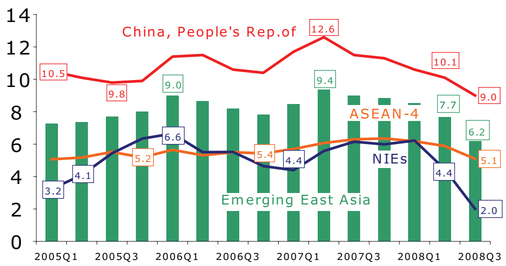
Emerging East Asia—A Regional Economic Update

Recent Economic Performance

Growth and Inflation

Economic growth in emerging East Asia continued to slow in the second half of 2008, as the global financial crisis deepened and economic activity started to contract in major industrial countries.

Figure 1: Regional GDP Growth[1]—Emerging East Asia[2]



[1]Weighted by gross national income (atlas method, current $).
[2]Includes ASEAN-4, NIEs, and People's Republic of China. Aggregates do not include Brunei Darussalam, Cambodia, Lao People's Democratic Republic, Myanmar, and Viet Nam, for which quarterly GDP data are not available.

Source: OREI staff calculations based on national sources.

In the second half of 2008, economic growth in emerging East Asia continued to decelerate. Combined gross domestic product (GDP) in the nine largest economies in emerging East Asia[1] grew 6.2% (year-on-year)[2] in the third quarter of 2008—excluding the People's Republic of China (PRC), the aggregate growth slipped to 3.0%, down from the peak of 6.2% in the third quarter of 2007 **(Figure 1)**. In the PRC, GDP growth was 9.0% in the third quarter, the lowest since mid-2003—when the impact of severe acute respiratory syndrome hit. The four middle-income economies of the Association of Southeast Asian Nations (ASEAN-4)[3] grew 5.1%, compared with 6.0% in the first half. GDP growth in the four newly-industrialized economies (NIEs)[4] decelerated markedly to 2.0% in the third quarter from 5.3% in the first half of 2008. Early economic indicators for the region in the fourth quarter already show the widening impact of recession among the G3,[5] along with effects from the financial turmoil that engulfed global markets from mid-September.

The resilience of domestic demand is being tested, with a visible slowdown in the NIEs, although private consumption held up relatively well in the PRC and ASEAN-4.

In emerging East Asia, excluding the PRC, domestic demand grew 4.3% in the first three quarters of 2008 from 4.6% in 2007. Although the demand component is not available for the

[1] The nine largest emerging East Asian economies are People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand.

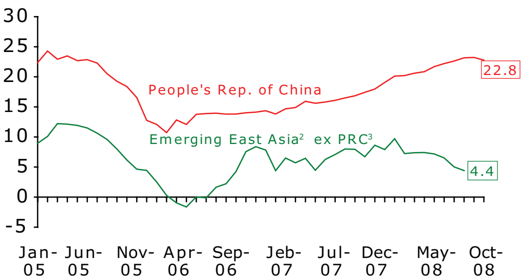
[2] Unless otherwise noted, all figures are year-on-year.

[3] Indonesia, Malaysia, Philippines, and Thailand.

[4] Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.

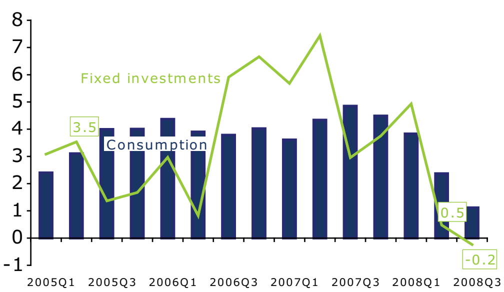
[5] United States, eurozone, and Japan.

Figure 2: Retail Sales Growth[1] (y-o-y, %)



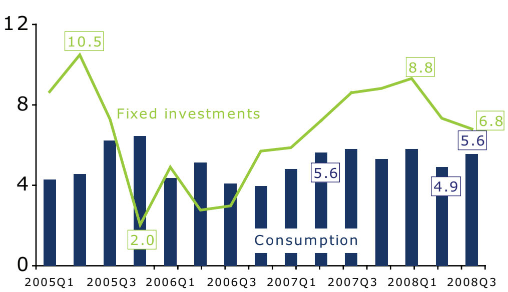
[1]3-month moving average.
[2]Refers to Hong Kong, China; Indonesia; Singapore; Taipei,China; Thailand, and Viet Nam; does not include Brunei Darussalam, Cambodia, Lao People's Democratic Republic, Malaysia, Myanmar, Republic of Korea, and Philippines, for which monthly data are not available.
[3]PRC = People's Republic of China

Figure 3: Domestic Demand Growth—NIEs (y-o-y, %)



Source: OREI staff calculations based on CEIC data.

Figure 4: Domestic Demand Growth—ASEAN-4 (y-o-y, %)



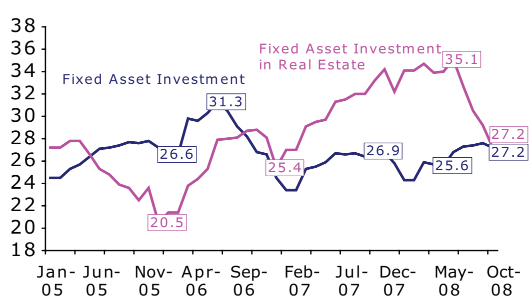
Source: OREI staff calculations based on CEIC data.

PRC, resilient growth in retail sales suggests continued strength in private consumption **(Figure 2)**. But, growth momentum in retail sales has weakened significantly elsewhere, reflecting a slowdown in private consumption. The slowdown in domestic demand growth is most visible in the NIEs, with fixed investment contracting in the third quarter from a year ago **(Figure 3)**. Among the ASEAN-4, investment is also cooling rather fast while consumption has held up relatively well **(Figure 4)**. For the year to date, the region's external sector still contributed positively to overall expansion despite recession among the G3 countries.

PRC economic growth slowed to 9.0% in the third quarter of 2008 from 11.5% in same quarter of 2007, and the pace of deceleration is quickening on falling investment and export growth.

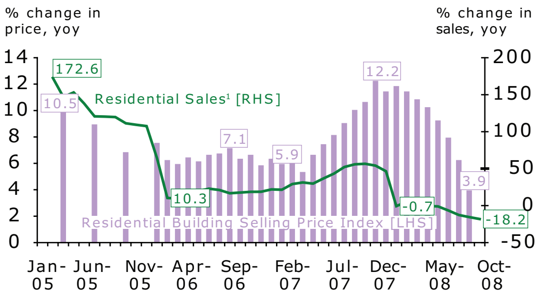
GDP growth has been slowing for five consecutive quarters—falling to 9.0% in the third quarter of 2008—mainly due to the effects of policy tightening from 2007 to end-June 2008, and the global downturn. While real investment and export growth fell, consumption remained buoyant. In the first 10 months, fixed-asset investment in nominal terms grew 27.2% from the same period in 2007, marginally higher than 26.9% in the first 10 months of 2007 **(Figure 5)**. However, with prices of capital goods rising much faster, investment growth in real terms will be lower in 2008 than in 2007. Similarly, exports in the first 10 months were up 22% this year (down from the 26.5% gain in 2007); but export growth in real terms is expected to be even lower in 2008 given higher export prices during the year. As the trade surplus in nominal US dollar terms in the first three quarters was slighter than that in the same period of 2007, net

Figure 5: Fixed Asset Investment—People's Republic of China
(nominal, year-to-date, y-o-y growth)



Source: OREI Staff Calculations based on CEIC data.

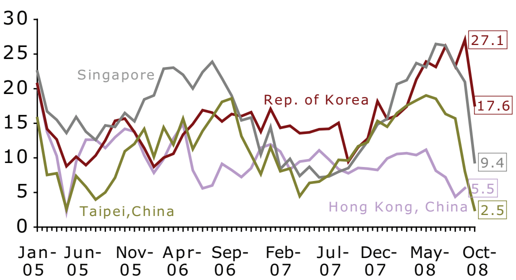
Figure 6: Residential Building Sales & Selling Price Index—PRC (y-o-y, %)



[1]Current value of sales; data for the month of January is not available.

Source: OREI staff calculations based on data from Datastream.

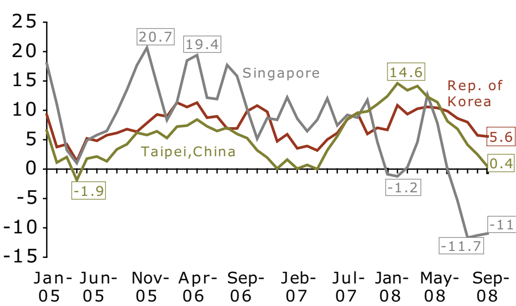
Figure 7: Merchandise Export Growth[1]—NIEs ($ value, y-o-y, %)



[1]3-month moving average.

Source: OREI staff calculations based on CEIC data.

Figure 8: Industrial Production Growth[1]—NIEs (y-o-y, %)



[1] 3-month moving average.

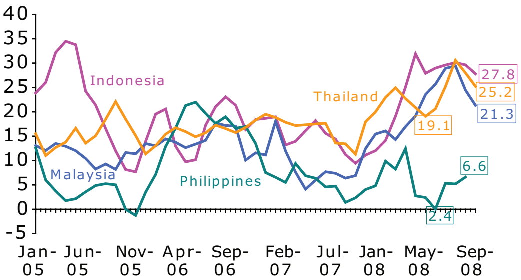
Source: OREI staff calculations based on CEIC data.

exports must have made no, if not negative, contribution to GDP growth in the third quarter of 2008. Net exports contributed 2.3 percentage points to GDP growth of 11.9% in 2007. Consumer spending apparently grew steadily in 2008, with growth in retail sales on an upward trend—reaching 22.8% in October. The housing sector, however, continued to cool, with property sales down sharply in recent months and property prices falling **(Figure 6)**. As a result, property investment—about a fifth of total fixed-asset investment—will likely continue to impact economic activity.

GDP growth in the NIEs decelerated markedly in 2008, with Singapore and Taipei,China already contracting in the third quarter, due to weakening exports, and as domestic demand slipped, particularly as asset prices plunged alongside big losses in the major global markets.

As global economic conditions worsened, NIEs export growth has decelerated sharply **(Figure 7).** Yet domestic demand has weakened even faster, dragged down by plunging asset prices in recent months. With slowing external and domestic demand, industrial production weakened sharply **(Figure 8)**. Korea's economic growth slid to 3.8% year-on-year in the third quarter as expansion in exports decelerated and household spending remained sluggish. Industrial production has been contracting in recent months, with increasing spillover on employment; jobs growth slowed in October to the weakest pace since 2005. On a quarter-on-quarter basis, Hong Kong, China; and Singapore have already experienced two consecutive quarters of contraction, from April through September. On a year-on-year comparison, Hong Kong, China's GDP grew 1.7% in the third quarter as private consumption stalled, despite positive contribution from business equipment investment and net exports. Singapore's GDP fell 0.6% year-on-year in the third quarter of 2008 with contraction largely coming from the manufacturing sector due to falling external demand. And in Taipei,China, the fall in domestic demand saw the economy contract 1.0% year-on-year in the third quarter. Private consumption and fixed investment were down 2% and 11%, respectively; net exports contributed 0.85 percentage points to GDP growth due to imports falling much faster than exports.

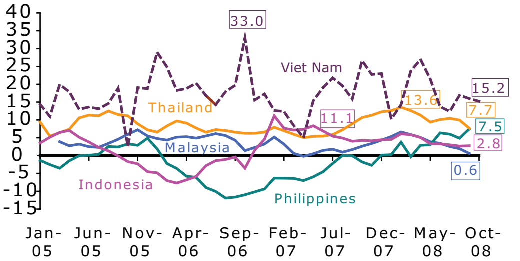
Figure 9: Merchandise Export Growth[1]—ASEAN-4 ($ value, y-o-y, %)



[1]3-month moving average.

Source: OREI staff calculations based on CEIC data.

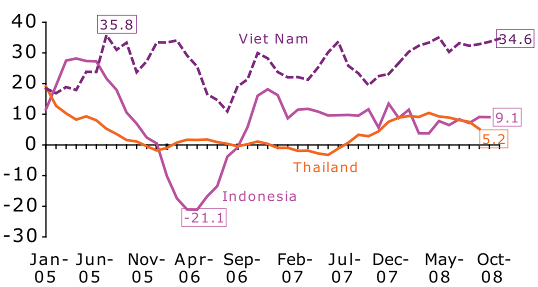
Figure 10: Industrial Production Growth[1]—ASEAN-4, Viet Nam (y-o-y, %)



[1]3-month moving average.

Source: OREI staff calculations based on CEIC data.

Figure 11: Retail Sales Growth[1]—Selected Economies (y-o-y, %)



[1]3-month moving average.

Source: OREI staff calculations based on CEIC data.

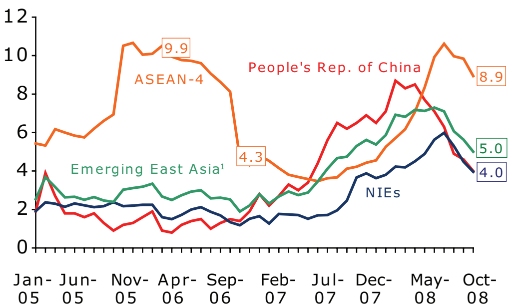
Growth in the four middle-income ASEAN economies moderated in the second half of 2008—as the global downturn cut into exports—after growing strongly in the first half.

In response to the global financial crisis, GDP growth in ASEAN-4 has begun to slow. Thailand's economic growth in the third quarter fell to 4.0%, from 5.6% in the first half of 2008, due to sluggish investment and weakening exports. Malaysia's GDP growth also declined in the third quarter to 4.7% from 7.1% in the first half, due to weakening exports and the drop in commodity prices after July. The other two countries have fared somewhat better **(Figure 9)**. Indonesia's GDP growth in the third quarter eased to 6.1%, compared with 6.4% in the first two quarters. The Philippine economy remained resilient, growing 4.6% year-on-year in the third quarter (about the same rate as in the first half) on increased government spending and solid domestic demand. In the third quarter, industrial production growth in ASEAN-4 showed signs of slowing, yet retail sales held up well due to resilient domestic demand **(Figures 10, 11)**.

Of the remaining ASEAN countries, growth in Cambodia, Lao People's Democratic Republic (Lao PDR), and Viet Nam also showed signs of slowing as external demand softened in the difficult global environment.

In Viet Nam, GDP growth in the first 9 months of 2008 was 6.5%, the lowest since 1999. Domestic demand slowed with retail sales (in real terms deflated by consumer prices) rising by only 7.5% in the first 10 months, compared with 15% in the same 2007 period. GDP in Brunei Darussalam likely contracted 0.5% in 2008 as oil production dropped due to overproduction in previous years and ongoing renovation in existing facilities. In Cambodia, a gradual deceleration in GDP growth continued as external demand softened and private consumption eased, although GDP growth remained robust at an estimated 6.5% this year. In Lao PDR, GDP likely grew 7.5% in 2008 as foreign investment continued to drive a robust expansion of the industrial sector, especially in mining and energy. In Myanmar, estimates from unofficial sources put GDP growth in a range of about 0.9–2.0% for the 2008 fiscal year, after agriculture and manufacturing were hit hard by the devastating cyclone and flooding in May.

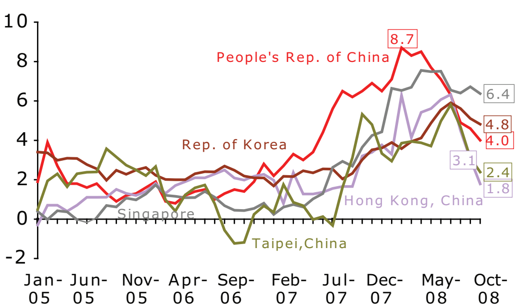
Figure 12: Regional Inflation—Headline Rates (y-o-y, %)



[1]Refers to ASEAN-4, NIEs, People's Republic of China, and Viet Nam; does not include Brunei Darussalam, Cambodia, Lao People's Democratic Republic, and Myanmar, for which monthly data are not available.

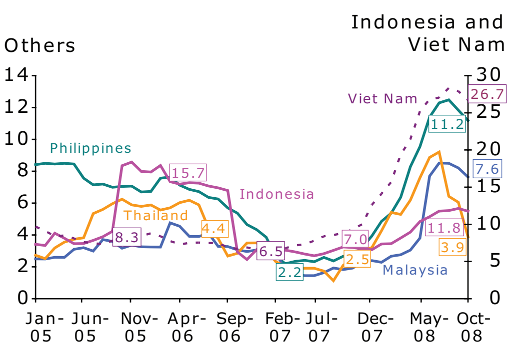
Source: OREI staff calculations based on CEIC data.

Figure 13a: Inflation in NIEs and PRC—Headline Rates (y-o-y, %)



Source: OREI staff calculations based on CEIC data.

