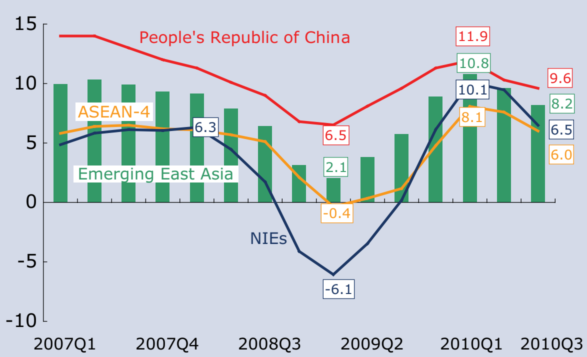
Recent Economic Performance

Growth and Inflation

Robust recovery was the norm across most of emerging East Asia in 2010, though moderating somewhat in the second half as stimulus was withdrawn.

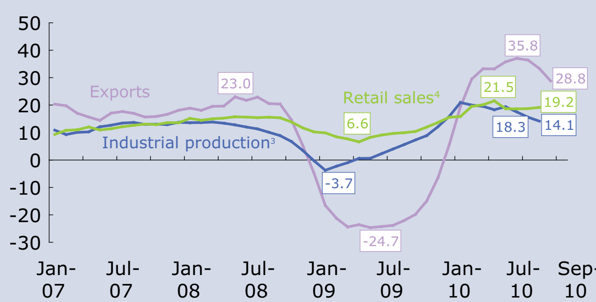
Emerging East Asian economies continued to post strong growth in the third quarter of 2010, driven by domestic demand. But the weaker external environment and phasing out of policy stimulus slowed demand, which began to appear in the second quarter. Combined gross domestic product (GDP) growth of the 10 largest economies in emerging East Asia[1] eased slightly, but with a robust 8.2% year-on-year[2] growth in the third quarter, down from the 10.2% expansion in the first half of 2010 **(Figure 1)**. Growth in the People's Republic of China (PRC) is beginning to ease, still robust at 9.6% in the third quarter, but a good sign nonetheless. Aggregate GDP growth in the four middle-income economies of the Association of Southeast Asian Nations (ASEAN-4)[3] declined to 6.0% in the third quarter from a strong 7.8% first half growth. The four newly-industrialized economies (NIEs)[4] expanded 6.5% in the third quarter, after growing 9.8% in the first half. Singapore, the region's fastest growing economy, moderated to 10.6% in the third quarter, after two quarters of rapid growth. With exports, retail sales, and industrial production slowing, growth is expected to continue to moderate in the fourth quarter **(Figure 2)**.

Figure 1: Regional GDP Growth[1]—Emerging East Asia[2] (y-o-y, %)



y-o-y = year-on-year.
ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; GDP = gross domestic product; NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.
[1]Weighted by gross national income (atlas method, current $). [2]Includes ASEAN-4, NIEs, Viet Nam, and People's Republic of China.
Source: OREI staff calculations based on national sources.

Figure 2: Merchandise Export, Industrial Production, and Retail Sales Growth[1]—Emerging East Asia[2] (y-o-y, %)



y-o-y = year-on-year.
Note: Exports in $ value; industrial production and retail sales in local currency.
[1]3-month moving average. [2]Includes People's Republic of China; NIEs (Hong Kong, China; Republic of Korea; Singapore; and Taipei,China); and ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand); and Viet Nam. [3]Does not include Hong Kong, China for which monthly data unavailable. [4]Does not include Malaysia and Philippines for which monthly data unavailable. Data on industrial production and retail sales until Aug 2010.
Source: OREI staff calculations based on CEIC data.

[1]The 10 largest emerging East Asian economies are the People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

[2]All growth figures are year-on-year unless otherwise indicated.

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

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

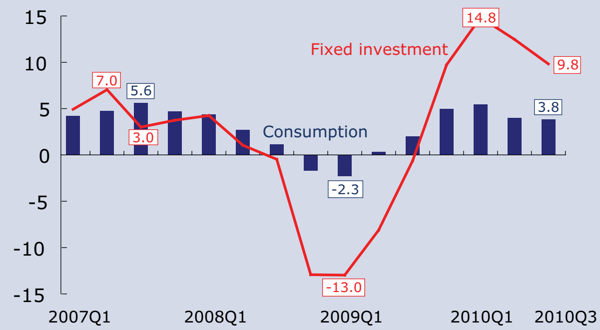
Domestic demand continues to drive economic growth in the region but at a slower pace.

In the third quarter, domestic demand remained the largest contributor to GDP growth in most of ASEAN-4 and NIEs **(Figure 3)**. Investment eased, but still grew at a healthy pace, as the impact of fiscal and monetary stimulus waned, and contribution from inventories restocking grew smaller. Fixed investment growth in the NIEs slowed further to 9.8% in the third quarter from the previous quarter's 12.5% **(Figure 4)**. In the ASEAN-4, investment growth fell for the first time this year—to 9.7% in the third quarter **(Figure 5)**. The steady growth in consumption in ASEAN-4 and the NIEs benefited from generally stable consumer confidence throughout the year **(Figure 6)**. In the PRC, private consumption, proxied by retail sales, remained strong as well **(Figure 7)**.

Robust growth continued in the PRC, though tempered somewhat by fading impact of stimulus.

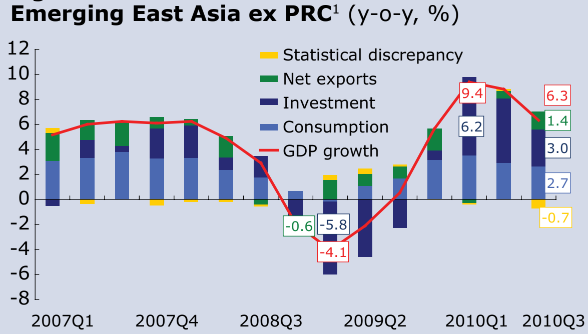
PRC's GDP grew 10.6% in the first three quarters—well above the 8.1% growth in the same period of 2009. However, it eased to 9.6% in the third quarter. The weaker growth was likely due to slower investment. Fixed asset investment is moderating but still growing at a rapid 24.4% in October **(Figure 8)**. The surge in real-estate investment has not offset the significant slowdown in government-led investment. Growth in industrial output eased with fewer infrastructure start-ups and the government's efforts to reduce energy consumption **(Figure 9)**. Private consumption and exports were probably behind growth in the third quarter. Retail sales grew steadily in the third quarter as real incomes rose from more new jobs than expected and increased salaries

Figure 4: Domestic Demand Growth—NIEs[1] (y-o-y, %)



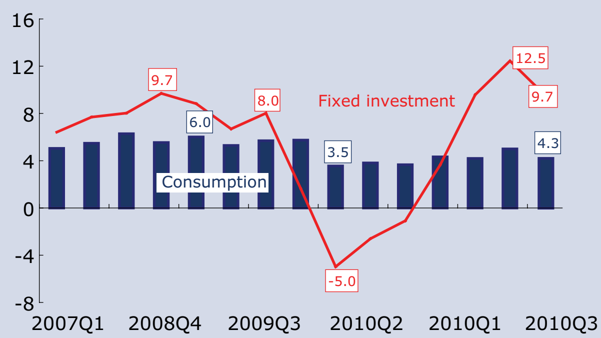
y-o-y = year-on-year.
[1]Includes Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.
Source: OREI staff calculations based on CEIC data.

Figure 3: Contributions to GDP Growth—Emerging East Asia ex PRC[1] (y-o-y, %)



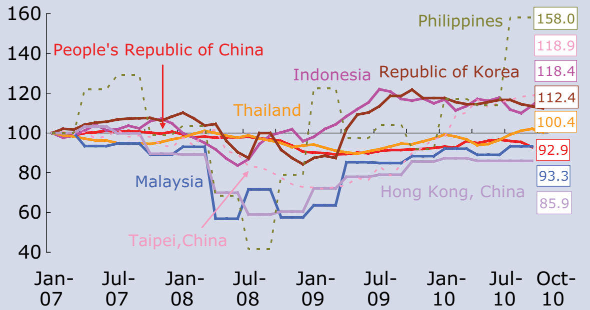
GDP = gross domestic product, PRC = People's Republic of China, y-o-y = year-on-year.
[1]Includes ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand) plus NIEs (Hong Kong, China; Republic of Korea; Singapore; and Taipei,China).
Source: OREI staff calculations based on CEIC data.

Figure 5: Domestic Demand Growth—ASEAN-4[1] (y-o-y, %)



y-o-y = year-on-year.
[1]Includes Indonesia, Malaysia, Philippines, and Thailand.
Source: OREI staff calculations based on CEIC data.

Figure 6: Consumer Confidence Indexes—Selected Economies (Jan 2007 = 100)



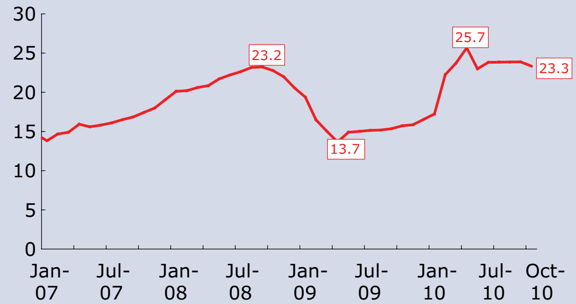
Note: For Hong Kong, China; Malaysia; and Philippines data are quarterly.
Source: National Bureau of Statistics (People's Republic of China); Chinese University of Hong Kong (Hong Kong, China); Bank Indonesia (Indonesia); Korea National Statistical Office and Bank of Korea (Republic of Korea); Malaysia Institute of Economic Research (Malaysia); Bangko Sentral ng Pilipinas (Philippines); CEIC (Taipei,China); and The University of the Thai Chamber of Commerce (Thailand).

and pensions. Net exports turned positive in the second quarter for the first time since the onset of the global recession, and continued to contribute to growth in the third quarter. Merchandise trade surplus in the third quarter rose 70.9% compared with the same period of 2009 as rising exports to other Asian economies compensated for slowing shipments to Europe and US.

Growth in the export-driven NIEs moderated in the third quarter on weaker external demand.

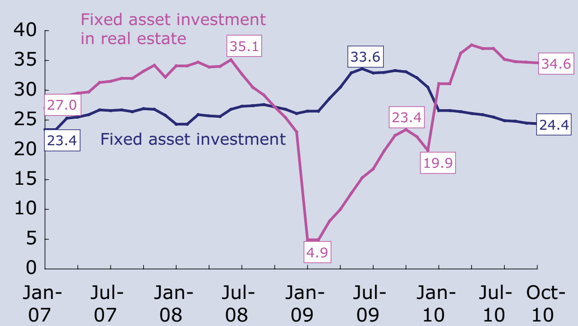
Economic growth in the NIEs slowed in the third quarter as weaker external demand pulled down export growth **(Figures 10, 11)**. While powering growth in the third quarter, investment tempered as inventory accumulation was almost zero **(Figure 12)**. Singapore grew fastest in the third quarter at 10.6%, down from the stunning 18.2% growth in the first half. This more rational growth rate was due to slowing manufacturing growth—particularly the volatile biomedical sector—and weaker construction. GDP growth in the Republic of Korea (Korea) slowed to 4.4% in the third quarter from the 7.6% first half growth

Figure 7: Retail Sales Growth[1]—People's Republic of China (y-o-y, %)



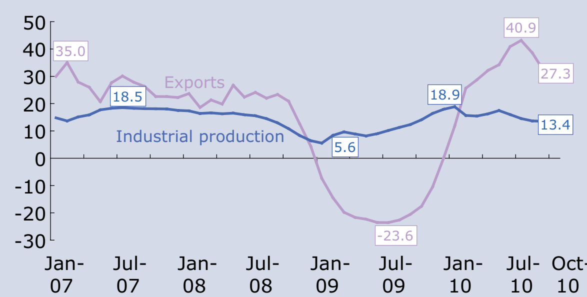
y-o-y = year-on-year.
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

Figure 8: Fixed Asset Investment—People's Republic of China (nominal, year-to-date, y-o-y, %)



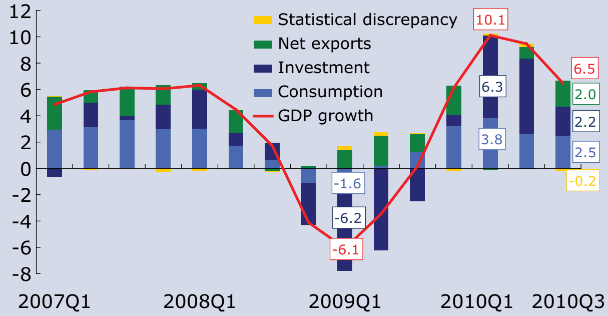
y-o-y = year-on-year.
Source: CEIC.

Figure 9: Merchandise Export and Industrial Production Growth[1]—People's Republic of China (y-o-y, %)



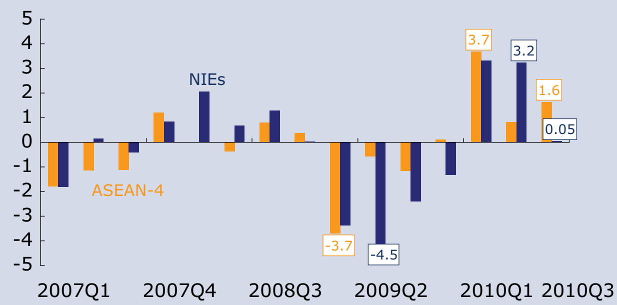
y-o-y = year-on-year.
Note: Exports in $ value; industrial production in local currency.
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

Figure 10: Contributions to GDP Growth—NIEs[1] (y-o-y, %, percentage points)



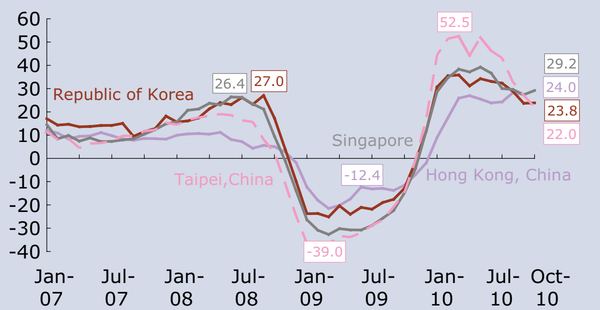
GDP = gross domestic product, y-o-y = year-on-year.
[1]Includes Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.
Source: OREI staff calculations based on CEIC data.

Figure 12: Contribution of Changes in Inventories to GDP Growth—ASEAN-4 and NIEs (y-o-y, %, percentage points)



ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; GDP = gross domestic product; NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China; y-o-y = year-on-year.
Source: OREI staff calculations based on CEIC data.

Figure 11: Merchandise Export Growth[1]**—NIEs** ($ value, y-o-y, %)



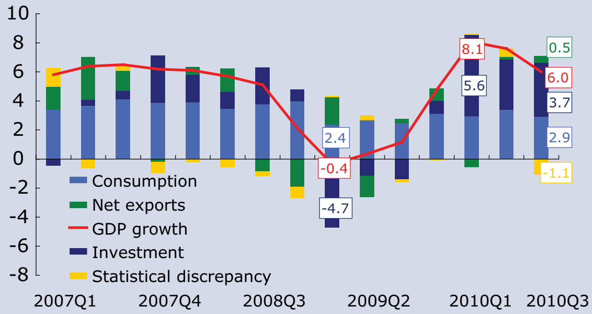
NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China; y-o-y = year-on-year.
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

due to moderating private and government consumption. After posting 13.2% growth in the first half, Taipei,China's GDP grew 9.8% in the third quarter as strong private consumption was offset by decelerating investments and net exports. Growth in Hong Kong, China moderated only slightly—to 6.8% in the third quarter from 7.2% in the first half. The strong third quarter performance was mainly due to rapid growth in net exports and continued gains in private consumption.

The solid economic expansion in the ASEAN-4 slowed in the third quarter as exports lost momentum.

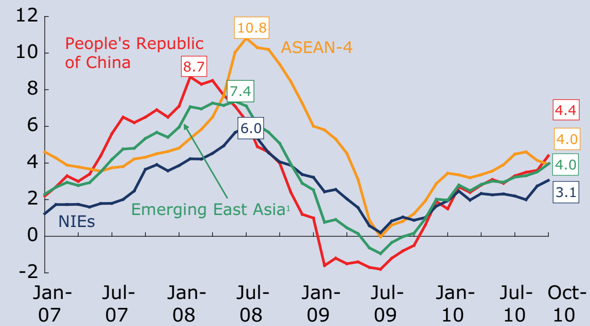
Aggregate GDP growth in the ASEAN-4 fell to 6.0% from 7.8% in the first half **(Figure 13)**. ASEAN-4 exports, not including the Philippines, have been on a downtrend throughout the third quarter **(Figure 14)**. Malaysia and Thailand—being more open economies—were more affected by the slowdown in external demand. Malaysia's GDP expanded 5.3% in the third quarter, down from 9.4% in the first half. Aside from slower export growth, contraction in government spending also dampened growth. In Thailand, GDP growth moderated to 6.7%—after rising 10.7% in the first half—as domestic demand slowed and exports weakened. Indonesia's GDP growth slightly eased to 5.8% in the third quarter from a 5.9% expansion in the first half with private consumption and investments continuing to drive the recovery. The Philippines' economic growth in the third quarter slowed to 6.5%—following a robust 8.0% growth in the first half—due to contraction in government spending and lower investments. Bucking the trend in the ASEAN-4, exports were the main engine of growth for the Philippines in the third quarter.

Figure 13: Contributions to GDP Growth—ASEAN-4[1] (y-o-y, %, percentage points)



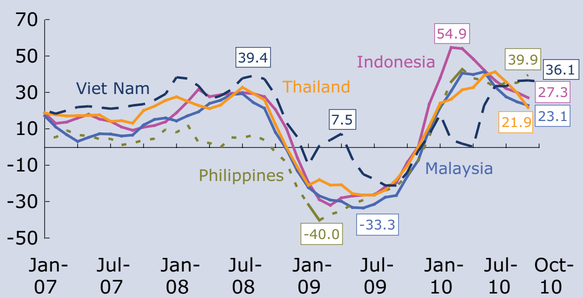
GDP = gross domestic product, y-o-y = year-on-year.
[1]Includes Indonesia, Malaysia, Philippines, and Thailand.
Source: OREI staff calculations based on CEIC data.

Figure 15: Regional Headline Inflation (y-o-y, %)



ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China; y-o-y = year-on-year.
[1]Includes ASEAN-4, NIEs, People's Republic of China, and Viet Nam. Weighted using gross national income (atlas method, currrent $).
Source: OREI staff calculations based on CEIC data.

Figure 14: Merchandise Export Growth[1]**—ASEAN-4 and Viet Nam** ($ value, y-o-y, %)



y-o-y = year-on-year.
[1]3-month moving average. Data for Indonesia, Malaysia, Philippines, and Thailand until Sep 2010.
Source: OREI staff calculations based on CEIC data.

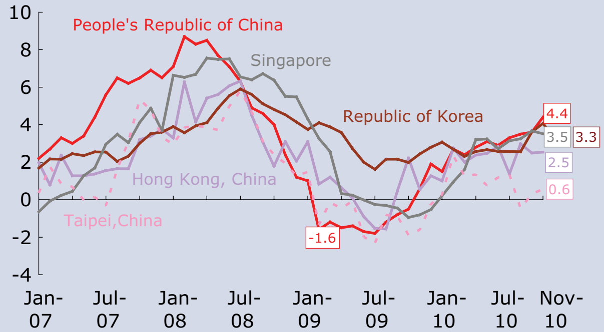
Viet Nam's growth gained momentum during 2010, while the other smaller ASEAN economies are expected to show mixed performances.

Viet Nam's economic growth strengthened this year, growing 7.2% in the third quarter, above the 6.2% first half expansion. In Myanmar, economic growth improved to 4.4% in 2009 from 3.6% the previous year boosted by large inflows of foreign direct investment. The Lao People's Democratic Republic (Lao PDR) grew 6.5% in 2009 due to construction related to the Southeast Asian games and higher mineral production. GDP in Brunei Darussalam contracted for the second year in a row, dropping 1.8% in 2009 due to lower oil and gas production. Cambodia's economic growth eased to 0.1% in 2009 after growing 6.7% in 2008.

Inflation edged up on strong economic performance across the region.

