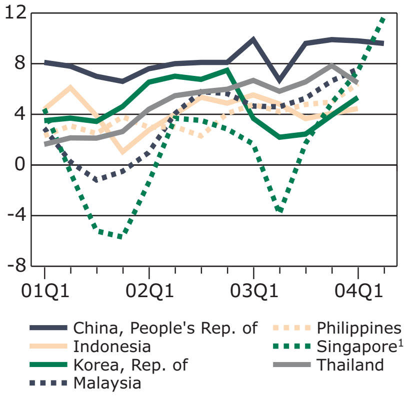
East Asia's Growth and Restructuring—A Regional Update

Economic Performance in the First Half of 2004

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



[1]2004Q2 GDP is an advance official estimate.
Source: ARIC Indicators.

Real Sector Developments

East Asia's[1] synchronized economic growth that started in the second half of 2003 continued in the first half of this year, despite the sharp increase in world oil prices. The seven big economies in the region for which quarterly GDP data are available—the People's Republic of China (PRC), Indonesia, the Republic of Korea (Korea), Malaysia, the Philippines, Singapore, and Thailand—taken together posted 8% GDP growth in the first quarter of 2004, improving upon their collective growth rate of 7.6% in the fourth quarter of 2003, and 6.7% for 2003 as a whole (Figure 1).[2] The first quarter growth was the fastest since the second quarter of 2000. In recent months growth has exceeded market expectations, as reflected in the almost uniform upward revisions of consensus growth forecasts for East Asia. The most significant positive surprises were for Singapore, Malaysia, the Philippines, and the PRC.

In the PRC, first quarter 2004 GDP growth was 9.8%, one of the briskest quarterly rates in 7 years, and only marginally below the 9.9% growth in the fourth quarter of last year. Singapore, Philippines, Malaysia, and Korea experienced a sharp acceleration of growth. Growth moderated only in Thailand, to 6.5% in the first quarter from a rapid 7.9% pace in the final quarter of 2003, reflecting the impact of drought, higher oil prices, avian flu, and unrest in some southern provinces.

Data for the second quarter suggest that growth in the region continues to be robust. An advance official estimate of Singapore's second quarter GDP shows growth accelerating to 11.7% from 7.4% in the previous quarter. In the PRC, GDP growth eased to 9.6% as consumption remained buoyant while fixed asset investment growth is estimated to have slowed sharply from 48% in the first quarter. Other countries have yet to release GDP data for the second quarter. Monthly indicators show that in all countries except the Philippines and Thailand, industrial production was expanding at double-digit rates, similar to first quarter growth. The SARS-induced low base from the second quarter of 2003

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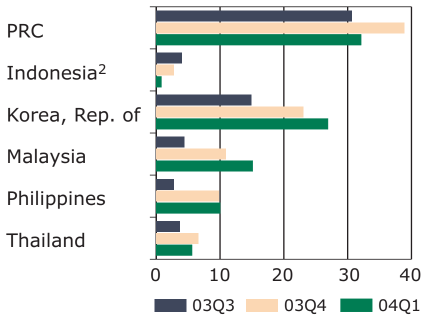
[1]Defined here as the 10 members of the Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus the People's Republic of China and the Republic of Korea.

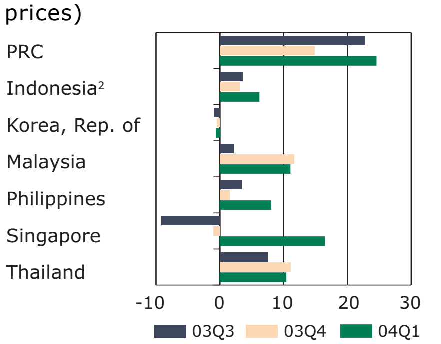
[2]Unless otherwise indicated, all growth figures are year-on-year.

Figure 2: **Growth of Exports of Goods and Services**[1] (y-o-y, %, at constant prices)



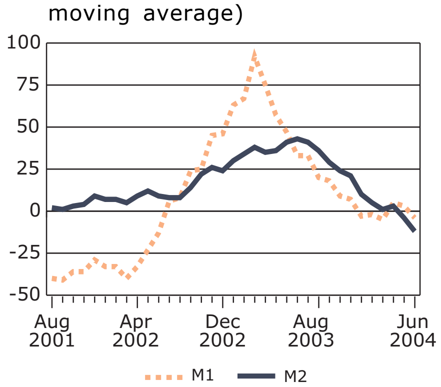
[1]Based on national income accounts except for the PRC which is based on merchandise exports (at 1997 constant prices).
[2]Data prior to 2004Q1 are still based on 1993 prices while 2004Q1 data are based on 2000 prices.
Source: ARIC Indicators.

Figure 3: **Growth of Domestic Demand**[1] (y-o-y, %, at constant prices)



[1]Based on national income accounts except for PRC which is the sum of retail sales and fixed investment (at constant 1997 prices).
[2]Data prior to 2004Q1 are still based on 1993 prices while 2004Q1 data are based on 2000 prices.
Source: ARIC Indicators.

Figure 4: **PRC—Money Supply Growth** (3-month moving average)



Source: Bloomberg.

will favorably influence year-on-year comparisons for the second quarter of this year. However, uniformity in the strength of industrial production, even in countries that were relatively immune to SARS, such as Korea, indicates that economic growth remains strong in the region.

This robust expansion has been driven by a combination of a rapid increase in exports and continued strength in domestic demand in most countries. East Asia's exports have benefited from a confluence of strong global growth, a surge in import demand from the PRC, and high commodity prices. A revival of tourism has also boosted exports of services in some countries. In the first quarter, real exports of goods and services in many countries rose at their fastest rates since 2000 (Figure 2). In Singapore, the strong rise in exports was offset by an even more rapid growth of imports, reflecting the improvement in domestic demand, so that net exports were negative. More recent monthly data show that the 3-month moving average of the US dollar value of merchandise exports was up 20-40% in the PRC, Korea, Malaysia, Singapore, and Thailand. Indonesia and, to a lesser extent, the Philippines, continued to lag behind. Even in these two countries, however, export growth in US dollar terms appears to be strengthening.

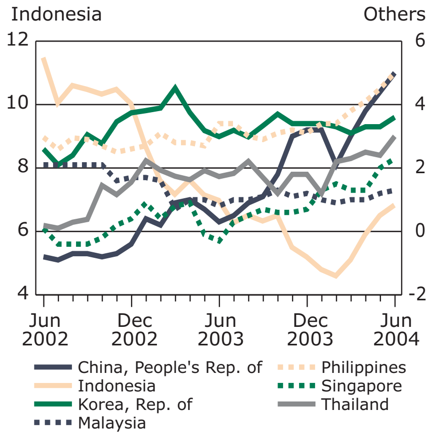
The record on domestic demand growth is mixed. Accommodative fiscal and monetary conditions and the buoyant income from exports have contributed to improved sentiment among both consumers and businesses in most countries. Demand growth was the highest in the PRC in the first quarter, primarily reflecting a sharp rise in fixed investment (Figure 3). More recently, PRC authorities' attempts to restrain fixed investment to more sustainable levels seem to be having some impact. Other indicators on credit and money supply are moderating as well (Figure 4).

Malaysia, Singapore, and Thailand are also showing robust increases in domestic demand. The improvement has been the sharpest in Singapore. These three economies are also the most export-dependent in the region, which suggests that the improvements in domestic demand, particularly in the first two countries, were partly due to the buoyancy of export income in recent quarters. In Thailand, off-budget stimulus and government policies to promote the property and rural sectors since 2002 have contributed to the strength of domestic demand.

Both consumer spending and fixed investment have risen at healthy rates in the past two quarters in Malaysia and Singapore, and since the second quarter of 2002 in Thailand. Private consumption spending remains the main driver of domestic demand in Indonesia and the

Philippines. In Korea, both consumer and investment demand have weakened sharply since last year. The household sector's efforts to de-leverage, following a buildup of debt, continue to dampen consumer spending. Lingering problems in the corporate sector and the trend toward outsourcing production, mainly to the PRC, also seem to have dampened investment in new plant and equipment.

