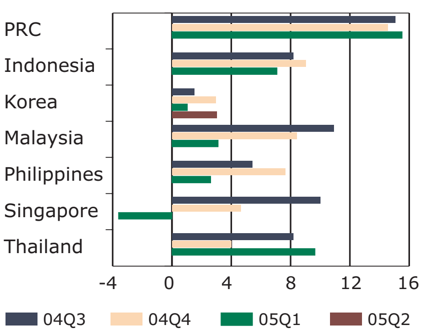
In the Philippines, growth decelerated from a postcrisis peak of 6.6% in the second quarter of 2004 to 5.4% in the final quarter and further to 4.6% in the first quarter of this year, as the effects of El Niño induced a sharp downturn in agricultural output. Korea's growth improved modestly to 3.3% in the second quarter of 2005 from 2.7% in the first. However, it was lower than the 4.6% growth posted in 2004 as exports were more sluggish and domestic demand, although improving,

[1]Defined here as the 10 members of the Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China and the Republic of Korea.

[2]Unless otherwise indicated, all growth figures are year-on-year.

remained weak. In Singapore, domestic demand decelerated in conjunction with a sharp moderation in export growth. Singapore's GDP growth was 3.9% in the second quarter, faster than the 2.8% posted in the first, but significantly lower than the 6.5% in the final quarter of 2004. In Thailand, a prolonged drought, the dampening effects of the tsunami on tourism, unrest in some southern provinces, and the negative effects of avian flu added to the deleterious effect of higher oil prices and contributed to a slower first quarter growth of 3.3%, compared with 5.3% in the previous quarter.

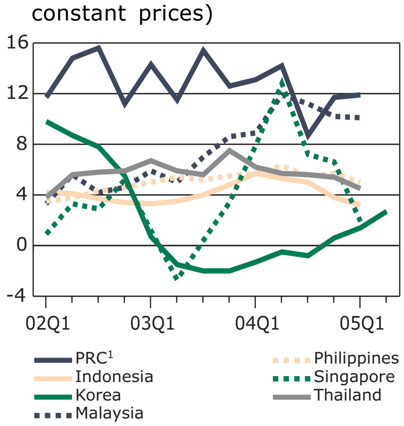
Figure 2: **Growth of Domestic Demand**[1] (y-o-y, %, at constant prices)



[1]Based on national income accounts except for PRC which is the sum of retail sales and fixed investment (at constant 1997 prices).
Sources: OREI staff calculations based on ARIC Indicators and CEIC.

The growth of domestic demand, including changes in inventories, was lower in the first quarter of this year than in the previous two quarters in the larger economies of East Asia, except in the PRC and Thailand, where public spending helped offset some of the slowdown in private sector demand (Figure 2). The general slowdown in domestic demand was likely the result of weaker export growth (especially in countries that are more dependent on external demand), higher oil prices, and a bias toward tighter macroeconomic policies. Changes in inventories contributed significantly to the extent of the slowdown in some countries. There was a sharp drawdown of inventories in Malaysia and Singapore and, to a lesser extent, in the Philippines and Korea. Nonetheless, the trend in domestic demand is similar if changes in inventories are excluded, except in Korea. In Korea, the contribution of domestic demand to overall GDP growth rose to 2.5 percentage points in the second quarter of this year from 1.1 percentage points in the first quarter and 0.1 percentage point in the final quarter of 2004 if changes in inventories are excluded.

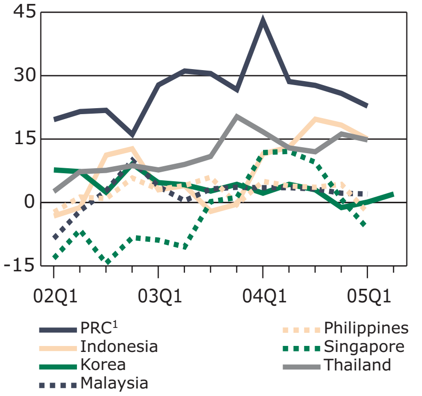
Figure 3: **Growth of Private Consumption** (y-o-y, %, at constant prices)



[1]Growth of retail sales deflated by the retail price index (1997=100).
Sources: ARIC Indicators and CEIC.

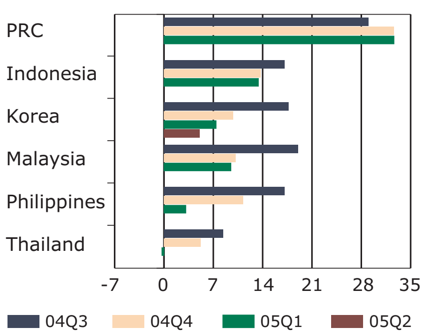
Domestic demand rose the fastest in the PRC in the first quarter, with a continued, albeit slower, rise in fixed investment and robust consumer spending. Growth in retail expenditures, in real terms, accelerated to 11.9% in the first quarter from 11.7% in the previous quarter on the back of strong employment and income growth (Figure 3). Private consumption also remained strong in Malaysia, with growth of 10.1%, partly reflecting improved terms of trade from high commodity prices. In Indonesia, Philippines, and Thailand, private consumption growth continued to moderate. The deceleration was particularly sharp in Singapore, probably reflecting a combination of a slowdown in exports and a sharp contraction in the volatile pharmaceutical industry that dampened manufacturing output. In Korea, there are signs that private consumption has started to strengthen, following a decline since the household credit bubble burst in 2002, although it still remains weak. Private consumption rose by 2.7% in the second quarter, following growth of 1.4% in the first quarter and a decline of 0.5% in 2004.

Figure 4: **Growth of Fixed Investment** (y-o-y, %, at constant prices)



[1]Nominal fixed asset investment (year to date, y-o-y growth).
Sources: ARIC Indicators and CEIC.

Figure 5: **Growth of Exports of Goods and Services**[1] (y-o-y, %, at constant prices)



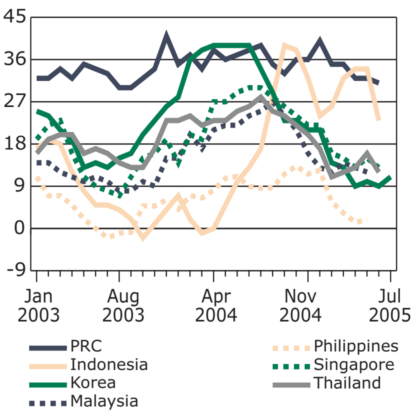
[1]Based on national income accounts except PRC, which is based on merchandise exports (at constant 1997 prices).
Source: ARIC Indicators.

Fixed investment growth slowed generally across the region in the first quarter of this year (Figure 4). However, it is growing at double-digit rates in PRC, Indonesia, and Thailand. In the PRC, nominal fixed investment grew by 23% in the first quarter compared with a peak rate of 43% a year earlier as restrictive measures implemented over the past year and a half took effect. But, at around 50% of GDP, it remains high. Fixed investment growth decelerated sharply in the Philippines and Singapore, and remained weak in Korea, probably reflecting the softness in exports and generally weak economic prospects. In Malaysia, private fixed investment rose by a strong 10.2%, but government efforts at fiscal consolidation over the past year by scaling back development spending led to an 11% contraction in public investment, and hence total fixed investment rose only modestly.

The deceleration in domestic demand mirrors a corresponding slow-down in exports. The slowdown in major industrial markets and softer demand for high tech products contributed to the slower growth of the region's exports. Real exports of goods and services rose at a slower rate in the first quarter of this year, continuing the trend since the middle of 2004 in all East Asia's larger economies except the PRC (Figure 5). The slowdown was particularly sharp in Thailand, which in addition to region-wide shocks, was buffeted by several country-specific shocks, including the effect of the drought on agricultural exports and the tsunami-induced 9% decline in tourist arrivals. Except Thailand, the region's larger economies also posted slower import growth in line with softer domestic demand, so that net exports of goods and services contributed significantly to GDP growth, especially in Singapore.

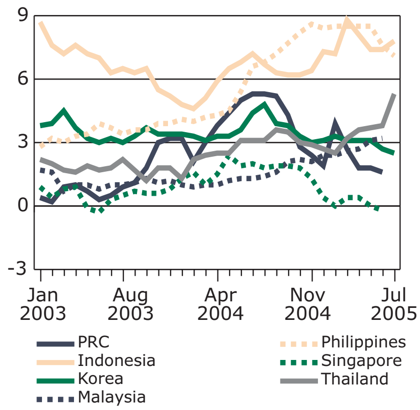
Monthly data since the first quarter suggest that, in most countries, the growth of merchandise exports in US dollar terms, although falling, was more stable in the past several months (Figure 6). Although nominal oil prices have increased further in the past few months, healthy growth in the US and the PRC probably contributed to greater stability in regional export growth. There is also some evidence that the downturn in the high tech cycle may be bottoming out. The semiconductor book-to-bill ratio, a measure of future orders relative to current shipments, rose to 0.85 in May from a recent low of 0.77 in February, while the spot price of DRAM chips has stabilized at $2.50 since April this year, following successive declines from a year earlier. Furthermore, the effect of some of the factors that suppressed economic growth in the first quarter, such as the tsunami's impact on tourism in Thailand, and adverse weather conditions in the Philippines and Thailand, may also be diminishing.

Figure 6: **Growth of Merchandise Exports**[1] (y-o-y, %)



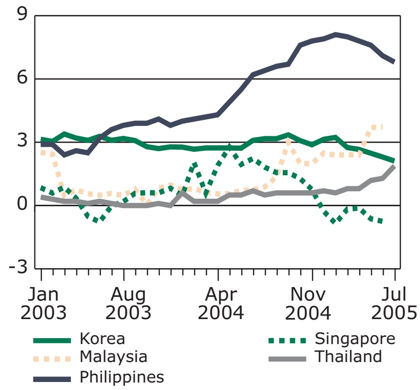
[1]Three-month moving average of dollar values.
Source: OREI staff calculations based on ARIC Indicators.

Figure 7: **Headline Inflation Rates** (y-o-y, %)



Source: ARIC Indicators.

Figure 8: **Core Inflation Rates** (y-o-y, %)



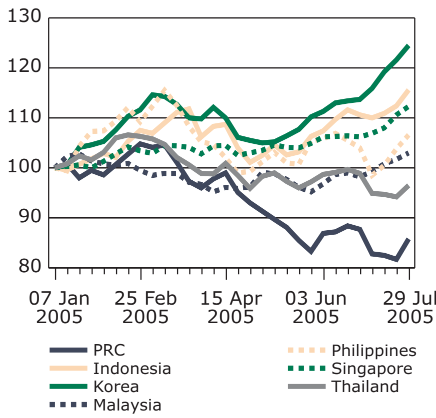
Sources: Bank of Thailand, Bangko Sentral ng Pilipinas, and OREI staff estimates derived from Bloomberg data.

In the first half of this year, headline consumer price inflation remained high in Indonesia and the Philippines and started to accelerate in Malaysia and Thailand (Figure 7). Inflation moderated in PRC, Korea, and Singapore, starting in the second half of last year, with a slowdown in demand, stronger currencies (in trade-weighted terms), and more stable food prices. The most persistent increase in headline inflation this year was evident in Thailand and to a lesser extent Malaysia, reflecting a reduction in oil subsidies and, in Thailand, a contraction in agricultural production as well. In the Philippines, too, inflation accelerated persistently over the past year, although it has moderated somewhat in June and July this year. In the PRC and Indonesia, inflation spiked in February and March, but has trended down in recent months. In the PRC, the spike was associated with the lunar new year and a sharp jump in food prices, while in Indonesia, cutbacks in oil subsidies led to an average 29% rise in fuel prices in March.

Core inflation has followed a trend similar to that of headline rates, with Korea and Singapore showing some moderation in recent months (Figure 8). In the Philippines, core prices rose at a slower rate in the past several months, but remained high at 6.8% in July. Malaysia posted a notable increase in core inflation, reflecting partly the pass-through of higher oil prices to non-oil sectors and adjustment of administered prices of transportation and utilities.

Financial Markets

Figure 9: **Composite Stock Price Indexes**[1] (weekly average, first week of Jan 2005=100, local index)

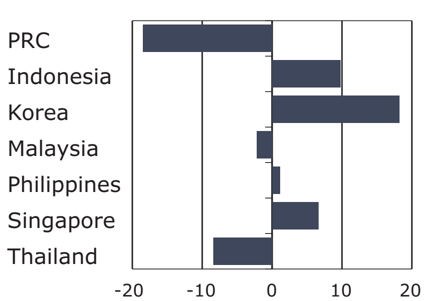


[1]Weekly averages of JCI (Indonesia), KOSPI (Korea), KLCI (Malaysia), PCOMP (Philippines), STI (Singapore), and SET (Thailand). For PRC, the index is calculated based on the weekly averages of the Shanghai Composite and Shenzen Composite, weighted by the market capitalization of each market.
Source: OREI staff calculations derived from Bloomberg data.

The region's stock markets have held up well this year, except in the PRC, despite the loss of growth momentum (Figure 9). The resilience likely reflects in part some reduction of the risk of a hard landing in the PRC, the measured and predictable pace of increases in US interest rates, and the market expectation that the global IT cycle has bottomed out. As of end-July this year, stock markets (in local currency terms) rose more than 25% in Korea, 16% in Indonesia, and 12% in Singapore. They fell in Thailand, reflecting lower-than-expected economic growth, and in the PRC, where the stock market continued to remain weak with a decline of 14% so far this year. Relative to the US Russell 3000 index, the performance of the regional stock markets ranged from a 19% decline in the PRC to an 18% increase in Korea (Figure 10).

The weak performance of the PRC stock market reflects mostly structural shortcomings such as the supply overhang from the large proportion of shares held by state-owned or state-controlled entities which are likely to be sold as part of the financial reform agenda, as well as limits on foreign ownership. The weak performance may also be related to cyclical concerns, such as the uncertainty about further policies to ensure a soft landing of the economy.