Figure 13b: Inflation in Selected ASEAN Economies—Headline Rates (y-o-y, %)



Source: OREI staff calculations based on CEIC data.

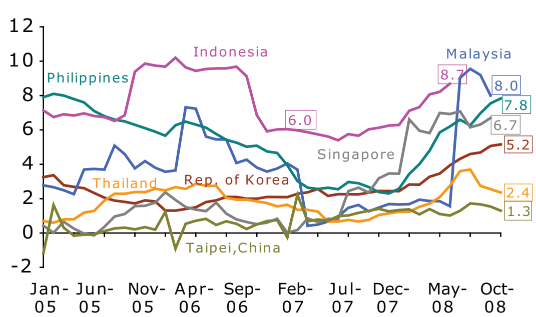
Inflation peaked across most of emerging East Asia during the third quarter as sharp declines in oil and other commodity prices followed tightening credit conditions.

After rising rapidly in the first half of 2008—mainly due to fast-rising food and oil prices and the removal of fuel subsidies in some economies—headline inflation across much of the region has subsided **(Figure 12)**. Average inflation was down to 5.0% in October; from its June 2008 peak of 7.3%, mainly due to the rapid fall in commodity prices, especially oil, amid slowing demand. Inflation fell most in Thailand (from 9.2% to 3.9%); PRC (from 8.7% to 4.0%); and in Hong Kong, China (from 6.3% in July and 1.8% in October).[6] Headline inflation has also moderated in Korea; Singapore; Malaysia; and Taipei,China **(Figure 13a)**. Headline inflation was still hovering above 10% in Indonesia and Philippines, and remained above 25% in Viet Nam in October **(Figure 13b)**.

Core inflation—excluding food and energy—is still rising in some economies, such as Korea, Philippines, and Singapore **(Figure 14)**, as previously high input prices continue to work their way through. Also, producer price inflation remains relatively high in Thailand, Malaysia, Korea, PRC, Singapore, and Philippines

[6] After netting out the effect of various government relief measures, CPI inflation in Hong Kong, China eased from 6.3% in July to 5.9% in October.

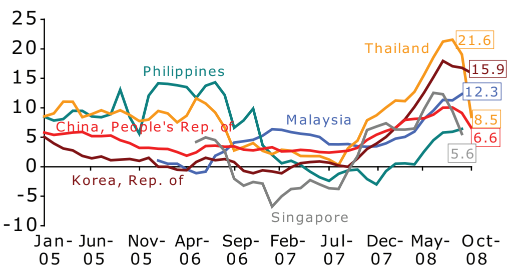
Figure 14: Core Inflation Rates (y-o-y, %)



Note: Official figures, except for Malaysia (excl. food, fuel, utilities) and Singapore (excl. food, private transport).

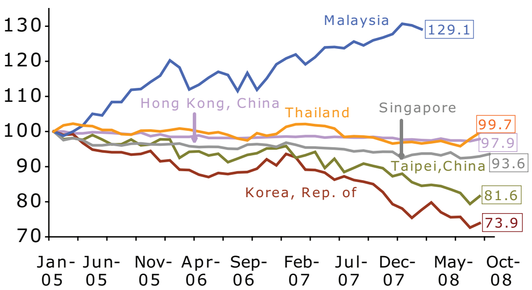
Source: OREI staff calculations based on CEIC data.

Figure 15: Producer Price Inflation—Selected Economies (y-o-y, %)



Source: CEIC.

Figure 16: Terms of Trade Indexes
(Jan 2005 = 100)



Source: CEIC.

(Figure 15), although it has begun to drop in most regional economies, indicating that underlying inflationary pressures may have worked their way through their economies.

Balance of Payments

The balance of payments remained in surplus across much of the region, even as current account balances narrowed and net capital flows declined.

Despite a narrowing of current account balances—as export growth (by value) in emerging East Asia softened on slowing external demand and imports remained generally strong—the balance of payments remained in surplus in most of the region. A sharp drop in oil and commodity prices since mid-September, however, has slowed the pace of growth in import bills. And terms of trade has also improved marginally across much of emerging East Asia during the second half of the year **(Figure 16)**. Capital and financial account net inflows remained strong in the first half, contributing to a continued strong overall balance of payments for the first two quarters of 2008 **(Tables 1a, 1b, 1c)**. Financial accounts in many economies turned to net outflows in the second quarter and likely worsened further into the second half as the global financial crisis intensified. Still, foreign exchange reserves in most economies kept rising **(Table 2)**. In recent months, however, some central banks in the region have actively intervened in foreign exchange markets to prevent excess volatility in their currencies, resulting in losses in international reserves.

Current account surpluses fell across much of the region as export growth slowed amid continued resilient domestic demand.

The current account surplus as a ratio to GDP in the PRC likely narrowed in 2008 from 11.4% in 2007 as the $216 billion trade surplus in the first 10 months was only marginally higher than last year's. For the NIEs, on the back of declines in exports to advanced economies like the US and Europe, the merchandise trade deficit in Hong Kong, China and Korea widened, while the surplus in Singapore and Taipei,China narrowed, compared with the same 2007 period. Investment income surpluses in Hong Kong, China and Taipei,China increased in the first half of 2008**.** In aggregate, the current account surplus, as a ratio to GDP, fell

Table 1a: Balance of Payments—ASEAN-4 (% of GDP)

	2000-2004 Average	2004H1	2004H2	2005H1	2005H2	2006H1	2006H2	2007H1	2007H2	2008H1
Current Account	**4.2**	**2.2**	**4.4**	**1.2**	**2.9**	**3.9**	**6.2**	**5.6**	**6.2**	**4.0**
Net goods balance	9.7	7.3	9.4	5.3	7.9	7.7	9.5	8.4	8.9	5.5
Net services	-3.4	-2.6	-2.7	-2.5	-3.2	-2.5	-2.3	-2.1	-1.9	-0.3
Net income	-3.6	-3.9	-3.6	-3.5	-4.1	-3.3	-3.0	-2.6	-2.5	-2.9
Net transfers	1.5	1.4	1.3	1.9	2.3	2.0	2.0	1.9	1.8	1.7
Capital and Financial Account	**-1.8**	**0.4**	**1.6**	**2.8**	**-2.5**	**1.6**	**-1.7**	**1.0**	**-1.8**	**3.1**
Capital Account[1]	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.1	0.1
Net direct investment	0.9	0.9	1.3	2.7	1.7	1.8	1.3	0.9	0.5	0.9
Net portfolio investment	0.2	1.9	3.0	2.1	0.6	1.9	1.9	4.1	-2.1	0.8
Net other investment	-3.0	-2.4	-2.7	-2.1	-4.9	-2.2	-4.9	-4.0	-0.2	1.4
Net errors & omissions	-0.4	0.6	-1.3	-1.2	-0.7	0.2	-0.7	-0.1	-0.6	0.2
Overall Balance	**2.0**	**3.2**	**4.7**	**2.8**	**-0.3**	**5.7**	**3.8**	**6.6**	**3.8**	**7.4**

[1]Capital account records acquisitions less disposals of non-financial assets by resident units and measures the change in net worth due to saving and capital transfers.
Note: ASEAN-4 = Indonesia, Malaysia, Philippines, Thailand
Sources: *International Financial Statistics Online*, International Monetary Fund; and CEIC.

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

Current Account	**5.3**	**5.6**	**7.0**	**4.8**	**5.5**	**4.2**	**6.4**	**5.5**	**6.7**	**4.1**
Trade balance	4.9	5.5	6.3	5.0	6.2	4.4	5.8	4.8	5.5	2.2
Net services	0.4	0.7	0.5	0.3	0.6	0.5	0.8	0.6	1.2	1.1
Net income	0.6	0.2	0.9	0.3	-0.7	0.1	0.4	0.9	0.7	1.4
Net transfers	-0.7	-0.8	-0.7	-0.7	-0.7	-0.8	-0.6	-0.7	-0.7	-0.7
Capital and Financial Account	**-0.7**	**-0.8**	**-0.7**	**-0.7**	**-0.7**	**-0.8**	**-0.6**	**-0.7**	**-0.7**	**-0.7**
Capital Account[1]	-0.2	-0.2	-0.2	-0.3	-0.2	-0.2	-0.2	-0.2	0.0	0.0
Net direct investment	0.5	-0.7	0.1	1.5	0.1	0.7	0.4	1.1	-0.8	-1.3
Net portfolio investment	-2.7	-6.5	-0.2	-4.7	-0.9	-3.7	-5.9	-3.8	-4.5	-5.3
Net other investment	1.3	8.6	-3.0	3.3	-3.7	1.6	1.9	-3.2	-2.7	6.0
Net errors & omissions	0.6	0.9	1.1	1.1	1.0	0.7	0.9	2.9	4.2	-0.7
Overall Balance	**4.7**	**7.8**	**4.9**	**5.7**	**1.8**	**3.2**	**3.3**	**2.3**	**2.9**	**2.7**

[1]Capital account records acquisitions less disposals of non-financial assets by resident units and measures the change in net worth due to saving and capital transfers.
Note: NIEs = Hong Kong, China; Republic of Korea; Singapore; Taipei,China.
Sources: *International Financial Statistics Online*, International Monetary Fund; and CEIC.

Table 1c: Balance of Payments—People's Republic of China (% of GDP**)**

Current Account	**2.7**	**1.1**	**6.5**	**7.0**	**7.4**	**8.0**	**10.6**	**11.8**	**11.2**	**10.4**
Net goods balance	3.3	0.8	5.7	5.6	6.3	7.0	9.2	9.8	9.6	7.2
Net services	-0.6	-0.8	-0.4	-0.4	-0.4	-0.5	-0.2	-0.2	-0.3	-0.2
Net income	-1.0	-0.3	-0.1	0.5	0.5	0.3	0.5	0.9	0.7	2.1
Net transfers	1.0	1.4	1.4	1.3	1.1	1.2	1.0	1.3	1.1	1.3
Capital and Financial Account	**3.2**	**9.4**	**4.7**	**4.0**	**2.0**	**3.4**	**-1.9**	**6.5**	**-0.9**	**3.9**
Capital Account[1]	0.0	0.0	0.0	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Net direct investment	3.4	4.3	2.4	2.3	3.6	2.7	2.0	3.7	3.8	2.2
Net portfolio investment	-0.2	3.9	-0.9	-0.1	-0.3	-2.6	-2.6	-0.3	1.3	1.1
Net other investment	0.0	1.2	3.1	1.5	-1.5	3.1	-1.5	3.1	-6.0	0.5
Net errors & omissions	0.4	-1.0	3.7	-0.5	-0.9	-0.7	-0.3	0.9	0.2	0.9
Overall Balance	**6.4**	**9.4**	**14.8**	**10.4**	**8.4**	**10.7**	**8.4**	**19.2**	**10.5**	**15.2**

[1]Capital account records acquisitions less disposals of non-financial assets by resident units and measures the change in net worth due to saving and capital transfers.
Sources: *International Financial Statistics Online*, International Monetary Fund; and CEIC.

Table 2: Foreign Exchange Reserves (excluding gold)

	Value ($ billions)				% change (y-o-y)			m-o-m % change		
	Dec-07	Mar-08	Jun-08[3]	Sep-08[3]	Mar-08	Jun-08[3]	Sep-08	Jul-08	Aug-08	Sep-08
Brunei Darussalam	0.7	0.7	0.7	0.7	36.5	22.1	...	0.6	...	...
Cambodia	1.8	2.1	2.3	2.4	64.8	62.3	...	-1.1	8.6	...
China, People's Rep. of	1528.2	1,682.2	1808.8	1905.6	39.9	35.7	32.9	2.0	2.1	1.1
Hong Kong, China	152.6	160.7	157.5	160.5	18.8	15.6	14.0	0.0	0.3	1.6
Indonesia	55.0	56.8	57.3	56.4	24.4	16.0	...	2.0	-3.5	...
Korea, Rep. Of	262.2	264.2	258.0	239.6	8.3	3.0	-6.9	-4.1	-1.7	-1.5
Lao PDR	0.5	0.7	0.7	...	75.9	57.3	...	...	...	...
Malaysia	101.0	120.0	125.5	109.4	36.0	27.9	11.8	-0.6	-2.0	-10.5
Myanmar	...	...	...	...	...	...	...	...	...	...
Philippines	30.2	32.8	32.7	32.9	51.3	39.6	17.9	0.8	0.5	-1.0
Singapore	163.0	177.5	176.7	170.1	28.8	22.6	...	-1.0	-2.8	...
Taipei,China	270.3	286.9	291.4	281.1	7.2	9.5	6.9	-0.2	-3.0	-0.3
Thailand	85.2	107.5	103.2	100.0	55.5	44.8	27.1	-0.9	-3.2	1.0
Viet Nam	23.6	25.0	21.0	...	36.7	0.9	...	...	...	...
Emerging East Asia	**2674.3**[1]	**2,916.9**[1]	**3035.8**[1]	**3,058.8**[2]	**30.6**[1]	**26.7**[1]	**25.2**[5]	**0.8**[3]	**0.5**[4]	**0.1**[5]
Japan	952.8	992.6	978.7	974.1	11.2	9.0	5.0	0.3	-0.6	-0.2
East Asia	**3,627.1**[1]	**3,909.6**[1]	**4,014.5**[1]	**4,032.9**[2]	**25.1**[1]	**21.9**[1]	**19.8**[5]	**0.7**[3]	**0.2**[4]	**0.2**[5]

[1]Excludes Myanmar as data are unavailable.
[2]Excludes Lao PDR, Myanmar, and Viet Nam as data are unavailable.
[3]If data is unavailable for reference month, data is for most recent month in which data is available.
[4]Excludes Brunei Darussalam, Lao PDR, Myanmar, and Viet Nam as data are unavailable.
[5]Excludes Brunei Darussalam; Cambodia; Indonesia; Lao PDR; Myanmar; Singapore; and Viet Nam as data are unavailable.

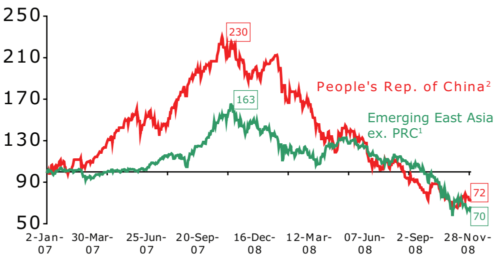
Source: *International Financial Statistics Online*, International Monetary Fund.

to 4.0% in ASEAN-4 during the first half of 2008 from 5.9% in 2007. It appears the ASEAN-4 current account narrowed further in the third quarter, as the aggregate trade surplus, at $15 billion, was $3 billion less than the same period of 2007. The strong inflow of remittances from overseas Filipino workers—equivalent to about 10% of GDP—have continued to aid the current account surplus, despite a large trade deficit. Viet Nam's trade deficit in the first 10 months increased to $16.3 billion, an increase of 66% from the $9.8 billion in the same period of 2007. Viet Nam's current account deficit is expected to rise to about 13% of GDP this year, compared with 9.9% in 2007.

Capital began flowing out of the region as the financial turmoil deepened—compared with strong capital inflows during the first half of 2008.

Balance of payments data for the third quarter—only available for Korea; Singapore; and Taipei,China—show that deficits in the capital and financial accounts widened. Compared with the first

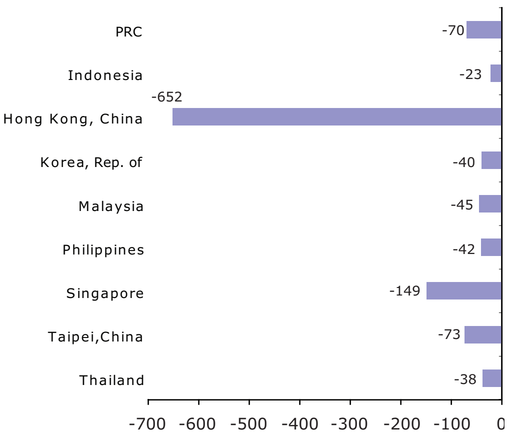
Figure 17: Composite Stock Price Indexes
(last daily price , 2 January 2007 = 100, local index)



[1]Daily stock price indexes of Hang Seng (Hong Kong, China), JCI (Indonesia), KOSPI (Korea), KLCI (Malaysia), PCOMP (Philippines), STI (Singapore), TWSE (Taipei,China) and SET (Thailand) weighted by market captialization.
[2]Daily stock price indexes of combined Shanghai and Shenzhen Composite, weighted by their respective market capitalization (PRC).

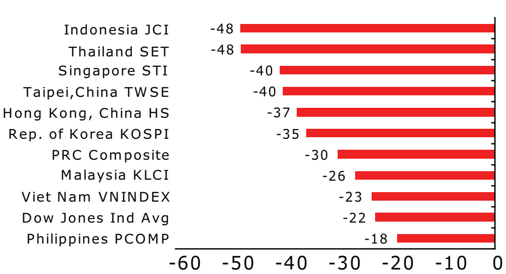
Source: OREI staff calculations based on Bloomberg data.