Figure 5: **Headline Inflation Rates** (y-o-y, %)

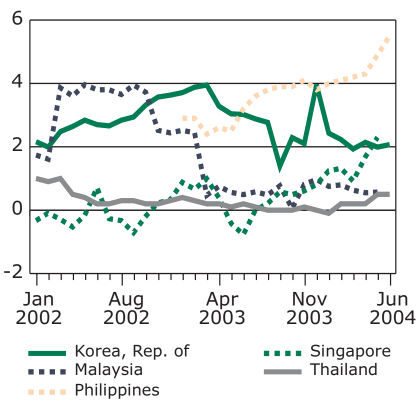


Source: ARIC Indicators.

The pickup in East Asia's growth and the increase in commodity prices, including fuel, have led to a gradual rise in consumer price inflation (Figure 5). The upward trend in inflation is especially noticeable in the past six months or so. The PRC, Indonesia, and the Philippines show the most pronounced upward trends. In the PRC, inflation accelerated to 5% in June, compared with a deflationary environment that existed until the end of 2002. The rise in PRC inflation reflects lagged effects of excessive credit growth, which the authorities have sought to curb, and a sharp increase in food prices.

In Indonesia, inflation accelerated to 6.8% in June from 4.6% in February. The faster increase in prices is attributable to the depreciation of the currency, which reflected heightened uncertainties surrounding legislative and presidential elections, and the consequent increase in imported inflation. In the Philippines, inflation rose to a 32-month high of 5.1% in June, driven by higher prices of food, fuel, and some services, including seasonal tuition fees and rent.

Figure 6: **Core Inflation Rates** (y-o-y, %)



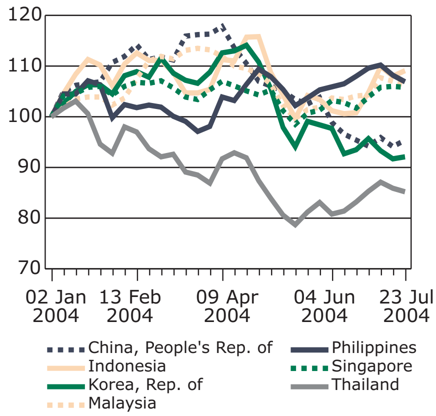
Source: Bank of Thailand, Bangko Sentral ng Pilipinas, and staff estimates derived from Bloomberg data.

With food and fuel prices accounting for much of the increase in headline inflation, core inflation (excluding food and energy) is much lower, except in the Philippines and Singapore, where prices of services have also risen at faster rates (Figure 6). In Korea, core inflation is around 2%, compared with 3-4% a year earlier. In Malaysia, it fell to 0.6% from 1% at end-2003, and in Thailand, the core rate has risen from 0-0.2% over most of the past year, but remains low at 0.5%.

Financial Markets

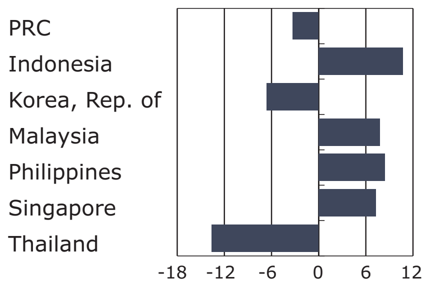
Generally, the region's stock markets have remained flat or weakened since the beginning of 2004, following last year's strong performance (Figure 7). Stock prices have been dampened by uncertainties over the magnitude and speed of the rise in global interest rates, higher oil prices, the risks of a sharper-than-planned slowdown in the PRC, global geopolitical risks, and in some cases, the elevated stock price levels after last year's surge. In 2003, gains in East Asia's stock markets ranged from 22% in Malaysia to 66% in Indonesia and 104% in Thailand. So far, as of 23 July, the increase in stock indexes ranged from 5.8% in Singapore to about 9.1% in Indonesia. The PRC, Korea, and Thailand

Figure 7: **Composite Stock Price Indexes**[1] (weekly average, first week of Jan 2004=100, local index)



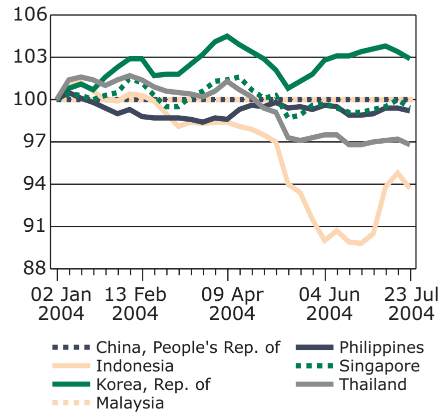
[1]Weekly averages of JCI (Indonesia), KLCI (Malaysia), PCOMP (Philippines), KOSPI (Korea), STI (Singapore), and SET (Thailand). For the PRC, the index is calculated based on the weekly averages of Shanghai A & B and Shenzen A & B, weighted by the market capitalization of each market.
Source: REMU staff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

Figure 8: **Percent Change in Stock Market Index**[1] **Relative to Russell 3000 Index** (between 3 Jan 2004 and week ending 23 Jul 2004)



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

Figure 9: **Exchange Rate Indexes** (weekly average, first week of Jan 2004=100, $/local currency)



Source: REMU staff calculations derived from Bloomberg data.

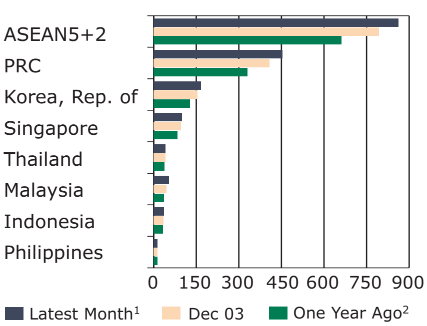
underperformed the 1.5% decline in the broad Russell 3000 index of US stocks so far this year (Figure 8).

Since the beginning of 2004, regional currencies generally have remained flat or weakened against the US dollar, mimicking the performance of the yen and the euro (Figure 9). Among the five larger East Asian countries with flexible exchange rates, only the Korean won appreciated, by 3%, against the US dollar. Currencies of Indonesia and Thailand weakened the most, by 6.3% and 3.2% respectively. The Singapore dollar and the Philippine peso have been broadly stable.

Some of these countries have continued to intervene in foreign exchange markets to keep their currencies stable (the PRC and Malaysia), or to mitigate the pressure for appreciation (Korea), although the rate of foreign exchange reserve accumulation has subsided (Figure 10). Total foreign exchange reserves of the seven countries increased by $71 billion to $864 billion so far this year, compared with an increase of $131 billion in the second half of 2003. Most of the increase was in the PRC, Korea, and Malaysia.

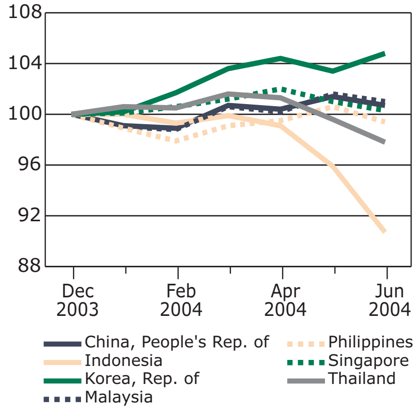
Over the past six months or so, the nominal effective exchange rates of the seven regional currencies remained flat or weakened except

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



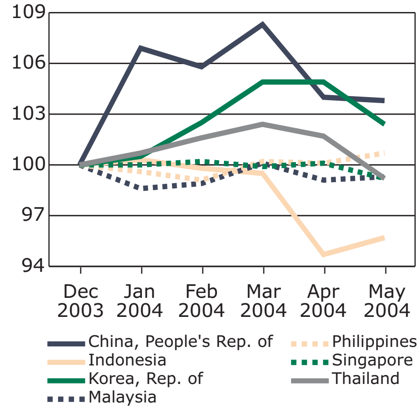
[1]Refers to April 2004 for the PRC, Indonesia, the Philippines, and Singapore. May 2004 for all others.
[2]From latest month.
Source: International Monetary Fund, International Financial Statistics Online.

Figure 11: **Nominal Effective Exchange Rate** (Dec 2003=100)



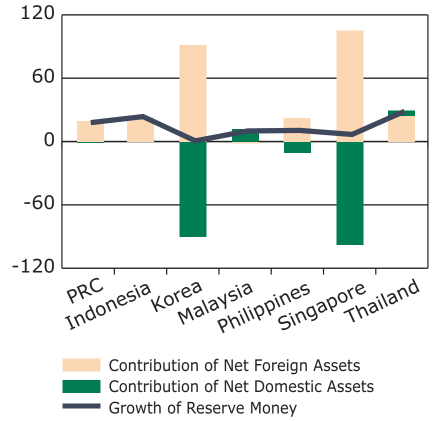
Note: An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: REMU staff calculations.