Prices rose 4.0% in emerging East Asia in October, mainly due to higher inflation in PRC, Korea and Singapore **(Figures 15, 16a)**. Viet Nam continued to post the highest inflation rate in the region—11.1% in November **(Figure 16b)**. While headline inflation increased, core inflation for most economies remained steady during the year **(Figures 17a, 17b)**. Except for Thailand, housing prices across the region have started to trend downward in the third quarter following implementation of measures to cool the property sector **(Figures 18a, 18b)**.

Figure 16a: Headline Inflation—NIEs and PRC (y-o-y, %)



PRC = People's Republic of China, y-o-y = year-on-year.
Source: OREI staff calculations based on CEIC data.

Figure 16b: Headline Inflation—Selected ASEAN Economies (y-o-y, %)

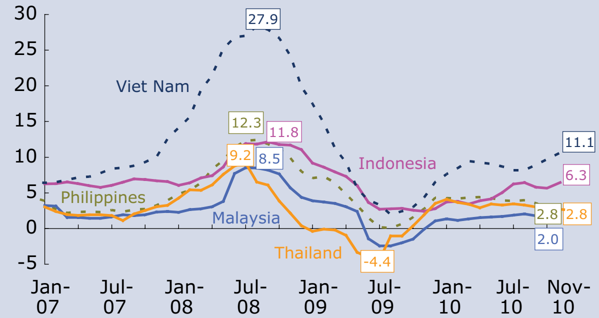


Figure 17a: Core Inflation—NIEs (y-o-y, %)

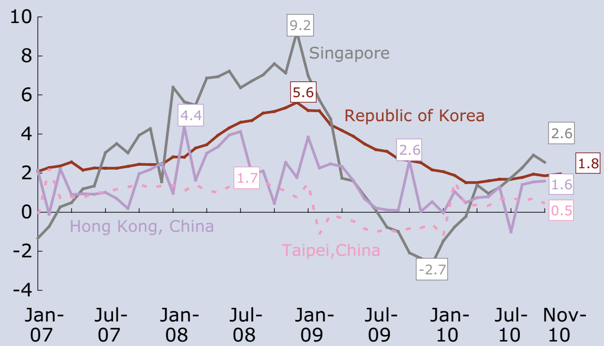
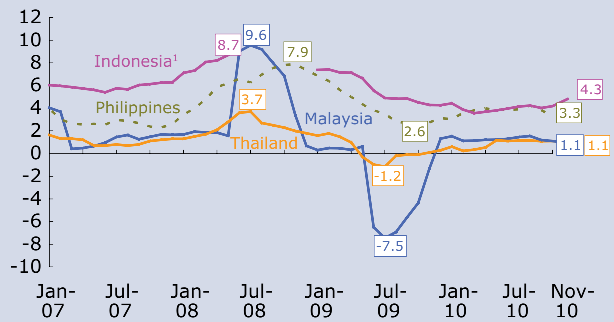


Figure 17b: Core Inflation—ASEAN-4 (y-o-y, %)



y-o-y = year-on-year.
[1]Series break due to unavailability of data.
Note: Official figures, except for Hong Kong, China (excluding food and utilities) and Singapore (excluding food and private transport). Official figures, except for Malaysia (excluding food, fuel, and utilities).
Source: OREI staff calculations based on CEIC data.

Figure 18a: Housing Prices[1]—PRC, Indonesia, Malaysia, and Thailand (y-o-y growth, %)

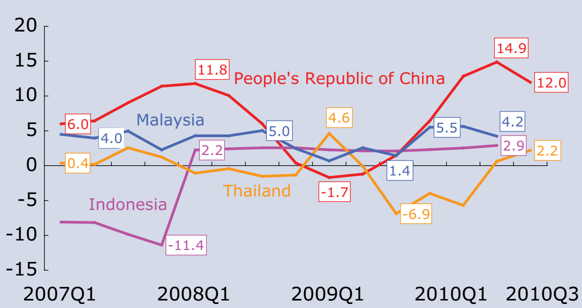
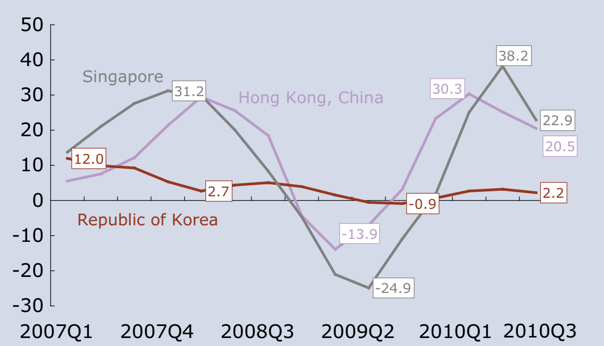


Figure 18b: Housing Prices[2]—NIEs (y-o-y growth, %)[3]



PRC = People's Republic of China, y-o-y = year-on-year.
[1]Data for PRC refers to sales price index for residential buildings; Indonesia refers to residential property price index; Thailand refers to housing price index. [2]Data for Hong Kong, China; and Singapore refer to residential property price index; Republic of Korea refer to housing price index. [3]3-month average for Hong Kong, China; and Republic of Korea.
Source: OREI staff calculations based on CEIC data.

Balance of Payments

Balance of payments remained in surplus across the region amid healthy current account surpluses and continued capital inflows.

Balance of payments across the region remained strong in the first half of the year **(Tables 1a, 1b, 1c)**. The NIEs had an overall balance of payments surplus of 7.7% of GDP though it was considerably below the 14.5% in the second half of 2009. ASEAN-4 likewise had its overall balance of payments surplus narrowing from 4.7% to 3.2% of GDP. While ASEAN-4 and the PRC saw bigger capital and financial account surpluses, inflows in the NIEs were substantially smaller. By October 2010, emerging East Asian economies—except Malaysia and Viet Nam—all drew double-digit annual growth in foreign exchange reserves **(Table 2)**.

In the first half of the year, imports rose faster than exports, leaving narrowing trade surpluses in many emerging East Asian economies.

Trade surplus in the NIEs narrowed in the first half of 2010 even if exports recovered, translating to a lower but nonetheless healthy current account surplus of 6.3% of GDP. In the third quarter, it rebounded however, reaching $20.8 billion—as exports grew faster than imports compared with the same period last year. The ASEAN-4 current account surplus dropped to 4.3% of GDP in the first half of 2010, due to a smaller trade surplus. The trend continued in the third quarter with import growth outpacing exports. The PRC's cumulative trade surplus in the first 9 months of 2010 stood at $120.6 billion, down from a $134.5 billion surplus during the same period last year, as import growth outpaced exports **(Figures 19, 20)**.

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

	2000–2004 Average	2004H1	2004H2	2005H1	2005H2	2006H1	2006H2	2007H1	2007H2	2008H1	2008H2	2009H1	2009H2	2010H1
Current Account	**4.2**	**2.2**	**4.4**	**1.3**	**3.0**	**4.1**	**6.4**	**5.6**	**6.8**	**4.6**	**3.1**	**7.3**	**5.5**	**4.3**
Net goods balance	8.3	5.8	7.9	3.6	6.4	6.3	8.1	6.9	7.8	5.7	4.7	7.8	7.0	6.1
Net services	-2.1	-1.3	-1.7	-1.4	-1.9	-0.9	-0.8	-0.4	-0.2	-0.4	-0.8	-0.3	-0.6	-0.4
Net income	-3.6	-3.9	-3.6	-3.5	-4.1	-3.3	-3.0	-2.8	-2.7	-2.5	-2.5	-2.0	-2.4	-2.8
Net transfers	1.4	1.4	1.3	1.9	2.3	2.0	2.0	1.9	1.8	1.7	1.7	1.9	1.5	1.4
Capital and Financial Account	**-1.8**	**0.6**	**2.2**	**2.4**	**-2.3**	**2.1**	**-2.1**	**1.3**	**-1.9**	**2.3**	**-6.8**	**-4.6**	**0.1**	**1.2**
Capital account	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Net direct investment	0.9	0.9	1.3	2.7	1.8	1.8	1.4	1.0	0.5	0.4	-0.2	0.3	-0.6	1.0
Net portfolio investment	0.2	1.5	3.0	2.1	0.6	1.9	1.6	4.3	-2.2	0.8	-5.7	-1.2	1.8	2.3
Net other investment	-2.9	-1.9	-2.1	-2.4	-4.8	-1.7	-5.2	-4.0	-0.3	1.0	-0.9	-3.7	-1.2	-2.1
Net errors & omissions	-0.4	0.7	-1.3	-0.6	-0.4	-0.7	-0.8	-0.4	-1.1	0.5	-0.5	0.6	-0.8	-2.3
Overall Balance	**2.0**	**3.4**	**5.4**	**3.1**	**0.4**	**5.6**	**3.5**	**6.5**	**3.8**	**7.4**	**-4.1**	**3.3**	**4.7**	**3.2**

ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; GDP = gross domestic product.
Source: *International Financial Statistics*, International Monetary Fund; and CEIC.

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

	2000–2004 Average	2004H1	2004H2	2005H1	2005H2	2006H1	2006H2	2007H1	2007H2	2008H1	2008H2	2009H1	2009H2	2010H1
Current Account	**5.2**	**5.5**	**7.4**	**4.9**	**5.6**	**4.3**	**6.4**	**5.8**	**6.6**	**4.3**	**5.7**	**9.6**	**7.5**	**6.3**
Net goods balance	4.7	5.2	6.7	4.7	5.9	4.2	5.5	4.2	5.0	1.6	1.5	6.1	5.2	3.6
Net services	0.5	0.8	0.5	0.5	0.8	0.7	1.0	1.4	1.9	2.1	2.9	2.3	2.1	2.1
Net income	0.6	0.2	0.9	0.4	-0.5	0.3	0.5	0.8	0.3	1.2	1.7	1.6	0.9	1.2
Net transfers	-0.6	-0.8	-0.7	-0.7	-0.6	-0.8	-0.6	-0.7	-0.6	-0.7	-0.4	-0.5	-0.6	-0.7
Capital and Financial Account	**-1.2**	**1.3**	**-3.0**	**0.3**	**-4.4**	**-1.3**	**-3.1**	**-4.3**	**-4.6**	**-1.1**	**-7.4**	**1.0**	**7.1**	**1.6**
Capital account	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	0.0	0.0	0.2	0.4	0.3	0.2
Net direct investment	0.5	-0.5	0.1	1.3	-0.1	0.5	0.2	-0.1	-1.5	-0.9	1.9	-0.2	-0.4	0.2
Net portfolio investment	-2.7	-6.5	-0.4	-4.5	-0.5	-2.8	-5.4	-5.1	-4.5	-4.0	-6.7	-2.0	-2.2	-3.0
Net other investment	1.3	8.4	-2.5	3.9	-3.6	1.2	2.3	1.0	1.4	3.8	-2.8	2.8	9.4	4.1
Net errors & omissions	0.5	0.8	0.7	0.2	0.6	0.0	-0.1	0.6	0.8	-0.3	0.6	0.2	-0.1	-0.2
Overall Balance	**4.5**	**7.5**	**5.1**	**5.4**	**1.8**	**3.0**	**3.1**	**2.2**	**2.8**	**2.9**	**-1.1**	**10.7**	**14.5**	**7.7**

NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.
Source: *International Financial Statistics,* International Monetary Fund; CEIC; and national sources.

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

	2000–2004 Average	2004H1	2004H2	2005H1	2005H2	2006H1	2006H2	2007H1	2007H2	2008H1	2008H2	2009H1	2009H2	2010H1
Current Account	**2.4**	**0.9**	**5.7**	**6.8**	**7.4**	**7.7**	**10.6**	**10.8**	**10.4**	**9.6**	**9.6**	**6.2**	**5.8**	**5.0**
Net goods balance	2.9	0.7	4.9	5.5	6.3	6.7	9.0	9.0	9.0	6.7	9.0	5.5	4.6	3.5
Net services	-0.5	-0.7	-0.4	-0.4	-0.4	-0.5	-0.2	-0.2	-0.2	-0.2	-0.3	-0.8	-0.5	-0.5
Net income	-0.9	-0.3	-0.1	0.5	0.5	0.3	0.8	0.9	0.6	1.9	0.1	0.8	0.9	1.1
Net transfers	0.9	1.2	1.2	1.2	1.0	1.1	1.0	1.2	1.1	1.2	0.9	0.7	0.7	0.8
Capital and Financial Account	**2.8**	**7.9**	**4.1**	**3.9**	**1.9**	**3.3**	**-2.1**	**6.0**	**-0.8**	**3.6**	**-2.1**	**2.8**	**3.0**	**3.6**
Capital account	0.0	0.0	0.0	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net direct investment	3.0	3.6	2.1	2.3	3.6	2.6	1.7	3.4	3.5	2.0	2.1	0.7	0.7	1.5
Net portfolio investment	-0.2	3.3	-0.7	-0.1	-0.3	-2.5	-2.5	-0.3	1.2	1.0	0.9	0.9	0.7	-0.3
Net other investment	0.0	1.0	2.7	1.5	-1.5	3.0	-1.4	2.8	-5.6	0.5	-5.2	1.1	1.6	2.3
Net errors & omissions	0.4	-0.9	1.7	-0.5	2.5	-0.7	2.2	0.9	0.1	0.9	0.3	-0.4	-1.2	-1.5
Overall Balance	**5.6**	**7.9**	**11.4**	**10.1**	**11.8**	**10.3**	**10.6**	**17.7**	**9.7**	**14.1**	**7.8**	**8.6**	**7.5**	**7.0**

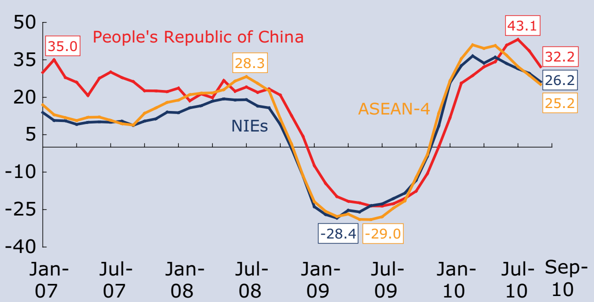
GDP = gross domestic product.
Source: *International Financial Statistics,* International Monetary Fund; and CEIC.

Table 2: Total Reserves (excluding gold)

	Value ($ billion)				**% Change** (y-o-y)				**% Change** (m-o-m)			
	Dec-09	**Mar-10**	**Jun-10**	**Oct-10**	**Dec-09**	**Mar-10**	**Jun-10**	**Oct-10**	**Jul-10**	**Aug-10**	**Sep-10**	**Oct-10**
Brunei Darussalam	1.4	1.3	1.3	—	80.7	69.8	54.9	—	—	—	—	—
Cambodia	2.9	3.0	3.1	3.2[4]	24.4	27.4	19.3	15.1[4]	1.2	0.4	—	—
China, People's Rep. of	2416.0	2463.5	2471.2	2666.9[4]	23.9	25.9	15.7	16.5[4]	3.4	0.3	4.0	—
Hong Kong, China	255.7	258.8	256.7	266.0[4]	40.1	38.9	24.1	17.3[4]	1.5	0.3	1.8	—
Indonesia	63.6	69.2	73.4	88.7	28.1	31.5	32.6	42.8	3.6	3.1	6.5	6.2
Korea, Republic of	269.9	272.3	274.1	293.3	34.2	32.0	18.3	11.0	4.3	-0.2	1.5	1.2
Lao People's Democratic Republic	0.7	—	—	—	11.8	—	—	—	—	—	—	—
Malaysia	95.4	94.0	93.3	103.8	4.7	7.5	2.4	9.4	0.3	0.2	5.8	4.7
Myanmar	—	—	—	—	—	—	—	—	—	—	—	—
Philippines	38.8	39.6	41.8	50.0	16.8	14.9	20.3	32.0	1.2	1.1	8.2	7.9
Singapore	187.8	197.1	200.0	221.4	7.8	18.6	15.5	20.1	3.5	-0.3	4.0	3.1
Taipei,China	348.2	355.0	362.4	383.8	19.4	18.3	14.1	12.5	2.1	0.5	2.3	0.9
Thailand	135.5	141.1	143.4	166.7	24.7	24.0	21.2	25.8	3.0	2.3	5.2	4.8
Viet Nam	16.4	13.9	—	—	-31.2	-39.8	—	—	—	—	—	—
Emerging East Asia	**3832.3**[1]	**3908.8**[2]	**3920.8**[3]	**4243.7**[5]	**23.3**[1]	**24.9**[2]	**16.4**[3]	**17.1**[5]	**3.1**[5]	**0.4**[5]	**3.5**[6]	**2.7**[7]
Japan	1022.2	1015.3	1019.6	1085.0	1.3	1.9	2.4	5.2	1.5	0.5	3.7	0.7
East Asia	**4854.5**[1]	**4924.1**[2]	**4940.5**[3]	**5328.7**[5]	**17.9**[1]	**19.3**[2]	**13.2**[3]	**11.9**[5]	**2.8**[5]	**0.4**[5]	**3.6**[6]	**1.8**[7]

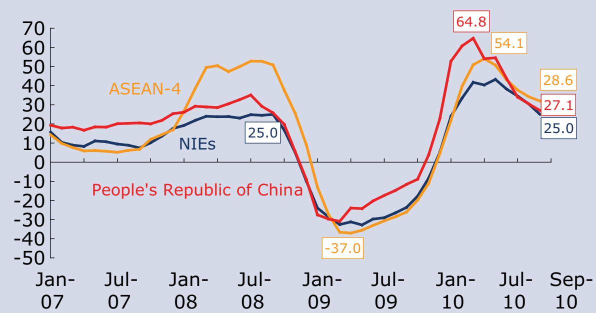
m-o-m = month-on-month, y-o-y = year-on-year, — = data unavailable.
[1]Excludes Myanmar as data unavailable. [2]Excludes Lao People's Democratic Republic and Myanmar as data unavailable. [3]Excludes Lao People's Democratic Republic, Myanmar, and Viet Nam as data unavailable. [4]Data are for most recent month in which data are available. [5]Excludes Brunei Darussalam, Lao People's Democratic Republic, Myanmar, and Viet Nam as data unavailable. [6]Excludes Brunei Darussalam, Cambodia, Lao People's Democratic Republic, Myanmar, and Viet Nam as data unavailable. [7]Excludes Brunei Darussalam; Cambodia; People's Republic of China; Hong Kong, China; Lao People's Democratic Republic; Myanmar; and Viet Nam as data unavailable.
Source: *International Financial Statistics,* International Monetary Fund; CEIC; and national sources.

Figure 19: Merchandise Export Growth[1]—PRC, ASEAN-4, and NIEs ($ value, y-o-y, %)



PRC = People's Republic of China; ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China; y-o-y = year-on-year.
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

Figure 20: Merchandise Import Growth[1]—PRC, ASEAN-4, and NIEs ($ value, y-o-y, %)



PRC = People's Republic of China; ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand; NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China; y-o-y = year-on-year.
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

Stronger growth, high interest rate differentials, and expectations of further currency appreciation attracted capital inflows.

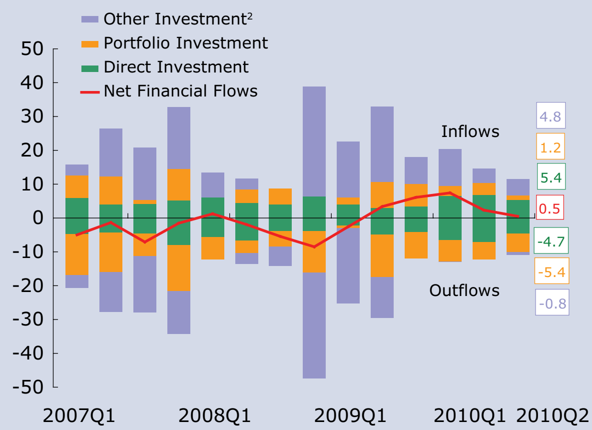
Amid anemic growth in advanced economies, robust performance and higher interest rates in emerging East Asia continued to attract capital flows in the second quarter of 2010. Expectations that the region's currencies will continue appreciating also contributed to the higher inflows. For ASEAN-4, net financial flows in the second quarter were stronger than first quarter levels due to smaller "other investment" outflows **(Figure 21)**. For the NIEs, net financial flows eased as strong inflows of "other investments" were offset by portfolio investment outflows **(Figure 22)**. In contrast, the PRC's capital and financial accounts steadily increased, driven by "other investment" **(Figure 23)**.