Figure 10: **Percent Change in Stock Market Index**[1] **Relative to Russell 3000 Index** (between 7 Jan 2005 and week ending 29 Jul 2005)

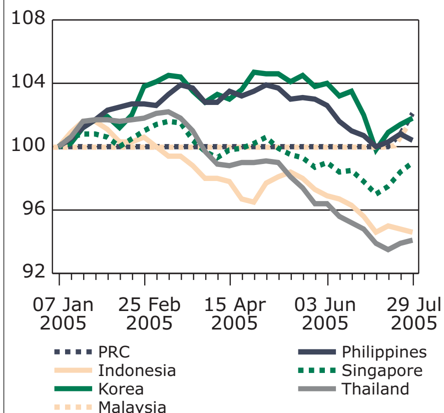


[1]Weekly averages of JCI (Indonesia), KOSPI (Korea), KLCI (Malaysia), PCOMP (Philippines), STI (Singapore), and SET (Thailand). For PRC, the index is calculated based on the weekly averages of the Shanghai Composite and Shenzen Composite, weighted by the market capitalization of each market.
Source: OREI staff calculations derived from Bloomberg data.

East Asia's currencies generally remained stable or depreciated against the US dollar this year, partly reflecting the desire of authorities to maintain price competitiveness in the face of weaker exports and the US dollar's strength against the euro and yen (Figure 11). Currencies in the PRC and Malaysia have appreciated by 1–2% against the US dollar following the 21 July shift in the exchange rate regimes of these countries, from a US dollar peg to one of a managed float with reference to a basket of currencies. The Korean won and the Philippine peso, after giving up in June much of the gains realized in the earlier part of the year, are marginally up against the dollar compared with the beginning of the year. The Singapore dollar has declined by 1%, the Indonesian rupiah by 5%, and the Thai baht by 6% since the beginning of this year.

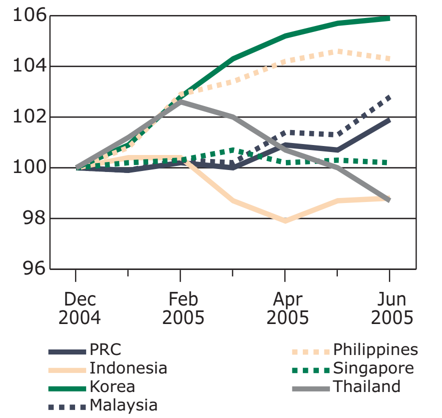
The broad strength of the US dollar, and the concomitant weakness of the currencies of East Asia's other trading partners, has meant that the nominal effective exchange rates of the seven regional currencies are stronger than the regional currencies against the US dollar (Figure 12). Data available up to June show that only the Indonesian rupiah and the Thai baht depreciated. The nominal effective exchange rates of the Philippine peso and the Korean won strengthened by 4–6%. The PRC yuan and the Malaysian ringgit, pegged to the US dollar until 21 July, appreciated by 2–3%.

Figure 11: **Exchange Rate Indexes** (weekly average, first week of Jan 2005=100, $/local currency)



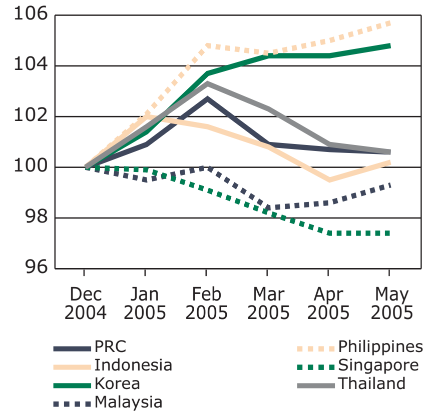
Source: OREI staff calculations derived from Bloomberg data.

Figure 12: **Nominal Effective Exchange Rate**[1] (Dec 2004=100)



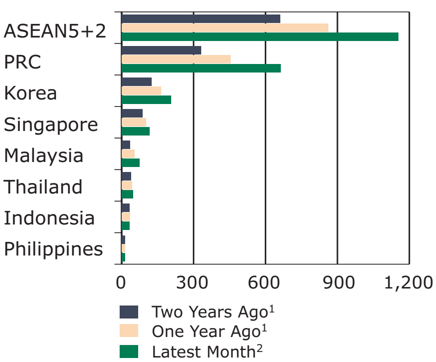
[1]An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: OREI staff calculations.

Figure 13: **Real Effective Exchange Rate**[1] (Dec 2004=100)



[1]An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: OREI staff calculations.

Figure 14: **Gross International Reserves Less Gold, End of Period** ($ billion)



[1]From latest month.
[2]May 2005 for Indonesia, Singapore, and Thailand; April 2005 for others.
Source: International Monetary Fund, *International Financial Statistics Online.*

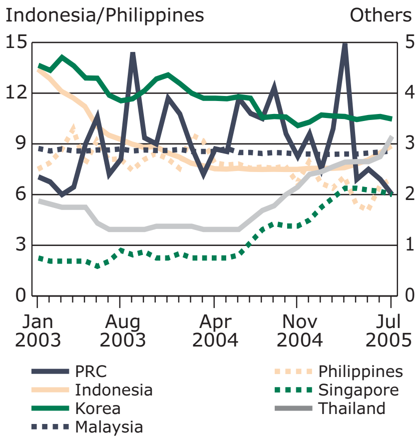
The real effective exchange rates exhibit a similar trend with a few exceptions (Figure 13). In Thailand, a higher inflation differential with trading partners led to a slight appreciation of the real effective exchange rate. Conversely, in Malaysia and Singapore, lower inflation contributed to a depreciation of the real effective rate.

Authorities have continued to intervene in foreign exchange markets in order to keep their currencies competitive. The rate of accumulation of foreign exchange reserves accelerated over the past year (Figure 14). Total foreign exchange reserves of the seven East Asian countries rose by $291 billion to $1,153 billion in the year to April, higher than the $202 billion increase in the previous year. The faster rate of increase was mostly in the PRC, where reserves rose by $209 billion in the year to April, compared with $123 billion in the previous year.

Monetary and Fiscal Policies

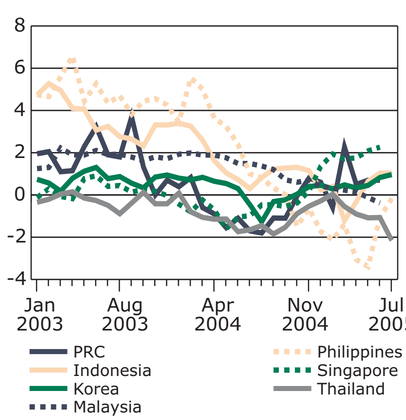
Several countries have maintained a tighter bias to monetary policy since last year. However, with only a moderate increase in inflation rates and some flexibility in exchange rates, the rise in policy rates has lagged that in the US. Thailand has significantly tightened monetary policy, reflecting concerns about the effect of the oil price increase on inflationary expectations. The Bank of Thailand raised the 14-day repo

Figure 15: **Short-term Interest Rates**[1] (nominal, end of month, %)



[1]Three-month interbank lending rates—PRC: average of interbank borrowing and lending rates (People's Bank of China); Indonesia: weighted average of banks' interbank lending rates (Bank Indonesia); Korea: certificate of deposit (3 month); Malaysia: average of interbank deposit rates (Bank Negara Malaysia); Philippines: PHIBOR (Banker's Association of the Philippines); Singapore: SIBOR (Association of Banks in Singapore); Thailand: interbank offer rate (Bangkok Bank).
Source: ARIC Indicators.

Figure 16: **Short-term Interest Rates**[1] (real, end of month, %)



[1]Three-month interbank lending rates.
Source: ARIC Indicators.

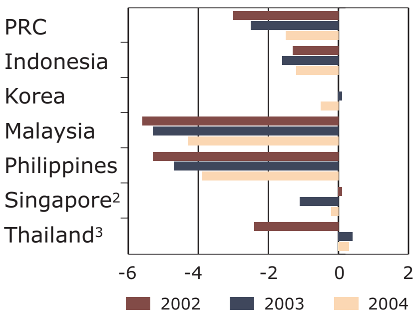
policy rate three times this year from 2% to 2.75%, after increasing it three times since August last year when it was 1.25%. The cumulative 150 basis point increase in the current cycle is still below the 225 basis point increase in the US Federal Funds rate to 3.25%.

In Singapore, the monetary authority has retained the tighter bias adopted in April last year when it shifted its policy of zero percent appreciation of the nominal effective exchange rate to one of modest and gradual appreciation. In Indonesia, the depreciation of the currency and concerns about its effect on inflation led the central bank to tighten policy more forcefully starting in March this year, so that the one-month Bank Indonesia Certificate (Sertifikat Bank Indonesia) rate rose to 8.49% in mid-July from 7.42% in March, and from a cyclical low of 7.32% in May last year. Similar concerns prompted the Philippine central bank to increase its overnight repo and reverse repo rates in April this year by 25 basis points to 9.25% and 7% respectively, and in July, the Monetary Board increased the regular reserve requirement and liquidity reserve requirement by one percentage point each.

Korea's monetary policy has been on hold in 2005, following two reductions in the policy rate last year, as inflation has remained manageable and domestic demand, although improving, remains weak. In the PRC, a number of measures were implemented over the past 18 months, including a 27 basis point hike in benchmark interest rates in October 2004 for the first time in nine years, an increase in reserve requirements, and restrictions on new lending to dampen credit and investment growth, to bring economic expansion to more sustainable levels. The moderation in inflation over the past year and the deceleration of investment growth have reduced the risk of a hard landing of the economy. However, concerns about overheating in the property sector have kept authorities vigilant on monetary policy. In March, the government allowed commercial banks to set their own mortgage rates and to raise the minimum required downpayment on property from 20% to 30%. Perhaps more significantly, in July, the authorities changed the exchange rate regime from a peg to the US dollar to one of managed float with reference to a basket of currencies, the first change in the regime since 1994, allowing the yuan to appreciate 2.1% from 8.28 yuan to the US dollar to 8.11.

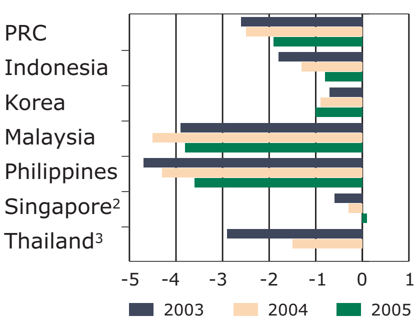
Nominal short-term interest rates have edged up in Singapore, Thailand, and more recently in Indonesia and the Philippines, from historically low levels (Figure 15). Real short-term interest rates have remained low over the past year, except in Singapore, where the real short-term rate rose to 2.3% in June from -1.0% a year earlier (Figure 16).

Figure 17: **Fiscal Balance**[1]**—Actual** (% of GDP)



[1]Data refer to central government for Indonesia, Philippines, Singapore, and Thailand; federal government for Malaysia; central and local governments for PRC; and consolidated budget for Korea.
[2]Data are FY Apr–Mar.
[3]Data are FY Oct–Sep.
Sources: ARIC Indicators; Ministry of Finance (Malaysia, Singapore, and Thailand); and Ministry of Finance and Economy (Korea).

Figure 18: **Fiscal Balance**[1]**—Budget** (% of GDP)



[1]Data refer to central government for Indonesia, Philippines, Singapore, and Thailand; federal government for Malaysia; central and local governments for PRC; and consolidated budget for Korea.
[2]Data are FY Apr–Mar.
[3]Data are FY Oct–Sep.
Sources: 10th National People's Congress and Chinese People's Consultative Conference (PRC); Bank Indonesia (Indonesia); Ministry of Planning and Budget (Korea); Ministry of Finance (Malaysia); Bureau of the Treasury (Philippines); Ministry of Finance (Singapore); and Bureau of the Budget (Thailand).

Real interest rates remain negative in Malaysia, Philippines, and Thailand.

In general, governments in the region have consolidated their fiscal positions. In all the larger economies, except Korea, the fiscal outturn in 2004 improved compared with the previous year, when many economies suffered the effects of SARS in the first half of the year (Figure 17). The fiscal account, excluding social security, financial sector restructuring costs, and privatization revenues, moved to a deficit in Korea last year, and the deficit is projected to widen modestly this year. Considering the weakness in domestic demand and decelerating export growth, as well as its relatively low public debt, a stimulus would be appropriate. The improved performance in other economies reflected primarily higher revenues by approximately 0.8–1% of GDP in PRC, Indonesia, Singapore, and 1.5% in Thailand. In Malaysia and the Philippines, expenditure reduction was the main contributor to the decline in the fiscal deficit.

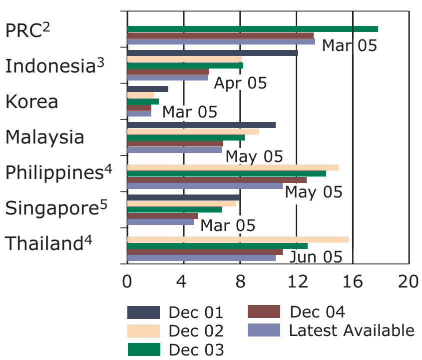
Further fiscal consolidation is expected this year in these economies (Figure 18). In the Philippines, where medium-term fiscal sustainability is a key source of concern, the overall deficit is expected to narrow to 3.4% of GDP in 2005 from 3.8% of GDP last year. In Indonesia, the government expects to reduce the deficit further to 0.8% of GDP from 1.2% last year. Fuel subsidies are slated to amount to 3% of GDP (Rp77 trillion) this year, the same proportion as last year, when subsidies doubled from 2003 as the government attempted to insulate domestic fuel prices from higher world prices. With international prices rising further, the authorities increased domestic fuel prices by an average 29% in March this year in order to keep the subsidies within target.