Figure 12: **Real Effective Exchange Rate** (Dec 2003=100)



Note: An increase is an appreciation. Trade weights are total trade from top 10 trading partners.
Source: REMU staff calculations.

Figure 13: **Sources of Reserve Money Growth** (latest value[1] compared with one year ago, %)



[1]March 2004 for Korea, May 2004 for Indonesia, and April 2004 for all others.
Source: REMU staff calculations based on data from the International Monetary Fund, International Financial Statistics Online.

the Korean won (Figure 11). These trends reflected the relative strength of the US dollar this year. As inflation remained low and stable in most countries, real effective exchange rates generally weakened, again except in Korea (Figure 12). In the PRC, the real effective exchange rate strengthened since the beginning of this year, partly reflecting the recent pickup in inflation.

Monetary and Fiscal Policies

The accumulation of net foreign assets by monetary authorities has contributed substantially to base money growth in the PRC, Indonesia, and Thailand (Figure 13). Reserve money is rising at rates above 20% in these three countries. In Korea and Singapore, and to a lesser extent, in the Philippines, the rise in net foreign assets has been sterilized with the issuance or sale of domestic securities to dampen the effect on base money growth. Base money growth in Malaysia is relatively modest and is driven mainly by the increase in net domestic credit.

Monetary policy has been tightened in several countries, including the PRC, Indonesia, the Philippines, and Singapore, to thwart inflationary expectations. In the PRC, authorities continue to implement measures, including an increase in reserve requirements and restrictions on new lending, to dampen credit growth and slow economic expansion to more sustainable levels. In early June, Bank Indonesia, the central bank, announced an increase effective 1 July in the statutory reserve requirement on banks with more than Rp1 trillion in third-party funds.

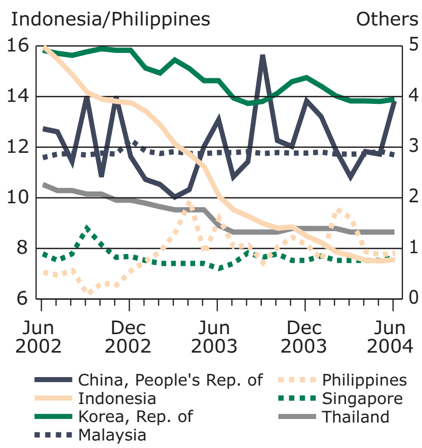
In the Philippines, the liquidity reserve ratio for peso deposits in financial institutions was raised by 2 percentage points to 10% in February to stem the downward pressure on the currency. In April, the Monetary Authority of Singapore shifted its policy from zero appreciation for the Singapore dollar's nominal effective exchange rate to one of modest and gradual appreciation.

Despite the June increase of 25 basis points in the US federal funds rate, policy rates have remained unchanged across the region, as authorities have relied mostly on quantitative measures to restrict money growth (Figure 14). Nominal short-term interest rates remain close to historic lows (Figure 15). Currently, they are 7-8% in Indonesia and the Philippines, and below 4% in other countries. With the increase in inflation, real short-term interest rates have declined in recent months (Figure 16). Real rates are negative in the PRC, Singapore, and Thailand. In Indonesia, real rates fell to 0.7% as of June, from 3.1% a year earlier.

Figure 14: **Policy Rates**[1] (end of week, % per annum)

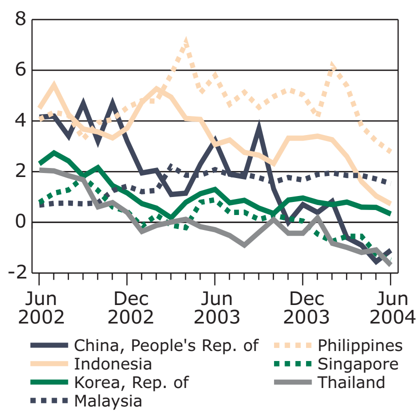
[1]Indonesia: Deposit facility overnight discount rate; Korea: Target overnight call rate; Malaysia A: 3-month intervention rate; Malaysia B: Malaysia overnight policy rate; Philippines: Overnight reverse repurchase rate; Thailand: 14-day repo rate.
[2]Malaysia changed its policy rate from 3-month intervention rate to overnight policy rate in April 2004.
Source: Bloomberg.

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



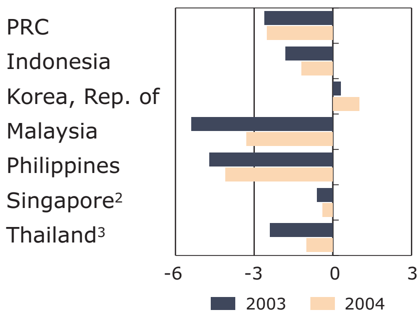
[1]Three-month interbank lending rates—PRC: Average of interbank borrowing and lending rate (People's Bank of China); Indonesia: Weighted average of banks' interbank lending rates (Bank Indonesia); Korea: Certificate of deposit (3 months); Malaysia: Average of interbank deposit rates (Bank Negara Malaysia);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

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



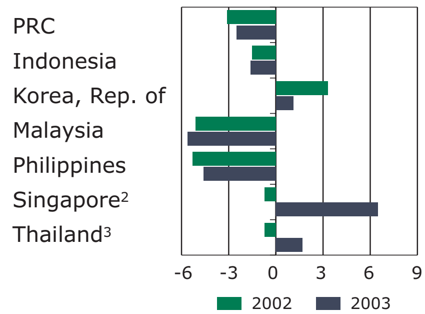
[1]Three-month interbank lending rates.
Source: ARIC Indicators.

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



[1]Data refer to central government for Indonesia, Korea, Philippines, Singapore, and Thailand; federal government for Malaysia; and central and local government for the PRC. For Korea and Malaysia, 2003 budget deficit incorporates supplementary budgets.
[2]Data are for fiscal year April–March.
[3]Data are for fiscal year October–September.
Source: 10th National People's Congress and Chinese People's Consultative Conference (PRC); Bank Indonesia; Ministry of Planning and Budget (Korea); Ministry of Finance (Malaysia); Bureau of Treasury (Philippines); Ministry of Finance (Singapore); Bureau of the Budget (Thailand).

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



[1]Data refer to central government for Indonesia, Korea, Philippines, Singapore, and Thailand; federal government for Malaysia; and central and local government for the PRC. For Korea and Malaysia, 2003 budget deficit incorporates supplementary budgets.
[2]Data refer to fiscal year April-March.
[3]Data refer to fiscal year October-September.
Source: ARIC Indicators and Ministry of Finance (Malaysia, Singapore, and Thailand); CEIC Data Company Ltd.

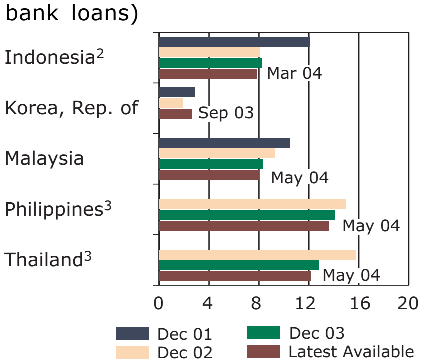
With the improvement in economic prospects, the region's governments have moved fiscal policies toward a more neutral stance (Figure 17). Official projections for this year's deficits are narrower than those in the previous year's budgets in almost all countries. For Korea, the surplus is projected to rise. However, the weakness in Korea's domestic demand probably calls for additional stimulus.

The fiscal outturn last year was largely on target (Figure 18). In some countries, the outcome was less expansionary than initial budget projections. Singapore's fiscal accounts reverted to a surplus of 6.5% of GDP in FY2003-04 (April–March), compared with a deficit of 0.7% in 2003, and a budget projection for a deficit of 0.6% of GDP. In Thailand, the fiscal balance was a surplus amounting to 1.7% of GDP. Actual revenues grew faster than projected, reflecting strong economic recovery and improved tax collection. Only in Malaysia did the fiscal gap slightly exceed budget projections.