Financial Markets and Exchange Rates

Most emerging East Asian stock markets recovered dramatically in the second half of the year following the region's rapid economic turnaround.

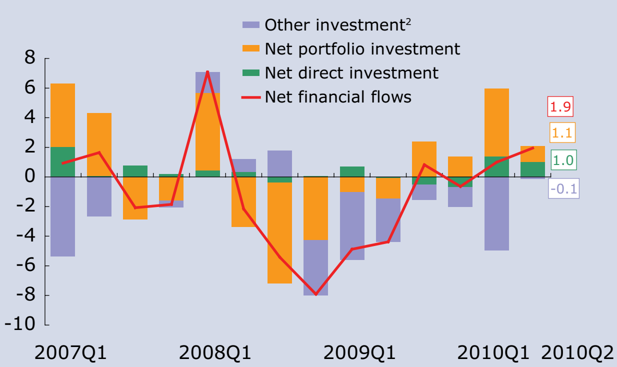
Equity markets in the region rose as robust economic growth and the positive economic outlook attracted increased capital inflows **(Figure 24)**. Recovering from first half losses, stock market in the NIEs gained rapidly during the second half of 2010. The PRC market has declined, but improved vis-à-vis its first half performance. ASEAN-4 bourses soared, with Indonesia (44.3%), Thailand (38.3%), Philippines (35.7%), and Malaysia (17.5%) posting record highs. Markets in advanced economies also recovered, with the Dow Jones Industrial Average and FTSE 100 expanding 6.6%

Figure 22: Financial Account Flows—NIEs[1]
(% of GDP)



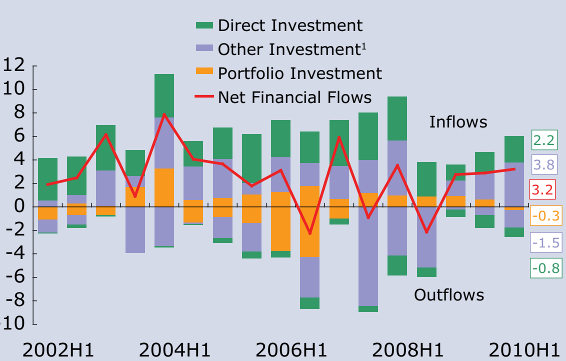
[1]NIEs = Hong Kong, China; Republic of Korea; Singapore; and Taipei,China. [2]"Other investment" includes financial derivatives.
Source: OREI staff calculations based on data from *International Financial Statistics,* International Monetary Fund; and national sources.

Figure 21: Net Financial Flows—ASEAN-4[1]
(% of GDP)



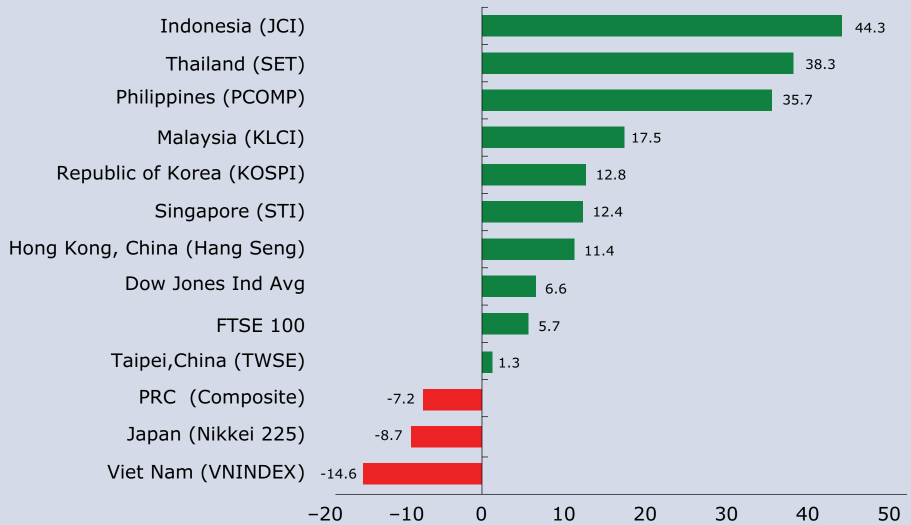
[1]ASEAN-4 = Indonesia, Malaysia, Philippines, and Thailand. [2]"Other investment" includes financial derivatives.
Source: OREI staff calculations based on data from *International Financial Statistics,* International Monetary Fund; and national sources.

Figure 23: Financial Account Flows—People's Republic of China (% of GDP)



[1]"Other investment" includes financial derivatives.
Source: OREI staff calculations based on data from national sources.

Figure 24: Stock Price Indexes[1] (4 Jan 2010 to 12 Nov 2010, % change)



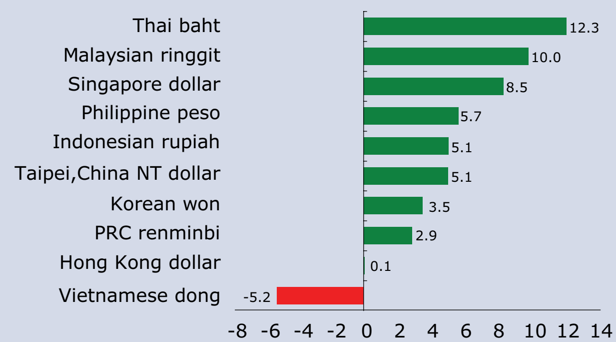
PRC = People's Republic of China.
[1]Closing as of 12 November 2010.
Source: OREI staff calculations based on data from Reuters and Bloomberg.

and 5.7%, respectively. However, the Nikkei 225 declined 8.7% due to a strong yen—although the fall in the index was muted by additional stimulus and quantitative easing in the US.

Almost all of the region's currencies appreciated as capital continued to return to the region.

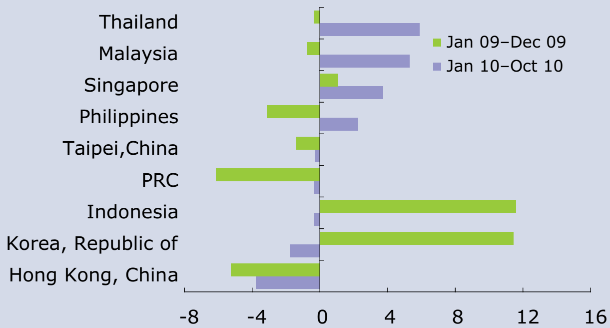
With the exception of the Vietnamese dong, all currencies appreciated against the US dollar as capital inflows were looking for higher returns **(Figure 25)**. The Thai baht and Malaysian ringgit gained the most, appreciating 12.3% and 10.0%, respectively. The Vietnamese dong was devalued by 2.1% in mid-August and further depreciated by 5.2% since. Against a basket of most traded currencies, the region's currencies generally appreciated in both nominal and real effective terms **(Figures 26, 27)**. Thailand appreciated the most in both nominal and real effective exchange rates, while Korea and Hong Kong, China—with its US dollar currency board—depreciated in both nominal and real effective exchange rates.

Figure 25: Exchange Rate vis-à-vis US dollar[1]
(4 Jan 2010 to 10 Nov 2010, % change)



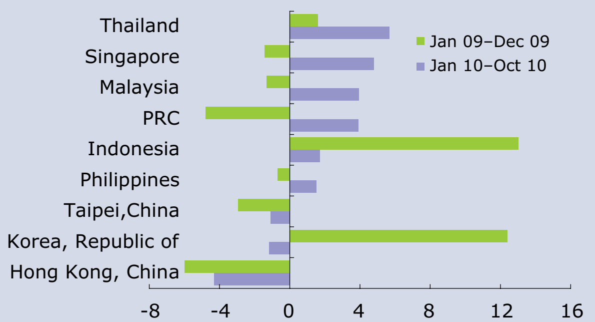
PRC = People's Republic of China.
[1]Latest closing as of 10 Nov 2010, based on local currency value of the US dollar. Negative values indicate depreciation.
Source: OREI staff calculations based on Reuters data.

Figure 26: Change in Nominal Effective Exchange Rate (%)



PRC = People's Republic of China.
Source: OREI staff calculations using data from Bank for International Settlements.

Figure 27: Change in Real Effective Exchange Rate[1] (%)



PRC = People's Republic of China.
[1]Consumer price index-based.
Source: OREI staff calculations using data from Bank for International Settlements.

Bond yield curves flattened in several emerging East Asian markets due to monetary policy normalization, while yield curves in other economies shifted downward due to ample global liquidity.

Tighter monetary policies flattened yield curves during the second half of 2010 **(Figures 28a, 28b, 28c, 28d, 28e, 28f)**. Malaysia, Korea, and Thailand—which have increased policy rates during the past 5 months—saw yields at the lower end of their curves increase and yields for longer maturities decline. Lower yields for longer maturities resulted from markets' lower future inflationary expectations from a tighter monetary

Figure 28a: Benchmark Yields—People's Republic of China (% per annum)

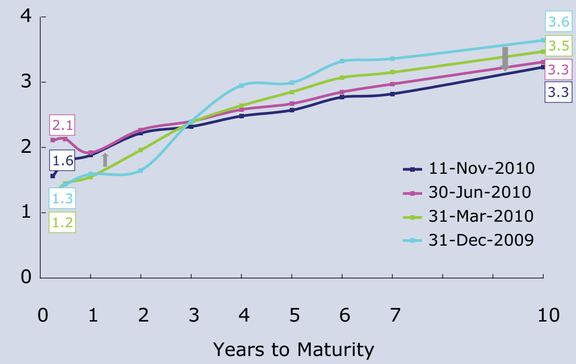


Figure 28b: Benchmark Yields—Hong Kong, China (% per annum)

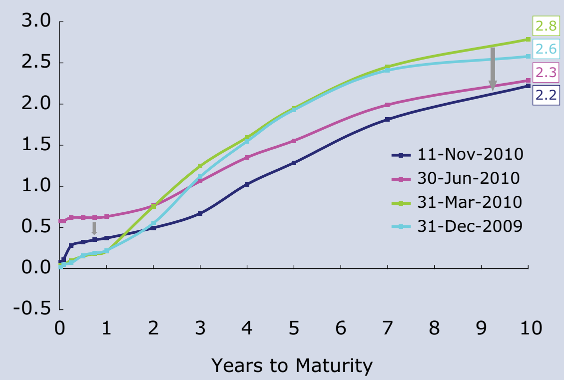
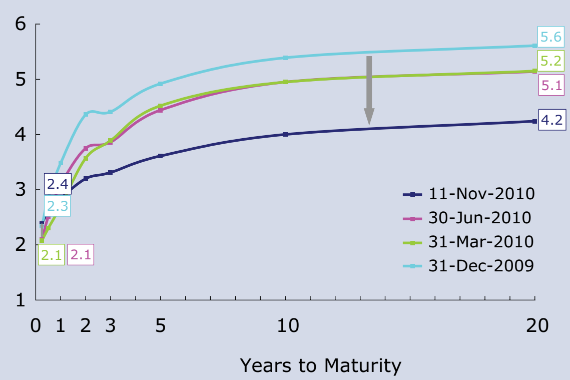


Figure 28c: Benchmark Yields—Republic of Korea (% per annum)



Continued on next page

Figure 28d: Benchmark Yields—Indonesia
(% per annum)

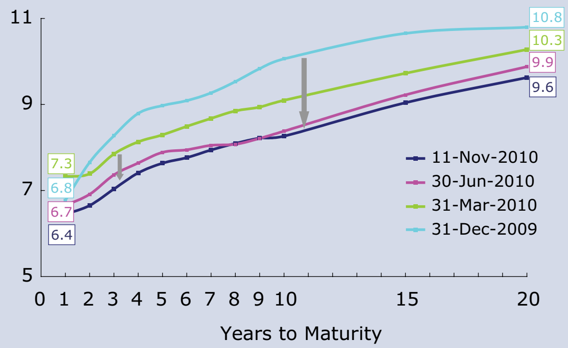


Figure 28e: Benchmark Yields—Malaysia
(% per annum)

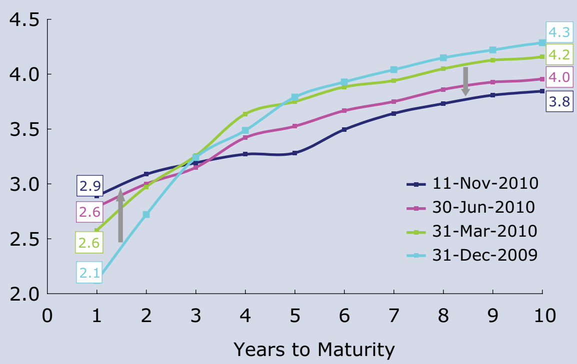
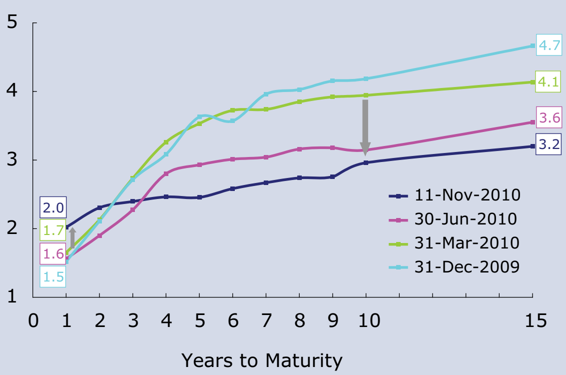


Figure 28f: Benchmark Yields—Thailand
(% per annum)



Source: Bloomberg.

stance. Meanwhile, yield curves for PRC; Hong Kong, China; and Indonesia shifted downward due to lower risk perception for the region as a whole and greater foreign appetite for the region's bonds (see Figure 31).

Monetary and Fiscal Policy

Across the region, authorities continue to normalize macroeconomic policy and have been introducing measures to manage capital inflows.

Despite the sluggish growth in advanced economies, the region's recovery remains strong and intact. With rising inflationary pressures, several economies in the region tightened monetary and fiscal policy. Nonetheless, authorities are cautious in normalizing too quickly given the weakening external environment. A further challenge to policymakers in the region is the widening interest rate differentials between emerging and advanced economies, which adds the risk of volatile currency markets and destabilizing capital flows. This has prompted some economies in the region to impose measures to discourage short-term capital flows and impose stricter prudential requirements on financial institutions.

Policy rates were raised in the PRC, NIEs, Thailand, and Viet Nam to keep inflation in check and dampen rising property prices.

For the first time since December 2007, the People's Bank of China raised its 1-year deposit and lending rates by 25 basis points (bps)—to 2.50% and 5.56%, respectively—amid the robust economic growth that pushed October inflation to a 2-year high **(Figures 29a, 29b)**. Prior to this, the PRC used other quantitative and administrative tools such as bank reserve requirements to manage liquidity—rather than use policy rates. Bank reserve requirement ratios have been raised five times since the start of the year to control credit, particularly in real estate, along with other measures to cool the property market. Among the NIEs, Taipei,China increased its discount rate by 12.5 bps to 1.50% effective

Figure 29a: Policy Rates[1]—ASEAN-4 and Viet Nam (% per annum)

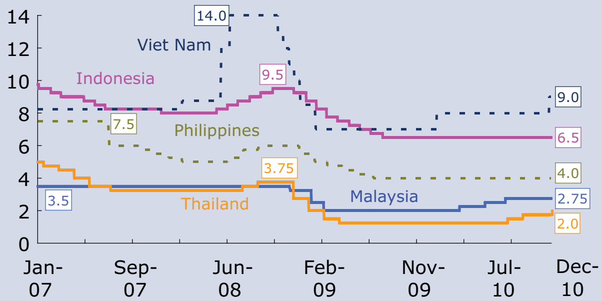
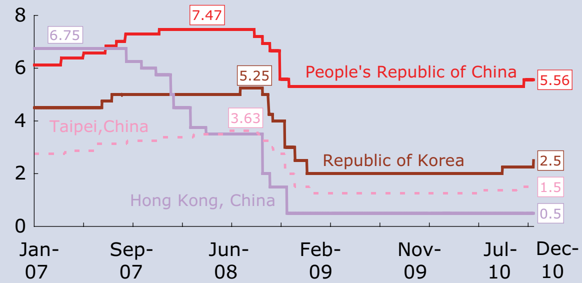


Figure 29b: Policy Rates[2]—People's Republic of China; Hong Kong, China; Republic of Korea; and Taipei,China (% per annum)



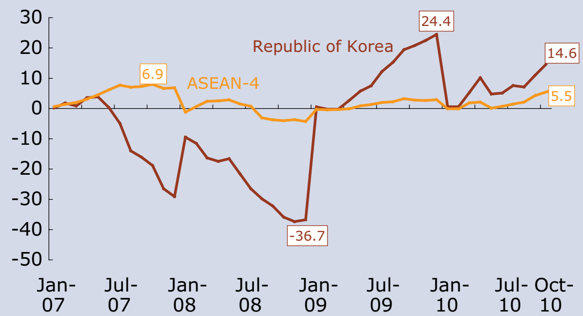
[1]Bank Indonesia (BI) rate (Indonesia), overnight policy rate (Malaysia), reverse repurchase (repo) rate (Philippines), 1-day repo rate (Thailand), and prime rate (Viet Nam). [2]One-year lending rate (People's Republic of China), Hong Kong base rate (Hong Kong, China), Korea base rate (Republic of Korea), and discount rate (Taipei,China).
Source: Bloomberg, Datastream, and State Bank of Viet Nam website.

October, while Korea increased its policy rate from 2.25% to 2.50% to curb rising inflation. The Monetary Authority of Singapore also reiterated its tightening stance by way of a slight increase in the slope of its exchange rate policy band, after re-centering the band in April 2010. Although Hong Kong, China's base rate remains unchanged (as it mimics US Federal Reserve adjustments), the Hong Kong Monetary Authority increased down payment requirements for mortgage applicants to minimize risks of a property market bubble forming. Elsewhere, Thailand raised its 1-day repurchase rate by 25 bps to 2.0% while the State Bank of Viet Nam raised its discount rate by 100 bps to 9.0% to contain high inflation and currency pressures. Other economies have restrained from further policy rate hikes, given continuing moderation in global growth momentum and—perhaps more importantly—to stem excessive capital inflows as foreign investors continue to search for yield.

Across the region, authorities are actively trying to manage capital inflows.

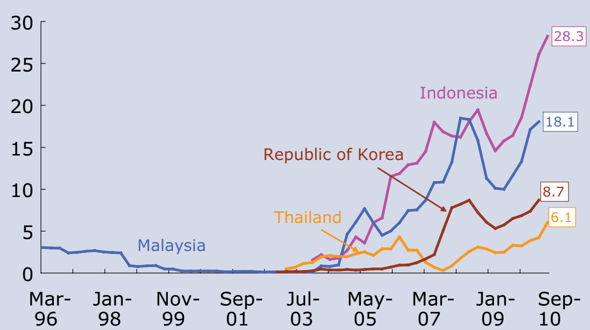
Inflows to the region's equity and debt markets are rising quickly as foreign investors are attracted to the region's strong economic performance, rising currencies, and higher interest rates **(Figures 30, 31)**. Several economies are trying

Figure 30: Net Foreign Portfolio Investment in Equities—Republic of Korea and ASEAN-4[1] ($ billion)



[1]Monthly data excluding Malaysia.
Source: Bloomberg and CEIC.

Figure 31: Foreign Holdings of Local Currency Government Bonds[1] (% of total)



[1]Data for Indonesia and Thailand as of Sep 2010; Malaysia and Republic of Korea as of Jun 2010.
Source: *AsianBondsOnline*.

Table 3: Capital Control Measures[1]—Selected Economies

Economy	New Capital Control Measures
China, People's Republic of	New rules announced (Nov) covering:
	— tighter management of banks' foreign debt quotas
	— regulation of PRC special purpose vehicles overseas
	— tighter control over equity investments by foreign firms
Indonesia	Foreign exchange holding limit by banks capped at 20% of capital (Jul)
	Minimum 1-month holding period required for SBI investors with 1-month maturities (Jul)
Korea, Republic of	Ceilings set on foreign exchange derivatives contracts of domestic and foreign banks (Jun)
	Use of foreign currency bank loans tightened (Jun)
	Regulations tightened on foreign currency liquidity of banks (Jun)
	Plans to impose a withholding bond tax on foreign investors and a bank levy announced (Nov)
Taipei,China	Holding limit of foreign investors for local government bonds and money market products with maturities of one year or less set to a maximum of 30% (Nov)
Thailand	15% tax on interest and capital gains imposed on foreign investors in Thai bonds; 15% withholding tax on those trading Thai bonds (Oct)
	Thai investments abroad and capital outflows encouraged (Sep):
	— Thai firms allowed to invest and lend to affiliate companies abroad
	— Foreign currency deposit limit raised
	— Cross-border property investment cap increased
	— Minimum amount required for mandatory repatriation of export earnings raised

[1]Measures announced and/or imposed in 2010.
PRC = People's Republic of China, SBI = Sertifikat Bank Indonesia.
Source: News articles and government press releases.

to manage these capital inflows, using tighter management of banks' foreign debt quotas and equity investments of foreign firms (PRC); limits on banks' foreign currency asset holdings (Indonesia, Korea); limits on foreign investor ownership of selected domestic securities (Taipei,China); and taxing interest and capital gains for foreign investors holding or trading domestic bonds (Thailand) **(Table 3)**.