Figure 18: Fall in Market Capitalization
(% of GDP, 01 January to 27 November 2008)



¹ PRC = People's Rep. of China.

Figure 19: Stock Price Indexes*
(01 July to 28 November; % change)



*Latest closing as of 28 November 2008.

Source: OREI staff calculations based on Bloomberg data.

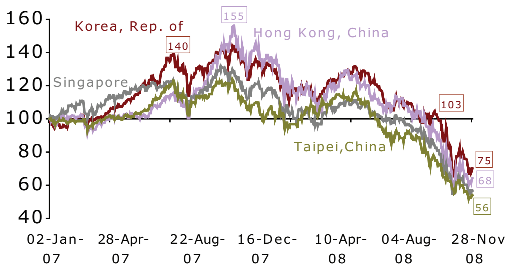
half, portfolio investment outflows grew much larger in Korea and Taipei,China, and in Singapore direct investment and other investment reversed capital flows outward in the third quarter. In the first two quarters of 2008, while NIEs maintained a small capital and financial account deficit, the capital and financial account surpluses increased in ASEAN-4 and the PRC (see Tables 1a, 1b, 1c). Direct investment in the PRC moderated, but other investment reversed from net outflows to net inflows. Foreign direct investment in ASEAN-4 remained robust at 0.9% of GDP in the first half of 2008, and the "other investment" account recorded net inflows, compared with net outflows over the past few years as ASEAN-4 repaid outstanding debt. The financial account turned to net outflows in Malaysia and Thailand in the second quarter. In general, the NIEs run capital and financial account deficits—with direct and portfolio investment outflows, and while other investment generally records inflows. In the first half, while there were net capital inflows into Hong Kong, China and Taipei,China (mainly in the form of other investments), net outflows were recorded in Korea (mainly direct and portfolio investment outflows) and Singapore (portfolio investment outflows).

Financial Markets and Exchange Rates

Stock markets across the region continued their downward slide in the second half of 2008 as the global crisis triggered massive sell-offs amid expectations of a major global economic downturn.

Equity markets in emerging East Asia continued their downward trend in 2008 on heightened risk aversion and worsening global economic prospects **(Figure 17)**. The sharp fall in stock market capitalization across the region—representing seriously reduced asset values and thus wealth—will hurt consumption and investment as well, further exacerbating the economic slowdown **(Figure 18)**. Among the region's economies, Indonesian and Thai stock price indexes fell by nearly 50%, followed by the NIEs at about 40% **(Figure 19)**. Indonesia's stock market index plummeted as investors shunned local assets and remained concerned that a weaker rupiah might stoke more inflationary pressure. Thailand's main index fell dramatically on worries that the political crisis would delay policies to support the economy amid the global financial crisis. Stock prices in Singapore and

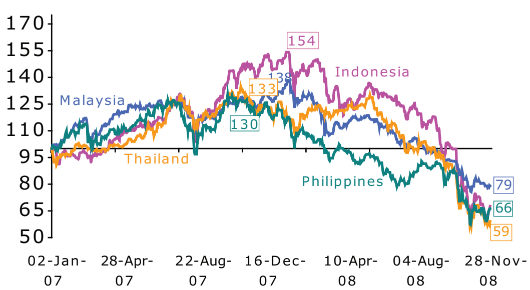
Figure 20: Composite Stock Price Indexes—NIEs[1] (last daily price, 2 January 2007 = 100, local index)



[1]Daily stock price indexes of Hang Seng (Hong Kong, China), KOSPI (Korea), STI (Singapore), and TWSE (Taipei,China).

Source: OREI staff calculations based on Bloomberg data.

Figure 21: Composite Stock Price Indexes—ASEAN-4[1] (last daily price, 2 January 2007 = 100, local index)



[1]Daily stock price indexes of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), and SET (Thailand).

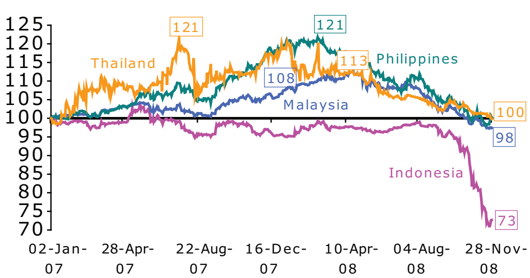
Source: OREI staff calculations based on Bloomberg data.

Hong Kong, China dropped as tightened financial conditions and worsened economic prospects undermined corporate profitability and curtailed domestic spending **(Figure 20)**. In Korea and Taipei,China, stock market indexes fell by 35–40% amid the worsening growth outlook as credit conditions tightened, export demand for technology products softened, and overseas investments incurred substantial losses. Stock prices in the PRC continued a marked decline. The Shanghai composite index fell 30% from July to end-November 2008, despite government measures to stimulate growth and restore investor confidence. Benchmark indexes in other ASEAN economies, likewise, dropped **(Figure 21),** with share prices in Malaysia, Philippines and Viet Nam down by 18–26% from July to November.

Most emerging East Asian currencies depreciated against the US dollar on flight-to-safety, particularly since mid-September, following massive financial deleveraging and as slower external demand pared export earnings.

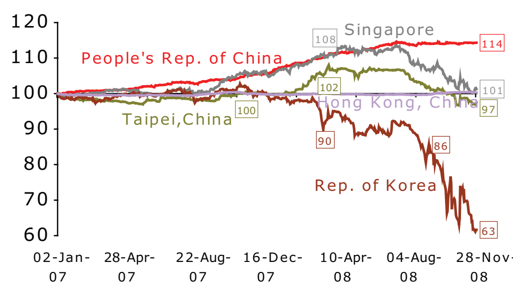
Since the freeze in global credit markets beginning mid-September, most currencies in the region have depreciated sharply against the US dollar **(Figures 22a, 22b)**. The Korean won depreciated most—29% from July to end-November—on a widening current account deficit and a sharp withdrawal of foreign portfolio investment flows **(Figure 23)**. The Indonesian rupiah fell 25% during the period on foreign portfolio deleveraging and flight-to-safety. The Malaysian ringgit, Philippine peso, Singapore dollar, and new Taiwan dollar depreciated 8–10% as demand for the region's assets and exports weakened. Viet Nam's dong faced limited depreciation pressures compared with the first half of 2008, on declining imports and restrictions

Figure 22a: Exchange Rate Indexes—ASEAN-4 (local currency vis-à-vis US$; 2 January 2007=100)



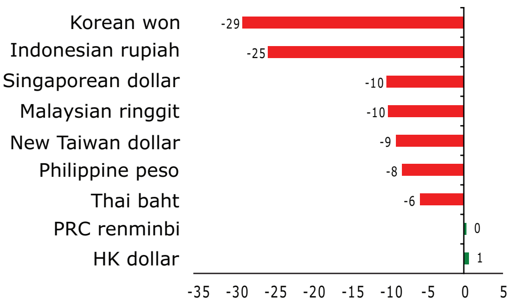
Source: OREI staff calculations based on Bloomberg data.

Figure 22b: Exchange Rate Indexes—NIEs and People's Rep. of China (local currency vis-à-vis US$; 2 January 2007=100)



Source: OREI staff calculations based on Bloomberg data.

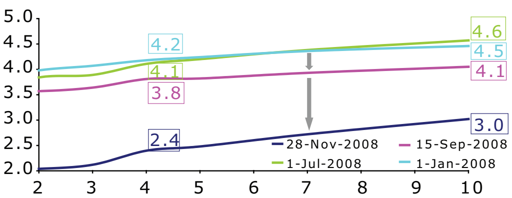
Figure 23: Regional Currencies*
(01 July to 28 November 2008, % change)



*Latest closing as of 28 November 2008, based on the $ value of local currency. Negative values show depreciation of local currency.

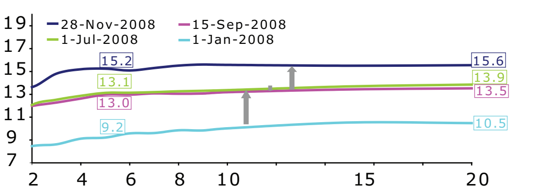
Source: OREI staff calculations based on Bloomberg data.

Figure 24a: PRC Benchmark Yields
(% per annum)



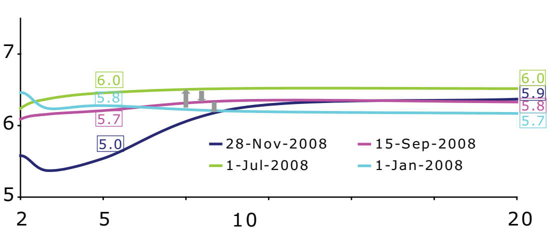
Source: Bloomberg.

Figure 24b: Benchmark Yields—Indonesia (% per annum)



Source: Bloomberg.

Figure 24c: Benchmark Yields—Republic of Korea (% per annum)



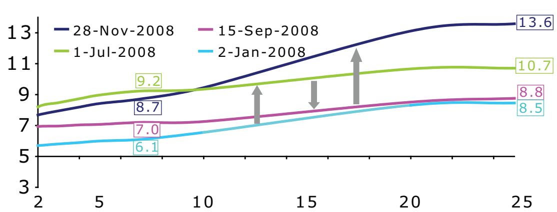
Source: Bloomberg

on capital transactions. Authorities in some economies have intervened in foreign exchange markets to prevent disorderly conditions. The PRC renminbi remained relatively stable during the period while the Hong Kong dollar stayed at the strong side of the convertibility zone, triggering injections of liquidity into the banking system by the Hong Kong Monetary Authority in response to growing demand for Hong Kong dollar funds.

Local currency bond market yield curves shifted downward in the second half of 2008 as inflationary expectations eased and the severity of the global financial crisis deepened.

Government bond yield movements in emerging East Asia went through three distinct phases in 2008: (i) most yield curves shifted up during the first half as many central banks raised interest rates to fight inflation; (ii) yield curves shifted downward from July to early September as the severity of the global credit crisis deepened and inflationary expectations peaked; and (iii) global credit markets seized-up in September and the combination of an investor "flight-to-quality" and emergency measures drove government bond yields lower. In Malaysia; Singapore; Taipei,China; and Thailand, yield curves fell sharply as inflationary expectations peaked and the financial contagion spread to the region. Yield curves in PRC, Thailand, and Singapore shifted below their January 2008 levels. In the fourth quarter, however, yield curves in Indonesia, Korea, and Philippines shifted upward—most notably for longer maturities—on rising credit risks **(Figures 24a, 24b, 24c, 24d)**. In Korea, the yield curve also steepened significantly as the Bank of Korea aggressively cut policy rates in October and November.

Figure 24d: Benchmark Yields—Philippines
(% per annum)



Source: Bloomberg.

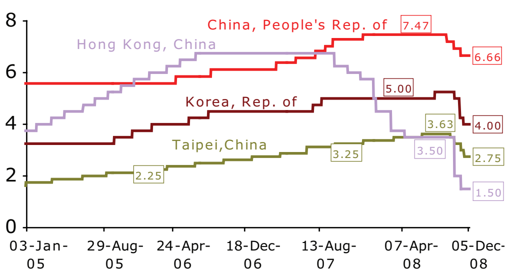
Monetary and Fiscal Policy

With the prospect of slowing growth, policy makers in the region have begun to ease monetary and fiscal policies.

Since mid-September, the balance of risks through most of emerging East Asia has shifted from rising inflation to slowing growth. Authorities across the region have announced—and some have begun implementing—a series of policy measures to stabilize financial markets, restore investor confidence, and to mitigate the impact of the financial crisis on the real economy. Policy measures include deposit guarantees, monetary easing, liquidity injections, foreign exchange market intervention, and fiscal stimulus, and other administrative and regulatory measures **(Table 3)**. Were economic growth to slow and financial conditions worsen further, additional policy responses could be expected.

Monetary authorities in the PRC and the NIEs have loosened policy and adopted various measures to stabilize financial markets.

Figure 25a: Policy Rates[1]—NIEs and People's Republic of China (% per annum)



Note: [1]Hong Kong base rate (Hong Kong, China); Korea base rate (Korea); official discount rate (Taipei,China), one-year lending rate (People's Republic of China).

The PRC dramatically shifted its monetary stance from one of tightening to easing. Benchmark interest rates have been cut four times since mid-September by a total of 1.89% and the reserve requirement ratio cut by between 350 to 450 basis points **(Figure 25a)**. The People's Bank of China lifted the credit quota that had been the binding constraint on credit expansion since late 2007. Until recently, PRC monetary policy had been restrictive with the last measure a rise in reserve requirements on 7 June. Authorities have also encouraged state-owned companies to buy shares in companies where they are major shareholders, and the China Investment Corporation took stakes in key banks to support share values. To stabilize financial markets and ease financial distress, the NIEs have adopted various policy measures, such as deposit guarantees, liquidity injections, and interest rate cuts. Since mid-September, interest rates have been cut significantly in Korea and Taipei,China, by 125 basis points and 88 basis points, respectively, and the Hong Kong Monetary Authority (HKMA) adjusted its formula for determining its base rate – from 150 basis points above the prevailing US federal funds rate to 50 basis points, with effect until the end

Table 3: Government Responses to the Financial Crisis

	Deposit Guarantee	Government Stakes in Banks	Regulatory Forbearance	Monetary Policy (Policy Rate and Reserve Ratio)	Exchange Rate (New Arrangement & Government Intervention)	Stock Market Intervention	Fiscal and Administrative Measures
Cambodia				Doubled reserve requirements for private banks from 8.0% to 16.0% in Jul 08. Implemented measures to strengthen banks' financial status in Oct 08: (i) increased capital requirements for commercial and specialized banks to 150 billion riels ($37.5 million); and (ii) reserves of at least 10 billion riels and 30 billion riels will be required from rural specialized banks with single and multiple shareholders, respectively.			Banned rice exports from Mar through May 2008 and subsidized fuel [ongoing].
China, People's Republic of		China Investment Corporation took stakes in key banks to support their shares.		Lending rate cut by 108 bp to 5.58% on 26 Nov 08, preceded by three 27 bp cuts from 16 Sep 08 to 29 Oct 08. Deposit rate cut by 108 bp to 2.52% on 26 Nov 08, preceded by two 27 bp cuts in Oct 08. Reserve requirement ratio cut for major deposit-taking institutions by 100 bp to 16% and for smaller institutions by 200 bp to 14% on 27 Nov 08. This was preceded by 100 bp cut for small banks on 15 Sep 08, followed by 50 bp cut applicable to all banks on 8 Oct 08. Separately exempted interest paid on bank deposits from tax on 8 Oct 08. Announced on 5 Oct 08, the restarting of the program that allows non-financial companies to raise funds in interbank market by issuing medium-term notes. Imposed a hike in lending quota to provide additional financing for small and medium-scale enterprises in Jun 08.		Eased rules on share buybacks in Sep 08 and eliminated stamp duty on stock purchases on 23 Apr 08. Approved a trial program for margin trading and short-selling on Oct 08.	Announced a fiscal stimulus package of 4 trillion yuan over the next 2 years or about 7% of GDP in new spending per year, on 9 Nov 08. Implemented changes to the property market, e.g., reduction of the down payment requirement for first homes, cuts in mortgage interest rate & reduction of VAT on land sales, on 22 Oct 08. Tax rebates raised on 3,486 industry items on 22 Oct 08.
Hong Kong, China	Blanket guarantee of all deposits in authorized institutions announced on 14 Oct 08 backed by the Foreign Exchange Fund until end-2010. A Contingent Bank Capital Faciltiy will be established to make available capital to locally incorporated licensed banks when necessary, until end-2010.			Base rate adjusted downwards to 1.5% on 30 Oct 08 according to a new pre-set formula of 50 bp above the prevailing US Fed funds target rate (announced on 8 Oct 08). This was preceded by a 2% downward adjustment in the base rate on 9 Oct 08. Implemented five liquidity enhancement measures for the banking system effective 2 Oct 08 to Mar 09: (i) broadened eligible securities to access funds from HKMA discount window; (ii) extended the duration of HKMA liquidity assistance; (iii) waived the penalty for using over 50% of the Exchange Fund paper as collateral for borrowing through the discount window; (iv) HKMA to conduct foreign exchange swaps with individual banks when necessary; (v) HKMA lending term money up to one month to individual banks when necessary.	Injected HK$ 2.183 billion to the interbank market on 31 Oct 08 and simultaneously purchased US$361 million from the foreign exchange market, following the same action (involving different amounts) on 27 Oct 08. Since the Lehman Brothers collapse in Sep 08, interbank market interventions have been frequent and have totaled HK$ 31.6 billion (US$4.2 billion).		Fiscal measures such as reinforcement of large infrastructure projects, household electricity charge subsidy, increasing old-age allowance and tax cuts, among others.