The data for the initial months of this year show a similar pattern, with the actual deficits, relative to GDP, marginally lower than budget projections for most countries. In the Philippines, where fiscal sustainability is a major concern, the Government exceeded its target, albeit slightly, in the first half of this year. Korea is probably the only country in this group that will require further stimulus this year, considering its weakness in domestic demand and the Government's capacity to provide adequate funds. The Government's fiscal position for the first 5 months of 2004 shows a marginal surplus of 0.01% of GDP, compared with a programmed surplus of 1% of GDP for the full year. With a supplementary budget of W4.5 trillion (approximately 0.6% of GDP) planned for the year, the fiscal position could show an appropriate, more modest surplus.

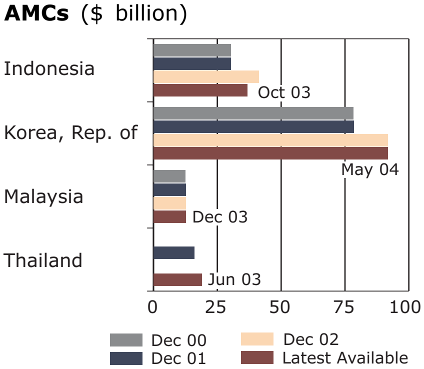
Financial Restructuring and Prudential Indicators

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



[1]Data on NPLs exclude those transferred to AMCs. NPLs are on a three-month accrual basis.
[2]Data refer to NPLs in the banking sector.
[3]NPL criteria were changed so no comparable data are available prior to 2002.
Source: ARIC Indicators.

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



Source: REMU staff calculations based on data from IBRA, KAMCO, Danaharta, and TAMC.

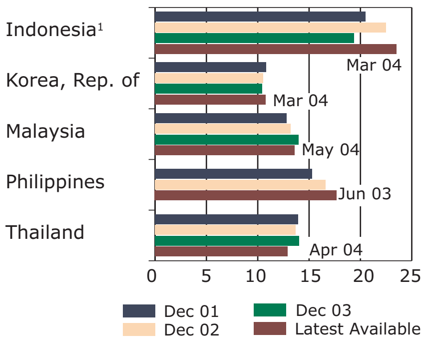
Nonperforming Loans of Banks

The nonperforming loan (NPL) ratio of banks declined further in 2004 in four of the five crisis-affected countries: Indonesia, Malaysia, the Philippines, and Thailand. The declines partly reflect continued progress in debt restructuring, debt repayment, and reduction in new and re-entry NPLs, and partly the increases in the stock of outstanding bank loans. In Korea, however, there was some increase in the domestic commercial banks' NPL ratio in the first quarter, partly a result of mergers of some banks with credit-card companies that hold high levels of bad consumer debt. The latest available data show that the NPL ratio was 7.8% in Indonesia, 2.6% in Korea, 8.0% in Malaysia, 13.6% in the Philippines, and 12.1% in Thailand (Figure 19).

As recent AEMs had emphasized, the reduction in NPL ratios in most crisis-affected countries from their peaks at the height of the 1997 financial crisis was largely a result of transfers of large amounts of nonperforming assets from banks' balance sheets to centralized asset management companies (AMCs). The latest available data show that the cumulative volume of NPLs acquired by AMCs stood at $36.8 billion in Indonesia, $91.8 billion in Korea, $12.6 billion in Malaysia, and $18.8 billion in Thailand (Figure 20).

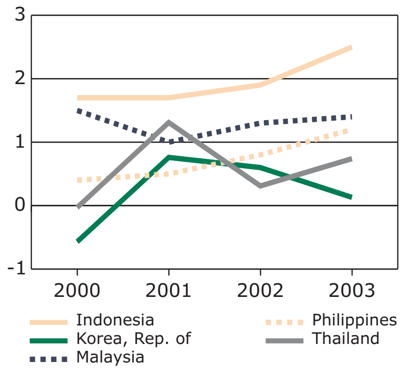
Official estimates show that the NPL ratio of the four PRC state-owned commercial banks was 19.2% at end-March 2004, down 1.2 percent-age points from the beginning of the year. But independent estimates suggest that the actual NPL ratio could be higher.

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



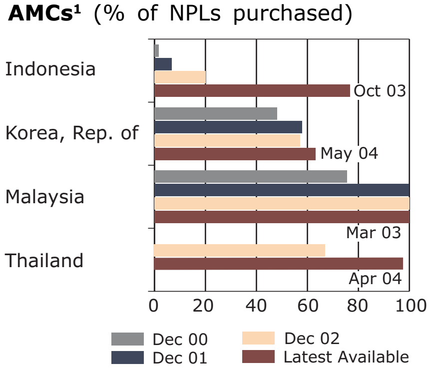
[1]Refers to CAR of the banking system.
Source: ARIC Indicators.

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



[1]Rate of return on assets for all commercial banks in Indonesia, Philippines, and Thailand; domestic commercial banks in Korea; and banking/financial system in Malaysia.
Source: Bank Indonesia; Financial Supervisory Service, Korea; Bank Negara Malaysia; Bangko Sentral ng Pilipinas; Bank of Thailand; and Ministry of Finance and Economy, Korea.

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



[1]Refers to those held by IBRA in Indonesia, KAMCO in Korea, Danaharta in Malaysia, and TAMC in Thailand, as of dates indicated.
Source: ARIC Indicators; Ministry of Finance, Thailand.

Capital Adequacy and Bank Profitability

Latest available data indicate that the risk-weighted capital adequacy ratios (CARs) of commercial banks in the five crisis-affected countries were all above the Basel norm of 8%. The ratios were 23.5% in Indonesia, 10.8% in Korea, 13.6% in Malaysia, 17.7% in the Philippines, and 12.7% in Thailand. Early in 2004, the CAR in Indonesia increased by 4.1 percentage points and the ratio in Korea rose 0.3 percentage point, while CARs for Malaysia and Thailand declined by 0.4 percentage point and 1.3 percentage points, respectively (Figure 21). Previous AEMs pointed out that improvements in CARs in these countries were brought about by government-sponsored bank re-capitalization programs, continued progress in financial restructuring, and improvements in banks' risk management.

In the PRC, new rules require all banks to have minimum risk-weighted CAR of 8%. The Government will allow a transition period through the end of 2006 before this rule is fully implemented.

In 2003, the profitability of banking systems (as measured by the ratio of net income to total assets) improved significantly in most crisis-affected countries except in Korea. The rate of return on assets reached 2.5% in Indonesia, 1.4% in Malaysia, 1.2% in the Philippines, and 0.7% in Thailand (Figure 22). Improved economic conditions, lower NPLs and better asset quality, wider net interest margins, increased non-interest incomes, and cost cutting have been responsible for improved profitability of banks. In Korea, domestic commercial banks' rate of return on assets was only at 0.13% in 2003. However, the Financial Supervisory Service of Korea recently announced that performance of Korean banks improved significantly in the first half of 2004, with net income of domestic commercial banks jumping by 272.6%, due to increases in bank loans and a reduction in insolvencies.

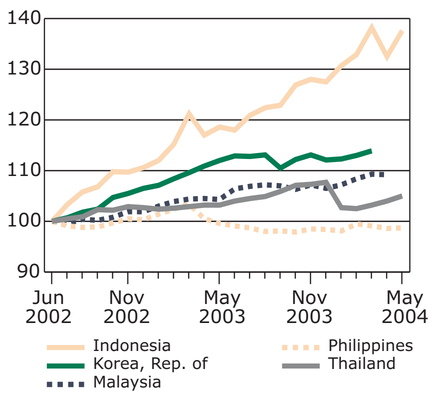
Asset Resolution by Asset Management Companies

In Indonesia, Korea, Malaysia, and Thailand, AMCs have played a key role in reducing banks' NPL levels since the 1997 financial crisis. The latest available data show that the percentage of assets resolved by AMCs ranged from about 63% in Korea to 100% in Malaysia (Figure 23).

By the time the mandate of the Indonesian Bank Restructuring Agency (IBRA) ended in February 2004 after 5 years in operation, it had completed most of its work program. Subsequently, three government bodies have been established to take over the remaining tasks under IBRA's purview. One is the Asset Management Body set up by the Ministry of Finance in March 2004. It is the legal entity primarily tasked with managing the remaining state assets transferred from IBRA, such as the divestiture of IBRA's majority shareholding in Bank Permata.

Korea's Asset Management Corporation stopped acquiring NPLs with public funds at the end of 2002. It has continued efforts to resolve the remaining $33 billion of NPLs in its possession as of end-March 2004, three-quarters of which comprise Daewoo-related workout loans. The latest data show that for the 63% NPLs the asset management corporation resolved, recovery rate is about 48%.