Fiscal consolidation continues across much of emerging East Asia, even as several governments continue spending to address structural reforms and ensure long-term growth.

As fiscal stimulus is scaled back across emerging East Asia, the region's economies continue to maintain comfortable fiscal positions. However, as a consequence of fiscal spending, some economies have seen deficits rise from 2009, such as Cambodia; Hong Kong, China; and Indonesia. Fiscal deficits are generally expected to decline from last year's levels as governments reduce stimulus and the economic recovery helps boost revenues. **(Table 4)**. Fiscal consolidation in emerging East Asia is expected to continue in 2011, although at varying speeds as the overall fiscal stance continues to be accommodative. The region's governments should take stock of the effectiveness of fiscal stimulus **(Box 1)**. Hong Kong, China foresees higher operating revenues from duties and taxes to cut by half its fiscal deficit in FY2011. The Philippines is targeting to reduce its budget shortfall by at least half a percentage point—similar to Taipei,China—through rationalizing expenditures and stronger tax administration. Malaysia, on the other hand, aims to reduce its fiscal deficit only slightly in 2011, as opposed to the large 1.4 percentage point reduction in 2010, as the government begins its new medium-term development plan. Indonesia's parliament set a higher deficit target for 2011 than initially proposed to support economic growth, while also cutting some subsidies. Thailand, in

Table 4: Fiscal Balance of Central Government (% of GDP)

	2000–2004 Average	2005	2006	2007	2008	2009[3]	2010[4]	2011[4]
Cambodia	-5.7	-2.5	-2.7	-2.9	-2.8	-5.9	-7.4	—
China, People's Rep. of	-2.2	-1.2	-1.0	0.6	-0.4	-2.8	-2.8	-2.6
Hong Kong, China[1]	-2.4	1.0	4.0	7.7	0.1	0.8	-1.5	-0.7
Indonesia	-1.5	-0.5	-0.9	-1.3	-0.1	-1.6	-2.1	-1.8
Korea, Rep. of	-1.3	-2.5	-2.6	0.4	-2.1	-3.9	-3.0	—
Malaysia	-5.0	-3.6	-3.3	-3.2	-4.8	-7.0	-5.6	-5.4
Philippines	-4.5	-2.7	-1.1	-0.2	-0.9	-3.9	-3.9	-3.2
Singapore	-0.1	0.7	0.0	3.0	0.1	-1.1	-1.1	—
Taipei,China[1]	-2.7	-0.6	-0.3	-0.4	-0.9	-4.5	-3.9	-3.2
Thailand[1]	-1.2	0.2	0.1	-1.1	-0.3	-4.8	-3.8	-4.1
Viet Nam[2]	-4.9	-3.6	-1.2	-5.5	-4.0	-10.6	-8.3	—

Data updated as of 11 Nov 2010, — = unavailable.
[1]Fiscal year. [2]State budget balance for 2000-2004. 2005-2010 figures are from the *Asian Development Outlook 2010,* Asian Development Bank. [3]2009 deficit figures are actual, except for Cambodia; People's Rep. of China; Hong Kong, China; and Republic of Korea. [4]2010/2011 budget estimates and government targets of respective economies, except Cambodia (International Monetary Fund projection), Republic of Korea, and Viet Nam (*Asian Development Outlook 2010* forecasts).
Source: National sources; *Asian Development Outlook* (various issues), ADB; *Article IV Consultations,* International Monetary Fund; and CEIC.

comparison, expects a higher fiscal deficit next year, as social welfare programs initially introduced as stimulus are now integrated in the government budget. Overall, public debt levels in the region remain manageable despite higher government spending in previous years **(Table 5)**.

Financial Vulnerability

Financial vulnerability in emerging East Asia remains low as most economies maintain healthy fiscal balances and have low external debt.

As most of the region's economies have comfortable external and fiscal positions, the financial vulnerability across emerging East Asia remains low **(Table 6)**. Ratings agencies confirm this, with the Philippines upgraded from BB- to BB by Standard and Poor's, Moody's upgrading PRC's rating from A1 to Aa3, and Hong Kong, China's rating from Aa2 to Aa1 **(Figures 32a, 32b, 32c, 32d)**. However, as a consequence of fiscal stimulus, some economies have seen budget deficits rise, such as Viet Nam, Lao PDR, and Cambodia—where fiscal deficits are seen to rise above 7% of GDP. These countries may need some fiscal consolidation when economic conditions allow. Externally, most emerging East Asian economies run current account surpluses. However, the double-digit current account deficits in Cambodia and Lao PDR are worrying. In Lao PDR and Viet Nam, foreign reserve levels are somewhat low, covering about 2 months of imports.

Banking systems across the region should remain healthy, with strong capitalization, profitability, and low levels of nonperforming assets.

Banks across the region are well-capitalized—with risk-weighted capital adequacy ratios well in excess of 10% **(Table 7)**. Bank profits have also generally held up well **(Tables 8, 9)**. However, as the region continues growing and interest rates rise, bank funding costs will rise as well. While that might depress profits, the economic recovery in the region is also expected to reduce nonperforming loans, which will boost bank profits **(Table 10)**. Some economies have seen nonperforming loans ratios decline in 2010.

Table 5: Public and External Debt (% of GDP)

	2000–2004 Average	2004	2005	2006	2007	2008	2009	2010
Public Sector Debt								
China, People's Republic of	19.3	18.5	17.6	16.2	19.6	17.0	17.7	36.0[p]
Hong Kong, China	0.7	2.4	2.2	1.8	1.5	1.3	3.4	4.5[4]
Indonesia[1]	70.8	55.8	46.3	39.0	35.1	33.2	28.6	27.0[p]
Korea, Republic of[1]	20.8	23.7	27.6	30.1	29.7	29.0	32.6	33.1[5]
Lao People's Democratic Rep.	77.6	88.2	79.7	64.6	60.7	55.2	57.2[p]	—
Malaysia[2]	42.1	45.7	43.8	42.2	41.7	41.4	53.3	53.2[5]
Philippines[3]	88.7	95.4	82.2	73.3	63.1	64.3	65.3	64.0[5]
Singapore	96.8	100.7	95.8	89.6	87.9	93.4	110.0	107.5[5]
Taipei,China[1]	28.0	29.6	30.2	29.6	28.8	29.8	33.0	32.9[5]
Thailand	52.9	48.0	46.4	40.3	37.4	38.2	43.8	43.3[5]
Viet Nam	38.5	42.4	44.5	42.9	45.6	43.9	49.0	51.3[5]
External Debt								
Brunei Darussalam	9.6	8.7	7.7	7.0	7.5	7.9	12.2	—
Cambodia	27.2	25.7	24.6	21.5	23.1	19.7	22.0[e]	—
China, People's Republic of	8.1	6.7	6.8	6.0	6.8	5.2	4.4	4.0[5]
Hong Kong, China	128.9	138.6	141.6	153.6	173.1	176.3	182.9	188.2[5]
Indonesia	57.5	42.5	40.5	29.2	26.9	27.0	18.4	17.0[5]
Korea, Republic of	22.3	20.3	19.1	23.1	26.7	26.4	34.4	31.1[5]
Lao People's Democratic Rep.	64.9	59.9	62.7	55.1	58.1	48.9	41.0	—
Malaysia	43.2	44.4	44.7	41.5	39.4	29.0	31.5	29.2[5]
Myanmar	59.5	52.4	42.7	35.7	24.6	18.2	4.2[e]	—
Philippines	78.0	76.9	73.9	60.1	52.5	44.4	40.2	38.1[5]
Singapore	266.6	270.9	261.4	238.3	265.1	259.8	249.6	231.4[5]
Taipei,China	14.1	24.6	22.2	18.3	19.4	15.6	14.8	15.6[5]
Thailand	38.3	26.3	24.8	22.3	17.0	14.3	13.8	12.6[5]
Viet Nam	29.3	33.2	31.7	31.4	35.5	40.6	29.2	30.0[5]

GDP = gross domestic product, e = estimate, p = projection, — = not available.
[1]Central government debt. [2]Federal government debt. [3]National government debt. [4]As of Sep 2010. [5]As of Jun 2010.
Source: *Article IV Consultations,* International Monetary Fund; CEIC (Public Debt); and Joint External Debt Hub database (External Debt).

Credit conditions are expected to become more favorable across the region as private sector confidence returns.

As economic recovery moves toward sustained growth, banks in the region have become more willing to extend credit **(Figures 33a, 33b)**. Bank lending picked up in ASEAN-4 and the NIEs—particularly in Hong Kong, China, where it jumped 25.9% in September. In contrast, growth in bank lending moderated in the PRC, but remains robust at 19.3% in October **(Figure 33c)**. There are concerns that rapid credit expansion in Hong Kong, China and the PRC may be behind the double-digit price increases in housing (see Figures 18a, 18b). To counter this, PRC authorities introduced several measures to cool the property market by increasing down payments on second homes and raising mortgage rates. Similarly, the Hong Kong Monetary Authority also introduced measures to increase down payments on mortgages. These

Table 6: Assessment of Vulnerability (%)

	Inflation Rate (latest available)	**Fiscal Balance/ GDP** (2010)[1]	**Public Sector Debt/ GDP**[2] (latest available)[3]	**Current Acct./ GDP** (latest available)	**External Debt/ GDP**[4] (latest available)	**Short-Term External Debt/ Reserves** (Q210)[5]	**Foreign Reserves** (number of months of imports)[6]	**Foreign Liabilities/ Foreign Assets**[7] (latest available)	**Loans/ Deposits of Banks**[8] (latest available)
Brunei Darussalam	0.2 (Jun10)	17.0	—	35.0 (2009)	12.2	43.7	6.3 (Jun10)	4.9 (Aug10)	60.8 (Aug10)
Cambodia	1.8 (Aug10)	-7.4	—	-10.7 (2009)	22.0	5.1	6.1 (Aug10)	44.2 (Aug10)	76.9 (Aug10)
China, People's Rep. of	4.4 (Oct10)	-2.8	36.0 (2010)	5.0 (H110)	4.0	8.7	24.5 (Sep10)	36.4 (Aug10)	74.0 (Aug10)
Hong Kong, China	2.5 (Sep10)	-1.5	4.5 (Sep10)	1.5 (Q210)	188.2	45.5	7.6 (Sep10)	70.9 (Jul10)	56.9 (Jul10)
Indonesia	6.3 (Nov10)	-2.1	27.0 (2010)	0.7 (Q310)	17.0	47.7	8.5 (Oct10)	55.0 (Jul10)	76.3 (Dec09)
Korea, Rep. of	3.3 (Nov10)	-3.0	33.1 (Jun10)	4.1 (Q210)	31.1	62.4	8.6 (Oct10)	227.6 (Jun10)	120.1 (Jun10)
Lao People's Democratic Republic	8.1 (Sep10)	-7.8	57.2 (2009)	-11.8 (2009)	41.0	18.3	2.5 (Dec09)	46.8 (Dec08)	48.8 (Dec08)
Malaysia	1.8 (Sep10)	-5.6	53.2 (Jun10)	8.7 (Q210)	29.2	22.2	7.9 (Oct10)	98.8 (Aug10)	93.9 (Aug10)
Myanmar	8.0 (Jul10)	-3.7	—	-1.0 (2009)	4.2	9.4	4.7 (Jun07)	—	38.0 (Jan10)
Philippines	2.8 (Oct10)	-3.9	64.0 (Jun10)	5.6 (Q210)	38.1	31.3	11.9 (Oct10)	49.5 (Aug10)	77.7 (Sep10)
Singapore	3.3 (Aug10)	-1.1	107.5 (Jun10)	19.9 (Q210)	231.4	56.5	8.8 (Oct10)	91.6 (Aug10)	80.2 (Aug10)
Taipei,China	0.6 (Oct10)	-3.9	32.9 (Jun10)	10.3 (Q210)	15.6	15.8	19.1 (Oct10)	67.7 (Sep10)	62.1 (Sep10)
Thailand	2.8 (Nov10)	-3.8	43.3 (Jun10)	2.2 (Q210)	12.6	8.9	11.5 (Oct10)	121.2 (Aug10)	96.3 (Aug10)
Viet Nam	11.1 (Nov10)	-8.3	51.3 (2010)	-7.7 (2009)	30.0	45.8	2.0 (Mar10)	95.2 (Mar10)	105.0 (Mar10)

GDP = gross domestic product, — = unavailable.

[1]Balance ratios are 2010 budget estimates and/or government targets for respective economies, except for the following: Latest IMF Article IV consultation estimates for Brunei Darussalam (overall primary balance), Cambodia, and Lao People's Democratic Republic (Lao PDR); and *Asian Development Outlook* estimates for Republic of Korea, Myanmar, and Viet Nam. Figures for Lao PDR and Myanmar are 2009 balances. Overall primary balance (excludes interest and investment income) for Brunei Darussalam and overall balance (including grants) for Lao PDR. Data for Brunei Darussalam is on a calendar year basis; and on a fiscal year basis for Hong Kong, China; Lao PDR; Taipei,China; and Thailand. [2]Central government debt for Indonesia; Republic of Korea; and Taipei,China; federal government debt for Malaysia; and national government debt for the Philippines. [3]Data are projections for People's Republic of China, Indonesia, Lao PDR, and Viet Nam from IMF Article IV Consultation reports. [4]Data as of June 2010, except for Brunei Darussalam, Cambodia, Lao PDR and Myanmar (2009 figures). Data for Cambodia and Myanmar were computed using GDP estimates from the *World Economic Outlook,* International Monetary Fund. [5]Short-term external debt includes loans and credits due and debt securities due within a year as defined in the Joint External Debt Hub. Total reserves data for Myanmar as of Jun 2007. [6]Refers to reserves minus gold over a 12-month moving average of imports (cif). Latest month when data is available. Import data may be earlier, the same, or later than period indicated. [7]Foreign liabilities and assets of banking institutions, deposit money banks, and other depository corporations. [8]Loans to private sector and non-financial institutions; and deposits (demand, time, savings, foreign currency, bond, and money market instruments—when available) of banking institutions, deposit money banks, and other depository corporations of each economy. Source: CEIC; national sources; *Asian Development Outlook 2010 Update,* Asian Development Bank; Joint External Debt Hub, BIS-IMF-OECD-WB; *International Financial Statistics, Direction of Trade Statistics, World Economic Outlook* and *Article IV Consultations,* International Monetary Fund.

Figure 32a: S&P Sovereign Ratings—ASEAN-4 and Viet Nam (long-term foreign currency)

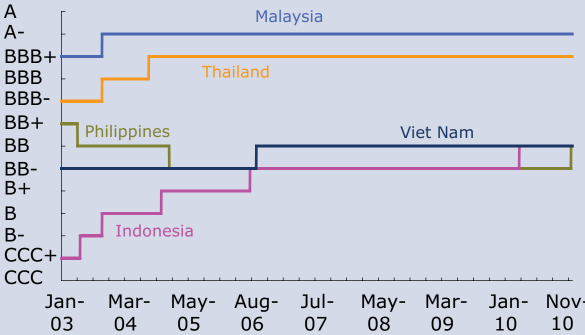


Figure 32c: Moody's Sovereign Ratings—ASEAN-4 and Viet Nam (long-term foreign currency)

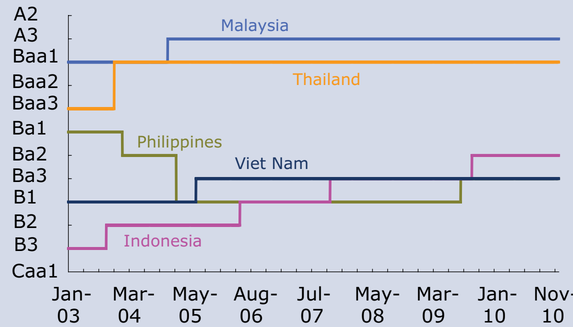


Figure 32b: S&P Sovereign Ratings—PRC and NIEs (long-term foreign currency)

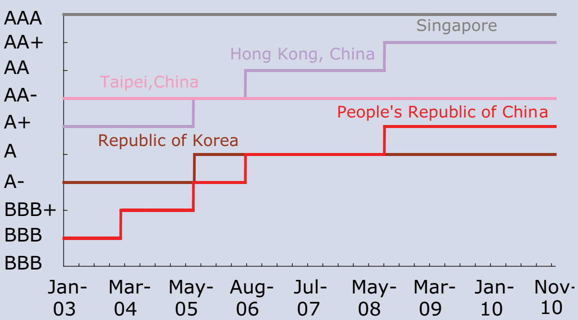
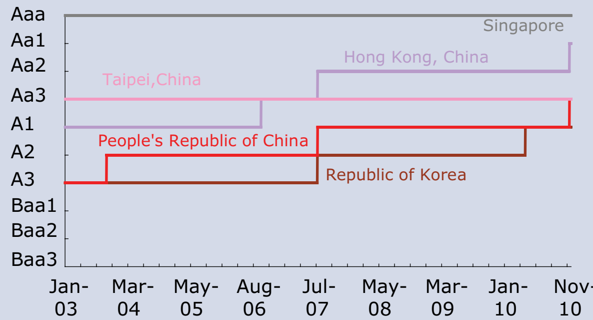


Figure 32d: Moody's Sovereign Ratings— PRC and NIEs (long-term foreign currency)



NIEs = newly industrialized economies, PRC = People's Republic of China.
Source: Bloomberg.

Table 7: Risk-Weighted Capital Adequacy Ratios[1]
(% of risk-weighted assets)

Economy	2000–2004 Average	2005	2006	2007	2008	2009[2]	2010[3]
China, People's Rep. of	-2.3[4]	2.5	4.9	8.4	12.0	11.4	–
Hong Kong, China	16.1	14.8	14.9	13.4	14.7	16.8	16.2
Indonesia	18.7	19.3	21.3	19.3	16.8	17.4	18.1
Korea, Republic of	10.7	12.4	12.3	12.0	12.7	14.6	14.6
Malaysia	13.4	13.6	13.1	12.8	12.2	14.9	14.4
Philippines	17.0	17.7	18.5	15.9	15.7	16.0	16.2
Singapore	17.7	15.8	15.4	13.5	14.7	16.5	–
Taipei,China	10.5	10.3	10.1	10.6	10.8	11.7	11.6
Thailand	13.2	14.2	14.5	15.4	14.1	16.1	16.8

– = unavailable
[1]Based on official risk-adjusted capital adequacy ratios and applied to commercial banks for most economies except Hong Kong, China (covers authorized institutions) and the Philippines (covers universal and commercial banks). Data for the Philippines is on a consolidated, not solo, basis. [2]Data for Singapore as of Sep 2009. [3]Data for Malaysia and Thailand as of Sep 2010; Hong Kong, China; Indonesia; and Republic of Korea as of Jun 2010; Philippines and Taipei,China as of Mar 2010. [4]Average of 2000 and 2002–2004 figures. Figure for 2000 is ratio for state commercial banks.
Source: National sources and *Global Financial Stability Report October 2010,* International Monetary Fund.

