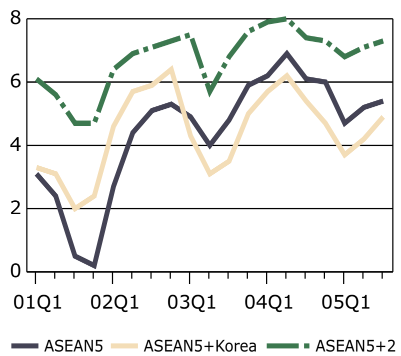
East Asia's Growth and Restructuring—A Regional Update

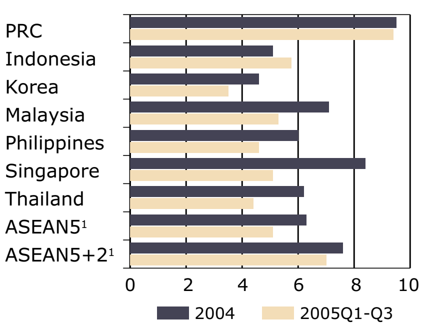
Recent Economic Performance

Figure 1: **Regional GDP Growth**[1] (y-o-y, %)



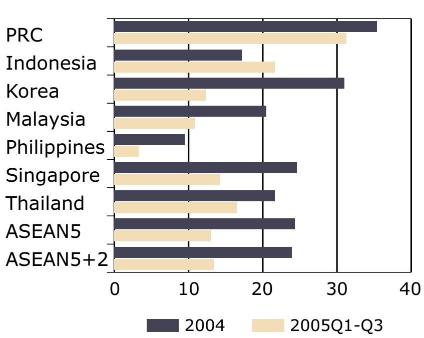
[1]Weighted by gross national income (atlas method, current $).
Source: OREI staff calculations based on ARIC Indicators.

Figure 2: **GDP Growth** (y-o-y, %)



[1]Weighted by gross national income (atlas method, current $).
Source: OREI staff calculations based on ARIC Indicators.

Figure 3: **Growth in Merchandise Exports**[1] (y-o-y, %)



[1]In current $.
Source: OREI staff calculations based on ARIC Indicators.

GDP Growth

The moderation in emerging East Asia's[1] gross domestic product (GDP) growth that began in mid-2004 continued into the early part of this year before giving way to a modest pickup in most economies in the second and third quarters. The seven largest economies in the region for which quarterly GDP data are published—People's Republic of China (PRC), Indonesia, Republic of Korea (Korea), Malaysia, Philippines, Singapore, and Thailand—taken together saw growth decline to 6.8% in the first quarter of 2005 from almost 8% in the first half of last year[2] (Figure 1). Starting in the second quarter of this year, there has been a modest rebound in many economies, with GDP growth in these seven economies accelerating to 7.3% in the third quarter of 2005. The recent pickup, however, has not been strong enough to offset the earlier weakness and thus growth for emerging East Asia as a whole in 2005 is likely to be 0.5 percentage point below the 7.6% rate recorded in 2004 (Figure 2).

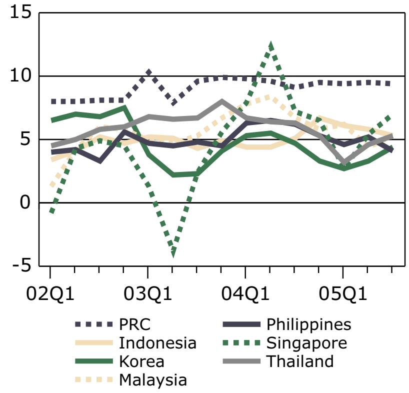
The easing in regional growth in 2005 largely reflected a slowdown in exports (Figure 3). Weaker exports, in turn, mirrored the downshifting of the global economy from the exceptionally rapid rates in late 2003 and early 2004. Factors contributing to the cyclical downturn in the global economy included sharp increases in world oil prices and a temporary weakness in the information technology (IT) sector in late 2004 and early this year. Within the region, the degree of the slowdown was influenced by a return to trend in a number of economies. This followed the sharp rebound in late 2003 and early 2004 from the outbreak of severe acute respiratory syndrome (SARS), and a number of country-specific developments, such as last year's tsunami, drought, terrorist attacks, and political uncertainties.

The overall slowdown in regional growth in the first three quarters of 2005 masks some significant differences in performance across countries (Figure 4). For the most part, the deceleration was concentrated in the five largest ASEAN economies (ASEAN5)—Indonesia, Malaysia, Philippines, Singapore, and Thailand. Even among these five economies, however, performance varied with the sharpest slowdowns early in the year in Singapore and Thailand. Indonesia has been the only economy that recorded higher

[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.

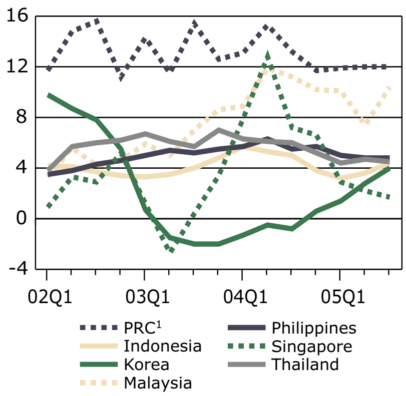
[2]Unless otherwise indicated, all growth figures are year-on-year.

Figure 4: **Real GDP Growth** (y-o-y, %)



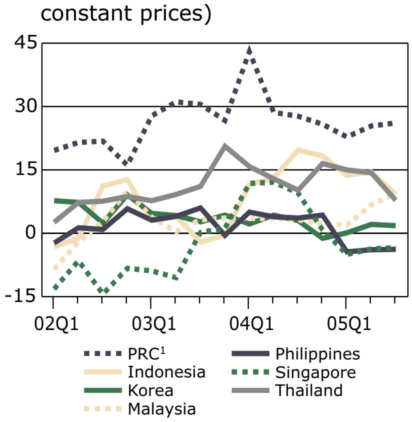
Source: ARIC Indicators.

Figure 5: **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.

Figure 6: **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.

growth in the first three quarters of this year than in 2004. Growth in Korea has been picking up since the first quarter of 2005, while the PRC economy has not shown signs of slowing from the very rapid pace in 2004.

Private consumption in the region rose at a slower rate of 4.9% on average in the first three quarters of the year, compared with 7.2% in 2004, mainly reflecting higher oil prices, tighter monetary policies, and possibly slower increases in disposable income. Nonetheless, consumption growth remained stable or started to pick up in the third quarter across the region, except in Singapore (Figure 5). The PRC's consumption growth remained steady at around 12% throughout the year, buoyed by a 10% increase in real per capita disposable income in urban areas and an 11.5% increase in per capita farm income. In Korea, private consumption rose in the July–September period for the fourth quarter in a row, following six consecutive quarters of decline. The steady increase, partly reflecting a resumption of household credit growth, suggests that household balance sheets have strengthened considerably since the credit bubble started to deflate in 2002.

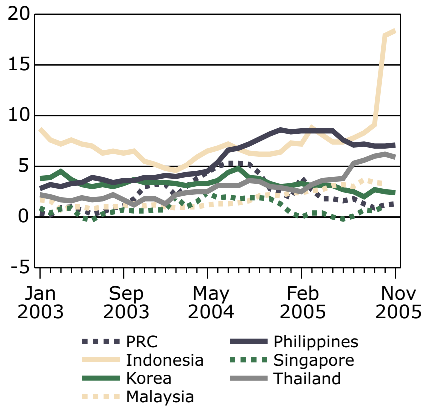
Among the ASEAN5 economies, private consumption growth started to pick up in Indonesia and Malaysia, but continued to slow during the third quarter in Singapore, partly reflecting a soft labor market and modest earnings growth. In the Philippines and Thailand, it remained relatively stable but weak compared with 2004, reflecting higher oil prices, the adverse effects of drought on farm incomes, and tighter monetary policy.

Fixed investment was generally weak in the region this year, except in the PRC, where it continued to grow very strongly—at an average rate of about 25% in the first three quarters—although this increase was lower than the exceptionally rapid growth in the first quarter of 2004 (Figure 6). Investment in Korea failed to revive in the third quarter. Although facilities investment continued to grow at a moderate rate of around 4%—as the small and medium enterprise sector continues to adjust—measures to cool the housing sector contributed to stagnant investment in construction.

Among the ASEAN5 economies, investment declined in the Philippines and Singapore throughout this year, while investment growth slowed in Indonesia and Thailand to below 10% in the third quarter, from about 15% in the first half. In Malaysia, investment showed signs of picking up following a protracted period of weakness. Much of the increase in investment was by the private sector, as the government continues to cut back on large infrastructure spending. The slowdown in Thailand also reflected a sharp deceleration in investment by state enterprises—to 0.2% in the third quarter from 20–30% rates in the previous quarter—as disbursements for the fiscal year that ended in September were front-loaded. Private investment remained strong at 11.5% in the third quarter, similar to the rates in the first half.

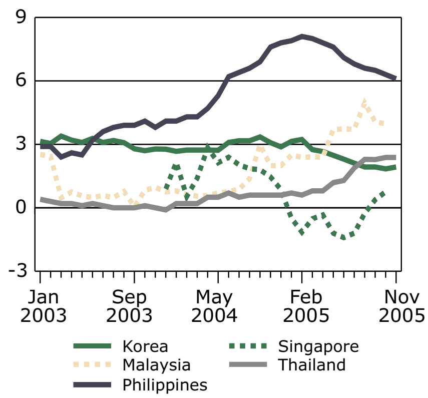
Inflation

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



Source: ARIC Indicators.

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



Sources: Bangko Sentral ng Pilipinas and OREI staff estimates derived from Bloomberg data.

Even as growth slowed in the region, headline inflation increased in several economies during 2005 (Figure 7). The differences in inflationary trends across countries mainly relate to the extent and timing of the pass-through of world oil prices into domestic energy prices (including administered price increases and subsidy reductions), the behavior of domestic food prices, and any second-round pass-through effects into core inflation. Generally, in the five countries where data are available, core inflation, which excludes volatile items, remained relatively muted (Figure 8).

Headline inflation remained high or increased in Indonesia, Philippines, and Thailand, but eased in both the PRC and Korea during the course of this year. Indonesia recorded the largest increase to around 18% in October and November following rates of 7–9% earlier in the year. The jump reflected the immediate impact of a sharp increase in fuel prices on 1 October, as well as increases in food prices and utility charges. In the Philippines, inflation was above 8% early in the year before falling to around 7% in later months as food prices eased.

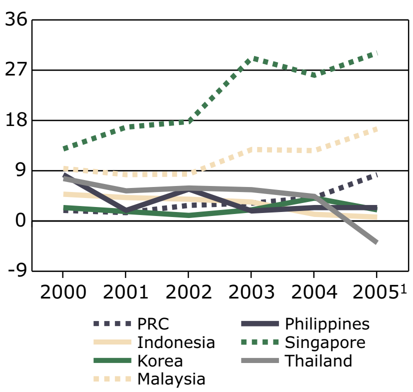
Persistent increases in headline inflation in 2005 were recorded in Thailand and, to a lesser extent, Malaysia. Thailand's headline inflation rate increased from the 2–3% range early in the year to around 6% in September through November, as the authorities gradually permitted increases in fuel prices toward world levels, and food prices increased. Inflation in Malaysia edged up modestly during the course of 2005, reflecting a faster increase in transportation tariffs, fuel prices (as subsidies were reduced), and food prices. In the PRC, headline inflation trended down during the year, following a lunar New Year-induced spike in February. As in Korea, the downward movement was related in large measure to an easing of food prices.

Core inflation, although lower than headline inflation, has been rising in several countries. In Malaysia, core inflation edged up to a peak of 5% in August from less than 1% a year earlier before easing to 4% in October. Thailand's core inflation rose to 2.4% in November from less than 1% early in the year. Both these increases included some second-round pass-through effects from higher oil prices, as well as administered price increases. After rising sharply to above 8% early in the year, core inflation in the Philippines subsequently eased, partly reflecting slower increases in prices of services, particularly transportation.

Balance of Payments

The current account surplus for emerging East Asia as a whole increased further to almost 6.2% of GDP in the first half of 2005 from below 5% in 2004. A significant increase in the PRC's surplus outweighed reductions in surpluses in the ASEAN5 economies taken together, and Korea. The main factors contributing to the differences in payments outcomes include the impact of macroeconomic policies and the differential effects of oil and other commodity prices on the terms of trade across countries.

Figure 9: **Current Account Balance** (% of GDP)

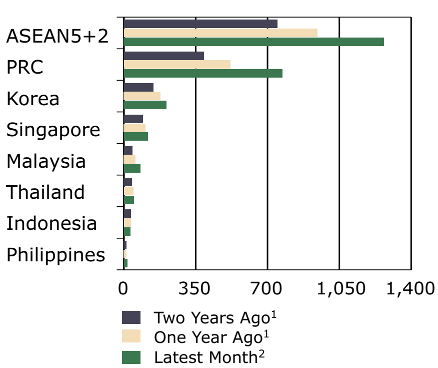


[1]As of September 2005 for Korea, Singapore, and Thailand; June 2005 for others.
Sources: ARIC Indicators and OREI staff calculations based on ARIC data.

Notwithstanding sharp increases in oil prices, the PRC's current account surplus increased to over 8% of GDP in the first half of 2005 from a shade above 4% in 2004, as import growth slowed, while exports continued to grow robustly, influenced in part by the lifting of global quotas for textiles and clothing (Figure 9). The current account surplus in Korea continued to narrow in the first half of 2005 as a result of slowing export growth in the face of strong increases in imports, including energy.