Figure 24: **Real Bank Credit[1]—Five Crisis-Affected Countries, seasonally adjusted** (Jun 2002=100)



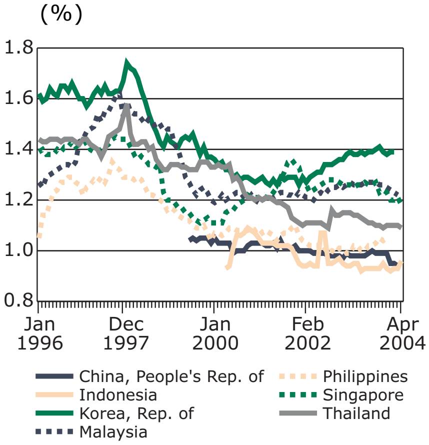
[1]Claims on the private sector: deposit money banks.
Source: ARIC Indicators.

In Malaysia, Danaharta resolved all of its acquired NPLs and collected 78% of the expected recovery proceeds by end-March 2004. It expects to achieve a recovery rate of 59% by its sunset date in 2005.

The Thai Asset Management Corporation (TAMC) continues to make progress in debt resolution. From mid-October 2003 to end-March 2004, TAMC redeemed promissory notes amounting to B7.1 billion. At the same time, the Bank of Thailand proposed measures to tighten loan-loss reserve requirements and to allow further sales of impaired assets to government-owned AMCs over the next two years.

In the Philippines, the Bangko Sentral ng Pilipinas (BSP), the central bank, announced early this year that certificates of eligibility have been issued to allow banks to transfer nonperforming assets to AMCs set up under the Special Purpose Vehicle (SPV) Law with tax exemptions and reduced fees. To further encourage banks and financial institutions to use these incentives, rules on the sale of nonperforming assets were relaxed in February. In July 2004, the Bank of the Philippine Islands signed a deal to sell P8.6 billion worth of bad loans to Morgan Stanley Emerging Markets Inc. This is the first transaction structured by a Philippine bank under the SPV law.

Figure 25: **Credit-Deposit Ratios of Commercial Banks** (%)

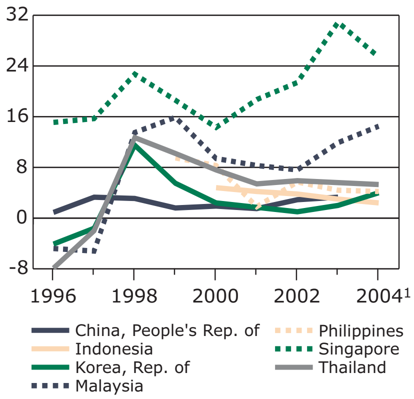


Source: ARIC Indicators.

Trends in Bank Credit

Bank credit to the private sector has grown recently in most crisis-affected countries, a result of the continued progress in financial restructuring and an improved business environment. Indonesia and Malaysia saw real bank credit growth of 7.9% and 2.5%, respectively, since the beginning of 2004, while bank credit levels in Korea and the Philippines have been roughly stable since mid-2003 (Figure 24). In Thailand, real bank credit grew by 4.9% in 2003. It declined somewhat in January of this year but has risen steadily since. However, the credit-deposit ratios of commercial banks in most crisis-affected countries remain below precrisis levels (Figure 25).

Figure 26: **Current Account Balance** (% of GDP)



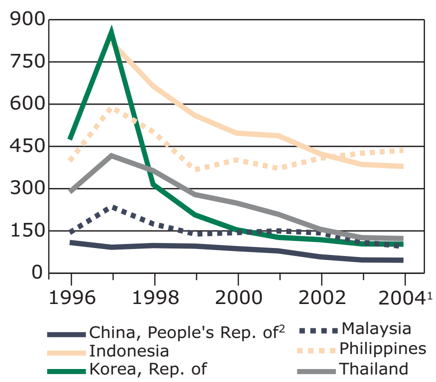
[1]Refers to Q1 data.
Source: REMU staff estimates and ARIC Indicators.

Prudential Indicators

A number of indicators suggest that the region's vulnerability to external shocks is low. For the sixth consecutive year since the financial crisis, current accounts in 2003 were in surplus in the PRC, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand. In the first quarter of 2004, current accounts remained in surplus, ranging from 2.4% of GDP in Indonesia to 25.5% in Singapore, although the figure is not yet available for the PRC (Figure 26). Large current account surpluses and strong capital inflows (see Box) in some of these countries have led to a continued buildup of foreign reserves. Consequently, the ratio of external debt (both short-term and total) to reserves either dropped further or remained stable, with the exception of the Philippines, where there was a sizable increase, particularly in the ratio of short-term external debt to reserves, due to increases in the level of external debt (Figures 27 and 28). Total debt service as a percentage of export incomes fell in 2003 in the PRC, Indonesia, Korea, Malaysia, the Philippines, and Thailand. Debt service was 29% in Indonesia and 19% in the Philippines, but below 10% in the other four countries (Figure 29).

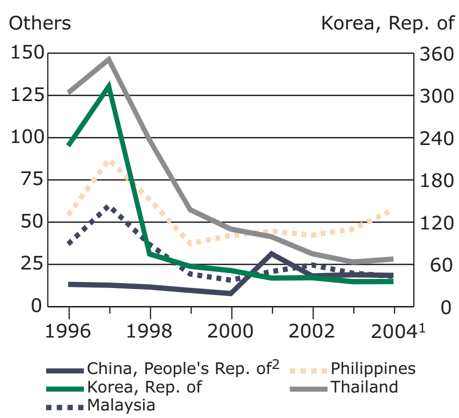
The strong external payments position and improved bank balance sheets have led to an improved perception of credit risks in most countries in the region. There was a record number of sovereign credit rating upgrades in East Asia last year. The ratings outlooks for Korea,

Figure 27: **Total External Debt** (% of gross international reserves)



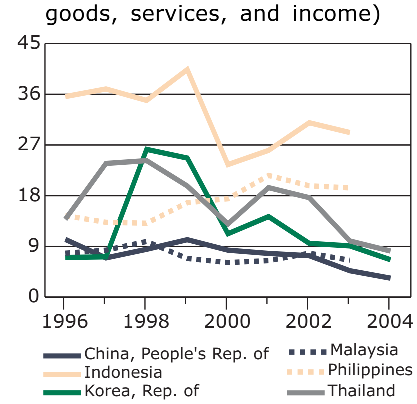
[1]As of first quarter 2004.
[2]External debt definition changed in 2001 (revisions in the coverage).
Source: ARIC Indicators.

Figure 28: **Short-Term External Debt** (% of gross international reserves)



[1]As of first quarter 2004.
[2]External debt definition changed in 2001 (revisions in the coverage).
Source: ARIC Indicators.

Figure 29: **Total Debt Service** (% of exports of goods, services, and income)



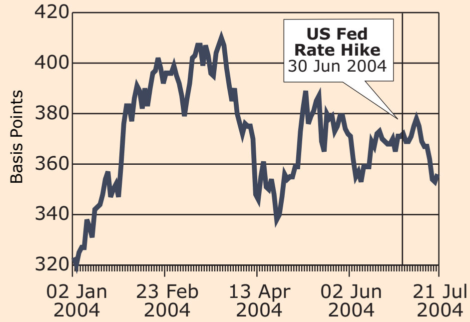
Note: Data for Indonesia as of April 2003, Philippines and Malaysia as of July 2003. 2004 data for the PRC, Korea, and Thailand as of April, May, and July, respectively.
Source: Institute of International Finance.

Box: **Private Capital is Starting to Return**

The Institute of International Finance (IIF) estimates that net private capital flows to the five crisis-affected countries in East Asia (Indonesia, Korea, Malaysia, Philippines, and Thailand) almost tripled to $25.5 billion in 2003, driven almost entirely by a sharp reversal in portfolio equity investment (Box Table). The appetite for risk was high last year and investors moved cash out of low-yielding assets into higher-yielding securities in emerging markets, including the five crisis-affected countries. Net foreign direct investment (FDI) inflows continued to soften, as the PRC dominated the rest of the region in attracting direct investments. However, commercial banks lent a net $4.7 billion to the five countries, the second consecutive year of positive inflows following the large net outflows which began at the onset of the 1997 crisis.

The IIF forecasts a similar pattern of inflows into the five countries this year, albeit with a much more moderate increase. The rise is again likely to be driven by net portfolio equity inflows, despite concerns over global interest rate increases. Private nonbank credit is forecast to register a net outflow of $2.6 billion as countries pay down their fixed income debts during the year, and new issuance may moderate with the turn in the interest rate cycle.