In Thailand, the budget for this fiscal year (October 2004–September 2005) includes 0.7% of GDP (B50 billion) in supplementary spending to support domestic demand while maintaining fiscal stability. The overall fiscal position is expected to be in balance, compared with an actual surplus of 0.3% of GDP last fiscal year. Against the backdrop of persistently high world oil prices, a view to promote efficiency in energy use, and to build better demand management in the long run, Thailand abolished fuel subsidies in July. These amounted to 1.2% of 2004 GDP (B82 billion) between January 2004 (when they were implemented) and mid-April this year.

In Malaysia, the 2005 deficit is projected to narrow to 3.8% of GDP from an actual gap of 4.3% of GDP in 2004 as development spending is reduced further. Malaysia, a large net exporter of oil, has also gradually begun to adjust its domestic oil prices. The government expects subsidies to decline to 1.2% of GDP (RM5.3 billion) this year from 1.5% of GDP (RM6.3 billion) last year.

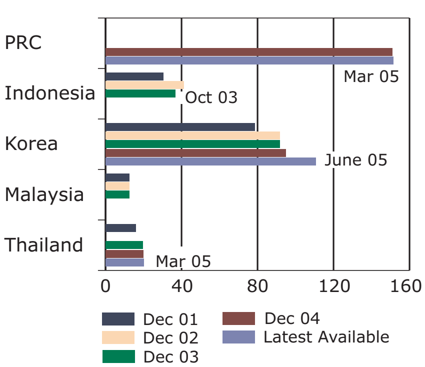
Financial Restructuring and Prudential Indicators

Figure 19: **NPLs[1] of Commercial Banks** (% of total commercial bank loans)



[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis in Malaysia, and three months or more in Korea and Thailand.
[2]Available official statistics from the China Banking Regulatory Commission start in 2003.
[3]Data refer to NPLs in the banking sector.
[4]NPL criteria were changed so no comparable data are available prior to 2002.
[5]Data refer to local commercial bank NPLs as a percent of nonbank loans.
Sources: ARIC Indicators, China Banking Regulatory Commission, and Monetary Authority of Singapore.

Figure 20: **NPLs Purchased by AMCs** ($ billion)



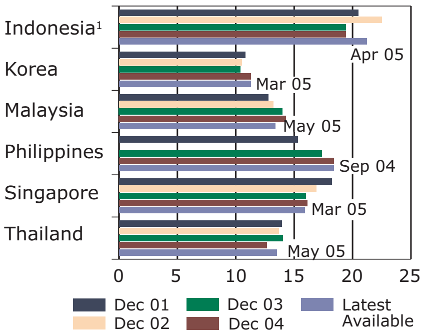
Sources: OREI staff calculations based on data from China Banking Regulatory Commission (PRC), IBRA (Indonesia), KAMCO (Korea), Danaharta (Malaysia), and TAMC (Thailand).

Nonperforming Loans, Capital Adequacy, and Bank Profitability

Nonperforming loans (NPLs) as a percentage of total outstanding loans of commercial banks continued to fall in most East Asian countries for which data are available, partly due to continued disposal of bad assets by banks and partly due to improved performance. Latest available data show that the NPL ratio stood at 1.7% in Korea, 4.7% in Singapore, 5.7% in Indonesia, 6.7% in Malaysia, 10.5% in Thailand, 11.0% in Philippines, and 13.3% in PRC (Figure 19). Since the third quarter of 2004, the volume of NPLs declined by 17–18% in Korea and the Philippines and 5-6% in Indonesia and Thailand. The cumulative NPLs transferred to centralized asset management companies (AMCs) since the 1997 financial crisis now stands at $151.4 billion in PRC, $110.8 billion in Korea, $36.8 billion in Indonesia, $20.2 billion in Thailand, and $12.6 billion in Malaysia (Figure 20). In the Philippines, where privately-owned Special Purpose Vehicles (SPVs) were established under the SPV Act of 2002 to help clean up balance sheets of commercial banks, the cumulative NPLs transferred to SPVs stood at $1.0 billion as of June 2005.

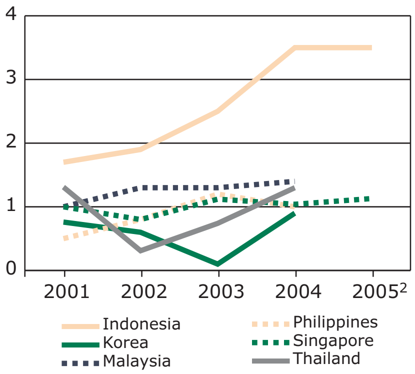
The average capital adequacy ratio (CAR) of commercial banks continues to be above the 8% international norm in Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand (Figure 21). The generally stable capital positions of banks largely reflect improved economic fundamentals, tighter prudential regulation, and better risk management in these countries. In the PRC, although the CAR of a large part of the commercial banking sector remains below the 8% norm, there were significant improvements in the capital base of the commercial banks in 2004. According to the China Banking Regulatory Commission (CBRC), the average CAR for 11 joint-stock commercial banks improved to 6.6% at the end of 2004 from 3.4% a year earlier. The average CAR of the four state-owned commercial banks increased by 2.6 percentage points during the same period. These improvements were largely attributed

Figure 21: **Capital Adequacy Ratios of Commercial Banks** (%)



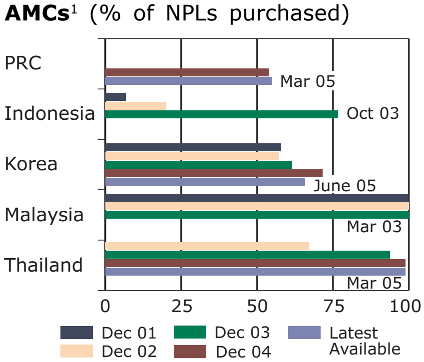
[1]Refers to CAR of the banking system.
Sources: ARIC Indicators and Monetary Authority of Singapore.

Figure 22: **Banking Sector Profitability**[1] (%)



[1]Rate of return on assets for all commercial banks in Indonesia, Korea, Philippines, and Thailand; banking/financial system in Malaysia; and local commercial banks in Singapore.
[2]As of April 2005 for Indonesia and March 2005 for Singapore.
Sources: Bank Indonesia; Financial Supervisory Service, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; Monetary Authority of Singapore; and Bank of Thailand.

Figure 23: **NPLs Resolved by AMCs**[1] (% of NPLs purchased)



[1]Refers to those held by China Banking Regulatory Commission (PRC), IBRA (Indonesia), KAMCO (Korea), Danaharta (Malaysia), and TAMC (Thailand), as of dates indicated.
Source: ARIC Indicators.

to the government's bank recapitalization programs and the transfer of NPLs from banks to AMCs. It also reflects progress in banking reform.

In 2004, four East Asian countries most affected by the 1997 financial crisis saw improvements in the rate of return on assets (ROA) for commercial banks compared with 2003 levels (Figure 22), with the improvement particularly significant in Indonesia, Korea, and Thailand. The better ROAs were partly attributed to improved asset quality of commercial banks and reduced loan loss provisions. The ROA, however, declined slightly in the Philippines and Singapore in 2004 from the previous year. The latest available data suggest that, in the first quarter of 2005, the average ROA of the commercial banks remained more or less at its 2004 level in Indonesia and Singapore.

Asset Resolution by Asset Management Companies

With substantial progress made in the resolution of distressed assets during the past years, most centralized and publicly-owned AMCs in the region have started to wrap up operations. The Indonesian Bank Restructuring Agency (IBRA) ceased operations in 2004, and the State-owned Asset Management Company (PT Perusahaan Pengelola Aset [PPA]), the AMC established to manage the "free and clean" assets of IBRA, was able to divest government shareholdings in four banks (Bank Danamon, Bank Internasional Indonesia, Bank Niaga, and Bank Permata) as of May 2005. With respect to the problem assets of IBRA taken over by the Ministry of Finance, while the settlement team has wrapped up its asset assessments, there has been no asset disposition or transfer as yet. In Korea, as of June 2005, the Korea Asset Management Corporation had resolved 65.8% of its acquired NPLs using public funds with a recovery rate of 49.4%. In Malaysia, Danaharta had worked out the resolution of all NPLs purchased and had collected 94% of its total expected recovery by end-2004, and is expected to have a recovery rate of 59% by its targeted closing date at the end of this year. In Thailand, the Thai Asset Management Company had resolved 98.8% of its acquired NPLs by March 2005 with an expected recovery rate of 49.2% (Figure 23).

In the Philippines, the Special Purpose Vehicle Act of 2002, enacted to support the resolution of distressed bank assets, lapsed in April 2005. As of May 2005, a total of 197 Certificates of Eligibility had been issued. Draft legislation is now pending in congress to amend the law to extend the registration and establishment of SPVs and the accompanying tax incentives.

Banking Sector Divestment and Consolidation

Bank recapitalization programs implemented after 1997 in most crisis-affected countries left governments as significant shareholders in many banks. Significant progress has been made in the divestment of this state ownership and consolidation of the banking sector.

- In Indonesia, the government has continued to divest its stakes in the banking sector. PPA sold state-owned shares in four banks in 2004 and early 2005, and is planning to fully divest state shareholdings in six banks under its purview through 2008. There is also an expected acceleration in the implementation of the Indonesian Banking Architecture Program by identifying "anchor banks" around which mergers and acquisitions will revolve.

- In Korea, the investment in KorAm Bank by Citigroup in early 2004 eventually led to the merger of KorAm Bank and Citibank N.A. Seoul Branch into Citibank Korea in November 2004. In April 2005, Standard Chartered Bank fully acquired Korea First Bank from Newbridge Capital and the government. This reduced the number of government-controlled commercial banks to two. Related to this is the amendment to the Financial Holding Company Act that mandates the government to dispose its shares in state-owned and controlled financial holding companies within seven years.

- After consolidating the domestic banking sector into ten banking groups, Malaysia is focusing on improving operational efficiencies and streamlining business structures. An integrated commercial bank and finance company framework, also referred to as the Bafin framework, was adopted in 2004 to rationalize commercial banks and finance companies within the same banking group. This led to the merger of five finance companies with their respective commercial banks during the year. In March 2005, a framework for establishing investment banks, aimed at rationalizing merchant banks, stock-broking companies, and discount houses within the same banking group, was finalized and is ready for implementation in the second half of this year. Under this framework, the ceiling of foreign equity in investment banks will be raised to 49%, in line with the country's commitment to liberalize the banking sector.

- In the Philippines, the consolidation of commercial banks continues with the acquisition by Banco de Oro Universal Bank of the branch network of United Overseas Bank Philippines in May 2005. As a result of this transaction, the selling bank will have to operate as a thrift bank. In July 2005, Bank of the Philippine Islands announced its purchase of Prudential Bank. These transactions will reduce the number of commercial banks to 40.

- In Thailand, the Financial Sector Master Plan is paving the way to the restructuring and consolidation of the banking sector. A merger plan between two commercial banks is awaiting government approval while three commercial banking licenses have been granted to merging finance companies late last year. Finance companies and credit fonciers have also obtained retail banking licenses.

Financial and Corporate Reforms

There have been a number of important developments in the area of financial and corporate reforms in the region. First, several East Asian countries are in the process of establishing deposit insurance systems. A deposit insurance law will take effect in Indonesia in September 2005, while proposals for deposit insurance schemes are being studied in PRC, Malaysia, and Singapore. For Thailand, the Deposit Insurance Act has been approved by the cabinet. Second, many countries are in the process of establishing or strengthening credit information bureaus. PRC, Indonesia, and Philippines have initiated efforts to establish credit information bureaus. In Korea, 11 financial institutions submitted a plan to the Financial Supervisory Commission last November to set up a credit bureau for information sharing. In Thailand, mergers between existing credit information bureaus were completed in May 2005. Third, national efforts in developing local currency bond markets as an effective way to avoid currency and maturity mismatches that were at the heart of the 1997 Asian financial crisis are being complemented by efforts at the regional level (Box 1). Fourth, measures are being taken in Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand to move towards Basel II standards in the next two to three years. Apart from these developments, some of the country-specific financial and corporate reforms are highlighted below:

➲ **Cambodia.** The government has drafted a proposal that lays down the legal framework for government and corporate securities. Another pending reform is a draft law on negotiable instruments and payment transactions intended to reduce risks in the payment system.

➲ **PRC.** In April 2005, the government injected $15 billion into the Industrial and Commercial Bank of China, making it the third state-owned commercial bank to receive capital infusion. Also, the Bank of Communications, one of 11 joint-stock commercial banks in the country, completed its initial public offering in June 2005. To stimulate reforms in the state-owned enterprise (SOE) sector, the government

Box 1: **Local Currency Bond Markets in East Asia**[1]

Since the 1997 financial crisis, East Asia has taken important steps at both national and regional levels to develop local currency bond markets. The objectives of these efforts are (i) to reduce the risks associated with excessive reliance on short-term external financing, thereby mitigating the currency and maturity mismatch problem; (ii) to provide an alternative vehicle for channeling domestic savings into productive investment and reducing dependence on bank lending; and (iii) to support economic and financial integration within East Asia.