Table 8: Rate of Return on Commercial Bank Assets (% per annum)

Economy	2000–2004 Average	2005	2006	2007	2008	2009[1]	2010[2]
China, People's Rep. of	0.2	0.6	0.9	0.9	1.0	0.8	–
Hong Kong, China[3]	1.2	1.7	1.8	1.9	1.8	1.5	1.3
Indonesia	2.2	2.6	2.6	2.8	2.3	2.6	3.0
Korea, Republic of	0.4	1.2	1.1	1.1	0.5	0.4	–
Malaysia	1.3	1.4	1.3	1.5	1.5	1.2	–
Philippines	0.8	1.1	1.3	1.4	0.8	1.2	1.3
Singapore	1.1	1.2	1.4	1.3	1.0	1.1	–
Taipei,China	0.3	0.3	-0.4	0.1	-0.1	0.3	0.5
Thailand	0.7	1.3	0.8	0.2	1.0	0.9	1.1

– = unavailable
[1]Data for Singapore as of Sep 2009. [2]Data for Thailand as of Sep 2010; Hong Kong, China; Indonesia; and Philippines as of Jun 2010; Taipei,China as of Mar 2010. [3]Net interest margin of retail banks. Year-to-date annualized.
Source: National sources and *Global Financial Stability Report October 2010,* International Monetary Fund.

Table 9: Rate of Return on Commercial Bank Equity (% per annum)

Economy	2000–2004 Average	2005	2006	2007	2008	2009[1]	2010[2]
China, People's Rep. of[3]	—	15.1	14.9	16.7	17.1	15.1	–
Hong Kong, China[4]	14.9	16.7	16.7	21.3	13.0	14.4	–
Indonesia[5]	16.2	21.4	22.4	23.2	15.5	18.4	–
Korea, Republic of	7.2	20.3	15.6	16.2	9.0	6.6	–
Malaysia	16.2	16.8	16.2	19.7	18.5	16.1	15.2
Philippines	5.9	9.5	11.5	11.8	7.2	11.4	11.8
Singapore	9.6	11.2	13.7	12.9	10.7	11.0	–
Taipei,China	4.1	4.4	-7.3	2.6	-0.7	4.3	7.3
Thailand	13.3	16.5	10.2	2.8	12.2	10.4	11.9

– = unavailable
[1]Data for Indonesia and Singapore as of Sep 2009. [2]Data for Thailand as of Sep 2010; Philippines as of Jun 2010; Malaysia and Taipei,China as of Mar 2010. [3]Total banking industry, except for 2006, which refers only to four listed state-owned banks. [4]Locally-incorporated banks. [5]After taxes.
Source: National sources and *Global Financial Stability Report October 2010,* International Monetary Fund.

Table 10: Nonperforming Loans (% of commercial bank loans)

Economy	2000–2004 Average	2005	2006	2007	2008	2009[1]	2010[2]
China, People's Rep. of	21.0	8.6	7.1	6.2	2.5	1.6	1.3
Hong Kong, China[3]	4.0	1.4	1.1	0.9	1.2	1.3	1.0
Indonesia	10.2	7.6	6.1	4.1	3.2	3.3	3.0
Korea, Republic of	3.1	1.3	0.9	0.7	1.2	1.2	1.9
Malaysia[3]	8.9	5.6	4.8	3.2	2.2	1.8	2.0
Philippines[3]	14.8	8.5	5.7	4.4	3.5	3.0	3.3
Singapore	5.3	3.8	2.8	1.5	1.7	2.3	–
Taipei,China	5.2	2.2	2.1	1.8	1.5	1.2	1.1
Thailand[3]	13.5	8.3	7.5	7.3	5.3	4.8	4.2

– = unavailable
[1]Data for Singapore as of Sep 2009. [2]Data for Malaysia and Thailand as of Sep 2010; Philippines as of Aug 2010; People's Republic of China; Hong Kong, China; Indonesia; and Republic of Korea as of Jun 2010; Taipei,China as of Mar 2010. [3]Reported nonperforming loans are gross classified loans of retail banks.
Source: National sources and *Global Financial Stability Report October 2010,* International Monetary Fund.

Figure 33a: Bank Lending Growth[1]—ASEAN-4 (y-o-y, %)

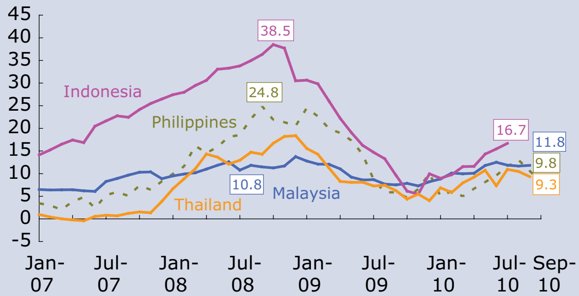


Figure 33c: Bank Lending Growth[3]—People's Republic of China (y-o-y, %)

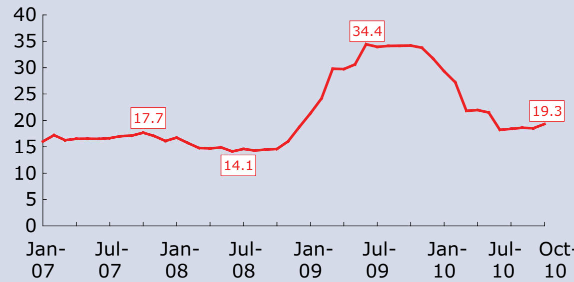
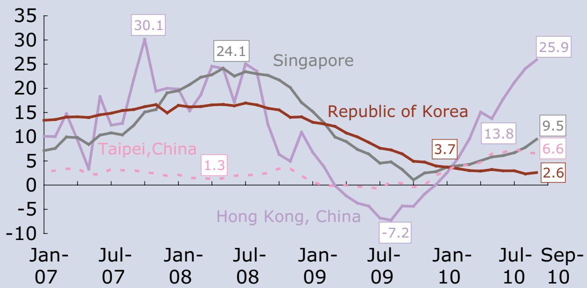


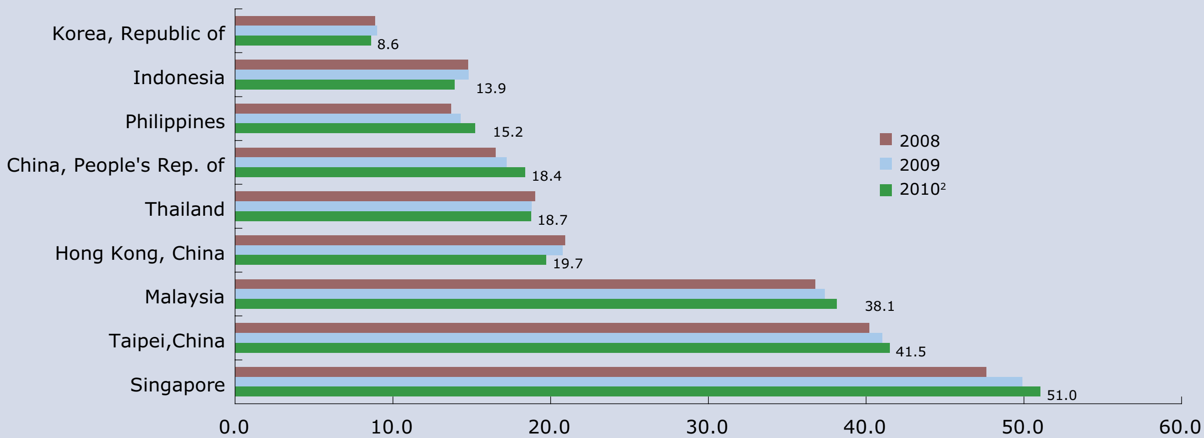
Figure 33b: Bank Lending Growth[2]—NIEs (y-o-y, %)



y-o-y = year-on-year.
NIEs = newly industrialized economies (Hong Kong, China; Republic of Korea; Singapore; and Taipei,China).
[1]Data for Indonesia refers to commercial bank loans; Malaysia to commercial bank loans and advances; Philippines to commercial and universal bank loans net of RRAs (reverse repurchase arrangements), starting in 2007; and Thailand to commercial bank loans. Data for Indonesia until Jul 2010. [2]Data for Hong Kong, China refers to authorized institutions' loans and advances; Republic of Korea to commercial and specialized bank loans; Singapore to domestic banking unit loans and advances; and Taipei,China to domestic bank loans and advances. [3]Data for People's Republic of China refers to financial institution loans.
Source: OREI staff calculations using data from CEIC, Bank of Korea website, and People's Bank of China.

measures have recently moderated housing prices. In Singapore, fast rising home prices are worrying as real estate lending accounts for more than half of total loans in the banking system **(Figure 34)**. Authorities there also introduced measures to reduce speculation in the property market.

Figure 34: Real Estate Loans[1]—PRC, ASEAN-4, and NIEs (percent of total loans)



NIEs = newly industrialized economies, PRC = People's Republic of China.
[1]Data for PRC includes real estate loans of major financial institutions; for Hong Kong, China loans for building, construction, property development, and investment of all authorized institutions; for Indonesia, property loans of commercial and rural banks; for Republic of Korea, real estate, renting and leasing loans of commercial and specialized banks; for Malaysia, sum of loans for purchase of residential and non-residential property, and for purchase of fixed assets other than land and buildings of the banking system; for the Philippines, banking system loans for real estate, renting, and business activities; for Singapore, business loans for building and construction, and housing and bridging loans for consumers of domestic banking units; for Taipei,China, real estate loans of all banks; and for Thailand, loans for real estate activities, renting and business, and loans for land, for provision of dwelling, and for purchase of real estate for others by commercial banks. [2]Data for Hong Kong, China; Indonesia; Malaysia; Singapore; Taipei,China; and Thailand as of Sep 2010; PRC and Republic of Korea as of Jun 2010; Philippines as of Mar 2010.
Source: OREI staff calculations using data from People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank Negara Malaysia, Bangko Sentral ng Pilipinas (Philippines), Monetary Authority of Singapore, Bank of Thailand, and CEIC.

Box 1: Has Fiscal Policy Worked for ASEAN-5?[1]

This section attempts to answer a simple question: how effective is fiscal policy in stabilizing output in the five charter Association of Southeast Asian Nations (ASEAN) members?[2] It is the counterpart to monetary policy in affecting output and/or inflation. Surprisingly, there has been very little empirical work on the ASEAN-5.[3] Yet judging from the prolific use of discretionary fiscal stimulus during the recent global financial crisis, it would seem that policymakers have unequivocal confidence in its efficacy.

Empirical findings, however, are quite different. Using a Blanchard and Perotti structural vector autoregression (SVAR) model,[4] Tang et al. (2010) find that the overall impact of government spending on output is largely benign—the impact of the fiscal multiplier is far below one and statistically insignificant. This is true in all the ASEAN-5. And in the case of taxes, a consistent pattern of output expansion with fiscal contraction is evident, although the result is statistically significant only in Indonesia and Thailand.

The literature offers several explanations. Being small and highly open economies—Singapore (with a total trade-to-GDP share of 283% in 2009), Malaysia (146%), Thailand (108%), and to a lesser extent the Philippines (51%) and Indonesia (39%)—are very susceptible to fiscal stimulus leaking out through higher imports. Coupled with the adoption of more flexible exchange rates, especially after the 1997/98 Asian financial crisis, the leakage would have been greater. In addition, the combination of low financial depth and largely liberalized interest rates, particularly in the Philippines and Indonesia, facilitates the crowding out effects through greater upward pressure on interest rates. If monetary policy accommodation does not follow, the crowding out effects are even larger.

More important, fiscal credibility that comes from a good track record of budget balances and low public debt is key to policy effectiveness. The lack of fiscal credibility is a major factor for the expansionary fiscal contraction phenomenon observed in many other studies. Among the ASEAN-5, with the exception of Singapore, many have run persistent budget deficits. Their public debt levels may be considered "comfortable" for developed countries, but not for developing countries largely characterized by weak fiscal management and institutions, and a small tax base.[5] The Philippines and Indonesia, well-known for their fiscal weaknesses, are two countries that have faced sovereign debt problems resulting to debt restructuring. Thailand came close in facing the same problem during the Asian financial crisis and Malaysia has shown some weaknesses since.[6] Singapore's

[1]This box is based on a forthcoming paper by H.C. Tang et al. The Impact of Fiscal Policy Effectiveness in Selected ASEAN Countries. *ADB Working Paper Series on Regional Economic Integration*. References cited here can be found in the paper.

[2]Indonesia, Philippines, Malaysia, Singapore, and Thailand.

[3]Jha et al. (2010) is a notable exception. The authors used a sign-restricted VAR on 10 emerging Asian economies including the ASEAN5 studied here. Their results are largely similar to Tang et al.

[4]This is the three-variable model of taxes, government spending, and GDP of Blanchard and Perotti (2002). Quarterly data from 1990 (depending on availability) until end-2009 are used. Results are not shown here but they can be gleaned from the average impulse responses plotted in Figure B1.1.

[5]The 60% public debt-to-GDP rule that applies to countries in the eurozone would suggest that most ASEAN-5 countries are generally safe. (The ratio at end-2009 for Indonesia was 29%; the Philippines, 49%; Malaysia, 55%; Singapore, 110%; and Thailand, 44%). A more conservative and appropriate yardstick used by the International Monetary Fund (IMF) is above 25% for high-debt emerging economies.

[6]Malaysia took more than a decade to reduce its public debt ratio of over 100% since the twin-deficit crisis in the mid-1980s to less than 40%. Nevertheless, despite the good economic years before the global financial crisis, its ratio has stayed above 40%, while its budget deficit has persisted.

headline public debt-to-GDP at over 100% is startling but misleading.[7]

While the Blanchard and Perotti SVAR model only summarizes the dominant influence over time, there may be instances when either government spending or tax reform is more or less effective. To do this, Tang et al. employ a time-varying VAR model.[8] They find that the expansionary impact on output from a positive tax shock in most countries is most prominent during crisis periods **(Figure B1.1)**. This is most obvious in the Philippines—during both the Asian financial crisis and the global financial crisis—and lasted several years. Similar evidence is found in Malaysia, but not as persistent, and in Thailand and Singapore, mostly during the global financial crisis. In Indonesia, the phenomenon was most evident prior to the Asian financial crisis, but has improved due to the fiscal reforms undertaken since.

On the other hand, in terms of the impact on output of a government spending shock, Indonesia's fiscal policy effectiveness appears to have also improved since the Asian financial crisis in tandem with improved macroeconomic management. The Philippines, however, followed the opposite path of deteriorating government spending's impact on output. With weak fiscal credibility, a further rise in public debt and persistent budget deficits since the Asian financial crisis did not encourage market confidence. Similarly, in Malaysia, while the impact on output of a government spending shock was small but largely positive prior to the Asian financial crisis, it has turned somewhat negative since. This may have to do with the introduction of capital controls during the Asian financial crisis and subsequent fiscal weakness. In Thailand and Singapore, there is more evidence that government spending was countercyclical when tried during crisis periods (Singapore's case was most obvious during the global financial crisis, while Thailand's also included the Asian financial crisis). Perhaps the difference in potency is due to the relatively closed Thai economy compared with a very open Singaporean economy.

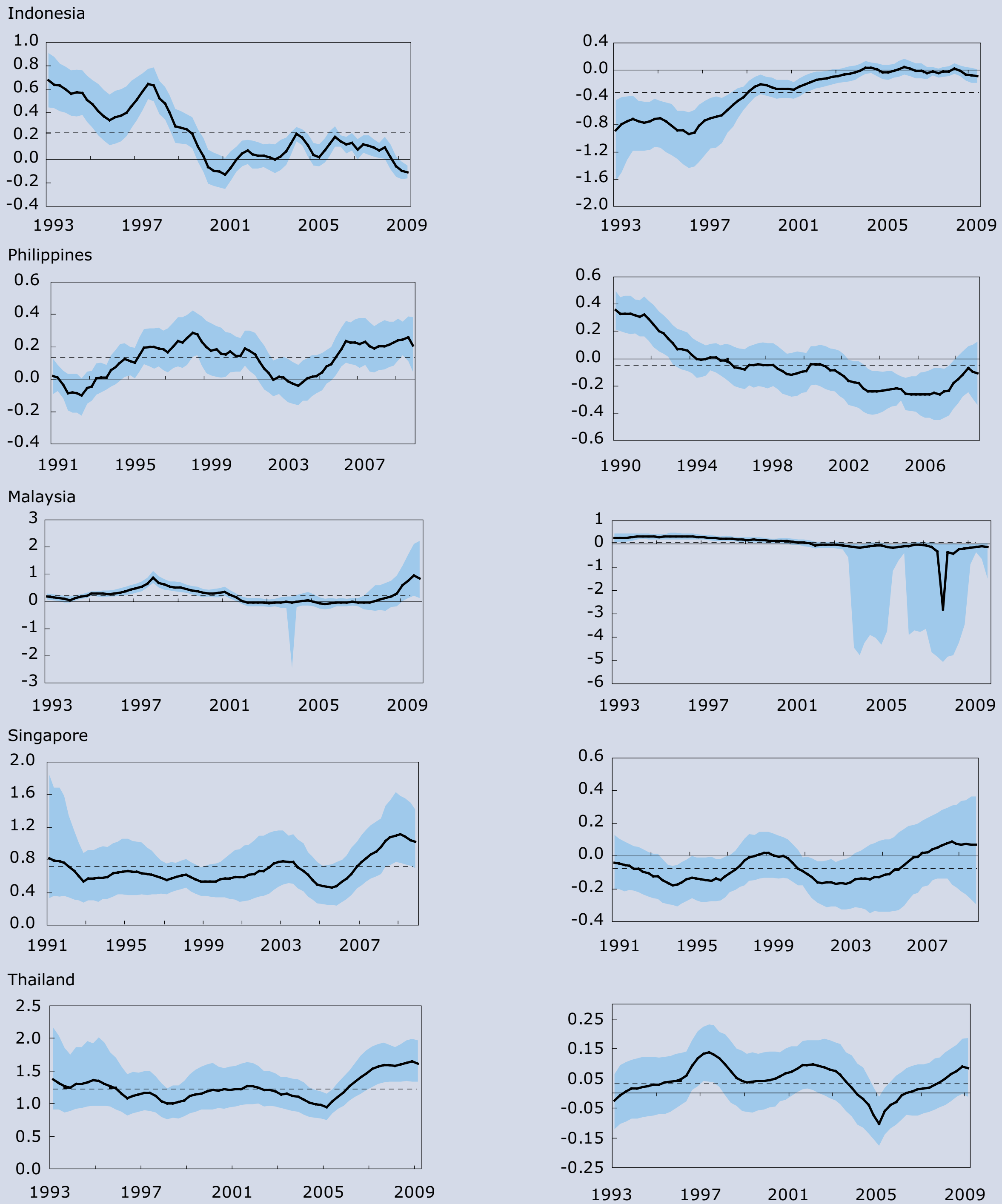
In sum, fiscal spending can be effective at times in some countries. But the evidence is by no means overwhelming and that the multiplier is much less than one. In contrast, tax cuts do not appear to have the same effect. On the contrary, tax hikes seem to boost output especially during crisis periods. Perhaps these actions are interpreted as greater fiscal responsibility and credible efforts which in turn spur consumption and investment. Reduction in government spending may not have the same impact because it is often viewed as essential for development and future economic growth.

[7]Most published debt-to-GDP numbers refer to gross public debt which is also used here. A better gauge is net debt-to-GDP, but this number is not widely available. Singapore's high public debt ratio is influenced by a high proportion of bond issuance that caters for the investment needs of the Central Provident Fund.

[8]The authors follow Primiceri (2005). An intuitive way of thinking about the model is that instead of having one impulse response summarizing the overall result for the whole sample period, with a time-varying VAR, each impulse response can be derived by summarizing the result for every quarter.

Box 1 continued

Figure B1.1: One-Year Cumulative Impulse Response of GDP to Tax (left) and to Government Spending (right) Shocks (%)



Note: Each shock is a positive one unit (percent) shock. The horizontal line in each plot refers to the average one-year cumulative impulse response for the whole period. The error bands are the 95% confidence intervals. The kinked error bands and impulse responses for Malaysia are modeling discrepancies due to draws being very close to unit root.

Economic Outlook, Risks, and Policy Issues

External Economic Environment

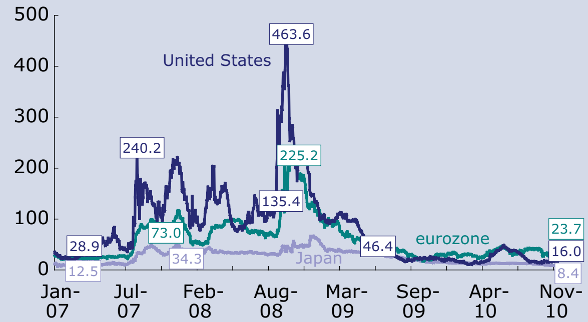
The external economic environment for emerging East Asia has weakened as the US economy continues to struggle and doubts remain over the sustainability of the eurozone recovery.