In the ASEAN5 economies, the current account surplus fell sharply in the first half of 2005 to around 5.5% of GDP, from 7.5% last year and almost 9% of GDP in 2003. This weakening, however, was concentrated in Indonesia and Thailand. The current account in Thailand moved into deficit in the first half of 2005 for the first time since the 1997–98 financial crisis, with higher energy prices, the drought, and the effects of the tsunami on tourism as contributing factors. Subsequently, Thailand's current account moved back into surplus in the second half of the year as the latter two effects dissipated. In both Malaysia and Singapore, current account surpluses as a share of GDP increased in the first half of 2005, with higher oil and non-oil commodity export prices in Malaysia being an important contributor to the sharp increase.

Figure 10: **Gross International Reserves Less Gold, End of Period** ($ billion)



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

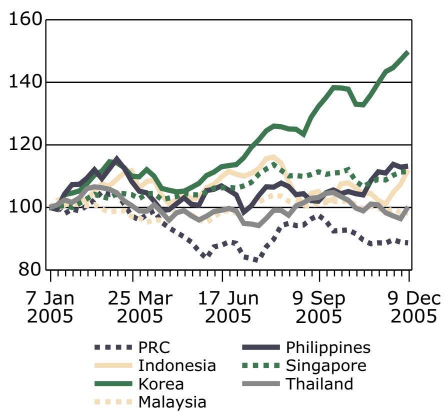
Since the 1997–98 financial crisis, governments of emerging East Asia have been accumulating substantial stocks of international reserves, driven by large current account surpluses as well as increased capital inflows. The rate of reserve accumulation has continued to remain strong in recent years with no signs of easing. International reserves, excluding gold, rose by about $300 billion to $1.3 trillion in emerging East Asia in September compared with a year earlier. This was higher than the 12-month increase a year earlier (Figure 10). As in recent years, much of the increase has been accounted for by the PRC, where reserves increased by over $250 billion during the 12 months to September.[3] In Korea,

[3]This increase does not include a $15 billion injection of PRC reserves into the state-owned Industrial and Commercial Bank of China (ICBC).

international reserves increased by over $30 billion in October from a year earlier. In contrast, reserve accumulation slowed in a number of ASEAN economies, although the pace of accumulation for ASEAN5, taken together, was broadly unchanged. Malaysia recorded the largest increase in reserves over the past 12 months, albeit with some declines in recent months as a result of capital outflows, while reserves fell in Indonesia over the same 12-month period.

One significant development during the year was a change in the sources of reserve accumulation in the region. During 2003 and early 2004, a major part of the reserve accumulation in the PRC was driven by short-term capital inflows ("hot" money) in addition to foreign direct investment (FDI) inflows. In contrast, the rapid pace of reserve accumulation during the past 12 months has owed much to the significant increase in the PRC's current account surplus and FDI inflows. There has been some moderation in short-term capital inflows. Conversely, with the current account surplus narrowing in ASEAN5 in the first half of 2005, capital inflows have become a marginally more important source of reserve accumulation in these economies.

Figure 11: **Composite Stock Price Indexes**[1] (weekly average, first week of Jan 2005=100, local index)

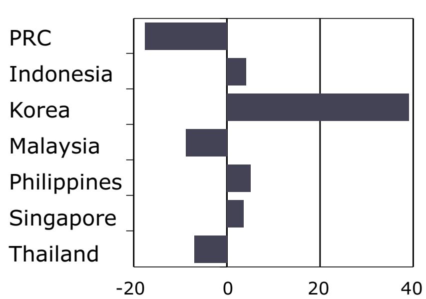


[1]Weekly averages of JCI (Indonesia), KOSPI (Korea), KLCI (Malaysia), PCOMP (Philippines), STI (Singapore), and SET (Thailand). For PRC, the index is calculated based on the weekly averages of the Shanghai Composite and Shenzhen Composite, weighted by the market capitalization of each market.
Source: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

Financial Markets and Exchange Rates

Following rapid advances in the previous two years, the region's stock markets generally recorded much smaller increases in 2005. As growth slowed early in the year and the IT sector remained weak, most markets in the region posted modest increases through the end of June (Figure 11). Exceptions during this period include Korea, where the market rose by almost 14% in response to economic recovery starting to take hold, and Indonesia, where positive sentiment on reform prospects drove the market up by over 10%. The stock markets fell in the PRC during the first half of the year and were essentially flat in Malaysia and Thailand.

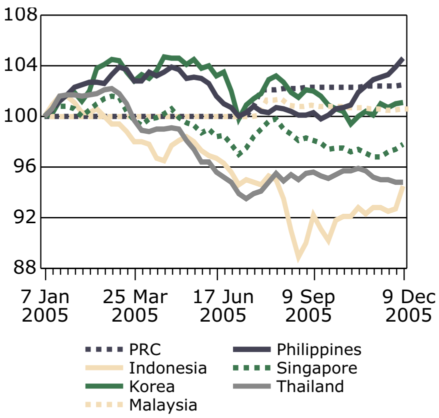
Figure 12: **Percent Change in Stock Market Index**[1] **Relative to Russell 3000 Index** (between 7 Jan 2005 and week ending 9 Dec 2005)



[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 Shenzhen Composite, weighted by the market capitalization of each market.
Source: OREI staff calculations derived from Bloomberg data.

After mid-year and the October "correction" in global stocks, Korea's market continued to advance strongly, up about 50% on the year through mid-December. Markets in the Philippines and Singapore also advanced during the second half, but at relatively tepid rates. Stock markets in PRC, Malaysia, and Thailand either weakened in the second half or remained essentially flat, as they did not share in the global market rise during this period. Indonesia's markets were volatile in the second half of the year, reflecting shifts in investor sentiment due to a delay in adjusting monetary policy and burgeoning fuel subsidies. For the year to early December, markets in Indonesia, Korea, Philippines, and Singapore increased relative to the US Russell 3000 Index (Figure 12).

Figure 13: **Exchange Rate Indexes** (weekly average, first week of Jan 2005=100, $/local currency)



Source: OREI staff calculations derived from Bloomberg data.

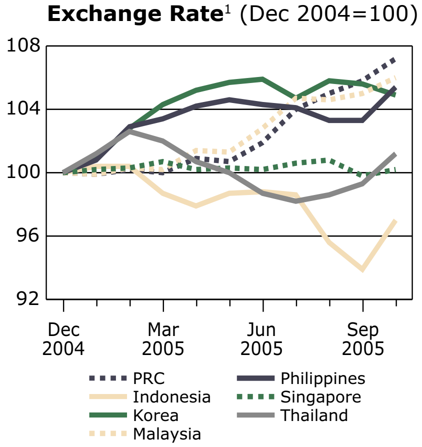
Several regional currencies weakened against the US dollar in 2005 in sharp contrast to recent years. Bilateral exchange rates displayed considerable volatility as well (Figure 13). These movements in regional currencies took place against the background of a general strengthening of the US dollar against major currencies, in large measure a reaction to widening short-term interest rate differentials in favor of the dollar. Repatriation of profits by US companies, to take advantage of a one-time tax benefit that expires at the end of this year, also contributed to US dollar strength.

Among the main regional currencies, the PRC yuan, Korean won, Malaysian ringgit, and Philippine peso appreciated modestly against the US dollar, with the rate of appreciation from the beginning of 2005 to early December ranging from 0.6% for the ringgit to 4.6% for the peso. The Indonesian rupiah, Singapore dollar, and Thai baht weakened, with the rate of depreciation ranging from over 2% for the Singapore dollar to 5.5% for the rupiah.

The peso, rupiah, and won displayed considerable exchange rate volatility against the dollar during the year. In late August and early September, the rupiah came under significant downward pressure in response to investor concerns over the fiscal implications of fuel subsidies, and a perception that monetary policy was significantly “behind the curve.” Subsequently, in response to decisive policy measures taken by the authorities, including an aggressive increase in short-term interest rates, the rupiah partly recovered, but through mid-December it was still below its 1 January value (Box 1).

In the Philippines, the peso fell sharply in June and July in response to political and economic uncertainties, but recovered later in the year, partly due to the record high remittances from overseas workers and reduced political uncertainty. Following a sharp appreciation in late 2004, the Korean won continued to appreciate during the first half of 2005 before weakening late in the year. By late November it was only marginally higher than its value at the beginning of the year.

Figure 14: **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.

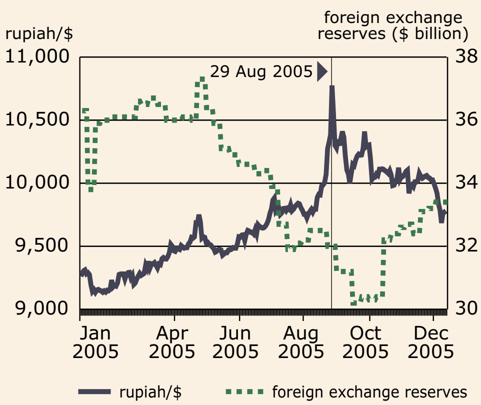
On 21 July, the PRC and Malaysia announced changes in their exchange rate policies. In both cases, the changes involved a small initial revaluation against the US dollar, replacing a de facto or actual US dollar peg with a managed currency-basket system where exchange rates would be managed more flexibly with reference to a basket of currencies. Following these initial moves, neither currency has changed much against the US dollar as of early December.

With the general strength of the US dollar during 2005 and the associated weakness of emerging East Asia’s currencies, the nominal effective exchange rates of the seven regional currencies are stronger than their bilateral exchange rates against the US dollar (Figure 14). Data available

Box 1: **Indonesia: The Financial Market Turmoil in August**

Indonesia's financial markets came under pressure in August this year. The rupiah, which had gradually depreciated against the US dollar through much of the year, fell on 29 August by 3.6%, its single largest decline since April 2001 (Figure B1.1). The stock market index slid 18% during the month from its 3 August 2005 peak.

Figure B1.1: **Exchange Rate and Foreign Exchange Reserves** (IFO Survey)



Source: Bloomberg.

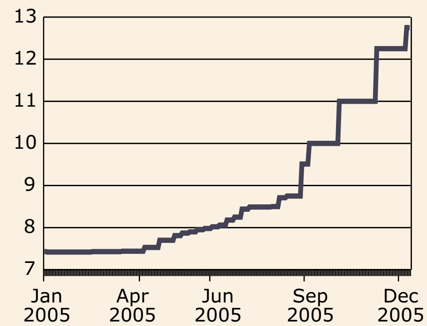
The proximate causes of this turmoil were the fiscal pressure from burgeoning fuel subsidies and a narrowing gap between domestic and international interest rates. Although fuel subsidies had been cut in March this year, leading to an average 29% increase in domestic fuel prices, subsidies began to increase again given the subsequent rise in world oil prices. By mid-August, in the absence of further reduction, it was estimated that fuel subsidies could rise to over 5% of GDP, sharply higher than the 0.7% of GDP projected in the original 2005 budget. The fear of further increases in world oil prices following projected supply disruptions, as Hurricane Katrina passed east of New Orleans 29 August, helped exacerbate perceptions of Indonesia's fiscal position. It was perceived that either the financing of the enlarged deficit would be problematic or the reallocation of expenditures away from development spending, which had occurred for much of the postcrisis period, would hinder long-term growth.

Worsening investor sentiment contributed to a sharp reversal of portfolio flows this year. Net portfolio investment and other investment, including net borrowing from abroad, showed outflows of $3.6 billion in the first half of this year, compared with an inflow of $72 million a year earlier. The current account had also slipped into a small deficit in the second quarter, although the $920 million surplus in the first half was substantially larger than the $21 million surplus a year earlier. The worsening overall balance of payments, coupled with the central bank's efforts through the year to slow the depreciation of the rupiah, led to a fall in foreign exchange reserves from $36.3 billion at end-December 2004 to $31.1 billion at end-August.

Following the turbulence in the financial markets in August, the central bank raised the policy rate twice by a cumulative 125 basis points to 10% and increased reserve requirements during the first week of September. To help stabilize the exchange rate, in mid-September, rupiah margin trading against foreign currencies was banned. The rupiah recovered somewhat, but foreign exchange reserves continued to dip in September to $30.3 billion.

Markets did not stabilize until 1 October, when the government announced a major cutback in fuel subsidies, which led to a 126% increase in average price of subsidized fuel, bringing the total increase this year to 165%; and announced its intent to align domestic fuel prices to world prices. The central bank also raised the policy rate by 2.75 percentage points to 12.75% between October to December, compared with 2.6 percentage points increase in all of the previous nine months (Figure B1.2).

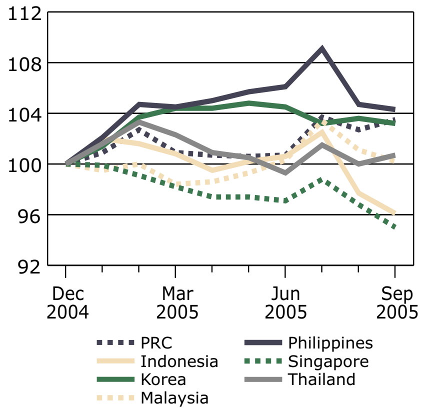
Figure B1.2: **One-Month SBI (Bank Indonesia Certificates) Rate** (%)



Source: Bloomberg.