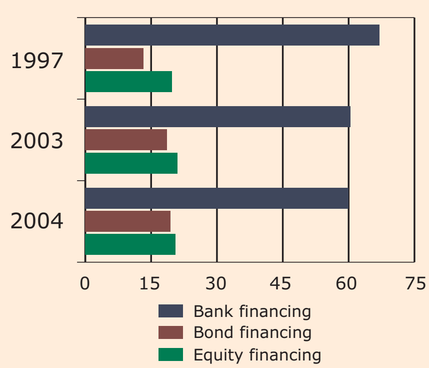
Partly as a result of these efforts in the past several years there has been a rapid expansion of local currency bond markets in the region. Between 1997 and 2004, the size of these markets more than tripled (from $355.5 billion to $1,390.1 billion), with Thailand registering the fastest growth, Korea having the largest amount of bonds outstanding, and Malaysia achieving the highest ratio of local currency bonds outstanding to GDP. Although the growth has been skewed toward the government sector (at 27% annually for East Asia as a whole), corporate bond markets have also seen rapid growth (at about 18% annually during the last eight years).

Consequently, the importance of local currency bond markets as a source of financing for domestic investment in East Asia has been increasing. In 2004, bond financing accounted for 19.4% of total domestic financing for East Asia as a whole, up from 13.3% in 1997, while bank lending accounted for 60%, down from 67% in 1997 (Figure B1.1). The role of bond issuances in corporate finance has also increased. In 1997, bank lending accounted for 70.9% of total corporate finance, with bond financing at 8.4%. In 2004, the corresponding shares were 64.6% and 11.7 %, respectively (Figure B1.2).

The structure of East Asian local currency bond markets has also changed in recent years. These include, among others, (i) issuance of longer tenor bonds extending yield curves in several countries, (ii) increases in the issue size of benchmark bonds, (iii) strong growth of asset-backed securities and the emergence of a wider issuer base backed by strong investor appetite, and (iv) the launch of the Asian Bond Fund 2, likely to provide a boost to investment in local currency bond markets in the region.

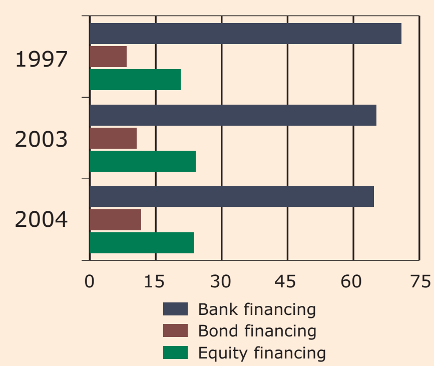
East Asian local currency bond markets still have great potential to grow compared with those of the developed countries. As a percentage of GDP, the average size of East Asian local currency bond markets is only a little over 40%, compared with the average size of OECD countries of more than 120%. Increasing bond market liquidity is also a significant challenge. Policy makers in the region are working together under the ASEAN+3 Asian Bond Markets Initiative to address these key policy issues in local currency bond market development.

Figure B1.1: **Domestic Financing Profile in East Asia** (% of total domestic financing)



Sources: International Monetary Fund (bank financing); Bank for International Settlements (bond financing); and World Federation of Exchanges (equity financing).

Figure B1.2: **Corporate Domestic Financing Profile in East Asia** (% of total corporate domestic financing)



Sources: International Monetary Fund (bank financing); Bank for International Settlements (bond financing); and World Federation of Exchanges (equity financing).

[1]Based on ADB's *Asia Bond Monitor,* November 2004 and April 2005, available at asianbondsonline.adb.org.

announced a package of tax breaks for SOEs with approved debt-to-equity swap transactions.

- **Indonesia.** In implementing the Indonesian Banking Architecture Program, the government has initiated measures to strengthen the financial infrastructure. In January 2005, a package of regulations was issued to foster risk management and corporate governance by banks, stimulate lending, and improve the reporting system for information on borrowers. Also, the regulation and supervision of nonbank financial institutions are in the process of being consolidated under the Capital Market Supervisory Agency.

- **Korea.** The Securities Class Action Suit Law became effective in January 2005 for companies with assets above W2 trillion. Amendments to the Monopoly Regulation and Fair Trade Act were passed in December 2004 and became effective in April 2005. These were intended to reinforce the deterrence against cartels, improve the merger and acquisition review system, and encourage improvement of corporate ownership and governance structure. Moreover, the amendments provide the legal and institutional foundation to the 3-year Market Reform Roadmap of the Korean government. The Consolidated Insolvency Law was enacted in March 2005, and is to take effect in March 2006.

- **Lao PDR.** The full implementation of the regulation on loan classification issued in May 2004 is expected in 2005. There is also an amendment to the banking law pending in the legislature for the opening up of the banking sector to more foreign institutions.

- **Malaysia.** The incorporation of market risk into the capital adequacy framework is currently being implemented with banks required to comply with the minimum CAR by the second quarter of 2005. In the area of corporate reform, the Malaysian Institute of Corporate Governance is working on corporate governance rules to improve the quality of listed companies, to be released by end-2005. This is in preparation for the cross-trading of equities between Malaysia and Singapore, and the eventual liberalization of capital markets.

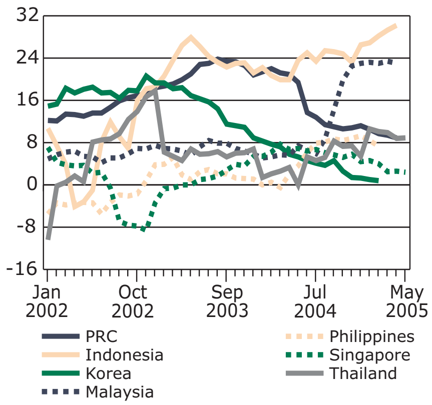
- **Philippines.** In March 2005, the Fixed Income Exchange started operating with the launch of the interdealer trading platform for secondary market trading of government securities. Several legislative amendments have been proposed aimed at strengthening the supervisory and regulatory powers of the central bank.

- **Singapore.** The Competition Commission of Singapore, the government agency tasked to check anti-competition practices, began operating in January 2005 and has started issuing guidelines to implement the Competition Act of 2004. In the area of corporate governance, the Singapore Exchange has proposed stricter listing rules.

- **Thailand.** Bank supervision is being strengthened to cover market risks. At the same time, banks have been permitted a wider range of instruments for risk management.

- **Viet Nam.** The government infused D11 trillion into five state-owned commercial banks as of end-2004 to help them implement restructuring plans. As of June 2005, two state-owned commercial banks had submitted equitization plans to the central bank, with one already approved and the other pending. In an effort to improve monitoring of bank lending, a new regulation was issued in May 2005 expanding the number of loan classification categories from two to five, together with the requirement for banks to set up a fund to cover future repayment defaults.

Figure 24: **Nominal Bank Credit Growth**[1] (y-o-y, %)

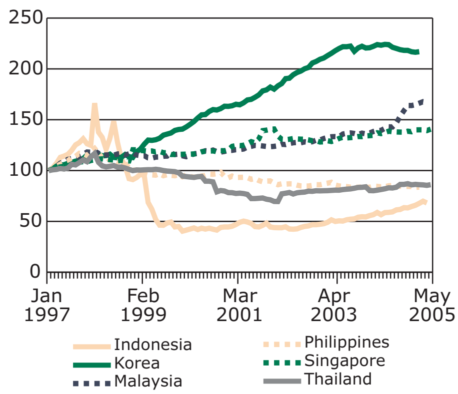


[1]Claims on the private sector: deposit money banks.
Source: OREI staff calculations based on ARIC Indicators.

Bank Lending

During the past 12 months or so, bank credit to the private sector has increased particularly in Indonesia and Malaysia, and to a lesser extent, the Philippines and Thailand, reflecting the progress in financial restructuring and improvement in the business environment. Outstanding bank credit to the private sector increased by 30% in Indonesia and 23% in Malaysia in April 2005 compared with its level a year earlier (Figure 24). Although the growth rate was much lower in the Philippines and Thailand, at about 7% and 9%, respectively, these represent a significant improvement from the situation one or two years ago. In the PRC, growth of outstanding bank credit has slowed significantly since the second half of last year, largely due to government measures to control excessive investment growth in certain sectors of the economy. In Korea, outstanding bank credit to the private sector has been falling since the end of 2002 partly due to sluggish business investment as a result of continued economic weaknesses and because of low borrowing by households already burdened with a high level of debt. Despite the increased growth, however, in real terms, outstanding bank credit to the private sector remained below the pre-1997 crisis levels in Indonesia, Philippines, and Thailand (Figure 25).

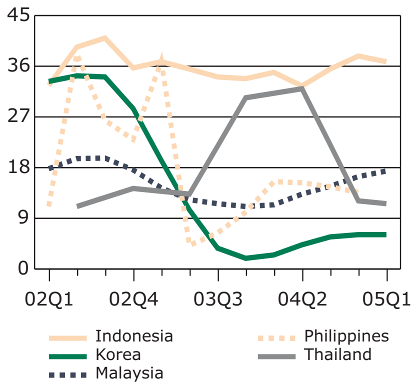
Figure 25: **Real Bank Credit**[1] (seasonally adjusted, Jan 1997=100)



[1]Claims on the private sector: deposit money banks.
Source: OREI staff calculations based on ARIC Indicators.

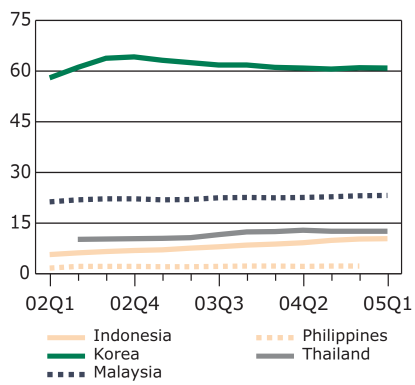
In many countries, recent growth in bank credit to the private sector was driven to a large extent by lending to households. At end-December 2004, outstanding household credit grew by 37.8% year-on-year in Indonesia, 16.4% in Malaysia, 13.6% in Philippines, 11.6% in Thailand,

Figure 26: **Growth of Household Credit** (y-o-y, %)



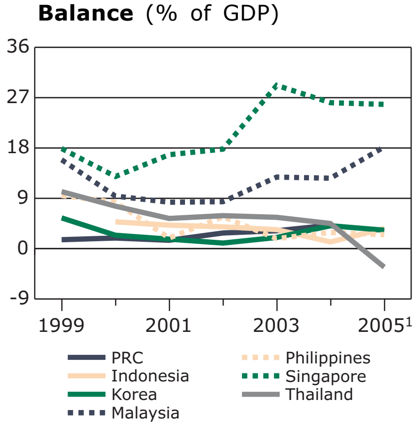
Sources: Bank Indonesia, Bank of Korea, Bank Negara Malaysia, Bangko Sentral ng Pilipinas, and Bank of Thailand.

Figure 27: **Household Credit** (% of GDP)



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

Figure 28: **Current Account Balance** (% of GDP)



[1]As of March 2005.
Sources: OREI staff estimates and ARIC Indicators.

and 6.1% in Korea (Figure 26). The growth remained strong in Indonesia and Malaysia in the first quarter of 2005. However, as a percentage of GDP, outstanding household credit is stable, at 61% in Korea, 23% in Malaysia, below 13% in Thailand, a little over 10% in Indonesia, and below 3% in Philippines (Figure 27).

Prudential Indicators

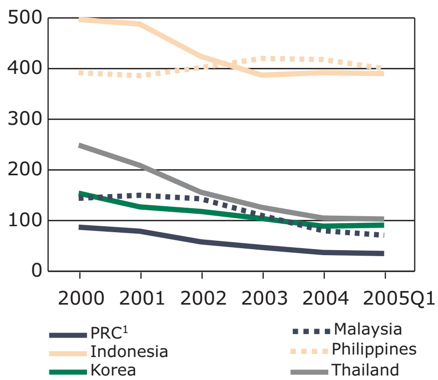
In general, improvements in the health of the financial sectors in the region have been accompanied by improved external payment positions and other prudential indicators in recent years. First, the current account was in surplus in PRC, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand for the past seven consecutive years (Figure 28). Latest available data show that the current account remained in surplus in these countries in the first quarter of 2005 with the exception of Thailand, which recorded a deficit amounting to 3.3% of GDP, mainly due to high oil prices. The latest Consensus Economics survey (July 2005) projects that the current account will record another surplus in 2005 for PRC, Indonesia, Korea, Malaysia, Philippines, and Singapore, but with a marginal deficit for Thailand.

Second, the sustained current account surpluses and strong private capital inflows have resulted in a continued buildup of foreign reserves. Consequently, most countries in the region have seen stable or falling external debt to foreign reserve ratios (Figure 29). Although the ratio of short-term external debt to foreign reserves increased slightly in Korea, Philippines, and Thailand in the first quarter of 2005, it is still very much within prudent levels (Figure 30).

Third, the debt service ratio has continued to fall in 2005 in PRC, Indonesia, Malaysia, and Thailand (Figure 31). In Korea, total debt service as a percentage of exports of goods, services, and income increased in the first two months of 2005, but only marginally.

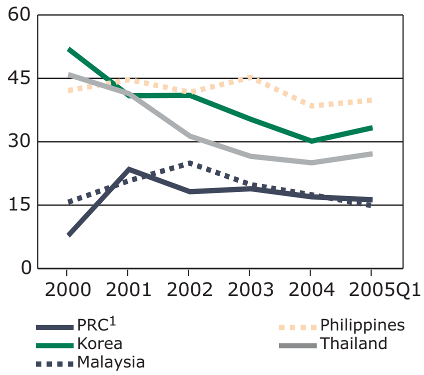
Strong external payment positions, improved macroeconomic fundamentals, and healthier banking sectors have led to improved perception of credit risk in most countries in the region. Rating outlooks were revised upward for Korea, Malaysia, and Thailand last year and for Indonesia early this year by at least one of the three major global ratings agencies—Moody's, Standard & Poor's (S&P), and Fitch IBCA. More recently, S&P upgraded the sovereign credit rating for the PRC and Korea. The exception is the Philippines, where the sovereign rating was downgraded by S&P and Moody's earlier this year, due mainly to concerns over fiscal conditions, and its outlook revised downward more recently, due to political uncertainties.