Box Figure: **EMBI+ Asia, Sovereign Spread**



Source: JPMorganChase.

Still, the "measured pace" of rate increases adopted by the US Federal Reserve appears to have had minimal effect so far on credit spreads in Asia (Box Figure). The impact of tighter global liquidity on capital flows should be tempered by the strong fundamentals of the five countries, reflected by improved creditworthiness.

After a long period of adjustment since the onset of the crisis, capital flows are finally beginning to return. However, they remain well below precrisis levels. In 1996, for instance, net private capital inflows totaled $111 billion, with $63 billion from commercial banks. The risk of large capital withdrawals fomenting a crisis in the face of a rise in global interest rates seems small, given that the five countries have significantly paid down external debt and the moderate net inflows of portfolio capital. Prudential indicators, analyzed on page 13, confirm this assessment.

Box Table: **Net Private Capital Flows to the Five Crisis-Affected Countries** ($ billion)

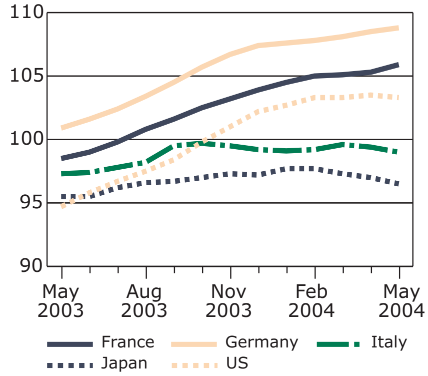
	1998	1999	2000	2001	2002	2003	2004f
Net Private Flows	-36.44	1.73	15.11	4.82	9.79	25.51	30.23
Equity investment, net	17.81	31.01	24.64	19.34	7.27	21.02	28.10
Direct equity investment, net	13.54	16.45	13.12	9.70	7.68	5.94	5.50
Portfolio equity investment, net	4.26	14.55	11.53	9.64	-0.41	15.08	22.60
Private Creditors, net	-54.25	-29.28	-9.54	-14.52	2.52	4.49	2.13
Commercial banks, credit flows, net	-50.95	-28.96	-13.00	-7.71	2.81	4.71	4.71
Other private creditors, net	-3.30	-0.31	3.46	-6.81	-0.28	-0.22	-2.58

f = forecast
Note: Data as of 1 April 2004.
Source: Institute of International Finance.

Malaysia, and Thailand have been revised up this year by at least one of the three major global ratings agencies—Moody's, Standard & Poor's, and Fitch IBCA. Standard & Poor's upgraded the sovereign credit rating for the PRC.

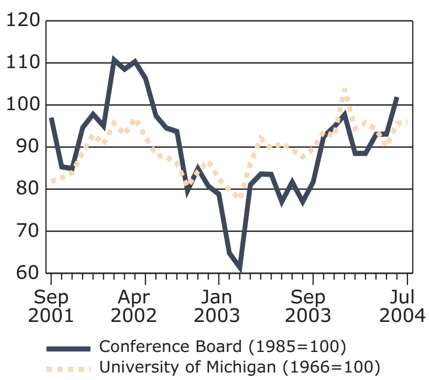
Economic Outlook, Risks, and Policy Issues

Figure 30: **OECD Leading Indicators**



Source: OECD web site.

Figure 31: **US Consumer Confidence Index**



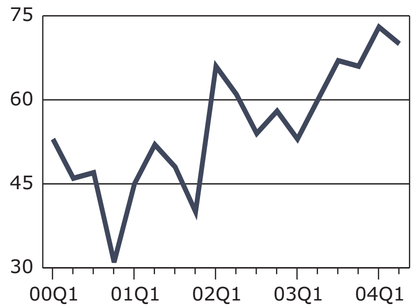
Note: Conference Board numbers are released in the fourth week of every month based on surveys conducted in the first half of each month. Michigan sentiment index is published weekly.
Source: Bloomberg.

External Economic Environment

The external environment facing East Asia has continued to improve in recent months. Recent economic data show that while the US recovery is strengthening, the Japanese economy is also performing much better than expected. Although Europe is lagging behind the US and Japan, it is also showing signs of a gradual expansion. The global upturn is not only strengthening but also becoming more broad-based, as leading economic indicators in most major industrial countries continue to be on an upward trend (Figure 30). Current indications are that the global economy will expand in 2004 at its most rapid pace in about two decades.

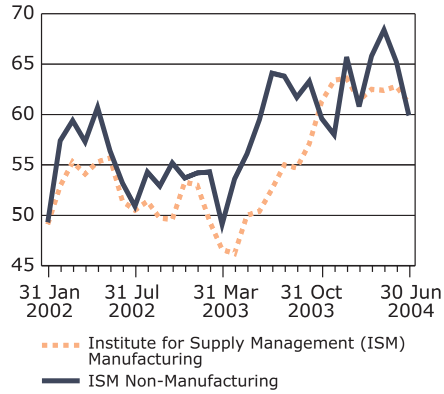
The US recovery, helped by tax cuts and historically low interest rates, has continued to strengthen. First, GDP growth in the first quarter (q-o-q, annualized) came in at a strong 3.9%, after 4.1% growth in the fourth quarter of 2003. Second, forward-looking indicators such as consumer confidence, business sentiment, ISM surveys of business activity, and stock market indexes remain strong (Figures 31 to 34). Third, there are increasing signs that the employment situation is improving—initial jobless claims are declining, non-farm employment is increasing at a robust pace, and the unemployment rate is declining after hitting a high of 6.3% about a year ago (Figures 35 and 36). Fourth, although the inflation rate has picked up in recent months, core inflation remains below 2%. Finally, although the strengthening economic recovery has prompted the US Federal Reserve Board to raise interest rates for the first time in four years, rate increases are expected to be at a "measured pace" and hence are unlikely to derail the recovery. Overall, US GDP is now forecast to grow 4.5% this year, an upward revision from the 4.2% December 2003 AEM forecast (Figure 37). With recent fiscal easing coming to an end and a gradual increase in interest rates, growth is expected to moderate to a more sustainable, yet robust, pace of about 3.8% next year.

Figure 32: **US Business Confidence Index (Conference Board)**



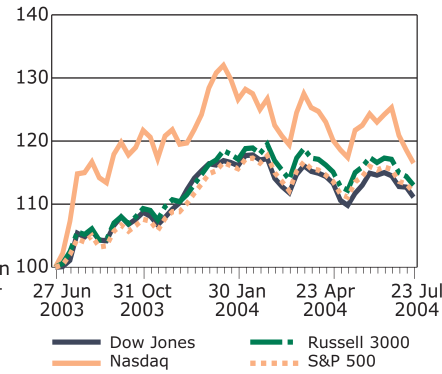
Source: Bloomberg.

Figure 33: **Surveys of US Business Activity**



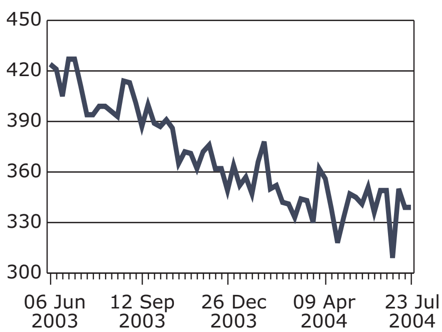
Source: Bloomberg.

Figure 34: **US Stock Market Indexes** (weekly average, 27 Jun 2003=100)



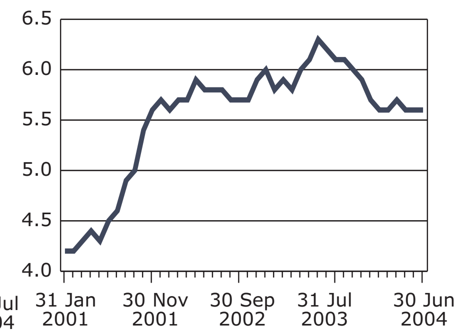
Source: REMU staff calculations derived from Bloomberg.

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



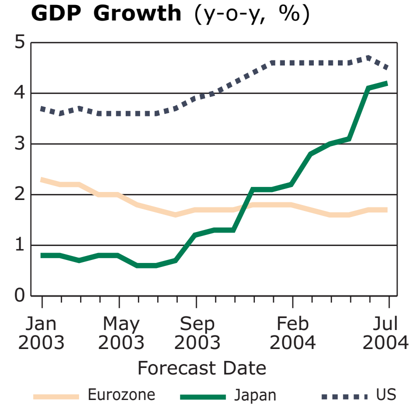
Source: Bloomberg.