While growth in the United States (US) and Japan picked up in the third quarter of 2010 compared with the first half, the outlook for 2011 is weak and fragile. Growth in the eurozone slowed in the third quarter after a strong second quarter performance. Growth momentum may ease on weak domestic US demand, uncertainty over the sovereign debt crisis in Europe, and deflationary pressures in Japan. The second round of quantitative easing by the US Federal Reserve may help shore up the US recovery, but could also increase risks of asset price bubbles and higher inflation in emerging East Asia. The International Monetary Fund (IMF) forecasts GDP in advanced economies to grow 2.7% in 2010 from a 3.2% decline in 2009, further downgrading its 2011 projection to 2.2%.

Positively, global financial conditions appear to have stabilized. Financial markets have recovered and have been stable apart from a slight wobble in the middle of the year from the Greek debt crisis.

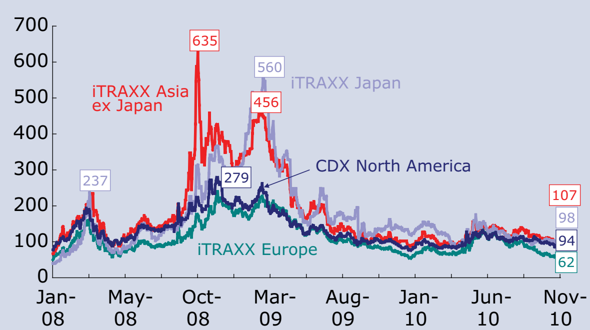
The TED spread—the difference between Treasury bill rates and interbank rates—has returned to historical levels **(Figure 35)**. Similarly, credit default swaps—the cost of insuring against corporate defaults—have also returned to pre-crisis levels **(Figure 36)**. Equity markets have stabilized, and growing strongly in emerging markets **(Figure 37)**. The VIX index—measuring US stock market volatility—has been trending downward after a slight spike in the middle of the year **(Figure 38)**. At the same time, yield curves in mature markets have flattened—though steepening slightly in November—suggesting that economic recovery in advanced economies may be stalling **(Figure 39)**. But as global financial and equity markets normalized, attention has now turned to the high public debt in parts of Europe. Recently, yields for Greek, Irish, Portuguese, and Spanish bonds

Figure 35: TED Spreads[1]–G3



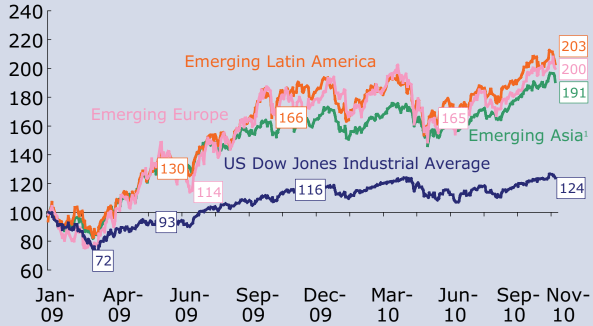
[1]Difference between the 3-month LIBOR (London Interbank Offered Rate) and 3-month government debt (e.g. Treasury bills).
Source: OREI staff calculations based on Bloomberg and Datastream data.

Figure 36: Credit Default Swap Indexes
(investment grade, senior 5-year)



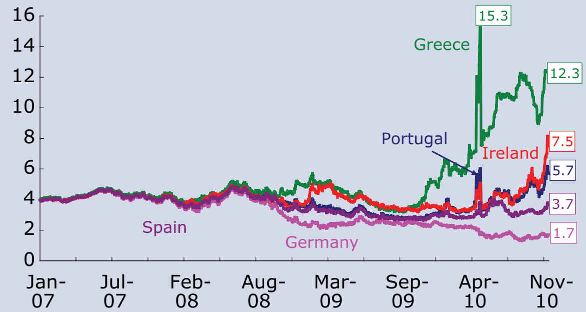
Source: Bloomberg.

Figure 37: MSCI Indexes (2 Jan 2009 = 100)



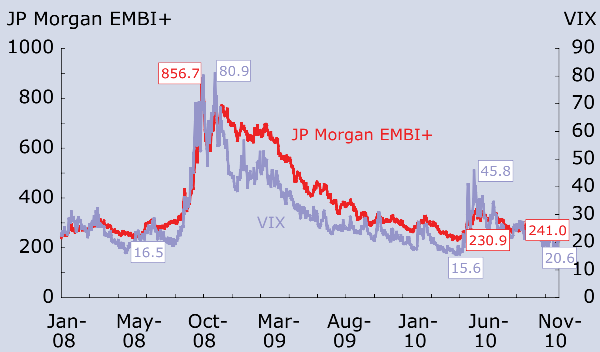
[1]Includes People's Republic of China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Taipei,China; and Thailand.
Source: Morgan Stanley Capital International (MSCI) Barra and Datastream.

Figure 40: Sovereign Bond Yields—Selected European economies (%, 5-year)



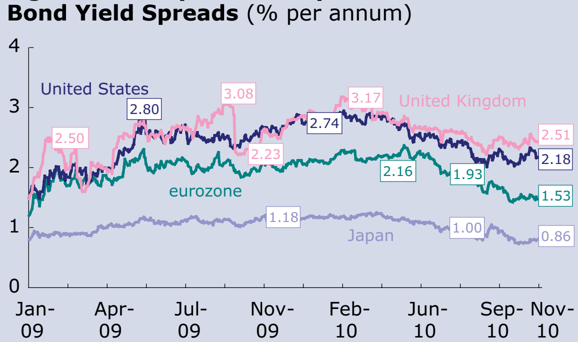
Source: Bloomberg.

Figure 38: Equity Market Volatility and Bond Spreads



VIX = Chicago Board Options Exchange Volatility Index, JPM EMBI+ = JP Morgan Emerging Markets Bonds Indices Plus.
Source: Bloomberg.

Figure 39: 10-year and 2-year Government Bond Yield Spreads (% per annum)



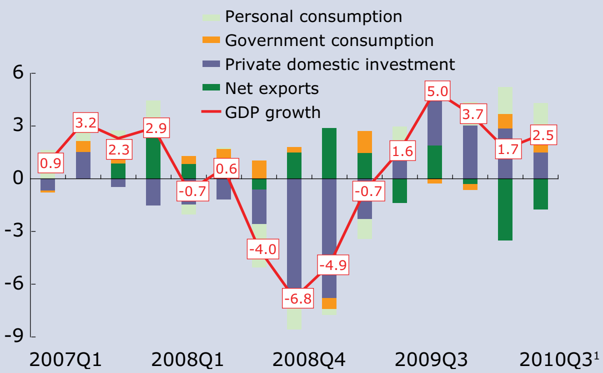
Source: Datastream.

have risen on fiscal worries **(Figure 40)**. Ireland has had to accept a bailout from the European Union (EU) and IMF. Heightened scrutiny will likely force these governments to tighten budgets. And consumer spending may be muted as households repair balance sheets.

The US recovery appears weak and will likely be gradual, with continued high unemployment amid waning consumer and business confidence.

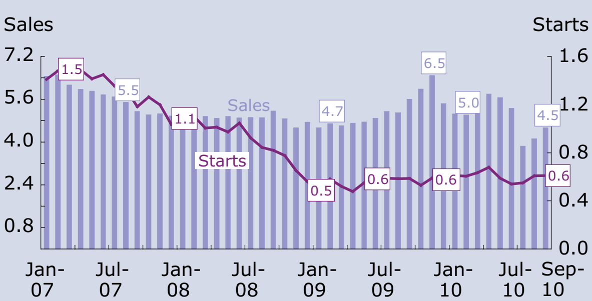
Growth in the US picked up slightly in the third quarter of 2010—to 2.5% (quarter-on-quarter [q-o-q] seasonally adjusted annualized rate [saar]) compared with 1.7% (q-o-q, saar) in the second quarter. Compared with the second quarter, the improved performance was due to higher consumption growth, though partly offset by weaker investment **(Figure 41)**. Moribund housing is taking its toll, as residential fixed investment declined 27.5% (q-o-q, saar) in the third quarter. The housing market is expected to remain a drag on growth as both private housing sales and starts remain depressed **(Figure 42)**. Lingering uncertainty over the foreclosure process may also hamper the recovery. Leading indicators are not much help. Industrial production growth slowed to 5.4% year-on-year in September 2010

Figure 41: Contributions to Growth—US
(seasonally adjusted, annualized, q-o-q, % change)



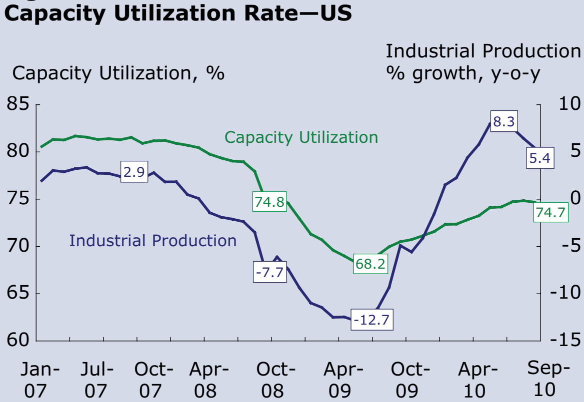
GDP = gross domestic product, q-o-q = quarter-on-quarter, US = United States.
[1]Second estimate as of 23 Nov 2010.
Source: US Bureau of Economic Analysis.

Figure 42: Private Housing Starts[1] and Existing Home Sales[2]—US (million units)



US = United States.
[1]Seasonally adjusted levels. [2]Seasonally adjusted and annualized.
Source: CEIC.

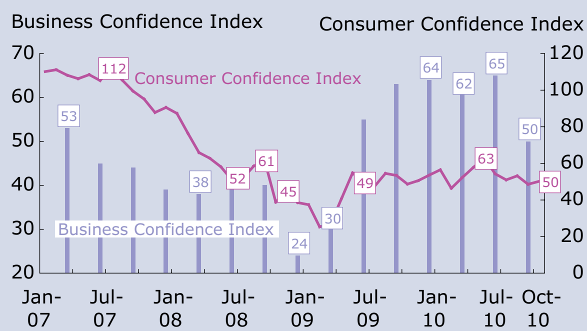
Figure 43: Industrial Production Growth and Capacity Utilization Rate—US



y-o-y = year-on-year.
Source: Board of Governors of the US Federal Reserve System.

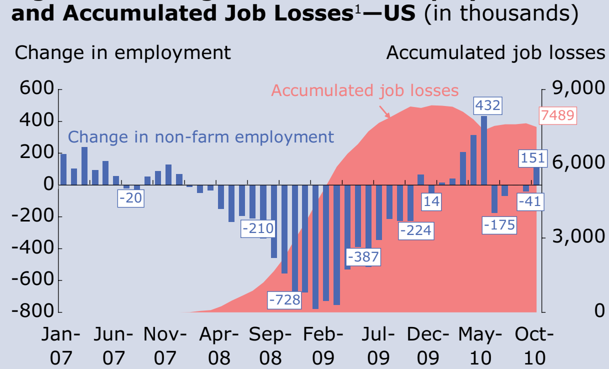
(Figure 43). Business and consumer confidence is down **(Figure 44).** Pessimism may be due to continued high unemployment and the recent return of job losses **(Figure 45).** High unemployment and continued housing market weakness suggest US growth will continue to be fragile. In sum, the US economy is expected to grow 2.8% this year, moderating slightly to 2.6% in 2011.

Figure 44: Business and Consumer Confidence Indexes—US



US = United States.
Note: Consumer confidence (1985 = 100). A business confidence index above 50 means there are more positive than negative responses. Consumer confidence index is monthly; business confidence index is quarterly.
Source: Datastream.

Figure 45: Change in Non-Farm Employment and Accumulated Job Losses[1]—US (in thousands)

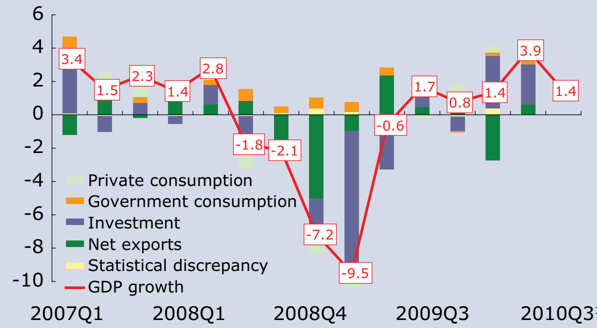


[1]Accumulated job losses since December 2007. Preliminary figures for Sep and Oct 2010.
Source: OREI staff calculations based on data from the US Bureau of Labor Statistics.

A second round of quantitative easing (QE2) by the Federal Reserve may help the US economy avoid deflation and a double-dip recession, but could have unintended consequences both in the US and globally.

The gloomy outlook for the US economy prompted the Federal Reserve to inaugurate a strategy to purchase $600 billion in longer-dated US Treasuries from November 2010 to June 2011. This should lower both nominal and real long-term interest rates while boosting prices for assets such as equities and corporate bonds. This could invigorate private consumption and investment. And it could further weaken the US dollar and boost US exports. There is some evidence that QE2 is already starting to work, as 10-year Treasury bond yields fell and stock prices rose after QE2 rumors spread through markets—though yields rose again following the 3 November formal announcement. However, QE2 stimulus could be muted: (i) US consumers may not want to borrow while deleveraging household debt; and (ii) banks may not want to lend more with excess reserves. There are plenty of risks with QE2. Commodity prices are rising due to cheap money, which could be inflationary and hurt consumption. Giving investors incentives to seek higher yields in riskier assets could create asset bubbles. Inflationary expectations could accelerate. And abundant liquidity could once again lead to inordinate capital flows—particularly to emerging economies—with possible destabilizing effects.

Figure 46: Contributions to Growth—eurozone
(seasonally adjusted, annualized, q-o-q, % change)



GDP = gross domestic product, q-o-q = quarter-on-quarter.
[1]Eurostat flash estimate.
Source: Eurostat website.

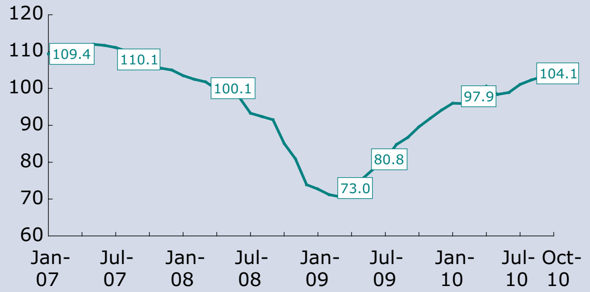
Figure 47: Export Growth[1]—eurozone[2]
(y-o-y, % change)

[1]Year-on-year (y-o-y) growth of 3-month moving averages of export values. [2]Refers to Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain.
Source: OREI staff calculations based on Datastream data.

Recovery in the eurozone is slowing due to fiscal tightening and lingering uncertainty over sovereign debt, even if euro depreciation has helped boost exports.

Growth in the eurozone slowed to 1.4% (q-o-q, saar) in the third quarter of 2010 from a robust 3.9% growth (q-o-q, saar) in the second quarter **(Figure 46)**. Leading indicators suggest that recovery will continue. Exports were the bright spot growing 24.9% in August 2010 **(Figure 47)**. However, a recent euro rebound may dampen export growth in the coming months. Confidence remains high in the eurozone with economic sentiment on the rise **(Figure 48)**. This confidence should bring stronger demand with both retail sales and industrial production on the upswing **(Figure 49)**. Following the Greek debt crisis in the middle of 2010, eurozone economies moved to adopt a tighter fiscal stance. This may hurt growth in eurozone economies where recovery remains fragile. And while fears of a Greek debt crisis have mostly faded, the watch has turned toward other indebted members like Ireland, Portugal, and Spain. Ireland had to avail of a bailout package from the EU and IMF. Continued uncertainty may

Figure 48: Economic Sentiment Indicator[1]—eurozone[2]



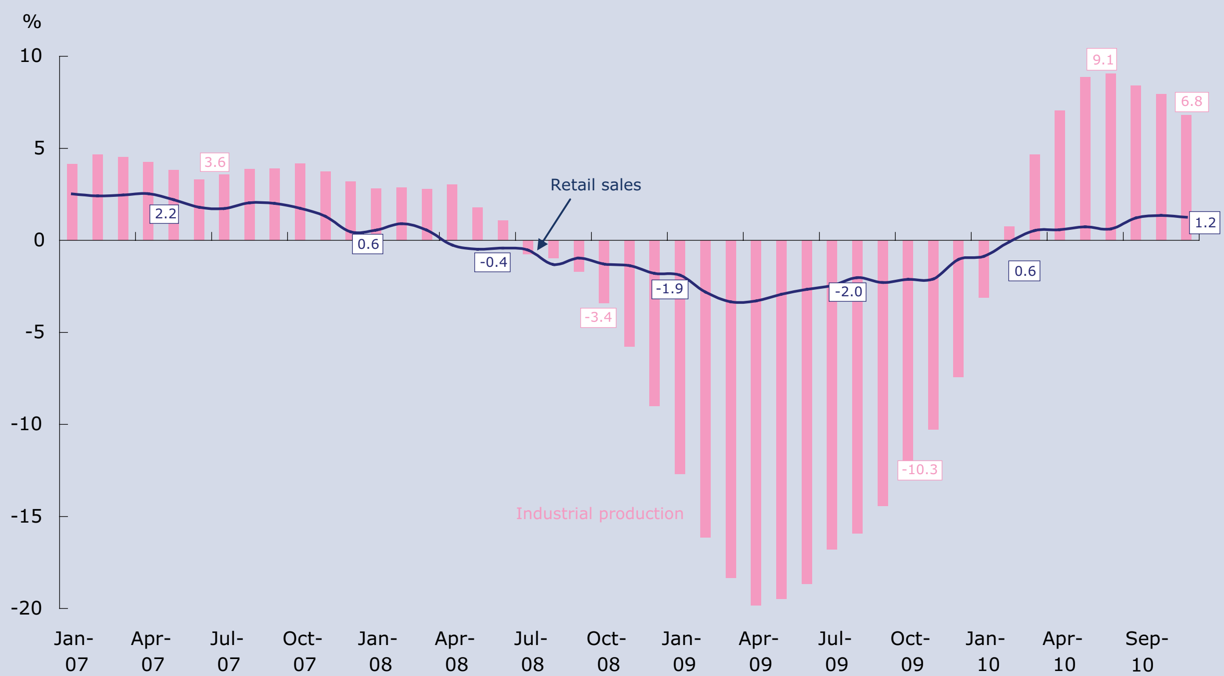
[1]The economic sentiment indicator is a composite index of business and consumer confidence indicators based on surveys of economic assessments and expectations in the eurozone. [2]Refers to Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain.
Source: Datastream.

stifle recovery as well. Growth in the eurozone is forecast at 1.5% for 2010, slowing slightly to 1.4% next year.

The Japanese recovery is expected to slow in 2011, weakened by strong yen appreciation and persistent deflationary pressures.

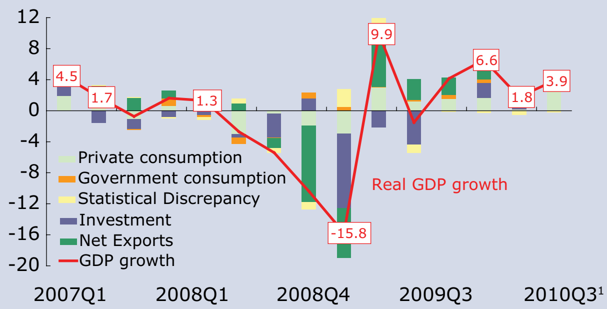
Japan's economy grew 3.9% (q-o-q, saar) in the third quarter of 2010, up from 1.8% growth (q-o-q, saar) in the second quarter—largely due to strong consumer demand ahead of an increase in cigarette taxes and the phasing out of government subsidy for fuel-efficient cars. However, net exports contributed a mere 0.4%

Figure 49: Retail Sales and Industrial Production[1]—eurozone



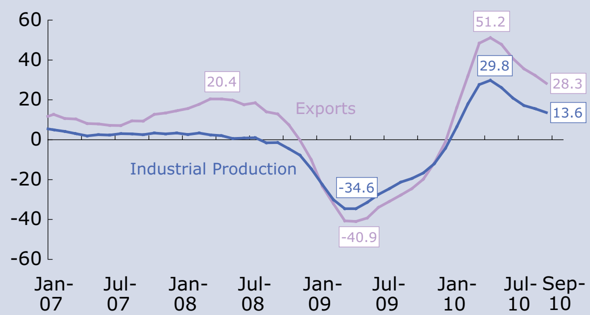
[1]Working-day adjusted, year-on-year growth rate of 3-month moving averages.
Source: OREI staff calculations based on CEIC data.