Figure 29: **Total External Debt** (% of gross international reserves)



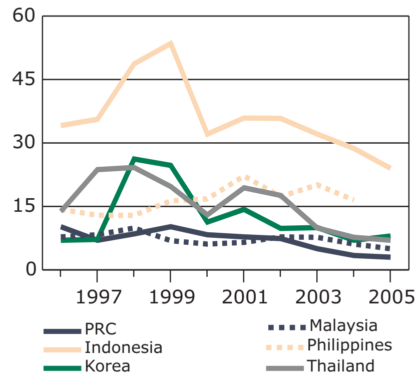
[1]External debt definition was revised in 2001.
Source: OREI staff calculations based on ARIC Indicators.

Figure 30: **Short-term External Debt** (% of gross international reserves)



[1]External debt definition was revised in 2001.
Source: ARIC Indicators.

Figure 31: **Total Debt Service** (% of exports of goods, services, and income)

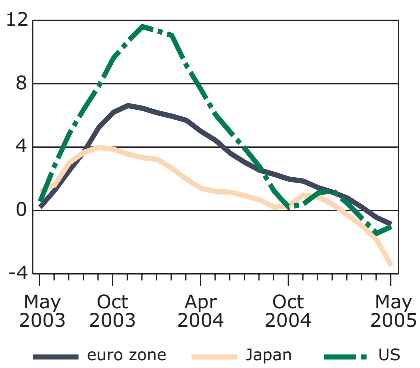


Note: As of January 2005 for Indonesia and Thailand, February for Korea, and March for PRC and Malaysia. Philippines 2004 data revised as of July 2005.
Source: Institute of International Finance.

Economic Outlook, Risks, and Policy Issues

External Economic Environment

Figure 32: **OECD Six-Month Rate of Change of the Trend Restored CLI, Annualized** (% change)

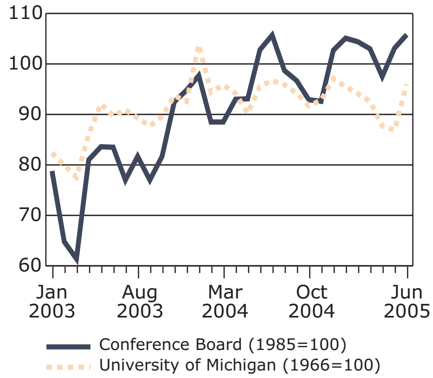


Source: OECD website.

Last year, strong growth in the US, improved growth in Japan and the euro zone, and a recovery in the IT sector provided one of the most favorable external environments that East Asian countries had seen in recent years. The external economic environment is expected to be less favorable this year. The latest GDP growth forecasts for major industrial countries suggest that growth is likely to be lower in 2005 than in 2004. Organisation for Economic Co-operation and Development (OECD) leading indicators also suggest a slowdown of growth in major industrial countries during the rest of the year (Figure 32). Moreover, the global demand for IT products has remained weak in the first half of 2005, although there are signs that it could turn around somewhat in the second half. Even as global growth has slowed, however, the growth differential among the major industrial countries is increasing, with the US still posting strong growth, while Japan and the euro zone posting below-potential growth.

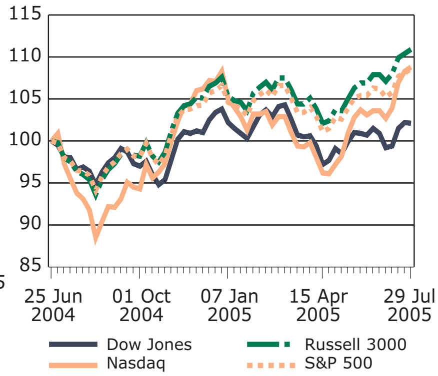
The US economy, after posting an impressive 4.2% GDP growth last year, is expected to slow to a more sustainable level this year and in 2006. First quarter US GDP growth on a quarterly annualized basis came in at 3.8%, while second quarter growth, although solid, was lower at 3.4%, yielding a (year-on-year) GDP growth of 3.6% for the

Figure 33: **US Consumer Confidence Index**



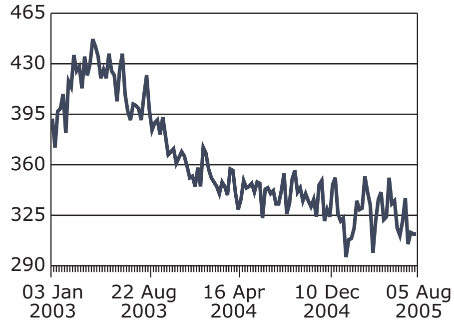
Note: Conference Board numbers are released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

Figure 34: **US Stock Market Indexes** (weekly average, 26 June 2004=100)



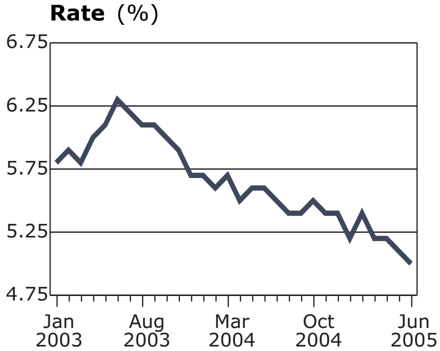
Source: OREI staff calculations derived from Bloomberg.

Figure 35: **US Initial Jobless Claims** (weekly, '000s)



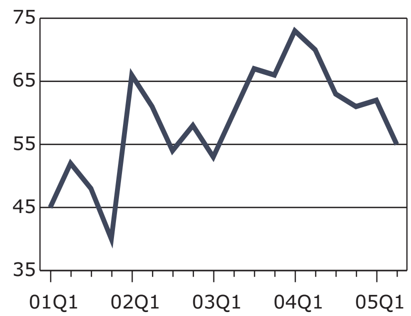
Source: Bloomberg.

Figure 36: **US Unemployment Rate** (%)



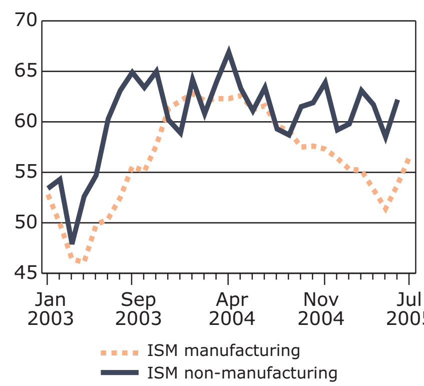
Source: Bloomberg.

Figure 37: **US Business Confidence Index** (Conference Board)



Source: Bloomberg.

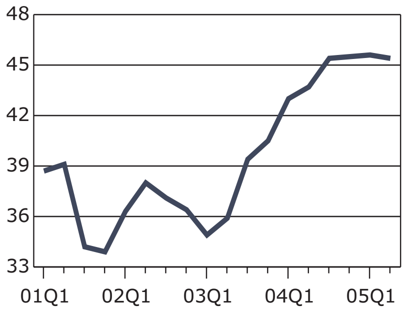
Figure 38: **Surveys of US Business Activity**



Source: Bloomberg.

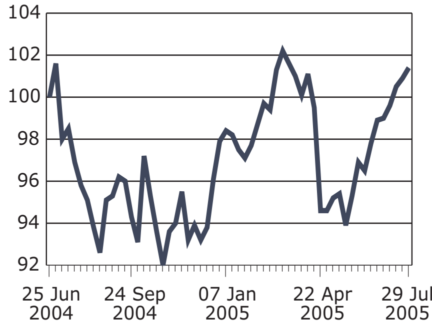
first half of 2005. Similar GDP growth is expected for the second half of the year. Indications are that US consumer spending should hold up well for the rest of the year. For example, in recent months, consumer confidence has remained high, stock markets have trended up, property prices have held up, and both jobless claims and the unemployment rate have continued to decline (Figures 33, 34, 35, 36). However, the Federal Reserve has reiterated that it will "continue to remove monetary accommodation" in the months ahead. Business investment could soften as a result. The continued decline in the business confidence index in recent quarters supports this assessment (Figure 37). Business activity indexes both in the manufacturing, and to a lesser extent, in the non-manufacturing sectors remain weak although these have improved in June and July (Figure 38). As for net external demand for US goods and services, which has made a negative contribution to GDP growth

Figure 39: **Japan: Consumer Confidence** (y-o-y, %)



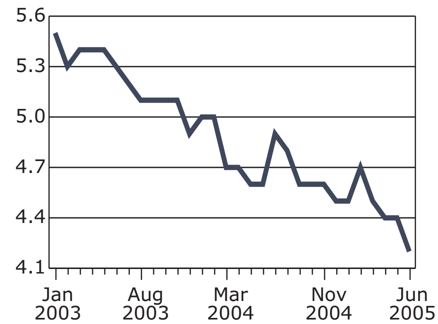
Source: Bloomberg.

Figure 40: **Nikkei 225** (weekly average, 26 June 2004=100)



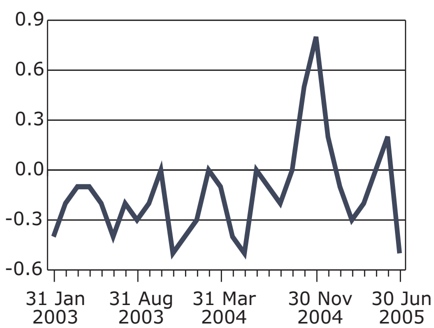
Source: OREI staff calculations derived from Bloomberg.

Figure 41: **Japan: Unemployment Rate, Seasonally Adjusted** (%)



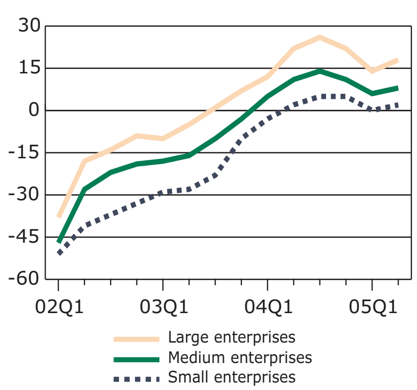
Source: Bloomberg.

Figure 42: **Japan: Consumer Price Index** (y-o-y, %)



Source: Bloomberg.

Figure 43: **Japan: Tankan Survey—Business Conditions Indicators** (Manufacturing)

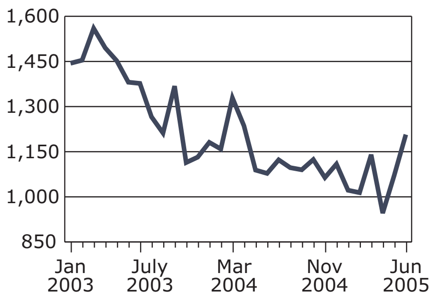


Source: Bloomberg.

in recent quarters, no major turnaround is seen despite the significant depreciation of the US dollar since May 2002. On balance, US GDP growth is forecast to slow both this year and next. Yet, at 3.6%, the current forecast for this year's US GDP growth is higher than its long-term potential. The 3.2% GDP growth forecast for 2006 is closer to US long-term potential growth.

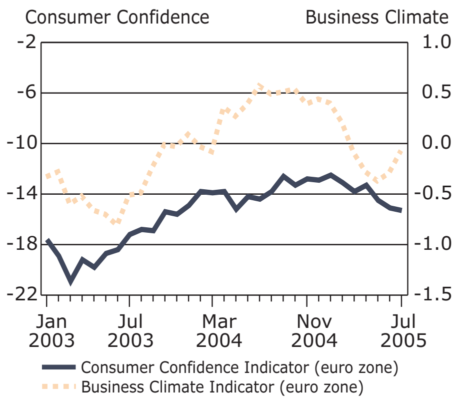
Japan posted a robust GDP growth of 2.7% last year, despite a major slowdown in the second half of the year. Supported by improved domestic demand, GDP growth accelerated to an impressive 5% annualized rate in the first quarter of this year. On a year-on-year-basis, this amounted to 1.3% GDP growth. It appears that domestic private demand is finally picking up, albeit gradually, after years of stagnation. There are indications that domestic private demand should hold up well in the near term: consumer confidence is on an upward trend, the stock market has turned around since end-May, the unemployment rate remains low, and consumer price deflation has slowed since the beginning of this year (Figures 39, 40, 41, 42). Moreover, there are signs that the property market—which has been a significant drag on the economy since the bursting of the property bubble more than a decade ago—is turning around. Residential land prices in Tokyo rose last year for the first time in the past 18 years. Also, office vacancy rates in Tokyo are falling moderately. All of this suggests robust growth in consumer spending. In terms of business investment, the Tankan business conditions indicators, after falling during the three quarters ending March this year, rose during the second quarter, while bankruptcy cases continue to trend downward (Figures 43, 44). With monetary policy continuing to try to end deflation, and commercial banks reporting improvements in their NPLs and capital

Figure 44: **Japan: Bankruptcy Cases**[1]



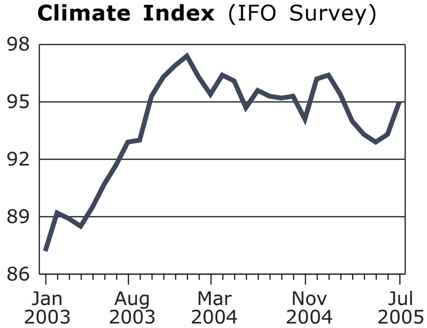
Note: End of month.
[1]Companies with total debts of ¥10 million or more.
Source: Bloomberg.

Figure 45: **Euro zone Consumer Confidence**[1] **and Business Climate Indicators**[2]



Note: End of month.
[1]Consumer Confidence Indicator: The arithmetic average of the answers (balances) to four questions on the financial situation of households and general economic situation (past and future) together with that on the advisability of making major purchases.
[2]Business Climate Indicator: Movement of indicator is linked to the industrial production of the euro area. May be interpreted as a survey result; a high level indicates that, overall, the survey points to a healthy cyclical situation.
Source: Bloomberg.