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



Source: Bloomberg.

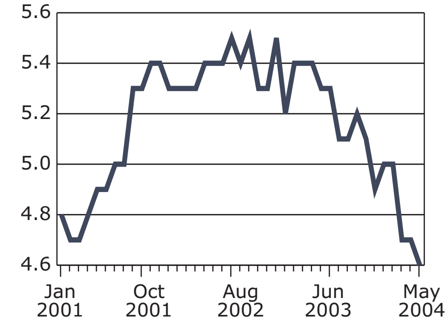
Figure 37: **Consensus Forecasts of 2004 G3 GDP Growth** (y-o-y, %)



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

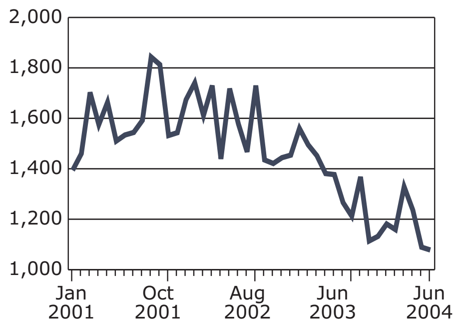
Japan's economy is also showing clear signs of a better-than-expected recovery. There is a growing consensus that the current economic upturn is qualitatively different from two earlier post-bubble upturns that eventually fizzled out. First, GDP growth in the first quarter was an impressive annualized rate of 6.1%, on top of a 7.3% expansion in the fourth quarter of last year. Second, although the recovery is driven primarily by exports, with exports to the US and the PRC rising particularly quickly, domestic demand is also making a significant contribution to growth; investment, especially in export-oriented sectors (and to a lesser extent the nontradable sector), is starting to rise, and household spending rose in May for the fifth consecutive month. Third,

Figure 38: **Japan: Unemployment Rate, Seasonally Adjusted** (%)



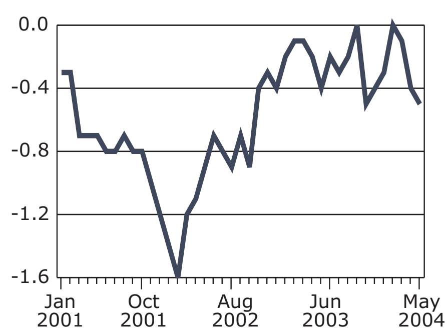
Source: Bloomberg.

Figure 39: **Japan: Bankruptcy Cases**[1]



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

Figure 40: **Japan: Consumer Price Index** (y-o-y, %)



Source: Bloomberg.

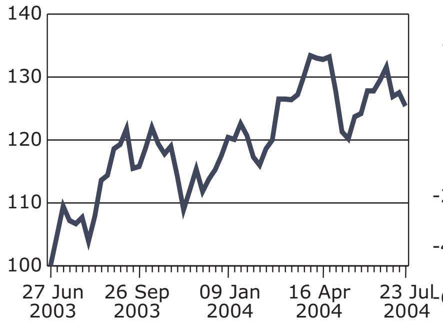
Japan's unemployment rate continues to trend downward (Figure 38). Fourth, reflecting improved corporate health, corporate bankruptcies continue to fall (Figure 39). Fifth, although prices are still falling, the pace of deflation is slowing (Figure 40). And finally, forward-looking indicators such as the Nikkei stock price index and the Tankan business conditions indicator continue to rise (Figures 41 and 42). Appropriately, the Bank of Japan has presented a more upbeat assessment of the economic outlook in its June 2004 survey. The latest monthly economic report from the Cabinet Office also upgraded its assessment for the first time in 6 months, calling it a "solid recovery"—a term used for the first time since 1997. Taking these positive developments into account, GDP is now forecast to grow 4.2% this year, much higher than the 1.3% forecast of the December 2003 AEM. Looking ahead, GDP is predicted to grow 1.8% in 2005, although the positive economic trends mean that significant upward revisions to this forecast are quite likely, as was the case for both 2003 and 2004 forecasts.

While Europe is still lagging, there are signs of an economic upturn, particularly since the beginning of the second half of 2003. GDP in the euro zone grew at an annualized rate of about 1.6% in the second half of last year, after stagnating in the first half. GDP growth picked up further to an annualized rate of 2.4% in the first quarter of this year. Although exports, especially to the US and Asia, provided the main impetus for this upturn, there are signs that the recovery could gradually broaden into the domestic sector. Improvements in forward-looking indicators point to this trend. The EU Business Climate Indicator, after declining in the first seven months of 2003, has been on an upward trend in the past 12 months (Figure 43). Similarly, the EU Consumer Confidence Indicator has steadily increased since March 2003 (Figure 43). The euro zone's GDP growth for this year is forecast at 1.7%, higher than 0.5% growth posted in 2003. Looking ahead, growth is forecast to strengthen to 2% in 2005.

Regional Economic Outlook

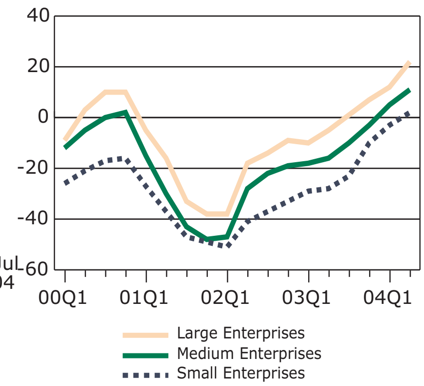
The December 2003 AEM presented a fairly upbeat economic assessment for East Asia based on global economic trends at that time. With the external environment improving the past six months, the economic outlook for East Asia has brightened further. The recent buoyancy in intra-regional trade among East Asian countries is another factor that augurs well for the region, as does the continued strength in domestic demand in most East Asian countries. Domestic demand remains strong in the PRC, despite the recent slowdown in fixed investment. Among the other countries, consumer spending accounted

Figure 41: **Nikkei 225** (weekly average, 27 Jun 2003=100)



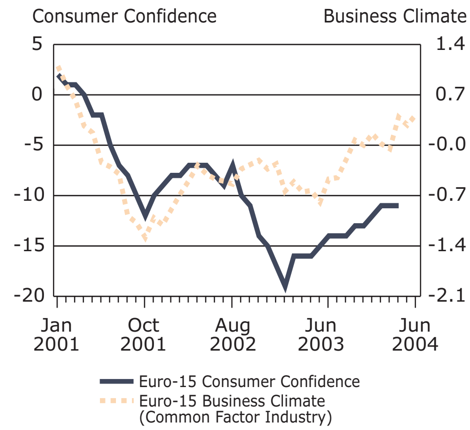
Source: REMU staff calculations derived from Bloomberg.

Figure 42: **Japan: Tankan Survey—Business Conditions Indicator (Manufacturing)**



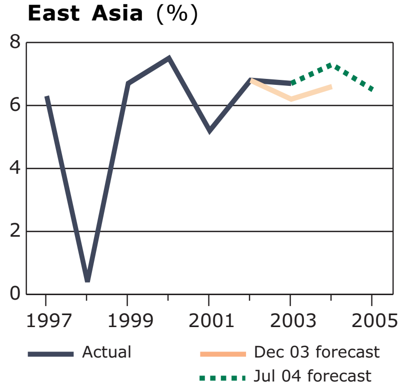
Source: Bloomberg.

Figure 43: **European Union: Consumer Confidence[1] and Business Climate Indicators[2]**



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

Figure 44: **Real GDP Growth—East Asia** (%)



Source: ARIC Indicators; Consensus Economics Inc., *Asia Pacific Consensus Forecasts* (July 2004); World Bank, *World Development Indicators Online;* Brunei Economic Bulletin; AEM December 2003.

for about one-third of GDP growth in Indonesia and Malaysia, and more than half in the Philippines and Thailand. There are also tentative signs that private investment, after remaining subdued for some time, is picking up in some of the crisis-affected countries, especially Thailand. The region's synchronized economic growth that began in the second half of last year is expected to peak this year, close to its post-crisis high of 7.5% in 2000. With growth in the major industrial countries and the PRC slowing to more sustainable levels next year, East Asia's growth is likely to moderate somewhat, but remain robust.