Figure 50: Contributions to Growth—Japan
(seasonally adjusted, annualized, q-o-q, % change)



GDP = gross domestic product, q-o-q= quarter-on-quarter.
[1]First preliminary estimates as of 15 Nov 2010.
Source: Cabinet Office, Government of Japan.

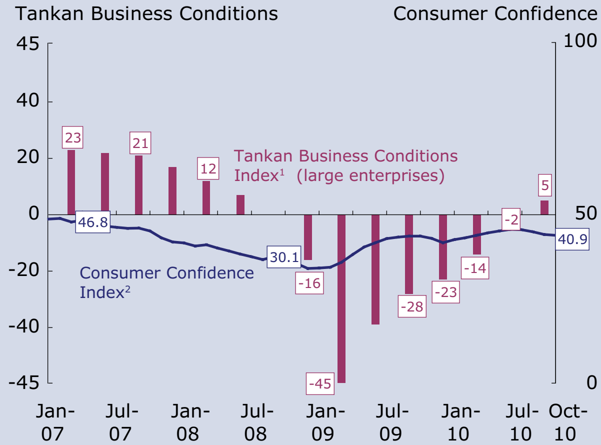
Figure 51: Merchandise Export and Industrial Production Growth[1]—Japan (y-o-y, %)



y-o-y = year-on-year.
Note: Exports in $ value; industrial production in local currency.
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

(Figure 50). For the first three quarters of 2010, GDP grew 4.0% compared with the same period of 2009. However, prospects for the remainder of 2010 and into 2011 remain bleak. As some car and cigarette purchases may have been brought forward, consumer spending is expected to weaken in the fourth quarter. Net exports are also likely on the downside, hurt by the rising value of the yen—which appreciated 12.5% against the US dollar thus far this year. Export growth has been trending downward, growing by a relatively low 23.9% in September. Industrial production growth is also down, slowing to 11.6% in September **(Figure 51)**. Domestic demand is likely to remain

Figure 52: Business and Consumer Sentiment Indexes—Japan



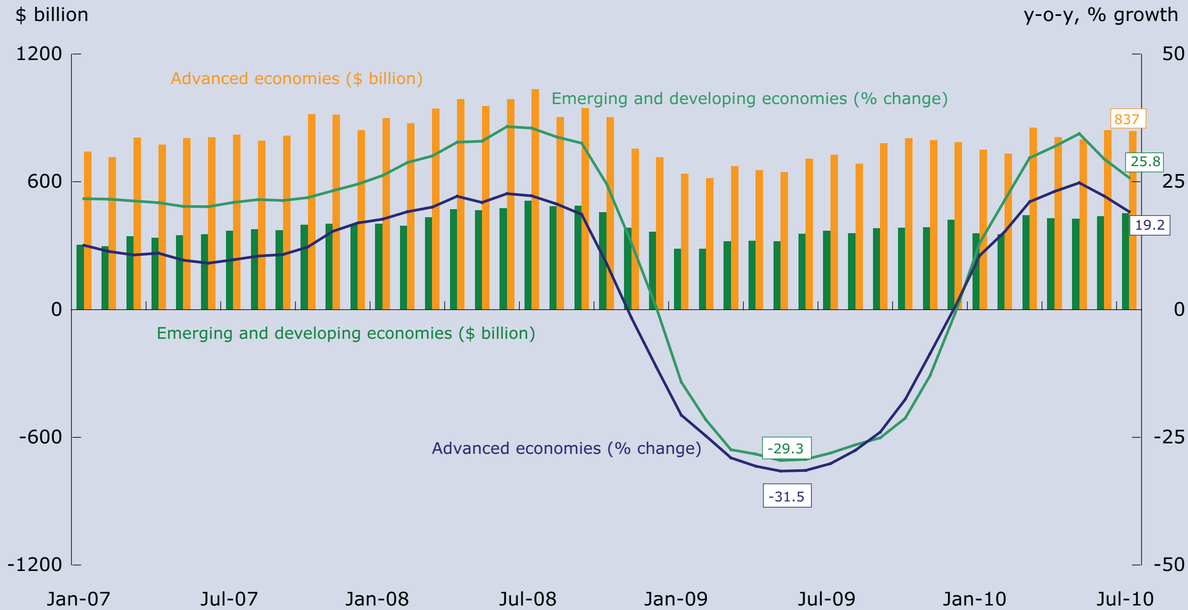
[1]Quarterly survey. A positive figure indicates higher percentage of companies reporting favorable business conditions from those reporting unfavorable conditions. [2]Monthly survey. A figure above 50 indicates positive consumer sentiment, while a number below 50 indicates negative consumer sentiment.
Source: Datastream.

muted as consumer confidence remains weak. Nonetheless, there has been a slight improvement in business confidence **(Figure 52)**. The economy is expected to grow 3.2% in 2010, slowing to 1.4% in 2011.

The rapid recovery in world trade is moderating, with trade volumes in 2010 returning close to pre-crisis levels.

Growth in world trade appears to have peaked following the strong rebound in early 2010. Imports from advanced, emerging, and developing economies have moderated, but remain high **(Figure 53)**. Estimates from the CPB Netherlands Bureau for Economic Policy Analysis also indicate world trade volume is moderating **(Figure 54)**. Demand for high-tech products recovered as companies again invested in information technology (IT) equipment and software as the global economy improved. New IT orders in G3 economies expanded 2.3% in July 2010, while computer and software sales climbed 10.4% in August **(Figures 55, 56)**.

Figure 53: Imports—Advanced Economies; Emerging and Developing Economies
($ billion, % growth)[1]

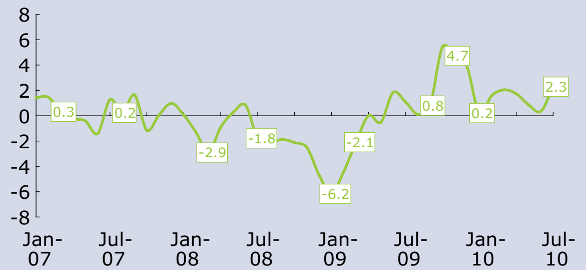


[1]Year-on-year (y-o-y) growth rates of 3-month moving averages.
Source: *International Financial Statistics*, International Monetary Fund.

Figure 54: World Trade Volume (seasonally adjusted index, % growth)[1]

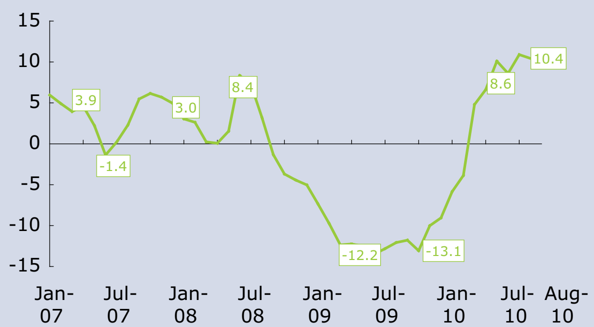
[1]Year-on-year (y-o-y) growth rates of 3-month moving averages.
Source: CPB Netherlands Bureau for Economic Policy Analysis.

Figure 55: New Information Technology Orders[1]—G3[2] (% change)



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

Figure 56: Computer and Software Sales[1]—G3[2] (y-o-y, % change)



[1]3-month moving average of year-on-year (y-o-y) growth in sales values.
[2]eurozone, Japan, and United States.
Source: Datastream and Eurostat.

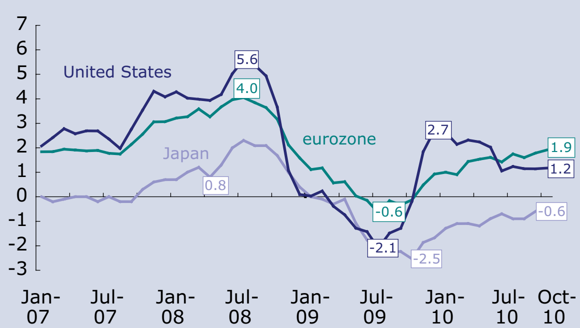
Inflationary pressures in advanced economies should remain low given the weak recovery and continued excess capacity.

While growth has returned to advanced economies, there is little sign inflationary pressures are building—inflation is running below 2% **(Figure 57)**. Inflation will be kept in check by excess capacity in advanced economies. US capacity utilization remains well below pre-crisis levels (see Figure 43). Implied inflation—estimated by the difference between 10-year bond yields and 10-year inflation-linked bond yields—in the US and France—has remained relatively stable, suggesting little increase in inflationary expectations **(Figure 58)**.

With growth in advanced economies likely to be weak in 2011, commodity prices are not expected to return to their high pre-crisis levels.

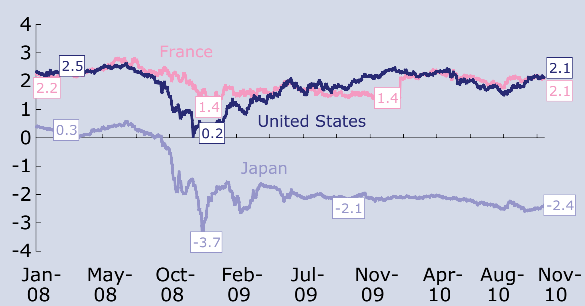
Faster growth in 2010 resulted in higher oil demand, moving crude oil up from $76 at the beginning of the year to around $87 currently. Nevertheless, further increases are likely to be incremental—1-year futures suggest that crude oil prices will marginally increase to $91 **(Figure 59)**. Furthermore, forecasts of higher excess capacity in the Organization of the Petroleum Exporting

Figure 57: Headline Inflation—eurozone[1], Japan, and United States (y-o-y, %)



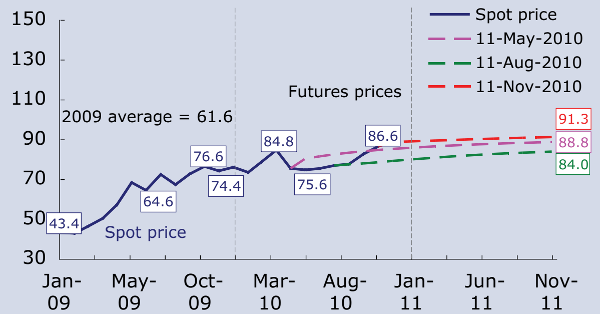
[1]Refers to Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain. Data for Japan is until Sep 2010.
Source: OREI staff calculations using data from CEIC.

Figure 58: Implied Inflation Expectations by Financial Market[1]—France, Japan, and US (percentage points)



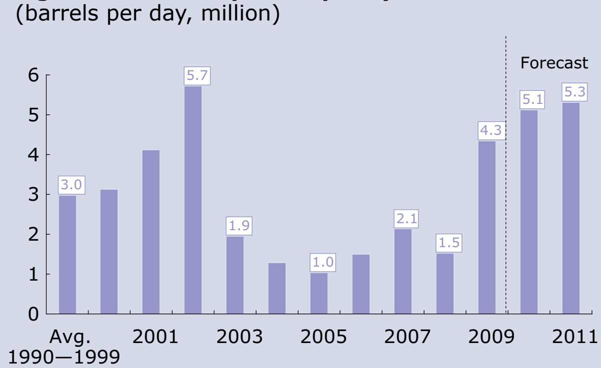
US = United States.
[1]Implied inflation expectation is the difference between yields of 10-year bonds and 10-year inflation-linked bonds.
Source: Bloomberg.

Figure 59: Brent Spot[1] and Futures Prices
($ per barrel)



[1]Monthly average of daily spot prices. As of 15 Nov 2010.
Source: Datastream.

Figure 60: OPEC Spare Capacity
(barrels per day, million)



OPEC = Organization of the Petroleum Exporting Countries.
Source: *Short-Term Energy and Summer Fuels Outlook* (Nov 2010), US Energy Information Administration.

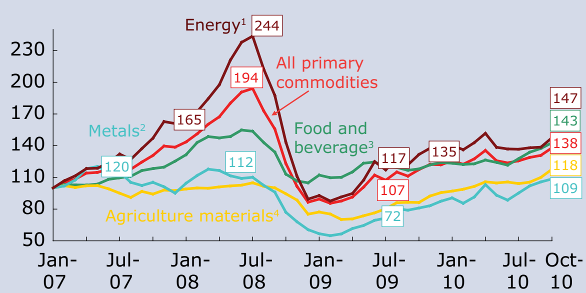
Countries (OPEC) in 2010 and 2011 are likely to help moderate any oil price increase **(Figure 60)**. Prices of other commodities have edged higher with the global recovery **(Figure 61)**. However, a weakening US dollar could push up commodity prices in US dollar terms.

Regional Economic Outlook

With stimulus being withdrawn and the recovery intact, growth in 2011 should moderate as the post-recovery phase kicks in.

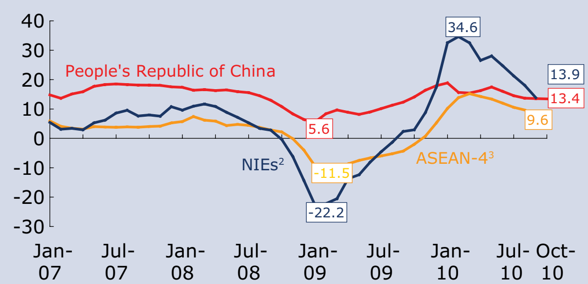
The weaker outlook for the global economy—together with phasing out of fiscal and monetary stimulus—will likely moderate growth for the region in 2011. External demand is expected to remain subdued given the weak and fragile recovery in advanced economies. Export growth is expected to ease after a strong rebound early in 2010 (see Figure 19). The more trade-dependent economies—such as the NIEs—will be more affected by weaker external demand, while the larger economies with greater domestic demand will be less affected. Other leading indicators—industrial production, purchasing managers index, and retail sales for example—also suggest a moderation in the growth trajectory **(Figures 62, 63, 64)**. Robust economic growth attracted large investments to the region—with several bourses

Figure 61: Primary Commodity Price Indexes
(Jan 2007 = 100)



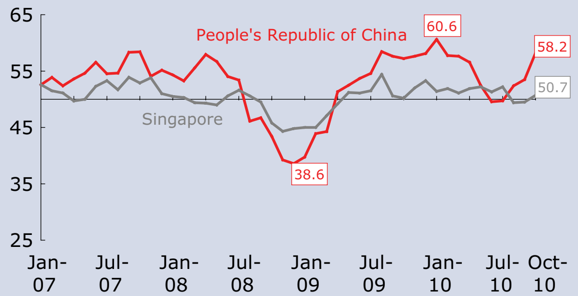
[1]Crude oil, natural gas, coal. [2]Copper, aluminum, iron ore, tin, nickel, zinc, lead, uranium. [3]Cereal, vegetable oils, meat, seafood, sugar, bananas, oranges, coffee, tea, cocoa. [4]Timber, cotton, wool, rubber, hides.
Source: OREI staff calculations based on data from *IMF Primary Commodity Prices*,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

Figure 62: Industrial Production Growth[1]—PRC, ASEAN-4, and NIEs (y-o-y, %)



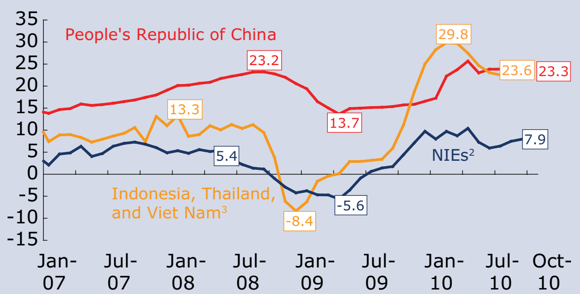
PRC = People's Republic of China, y-o-y = year-on-year.
[1]3-month moving average. [2]NIEs includes Republic of Korea; Singapore; and Taipei,China. Does not include Hong Kong, China, for which monthly data unavailable. Latest data for this group is Sep 2010. [3]ASEAN-4 includes Indonesia, Malaysia, Philippines, and Thailand. Latest data for this region is Aug 2010.
Source: OREI staff calculations based on CEIC data.

Figure 63: Manufacturing Purchasing Managers Indexes (PMI)[1]— Selected Economies



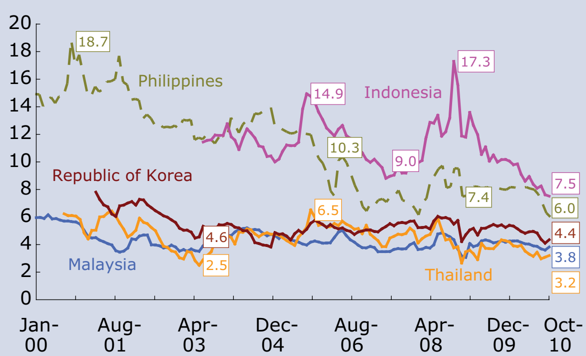
[1]Seasonally adjusted. Series for Japan refers to the composite manufacturing PMI, while series for the People's Republic of China and Singapore refers to manufacturing output PMI. PMI above (below) 50 indicates that manufacturing activity is expanding (contracting).
Source: Bloomberg, CEIC, and Datastream.

Figure 64: Retail Sales Growth[1]—PRC, NIEs, and Selected ASEAN Economies (y-o-y, %)



PRC = People's Republic of China, y-o-y = year-on-year.
[1]3-month moving average. [2]Includes Hong Kong, China; Republic of Korea; Singapore; and Taipei,China. Latest data for this region is Sep 2010. [3]Latest data for this group is Aug 2010.
Source: OREI staff calculations based on CEIC data.

Figure 65: Regional 10-Year Government Bond Yields (% per annum)



Source: Bloomberg.

reaching record highs (see Figure 24)—and falling bond yields **(Figure 65)**. Aggregate growth in emerging East Asia is expected to reach 8.8% in 2010, moderating to 7.3% in 2011 **(Table 11)**.

The PRC's robust economic growth should moderate as property prices cool and stimulus is withdrawn.

The PRC's moderated third quarter GDP growth against the second quarter is a good sign that the economy is shifting toward more sustainable growth from its earlier torrid pace. Rapid export growth—22.9% in October—is expected to ease, consistent with the weaker external environment (see Figure 9). Leading indicators suggest this moderating trend will continue. Industrial production growth slowed to 13.1% in October (see Figure 62). Fixed asset investment is also moderating with measures to cool the property sector expected to continue to restrain real estate investment (see Figure 8). Still, consumer spending remains robust with retail sales increasing 21.9% in October (see Figure 64). The purchasing managers index is also up (see Figure 63). These suggest domestic demand should remain strong. Growth is forecast at 10.1% in 2010, moderating to 9.1% in 2011.

The strong export-driven rebound in the NIEs is expected to moderate on weaker external demand.