Figure 46: **German Business Climate Index** (IFO Survey)



Note: End of month.
Source: Bloomberg.

positions, business investment should post robust growth. Current forecasts are for Japan's GDP growth for this year and next to be 1.5%—lower than last year's 2.7% rate but higher than the 1% average annual GDP growth posted in the last decade or so.

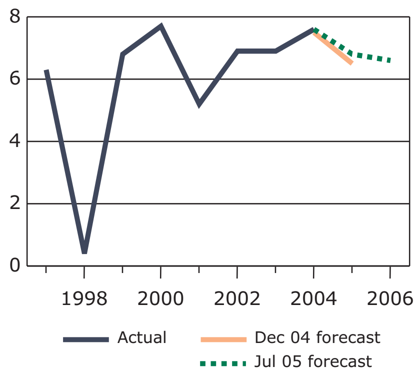
Last year, the euro zone posted GDP growth of 1.8%. In the first quarter of this year, GDP grew by 2% on a quarterly annualized basis and by 1.4% year-on-year. With the exception of France and Spain, the region's growth was driven largely by the external sector. Several factors are expected to continue to keep a lid on the region's growth: high oil prices, the strong euro, and the global economic slowdown. Reflecting this, the consumer confidence index for the euro zone has trended down in recent months, and although the business climate index was also falling, it has improved somewhat in the past few months (Figure 45). Unemployment has failed to retreat from historically high levels and real wages are now falling in the region. In Germany—the largest euro zone economy—both consumer confidence and business sentiment are languishing, although the IFO business confidence indicator rose in July after falling for four consecutive months (Figure 46). Against this background, domestic demand in the region is unlikely to show a significant turnaround, while the strength of the euro over the past few years and the global economic slowdown will limit external demand. Combined GDP of the euro zone is thus forecast to grow by 1.3% this year, before picking up marginally to 1.7% in 2006.

The recovery of the global market for IT products was one of the main factors for East Asia's buoyant exports and impressive GDP growth last year. However, the global market for IT products started to weaken since the second half of last year. The good news, however, is that there are some indications that the global IT industry is showing signs of bottoming out. Leading indicators for the industry, such as US new orders for IT products, the semiconductor book-to-bill ratio, and the spot price of dynamic random access memory (DRAM), after declining until May this year, have since stabilized. However, for the year as a whole, global IT demand will remain softer than it was in 2004.

Regional Economic Outlook

Despite a sharp increase in international oil prices, sporadic outbreaks of avian flu, and the tsunami disaster, the exceptionally favorable external environment enabled East Asia to post an impressive average GDP growth of 7.6% in 2004—the second highest rate since the 1997 crisis, behind only the 7.7% posted in 2000. Excluding the PRC, the average GDP growth was lower at 5.5% and closer to the annual average GDP growth posted by these countries in years since the 1997 crisis.

Figure 47: **Real GDP Growth—East Asia** (%)



Sources: ARIC Indicators; Consensus Economics, Inc., *Asia Pacific Consensus Forecasts,* December 2004 and July 2005; World Bank, *World Development Indicators Online;* and *Brunei Economic Bulletin.*

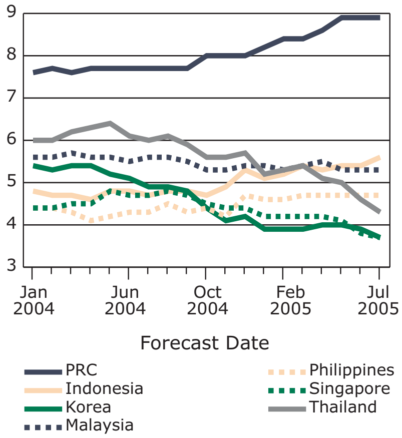
With the external economic environment turning somewhat less favorable and oil prices reaching record levels in nominal terms, East Asia is expected to experience a moderate slowdown this year. Available data for GDP and exports for the first half of this year already point to a slowdown, although with considerable variation among countries. Despite this, current forecasts place East Asia's 2005 average GDP growth at a robust 6.8% (Figure 47 and Table 1). This is about 0.8 percentage point lower than last year's actual GDP growth. It is however 0.3 percentage point higher than the December 2004 forecast, mainly due to the upward revision of the GDP growth forecast for the PRC, from 8% to 8.9%. However, excluding the PRC, the region is forecast to register a much lower average GDP growth of 4.4% this year. This is about 1 percentage point lower than last year's growth rate and 0.4 percentage point lower than the December 2004 forecast.

Table 1: **Annual GDP Growth Rates** (%)

									July 2005 Forecasts		Difference[1]	Postcrisis Average
	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2005**	**1999–2004**
Brunei Darussalam	3.6	-4.0	2.6	2.8	3.0	2.8	3.2	1.7	3.6	. . .	. . .	2.7
Cambodia	6.8	3.7	11.2	7.0	5.6	5.5	5.2	6.0	2.3	4.1	0.0	6.7
PRC	8.8	7.8	7.0	7.6	7.3	8.0	9.4	9.5	8.9	8.0	0.9	8.1
Indonesia[2]	4.7	-13.1	0.8	4.9	3.8	4.4	4.9	5.1	5.6	5.7	0.3	4.0
Korea	4.7	-6.9	9.5	8.5	3.8	7.0	3.1	4.6	3.7	4.7	-0.5	6.1
Lao PDR	6.9	4.0	7.3	5.8	5.8	5.9	5.9	6.5	7.0	6.5	0.0	6.2
Malaysia	7.3	-7.4	6.1	8.9	0.3	4.4	5.4	7.1	5.3	5.7	-0.1	5.4
Myanmar[3]	5.7	5.8	10.9	13.7	11.3	12.0	13.8	12.6	. . .	. . .	. . .	. . .
Philippines	5.2	-0.6	3.4	6.0	3.0	3.1	4.7	6.1	4.7	4.7	0.0	4.4
Singapore	8.6	-0.8	6.8	9.6	-2.0	3.2	1.4	8.4	3.7	4.7	-0.7	4.6
Thailand	-1.4	-10.5	4.4	4.8	2.2	5.3	6.9	6.1	4.3	5.3	-1.4	4.9
Viet Nam	8.2	4.4	4.7	6.1	5.8	6.4	7.1	7.5	7.4	7.3	0.3	6.3
East Asia[4,5]	6.3	0.4	6.8	7.7	5.2	6.9	6.9	7.6	6.8	6.6	0.3	6.8
East Asia exc PRC[4,5]	4.5	-6.8	6.6	7.5	2.9	5.6	4.1	5.5	4.4	5.1	-0.4	5.4
ASEAN[4,5]	4.5	-6.7	4.1	7.0	2.0	4.4	5.0	6.3	5.0	5.4	-0.3	4.8
ASEAN5+2[5]	6.3	0.4	6.8	7.5	5.2	6.9	7.0	7.7	6.8	6.6	0.3	6.8

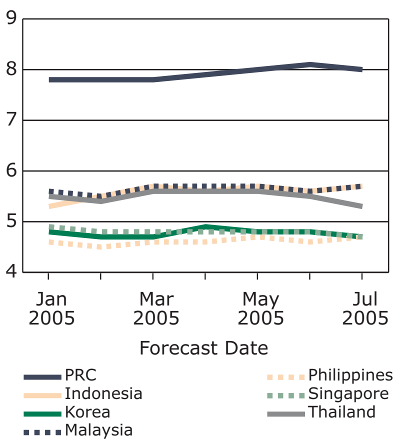
. . . = not available.
[1]Difference between July 2005 forecasts and the December 2004 forecasts.
[2]GDP growth from 1997–2000 is based on 1993 prices, while growth from 2001 onwards is based on 2000 prices.
[3]For FY April–March.
[4]Excludes Myanmar and Brunei Darussalam for all years.
[5]Aggregates are weighted according to gross national income levels from the World Bank's World Development Indicators.
Sources: ARIC Indicators for 1997–2004. Forecasts for 2005–2006 from Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* December 2004 and July 2005 for Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand, and Viet Nam; Asian Development Bank, *Asian Development Outlook 2005* for Cambodia and Lao PDR; and *Brunei Economic Bulletin,* March 2005 for Brunei Darussalam.

Figure 48: **Consensus Forecasts of 2005 ASEAN5+2 GDP Growth** (y-o-y, %)



Source: Consensus Economics Inc., *Consensus Forecasts,* various issues.

Figure 49: **Consensus Forecasts of 2006 ASEAN5+2 GDP Growth** (y-o-y, %)



Source: Consensus Economics Inc., *Consensus Forecasts,* various issues.

Within this broad pattern, however, countries such as Brunei Darussalam, Indonesia, and Lao PDR are expected to post higher growth this year than last year, while other countries are forecast to slow by varying degrees depending on their openness and dependence on imported oil. Since December 2004, Consensus Economics has revised its growth forecasts upward for the PRC, Indonesia, and Viet Nam, but has made downward revisions for Thailand, Singapore, Korea, and Malaysia (Figure 48, 49, and Table 1). Despite the regional growth slowdown, five of the 12 East Asian countries are forecast to post GDP growth of above 5%. Among these, the PRC will continue to be the fastest growing economy with a GDP growth of about 9%, followed by Viet Nam, Lao PDR, Indonesia, and Malaysia.

For 2006, the July Consensus Economics survey forecasts GDP growth to be better or similar to this year's figure for most East Asian economies, except for the PRC and Lao PDR. The PRC is expected to slow down by almost a percentage point, mostly due to the policy-induced soft landing. In fact, excluding the PRC, the region's average GDP growth next year is forecast to pick up to 5.1%.

Individual Country Outlook

- **Brunei Darussalam.** From 1% in the first half, GDP growth accelerated to 2.8% in the fourth quarter of 2004 to yield a 1.7% GDP growth for the full year. Although oil and gas production continued to decline relative to the previous year, improved terms of trade (owing to higher oil prices), and strong growth in money and credit supported GDP growth. Considering the dependence of the economy on oil, the volatility in oil prices poses a major risk over the medium term. The government has targeted GDP growth of 3.6% in 2005, higher than the projection of 2.2% by the International Monetary Fund (IMF). The government's optimism is based partly on high oil prices, and partly on the recent collaboration with Japanese firms in the chemical industry, which is expected to lead to fairly large investment projects.

- **Cambodia.** GDP grew by an estimated 6% in 2004, supported by healthy performance in the garments, construction, and tourism sectors. Garment exports, which comprise 80% of total exports, have continued to perform well, with strong growth in demand from the US in the first half of this year, despite initial fears of a drastic slowdown after the elimination of quotas under the multifiber arrangement. Current forecasts are for a slowdown in GDP growth to 2.3% in 2005. Given this expected slowdown and modest inflation of about 4%, the government's program to reduce the fiscal deficit only gradually (to about 5% of GDP by 2008) from about 7% in 2003 seems appropriate.

- **PRC.** In the first and second quarters of this year, GDP grew by 9.4% and 9.5%, respectively. However, a gradual softening of fixed investment, already underway, and somewhat diminished export prospects are expected to slow GDP growth in the quarters ahead. GDP growth for this year as a whole is thus forecast to be 8.9%. Growth is expected to slow further to 8% in 2006. Quite appropriately, fiscal policy for this year is somewhat restrictive, with the fiscal deficit budgeted to fall from 2.5% of GDP for 2004 to 2.0% this year. Although inflation has fallen after peaking at 5.3% in August 2004, continued high oil prices could put pressure on inflation. Coupled with slowing but strong growth in fixed investment, this suggests that monetary policy would need to continue its tightening bias, especially if inflation edges up. The recent decision to move to a managed floating exchange rate regime with reference to a basket of currencies should give the PRC monetary authorities greater freedom in using monetary policy to achieve domestic macroeconomic objectives.

- **Indonesia.** Driven by a robust increase in domestic demand, the country maintained a GDP growth of 6.4% in the first quarter of this year. Growth is expected to moderate somewhat, both due to a cooling of domestic demand and subdued export growth. Current forecasts place the 2005 GDP growth at 5.6%. Similar GDP growth is expected in 2006. Indonesia has made significant progress in fiscal consolidation in recent years. Further consolidation is a medium-term policy priority of the government, although this is being made more difficult by the continued increase in oil prices, which increases budgetary expenditures on fuel subsidies. With annual inflation running over 7% for sometime now, monetary policy will require further tightening in the months ahead.

- **Korea.** With exports slowing in the face of weakness in global IT demand and an appreciation of the won, GDP growth was an anemic 2.7% in the first quarter of this year and 3.3% in the second quarter, thus giving a GDP growth of 3% in the first half of the year. Exports are forecast to remain relatively weak. However, with a modest pickup in both private consumption and fixed investment, GDP growth for 2005 is forecast to be 3.7%. This is lower than last year's actual figure of 4.6% as well as the December 2004 forecast for this year. With the recovery in private consumption expected to take hold, GDP growth in 2006 is forecast to be higher at 4.7%. And with inflation showing a declining trend since its peak of close to 5% in August 2004, and now running below 3%, monetary policy could shift to a neutral stance. However, given the slowing growth and a comfortable fiscal position, fiscal policy has become modestly expansionary this year. This is an appropriate policy response, and Korea needs to pursue this course until domestic demand has picked up decisively.

- **Lao PDR.** The economy expanded by 6.5% in 2004, reflecting strong growth in the mining and industrial sectors, and a boost in tourism which had been negatively affected by SARS in the previous year. With the planned expansion of projects in gold and copper mining, and the construction of the Nam Theun 2 hydropower dam, GDP growth is expected to be 7% this year. Although inflation has fallen in recent months, it is still running at close to 10%. Meanwhile, both fiscal and trade deficits increased last year, while the external debt to GDP ratio is now close to 100%. The emerging economic scenario makes a strong case for both fiscal and monetary tightening.

