

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

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## Highlights

### Recent Economic Performance

- Economic growth in emerging East Asia remained strong in the second half of 2007, in many cases performing better-than-expected—supported by healthy growth in consumption, investment, and continued solid exports.
- Inflationary pressures have been increasing across the region over the past several months, with headline inflation reaching multi-year highs in several economies on higher food and energy prices.
- Current account surpluses continued to grow, and with capital inflows remaining strong through the first 9 months of 2007, balance of payments positions strengthened across much of the region.
- Currency appreciation against the US dollar gained momentum throughout much of 2007, with exchange rates up nearly 5% on average since the beginning of the year.
- Monetary policies across the region have become more cautious since the July global financial turbulence—given the increased volatility of the region's financial markets, inflationary pressures, and the uncertain outlook for major industrialized economies.
- Despite limited spillover into emerging East Asia from the US subprime turmoil, there are several signs of financial vulnerability related to sharp gains in equity and real estate prices.

### Outlook, Risks, and Policy Issues

- The external environment for emerging East Asian economies is expected to weaken somewhat in 2008, as economic growth in industrial countries moderates, oil and commodity prices remain elevated, and global financial markets continue to exhibit heightened volatility.
- With the external environment weakening somewhat—and the PRC, the region's largest economy, expected to soften next year—aggregate GDP growth in emerging East Asia is forecast to slow to 8.0% in 2008 from a likely 8.5% this year.
- The region's economic outlook is subject to greater downside risks now than just a few months ago—including the possibility of a US hard landing, further tightening of global credit, an abrupt adjustment in exchange rates, and a continued rise in oil and commodity prices.

## Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AEM	Asia Economic Monitor
ASEAN	Association of Southeast Asian Nations
ASEAN-4	Indonesia, Malaysia, Philippines, Thailand
BIS	Bank for International Settlements
CLI	composite leading indicator
CPI	consumer price index
ECB	European Central Bank
EU	European Union
FDI	foreign direct investment
Fed	Federal Reserve
G3	Group of Three
GDP	gross domestic product
H1	first half
H2	second half
HKMA	Hong Kong Monetary Authority
IMF	International Monetary Fund
IT	information technology
JCI	Jakarta Composite Index
KLCI	Kuala Lumpur Composite Index
KOSPI	Korean Stock Price Index
Lao PDR	Lao People's Democratic Republic
M2	broad money
MSCI	Morgan Stanley Capital International Inc.
m-o-m	month on month
NEER	nominal effective exchange rate
NIE	newly industrialized economy
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OREI	Office of Regional Economic Integration
PCOMP	Philippine Composite Index
PRC	People's Republic of China
Q1	first quarter
Q2	second quarter
q-o-q	quarter on quarter
RMB	renminbi
ROA	return on assets
ROE	return on equity
ROPOA	real and other properties owned and acquired
ROW	rest of world
S&P	Standard & Poor's
SET	Stock Exchange of Thailand
STI	Straits Times Index
TWSE	Taiwan Stock Exchange Index
UK	United Kingdom
US	United States
y-o-y	year on year
WTO	World Trade Organization

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

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- Given specific domestic conditions facing the region's economies, monetary authorities will need great care in designing policy responses to the changing external environment:
  - in economies that use greater exchange rate control, increasing currency flexibility could add useful monetary leverage; and
  - East Asian economies may wish to explore ways to better maintain stability among intraregional exchange rates.
- Other policy priorities may focus on (i) managing the consequences of rapidly increasing capital inflows, (ii) improving the investment climate to strengthen domestic demand, (iii) continuing to develop efficient and deeper financial markets, and (iv) promoting energy efficiency and conservation.

## Can Emerging East Asia Weather Global Financial Instability?

- Despite strong resilience to the weakening external environment, vulnerabilities in the region's financial systems should not be underestimated, as resurgent capital inflows and excess liquidity may complicate a true assessment of risk.
- The region's largely bank-dominated financial systems—with weak systemic support for effective risk management—leave doors open to potential spillovers if conditions in global financial markets worsen or investor sentiment shifts.
- Recent trends in the global financial system—notably the growing presence of nonbank financial institutions and proliferation of new instruments for risk transfer—will also become increasingly relevant in the regional context.
- Greater financial linkages with global markets increases the region's exposure to risks arising from global financial instability.
- Similarly, strong trade ties to major industrialized countries suggest that the risk to the region might be greater if growth in those economies slows sharply.
- Monetary policy anchored on inflation targeting, a prudent fiscal approach, and greater exchange rate flexibility could limit any spillover of continued global financial instability.
- Policymakers will need to concentrate on enhancing risk management systems, strengthening disclosure requirements, and upgrading supervisory frameworks to better assess potential vulnerabilities.
- Economies with less-developed financial systems may not face immediate financial transmission from the subprime turmoil, but nonetheless could focus on longer-term development issues such as institution building, financial sector reforms, and capital market development.