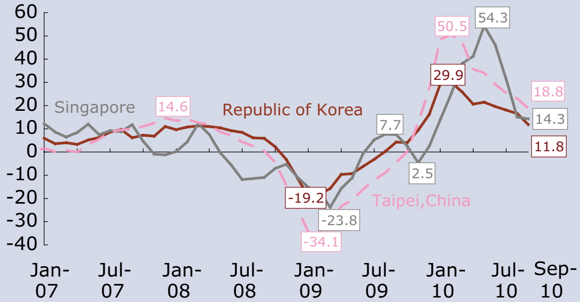
Economic expansion in the NIEs in the second half of 2010 is easing after growing 9.8% in the first half, as low base effects fade and export growth normalizes. Leading indicators suggest growth in the NIEs will moderate further in 2011. Both Korea and Taipei,China saw a sharp drop in industrial production growth—to 3.9% and 12.2%, respectively, in September **(Figure 66)**. Retail sales in Hong Kong, China and Taipei,China saw healthy gains in September. In Singapore, however, retail sales continued to contract due to increased costs of Certificates of Entitlements, which depressed automobile sales **(Figure 67)**. The overall growth trend should continue into

Table 11: Annual GDP Growth Rates (y-o-y, %)

	2000–2007 Average	2004	2005	2006	2007	2008	2009	2010H1	2010Q3	ADB Forecasts	
										2010	2011
Developing Asia[e]	**7.5**	**7.9**	**8.0**	**8.9**	**10.1**	**6.6**	**5.4**	**—**	**—**	**8.6**	**7.3**
Emerging East Asia[1,2]	**7.8**	**8.0**	**8.2**	**9.3**	**10.4**	**6.7**	**5.2**	**10.2**	**8.2**	**8.8**	**7.3**
ASEAN[1,2,3]	**5.5**	**6.5**	**5.7**	**6.1**	**6.6**	**4.4**	**1.3**	**7.4**	**6.7**	**7.5**	**5.4**
Brunei Darussalam	2.2	0.5	0.4	4.4	0.2	-1.9	-1.8	—	—	1.1	1.5
Cambodia	9.5	10.3	13.3	10.8	10.2	6.7	0.1	—	—	5.0	6.0
Indonesia[4]	5.1	5.0	5.7	5.5	6.3	6.0	4.5	5.9	5.8	5.9	6.3
Lao PDR	6.7	7.0	6.8	8.7	7.8	7.2	6.5	—	—	7.4	7.5
Malaysia[5]	5.6	6.8	5.3	5.8	6.5	4.7	-1.7	9.4	5.3	6.8	5.0
Myanmar[6]	9.1	5.0	4.5	7.0	5.5	3.6	4.4	—	—	5.0	5.3
Philippines[7]	5.1	6.4	5.0	5.3	7.1	3.7	1.1	8.0	6.5	6.8	4.6
Thailand	5.1	6.3	4.6	5.1	5.0	2.5	-2.3	10.7	6.7	7.6	4.5
Viet Nam	7.6	7.8	8.4	8.2	8.5	6.3	5.3	6.2	7.2	6.7	7.0
Newly Industrialized Economies[1]	**5.0**	**5.9**	**4.8**	**5.7**	**5.7**	**1.9**	**-0.8**	**9.8**	**6.5**	**7.6**	**4.5**
Hong Kong, China	5.3	8.5	7.1	7.0	6.4	2.2	-2.8	7.2	6.8	6.5	4.3
Korea, Republic of	5.2	4.6	4.0	5.2	5.1	2.3	0.2	7.6	4.4	6.0	4.6
Singapore[8]	6.3	9.2	7.4	8.6	8.5	1.8	-1.3	18.2	10.6	14.0	5.0
Taipei,China	4.4	6.2	4.7	5.4	6.0	0.7	-1.9	13.2	9.8	9.8	4.0
China, People's Republic of	10.5	10.1	11.3	12.7	14.2	9.6	9.1	11.1	9.6	10.1	9.1
Japan	**1.7**	**2.7**	**1.9**	**2.0**	**2.4**	**-1.2**	**-5.2**	**3.8**	**4.4**	**3.2**	**1.4**
US[9]	**2.6**	**3.6**	**3.1**	**2.7**	**1.9**	**0.0**	**-2.6**	**2.7**	**3.2**	**2.8**	**2.6**
eurozone	**2.1**	**2.1**	**1.7**	**3.0**	**2.8**	**0.4**	**-4.1**	**1.7**	**1.9**[10]	**1.5**	**1.4**

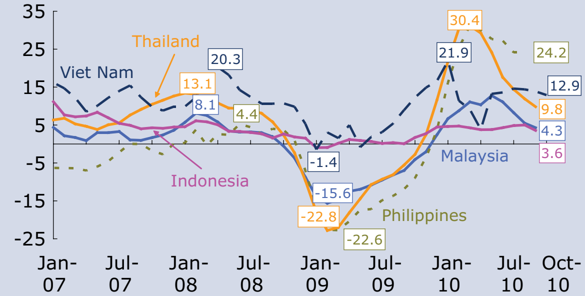
e = ADB estimates, GDP = gross domestic product, Lao PDR = Lao People's Democratic Republic, US = United States, y-o-y= year-on-year, — = unavailable.
[1]Aggregates are weighted according to gross national income levels (atlas method, current $) from the World Bank's *World Development Indicators.* [2]Excludes Myanmar for all years as weights are unavailable. Quarterly figures exclude Brunei Darussalam, Cambodia, Lao PDR, and Myanmar for which quarterly data is unavailable. [3]Includes Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Philippines, Singapore, Thailand, and Viet Nam. [4]GDP growth rates from 1999–2000 are based on 1993 prices; growth rates from 2001 onward are based on 2000 prices. [5]Growth rates from 1999–2000 are based on 1987 prices; growth rates from 2001 onward are based on 2000 prices. [6]Figures are ADB estimates as reflected in Asian Development Outlook 2010 Update. [7]Figures for 2004–2006 are not linked to the GDP figures prior to 2003 due to National Statistics Office revisions of sectoral estimates. [8]Revised its base year from 2000 to 2005 beginning 2010Q1. [9]Seasonally adjusted rate. [10]Uses flash estimate of seasonally adjusted rate for the third quarter of 2010.
Source: *Asian Development Outlook 2010 Update,* Asian Development Bank; Eurostat website (eurozone); Economic and Social Research Institute (Japan); Bureau of Economic Analysis (US); CEIC; and national sources.

Figure 66: Industrial Production Growth[1]—NIEs[2] (y-o-y, %)



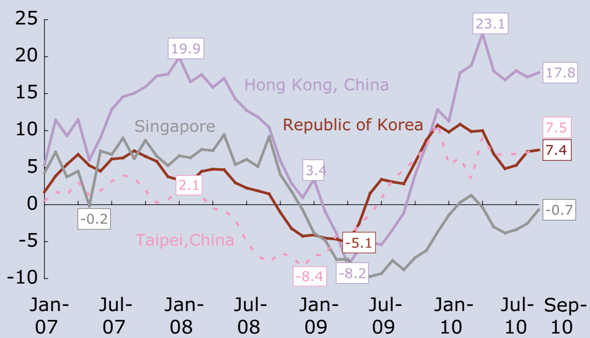
y-o-y = year-on-year.
[1]3-month moving average. [2]Does not include Hong Kong, China, for which monthly data unavailable.
Source: OREI staff calculations based on CEIC data.

Figure 68: Industrial Production Growth[1]—ASEAN-4 and Viet Nam (y-o-y, %)



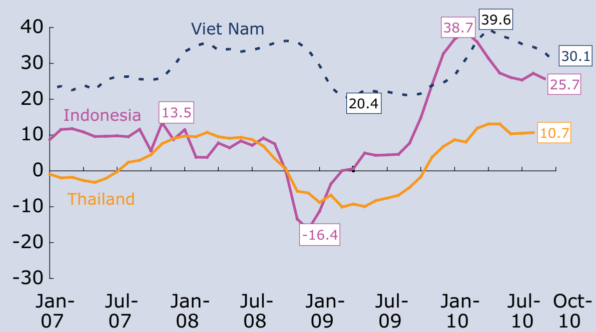
y-o-y = year-on-year.
[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

Figure 67: Retail Sales Growth[1]—NIEs (y-o-y, %)



[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

Figure 69: Retail Sales Growth[1]—Selected ASEAN Economies (y-o-y, %)



[1]3-month moving average.
Source: OREI staff calculations based on CEIC data.

2011 as the highly export-dependent NIEs will suffer from a weaker external environment and cooling in the PRC. Singapore's growth is expected to fall sharply to 5.0% in 2011 from its exceptional 14.0% growth in 2010. Korea's economy should moderate to 4.6% in 2011 from a 6.0% rise this year, while Hong Kong, China's and Taipei,China's economic expansion is forecast to ease to 4.3% and 4.0% in 2011, respectively, from 6.5% and 9.8% in 2010.

While strong domestic demand is expected to drive Indonesia's economy, growth among other middle-income ASEAN economies will likely moderate.

Of the more open middle-income ASEAN economies (ASEAN-4), Thailand and Malaysia grew rapidly in the first half of 2010 partly due to low base effects, as both economies contracted in the first half of 2009. Growth should moderate during the second half. Leading indicators—industrial production and retail sales—have already been moderating **(Figures 68, 69)**. Economic growth this year in Thailand and Malaysia is forecast at 7.6% and 6.8%, respectively. With the global recovery looking more anemic, growth in the two countries should slow in 2011 to 4.5% and 5.0%, respectively. Indonesia and the Philippines grew a strong 5.8% and 6.5%, respectively, in the third quarter. Both economies benefited from strong domestic demand. While Philippine growth is expected to moderate in the second half—2010 growth forecast at 6.8%—Indonesia's GDP is expected to expand 5.9% for the full year. In 2011, growth in the Philippines is forecast to decelerate to 4.6%, due to weaker external demand and the need for fiscal consolidation, while growth in Indonesia should accelerate to 6.3% as private consumption growth and private and public investment will continue to drive the recovery.

The smaller ASEAN economies should see improved economic growth.

Viet Nam's economy strengthened this year with third quarter growth outpacing first half expansion. The rebound in world trade and the depreciation of the Vietnamese dong should help the economy grow 6.7% in 2010. Strong growth will continue into 2011, with growth forecast currently at 7.0%. Cambodia's economy is expected to rebound as garment exports and tourism receipts recover, growing 5.0% in 2010 and further improving to 6.0% in 2011. Lao PDR's economy is expected to expand 7.4% in 2010 on increased investments in mining and hydropower—and buoyant copper and gold prices. In 2011, growth should remain robust at 7.5%, as electricity and mineral exports increase with new hydropower and mining projects. Brunei Darussalam's economy, heavily dependent on oil and gas, is expected to recover modestly, growing 1.1% in 2010 and 1.5% in 2011, as oil and gas production recovers with the global economy.

Inflationary pressures up across the region as economies thrive and world prices rise.

With economic recovery well-entrenched, inflation is edging up across the region. Thus far, the rise has been moderate and remained manageable (see Figure 15). In the PRC, inflation rose to 4.4% in October—the highest in 2 years—mainly due to higher food prices. Both the NIEs and ASEAN-4 economies are also seeing higher inflationary pressures as output gaps narrow. The appreciation of most of the region's currencies may temper some impact from imported inflation.

The region's current account surpluses should narrow, but capital inflows are expected to rise.

In the first half of 2010, current accounts remained in surplus as exports recovered. Expected slower export growth in 2011 from weaker external demand will likely result in smaller current account surpluses for most emerging East Asian economies. Capital inflows to ASEAN-4 economies are resuming as the strong recovery and higher interest rates attract portfolio investment. However, net capital inflows to the NIEs in the first half of 2010 slowed (see Figures 21, 22). As low interest rates and quantitative easing continue in advanced economies, funds are expected to continue to flow into the region, swelling the region's capital accounts. Thus, overall balance of payment surpluses are expected to keep rising.

Risks to the Outlook

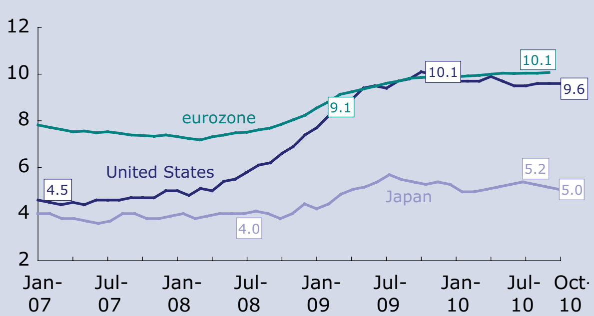
The economic outlook is subject to four major risks: (i) persistent weak growth in advanced economies; (ii) destabilizing capital flows; (iii) inflation and asset price bubbles in some economies; and (iv) protectionism.

The economic outlook for emerging East Asia remains highly uncertain and subject to several downside risks, given the weaker external environment and uncertain effects of further monetary stimulus in advanced economies.

A weaker- and longer-than-expected recovery process in advanced economies will further delay policy normalization, increasing economic distortions and lowering long-term growth prospects.

The severe economic damage caused by the Great Recession will take a long time to heal. The fallout from the financial meltdown will depress private spending for several more years—as banking systems are repaired, and households and firms reduce debt. High unemployment could become entrenched and last for many years, as the unemployed lose their skills in time or possess outdated skill sets **(Figure 70)**. Factories and equipment will also deteriorate quickly if not used or maintained properly, decreasing potential output. Growth in productivity could also suffer as capital investment plummeted during the crisis and has not returned to pre-crisis trend growth. Aging populations and a shrinking labor force—due to demographic changes—could aggravate the slowdown in potential growth in advanced economies. If the recovery in advanced economies falters, sluggish external demand could once again disrupt the region's robust growth.

Figure 70: Unemployment Rate—eurozone[1], Japan, and US (seasonally adjusted, % of labor force)



US = United States.
[1]Refers to Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain. Data for eurozone and Japan until Sep 2010.
Source: US Bureau of Labor Statistics, European Central Bank, and CEIC.

Capital flows could become volatile and destabilizing, creating major challenges for macroeconomic management.

Global liquidity is once again plentiful, as central banks in major economies keep interest rates close to zero and are adopting more unconventional monetary policy measures—such as quantitative easing—to stimulate their economies. Risk appetite has returned—with rising global share prices and US dollar depreciation against most of the region's currencies. Interest rate differentials between emerging market economies and major developed countries are wider than before the crisis—the rapid recovery and higher growth in emerging East Asian economies led authorities to unwind policy stimulus before advanced economies. Moreover, limited exchange rate flexibility in the region can also draw capital inflows as investors anticipate currency appreciation. Yet, these capital flows could destabilize the real economy, posing major challenges for macroeconomic management. The links between capital flows and credit expansion—lending booms with capital account liberalization—and their adverse macroeconomic consequences are not new to emerging East Asia. Moreover, risk sentiment might abruptly change, leading to sudden capital flow reversals.

In several economies, inflation could exceed targets with surging capital inflows fueling asset price bubbles.

Even with economic growth moderating somewhat in recent months, headline inflation continues to rise in several emerging East Asian economies, as world commodity and food prices edge higher and domestic demand remains resilient. In these economies, core inflation is also up. Asset prices have been rising quickly in many emerging East Asian economies, with equity prices at double-digit growth rates this year and housing costs maintaining their upward trend. A few economies are withdrawing monetary stimulus and taking macroprudential measures to curb asset price inflation. However, robust growth and ample credit suggest asset prices may continue to rise despite controls. Moreover, expectations of continued robust growth and currency appreciation have drawn surging capital inflows, which could inflate asset prices further. Monetary tightening in response to demand pressure and rising asset prices could merely attract more capital inflows in the short term, aggravating inflated asset bubbles.

Protectionism could emerge given the unsynchronized global recovery.

With growth in advanced economies slowing again and unemployment remaining stubbornly high, fears of protectionism are rising. Several emerging East Asian economies have already introduced temporary capital controls to counter surging capital flows and appear to be intervening directly in currency markets to stem appreciation. Competitive non-appreciation—or “currency wars” as some put it—may escalate into trade wars as countries try to preserve international competitiveness and exports. One important lesson from the 1930s is that raising trade barriers merely compound recessionary forces and risk lengthening and deepening the economic morass.

Policy Issues

With the V-shaped recovery in hand, many emerging East Asian economies now face the challenge of managing strong growth and capital flows amid a weaker external environment.

After slowing sharply in 2008 and 2009, the strong emerging East Asian economic recovery in 2010 has led GDP growth back near 2007 levels. Despite the weaker external environment, this robust growth should continue next year—though at a somewhat slower pace. The recovery in advanced economies has lost some steam and is expected to weaken in 2011. This suggests that macroeconomic policy in advanced economies will remain loose for some time. The unsynchronized global recovery—red, hot growth in emerging economies against tepid, uncertain recovery in advanced economies—pose policy challenges for emerging East Asia.

Continued robust growth in many emerging East Asian economies suggests authorities are on track in normalizing macroeconomic policy.

Emerging East Asia continues to lead the global recovery with many economies performing strongly despite sluggish growth in advanced economies. While growth momentum in emerging East Asia is now slowing as policy stimulus is withdrawn, external demand weakens, and the effects of inventory restocking fade. Output gaps in the region are narrowing quickly and may have closed in several economies. Demand pressures have emerged in these economies with inflation edging higher. Also, surging capital inflows can inflate asset prices, leading to additional demand pressures. Limited exchange rate flexibility in several economies also adds to inflationary pressures. The relatively rapid growth of the region’s economies suggests quick stimulus withdrawal may be needed to avoid the risk of inflationary pressures intensifying. In fact, several economies in the region have already begun to normalize macroeconomic policy by raising policy rates and reserve requirements and allowing fiscal stimulus to expire (see Figures 29a, 29b). With the external environment weakening, policymakers should constantly assess risks and fine-tune exit strategies as needed.

A "money first with somewhat faster appreciation" strategy seems appropriate for many emerging East Asian economies to both sustain economic growth, while helping rebalance the region's sources of growth.

Unwinding stimulus in emerging East Asia must be calibrated to both specific regional economic conditions and potential spillovers from external macroeconomic policies. In advanced economies, the mix of fiscal tightening and continued low interest rates could create a wave of "search for yield" capital outflows and further depreciating currencies. This complicates macroeconomic management and could reduce external demand for emerging East Asia. With robust fiscal positions in the region, emerging East Asian countries may not need to consolidate fiscal policy. In contrast, removing monetary stimulus first would allow fiscal policy to continue to support domestic demand in the near term. Moreover, the region could adopt a strategy that allows currency appreciation at a somewhat faster rate, keeping interest rates from rising too quickly or too high. This strategy of "money first with somewhat faster appreciation" would be able to support domestic demand, address inflationary pressures, and help facilitate global rebalancing. The strategy can also help manage capital flows and their impact on the domestic economy.

Mitigating the negative effects of surging capital flows will require an appropriate mix of sound macroeconomic management, flexible exchange rates, resilient financial systems, and—in some cases—temporary and targeted capital controls.

While capital flows can benefit economies by financing more investment, volatile short-term capital flows pose a risk to macroeconomic and financial stability. There is no magic solution to effectively managing capital flows. Each policy option has its merits and shortcomings and involves difficult trade-offs. An appropriate mix includes currency flexibility, clear and stable monetary and fiscal policies, and an appropriate regulatory and supervisory framework to help prevent asset bubbles from forming. Under certain circumstances, temporary and targeted capital controls could be considered as part of the policy mix to avoid destabilizing capital flows. The ultimate aim is to ensure macroeconomic and financial stability. However, authorities must be cautious, recognizing that capital controls can have deleterious long-term and cross-border repercussions.

Deeper and more comprehensive structural reforms are needed to improve productivity growth and to build an environment more conducive for private consumption and business investment.

To sustain rapid growth over the long term, policymakers must prioritize structural supply-side policies that improve an economy's productive capacity by fostering factor accumulation and productivity growth. While countercyclical fiscal and monetary policies can smooth temporary output fluctuations, they cannot sustain growth over the long term. Thus, policymakers should broaden and deepen structural reforms. At the same time, however, they also need to strengthen domestic demand. Structural reforms should address key weaknesses in the investment climate—such as policy uncertainty, competition in product and service markets, governance, the quality of legal and institutional frameworks, and regulatory capacity. In economies with lower levels of private consumption, authorities could tackle income inequalities and increase public spending on social safety nets, housing, education, and health. This would increase disposable income and reduce precautionary savings, removing some of the impediments to boosting household consumption. Deeper and more comprehensive structural reforms can better the region's growth prospects and address more pressing challenges ahead.

It is vital that emerging East Asia continue to work together to address post-crisis challenges.

National policies can have significant spillover effects, or externalities, on other countries, thus the need for policy coordination. To attain financial stability and create an environment conducive to sustained growth—whether global or regional—externalities must be considered in the decision-making process. And policy coordination can help smooth spillover effects. ASEAN+3[5] has taken the lead by improving its regional financial arrangement through the Chiang Mai Initiative Multilateralization (CMIM), backed by stronger regional economic surveillance. Also, the soon-to-be-operational Credit Guarantee and Investment Facility—supported by ADB and developed under the ASEAN+3 Asian Bond Markets Initiative—will help develop local currency and regional debt markets by providing credit upgrades for issuers otherwise unable to tap bond markets for finance. This helps limit the possibility of maturity and currency mismatches developing. To effectively manage surging capital inflows to the region and better rebalance the sources of growth, ASEAN+3 could explore the possibility of regional exchange rate cooperation and coordination **(see *Exchange Rate Cooperation: Is East Asia Ready?*, page 46)**. The results of the recent G20 summit should help ease currency tensions somewhat, while stressing the shared responsibility between advanced and emerging economies—and among groups of emerging market economies—to resolve global imbalances and avoid protectionism.

[5]ASEAN+3 comprises the 10 members of the Association of Southeast Asian nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China, Japan, and Republic of Korea.