- **Malaysia.** In the first quarter of this year, slowing exports was compensated by stronger private consumption, thus enabling Malaysia to post a robust GDP growth of 5.7%. Going forward, exports are expected to remain subdued, and private consumption will soften as a result. Public expenditures are also expected to slow as the government continues its fiscal consolidation program. GDP growth in 2005 is thus forecast to be 5.3%, much lower than the 7.1% achieved in 2004. A slightly higher GDP growth of 5.7% is forecast for 2006. With the government committed to continuing its fiscal consolidation program, there is not much that fiscal policy can do to spur growth. With headline inflation now slowly edging up above 3%, and more importantly, core inflation for May 2005 suddenly jumping to 3.7%, monetary policy also requires a tightening bias. The recent decision to end the ringgit's peg to the dollar should give increased freedom to Central Bank of Malaysia (Bank Negara Malaysia) in using monetary policy to contain inflation.

- **Myanmar.** The official GDP growth target for 2004 was 12.6%. However, chronic shortages of key production inputs such as power and fertilizer suggest that actual growth could have been substantially lower. IMF estimates place last year's GDP growth at 3.6%. Economic sanctions continue to restrain growth, and the IMF forecasts a GDP growth of 3.3% for this year. Much of this growth will be in the oil and gas sectors, as recent exploration and production agreements with some Asian countries suggest that these sectors will be the main recipients of foreign investment.

- **Philippines.** Weakening export growth and declining output in the agriculture sector pulled GDP growth down to 4.6% in the first quarter of this year from 5.4% in the fourth quarter of last year. Personal consumption, which had supported the economy in 2004, likewise registered a slightly slower growth rate during the quarter. Going forward, personal consumption may be boosted by remittances from overseas workers. However, investment will continue to be constrained by weak investor sentiment arising from political uncertainties, while public spending will be restrained by the government's fiscal consolidation program. In addition, sluggish growth in export markets may result in softening export demand. Consequently, GDP growth is forecast at 4.7% this year. Similar GDP growth is forecast for 2006. Given the need to continue the fiscal consolidation program, there is no scope for using fiscal stimulus to counter the economic slowdown. With an average inflation rate at about 8%, monetary policy may require further tightening.

- **Singapore.** Singapore's GDP growth started to lose momentum toward the second half of last year, and this deceleration persisted in the first quarter of this year as well, although an improvement was seen in the second quarter. Being a highly open economy, Singapore's economy will be adversely affected by the weak export prospects. Weak export growth may affect consumer and business sentiments, thus affecting domestic demand. Current forecasts place 2005 GDP growth at 3.7%, compared with 8.4% in 2004, before picking up to 4.7% in 2006. Given the growth slowdown, stable or even declining prices, and a comfortable fiscal position, there is scope for fiscal stimulus—although the openness of the economy to trade tends to make fiscal stimulus less effective in spurring domestic demand and growth.

- **Thailand.** Higher oil prices, slower export growth since August 2004, a prolonged drought, and reduced tourist arrivals in the aftermath of the tsunami led to a major slowdown in Thailand's GDP growth from 5.3% in the last quarter of 2004 to 3.3% in the first quarter of this year. Exports are expected to remain subdued in the coming months and the current account deficit is expected to revert to a deficit this year for the first time since the 1997 crisis. Coupled with modest slowdown in private consumption, GDP growth is forecast to slow to 4.3% this year from 6.1% last year, before picking up to 5.3% in 2006. Because the consolidated government budget is in surplus and the public debt has now fallen to less than 50% of GDP, there is some scope for using fiscal stimulus to support growth if needed. Although core inflation is less than 2%, headline inflation has now exceeded 5%, requiring continued monetary tightening.

- **Viet Nam.** Despite the outbreak of avian flu and adverse weather, Viet Nam posted 7.5% growth in 2004. In the first quarter of this year, GDP growth was an impressive 7.2%. Going forward, exports should remain soft partly due to the economic slowdown in many of Viet Nam's trading partners, and partly due to increased competition in response to the expiration of garment quotas. However, driven by the favorable trends in commodity prices, increased private sector participation in the economy, and buoyant foreign direct investment, Viet Nam is forecast to sustain GDP growth at close to 7.5% this year. A similar growth rate is projected for 2006.

Risks and Policy Issues

The forecasts outlined above are subject to two major risks: (i) further increases in oil prices, and (ii) a disorderly adjustment of the global payment imbalance.

Despite the persistent rise in nominal oil prices to record levels, the impact on growth in most East Asian countries has so far been limited. Further increases in oil prices could, however, reduce East Asia's growth significantly (Box 2). The price of Brent crude reached $56 a barrel in mid-March of this year. While the price softened to about $47 by mid-May, it has increased again to record level, driven by both stronger demand and constraints in oil production and refining capacity. Over the past year, prices for far future delivery of oil have risen even more than spot prices, indicating that the market does not see much relief from high oil prices for some time to come. The net oil importers—Thailand, Philippines, and Korea (and to a lesser extent the PRC)—would bear the major brunt. Even Malaysia, which is a net oil exporter, will suffer a loss from higher oil prices, reflecting the secondary impact of an economic slowdown in its main trading partners.

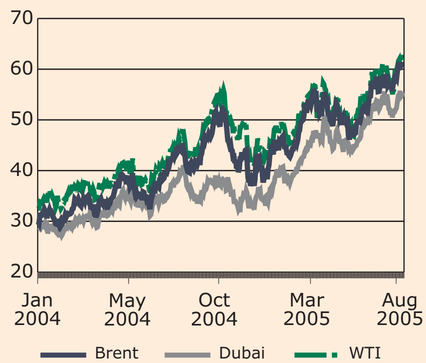
The world economy now suffers from a major payments imbalance: the US is running a large current account deficit, while Asia, and to a lesser extent Europe, are running large current account surpluses. The US current account deficit, which reached a record 6.7% of GDP in the second quarter of this year, has so far shown no signs of receding. Most analysts agree that the US current account deficit is increasingly unsustainable, and that sooner rather than later the deficit has to be trimmed, with the US dollar depreciating further (Box 3). If the adjustment progresses in an orderly manner, the US dollar would

Box 2: **Higher Oil Prices and East Asian Growth**

Crude oil spot prices (West Texas Intermediate [WTI] and Brent) breached $60 per barrel in early July from about $40 per barrel at end-2004 and $10 at end-1998 (Figure B2.1). Several factors contributed to this sharp increase. First, demand for oil rose with the strong global economic growth, which in 2004 was the highest in almost three decades. The International Energy Agency (IEA) estimates that world demand for oil rose 5.1 million barrels per day (mbd) from 77.4 mbd in 2001 to 82.5 mbd in 2004. The rate of increase in demand accelerated to 3.4% in 2004, following increases of 2.3% and 0.8% respectively in the previous two years. Demand from North America, which is the largest consumer (accounting for 30% of the total in 2004), rose strongly and contributed to 23% of the total increase in oil demand in the past three years. Demand from the People's Republic of China (PRC) (at 8% of total consumption in 2004) rose even faster, accounting for 35% of the increase in oil demand in the past three years.

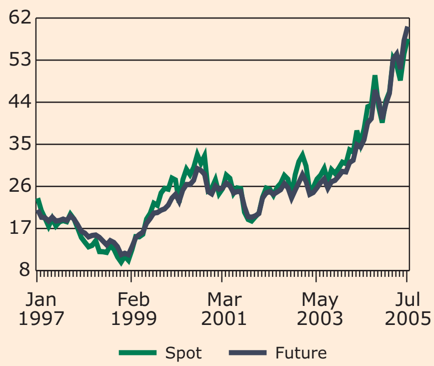
Second, although supply has more or less kept up with demand, spare production and refining capacities are limited. World supply of oil rose 5.9 mbd from 77.2 mbd in 2001 to 83.1 mbd in 2004, according to the IEA. Countries belonging to the former Soviet Union and the Orginization of the Petroleum Exporting Countries accounted for 44 percent each of the increase. Organisation for Economic Co-operation and Development (OECD) commercial stocks are comfortably at the top half of their five-year range, although the number of days of forward demand that these stocks are expected to cover has been in the bottom half of the range since mid-2002. Spare production capacity has declined to 1 mbd in 2004 from a recent high of almost 6 mbd in 2002 and an annual average of about 3 mbd since 1991, according to data from the US Energy Information Administration, as new exploration and production has not kept pace with the rise in demand. Only Saudi Arabia has remaining spare capacity. Furthermore, bottlenecks along the supply chain, for example in refining, impose additional constraints on supply. The tight refining capacity is partly reflected in the divergence between the price of heavier crude oil (Dubai) and lighter crude (WTI and Brent), which widened sharply in October last year before normalizing somewhat.

Figure B2.1: **International Oil Prices** ($/barrel)



Sources: Datastream and Bloomberg.

Figure B2.2: **Spot and 6-Month Futures Crude Oil Prices**[1] (monthly average)



[1]Brent crude.
Source: Bloomberg.

World demand for oil is forecast to rise at a slower rate of 2.2% this year as global economic growth moderates. Nonetheless, spare capacity is projected to remain tight as limited new production and refining capacity is likely to come onstream in the short term. Tight capacities and the expectation that they will remain limited have led to successively higher oil prices, contributed to periodic speculative pressures, and led to greater volatility as prices become vulnerable to periodic supply disruption caused by unexpected events, such as hurricanes, terrorist attacks, as well as other news affecting the industry. Market expectations have priced in the durability of higher oil prices in the short term. The six-month futures price for Brent crude, for example, has exceeded the spot price for most of this year, in contrast to much of recent history (Figure B2.2).

East Asian economies are vulnerable to high oil prices considering their greater dependence on oil. Oil consumption per unit of output was 2–4 times higher in some larger East Asian countries in 2003 than in the OECD (Table B2.1). East Asian countries are also significant net importers of oil, except for Malaysia, Viet Nam, and to a lesser extent Indonesia (which became a net oil importer in 2003). The dependence on imported oil has increased over the past two decades in the PRC and Indonesia. In Malaysia, net oil exports have fallen.

Despite the persistent rise in nominal oil prices and the region's relatively greater dependence on imported oil, however, the impact on growth in most East Asian countries has so far been limited, in contrast to previous supply shocks

Continued next page

Box 2 *(Cont'd)*

Table B2.1: **Petroleum Consumption and Net Imports**

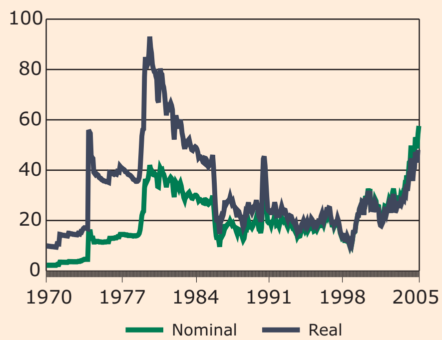
	Petroleum Consumption Per Unit of GDP (OECD=100)	**Net Petroleum Imports** (% of GDP)			
	2003	**1980**	**1990**	**2000**	**2003**
PRC	226	-	-0.88	1.33	1.49
Indonesia	370	-11.65	-4.36	-0.97	0.23
Korea	214	9.79	3.28	4.19	3.78
Malaysia	280	-6.45	-6.89	-2.33	-2.13
Philippines	237	6.97	3.85	4.34	3.92
Thailand	299	8.65	3.44	4.42	4.36

Note: For net petroleum imports, a minus sign denotes net exports. Fuel imports defined in SITC Rev. 2 Code 33 (petroleum, petroleum products, and related materials).
Sources: United Nations, *Commodity Trade Statistics Database*; International Monetary Fund, *World Development Indicators Database;* Energy Information Administration, US Department of Energy, *International Energy Annual 2003;* and OECD Database.

experienced in the 1970s and 1980s. First, much of the increase in oil prices this time around is demand driven. To this extent, higher oil prices reflect strong economic growth. Second, in real terms, oil prices are still about one half of the record levels reached during the 1979-80 period (Figure B2.3). This factor, combined with lower oil-intensity of production in the major industrialized countries, structural changes including greater integration of the world economies, and greater flexibility in monetary policy, has kept global and thus East Asia's growth resilient. Third, the adjustment after the 1997 financial crisis led to substantial current account surpluses and accumulation of foreign exchange reserves, providing a significant cushion to absorb oil price shocks. Similarly, following the 1997 crisis, the economies had started out with generally moderate inflation, reflecting previous excess economic capacity, stable labor markets, and more flexible exchange rate policies, providing some room to maneuver in macroeconomic management.

The relatively benign environment sketched above may not last if oil prices remain high or increase further.

Figure B2.3: **Nominal and Real Oil Prices** ($/barrel)



Note: Brent crude. Real prices are nominal, adjusted by US CPI.
Source: International Monetary Fund, *International Financial Statistics Online*.

In some countries, such as Thailand, which is relatively more dependent on imported oil, the adverse impact of high oil prices on growth, current account balance, and inflation is already perceived to be significant. The price of Brent crude has averaged $51 as of 29 July 2005, compared with $38 in 2004. If the price were to average $55 per barrel for the remainder of the year, it would average $53 per barrel in 2005. According to an Asian Development Bank (ADB) study[1] published last year, an increase of this magnitude could reduce East Asia's growth by about 1.6 percentage points, raise the inflation rate by 2.2 percentage points, and worsen the trade balance by 0.6 percent of GDP.

There is likely to be substantial variation within the region. Countries dependent on imported oil such as Thailand, Philippines, and Korea and to a lesser extent PRC, would be affected the most. Malaysia, despite its status as a net oil exporter, would suffer a loss of growth from higher oil prices, partly reflecting a secondary impact of the slowdown in major trading partners.