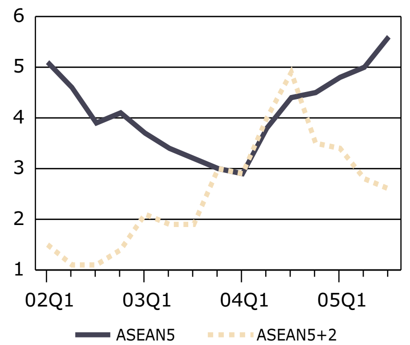
Following the decisive measures of 1 October, the currency regained some lost ground. The $2 billion increase in foreign exchange reserves during October suggests that foreign inflows have resumed. Although world oil prices now seem to have stabilized at a lower level, the events over the past three months underscore the need for the government's vigilance in aligning domestic and international fuel prices to stem the rise in subsidies, which are now expected to reach 3.4% of GDP this year. With annual inflation shooting up to 17.9% in October from 9.1% in September, following the hike in fuel prices, and international interest rates expected to rise further, monetary policy will require additional tightening. Implementation of the government's agenda on regulatory reforms to improve the investment climate for oil and gas exploration and production would also help Indonesia capitalize on its vast resources and restore its status as a significant net oil exporter.

Figure 15: **Real Effective Exchange Rate**[1] (Dec 2004=100)



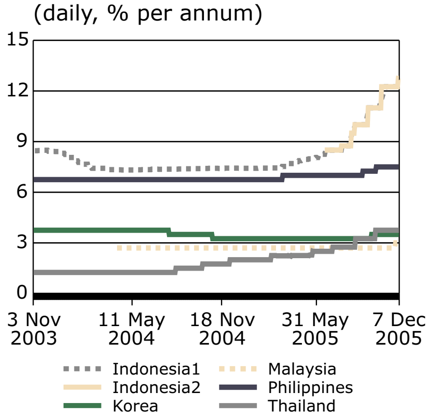
[1]An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: OREI staff calculations.

Figure 16: **Headline Inflation Rates for the Region**[1] (y-o-y, %)



[1]Weighted by gross national income (atlas method, current $).
Source: OREI staff calculations based on ARIC Indicators.

Figure 17: **Policy Rates**[1] (daily, % per annum)



[1]Indonesia1: SBI, 1-month; Indonesia2: Bank Indonesia Rate; Korea: Target Overnight Call Rate; Malaysia: Overnight Policy Rate; Philippines: Overnight Reverse Repurchase Rate; Thailand: 14-day Repo Rate.
Source: Bloomberg.

through October show that the currencies of the PRC, Korea, Malaysia, and the Philippines appreciated in nominal effective terms by 5–7% during 2005. The Thai baht appreciated by 1% during the period, the Singapore dollar changed little, and the Indonesian rupiah depreciated by 3%.

Broadly, and with only a few exceptions, real effective exchange rates showed similar trends to nominal effective exchange rates (Figure 15). The Singapore dollar, however, depreciated by about 5% in real terms, in contrast to the trend in its nominal effective exchange rate, reflecting lower inflation relative to its trading partners.

Monetary and Fiscal Policies

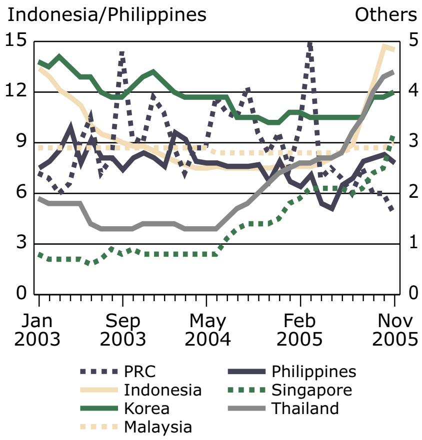
Slower growth, sharp increases in world oil prices, rising US short-term interest rates, the effects of the 2004 tsunami, avian flu, and terrorism created a challenging environment for monetary and fiscal policies this year. Policies have been adopted pragmatically and flexibly taking into account the cyclical state of the economy, the risks of higher inflation posed by higher oil prices, and the budgetary and other costs of subsidies that kept domestic energy prices below world levels. Not surprisingly, the diversity of experiences and shocks faced by the region in 2005 brought different macroeconomic policy responses across countries.

Notwithstanding softer growth in the region, the pace of monetary tightening accelerated in 2005, particularly in the ASEAN5 economies, as inflation tended to increase and currencies weakened against the US dollar (Figure 16). Central banks in four of the ASEAN5 economies raised short-term policy interest rates in 2005, in some instances on several occasions (Figure 17).[4]

In both Singapore and Thailand, the move toward tighter monetary policy that started in 2004 was continued. In Indonesia and the Philippines, policy rates were raised several times during 2005, with November and December increases in Indonesia relatively sharp. Malaysia raised its policy rate by 30 basis points (as well as its interest-rate band) at the beginning of December, against the background of a shift in the balance of risks from growth to inflation and following several months of capital outflows related in part to a widening interest-rate differential in favor of the US. The increase in the policy interest rate was the first monetary tightening since 1998, raising the central bank policy rate to 3%.

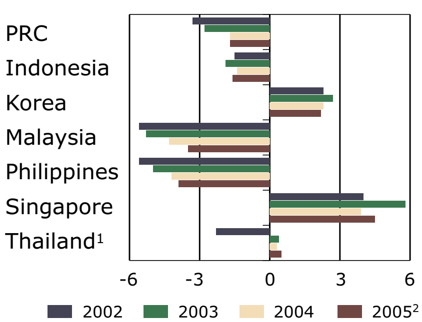
[4]In Singapore, the instrument of monetary policy is the nominal effective exchange rate rather than a policy interest rate.

Figure 18: **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: 3-month certificate of deposit (Bank of Korea); 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 19: **Central Government Fiscal Balance** (% of GDP)



[1]Fiscal year ending September.
[2]2005 are estimates.
Source: IMF, *Asia-Pacific Regional Outlook,* September 2005.

With increases in oil prices and inflation concerns, the Bank of Korea raised its policy rate twice this year in equal installments of 25 basis points, to 3.75%. In the PRC, the tightening bias that was introduced last year to rein in fixed investment growth has been maintained.

Reflecting these monetary policy stances, market determined short-term interest rates have been edging up, especially in Indonesia, Singapore, and Thailand (Figure 18).

To strengthen fiscal positions that deteriorated sharply during the 1997–98 financial crisis, many governments in the region have consolidated their budgets significantly since 2000 (Figure 19). For the most part, fiscal consolidation was pragmatic, with the year-to-year pace of deficit reduction influenced by the business cycle as well as the need to respond to shocks—such as the outbreak of SARS in 2003 and, more recently, the tsunami and avian flu. Notwithstanding the significant progress since 2000, however, fiscal deficits remain high in a number of countries in the region and further consolidation remains a priority in many countries.

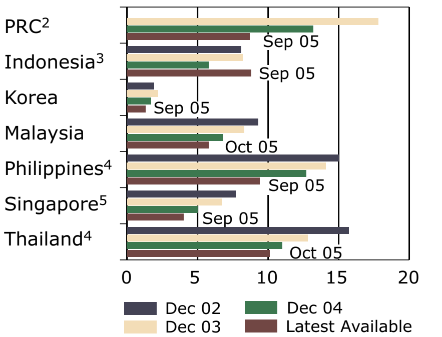
Given slower growth early in the year and the negative effects of oil prices on budgets, 2005 has not made it easy for authorities in several countries in emerging East Asia. Nevertheless, fiscal consolidation has continued in much of the region, with only minor slippages related either to efforts to provide cyclical support as growth eased early in the year or to increased costs of fuel subsidies. In some countries, such as the Philippines, significant progress has been made recently toward addressing deep-seated fiscal vulnerabilities.

Fiscal deficits declined in both Malaysia and the Philippines in 2005, by 0.3% and 0.8% of GDP, respectively, while the surplus in Thailand increased by 0.2% and Singapore's increased 0.6%. Conversely, in Indonesia, where the budget was eroded during much of the year by rising fuel subsidies, the fiscal deficit is estimated to have increased marginally in 2005 (by less than 0.25% of GDP), following a reduction of around 0.5% of GDP in 2004. In the PRC, the deficit as a share of GDP is estimated at 1.7% in both 2004 and 2005, while Korea recorded a modest reduction in its budget surplus as a share of GDP, in part due to the provision of cyclical support.

Financial Restructuring and Prudential Indicators

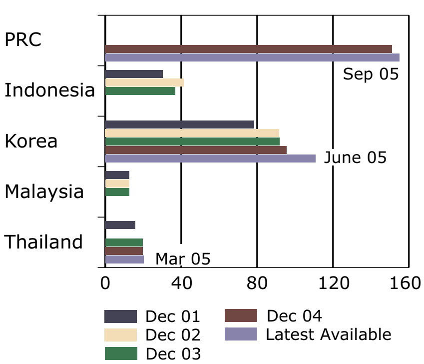
Nonperforming Loans, Capital Adequacy, and Bank Profitability

Figure 20: **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 21: **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).

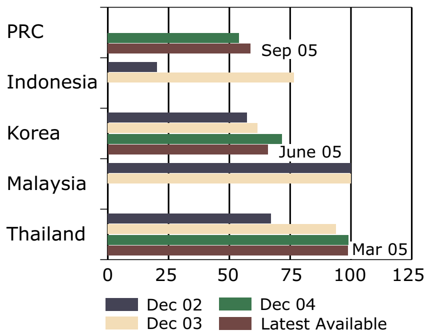
Nonperforming loans (NPLs) as a percentage of total outstanding commercial bank loans continued to fall in many countries in emerging East Asia during 2005, with a particularly sharp decline in the PRC, where the ratio fell from 13.2% in 2004 to 8.7% in September 2005 (Figure 20). The same is true for the Philippines, where the ratio declined from 12.7% to 9.4% over the same period. In Thailand, the ratio declined from 11.0% to 9.9% in October 2005. Korea and Singapore have maintained NPL ratios at low single-digit rates. Only in Indonesia did the NPL ratio rise in 2005 (following a sharp decline in 2004), but the increase largely reflected new and more stringent rules for loan classification. In spite of the significant progress in recent years, NPL ratios remain high in a number of countries.

Declines in banks' NPL ratios reflect both the "work out" of impaired loans—including transferring them to publicly centralized or private bank-owned asset management companies (AMCs) for resolution—as well as improvements in risk management that reduce the proportion of new loans that eventually become impaired. Since the 1997–98 financial crisis, the cumulative transfer of NPLs to public AMCs is $155 billion in the PRC, $111 billion in Korea, $37 billion in Indonesia, $20 billion in Thailand, and $13 billion in Malaysia (Figure 21). During 2005, only the PRC and Korea saw additional small transfers of impaired loans to centralized AMCs. Malaysia and Thailand have largely completed the process. With this progress, most public AMCs in the region have begun to wrap up operations (Figure 22). In the Philippines, where privately-held "special purpose vehicles" have been established, the cumulative NPLs transferred stood at $1 billion in June 2005.

The average capital adequacy ratio (CAR) of commercial banks in the region under Basel I remains well above the international norm of 8%, with both Indonesia and the Philippines reporting ratios in 2005 of 18–19% (Figure 23). As in normally functioning market economies, average CAR ratios declined modestly in Malaysia,[5] Philippines, and Singapore in 2005, as a result of the somewhat-less-favorable economic environment. In the PRC, although the CARs of a number of state banks remain below the 8% international norm, there have recently been significant improvements

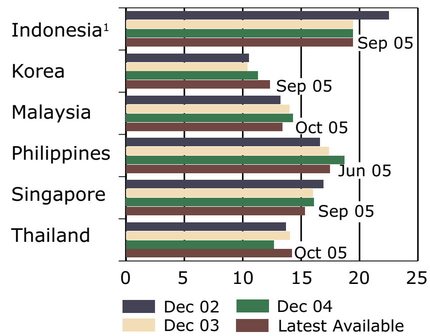
[5]In Malaysia, changes in the way market risk is treated in defining capital adequacy influenced the performance.

Figure 22: **NPLs Resolved by AMCs**[1] (% of NPLs purchased)



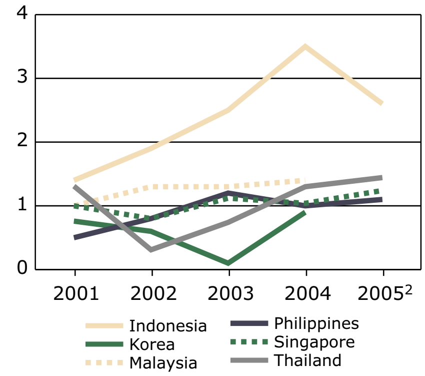
[1]Refers to those held by China Banking Regulatory Commission (PRC), IBRA (Indonesia), KAMCO (Korea), Danaharta (Malaysia), and TAMC (Thailand), as of dates indicated.
Source: ARIC Indicators.

Figure 23: **Capital Adequacy Ratios of Commercial Banks** (%)



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

Figure 24: **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 June for the Philippines and September for others.
Sources: Bank Indonesia; Financial Supervisory Service (Korea), Bank Negara Malaysia, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, and Bank of Thailand.

in capital positions and risk management. Early this year, $15 billion was injected by the authorities into the Industrial and Commercial Bank of China (ICBC), which is the largest bank in China by asset value, while China Construction Bank raised around $8 billion in an initial public offering in October.

During the past several years, many commercial banks in the region have improved or maintained profitability through restructuring programs, addressing impaired assets, and strengthening risk management. The improvements have been particularly marked in Indonesia, Korea, and Thailand (Figure 24). During 2005, profitability was broadly maintained in Thailand, Singapore, and Philippines, but declined in Indonesia as tighter standards were introduced for loan classification.