	Deposit Guarantee	Government Stakes in Banks	Regulatory Forbearance	Monetary Policy (Policy Rate and Reserve Ratio)	Exchange Rate (New Arrangement & Government Intervention)	Stock Market Intervention	Fiscal and Administrative Measures
Indonesia	Guaranteed deposits up to 2 billion rupiah (about $200,000) from 1 million rupiah on 14 Oct 08.	Approved the bailout of an overseas subsidiary of Bank Indonesia in Amsterdam with a capital injection of €546 million ($700 million) on 27 Oct 08.	Abolished the limits on the daily balance of short-term foreign borrowings on 15 Oct 08. Exempted banks from mark-to-market accounting for debt on 9 Oct 08.	Cut policy rate by 25 bp to 9.25% on 4 Dec 08. It was on hold in Nov 08, which broke a string of six consecutive meetings from May to Oct 08 which hiked the policy rate. Cut reserve requirement ratio to 7.5% from 9.08% for rupiah deposits on 9 Oct 08, and for foreign currency deposits, to 1% from 3% on 14 Oct 08. Subsequently allowed commercial banks to use central bank debt and government bonds as secondary reserves on 22 Oct 08. Extended the FX swap tenor up to 1-month from 7 days on 15 Oct 08. Made available foreign currencies for domestic firms through commercial banks on 15 Oct 08. Injected $483.2 million in 6-day repo on 19 Sep 08, lowered overnight repo rate and adjusted the rate of liquidity facility on 16 Sep 08.	Implemented a new regulation on 13 Nov 08 requiring that purchases of foreign currencies above $100,000 per month be backed by underlying transactions. Introduced a wave of measures to improve USD/IDR demand and supply balance on 28 Oct 08: remove palm oil levies, tighten control against illegal importation and provide post-shipping guarantees to exporters. Proposed a clearing house to manage the supply and demand of foreign currency among state-owned enterprises and ordered the latter to place their forex receipts in onshore banks.	Suspended trading on 8-9 Oct 08 (first time in 8 yrs). Imposed ban on short-selling for month of Oct. Eased rules/cap for firms to buy back shares on 10 Oct 08.	Government announced on 24 Nov 08 that it is seeking credit lines from Australia, Japan, World Bank and ADB to fund 2009 deficit with plans to increase spending on infrastructure and public services. Also announced, together with the central bank, to buy back 4 trillion rupiah of government bonds on 28 Oct 08.
Korea, Republic of	Guaranteed banks' external debt taken up from 20 Oct 08 to 30 Jun 09 for three years with total value of guarantees capped at $100 billion.		Announced plans to implement selective lifting of real estate regulations on 21 Oct 08.	Benchmark interest rate cut by 25 bp on 7 Nov 08, preceded by 75 bp and 25 bp cuts on 27 Oct 08 and 8 Oct 08, respectively. Cut interest rates on special loans to 2.5% from 3.5% to small and mid-sized companies on 27 Oct 2008. Introduced a competitive auction swap facility from 20 Oct 08 for onshore FX swaps with the central bank. Established on 30 Oct 08 a $30 billion swap line with the Federal Reserve available until 30 Apr 09. Additional dollar liquidity of $30 billion in won-dollar swap market by utilizing foreign exchange reserves after an initial $10 billion on 6 Oct 08. Announced provision of windfall interest payment of 500 billion won ($340 million) on reserves deposited by domestic banks on 3 Dec 08. Raised aggregate ceiling to SMEs to KRW9 trillion (US$7.5 billion) effective Nov 08.		Imposed temporary ban on short selling on 8 Oct 08.	Announced increased spending of KRW10 trillion for 2009 on 3 Nov 08, which includes infra expenditure, financial support for small and medium-sized business and tax cuts. Invested KRW1 trillion ($840 million) to expand capital base of Industrial Bank of Korea and provided $5 billion to SMEs via Korea Export Import bank from 1 Oct 08. Announced a support package of KRW8 trillion ($6.7 billion) for the real estate/ construction sector on 24 Oct 08. The National Pension Service will buy up to KRW10 trillion ($8.3 billion) in new bonds from local banks and high-rated companies.
Lao People's Democratic Republic				Bank rate unchanged at 8% since the first quarter.			
Malaysia	Blanket guarantee on all deposits until Dec 2010 in 16 Oct 08 announcement.			Cut overnight policy rate by 25 bp to 3.25% (first move since Apr 06), and statutory reserve requirement to 3.5% from 4%, on 24 Nov 08. Allowed insurance companies and takaful operators to access funds from the bank's liquidity facility on 14 Oct 08.		Announced plans to infuse additional Rm5 billion in a state agency to buy undervalued stocks, on 20 Oct 08.	Announced a MYR 7 billion fiscal stimulus package on 04 Nov 08. Reduced subsidy on gas and diesel in Jun 08, followed by cuts in gas and diesel prices in Aug and Sep.
Myanmar					Waived a policy on forex entering the country to ease conditions on aid inflows on Sep 08 .		Restricted exports and domestic trade of rice on Aug 08, lifted Nov 08.

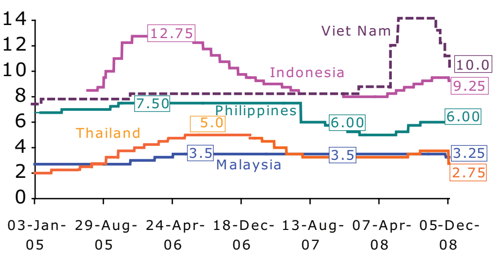
	Deposit Guarantee	Government Stakes in Banks	Regulatory Forbearance	Monetary Policy (Policy Rate and Reserve Ratio)	Exchange Rate (New Arrangement & Government Intervention)	Stock Market Intervention	Fiscal and Administrative Measures
Philippines	Announced plans to raise deposit guarantee from P250,000 to P1 million, pending Congress approval, on 21 Oct 08.		Allowed financial institutions to reclassify their investments in debt and equity securities from 23 Oct 08 until 31 Dec 2008. Eased FCDU asset cover requirements on 31 Oct 2008.	Policy rates kept at 6% since Jun 08. Reduced regular reserve requirement on bank deposits and deposit substitutes by 2 percentage points effective 14 Nov 2008. Increased central bank budget for the peso rediscounting facility from P20 billion P40 billion on 7 Nov 2008. Opened a $ repo facility on 20 Oct 2008 to ensure dollar liquidity with the banks' dollar-denominated Philippine sovereign bonds as underlying collateral.			Postponed planned 2008 budget balance to 2010 in May 08. Imposed domestic petrol price rollbacks in the third quarter of the year.
Singapore	Blanket guarantee on all deposits until Dec 2010, announced on 16 Oct 08.			Established on 30 Oct 08 a $30 billion swap line with the Federal Reserve available until 30 Apr 09. Injected liquidity via market operations in Sep 08 and committed to provide further liquidity if necessary on 10 Oct 08.	Abandoned its appreciation policy (first since 2003) in favor of a neutral stance on 10 Oct 08.		Announced on Aug 08, additional 50% increase in utility rebates and second installment of growth dividends, on top of special transfers disbursed earlier in the year.
Taipei,China	Blanket guarantee on bank deposits from 7 Oct 08 until 31 Dec 09.		Reduced the required reserve ratios on NT$ deposits, and expanded the scope (eligible parties now include insurance companies) and lengthened the terms of Repo operations (to 180 days from 30 days) on 25 Sep 08. Central bank extended the credit line for banks to extend funding to securities firms in Oct 08.	Cut major policy rates by 25 bp on 9 Nov 08, the fourth in two months and totaling a cumulative 87.5 bp. The discount rate is now at 2.75%, the secured accomodation rate at 3.125% and the unsecured loan rate at 5%. Reserve requirement ratio on TW$ deposits cut to a range of 4-10.75% on 16 Sep 08 from previously, 4.75-12%.		Banned short-selling 150 stocks in the Taiwan 50 Index, Taiwan Mid-Cap 100 and Taiwan Technology Index on 21 Sept 08 until 31 Dec 08. Activated the National Stabilization Fund on 19 Sep 08 (which has NT$500 billion in capital) to prop up the stock market.	Government announced on 18 Nov 09, the provision of NT$3,600 (US$108) in shopping vouchers to each individual on Jan 09 and to expire by Dec 09. On 7 Nov 08, increased government's donation to the SME Credit Guarantee Fund (CGF) to NT$6 billion (US$187 million) in 2009 from NT$5 billion in 2008, raised the ceiling of CGF-guaranteed credit to each SME by NT$20 million (US$625,000) and doubled bank-guaranteed credit to SMEs to NT$20 million.
Thailand	Blanket guarantee of bank deposits put in place in Aug 08 was extended until 2011 as of late Oct 08 (the 100% guarantee in Aug 08 version was set to decrease gradually over a 5-yr period).			Cut policy rate by 100 bp to 2.75% on 3 Dec 08. Rate was on hold in Oct 08 after twice raising this by 25 bp each in the two preceding meetings in Jul and Aug 08. Announced plans to convince commercial banks to extend loans equivalent to B400 billion ($11.4 billion) and B50 billion ($1.4 billion) from state-run banks or at least 5% loan growth in 2009 on 14 Oct 08.		Established B10 billion matching fund linking the Stock Exchange of Thailand and financial institutions on 14 Oct 08.	Announced on 4 Nov 08 a spending boost of B100 billion for fiscal year 2008/2009 to be financed locally targeted at low-income families and job-creation. Implemented a $1.4 billion six-month stimulus package on Aug 08 to cut excise tax on ethanol-mixed gasoline, provide free bus passage and partially subsidize home electricity costs.
Viet Nam				Cut key policy rate by 1 percentage point to 10%, refinancing rate to 11% and discount rate to 9% on 2 Dec 08, the fourth cut for these rates since 20 Oct 08 for a total of 400 bp. Cut reserve requirement ratio by 200 bp to 6% from 8% effective 5 Dec 08 (last move was a 200 bp cut on 20 Nov 08).	Expanded the trading band by 3% on either side of the fixed rate on 7 Nov 08.	Announced plans to set up a stabilization fund to contain volatility and support shares, scrap foreign investment in listed companies, strengthen prudential/disclosure norms, delaying IPOs in Mar 08.	Announced on 3 Dec 08 a fiscal stimulus package that includes $1 billion worth of foreign currency reserves for high-priority development projects, $89 million for canal dredging and interest-free credit to state-owned agri distributors. Controlled price increases in power, coal, cement, and steel until Jun 08. Lowered domestic petrol price for the third time on 21 Oct 08.

Sources: Country write-ups as of 27 Oct 08, Economic Observatory of BBVA as of 29 Oct 08 and the RGE Monitor (for some countries) and various analyst and financial institutions reports as of 4 Dec 08.

of March 2009. The Monetary Authority of Singapore—which targets exchange rates rather than interest rates—abandoned its appreciation policy in favor of a neutral stance. Korea and Singapore established swap lines with the US Federal Reserve. Korea also introduced a $130 billion financial-rescue plan in October, which includes a sovereign guarantee of $100 billion of local banks' foreign currency debt (effective until June 2009), to help renew loans on the international market, and ease the liquidity shortage.

With moderating inflation amid prospects of slower growth, ASEAN economies have begun to loosen monetary policy.

Figure 25b: Policy Rates[1]—ASEAN-4 and Viet Nam (% per annum)



[1]BI Rate, (Indonesia); Overnight Policy Rate (Malaysia); reverse repurchase (repo) rate (Philippines); 14-day Repo Rate (before 17 Jan 2007) and 1-day Repo from 17 Jan 2007 onwards (Thailand); prime rate (Viet Nam).

Source: Bloomberg.

In late November, Bank Negara Malaysia cut its overnight policy rate by 25 basis points to 3.25%, the first cut since 2003, citing heightened downside risks to growth and diminishing inflationary pressures **(Figure 25b)**. Since October, the State Bank of Viet Nam cut interest rates four times (by 400 basis points to 10%) and reserve requirements were lowered to protect growth—this despite inflation still hovering above 25%. After keeping rates unchanged since August 2007, Thailand cut its main policy rate by a full percentage point to 2.75% on 2 December to prop up a sagging economy. And with inflation around 10% but slowly falling, Indonesia and the Philippines have left their interest rates unchanged recently, though the Philippine central bank cut reserve requirements and doubled its rediscounting budget. While both central banks are concerned about strong inflationary pressures, they also cite exchange rate volatility as a factor behind their policies. Both the rupiah and the peso depreciated sharply in recent months.

Fiscal policy has moved to center stage; fiscal prudence over the past several years has given many emerging East Asian economies room for stimulus packages, with the PRC the most notable example.

Several economies have already announced fiscal measures to support aggregate demand (see Table 3). Most notably, the PRC unveiled a fiscal stimulus package of RMB4 trillion ($586 billion) over the next 2 years, of which RMB120 billion will be disbursed by the end of this year **(Box 1)**. The grand scale

Box 1: The PRC Moves Decisively with Bold Stimulus Package

Emerging East Asia's largest and fastest growing economy—the People's Republic of China (PRC)—slowed sharply in the second half of 2008, as the recession among G3[1] economies began to spill over into the region. GDP growth of 9.0% in the third quarter was the lowest in 5 years. The economy continued to weaken into the fourth quarter, with industrial production growth falling to its lowest level since late 1999, and both investment and export growth fell. The housing sector continued to cause concern as home sales slumped.

Table B1: Allocation of RMB4 Trillion Investment in the Stimulus Package

Roads, railways, airports and power grids	1.8 trillion
Sichuan post-earthquake reconstruction	1.0 trillion
Rural development and infrastructure	.37 trillion
Environmental protection	.35 trillion
Low-rent housing	.28 trillion
Technical innovation and industrial restructuring	.16 trillion
Public healthcare, culture and education	.04 trillion
	Total: 4.0 trillion

To shore up domestic demand in a fast deteriorating external environment, on 9 November the PRC government unveiled a unprecedented economic stimulus package worth RMB4 trillion. The adoption of counter-cyclical fiscal policy is a significant proactive way to counter the economic risks from deteriorating global and domestic growth prospects. The package also signals a policy shift to rebalance the PRC sources of growth from exports to domestic demand—and to stimulate consumption by raising household income, increasing social spending, and expanding rural demand.

To boost the economy in 2009 and 2010, the package identifies measures in 10 areas, including social and infrastructure spending, earthquake reconstruction, value-added tax reform, and subsidies to farmers and industries. The center piece of the package is for investment projects, the majority in infrastructure development **(Table B1)**. The central government has committed RMB1.18 trillion—with the remaining 70% financed by local governments, state-owned enterprises and bank financing. To fast-track the package, the central government allocated RMB100 billion for the remainder of 2008 for investments, 60% of which are for infrastructure with the rest to support long-term social development aimed at improving living standards.

The package should have a sizable impact on the PRC economy, but the exact size of the stimulus remains unclear. The RMB4 trillion stimulus is on a "gross" basis, as some projects have been long planned and will be simply brought forward, while others are delayed projects still awaiting approval. Thus, the actual amount of new spending is uncertain. Moreover, not all of the RMB4 trillion will be spent by the government. The government estimates the package will boost economic growth by 1 percentage point per year, yet the estimates by others range from 2 to 4 percentage points for 2009.

The PRC introduced a similar stimulus package in August 1998 after the Asian financial crisis. Again, one major component of the 1998 package was increased infrastructure expenditure. This was done by issuing long-term construction bonds (LTCB) to state-owned commercial banks. Unlike the current package, in 1998 the government did not name an overall amount for the package. Like today's stimulus package, however, it was rolled out gradually. From 1998 to 2000, RMB360 billion in LTCBs was issued, about 1.3% of annual GDP at the time.[2] According to official figures, the LTCBs generated RMB1.51 trillion in fixed-asset investments for 6,620 official projects—with co-financing from banks, local government, state-owned enterprises, and other non-government sources. The government estimates the LTCB-funded investments boosted GDP growth by 1.5, 2.0, and 1.7 percentage points from 1998 to 2000, respectively.

[1] United States (US), eurozone, and Japan.

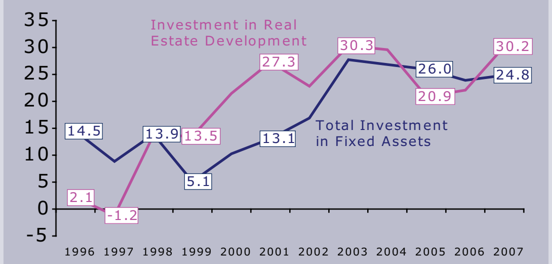
[2] Proportionally, the 1998–2000 package is similar to the 2008 package in terms of the central government contribution to infrastructure investment. The PRC's nominal GDP in 2007 was a little over three times of that in 1997. Coincidently, the size of central government contribution in the 2008 package, RMB1.18 trillion, is exactly three times of that in the 1998–2000 package (RMB360 billion), plus the RMB100 billion, which is to be spent in the fourth quarter of 2008.

During 1998–2000, however, the G3 economies were not in recession. But the domestic economy had cooled from the 1994/95 expansion—when inflation was running over 20%.