Considering the stickiness of supply in the short-term, high oil prices thus pose a substantial risk to East Asia's growth. Recognizing that prices may remain high or increase further, governments in the region have taken various measures to conserve on oil use and improve its efficiency. These measures include administrative steps, for example restricting activities such as air-conditioning of offices, and in Indonesia, Thailand, and to a lesser extent Malaysia, reduction of subsidies in order to bring domestic prices more in line with world prices.

[1]Park, Cyn-Young, *Higher Oil Prices: Asian Perspective and Implications for 2004-2005*, ERD Policy Brief No. 28, June 2004.

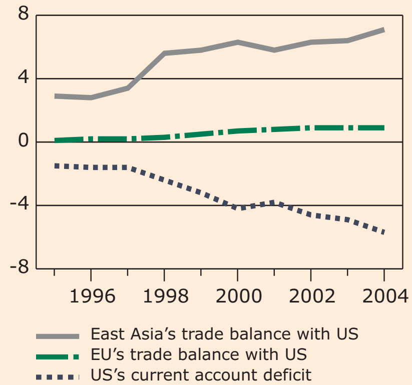
Box 3: **Global Payments Imbalance: The Need for a Shared Approach**

The world economy suffers from large and increasing payments imbalance—the US runs a large current account deficit, while Asia, and to a lesser extent Europe, run large current account surpluses with the US. This global payments imbalance has emerged over a relatively short period. For example, in 1997 the US had a current account deficit of only $136 billion (1.6% of GDP). In 2004, the deficit reached $666 billion, or 5.7% of GDP (Figure B3.1). More recent data show that the US current account deficit further increased to 6.7% of GDP by the second quarter of this year.

The buildup of this global payments imbalance essentially reflects a sharply worsening fiscal balance and a fall in personal savings in the US (which of course allowed the US economy to grow at above-normal growth rates), along with weak global demand for US goods and services. The latter, in turn, is attributable to a number of factors, including below-potential growth in Japan and a large part of Western Europe, inadequate exchange rate flexibility to varying degrees across several East Asian countries, and the weak private investment in several East Asian countries after the 1997 Asian financial crisis.

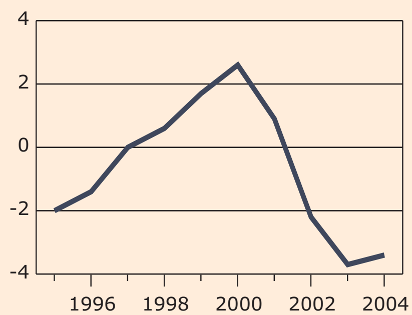
In 1997 the US had a balanced budget. But by 2003 the country had a fiscal deficit equivalent to 3.7% of GDP (Figure B3.2). The deficit declined marginally to 3.4% of GDP in 2004. Gross private savings as a percentage of GDP fell from about 18% in 1997 to about 15% in 2004. About half of this reduction in private savings was attributable to a decline in personal savings from 2.6% of GDP in 1997 to below 1% last year.

Figure B3.1: **Trends in Global Payments Imbalance** (% of GDP)



Source: Datastream.

Figure B3.2: **US Fiscal Balance** (% of GDP)



Source: Datastream.

Between 1997 and 2004, the US economy grew at an average annual rate of 3.2%, while the corresponding figures for Japan and the euro zone were 0.8% and 1.8% respectively. During this period, the People's Republic of China (PRC) grew at an average annual rate of over 8%, but at the same time accumulated substantial current account surpluses under a tightly-managed exchange rate regime. The period between 1997 and 2004 also saw a significant decline in investment rates (investment to GDP ratio) among several East Asian countries. In many of these countries, investment rates collapsed in the aftermath of the crisis, and are yet to recover significantly. These sharp reductions in investment contributed to lower growth as well as persistent current account surpluses among these countries.

There are sharply diverging views on whether and for how long the world economy can sustain the current global payments imbalance. A minority view is that the current global setting remains sustainable for years, even decades, because it serves strong national interests.[1] Asian countries and particularly the PRC need to grow rapidly and create jobs for millions of unemployed and underemployed. One of the best ways to do this is to export to the US at cheap prices—an export-led growth strategy with undervalued exchange rates—and, in turn, invest the foreign exchange earnings in US assets to finance the growing US current account deficit. Because everyone gains, the system can be sustained for a long period without much problem.

A similar view, attributable to the US Federal Reserve Board Chairman Alan Greenspan and former Governor Ben Bernanke (currently Chairman of the Council of Economic Advisers to the US President), argues that in an integrated global capital market where capital moves freely across national borders, savings and investments need not be balanced across each individual country but

Continued next page

[1]Michael P. Dooley, David Folkerts-Landau, and Peter Garber, "An Essay on the Revived Bretton Woods System," National Bureau of Economic Research, Working Paper No. 9971, September 2003; and Robert J. Samuelson, "Special Report on Bottom Dollar," *Newsweek*, 21 March 2005, pp. 37-45.

Box 3 *(Cont'd)*

only at the global level.[2] This implies that the US can continue to invest more than it saves (i.e., running a current account deficit), while other parts of the world, say Asia, can continue to save more than it invests (i.e., running current account surpluses with foreign reserve accumulation). So long as the rest of the world does not tire of saving more than it invests, the US current account deficit can be financed without undue difficulty. In fact, a stronger version of this view, attributable to Ben Bernanke, is that the US current account deficit, as well as the value of the dollar, are not "made in the US," but are the result of a savings glut (relative to investment) in the rest of the world, mainly the developing countries. The US current account deficit is thus the "tail of the dog."[3]

Finally, there is the view—more generally accepted by academic economists, financial market analysts, and the International Monetary Fund—that the current global payments imbalance is too large to be sustained for long, and hence needs to be resolved through actions by all major countries and regions involved. One implication of this view is that significant dollar depreciation would be required for the gradual resolution of this imbalance. Partly reflecting this, the US dollar has already depreciated since its peak in February 2002. One recent estimate suggests that to bring about a one percentage point reduction in the ratio of US current account deficit to GDP, the dollar would have to depreciate by anywhere from 8% to 18% (depending on the various parameter values).[4] This implies that to reduce the US current account deficit to about the 1.6% level that existed in 1997, the dollar will have to depreciate by anywhere from 32% to 72%. The longer the delay in bringing about the adjustment, the higher would be the eventual dollar depreciation, and the more chaotic the adjustment process as well. If an orderly resolution of current global imbalances is not done through appropriate policy actions by the major countries involved, the world economy runs the risk of a chaotic adjustment: a crisis of confidence in the US economy, rapid unloading of the large stock of US dollar assets held by Asian countries, a sudden and sharp US dollar depreciation along with skyrocketing US interest rates, and even perhaps unprecedented protectionist measures by the US. The end result of such a disorderly adjustment could be a deep and prolonged global recession.

It is thus in the interest of all major countries and regions concerned to facilitate a gradual and orderly resolution of the current global payments imbalance.[5] Clearly, one country or one region acting alone cannot resolve this situation. A shared approach is needed to address all aspects of the global payments imbalance: a credible fiscal consolidation program in the US, improved growth in Japan and the euro zone, revival of private investment in the crisis-affected Asian countries, and greater exchange rate flexibility in developing Asia. A consensus on a need for a shared approach has been reached in various international and academic fora. What is now required is an expeditious implementation of the required policies.

[2]Ben S. Bernanke, "The Global Savings Glut and the US Current Account Deficit," Speech delivered at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, US, 10 March 2005; and "America's Current-Account Deficit: Wide Gap, Wide Yawn," *The Economist*, 19-25 March 2005, p. 68.
[3]An almost opposite view that the US current account deficit is solely attributable to the US economy can be found in Ronald McKinnon, "Government Deficits and the Industrialization of America," *The Economists' Voice,* Volume 1, Issue 3, 2004.
[4]Oliver Blanchard, Francesco Giavazzi, and Filipa Sa, "The US Current Account and the Dollar," National Bureau of Economic Research, Working Paper No. 11137, February 2005. Similar conclusions are reached by other studies such as Menzie Chinn, "Doomed to Deficits? Aggregate US Trade Flows Re-examined," National Bureau of Economic Research, Working Paper, April 2005, and same author "Still Doomed to Deficits: An Update on US Trade Elasticities, Mimeo, University of Wisconsin, Department of Economics, May 2005.
[5]Rodrigo de Rato, "Correcting Global Imbalances—Avoiding the Blame Game," Speech delivered at the Foreign Policy Association Financial Services Division, New York, 23 February 2005.

depreciate gradually. However, there is growing anxiety that the process may not be orderly, and that the US economy could fall prey to a crisis of confidence. This could lead to a sudden fall in the US dollar, a sharp rise in US interest rates, instability in global financial markets, and a deep contraction of the global economy. The prospect of an increasing growth imbalance among industrial countries—slowing but more sustainable growth in the US coupled with weak growth in Europe and Japan—has further heightened the risk of a disorderly adjustment.

Against the backdrop of slowing growth, a gradual buildup of inflationary pressures, a tightening of US monetary policy, the risks of high and volatile oil prices, the large global payments imbalance, and country-specific fiscal and balance-of-payments situations, the key challenge for East Asia is to calibrate fiscal, monetary, and exchange rate policies while at the same time pursuing structural reforms to strengthen domestic demand (see the December 2004 AEM and the country paragraphs in this report for details).

There appears to be a case for fiscal consolidation to varying degrees in many countries. The notable exceptions to this are Korea, Singapore, and to a lesser extent Thailand, while the need for fiscal consolidation is perhaps strongest in the Philippines. A tightening of monetary policy is appropriate in PRC, Indonesia, Lao PDR, Myanmar, Philippines, Thailand, Viet Nam, and to a lesser extent Malaysia, while in other countries there is no compelling reason for monetary tightening.

Allowing greater exchange rate flexibility would have three key benefits for the region. It would give greater scope for using monetary policy to achieve domestic economic objectives, reduce the need for costly sterilization operations by central banks, and help rebalance sources of growth away from the external sector into domestic demand. It is encouraging that the PRC has made the initial move in imparting greater flexibility to its exchange rate regime by ending the yuan peg to the dollar and moving to a managed float with reference to a basket of currencies (Box 4). Malaysia also followed suit with a similar shift in its exchange rate regime. To the extent that greater exchange rate flexibility is expected to be accompanied by an appreciation of most regional currencies, it would also help lower inflationary pressures.

Strengthening domestic demand through structural reforms would also help rebalance sources of growth away from the external sector toward domestic demand. It is encouraging to note that fixed investment in 2004 grew at fairly robust rates in most of the countries affected by the 1997 crisis. Yet investment to GDP ratios have not risen much from the lows reached in the aftermath of the 1997 crisis. In several countries, continued current account surpluses largely reflect weak private investment. Therefore, there is a need to improve the investment climate in these countries.

This in turn underscores the need for expeditious completion of the remaining financial and corporate sector restructuring and reform

Box 4: **Implications of the PRC's and Malaysia's Move to a Managed Floating Regime**

On 21 July 2005, the People's Republic of China (PRC) announced that it was adopting a "managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies" with a band of ±0.3% for daily fluctuations against the US dollar. The exchange rate of the US dollar against the yuan was also adjusted to 8.11 yuan per US dollar, implying a revaluation of the yuan by about 2%. The same day Malaysia also announced that the ringgit would be "allowed to operate in a managed float with its value being determined by economic fundamentals…Bank Negara will monitor the exchange rate against a currency basket to ensure that the exchange rate remains close to its fair value."

It is too early to assess the impacts of these changes in exchange rate regimes in the PRC and Malaysia as a lot will obviously depend on how the new system operates in practice, and how the actual exchange rates of these countries move in the future. The 21 July exchange rate regime changes by the PRC and Malaysia are, however, welcome initial steps because they represent moves toward greater exchange rate flexibility. While the immediate effects of these changes have been rather limited, they have the potential to have profound economic implications.

First, these changes would give greater autonomy in using monetary policies toward achieving domestic macroeconomic objectives in the two countries. Second, the need for costly sterilization of foreign exchange inflows by the central banks of these countries would also be lessened. Third, to the extent that other countries in the region have been constrained not to let their currencies appreciate in recent years for fear of losing export competitiveness in the face of a yuan peg to the dollar, these measures by PRC and Malaysia would foster greater exchange rate flexibility in Asia as a whole; this could slow down the pace of foreign exchange reserve accumulation that several East Asian countries had resorted to in recent years and thus end the "revived Bretton Woods system" that had emerged in the post crisis period. Fourth, greater exchange rate flexibility in Asia could contribute to the resolution of the current global payments imbalance, subject of course to the US, Japan, and Europe also taking appropriate measures (Box 3).

Finally, the shift to a basket currency-based exchange rate regime by the PRC and Malaysia could have implications for regional exchange rate coordination in Asia over the longer run. Singapore already has a basket currency-based exchange rate regime. Now that two other countries have also shifted to a similar regime could encourage other countries in Asia, especially East Asia, to move toward a similar regime in the future, depending of course on how well the new regime works for the PRC and Malaysia. Such a move by other countries could lead to not only greater flexibility but also greater similarities in the exchange rate regimes across countries in the region, laying the groundwork for regional exchange rate coordination over time.

agendas. To point out some key areas of concern: (i) in countries such as PRC, Philippines, and Thailand, the NPL ratio remains high by international standards; (ii) despite progress in bank divestment, governments still own substantial portions of domestic banking assets, particularly in Indonesia, Thailand, and most transition economies; (iii) in corporate restructuring, although voluntary workouts have made significant progress, workouts through the courts have been slow due to weaknesses in insolvency frameworks and in judicial systems, and; (iv) in some countries, restructuring and reform of state-owned enterprises remain a formidable task.

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