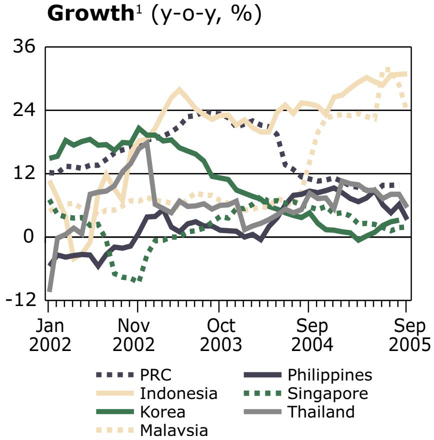
Banking Sector Divestment and Consolidation

Efforts to support and restructure financial systems after the 1997–98 financial crisis left many governments as large shareholders in banks. With significant progress in restructuring banking systems—including divesting state ownership—attention is increasingly turning to broader financial sector reform and development. In several instances,"master plans" for banking sector consolidation and development are being implemented.

There are several key developments:

- In the PRC, banking sector restructuring and reform, in particular the large state-owned banks, remains a priority. During the past year or so, the authorities have injected capital into three of the large state-owned banks, most recently the $15 billion injection into ICBC. At the same time, strategic foreign partners have been found for several banks (for example, Bank of America took about 10% of China Construction Bank to help strengthen its commercial orientation and improve risk management).
- Indonesia introduced a blueprint for the financial system in April 2005 to strengthen the financial system architecture, with an integrated supervisory and regulatory agency to be created for Nonbank Financial Institutions. In early October, the government provided initial capital of Rp4 trillion to create an Indonesian deposit insurance company. Following its establishment, the government intends to gradually phase out the current blanket government deposit guarantee.
- After consolidation of the banking sector into 10 banking groups, the focus in Malaysia has been shifting increasingly toward streamlining business operations and improving operational efficiency. In March 2005, Malaysia prepared a new framework for establishing investment banks, with implementation begun in the second half. In early September, the authorities removed the blanket deposit guarantee system introduced during the 1997–98 financial crisis. The new (partial) deposit insurance scheme covers commercial banks, including Islamic banks, as well as finance companies, and has prescribed coverage limits of RM60,000.
- Banking sector consolidation has continued in the Philippines with transactions in May and July, when the Bank of the Philippine Islands announced its intention to purchase another local bank. Under proposed amendments to the central bank charter, legal protection for bank supervisors and the "prompt corrective action" framework will be strengthened.
- Under the Financial Sector Master Plan, Thailand continues to restructure and consolidate its banking sector, partly in preparation for the new Basel II capital adequacy framework. At the same time, banks can avail of a wider range of instruments for risk management, while supervision is being strengthened to better deal with market risk.

Figure 25: **Nominal Bank Credit Growth**[1] (y-o-y, %)

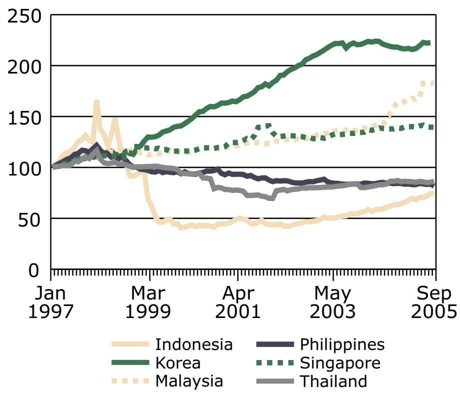


[1]Claims on the private sector: deposit money banks.
Source: OREI staff calculations based on ARIC Indicators.

Bank Lending

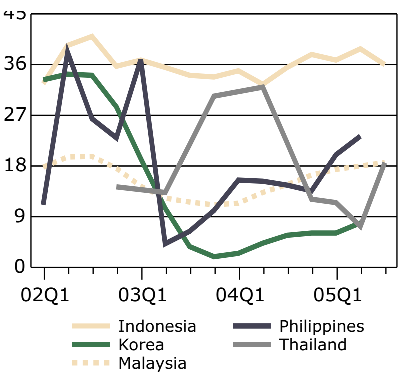
From mid-2004 to mid-2005, nominal bank credit to the private sector continued to grow strongly in Indonesia and rose sharply in Malaysia, with growth rates of 20–30% (Figure 25). Conversely, bank credit growth

Figure 26: **Real Bank Credit**[1] (seasonally adjusted, Jan 1997=100)



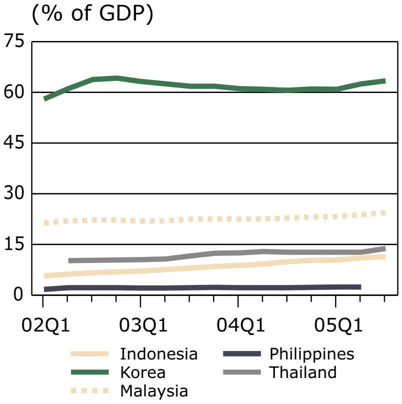
[1]Claims on the private sector: deposit money banks.
Source: OREI staff calculations based on ARIC Indicators.

Figure 27: **Nominal Household Credit Growth** (y-o-y, %)



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

Figure 28: **Household Credit** (% of GDP)



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

hovered in the 3–10% range in September in Philippines, Singapore, and Thailand. Over the past twelve months to September, private credit growth continued to slow in the PRC as a result of measures the authorities took to rein in overinvestment. Reflecting the slowdown in regional growth early this year, nominal credit growth eased or leveled off in Indonesia, Malaysia, Philippines, and Thailand during the first half of 2005, but began to pick up in Korea as the domestic recovery started to gain momentum.

To some extent, differences in nominal credit growth across countries reflect differences in price behavior. Adjusting for these can provide a clearer sense of the real differences and underlying trends. Viewed from this perspective, outstanding real bank credit to the private sector remains weak in much of the region, with Indonesia, Philippines, and Thailand still to regain their pre-financial crisis levels.[6] Conversely, in Malaysia and Singapore real outstanding bank credit has increased significantly since the crisis and, in Korea, it rose dramatically through late 2003 before declining somewhat the following year (Figure 26).

In many countries, the recent growth in bank credit to the private sector has included a significant component of lending to households rather than businesses, helping to finance strong consumption and housing spending in several cases. Household credit retained its strong growth in Indonesia, and started to pick up notably in Korea, Malaysia, Philippines, and Thailand (Figure 27). However, as a percentage of GDP, outstanding household credit is relatively stable at just above 60% in Korea, 24% in Malaysia, 14% in Thailand, 11% in Indonesia, and below 3% in the Philippines (Figure 28).

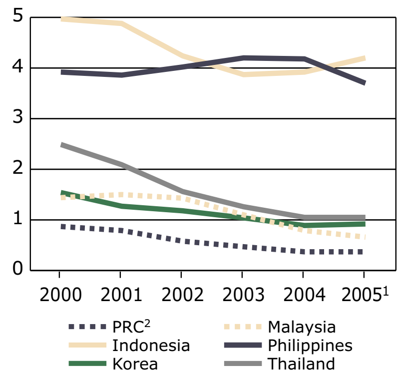
External Vulnerability Indicators

In the period since the 1997–98 financial crisis, countries in the region have significantly reduced external vulnerability through large current account surpluses, the accumulation of significant foreign exchange reserves, as well as reductions in external debt and extension of debt maturity. These reductions in external vulnerability, in turn, have been complemented by reduced internal vulnerability as far-reaching restructuring and reform programs in domestic financial sectors, in particular, have been implemented.

Judging by a number of key ratios, external vulnerability in emerging East Asia has continued to be reduced in recent years, although significant differences remain across countries. Most notably, external debt levels in relation to international reserves have trended down or remained stable

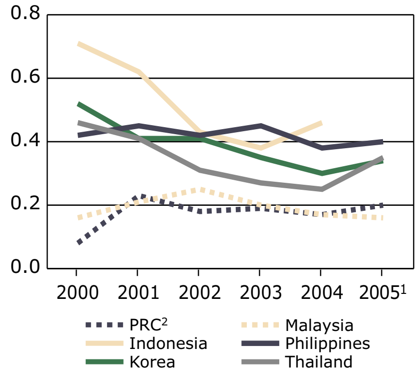
[6]However, as many banks were overextended in early 1997, the precrisis level of real credit should not necessarily be viewed as a target.

Figure 29: **Ratio of Total External Debt to Gross Foreign Exchange Reserves**



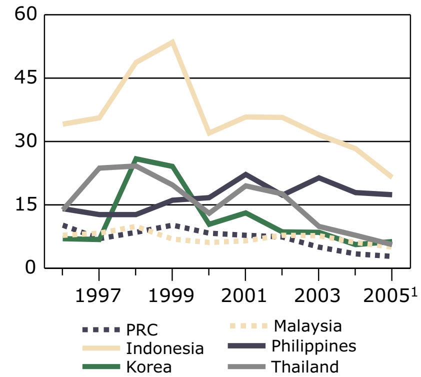
[1]As of September 2005 for Malaysia and Thailand; June 2005 for others.
[2]External debt definition was revised in 2001.
Source: OREI staff calculations based on ARIC Indicators.

Figure 30: **Ratio of Short-term External Debt to Gross Foreign Exchange Reserves**



[1]As of September 2005 for Malaysia and Thailand; June 2005 for others.
[2]External debt definition was revised in 2001.
Source: OREI staff calculations based on ARIC Indicators.

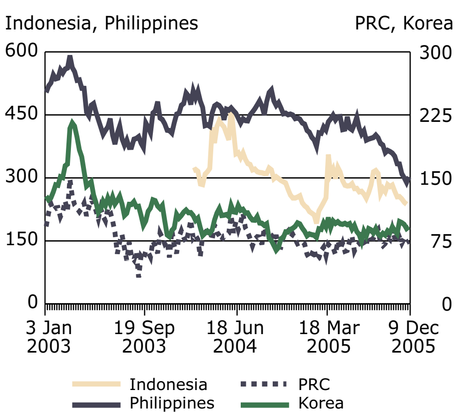
Figure 31: **Total Debt Service** (% of exports of goods, services, and income)



[1]As of November for the Philippines, October for Korea and Thailand, August for PRC, June for Indonesia, and March for Malaysia.
Source: Institute of International Finance.

in most countries in the region, with only a small increase in Indonesia in early 2005 (Figure 29). There remains, however, a considerable dispersion in the ratio of total external debt to foreign exchange reserves in the region, ranging from a ratio of 4.2 in Indonesia and 3.7 in the Philippines, down to around 1.0 or less elsewhere. More uniformly, all countries in the region have significantly reduced the ratio of short-term external debt to reserves to well below 1.0, implying significantly reduced vulnerability to sudden pullbacks of capital flows (Figure 30). Finally, all countries in the region have seen continued declines in external debt service ratios in recent years (Figure 31). The external debt service ratio in early 2005 ranged from less than 10% for most countries in the region to around 22% for Indonesia and 17% for the Philippines.

Figure 32: **$ Sovereign Spreads** (10-year yields against US 10-year benchmark, basis points)



Notes:
1. Spreads for PRC, Korea, and Philippines are based on Bloomberg's Fair Market Curve Indices ($ 10-year yields) against the 10-year US Treasury benchmark yield.
2. For Indonesia, spread is calculated by Bloomberg for Indonesia's sovereign 10-year $ bond to mature on 10 March 2014 with 6.75% coupon.
Source: Bloomberg.

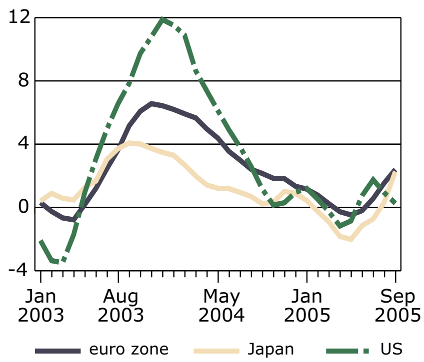
Reflecting lower external vulnerability as well as broader economic reforms, perceptions of sovereign credit risk have improved in much of the region since the financial crisis. Standard & Poors and Fitch raised sovereign credit ratings for both the PRC and Korea this year. Among the ASEAN5 economies, the most recent changes involved a downgrade in the ratings outlook for the Philippines in July from stable to negative by two rating agencies and a change in the ratings outlook for Indonesia from positive to stable, after an upgrade earlier in the year.

In 2005, following a brief period in March of risk aversion among investors to emerging markets, spreads for Philippine and Indonesian US dollar bonds have been decreasing (Figure 32). However, the spread on Indonesia's bond was more volatile, reflecting earlier fiscal concerns stemming from oil price subsidies (Box 1). The sharp reduction of subsidies in October, however, has allayed investors' concerns, as shown in the 4th quarter's declining spreads. Spreads in the PRC and Korea have been relatively stable since 2004, moving within the 50–120 basis points range.

Economic Outlook for 2006, Risks, and Policy Issues

External Economic Environment

Figure 33: **OECD Six-Month Rate of Change of the Trend Restored CLI, Annualized** (% change)

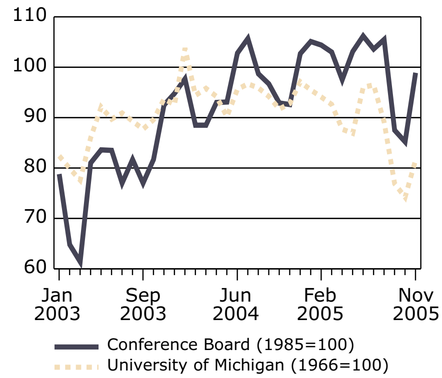


Source: OECD website.