The current stimulus package may not have the same economic effects as in 1998–2000. Then, infrastructure was lacking and the housing market had just begun to pick up. Government-sponsored infrastructure investments were a stimulus for private investment as well. Many of the projects then created profit opportunities for private sector investment, particularly in real estate, which grew twice as fast as total fixed-asset investment over 1999–2001 **(Figure B1)**. Since then, infrastructure has become far more developed. Also, with real estate now in a slump, private investment associated with stimulus spending will likely be more cautious. This may be part of the reason the government predicts a smaller contribution to economic growth than in 1998–2000.

It is widely expected that the government will resume LTCB issuance or similar government bonds in 2009. It also plans for local governments, state-owned enterprises, and banks to co-finance projects. As local governments may lack funds due to the housing market slump, the stimulus package may be co-financed mainly by bank financing and bond issuance. The PRC's monetary policy has been loosened dramatically to facilitate credit expansion, with interest rate cuts and reductions in reserve requirements. Lending restrictions on commercial banks have also been abolished to encourage lending. Still, after major structural reforms over the past decade aimed at promoting a commercially driven business culture, no one knows whether and how much banks will be willing to lend to potentially risky projects. For infrastructure projects partly funded by the central and local governments, however, banks will likely be eager to lend as these projects will have an explicit or implicit government guarantee. This may, however, crowd out bank lending to small and medium enterprises.

Figure B1: Investment in Fixed Assets—People's Republic of China (% change)



Source: China Statistical Yearbook 2008.

With rising government expenditures and falling revenues, the fiscal position will be in deficit in 2008 and 2009. While public debt over the next few years, as a ratio of GDP, would remain healthy despite the fiscal expansion, the PRC should prepare for consolidation following the package. Lower future spending commitments mean that future taxes will not need to rise as much. Moreover, the challenge of an aging population requires even stronger fiscal positions. The PRC's working population is projected to peak very soon with the elderly population rising rapidly.

It is crucial that the package provides opportunities for the country to rebalance sources of growth from external demand to a greater reliance on consumption. While it is important to shore up domestic demand immediately through direct government spending, the fiscal expansion could also increase spending on major impediments to private consumption, such as social security, health care, and education. In addition, the fiscal stimulus should be flexible and transparent. At times of major uncertainty, the size of the fiscal expansion may need to vary depending on how the economy performs. And transparency in spending and funding will help not only the public sector but also the private sector in making investment decisions.

of the package, representing some 17% of nominal GDP—and the equivalent of 29% of total fixed-asset investment in 2007—will have a significant impact on economic growth, adding an estimated one percentage point to GDP growth per year. The economic impact will be greater if business and consumer confidence is strengthened. Central and local governments have also implemented measures to support property markets—for example, tax refunds for home buyers, price subsidies, reduction in down payments for first-time home buyers, suspension of stamp duties and value-added tax on land for individual home sales. The authorities also raised tax rebates for many export items. With new spending and reduced revenue, the fiscal position is expected to post a small deficit in 2008, from its surplus of 0.7% of GDP in 2007.

With strong fiscal positions, the NIEs also announced a variety of fiscal measures to stimulate domestic demand.

Korea unveiled a raft of stimulus measures, including an $11 billion increase in public spending and tax cuts. Planned government spending in 2009 is now up 6.5% from 2008. Singapore announced recently that it would provide additional loan support of S$2.3 billion to improve credit access for local firms effective 1 December 2008, and it is also allocating S$600 million over the next 2 years for local worker skill upgrades. Taipei,China provided NT$3,600 ($108) in shopping vouchers to individuals—expiring 9 December. Hong Kong, China has also introduced several fiscal measures—such as reinforcement of large infrastructure projects, household electricity charge subsidies, increasing old-age allowances, and tax cuts.

Many ASEAN countries, given room for maneuver by recent fiscal prudence, have announced plans to increase expenditures in support of economic growth.

In Indonesia, the budget deficit has been generally modest following successful fiscal consolidation in recent years. The government plans to increase bilateral and multilateral borrowing and reduce fund-raising in the volatile capital markets to finance its budget deficit. Also, passage of an amended tax law—cutting corporate and personal income taxes from 1 January 2009—adds to a series of measures enacted to improve the business climate. Malaysia announced a RM7 billion ($2 billion) fiscal stimulus package in early November to buoy economic growth through infrastructure spending and private sector initiatives. As the stimulus package is funded by savings from fuel subsidy cuts, the government expects the budget deficit to remain at 4.8% of GDP in 2008 and 2009. In the Philippines, the government's focus shifted from balancing the budget this year to stimulating demand. Authorities have deferred their balanced budget goal to 2010. It has raised social spending, and also implemented tax breaks. With public debt at about 60% of GDP, the Philippines may have little scope for further fiscal expansion. In its recently approved 2009 financial year budget, Thailand boosts spending by B100 billion ($3 billion) during the fiscal year, increasing the fiscal deficit to 3.5% of GDP from the previous deficit target of 2.5%.

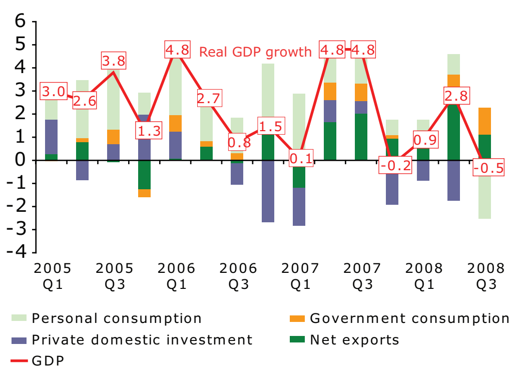
Economic Outlook for 2009, Risks, and Policy Issues

External Economic Environment

The world economy faces a major downturn, with major industrial economies in recession and the global financial crisis stifling credit to firms and households that are already under pressure from weaker income and record commodity prices earlier in the year.

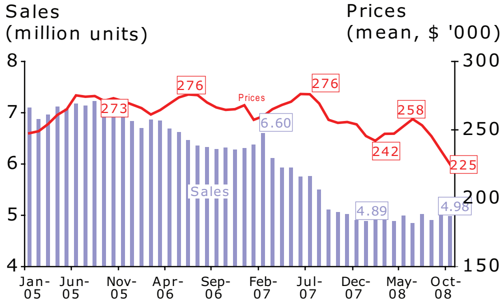
Major industrial economies have slipped into recession, with the IMF now projecting GDP in advanced countries to fall 0.3% in 2009—after estimated growth of 1.4% in 2008. This would be the first annual contraction in the advanced countries in the post-World War II period. G3 economies (US, eurozone, and Japan) have contracted in recent quarters, with domestic demand cooling fast. And the ongoing financial crisis has intensified its grip on global money and credit markets, choking off credit to the private sector. As financial deleveraging continues, the knock-on effects on cash-strapped households and the broad economy will increase significantly. While the measures authorities have taken so far around the globe should help reduce the severity and duration of the crisis, the damage to global credit conditions is significant and recovery will take considerable time.

Figure 26: Contributions to Growth—US
(seasonally adjusted, annualized, q-o-q, % change)



Source: US Bureau of Economic Analysis.

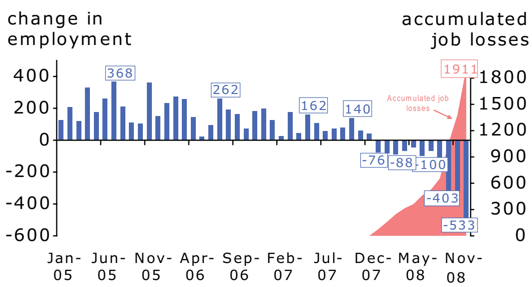
Figure 27: Existing Home Sales[1] and Prices—US



[1]Seasonally adjusted; annualized.

Source: CEIC.

Figure 28: Change in Non-Farm Employment (in thousands)



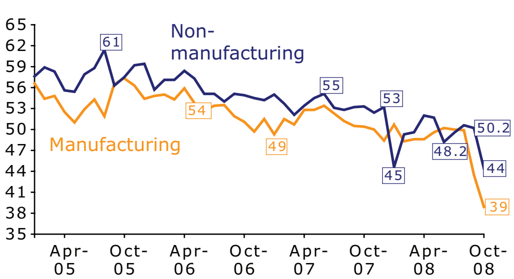
Source: OREI staff calculations based on US Department of Labor Bureau of Labor Statistics data.

The US economic outlook has darkened as the worst financial crisis in decades drives the economy into recession,[7] with suppressed consumer spending and business investment.

After contracting 0.5% (quarter-on-quarter [q-o-q], seasonally adjusted annualized rate [saar]) in the third quarter **(Figure 26)**, the US economy is expected to contract further into 2009. The IMF forecasts a 0.7% contraction in GDP in 2009. Private consumption expenditure dropped 3.7% in the third quarter, as consumers retrenched amid the continuing housing slump, mounting job losses, and the intensifying credit crunch. Home prices continue to fall amid high inventories, with sagging demand rapidly spilling over into business activity **(Figure 27)**. In November, job losses totalled 533,000, bringing losses to 1.9 million in the past year, with two-thirds in the past 3 months, a sign of an intensifying downturn **(Figure 28)**; the unemployment rate rose to 6.7%. Moreover, leading indicators suggest the downturn will likely be prolonged **(Figures 29, 30)**. The slump comes despite massive monetary and fiscal policy boosts, with the US Federal Reserve (US Fed) slashing its target policy rate 50 basis points (bp) to 1% on 29 October—for the ninth time since September 2007. In addition, since early September this year, the Fed has become a direct lender in credit markets under various programs to counter the impact on the economy of weak credit flows from the private

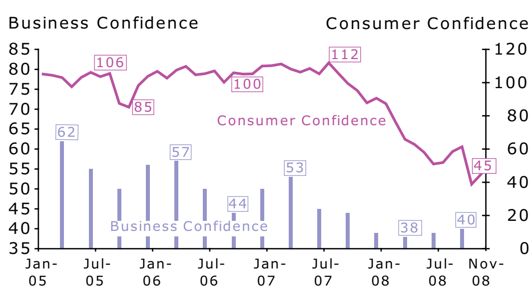
[7] On 1 December 2008, the Business Cycle Dating Committee of the National Bureau of Economic Research reported that the US economy entered into a recession in December 2007. The committee uses a number of economic indicators as well as GDP to date the beginning and end of US business cycles.

Figure 29: US Business Activity Survey Indexes[1]



[1]Data survey from the Institute for Supply Management. The indexes are summary measures showing the prevailing direction and scope of change. An index above 50% indicates that the manufacturing or non-manufacturing economy is generally expanding; below 50% indicates that it is generally declining.

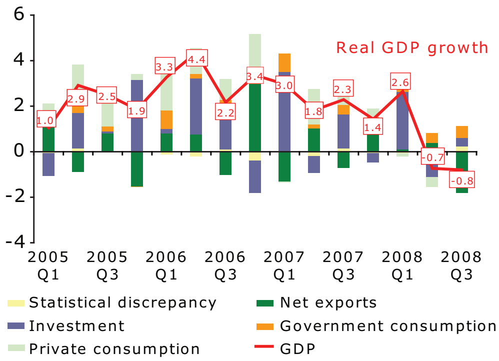
Figure 30: US Business and Consumer Confidence Indexes



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

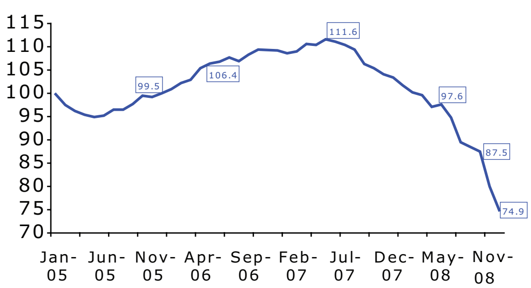
Source: Bloomberg.

Figure 31: Contributions to Growth—eurozone (seasonally adjusted, annualized, q-o-q, % change)



Source: Eurostat website.

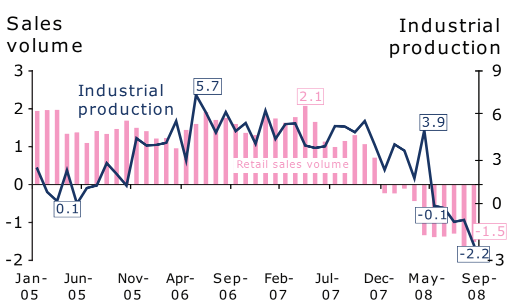
Figure 32: Economic Sentiment Indicator[1]—eurozone



[1]The economic sentiment indicator is a composite index of business and consumer confidence indicators based on survey of overall economic assessment and expectations in the eurozone.

Source: Bloomberg.

Figure 33: Retail Sales and Industrial Production[1]—eurozone



[1]Seasonally-adjusted, y-o-y growth rate of 3-month moving averages.

Source: OREI staff calculation based on CEIC data.

financial system. In doing so, the Fed's balance sheet had grown hugely to $2.2 trillion by end-November from about $900 billion in August. Meanwhile, a second, much larger, stimulus package is under discussion following the government's $150 billion fiscal package approved in February, and on top of the $700 billion financial rescue bill passed in September. Recent estimates indicate that to date the US government, through a broad range of programs, has committed an extraordinary $3.1 trillion as an insurer, $3.0 trillion as an investor, and $1.7 trillion as a lender to shore up the financial system. Slowing economic activity, however, is keeping price pressures at bay, as headline inflation eased to 3.7% in October, from the 5.6% July peak. Core inflation, which excludes food and energy, eased to 2.2% from 2.5% in September. The US trade deficit narrowed again in the third quarter as the effect of past dollar weakness was carried over, but the US dollar's recent strength may reverse the trend in coming quarters.

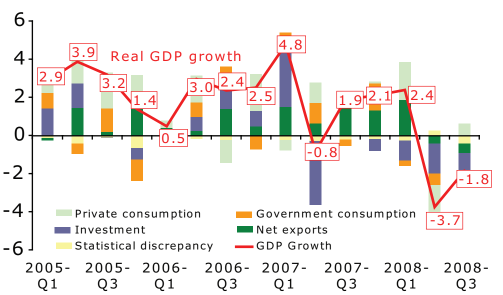
The eurozone is also already in recession after many financial institutions became direct casualties of the financial crisis, industrial production declined, and retail sales fell.

The eurozone is officially in recession, after contracting during the second and third quarters this year, battered by a series of negative shocks over the past year or so, including financial turbulence, high oil prices, and significant housing price declines in several countries **(Figure 31)**. High inflation eroded real incomes—hurting consumer spending—and business investment weakened amid heightened uncertainty. Financial systems have been visibly shaken since mid-September, when the financial crisis intensified, because many European banks were caught with severely damaged balance sheets. Belgium, France, Germany, Luxembourg, the Netherlands, and the United Kingdom took extraordinary measures to rescue banking systems at the national level, while Denmark and Ireland announced blanket deposit and debt guarantees for their banking systems. But the effect of financial deleveraging continues to reverberate through the real economy, as banks reduce lending and credit conditions tighten. Economic activity is likely to weaken further with consumer and business confidence down sharply **(Figure 32)**. Retail sales remain depressed and industrial production has slumped, reflecting a drop in exports **(Figure 33)**. The global downturn will likely dampen external demand further, partly offsetting the effect of the recent weakening in the euro and declines in oil and other commodity import bills. Inflationary pressures are subsiding on falling oil prices and the shrinking economy, which gives some room for monetary easing. In an attempt to restore confidence in financial markets—with the eurozone facing its worst downturn since the early 1990s—the European Central Bank (ECB) on 4 December cut its policy rate 75 basis points to 2.50%, its biggest cut ever, bringing its cumulative rate cuts since 8 October to 175 basis points. (UK, Swedish, and Danish central banks also cut rates). And there will likely be more stimulus in the period ahead to counter sagging demand: the European Commission has approved a €200 billion spending plan, although implementation falls to the individual EU countries.

The Japanese economy—hurt by declining external demand and still sluggish domestic consumption—has fallen into recession, with GDP now expected to contract 0.2% in 2009.