The external economic environment facing emerging East Asia softened somewhat this year. Growth slowed in the US and the euro area while remaining constant in Japan. In the US, GDP growth has slowed from an exceptionally high 4.2% in 2004 to 3.6% forecast for this year. The corresponding growth slowdown in the euro area is from 2.1% in 2004 to a forecast of 1.4% this year. Other factors that hurt the external economic environment include the continued increase in international crude oil prices, increases in US short-term interest rates, and softness in global demand for IT products. Looking ahead to 2006, while several aspects of the external environment are likely to remain unchanged, there are tentative signs that a turnaround in the global demand for IT products is possible. US GDP growth in 2006 is forecast to be slightly lower than this year, while GDP growth in the euro area and Japan is forecast to improve somewhat. The Organisation for Economic Co-operation and Development (OECD) leading indicators also suggest a pickup in growth in the euro area and Japan with more moderate growth in the US (Figure 33). Global GDP growth in 2006 is expected to be about the same as in 2005, at 4.3% using purchasing power parity weights and 3.2% using current exchange rates.

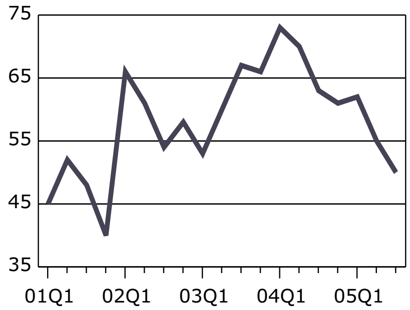
In the first three quarters of this year, US GDP grew by 3.6%. The continued increase in international prices of crude oil and US short-term interest rates had some moderating effects on consumer spending and business investment. Growth in consumer spending and business investment is estimated to have slowed as a result: the former from about 4% in 2004 to 3.5% this year and the latter from about 9.4% to less than 8.6%. The two hurricanes in September also had some negative impact on consumer and business sentiment, although consumer confidence bounced back (Figures 34 and 35) and business activity shows signs of stabilizing (Figure 36). Labor market conditions remain stable, and stock markets resumed their climb following a correction in October (Figures 37, 38, and 39).

Figure 34: **US Consumer Confidence Index**



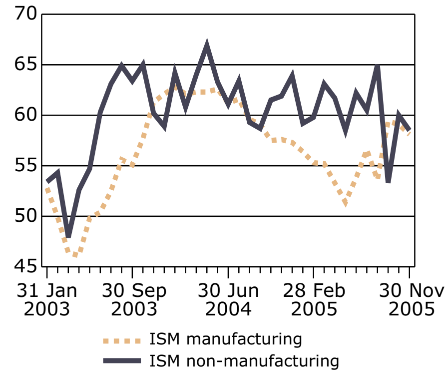
Note: Conference Board numbers are released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

Figure 35: **US Business Confidence Index** (Conference Board)



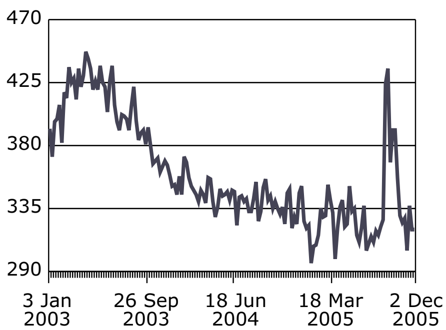
Source: Bloomberg.

Figure 36: **Surveys of US Business Activity**



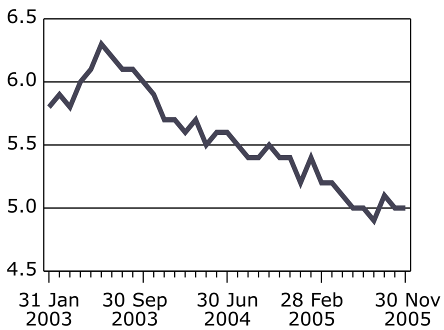
Source: Bloomberg.

Figure 37: **US Initial Jobless Claims** (weekly, '000s)



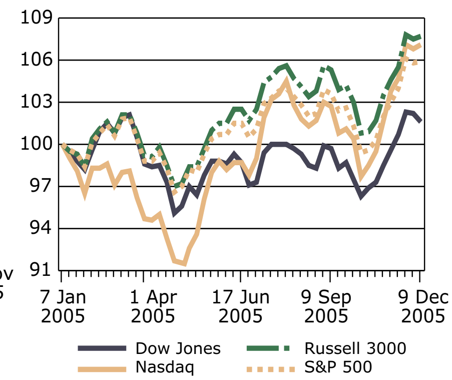
Source: Bloomberg.

Figure 38: **US Unemployment Rate** (%)



Source: Bloomberg.

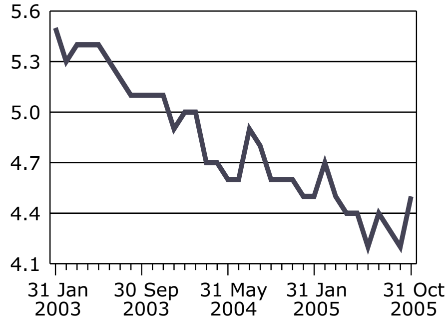
Figure 39: **US Stock Market Indexes** (weekly average, 7 Jan 2005=100)



Source: OREI staff calculations derived from Bloomberg.

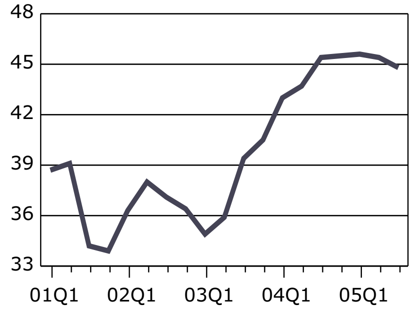
However, although US core inflation continues to be about 2%, headline inflation was above 4% for two consecutive months in September and October this year. It is possible that in the months ahead, as the effect of higher oil prices percolate down to other sectors of the economy, core inflation could gradually increase. Against this background, it is expected that monetary policy will continue to be tightened. Although long-term interest rates have not been very responsive to the US Federal Reserve (US Fed) tightening monetary policy for some time now, sooner or later long-term rates are likely to edge up in response to increases in short-term interest rates. There are some signs that this is slowly happening. Since mid-2005, US mortgage rates have edged up by 75 basis points across the

Figure 40: **Japan Unemployment Rate, Seasonally Adjusted** (%)



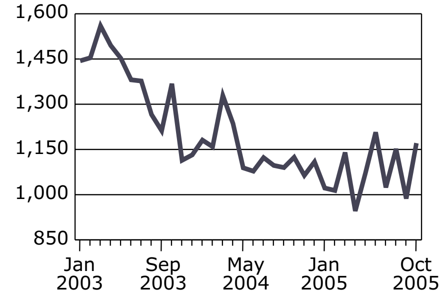
Source: Bloomberg.

Figure 41: **Japan Consumer Confidence** (y-o-y, %)



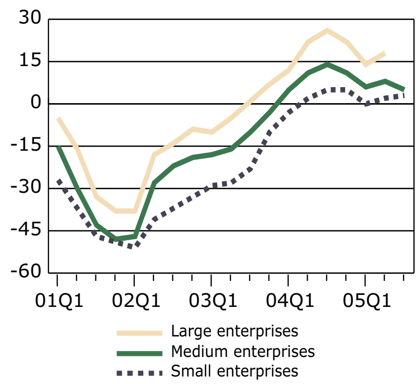
Source: Bloomberg.

Figure 42: **Japan Bankruptcy Cases**[1]



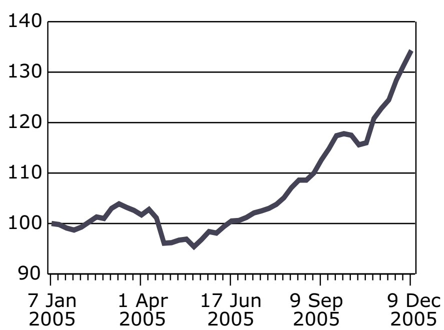
Note: End of month.
[1]Companies with total debts of ¥10 million or more.
Source: Bloomberg.

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



Source: Bloomberg.

Figure 44: **Nikkei 225** (weekly average, 7 Jan 2005=100)

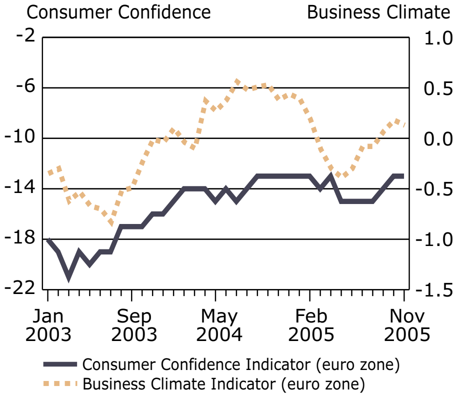


Source: OREI staff calculations derived from Bloomberg data.

term structure. As US long-term interest rates increase, investment—both residential and business—could soften further. The current forecast is for a GDP growth of 3.4% in 2006, marginally lower than the 3.6% forecast for this year as a whole. However, this forecast is subject to downside risks, such as the possible bursting of the real-estate bubble and a disorderly adjustment of the country's unsustainable current account deficit.

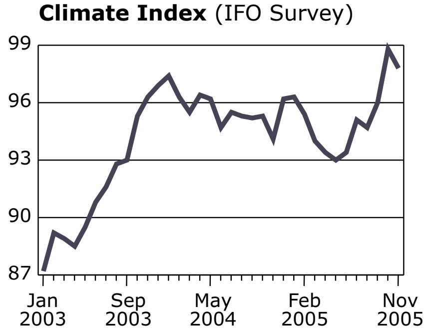
In the third quarter of this year, Japan's GDP growth accelerated to 3.0%, resulting in average GDP growth of 2.3% for the first three quarters. Over the past year, private domestic demand has been the main engine of growth, with little contribution from net exports. Growth in 2005 is likely to average 2.3%, the same as in 2004. Recent trends suggest that the economy will continue to expand at a healthy pace. The prospects for private consumption are encouraging with the steady rise in employment income, which was up more than 2% in the second and third quarters, the fastest rate of growth since the IT boom in 1999–2000. The increase reflects growth in both employment and real wages. The unemployment rate continued its downward trend from 5.5% in January 2003 to 4.5% in October 2005 (Figure 40). Consumer confidence remains high (Figure 41). Growth in private capital spending is also likely to be sustained as the post-bubble restructuring appears to be bearing fruit. Corporate bankruptcy cases have continued their declining trend, corporate profitability is buoyant, and corporate cash flow is at record levels (Figure 42). The latest Tankan survey shows optimism on business investment (Figure 43). In addition, exports, which slowed since the second half of last year, should benefit from the prospects for an upturn in global IT demand. Reflecting this positive outlook, the Nikkei stock index rose by 34% between May and early December (Figure 44). Given these positive developments, GDP growth in 2006 is expected to be about 2.6%, slightly higher than this year.

Figure 45: **Euro Area 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.

A combination of weaker export growth and subdued domestic demand continued to hold back euro area GDP growth to about 1.4% in the first three quarters of this year, below the 1.8% in the second half of 2004. At that time, there were tentative signs of an economic expansion in the euro area. But more recent data show that growth has faltered again, on the back of somewhat weaker exports and, more importantly, subdued domestic demand. Full-year growth for 2005 is likely to be about 1.3%. Looking ahead, the continued weakness in consumer spending is a key constraint on the euro area economy. With the region's inflation now above the European Central Bank's (ECB) target of 2%, and several countries already breaching the fiscal deficit limits set out in the Stability and Growth Pact, the euro area does not have many macroeconomic policy levers left to spur aggregate demand and growth. The ECB has already increased the interest rate in response to gradually climbing inflation. However, there are a few positive signals emerging. First, the region's business climate index, after declining for about seven consecutive months up to May 2005, has slowly increased since (Figure 45). Second, the German business climate index, after declining for months, generally edged up since May of this year (Figure 46). Third, the OECD leading indicator for economic activity has increased since May, following a slide of more than one and a half years. Although the September 2005 election results in Germany have raised fresh concerns on the possible course of economic policy, trends in economic indicators suggest some improvement in the region's economic growth in the coming months. The current forecast is for GDP to grow 1.9% in 2006.

Regional Economic Outlook for 2006

Although several components of the external environment are expected to remain more or less unchanged, a number of emerging trends both externally and regionally bode well for emerging East Asia's growth prospects in 2006. These include the possible turnaround in the global IT demand, signs of a sustained recovery in Japan, and continued strong, albeit slower, growth in the PRC. With a turnaround in global IT demand, the region's exports should get a boost. In the PRC, GDP growth is still forecast to be a shade below 9%, driven by continued strong growth in private consumption and a slowing, but still robust, investment growth. The PRC's imports for October 2005 suggest accelerating growth after being somewhat subdued in earlier months of the year. With the PRC a major trading partner for many countries in emerging East Asia, increasing PRC imports should provide additional impetus for these economies. Third quarter GDP growth in much of emerging East Asia was higher than the previous quarter and better than expected.

Combined GDP of emerging East Asia is now forecast to grow by 7.2% in 2006, slightly higher than the estimated 7.1% figure for this year and

0.2 percentage point higher than the September 2005 forecast (Table 1). Excluding the PRC, emerging East Asia is forecast to grow by 5.3% in 2006, higher than the estimated 4.6% for this year and 0.3 percentage point higher than the September 2005 forecast. ASEAN is forecast to grow by 5.6% in 2006, about half a percentage point higher than the estimated figure for this year and 0.2 percentage point higher than the September 2005 forecast.

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

							Dec 05 Forecast		Sep 05 ADO Update Forecast		Postcrisis Average
	1999	2000	2001	2002	2003	2004	2005	2006	2005	2006	1999-2004
Brunei Darussalam	2.6	2.8	3.0	2.8	3.2	1.7	3.6	. . .	. . .	. . .	2.7
Cambodia	12.6	8.4	5.5	5.2	7.1	7.7	6.3	6.1	6.3	6.1	7.7
PRC	7.2	7.9	7.3	8.1	9.4	9.5	9.3	8.9	9.2	8.8	8.2
Indonesia[1]	0.8	4.9	3.8	4.4	4.9	5.1	5.5	5.9	5.7	5.9	4.0
Korea	9.5	8.5	3.8	7.0	3.1	4.6	4.0	5.0	3.6	4.6	6.1
Lao PDR	7.3	5.8	5.8	5.8	5.8	6.9	7.2	8.0	7.2	8.0	6.2
Malaysia	6.1	8.9	0.3	4.4	5.4	7.1	5.1	5.3	5.1	5.3	5.4
Myanmar[2]	10.9	13.7	11.3	12.0	13.8	12.6	. . .	. . .	. . .	. . .	. . .
Philippines	3.4	6.0	1.8	4.3	4.6	6.0	4.7	4.8	4.7	4.8	4.4
Singapore	6.8	9.6	-2.0	3.2	1.4	8.4	5.2	6.0	4.0	4.7	4.6
Thailand	4.4	4.8	2.2	5.3	7.0	6.2	4.5	5.0	4.0	5.0	5.0
Viet Nam	4.8	6.8	6.9	7.1	7.3	7.7	7.6	7.6	7.6	7.6	6.8
Emerging East Asia[3,4]	6.9	7.9	5.2	6.9	6.9	7.6	7.1	7.2	6.9	7.0	6.9
Emerging East Asia exc PRC[3,4]	6.6	7.5	2.8	5.7	4.1	5.5	4.6	5.3	4.3	5.0	5.4
ASEAN[3,4]	4.1	6.5	1.9	4.6	5.1	6.4	5.2	5.6	5.0	5.4	4.7
ASEAN5+2[3]	6.9	7.7	5.2	7.0	7.0	7.7	7.1	7.2	6.9	7.0	6.9
ASEAN5[3]	4.1	6.6	1.6	4.4	4.8	6.4	5.0	5.4	4.8	5.2	4.6
Japan	-0.2	2.9	0.4	0.1	1.8	2.3	2.3	2.6	. . .	. . .	1.2
US	4.5	3.7	0.8	1.6	2.7	4.2	3.6	3.4	. . .	. . .	2.9
Euro area	2.9	3.7	1.9	0.9	0.7	2.1	1.4	1.9	. . .	. . .	2.0

. . . = not available
[1]GDP growth rates from 1997–2000 are based on 1993 prices, while growth rates from 2001 onward are based on 2000 prices.
[2]For FY April–March.
[3]Aggregates are weighted according to gross national income levels (atlas method, current dollars) from the World Bank's *World Development Indicators.*
[4]Excludes Myanmar and Brunei Darussalam for all years since weights based on gross national income (atlas method, current dollars) are unavailable for these countries.
Sources: ADB forecasts except for US and euro zone (Consensus Economics Inc., *Consensus Economics Forecasts,* December 2005) and Brunei Darussalam (*Brunei Economic Bulletin*, March 2005).

Risks and Policy Issues

The economic outlook outlined above is subject to four major risks: (i) disorderly adjustment of the growing global payments imbalance, (ii) a sharp upturn in global interest rates, (iii) further increases in international oil prices, and (iv) a possible avian flu pandemic.

The US current account deficit has widened further, yet the US dollar has appreciated against most major currencies, thus postponing the much-needed adjustment of the global payments imbalance. In 2004, the US current account deficit was 5% of GDP. Recent estimates suggest that in the first three quarters of 2005, the current account deficit rose to over 6% of GDP. In the meantime, the US dollar appreciated against most major currencies, partly because of the larger US interest rate differential with other major countries and partly because of the continued growth differential across major industrial countries. Since the beginning of this year, the dollar has appreciated by about 18% against the yen and about 13% against the euro. Hence, the movement in the US dollar exchange rate has been in the opposite direction to what is required for a gradual adjustment of the global payments imbalance. Coupled with the continued increase in the US current account deficit, this has raised fresh concerns about the possibility of a disorderly adjustment of the global payments imbalance.

An increase in US long-term interest rates, which has been delayed in the current cyclical upturn of the economy, poses another risk to the region's growth prospects. Despite the significant tightening of monetary policy by the US Fed and substantial increase in short-term interest rates in the past year or so, US long-term interest rates have hardly changed and continue to remain at historically low levels—a "bond market conundrum."[7] Low long-term interest rates have provided impetus to the US real-estate market. This has pushed up asset prices and household wealth, which in turn have kept consumer spending buoyant. It is unlikely that the bond market conundrum will last indefinitely. Sooner or later, long-term interest rates will have to move up in response to the continued increase in short-term interest rates. Part of the reason for the low long rates is subdued inflationary expectations based on low core inflation. If core inflation were to go up, which cannot be ruled out once the effect of higher oil prices is transmitted to other sectors of the economy, long-term interest rates could move up, perhaps more sharply than expected. That could prick the current US housing bubble which could then adversely affect consumer spending—a key driver of US growth in recent years. US economic growth and the US dollar could fall as a result, causing instability in the global economy and international financial markets.

Following significant run-ups and volatility in world oil prices earlier this year, spot and futures oil prices fell below $60 a barrel (bbl) as demand pressures and short-run concerns about supply disruptions eased. Nevertheless, futures prices indicate that oil prices are expected to remain at an elevated level for an extended period, while the market is thought likely to remain tight and vulnerable to further volatility. Oil prices are projected at $55–60/bbl in 2006. While the impact of the persistent rise

[7] *The Conundrums of Global Bond Markets—An Asian Perspective.* Speech by ADB President Haruhiko Kuroda at the Global Bond Summit, November 2005.

in the international oil price on growth in most countries of emerging East Asia has so far been moderate, further increases could reduce growth significantly. ADB staff calculations using an econometric model show that if the average crude price rises to $70/bbl in 2006 and remains at that level, compared with a baseline price of $53/bbl, GDP growth in many ASEAN economies would be significantly lower.[8] The effect of such an increase in crude prices would be to shave 2006 GDP growth by 1.8 percentage points for Thailand, 1.4 percentage points for Philippines, 1.3 percentage points for Singapore, 1.1 percentage points each for Malaysia and Indonesia, and 1 percentage point for the PRC. Even net oil exporting countries would be expected to suffer a loss from higher oil prices, reflecting the secondary impact of an economic slowdown on trading partners.

The possibility of an avian flu pandemic is the fourth key risk to emerging East Asia's growth. The overall economic impact of avian flu has thus far been small, although it has been significant within the poultry sector of some affected countries. If the avian flu were to escalate into a pandemic, however, the human and economic effects would likely be significant. Although any estimate of the economic impact of a pandemic is highly speculative, an ADB study shows that if the outbreak were to last for two quarters, GDP growth in the region in 2006 could be reduced by a total of 2.4 percentage points.[9] However, if the effects were to last for four quarters, GDP growth would be reduced by 6.5 percentage points (Box 2).

Against the backdrop of this economic outlook and associated risks, greater exchange rate flexibility may prove more effective in meeting the twin challenges of sustaining growth and containing inflation than fiscal and monetary policies.

The scope for using fiscal policy to spur domestic demand and growth—a route that many affected countries took in the postcrisis years—appears to be limited in most major countries in emerging East Asia. If anything, many still need significant fiscal consolidation. Countries that have some scope for fiscal easing, if needed, are Korea, Singapore, and Thailand. Korea runs a fiscal surplus equivalent to about 2% of GDP, and although its general government debt increased sharply in recent years from less than 8% of GDP in 1996, it remains about 30% of GDP. Singapore runs a sizable fiscal surplus of over 4% of GDP with only a small public debt. However, the economy's high degree of openness to trade significantly reduces the impact of fiscal stimulus on growth, and thus constrains the

[8]Asian Development Bank. September 2005. *Asian Development Outlook Update.*

[9]Bloom, Erik, Vincent de Wit, and Mary Jane Carangal-San Jose. 2005. *Potential Economic Impact of an Avian Flu Pandemic on Asia.* ERD Policy Brief No. 42, Asian Development Bank.

Box 2: **Assessing the Impact of Avian Flu**

The risk of an avian influenza (avian flu) pandemic has increased over the past year. The transmission of the avian flu virus is still largely limited to poultry and wild birds, but recent trends have led experts at the World Health Organization (WHO) to believe that "the world is now closer to another flu pandemic than at any time since 1968, when the last of the previous century's three pandemics occurred."[10] In East Asia, the number of human cases and fatalities from the virus has increased since December 2004, the period categorized by WHO as the third wave (Table B2.1). Human cases and deaths have now been confirmed in Cambodia, PRC, Indonesia, Thailand, and Viet Nam. Outbreaks of avian flu in poultry and migratory birds have also been reported in Kazakhstan, Mongolia, and Russia, and were confirmed in Croatia, Romania, and Turkey in recent months.

The economic impact of avian flu on the region has thus far been small, although it has been significant within the livestock sector of some affected countries. One estimate puts the direct cost to the livestock sectors in Cambodia, Thailand, and Viet Nam at $560 million, or 0.3% of 2004 gross domestic product (GDP) of these countries.[11] If avian flu were to escalate into a pandemic, however, the human and economic effects in East Asia would likely be significant, depending on the severity and duration.

The World Bank estimates that country programs to control the current avian flu outbreak and prepare for a possible human pandemic could reach a total of $0.75–1 billion over the next three years. However, this does not include vaccine development. While WHO has put the cost of urgent needs to prepare for a pandemic, such as improving vital surveillance systems, strengthening early warning systems, and building communications capacity at around $20 million, the development of anti-viral vaccines and bolstering production could reach $500 million over the next three to four years. Taking into account all these costs, the total amount needed for pandemic preparedness, including containing the current avian flu outbreak, may reach $1.5 billion.

The economic impact of a pandemic would be transmitted through several channels. On the demand side (i) consumption would be adversely affected by the uncertainty about the severity and duration of the disease and as consumers minimize contact with others for fear of infection; (ii) tourism would likely suffer; and (iii) investment would be negatively affected by the decline in overall demand, increased risks, and postponement of business-related travel by potential investors. Apart from these demand-side effects, a flu pandemic would also likely have a significant supply-side impact. In addition to a fall in livestock production, workplace absenteeism could increase because of sickness and the labor force may decline if the pandemic leads to a large number of deaths. Considering the openness of East Asian economies, the indirect repercussion of the pandemic through its effect on global trade and investment could also be significant.

The Severe Acute Respiratory Syndrome (SARS) outbreak in 2003 provides some indication of the ways in

Table B2.1: **Cumulative Number of Confirmed Human Cases of Avian Influenza A/(H5N1) Reported to WHO, as of 7 December 2005**

	Date of Onset			
	Dec 03–Mar 04	Jul 04–Oct 04	Dec 04 to date	Total
Indonesia				
Cases	0	0	13	13
Deaths	0	0	8	8
Fatality (%)	0	0	62	62
Viet Nam				
Cases	23	4	66	93
Deaths	16	4	22	42
Fatality (%)	70	100	33	45
Thailand				
Cases	12	5	4	21
Deaths	8	4	1	13
Fatality (%)	67	80	25	62
Cambodia				
Cases	0	0	4	4
Deaths	0	0	4	4
Fatality (%)			100	100
PRC				
Cases	0	0	4	4
Deaths	0	0	2	2
Fatality (%)			50	50
Total				
Cases	35	9	91	135
Deaths	24	8	37	69
Fatality (%)	69	89	41	51

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

Continued next page

[10]World Health Organization. 2005. *Current WHO phase of pandemic alert.* Available: http://www.who.int/csr/disease/avian_influenza/phase/en/index.html, downloaded 10 December 2005.

[11]R. McLeod. 2005. *The Socio-Economic Impact of Emerging Infectious Diseases in Asia, with a Focus on the Greater Mekong Sub-region*. Asian Development Bank mimeo.

Box 2 *(Cont'd)*

which a possible flu pandemic might affect East Asia. It is estimated that the SARS outbreak cost East Asia about $18 billion, or about 0.6% of regional GDP.[12] However, SARS was a relatively mild phenomenon, with a fatality ratio of 7% in East Asia and 10% globally. The much higher fatality ratio for the avian flu up to the present suggests that the effects of a flu pandemic could be significantly larger.

Any assessment of the likely economic impact of a possible flu pandemic is bound to be highly speculative because it could vary dramatically depending on severity and duration. However, a recent study by ADB[13] provides some tentative estimates of the effects under two scenarios. In both scenarios, the pandemic is assumed to cost the lives of 3 million people in the region. For purposes of comparison, the flu pandemics in 1957–58 and in 1968–69 are estimated to have killed 1–3 million each globally, while the 1918 "Spanish flu" is estimated to have cost the lives of 50–100 million. In the first scenario, the key assumption is that the pandemic has a serious demand effect for two quarters, reducing consumption (by 3%) and trade in services, followed by more moderate effects for the subsequent six quarters. The effects are limited to emerging East Asia only. In the second scenario, the serious impact lasts for four quarters, followed by another four quarters of more moderate effects. In this scenario, the region is also subject to indirect effects as the rest of the world reduces its consumption.

Table B2.2: **Estimated Effect of Avian Flu on Annual GDP Growth, 2006** (percentage points)

Economies	2006 ADO Baseline Forecast	Scenario 1	Scenario 2
Cambodia	6.1	-4.9	-9.5
PRC	8.8	-1.7	-5.3
Indonesia	5.9	-0.7	-2.8
Korea	4.6	-1.8	-6.3
Lao PDR	8.0	-4.9	-9.5
Malaysia	5.3	-7.3	-11.3
Philippines	4.8	-1.3	-3.0
Singapore	4.7	-10.8	-22.8
Thailand	5.0	-6.6	-11.7
Viet Nam	7.6	-1.7	-5.3
Total	**7.1**	**-2.4**	**-6.5**

Sources: Eric Bloom et al, Potential Economic Impact of an Avian Flu Pandemic on Asia, *ADB/ERD Policy Brief No. 42,* November 2005.