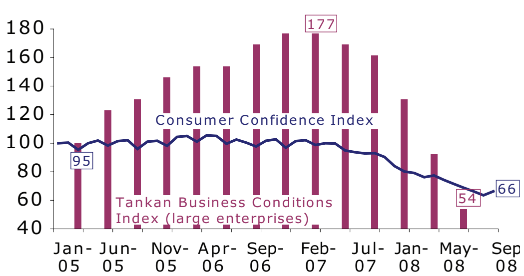
The Japanese economy contracted a seasonally adjusted, annualized 1.8% in the third quarter of 2008, after a 3.7% drop in the previous quarter **(Figure 34)**. Exports are expected to further weaken as the global downturn takes hold, while declining corporate profits and household income drive down business and consumer sentiment, suggesting that domestic demand will also likely remain weak **(Figure 35)**. The recent strengthening yen and plunge in Japan's stock prices—to a 26-year low—also cast a shadow over next year's economic performance. However, falling commodity prices should support consumption, and growth in emerging economies may still help Japan's exports. Concerns are rife, nonetheless, that global financial turmoil may depress consumer and investor sentiment further, particularly if the US economy contracts more significantly and emerging economies experience a hard landing. Headline inflation rose above 2% in recent months due to high food and energy prices, but fell to 1.7% by October, and is expected to fall substantially in 2009 on reduced commodity prices and the effects of recession

Figure 34: Contributions to Growth—Japan
(seasonally adjusted, annualized, q-o-q, % change)



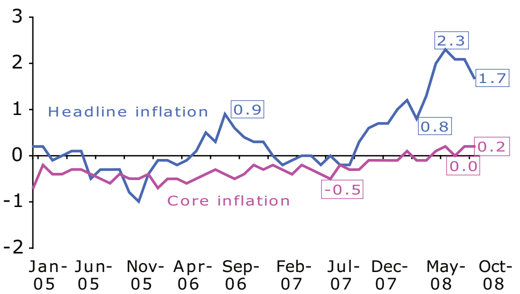
Source: Cabinet Office, Government of Japan.

Figure 35: Business and Consumer Sentiment Indexes—Japan (Jan 2005 = 100)



Source: OREI staff calculations based on Bloomberg data.

Figure 36: Inflation—Japan (y-o-y, %)

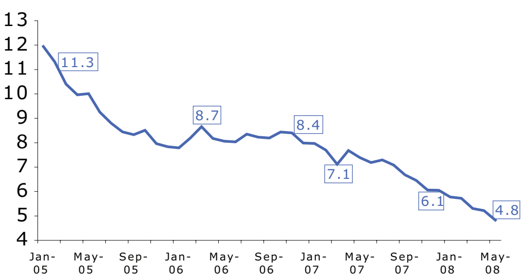


Source: OREI staff calculations based on CEIC data.

(Figure 36). The Bank of Japan cut its policy rate to 0.3% on 31 October after having kept rates steady since February, reflecting both softer economic activity and a more cautious stance given recent financial market volatility. The government unveiled another ¥27 trillion ($275.7 billion) stimulus package, including expanded credits for small businesses and a total of ¥2 trillion ($20.4 billion) in cash disbursements to households in October, following the introduction of the ¥11.7 trillion ($107.4 billion) stimulus package approved in August.

World trade growth is slowing sharply as demand from major industrial countries slumps, reducing export production in emerging market economies.

Figure 37: World trade volume[1] (y-o-y, %)

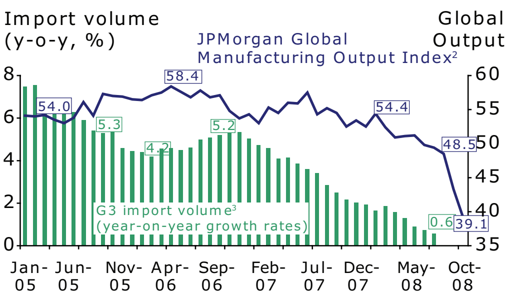


[1]12-month moving average; import values deflated by their respective price indexes.

Source: OREI staff calculations based on data from *International Financial Statistics,* International Monetary Fund.

A synchronized downturn in advanced economies is adding to pressure on world trade **(Figure 37).** The World Bank estimates trade volume will contract 2.5% in 2009, from an estimated 5.8% expansion this year. Global manufacturing output has slumped, with G3 import demand growth slowing rapidly **(Figure 38)**. The global financial crisis is spreading malaise to emerging market economies, where industrial production growth is dropping fast. Industrial output growth in the People's Republic of China (PRC) eased to 8.2% (y-o-y) in October, bringing the 3-month moving average to 10.8%, compared with average 18.3% growth in the first half **(Figure 39)**. Weaker export orders, softening investment demand, and increasing factory closures were key

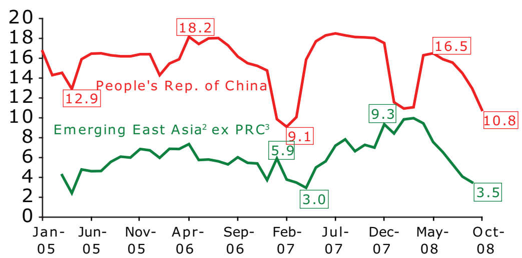
Figure 38: Global Manufacturing Output and Import volume[1]**—G3**



[1]Annual growth rate.
[2]A component of the JPMorgan Global Manufacturing Purchasing Managers' Index, which serves as an indicator of global manufacturing business conditions, based on data collected from surveys around the world. A reading above 50 indicates an increase in the variable since the previous month and below 50, a decrease.
[3]Import values deflated by import price indexes.

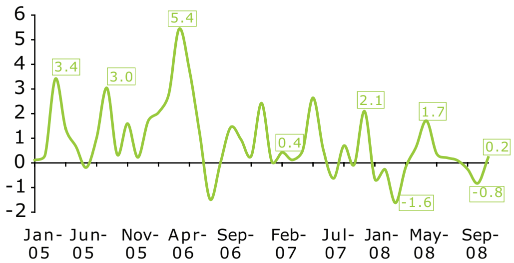
Sources: OREI staff calculations based on data from *International Financial Statistics,* International Monetary Fund; Bloomberg; and JP Morgan.

Figure 39: **Industrial Production Growth**[1] (y-o-y, %)



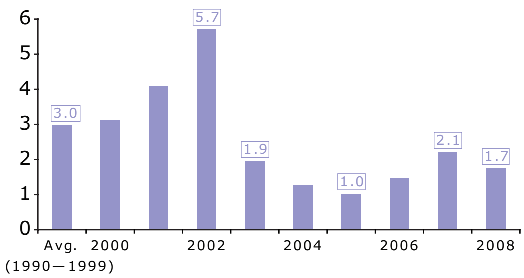
[1]3-month moving average.
[2]Refers to ASEAN-4; Republic of Korea; Singapore; Taipei,China; Thailand, and Viet Nam; does not include Hong Kong, China, Brunei Darussalam, Cambodia, Lao People's Democratic Republic, and Myanmar, for which monthly data are not available.
[3]PRC = People's Republic of China

Figure 40: New IT Orders[1]—G3[2]
(% change)



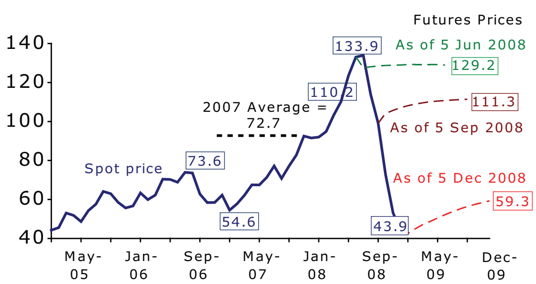
[1] Seasonally-adjusted, 3-month moving average, month-on-month.
[2] US, eurozone, and Japan.
Sources: OREI staff calculations based on national sources.

Figure 41: OPEC Spare Capacity
(in million barrels per day)



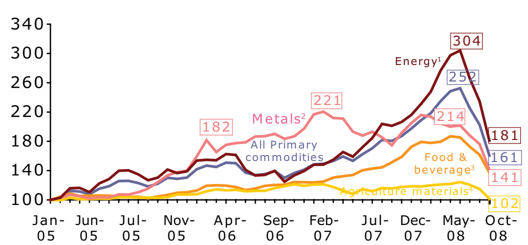
Source: US Energy Information Administration.

Figure 42: Brent Spot[1] and Futures Prices



[1]Monthly average of daily spot prices.
Source: Bloomberg.

Figure 43: Primary Commodity Price Indexes (Jan 2005 = 100)



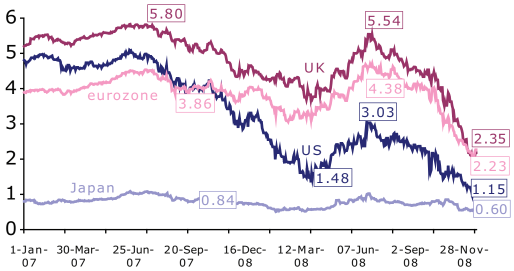
[1]Crude oil, natural gas, and coal.
[2]Copper, aluminum, iron ore, tin, nickel, zinc, lead, and uranium.
[3]Cereal, vegetable oils, meat, seafood, sugar, bananas, oranges, coffee, tea, and cocoa.
[4]Timber, cotton, wool, rubber, and hides.
Source: OREI staff calculations based on data from the *IMF Primary Commodity Prices*, International Monetary Fund.

factors behind the slowdown. Excluding the PRC, industrial production in emerging East Asia grew a mere 3.5% on average for July–September, down sharply from average first-half growth of 8.3%. Softening global demand for high-tech products, depressed chip prices, and sluggish inventory adjustments have taken a heavy toll on regional production. The tentative recovery earlier this year in new G3 orders for information technology (IT) products weakened amid heightened uncertainty about economic prospects **(Figure 40)**. Manufacturing output could tumble further over the next few quarters with major industrial countries in recession and emerging market economies feeling the global credit squeeze

Global oil and commodity prices have fallen sharply—some from record highs—amid fears of a global recession and a strengthening US dollar.

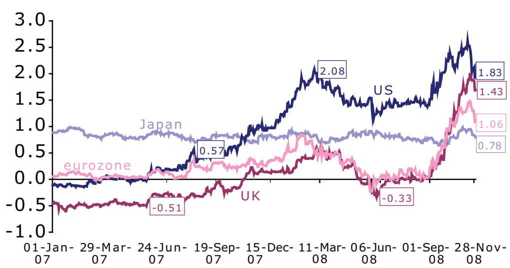
Crude oil prices dropped below $50 per barrel, from a mid-July peak near $150, on slowing world economic growth and the strengthening dollar. Expectations of a significant economic downturn have also reinforced the sense of an easing in market balances brought on by Saudi Arabia's oil production increase during July-August 2008 and the signs of slowing oil demand in response to extremely high prices in recent years. However, the market balance remains tight, particularly with the recent decision by the Organization of the Petroleum Exporting Countries (OPEC) to cut production by 1.5 million barrels per day from 1 November, and given the relatively low surplus capacity among OPEC countries **(Figure 41)**. Nevertheless, commodity markets are focused on rapidly deteriorating world demand. Futures suggest that crude oil prices will remain subdued, only moving back up toward $60 per barrel well into 2009, while prices of non-oil commodities have dropped sharply since mid-2008 on slowing demand **(Figures 42, 43)**. Softening import demand from the PRC—a major source of incremental demand in recent years—combined with the prospect of deteriorating world demand, will continue to place downward pressure on agricultural raw material and base metal prices—at least in the short run.

Figure 44a: 2-year Government Bond Yields (% per annum)



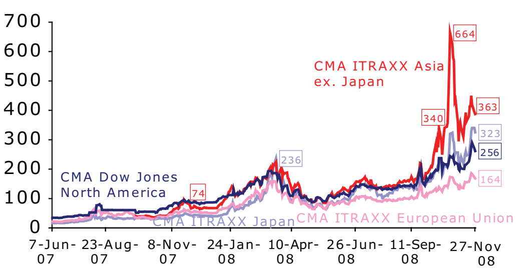
Source: Bloomberg.

Figure 44b: 10-year and 2-year Government Bond Yield Spreads (% per annum)



Source: Bloomberg.

Figure 45: Credit Default Swap Indexes (Investment Grade, Senior 5-Year)



Source: Datastream.

Despite substantial liquidity injections by monetary authorities across the globe, money markets and financial conditions generally remain stressed, and the recovery will take place only gradually.

Since mid-September, the world's major central banks have taken measures of unprecedented scope and magnitude—including coordinated massive injections of liquidity into institutions and markets and extending agreements on foreign exchange swaps—to stem the crisis and rebuild public confidence. But market volatility remains high and markets for bank funding remain under severe stress. Flight to quality and liquidity during the market sell-off has compressed US, UK, and euro government bond yields to historic lows on the short-end, thus steepening yield curves **(Figures 44a, 44b)**. The cost of protecting against corporate defaults, which shot up amid heightened risk aversion among global investors, will likely remain high or rise further, with corporate default rates expected to increase amid worsening economic conditions **(Figure 45)**. If global financial stress intensifies, the effect of tighter domestic credit on overall economic activity will be substantial for emerging East Asia, where firms rely heavily on banks for funding.

Group of 20 (G20)[8] leaders agreed on 15 November to enhance cooperation to revive economic growth and move quickly on reforms in the world's financial systems.

Leaders pledged to take "what further actions are necessary to stabilize the financial system" and to "use fiscal measures to stimulate domestic demand to rapid effect, as appropriate". They set five broad principles for financial system reform: (i) strengthening transparency and accountability; (ii) enhancing sound regulation; (iii) promoting integrity in financial markets; (iv) reinforcing international cooperation; and (v) reforming international financial institutions. A detailed action plan has been drawn up to implement the five principles and G20 finance ministers are expected to undertake the work under the 2009 G20 leadership. Some high priority actions would be completed before the G20 leaders meet next in April 2009. Leaders also pledged to avoid protectionism.

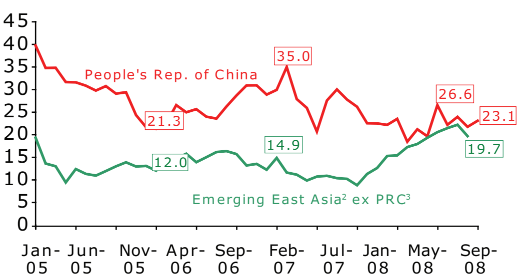
[8] G20 members include: Argentina, Australia, Brazil, Canada, People's Republic of China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, and the United States. The European Union is also a member, represented by the rotating Council presidency and the European Central Bank.

Regional Economic Outlook for 2009

The external economic environment for developing Asia is likely to worsen as major industrial economies contract further, global financial conditions remain constricted, and world trade growth slows sharply.[9] Aggregate GDP growth in developing Asia is forecast to fall to 5.8% in 2009 from this year's estimated 6.9%; economies in emerging East Asia will grow 5.7% in 2009, down from 6.9% this year.

The global economic downturn will have significant impact on developing Asia. But carefully crafted macroeconomic policies—especially fiscal stimulus programs—and underlying growth momentum should allow many of the region's economies to sustain a healthy, albeit slower expansion **(Table 4)**. In the PRC a marked weakening in external demand from industrial countries, as well as the lagged effects of an overheated property market and a sharp drop in stock market values, will weigh down growth. Nonetheless, it will remain the world's fastest growing large economy into next year. The rest of the region will also see economic expansion slow next year, with the more open economies slowing more than others. In 2009, GDP growth is expected to ease substantially in the NIEs and moderately in ASEAN-4. Despite worsening external demand and the cyclical downturn in the global IT industry, most economies in the region should post solid current account surpluses in 2008, driven until recently by robust exports **(Figure 46)**. With export growth expected to slow next year, current account surpluses across the region are likely to compress significantly.

Figure 46: Merchandise Export Growth[1]
($ value, y-o-y, %)



[1]3-month moving average.
[2]Refers to NIEs, ASEAN-4 and Viet Nam; does not include Brunei Darussalam, Cambodia, Lao People's Democratic Republic, and Myanmar, for which monthly data are not available.
[3]PRC = People's Rep. of China

Source: OREI staff calculations based on CEIC data.

Following years of very rapid GDP growth, the PRC economy is expected to slow to 8.2% in 2009 as the external environment weakens amid global financial turmoil.

The outlook for the PRC would be weaker without the government's recently announced RMB4 trillion stimulus program. GDP growth has slowed moderately over the past year, to 9% in the third quarter of 2008, in response to policy measures to rein in an overheated economy. Growth is expected to decelerate further next year, after an estimated expansion of 9.5% in 2008,

[9] Developing Asia includes all of the Asian Development Bank's developing member countries. Available at http://www.adb.org/Countries.