The estimated effects under the two scenarios are listed in Table B2.2. Under the first scenario, the average growth of the 10 countries of emerging East Asia covered in the Table would be reduced by an estimated 2.4 percentage points in 2006. Under the second scenario, the estimated effect is much larger, with a reduction of 2006 growth by 6.5 percentage points. These figures suggest that, under the second scenario, growth in the region could stall. Economies that are more open to trade in goods and services are affected the most. The longer-term effects on the region are also likely to be significant as potential growth could be reduced by the damage to human and physical capital.

Considering the risk from avian flu and its potentially severe human and economic impact, governments should take a number of measures to prevent and mitigate the risk of a pandemic. First, efforts to eradicate the disease at source with surveillance and control mechanisms should be strengthened. Second, timely and accurate information on the incidence and spread of avian flu is necessary to reduce uncertainties and irrational fear among the public. The experience during SARS suggests that, in the absence of such information, people tend to panic and avoid economic activities that involve face-to-face interaction, leading to a sharp downturn in economic performance. Third, as the prevention of a pandemic is both a regional and global public good, cooperation and coordination among government, international agencies, and the private sector would help affected countries, which may lack the resources and skills to control the spread of avian flu.

[12]Asian Development Bank. 2003. *Asian Development Outlook Update.*

[13]Erik Bloom, Vincent de Wit, and Mary Jane Carangal-San Jose. 2005. *Potential Economic Impact of an Avian Flu Pandemic on Asia.* ERD Policy Brief No. 42, Asian Development Bank. We would like to thank Erik Bloom for providing estimates for Cambodia, Lao PDR, and Viet Nam.

effectiveness of fiscal policy as a tool to stimulate domestic demand. Like Korea, Thailand's public debt has increased significantly in the postcrisis years, but it is still moderate. Moreover, after running fiscal deficits for many years since the crisis, Thailand now runs a small fiscal surplus. Most other major economies in the region require fiscal consolidation to varying degrees. The need is perhaps greatest in the Philippines, where the fiscal deficit remains about 4% of GDP and public debt is about 100% of GDP. The expansion of the value-added tax, which is expected to yield additional revenue of about 2% of GDP over a year, is a welcome step toward continued fiscal consolidation.

The pickup in inflation in several countries in emerging East Asia, the possibility of a further increase in crude oil prices, and the expected increase in US interest rates do not give much scope for easing monetary policy either. Indeed, monetary policies in many of these countries need continued tightening. Among the major economies in the region, one exception is Singapore, where inflation remains below 1%. In the PRC, inflation fell to around 1% in September from more than 5% a year ago, but given the need to rein in fixed investment, there is no scope for monetary easing.

There is, however, scope for using greater exchange rate flexibility for containing inflation and at the same time rebalancing sources of growth away from exports to domestic demand. It is encouraging that the PRC has made the initial move toward greater flexibility to its exchange rate regime by ending the yuan peg to the US dollar and moving to a managed float with reference to a basket of currencies. Malaysia followed suit with a similar shift in its exchange rate regime. To the extent that other countries in the region, in the face of the yuan peg to the dollar, have been constrained from letting their currencies appreciate for fear of losing export competitiveness, the new measures by the PRC and Malaysia could foster greater exchange rate flexibility in the region. However, the yuan-dollar exchange rate has not varied much since the one-time revaluation of the yuan by 2.1% on 21 July. Building on the 21 July policy shift by the PRC and Malaysia, greater flexibility of these currencies vis-à-vis the US dollar is needed in practice in the months ahead (Box 3).

Greater exchange rate flexibility in emerging East Asia would also assist the region to contribute to the resolution of the global payments imbalance. Emerging East Asia, especially PRC, Korea, and Singapore, have accumulated large foreign exchange reserves. A portion of these reserves is held to meet normal transactions and for precautionary purposes. However, a significant portion—mostly invested in US Treasuries—has been built up in an attempt to stem the pressure on exchange rates to appreciate. This has prevented regional currencies from appreciating against the US

Box 3: **East Asia and the Global Payments Imbalance**

Recent data show that the United States (US) current account deficit is now running above 6% of gross domestic product (GDP). Forecasts of the US current account deficit for both this year and the next have been revised upwards in recent months. However, despite the upward revision of the forecasts for the US current account deficit, the US dollar has appreciated against most major currencies, thus postponing the much needed adjustment of the global payments imbalance. Since the beginning of 2005, the dollar has appreciated by about 18% against the yen and 15% against the euro. Hence the movement in the US dollar exchange rate has been in the opposite direction to what is required for a gradual adjustment of the global payments imbalance. This has raised fresh concerns about the possibility of a disorderly adjustment of the global payments imbalance in the future, especially in view of the fact that recent estimates have suggested 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 (in real effective terms) by anywhere from 8% to 18% (depending on the various parameter values).[14] This implies that to reduce the US current account deficit to the 1997 level of 1–2% of GDP, the dollar would have to depreciate by anywhere from 30% to 75%. It is becoming clear that, the longer the delay in bringing about the adjustment, the greater would be the eventual dollar depreciation, and the more chaotic the adjustment process will be.

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. Clearly, one country or one region acting alone cannot resolve the 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 former crisis countries in East Asia and greater exchange rate flexibility in emerging East Asia.

Accompanying the sharp worsening of the US current account balance since 1997, there has been a substantial increase in the current account surpluses of East Asian economies (Figures B3.1–B3.3). East Asia accounted for about 41% of $707 billion total US trade deficit in 2004. Coupled with capital inflows, an increase in East Asia's current account surplus has led to a large buildup of foreign exchange reserves in the region (Figure B3.4). By September 2005, East Asia's official foreign exchange reserves reached $2.1 trillion, sharply up from about $500 billion in 1997. This accumulation has been particularly sharp since the beginning of 2002, and particularly rapid in the PRC, and until 2004, in Japan (Figure B3.5).

The 1997-2004 period also saw a significant decline in investment rates (investment to GDP ratios) among former crisis-affected countries in

Continued next page

Figure B3.1: **Current Account Balances—US and East Asia** (% of GDP)

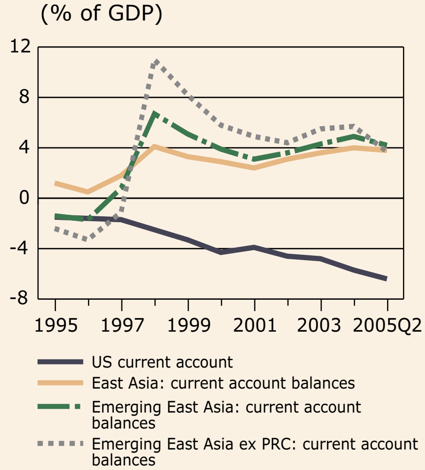


Figure B3.2: **US Trade Balance and East AsiaTrade Balances with US** (% of GDP)

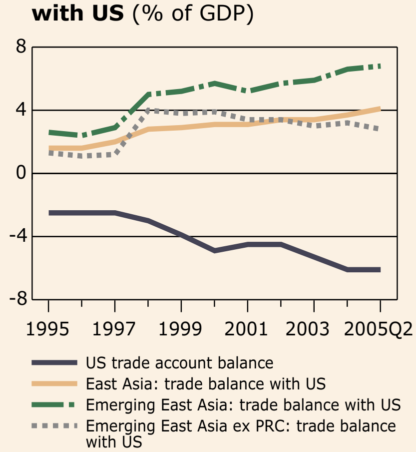
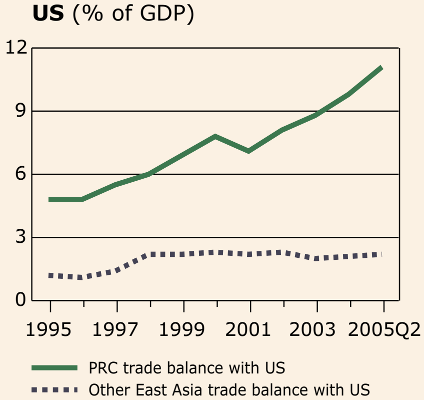


Figure B3.3: **PRC and Other East Asia Trade Balance with US** (% of GDP)

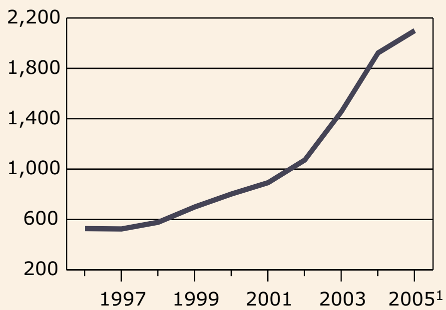


Note: East Asia is defined as emerging East Asia plus Japan.
Sources: Datastream and World Bank, *World Development Indicators.*

[14]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.

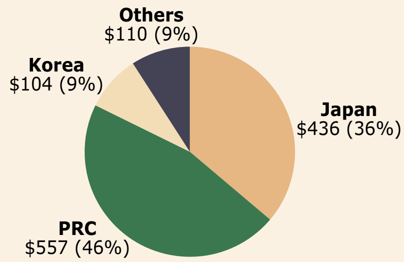
Box 3 *(Cont'd)*

Figure B3.4: **Gross International Reserves Less Gold—East Asia** (end of period, $ billion)



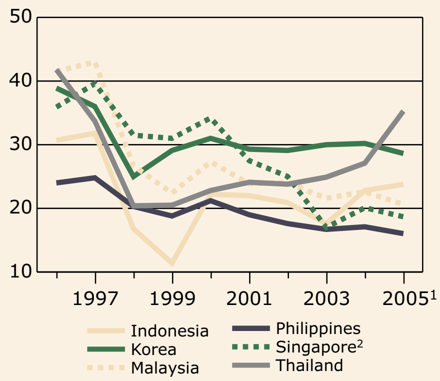
[1]Data as of September 2005.
Sources: International Monetary Fund, *International Financial Statistics Online* and CEIC.

Figure B3.5: **Accumulated Foreign Exchange Reserves—East Asia** (between 2001 and 2005,[1] $ billion)



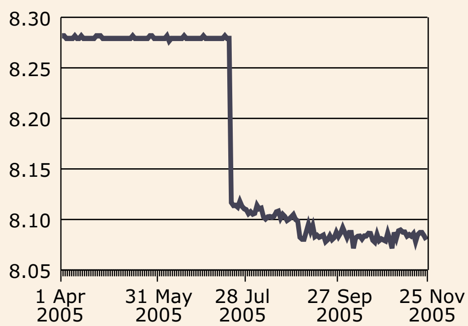
[1]Data as of September 2005.
Sources: International Monetary Fund, *International Financial Statistics Online* and CEIC.

Figure B3.6: **Gross Domestic Investment/GDP at Current Prices** (%)



[1]Data as of 2005Q2.
[2]Data used are in constant prices.
Source: OREI staff calculations based on ARIC Indicators and CEIC.

Figure B3.7: **Actual Yuan Exchange Rate Against US Dollar** (daily figures, yuan/$)



Source: Datastream.

emerging East Asia. In many of these countries, investment rates collapsed in the aftermath of the 1997–98 Asian financial 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. Although investment rates have picked up in recent years, they remain well below the precrisis levels (Figure B3.6).

From a regional perspective, East Asia needs to address both the issues of large reserve accumulation—and the possible consequence in terms of exchange rate adjustment—and the revival of investment if it is to contribute to the orderly resolution of the global current account imbalance. At the same time, if exchange rate adjustment is achieved while maintaining relatively stable intra-regional exchange rates, the adjustment costs to the individual economies would be minimized. This requires a collective approach to exchange rate management, i.e., East Asia must collectively adjust the exchange rates vis-à-vis the dollar.

Working towards greater exchange rate flexibility in East Asia

The PRC's exchange rate policy has critical implications for emerging East Asia's exchange rate management. The 21 July shift from a de facto US dollar peg to a managed floating exchange rate regime against a basket of currencies is a welcome initial step toward greater flexibility in the country's exchange rate policy. After the policy shift announcement, there were expectations that, unlike in the old regime, the yuan-dollar exchange rate would fluctuate more widely. However, it has moved very little from the 21 July value of 8.11 yuan per dollar (Figure B3.7). If the current slow pace of yuan appreciation persists, it would take about four years for a 10% appreciation and more than seven years to reach a 20% appreciation.

Building on the 21 July policy shift, the PRC needs to adopt greater exchange rate flexibility. There is merit in loosening the yuan's tight link to the US dollar as it would foster greater exchange rate flexibility in Asia as a whole and provide a greater opportunity for future collective appreciation vis-à-vis the US dollar. PRC's move toward a more flexibly managed basket currency system in July this year is thus potentially very significant in "unlocking" the process of exchange rate adjustment in the region. At this point, the PRC needs to make much more use of additional flexibility to allow for a meaningful appreciation in terms of the US dollar. Based on the appreciation of the yuan, other emerging economies in the region could move together toward more flexibly and collectively appreciate vis-à-vis the US dollar.

By explicitly taking into account the increased interdependencies in the region, this collective approach has the potential to lay the groundwork for a more formal system of exchange rate policy coordination over time. In the meantime, the needed appreciation of emerging East

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Box 3 *(Cont'd)*

Asian currencies against the US dollar could be achieved without an undue and potentially damaging increase in intra-regional exchange rate variability. This, in turn, could contribute to the resolution of the current global payments imbalance with smaller adjustment costs to the regional economies. This is subject, of course, to the US, Japan, and Europe also taking appropriate measures.

Reviving private investment in former crisis-affected countries

It is encouraging to see robust growth in fixed investment in several countries in emerging East Asia in the past several years. As one of the causes of the crisis was the excessively rapid increase in investment in the precrisis years—the so-called investment bubble—investment rates should not, and are not expected to, recover to precrisis levels. However, a significant increase in investment rates from the current levels would be desirable for sustaining high economic growth in the region, because there are still large unexploited investment opportunities with high social and/or private rates of return. There is, therefore, a need to improve the investment climate in these countries.

Improving the investment climate requires efforts on many fronts, but perhaps most crucial is strengthening financial sectors and addressing corporate sector vulnerabilities. Several emerging East Asian economies have made significant progress in addressing the weaknesses in their financial sectors, especially in banking systems. But, these economies still need to reduce their heavy corporate sector reliance on bank finance. Because the banking systems are still in the process of reform after the 1997–98 financial crisis, the ability to resume lending has been limited except in Korea and Malaysia. In such an environment, the large surplus savings of emerging East Asian economies simply find their way into international capital markets, despite the large scale investment needs in the region. Effective mechanisms to channel regional savings into regional investments are thus needed. Developing efficient capital markets—especially bond markets—is a promising way to achieve this, at least in the medium term. In addition to private investment, public sector-led infrastructure investment needs to be stimulated, given the large infrastructure needs in the region.

dollar and delayed the adjustment of the global payments imbalance. Allowing greater exchange rate flexibility would lessen the need for foreign exchange reserve accumulation by central banks and thus help contribute to an orderly resolution of the imbalance.

A well-structured energy policy is another key requirement for the region to build resilience to current as well as future oil price increases. It is encouraging that several countries have responded to the surge in oil prices by reducing domestic subsidies on oil and oil products, thus bringing domestic prices more in line with international prices. This has helped contain the fiscal cost of the oil price increase. Countries have also tightened monetary policy when domestic oil price increases have caused inflation to rise. These are appropriate policy responses, especially as high oil prices have persisted for longer than initially expected. However, viewed long term, a more comprehensive set of policies to achieve energy security is required. This will involve policies that both manage long-term demand and continuously augment supplies of traditional as well as newer sources of energy. The key to managing long-term demand is to increase energy efficiency, which requires fostering competitive energy markets and market mechanisms. Following a period of historically low international oil prices, countries had less incentive to either increase energy efficiency or to augment supplies through increased investment in oil exploration and refining. Investment in the energy sector should be stepped up, complementing several countries' efforts to maintain strategic oil reserves to guard against a sudden supply disruption.

Given the risk of an avian flu pandemic, there is merit in implementing measures to both prevent and manage the virus. Preventive measures could include eradicating the disease at source with surveillance and control mechanisms, and disseminating accurate information on the nature and incidence of the disease. Managing the outbreak would require building a sufficient hospital inventory of vaccines and medicine against the disease. As avian flu containment is a regional/global public good, regional and international cooperation in preventing as well as managing the disease is critical. Moreover, as the containment of an epidemic involves substantial costs, countries need to consider alternative ways of funding containment.

Other policy responses that the region needs to consider include measures to revive private investment in the countries most affected by the Asian financial crisis. In several of the former crisis-affected countries, investment rates collapsed and have yet to recover significantly. Of course, as one of the causes of the 1997–98 crisis was the investment boom in the precrisis years, investment rates are not expected to quickly rise to precrisis levels. However, there is scope to assist an investment recovery in these countries. This requires improving the investment climate by maintaining macroeconomic stability, strengthening the banking sector, expediting completion of corporate restructuring, improving corporate governance, and developing Asian bond markets.

Individual Country Outlook

- **Brunei Darussalam**. High oil prices are expected to boost GDP growth to 3.6% in 2005, following a slowdown to 1.7% in 2004, when oil production was hampered by the repair and upgrading of facilities. Inflation remains modest at 1.5%. Reflecting high oil prices, the trade balance continued to post a significant surplus during the first quarter of 2005, but the surplus is expected to have narrowed in later months with a surge in imports. The government plans to decrease economic dependency on the energy sector, and aims to make Brunei Darussalam a regional hub for services. Plans include the development of transport and communication industries. Effective implementation of these reforms should help diversify the economy away from its heavy dependence on energy.

- **Cambodia**. GDP growth is likely to have slowed to 6.3% this year from 7.7% in 2004. The economy is forecast to expand by 6.1% in 2006. Contrary to expectations at the beginning of this year, garment exports, which account for 72% of total exports, have proven to be resilient after the abolition of the Agreement on Textiles and Clothing. Higher oil prices have put pressure on inflation and the current account. Inflation rose to 6.4% in the third quarter from an average of 3.9% in 2004. With slower export growth and higher oil imports, the current account deficit is estimated to have widened to about 11% of GDP this year from 10% in 2004. International reserves have grown to $950 million, about 3.5 months of imports, partly reflecting foreign direct investment inflows. With the fiscal deficit estimated to rise somewhat this year, the government is attempting to expand the revenue base through the introduction of new taxes and improved tax and customs administration. Over the medium term, further efforts to promote private-sector development should include structural, legal, and civil service reforms that could improve the overall investment climate.

- **PRC.** Notwithstanding the authorities' efforts to slow the economy and rein in over-investment, the economy remained strong during the first three quarters of this year and the rate of fixed investment growth remains high. At the same time, as the PRC's current account surplus has increased sharply, the drivers of growth have shifted at the margin from domestic demand to net exports. Reflecting an easing of food prices, headline inflation fell during 2005 and concerns about inflation that surfaced in 2004 eased. Looking forward, growth in the PRC is expected to slow in 2006 but to remain high at a shade below 9%. As food prices stabilize, it is possible that headline inflation will increase somewhat in 2006. Against this background, it is appropriate that fiscal policy has been moderately restrictive in recent years to support the ongoing tightening of monetary policy. Given international concerns about the significant recent increase in the PRC's current account surplus, an important issue in 2006 will be whether continued restraints on domestic demand lead to a further widening of the surplus. The decision to move toward a more flexibly managed exchange rate regime will provide the authorities with an additional instrument to help achieve macroeconomic policy objectives and enhance the effectiveness of monetary policy.

- **Indonesia.** Following continued relatively rapid growth during the first half of the year, growth moderated in the third quarter while investment, which had been growing strongly, weakened somewhat and consumption continued to ease. Reflecting increases in oil prices, in particular, headline inflation rose sharply in October and November and the policy interest rate was raised sharply. As a result of these developments, growth is expected to be somewhat weaker in 2005 than earlier expected. The outlook for 2006, however, remains favorable, provided the recent financial market volatility does not adversely affect confidence and spending. GDP growth in 2006 is expected to reach almost 6%, following growth of 5.5% this year, with important contributions from exports and investment. A supportive external environment and measures to boost infrastructure investment should sustain growth in 2006. In the near term, the key monetary policy challenge is to prevent the recent sharp increase in headline inflation feeding into core inflation, which will likely require further increases in short-term interest rates. Further fiscal consolidation and implementation of the government's agenda on regulatory reforms to improve the investment climate is necessary to sustain growth over the medium term.

- **Korea.** Following earlier weakness, growth in Korea has started to pick up with the recovery being led by strong exports, including IT products, and a gradual recovery in private consumption. Despite low and softening headline inflation as a result of an easing of food prices, monetary policy was recently tightened modestly as an appropriate pre-emptive move. An important issue is the extent to which the recovery broadens and domestic demand revives. Given continued weaknesses in the small and medium enterprise sector, a significant strengthening in domestic demand may take some time to become self-sustaining. GDP is expected to grow by 4% this year and by 5% in 2006. Both monetary and fiscal policies continue to be supportive of the recovery and the recent modest raising of short-term interest rates leaves monetary policy still accommodative.

- **Lao PDR.** GDP growth is expected to accelerate to 7.2% this year from 6.9% in 2004. Growth in 2006 is forecast to reach 8%, reflecting an expansion of gold and copper mining, a strong tourism sector, and the Nam Theun 2 hydropower project. Macroeconomic discipline has generally improved over the past few years, as reflected in the fall in the inflation rate from 15.5% in 2003 to 6.6% in August 2005, in spite of higher prices for rice and fuel. Fiscal policy requires further improvement. Weak revenue collection remains a major factor contributing to the deficit, which is expected to expand in 2006 due to a loss of customs revenues as tariffs are reduced in line with the ASEAN Free Trade Area commitments. However, the government has pledged the introduction of a single value-added tax rate in 2007, which should help fiscal consolidation. The result of banking reforms initiated by the government has been below expectations thus far, although bank lending to state-owned enterprises has declined significantly.

The financial health of state commercial banks has strengthened only marginally as nonperforming loans remain high.

- **Malaysia.** With the recent pickup in growth, and inflation edging up this year, the balance of risks has been shifting and the central bank's decision to raise short-term interest rates in December was timely. Further increases in rates may be necessary to limit pass-through effects and would be consistent with the strengthening cyclical expansion. With the exchange rate system changed to permit more flexibility, the effectiveness of monetary policy can be enhanced. Even though the recovery is relatively broad-based, private investment remains weak as a share of GDP, underscoring the importance of the structural reforms to improve the investment climate. The government has appropriately continued the process of fiscal consolidation. Further reduction of fuel subsidies, which for this year will total an estimated RM6.6 billion, or about 1.4% of GDP, would increase efficiency and mitigate fiscal risks from higher world oil prices. In the financial sector, while the health of the banking system has improved, real-estate lending requires close monitoring as signs of excess supply in the residential property markets are emerging.

- **Myanmar.** Official estimates put GDP growth at 12.6% in 2004. The oil and gas sectors will likely remain the main engine of growth, as high international prices for energy draw more investment into these sectors. Inflation seems to have increased since the second half of last year, partly reflecting a lifting of the ban on rice exports that was imposed in the first half of 2004. This suggests a need for tighter monetary policy. Economic sanctions have restrained growth prospects. The slow pace of reforms also prevents the country from availing the benefits of regional growth.

- **Philippines.** Against the background of a challenging year, the economy again demonstrated resilience. Growth in the first half of 2005 slowed to 4.7% from 6% in 2004, and is estimated to remain at 4.7% for the full year. Higher fuel prices, the slowing exports due to the weakness in the global IT market, and the El Niño-induced drought contributed to the slowdown. Private consumption continued to grow, albeit more slowly, supported by overseas worker remittances, but fixed investment declined. Although a pickup in the IT sector should support growth, the forecast for 2006 is for GDP growth of 4.8%, partly reflecting lackluster investment arising from policy uncertainties. Significant challenges remain, including inflation, which remains high, and the implementation of fiscal and financial sector reform. Ensuring medium-term fiscal sustainability continues to be the main policy challenge. The government is on track to meet its budget deficit target for this year largely due to expenditure compression in the first three quarters. The implementation of the expanded value added tax, which is expected to raise substantial revenues, is encouraging for medium-term fiscal sustainability. The government could complement the measures to raise revenues with efforts to rationalize fiscal spending. Power sector reform should also be given high priority.

- **Singapore.** Reflecting its high degree of openness and sensitivity to shocks, growth in the Singapore economy has been volatile in the past few years. After slowing sharply early in 2005, the economy bounced back as the global recovery regained traction and the IT sector rebounded, but with limited spillovers to domestic demand. The latest estimate for this year's GDP growth is 5.2%. The expected strengthening of global IT demand should push up GDP growth to about 6% in 2006. The main risks to the economic outlook are higher oil prices, the spread of avian flu, and a sharp adjustment to global imbalances. However, Singapore has scope for loosening monetary as well as fiscal policy, if necessary, considering the low rate of inflation, large foreign exchange reserves, and strong fiscal position. The main challenges in Singapore are structural in nature and relate to the ongoing transformation of the economy in the face of an increasingly globalized world economy, and to respond to the challenges and opportunities posed by rapid growth in the PRC and India.

- **Thailand.** Following significant weakness early in 2005, the economy has begun to revive. GDP growth is likely to average 4.5% this year and is forecast to pick up to 5% in 2006, reflecting improved export prospects, increased agricultural production, the government's program to boost investment in infrastructure, and a recovery in tourism. Monetary policy has moved gradually and in a pre-emptive fashion to deal with inflationary pressures. With GDP growth expected to increase in 2006 and world oil prices assumed to remain high, a further rise in interest rates may be necessary. The authorities have appropriately pursued fiscal consolidation over the past few years in a flexible manner, and it will be important to ensure that the relatively large infrastructure program over the next few years remains consistent with this consolidation. The main risk to the outlook is the trend in world oil prices and a resurgence of avian flu. The increase in household debt in an environment of rising interest rates is another potential risk to the financial system as the resolution of distressed assets has yet to be completed.

- **Viet Nam.** GDP growth in 2006 is forecast at 7.6%, the same as the expected rate this year. The sustained pace of growth above 7% since 2003 reflects an improved business environment and a robust export performance. Inflation moderated from 10.3% in October 2004, but remains high, reflecting the rise in world prices of imported inputs along with reduced food supply due to a drought and avian flu. This suggests a need for a restrictive monetary policy. The government raised $750 million from the first-ever issue of dollar-denominated sovereign bonds in October. The progress made in trade and investment reforms suggests that Viet Nam will likely join the World Trade Organization in 2006, upon conclusion of bilateral trade negotiations with the US. The government's recent approval to "equitize" the Bank of Foreign Trade of Vietnam (Vietcombank) is encouraging, but reforms of state-owned enterprises and state-owned commercial banks in general are proceeding at a relatively slower pace.

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