Table 4: Annual GDP Growth Rates (%)

	2003	2004	2005	2006	2007	2008H1	2008Q3	ADB Forecasts	
								2008	2009
Developing Asia	**7.1**	**7.9**	**8.1**	**8.9**	**9.0**	**8.1**	**6.2**	**6.9**	**5.8**
Emerging East Asia[1,2]	**6.9**	**8.0**	**7.8**	**8.7**	**9.0**	**8.1**	**6.2**	**6.9**	**5.7**
ASEAN[1,2]	**5.4**	**6.5**	**5.8**	**6.0**	**6.5**	**5.8**	**4.4**	**4.8**	**3.5**
Brunei Darussalam	2.9	0.5	0.4	4.4	0.6	...	...	-0.5	2.0
Cambodia	8.5	10.3	13.3	10.8	10.2	...	...	6.5	4.7
Indonesia[3]	4.8	5.0	5.7	5.5	6.3	6.4	6.1	6.1	5.0
Lao PDR	5.8	6.9	7.3	8.3	7.9	...	...	7.5	6.5
Malaysia[4]	5.8	6.8	5.3	5.8	6.3	7.1	4.7	5.0	3.5
Myanmar[5]	13.8	13.6	13.2	12.7	...	...	...	...	...
Philippines[6]	4.9	6.4	5.0	5.4	7.2	4.5	4.6	4.5	3.5
Singapore	3.5	9.0	7.3	8.2	7.7	4.5	-0.6	2.3	1.2
Thailand	7.1	6.3	4.6	5.2	4.9	5.6	4.0	4.0	2.0
Viet Nam	7.3	7.8	8.4	8.2	8.5	6.5	6.5	6.3	5.0
Newly Industrialized Economies[1]	**3.2**	**6.0**	**4.8**	**5.5**	**5.6**	**5.3**	**2.0**	**3.5**	**2.4**
Hong Kong, China	3.0	8.5	7.1	7.0	6.4	5.8	1.7	3.3	2.1
Korea, Republic of	3.1	4.7	4.2	5.1	5.0	5.3	3.8	4.2	3.0
Singapore	3.5	9.0	7.3	8.2	7.7	4.5	-0.6	2.3	1.2
Taipei,China	3.5	6.2	4.2	4.8	5.7	5.4	-1.0	2.4	1.7
China, People's Republic of	10.0	10.1	10.4	11.6	11.9	10.4	9.0	9.5	8.2
Japan	1.4	2.7	1.9	2.0	2.4	1.1	-0.5	0.5	-0.2
US	2.5	3.6	3.1	2.9	2.2	2.3	0.8[7]	1.4	-0.7
eurozone	0.8	2.1	1.6	2.8	2.6	1.7	0.6[7]	1.2	-0.5

... = not available

[1]Aggregates are weighted according to gross national income levels (atlas method, current $) from *World Development Indicators* (World Bank).

[2]Excludes Brunei Darussalam and Myanmar for all years as weights are unavailable.

[3]GDP growth rates from 1999–2000 are based on 1993 prices, while growth rates from 2001 onward are based on 2000 prices.

[4]Growth rates from 1999–2000 are based on 1987 prices, while growth rates from 2001 onward are based on 2000 prices.

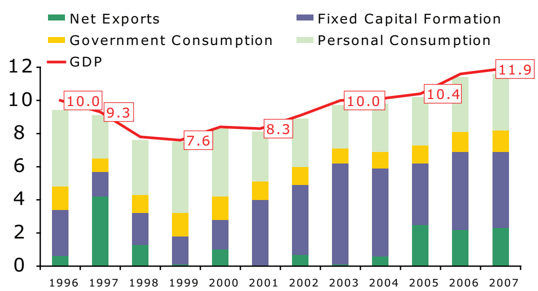
[5]For FY April–March.

[6]Figures for 2004–2006 are not linked to the GDP figures 2003 backwards due to National Statistics Office revisions of sectoral estimates.

[7]refers to year-on-year growth, seasonally adjusted data.

Sources: ADB; government estimates (Brunei Darussalam); Eurostat website (eurozone); Economic and Social Research Institute (Japan); Bureau of Economic Analysis (US); *World Economic Outlook,* International Monetary Fund (Oct. 2008).

Figure 47: Contributions to Growth—People's Republic of China (% change)



Source: China Statistical Yearbook 2008.

underpinned by robust private consumption and solid net exports. After contributing about 2 percentage points to GDP growth in 2007, net exports are expected to contract in 2009 as external demand slows sharply **(Figure 47)**. Macroeconomic policy has now shifted to spurring domestic demand to offset the expected weakening in exports and private investment growth. Monetary measures already adopted include sizeable cuts in interest rates and reserve requirements as well as lifting lending quotas for banks. Apart from the massive fiscal program (primarily infrastructure and social spending), the government has cut taxes, boosted subsidies to agriculture, and accelerated spending. Strong fiscal and trade positions should allow further initiatives to support economic growth in 2009, if needed.

As highly open economies, the NIEs are extremely sensitive to changes in the global economic environment; thus GDP is projected to grow by 2.4% in 2009, down from the 3.5% expected this year, outcomes well below recent trend and potential NIEs growth.

In recent months, falling stock prices and a weak won have undermined economic expansion in Korea. The authorities have taken various measures to ease financial stress and to stimulate demand, including a guarantee of $100 billion for local banks' foreign borrowing and an $11 billion fiscal stimulus package. Given the prospects for falling external demand and the reluctance of banks to lend, growth is expected to fall to 3.0% in 2009. Hong Kong, China's economy contracted again in the third quarter (q-o-q) and is expected to remain weak next year, reflecting its extensive trade and financial links with industrial countries. GDP growth is forecast to slow to 2.1% in 2009 from an estimated 3.3% this year. The outlook for Singapore, which is already in recession, is also bleak, with growth projected to slow to 1.2% in 2009 from 2.3% expected this year. The plunge in stock prices may further slow private consumption and investment. Growth in Taipei,China is projected at 1.7%.

Aggregate GDP growth in ASEAN is expected to weaken to 3.5% in 2009 from an estimated expansion of 4.8% in 2008 (which was only kept relatively high by a buoyant first half). Domestic demand, helped by policy measures, is likely to mitigate some of the impact of the weakening external environment.

The four largest, middle-income ASEAN economies—Indonesia, Malaysia, the Philippines and Thailand—are expected to see growth drop by about one to two percentage points, mainly due to the global downturn. In Indonesia, GDP growth is projected to moderate to 5.0% in 2009, after reaching 6.1% in 2008—growth in the first-half of 2008 was its best performance since the 1997/98 Asian financial crisis. In Malaysia, falling commodity prices weigh down economic activity, but domestic demand will be supported by increased public spending. Nevertheless, growth is expected to slide to 3.5% in 2009 from an estimated 5.0% this year. After slowing in the first half of 2008, Philippine GDP growth is expected to be sluggish at 3.5% in 2009—down from 4.5% this year—on weak exports and slower private consumption. In addition to the global financial turmoil, political uncertainty continues to drag on the Thai economy, with economic growth projected at 2.0% in 2009.

Growth in the remaining (smaller) ASEAN countries[10] is also expected to slow in response to the difficult global environment. After accelerating over the past few years, Viet Nam's GDP growth is projected to moderate to 6.3% in 2008 and 5% in 2009—on slowing industrial activity and investment. Cambodia is working to consolidate GDP growth by promoting a more balanced expansion among key industries—including agriculture, construction, garments, and tourism. But given a narrowly based economy that relies heavily on garment exports and tourism, deteriorating external demand will hamper growth—estimated at 4.7% in 2009. The Lao PDR economy has benefited from strong power and commodity prices. But with commodity prices falling, economic growth is forecast to slow to 6.5% in 2009 from an expected 7.5% this year. In Brunei Darussalam, with an economy concentrated on oil and gas production and exports, the sharp decline in oil prices will likely keep economic growth subdued at 2% in 2009.

[10] ADB forecasts are unavailable for Myanmar.

Inflation has peaked in most emerging East Asian economies as commodity prices have come off elevated levels, growth has slowed, and credit tightened. Given the global economic slump, inflation in the region in 2009 is expected to moderate substantially.

After rising rapidly in the first half of 2008, inflation has begun to subside recently, although headline and core inflation (which excludes food and energy) are still high in several economies. The recent weakening in some currencies may also add somewhat to inflationary pressures. Nevertheless, in general, lower oil and food prices and slowing economic activity should markedly reduce price pressures in 2009, though inflation in Indonesia, Philippines, and Viet Nam may remain relatively high.

The balance of payments position for most emerging East Asian economies is expected to weaken in 2009, with foreign exchange reserves declining in a few countries yet remaining comfortable in most.

In the first half of 2008, current account and balance of payments surpluses remained strong despite the run-up in oil and commodity prices. The aggregate current account surplus is expected to narrow in 2008 and 2009 after peaking at about 7.0% of GDP in 2007. Current accounts will likely post large, albeit smaller, surpluses in the PRC; Hong Kong, China; Malaysia; and Singapore, but are expected to be close to balance in Indonesia, Korea, and Thailand. During the recent financial turmoil, however, capital outflows rose markedly, particularly in Korea, Indonesia, and to a lesser extent, the Philippines and Thailand. Risk aversion and flight-to-safety have created depreciation pressures on the region's currencies, with the exception of the PRC. And foreign exchange reserves declined in a number of countries after authorities intervened in foreign exchange markets to curb the pace of depreciation (see Table 2).

Risks to the Outlook

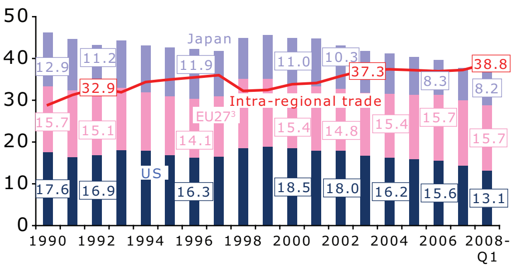
Major risks to the outlook include (i) a sharper or prolonged global recession, (ii) persistent financial stress with volatile capital flows, (iii) further tightening of external and domestic funding conditions, and (iv) excessively volatile conditions in foreign exchange markets.

A key assumption underlying the less favorable yet still positive regional outlook is that major governments continue to take measures to stabilize financial market conditions and shore up their economies. This remains a tenuous assumption, however, and leaves the outlook subject to much greater downside risks now than just a few months ago.

A deeper or more protracted economic downturn in the US and Europe would have severe spillover effects on emerging East Asian economies.

Major industrial economies have already seen a visible contraction and face a risk of deeper recession over the next few quarters. With the drastic intensification of the financial crisis, credit to households and firms could be further tightened, deepening and lengthening the downturn. Home prices in the US have already fallen about 18.5% from their peak in 2006, and could fall further as a result of continued mortgage defaults and foreclosures. Falling asset prices have sharply reduced household wealth, causing consumers to cut spending, which in turn further slows economic activity. The inability of the US to achieve wide-scale modifications in the growing number of distressed and negative equity mortgages to mitigate this negative feed-back loop from foreclosures may well delay a US recovery. Other components of aggregate demand, investment and net exports are also falling. Thus a downward demand spiral could become much worse and more prolonged across the developed world. Trade links between emerging East Asia and major industrial economies remain substantial despite a gradual decline in the overall trade share **(Figure 48)**. G3 economies account for more than 60% of final demand for Asian exports, after taking account of intraregional trade of intermediate goods.[11] With the world's major industrial economies slipping into recession, the region's exports will likely

Figure 48: Trade Links (share of G3[1] in Total Exports of Emerging Asia[2], %)

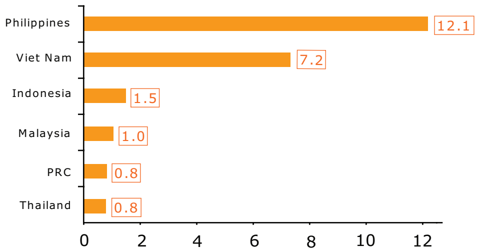


[1]US, EU-27, and Japan.
[2]Includes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Lao People's Democratic Republic; Malaysia; Myanmar; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
[3]Includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and United Kingdom.

Source: *Direction of Trade Statistics,* International Monetary Fund.

[11] ADB (2007) "Uncoupling Asia: Myth and Reality," *Asian Development Outlook 2007.*

Figure 49: Overseas Remittances
(% of GDP, 2007)



PRC = People's Republic of China
Sources: *World Development Indicators,* World Bank; *Balance of Payments Statistics Yearbook,* International Monetary Fund; and national sources.

suffer. Net exports in some advanced regional economies have already dipped into negative territory. A protracted recession could also provoke steps toward protectionism, further compromising the world trade environment. The ripple effects of a global recession will be felt in the region's current account balances through tourism receipts and remittances as well. In particular, overseas remittances are an important source of income and, more importantly during a crisis, a supply of dollars for many of the region's economies—including Philippines and Viet Nam **(Figure 49)**. Growth in remittances slowed to 10.4% (y-o-y) in August in the Philippines, for example, after gains of 24.6% in July and 30% in June. Overall, risks to the region's growth outlook are strongly tied to the global outlook through both trade and financial links, with increasing signs that further financial disruptions could also exert a significant influence on consumer and investor confidence in the region.

Continued global deleveraging and heightened risk aversion could cause a sudden dramatic reversal in capital flows to the region, further disrupting domestic asset prices and threatening wholesale depreciation.

As deleveraging continues in global financial systems, capital flows to the region have reversed with sharp swings in emerging Asian market asset prices. Emerging Asian equities have been particularly hard hit, as foreign investors reposition their investment portfolios. Net equity outflows for eight economies in the region are now estimated to have totaled around $72 billion in the year through November,[12] contributing to sharp depreciation of many of the region's currencies. Should foreign banks decide to suddenly liquidate holdings of domestic Asian assets—as part of the deleveraging process—it would affect Asia's domestic asset prices and place further pressure on exchange rates and external reserves.

[12] Hong Kong, China; Republic of Korea; Indonesia; Malaysia; Philippines; Taipei,China; Thailand; Viet Nam.

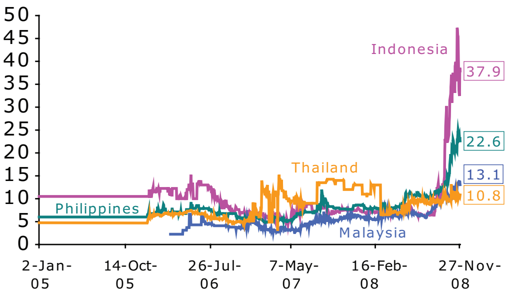
If international financial conditions worsen, external financing could dry up, placing several of the region's financial systems in jeopardy, and causing domestic credit conditions to deteriorate.

With risk aversion rising sharply, offshore funding conditions have deteriorated substantially. Offshore bond issuance dropped more than half and credit default swap (CDS) spreads for Asian sovereign and corporate issuers have widened sharply in tandem with global trends. With sharp rises in external borrowing costs, many emerging East Asian economies have also experienced difficulties in dollar funding. Cross-currency basis swap spreads increased sharply for a number of economies, reflecting both rising counterparty risk and dollar funding demand. Banking systems with relatively large short-term external debts experienced further stress due to heightened concerns about rollover risk. Liquidity and pricing strains in international funding markets could also be transmitted to local interbank markets and the domestic bond market. Pricing in domestic bank funding markets in some economies is already showing signs of stress and if the global credit crunch persists, local funding conditions could deteriorate sharply. Should the cost of capital and the level of investment be severely affected, the economic performance in countries in emerging East Asia could suffer far more significantly.

The region's relatively thin foreign exchange markets remain highly vulnerable, leading to excess volatility and overshooting.

The risk of one-way currency bets remains high in the region amid global deleveraging and the flight to safety. Heightened foreign exchange volatility threatens to undermine the financial health of the banking and corporate sectors in many of the region's economies where currency hedging remains difficult. Many currencies have been hard hit, largely due to heavy selling by foreign investors in local equity markets. Many emerging East Asian stock markets would face further sharp withdrawals of foreign portfolio investments in the event of a financial disruption. With relatively thin currency markets, these economies often have difficulties dealing with one-way bets on exchange rates. Excess volatility and overshooting in some currencies have already led policy makers to intervene heavily in foreign exchange markets over the past few months, depleting external reserves. Volatility

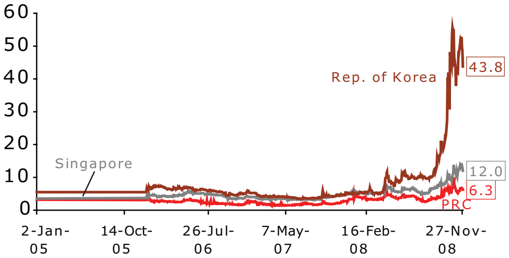
Figure 50a: Implied Volatility of Exchange Rates—ASEAN-4 (3-month ATM[1])



[1]At the money

Source: Bloomberg.

Figure 50b: Implied Volatility of Exchange Rates—PRC, Korea, and Singapore (3-month ATM[1])



PRC = People's Republic of China
[1]At the money

Source: Bloomberg.

remains high **(Figures 50a, 50b)**, adding strains on the trade sector, particularly where the domestic financial markets remain underdeveloped, providing few tools for the private sector's currency hedging. Rapid depreciation also places an added burden on monetary authorities to contain its pass-through onto domestic price levels, particularly in economies where inflation remains high and underlying price pressures from recent high oil and commodity prices are still working their way through the economy.

Policy Issues

Authorities should continue taking appropriate measures to calm financial markets and restore investor confidence.

As contagion struck Asia's financial markets, stock prices and currencies came under enormous pressure. In September and October, the region's major stock market indexes dropped between 20% and 60%, and some currencies depreciated by up to 29%, even as substantial reserves were used to smooth rate adjustments. Authorities have introduced various measures, including liquidity support and injections to financial institutions, deposit and loan guarantees, interest rate cuts, and other accommodative monetary measures, as well as adopting fiscal stimulus programs (see Table 3). Prompt and proactive action by the authorities remains key to stabilizing financial markets and keeping financial systems functioning normally.

As the effects of the global financial crisis intensify, emerging East Asia faces new challenges to ensure downside risks are properly addressed.

The global financial crisis has ravaged world financial systems on an unprecedented scale—leading to bank closures, stock market losses, and tremendous uncertainty across markets. While the measures taken so far around the globe should help reduce the severity and duration of the crisis, considerable damage has already been done to global financial systems, and the knock-on effects on the world economy will be felt for an extended period. As the financial storm has engulfed the global economy, downside risks to growth within the region have increased significantly. Detailed regulatory issues and some suggested policy options to safeguard financial stability are discussed in the Special Section.

The coming year will be a difficult one for emerging East Asia; but it will be manageable if countries respond promptly, decisively, and collectively.

Many predict the global economic slowdown will be the worst since the 1930's Great Depression. Emerging East Asia enters this tumultuous time probably better prepared than most other regions in the world. But for 2009 to be manageable for the region's policy makers, they will need to act promptly to stem both the threat to financial systems and the real economy. They must be decisive to rebuild confidence among both businesses and consumers. And they must cooperate and act collectively to minimize the contagion effects any further financial instability can cause.

Regional policy makers face the difficult task of navigating their economies through the global downturn while safeguarding financial stability.

Inflation has peaked in many of the region's economies, providing maneuverability for policy makers amid the rapidly deteriorating external environment. Global financial turmoil and its effects on the real economy have already called for immediate action to stabilize financial market conditions. However, much more needs to be done and a judicious mix of policy tools—monetary, fiscal, exchange rate, financial, and structural—should be used to minimize the deleterious effects of the crisis, while ensuring that short-term setbacks do not derail long-term economic growth. Overall, the region's ability to clear these short-term hurdles depends to a large extent on whether policy makers can successfully rebalance export-driven growth with a greater reliance on domestic demand, and to facilitate this rebalancing with financial deepening and continued reform.

With the balance of risks shifting from rising inflation to slowing growth, monetary policy must remain flexible to allow growth stimulus where appropriate while keeping inflation expectations firmly anchored.

In the past several months, PRC; Japan; Korea; Singapore; and Viet Nam have adapted their policy stances by cutting policy rates (see Figures 25a, 25b), reducing reserve requirements, or shifting the slope of their exchange rate bands to boost domestic demand. As inflation falls and economic activity slows, monetary fiscal policy in these economies may have more room to stimulate demand. Although inflationary pressures are subsiding, high inflation rates in several countries constrain monetary discretion. For example, Indonesia, Philippines, and until very recently, Viet Nam have had to maintain a tightening bias to fight inflation. While falling in many countries, inflation remains at double-digit levels in several, including Cambodia, Indonesia, Lao PDR, Philippines, and Viet Nam. Although world commodity prices are down considerably and capacity pressures are easing, currency depreciation has become a source of inflationary pressure in some countries. Moreover, prices may be less flexible downward as firms strive to maintain profitability in a weakening economic environment. In these circumstances monetary authorities will need to strike a careful balance to keep inflation under control, even though it may limit room to respond to a slowing economy. In particular, the implications of inflation on the poor is important as the burden of heightened food and fuel prices will likely fall disproportionately on those who face the prospect of lower incomes. Elevated price levels, diminishing employment opportunities, budgetary pressures on social programs, and the prospect of slowing growth in remittances, are likely to increase strains on the poor.

Fiscal policy could hold center stage for many emerging East Asian economies in mitigating/ minimizing the effects of deteriorating external economic conditions on growth prospects.

Authorities across the region have already taken fiscal measures in response to the global financial turmoil, with budget deficits expected for 2008/09 **(Table 5).** As discussed earlier, authorities in the PRC, Korea, and Malaysia have introduced large fiscal stimulus packages. In the Philippines, the government has deferred its goal of a balanced budget until 2010, raised social spending, and implemented tax breaks, and Thailand implemented a $1.4 billion 6-month stimulus package in August. Luckily, with healthy fiscal and external positions, many regional economies have sufficient scope to increase government expenditure to support growth **(Table 6)**. Current economic and financial circumstances also warrant more active fiscal responses as monetary policy may have less traction than in the past. Banks in the region have become more risk averse and are reluctant to lend in the face of a deteriorating and increasingly uncertain economic outlook. Authorities should carefully design fiscal support to cushion the most vulnerable from the immediate effects of the global downturn. When deploying fiscal stimulus, authorities should also be mindful of medium- and long-term fiscal challenges, as populations in several economies in the region are aging quickly.

Table 5: Fiscal Balance of Central Government (% of GDP)

	2000–2004 Average	2004	2005	2006	2007	2008[1]	2009[2]
Cambodia	-5.8	-4.6	-3.4	-3.0	-3.2	-3.2	-3.1
China, People's Rep. of[4]	-2.2	-1.3	-1.2	-0.8	0.7	-0.4	-2.6
Hong Kong, China[3]	-2.4	1.7	1.0	4.0	7.2	-0.4	2.7
Indonesia	-1.5	-1.1	-0.5	-1.0	-1.6	-1.1	-1.0
Korea, Republic of	-0.7	-0.5	0.1	-1.3	-1.5	-1.1	-1.0
Malaysia	-5.2	-4.1	-3.6	-3.3	-3.2	-4.8	-4.8
Philippines	-4.4	-3.8	-2.7	-1.1	-0.2	-1.0	-1.2
Singapore[3]	7.3	5.5	8.3	7.5	11.4	7.0	…
Taipei,China[3]	-2.2	-2.3	-1.8	-0.8	-0.1	-1.8	-1.1
Thailand[3]	-1.1	0.1	-0.6	1.1	-1.7	-1.8	-3.5
Viet Nam	-3.2	-4.7	-4.6	-4.1	-4.9	-5.0	-4.8

… = not available
[1]Figures for Hong Kong, China; Republic of Korea; Malaysia; and Singapore are from their respective national budgets. Figures for Indonesia; Philippines; Taipei,China; Thailand; and Viet Nam are government estimates. Figure for Cambodia is an IMF estimate.
[2]Budget except for Philippines; Taipei, China (government forecasts); Cambodia (IMF estimate).
[3]Fiscal year.
[4]2008–2009 figures for the PRC are World Bank projections and cover central and local governments.

Sources: *Asian Development Outlook* (various issues), Asian Development Bank; *International Monetary Fund Article IV,* International Monetary Fund; National sources; *China Quarterly Update* (December 2008), World Bank.

Table 6: Public and External Debt (% of GDP)

	2000-2004 Average	2004	2005	2006	2007	2008
Public Sector Debt						
China, People's Rep. of	19.3	18.5	17.9	17.3	...	...
Indonesia[1]	70.7	55.2	45.6	39.0	35.0	31.2^{p}
Korea, Rep. of[1]	21.1	25.2	29.5	32.2	32.1	32.8^{p}
Lao PDR	76.6	83.0	77.5	69.3	...	...
Malaysia[2]	42.1	45.7	43.8	42.2	41.6	...
Philippines[3]	93.2	95.2	86.0	73.9	62.3^{e}	59.0^{p}
Singapore[4]	96.9	101.1	100.3	95.1	96.3	94.4
Taipei,China[1]	28.0	30.4	31.0	29.9	30.7	...
Thailand	54.5	49.3	47.3	40.3	37.5	38.2^{p}
Viet Nam	39.7	42.4	43.8	43.3	43.4^{p}	44.9^{p}
External Debt[5]						
Brunei Darussalam	9.6	8.7	7.7	7.0	7.5	5.3
Cambodia	26.2	21.0	20.5	17.9	18.8	16.2
China, People's Rep. of	8.1	6.7	5.8	5.3	5.7	6.0
Hong Kong, China	128.9	138.5	141.6	153.7	171.2	175.3
Indonesia	55.0	30.1	31.0	21.9	20.7	19.7
Korea, Rep. of	23.5	21.5	20.4	24.8	28.9	32.0
Lao PDR	64.5	57.9	58.2	54.1	57.4	48.5
Malaysia	42.8	42.1	42.9	40.2	38.4	38.5
Myanmar	53.2	20.8	18.0	17.0	17.8	18.5
Philippines	75.0	62.2	63.1	51.9	45.7	37.3
Singapore	266.9	272.1	263.9	242.8	290.6	275.6
Taipei,China	14.1	24.6	22.2	18.3	20.1	20.2
Thailand	37.2	20.8	20.9	19.3	14.8	12.8
Viet Nam	27.1	22.0	22.4	22.8	27.0	25.9

^{p} = projection, ^{e} = estimate, … = not available.
[1]Central government debt.
[2]Federal government debt.
[3]Nonfinancial public sector debt.
[4]As of Sep 2008.
[5]As of Jun 2008.

Sources: *Article IV Consultations,* International Monetary Fund, CEIC; and Joint External Debt Hub database.

While some recent foreign exchange market Interventions appear warranted given the extreme volatility and overshooting, excessive support of the exchange rate and depletion in foreign exchange reserves make economies more vulnerable to future shocks and constrain policy maneuverability.

Some intervention in the region's foreign exchange markets seems warranted, particularly where excess volatility and overshooting undermine the normal functioning of currency markets and severely hamper economic activity. But the region's authorities should remain cautious, as excessive interventions may eventually increase the risk of one-way bets on their currencies, leading to greater exchange rate volatility and a more disruptive adjustment down the road. In some economies with relatively rigid currency regimes, introducing greater flexibility may also help enhance the effectiveness of monetary and fiscal stimulus, while rebalancing demand.

Policy makers in many emerging East Asian economies need to deepen and broaden structural reforms to rebalance the sources of growth from an over-reliance on exports to domestic demand.

To improve the investment climate, many ASEAN countries should focus on key weak areas, such as policy uncertainties, good governance, the quality of legal and institutional frameworks, and regulatory capacity. Addressing these problems will require additional structural reforms to improve efficiency and competitiveness. In the PRC, for example, there is need for continued rebalancing of expenditures to support social sector development and to address income inequalities, removing some impediments to private consumption. Structural reforms would increase economic efficiency and agility, yield higher economic growth, and generate a large number of productive employment opportunities, thus eventually boosting domestic consumption and investment. Incentives must also be provided to encourage rational resource allocation and use so that firm-level productivity can be improved. This would ensure that firms remain competitive and are able to participate in and benefit from globalization.

The region has the opportunity to take collective action to address the knock-on effects of the global financial crisis.

Existing mechanisms under ASEAN+3, particularly the Chiang Mai Initiative (CMI), should be strengthened and put into operation. Because the challenges facing Asian economies are structurally different from those in the US and Europe, strengthening the CMI would not imply mobilizing resources to buy toxic assets from regional financial institutions, but offering immediate liquidity injections to those economies which may have urgent needs. ASEAN+3 should also consider accelerating the establishment of a credit guarantee and investment mechanism (CGIM) to provide credit guarantees for domestic commercial banks' loans and bond issuance to gain easier access to US dollar funding **(Box 2)**. Moreover, Asian authorities may consider establishing an Asian Financial Stability Dialogue to coordinate efforts to address the financial crisis. Many national governments introduced measures to support their banking systems to help stabilize financial markets and facilitate economic recovery. Coordination of these national measures from a regional and global perspective could help ensure the actions of one country do not add stress to a neighbor's financial system by forcing them into inappropriate or rash ad hoc responses.

Box 2: A Credit Guarantee Facility—Easing the Impact of Financial Crisis

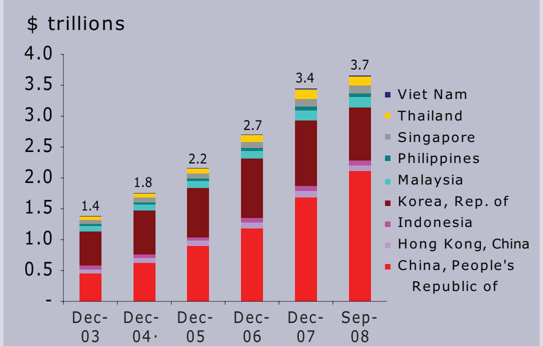
One of the most valuable lessons learned from the 1997 Asian financial crisis was the need to develop local currency bond markets as an alternative source of funding to bank loans. At the time, bank lending dominated. And with inadequate hedging, banks were highly vulnerable to foreign exchange risk. Also, there was considerable short-term borrowing to finance long-term investment. These currency and maturity mismatches made bank balance sheets vulnerable to sudden withdrawals by foreign investors, which helped trigger the crisis. Since then, to ensure availability of long-term domestic currency funding (preventing maturity and currency mismatches) and better channel the region's savings into regional investment, East Asia's policy makers have worked together to promote and develop a regional bond market.

In December 2002, the finance ministers of the Association of Southeast Asian Nations (ASEAN) and the People's Republic of China (PRC), Japan, and Republic of Korea (Korea)—or ASEAN+3—launched the Asian Bond Markets Initiative (ABMI) to promote the development of local currency bond markets. ASEAN+3 has focused policy support to create a larger supply of bonds denominated in Asian currencies, improve credit information on debt issuers to allow better investment decisions, and to help build market infrastructure supporting cross-border bond issuance and investment.

The ABMI has achieved much. Local currency denominated bonds outstanding in emerging East Asia grew sharply from $1.4 trillion in 2003 to almost $3.7 trillion in September 2008. However, much more needs to be done to give corporations better access to the region's bond markets and to offer a variety of maturities to meet issuers' financing needs. For example, regulators normally prescribe minimum ratings for bond investments for the institutions they supervise—generally A for banks and AA for insurance companies. The risk-return properties of these markets have not yet developed to the point where lower-rated companies can sell bonds—at any price.

This market failure is compounded by the lack of local bond guarantee agencies to enhance investment grade companies ratings (BBB and higher)—up to at least A, if not AA—to gain full market access. Most guarantee agencies in the region focus on providing loan guarantees for small and medium enterprises—a business that requires annual fiscal support, given the 2–4% nonperforming loans generally associated within this lending. Neither the skill sets nor the small capitalizations of these guarantee agencies allow them to be bonafide bond guarantee agencies.

Figure B2: Local Currency Bonds Outstanding in Emerging East Asia
(by market)



Source: *AsianBondsOnline*.

Another difficulty issuers face is limited bond maturities, particularly for infrastructure projects. For example, in Korea, while BBB-rated companies can issue bonds, the maximum maturity tends to be 3 years. Maturities of bonds issued by AAA-rated companies are not much longer, although government bonds can have maturities up to 20 years.

To address these constraints, ASEAN+3 has worked with the Asian Development Bank (ADB) on establishing a regional credit guarantee for bonds issued in local currencies to improve the corporate sector's access to bond markets and to minimize the currency and maturity mismatches.

ASEAN+3 and ADB recently agreed to establish a credit guarantee and investment mechanism (CGIM) to provide credit guarantees for bonds issued in the region and investments in domestic credit guarantee companies. CGIM will be an ADB trust fund, with capital from ASEAN+3 and ADB. It will carry an AAA rating. During the November 2008 Deputy Ministers of Finance meeting, ASEAN+3 and ADB agreed to fast-track setting up the CGIM, especially in light of the current global financial crisis.

With global credit tight, dollar illiquidity has reached Asian shores, despite the large build-up of foreign exchange reserves across the region. Major international banks have drastically reduced lending to Asian banks, as they try to hoard dollars for their own liquidity needs. This hurts Asian exporters, where dollar supply is an essential element for trade finance.

As the financial turmoil deepens, investors increasingly become risk averse. Offshore bond issuance dropped by more than half and credit default swap spreads for Asian sovereign and corporate issuers have widened significantly with the global trend. External borrowing costs have thus risen and many of the region's economies have trouble accessing dollars. Cross-currency basis swap spreads increased sharply in several economies, both from rising counterparty risk and dollar funding demand. Banking systems with relatively large short-term external debt face further stress with heightened concerns about rollover risk. Global liquidity and pricing strains have already transmitted to domestic interbank and local currency bond markets. Should this continue, the high cost of capital would severely dampen investment and economic growth in the region.

To help mitigate the impact of the financial turmoil, it would be highly desirable if the region's policy makers—together with ADB—could establish a credit guarantee facility to guarantee bonds issued by the corporate sector and selected ADB member countries seeking external funding for fiscal purposes. The facility could be built on the agreed ASEAN+3 framework for the CGIM, however, with a provision to expand availability to other ADB member countries. Moreover, the guarantees under the facility could be extended to bonds issued in both local currencies and US dollars to ease access to both international and domestic bond markets.

Credit guarantees for bonds in general help minimize capital outflows and those for bonds issued by banks in US dollars in particular make it possible for these institutions to continue lending to exporters, including small and medium size enterprises. Moreover, the facility would help reduce risks in the region's financial sectors by helping reduce currency and maturity mismatches. In turn, this helps make the region's financial systems more sound and resilient. Additionally, the credit guarantee facility would serve to promote regional public goods through promoting financial integration—allowing companies in the region to more effectively tap regional savings for financing regional trade and investment, and thus promoting economic growth.