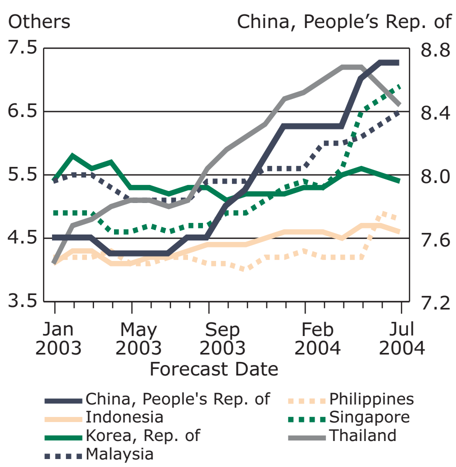
The combined GDP of the East Asian countries is now forecast to grow 7.3% this year, about 0.7 percentage point higher than the December 2003 forecast (Table 1 and Figure 44). Excluding the PRC, East Asia's GDP this year is forecast to grow 5.7%, or about 0.5 percentage point above the December 2003 forecast, and about 1.7 percentage points higher than actual 2003 growth. Since the December 2003 AEM, growth forecasts for this year have been revised up for several countries in the region: by 2 percentage points for Singapore, 1.1 percentage points for Malaysia, 0.8 percentage point for the PRC and the Philippines, 0.5 percentage point for Thailand, and 0.2 percentage point for Indonesia

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

								July 2004 Forecasts		Difference[1]	Average
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2004	1998–2003
Brunei Darussalam	3.6	-4.0	2.6	2.8	3.0	2.8	3.2	4.0[2]	. . .	. . .	1.7
Cambodia	6.8	3.7	10.8	7.0	5.7	5.5	5.0	5.4	5.4	-0.1	6.3
China, People's Rep. of	8.8	7.8	7.0	7.6	7.3	8.0	9.1	8.7	7.7	0.8	7.8
Indonesia[3]	4.7	-13.1	0.8	4.9	3.8	4.3	4.5	4.6	4.7	0.2	0.6
Korea, Rep. of	4.7	-6.9	9.5	8.5	3.8	7.0	3.1	5.4	4.9	0.2	4.2
Lao PDR	6.9	4.0	7.3	5.8	5.8	5.9	5.9	6.0	6.2	0.0	5.8
Malaysia	7.3	-7.4	6.1	8.9	0.3	4.1	5.3	6.5	5.6	1.1	2.8
Myanmar[4]	5.7	5.8	10.9	13.7	11.3	10.0	10.6	. . .	. . .	. . .	. . .
Philippines	5.2	-0.6	3.4	6.0	3.0	3.1	4.7	4.8	4.3	0.8	3.4
Singapore	8.6	-0.9	6.9	9.7	-1.9	2.2	1.1	6.9	4.7	2.0	2.8
Thailand	-1.4	-10.5	4.4	4.8	2.1	5.4	6.8	6.6	6.0	0.5	2.2
Viet Nam	8.2	4.4	4.7	6.1	5.8	6.4	7.1	7.3	7.1	-0.1	5.8
East Asia[5,6]	6.3	0.4	6.7	7.5	5.2	6.8	6.7	7.3	6.5	0.7	5.5
East Asia exc PRC[5,6]	4.5	-6.8	6.4	7.3	2.8	5.4	4.0	5.7	5.1	0.5	3.2
ASEAN[5,6]	4.4	-6.7	4.1	6.4	2.0	4.2	4.8	5.8	5.2	0.7	2.4
ASEAN5+2[6]	6.3	0.4	6.8	7.5	5.2	6.8	6.7	7.3	6.5	0.7	5.6
Five Crisis-Affected[6]	4.1	-7.9	6.5	7.2	3.1	5.7	4.2	5.5	5.0	5.5	3.1

. . . = not available.
[1]Difference between July 2004 forecasts and the November 2003 forecasts (presented in the December 2003 AEM).
[2]Upper end of government forecast of GDP growth of 3-4% for 2004 from the Department of Economic Planning and Development's Brunei Economic Bulletin.
[3]GDP growth from 1997-2000 are based on 1993 prices while growth from 2001 onwards are based on 2000 prices.
[4]For FY April-March.
[5]Excludes Myanmar for all years; Brunei Darussalam in 2005.
[6]Aggregates are weighted according to gross national income levels from the World Bank's World Development Indicators.
Sources: ARIC Indicators for 1997-2003; 2004-2005 forecasts for ASEAN5+2 and Viet Nam are from Consensus Economics Inc., *Asia Pacific Consensus Forecasts,* July 2004 and November 2003; Asian Development Bank, *Asian Development Outlook 2004* for other countries except for Brunei Darussalam.

Figure 45: **Consensus Forecasts of 2004 GDP Growth—ASEAN5+2** (y-o-y, %)



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

and Korea (Figure 45). Among the other countries, growth forecasts remain more or less unchanged from December 2003 levels for Cambodia, Lao People's Democratic Republic, and Viet Nam. Looking ahead to 2005, East Asia is expected to post somewhat lower, but still robust, GDP growth of 6.5%, although there are likely to be significant differences in individual country growth trends.

Individual Country Outlook

- **PRC.** Economic activity is cooling off as a result of government efforts to rein in fixed investment and GDP growth. Credit tightening measures initiated since the second half of last year are gradually slowing bank loans, money supply, fixed investment, and industrial production. While household consumption is expected to maintain last year's momentum, fixed investment growth is expected to moderate from last year's exceptionally high 27% rate. As a result, although the PRC's GDP growth forecast for this year has now been raised to 8.7% (from the 7.9% December 2003 forecast), it will still represent a slowdown from the 9.1% growth posted last year. A further cooling of the economy is predicted for 2005, as fixed investment growth continues to slow and the US economy settles down to more sustainable growth. Thus, the PRC's growth in 2005 is forecast to be lower at 7.7%.

- **Indonesia.** Helped by a steady improvement in domestic demand and modest growth in exports, Indonesia's GDP is forecast to grow 4.6% this year, marginally up from both the December 2003 forecast of 4.4% and actual 2003 growth of 4.5%. Next year's GDP growth rate is forecast to be similar to this year's. A number of factors, including favorable demographics, healthier household finances, and easier access to credit will support domestic demand. Political uncertainty surrounding the presidential elections could hold back a recovery in investment. But the improved growth prospects should enable the Government to continue its fiscal consolidation of recent years. With regard to monetary policy, although Bank Indonesia has not raised interest rates, it has tightened its policy stance by raising banks' reserve requirements in response to the weakness of the rupiah and the recent higher-than-expected inflation.

- **Korea.** Korea's economic rebound since the last quarter of 2003 has been driven primarily by exports, as domestic demand, especially private consumption, has not yet revived from last year's slowdown. The key to strengthening the economic rebound is private consumption, which declined 1.5% in 2003 and continued the trend in the first quarter of this year. Corporate capital spending also fell in the first quarter of this year to its lowest level since the Asian crisis. The months ahead may perhaps see these trends reversed. Based on strong export growth, GDP is now forecast to grow 5.4% this year. Given the moderation in global growth expected next year, a slightly slower growth rate of 4.9% is forecast for 2005. Even with this year's pickup, Korea's current growth remains below the long-term trend. Moreover, given the somewhat tentative nature of the pickup in private consumption, downside risks to these growth forecasts cannot be ruled out. Consensus growth forecasts are already starting to be revised down (Figure 45). Against this backdrop, there is scope for using fiscal policy to boost growth. Also, given the large foreign exchange reserves, there is scope for maintaining the current monetary policy stance, even in the face of increases in US interest rates.

- **Malaysia.** The economic outlook for Malaysia has improved recently, supported by stronger US capital spending and the weakness of the US dollar, to which the ringgit is pegged. The strong export growth of recent quarters is also feeding domestic consumption. Malaysia's exports, especially electronics, should grow rapidly in the coming months because of rising demand for intermediate and capital goods from the US. Export growth is forecast to rise significantly from last year's 6% rate. Fixed investment growth, subdued for the past 2 years, is forecast to increase significantly this year. Private consumption, which grew by close to 5% last year, is also expected to improve this year. Thus, GDP growth for 2004 is forecast to be a solid 6.5%, higher than both the December 2003 forecast of 5.4% and actual 2003 growth of 5.3%. A moderation in global export growth is expected to lead to a lower growth rate of 5.6% next year.

- **Philippines.** The Philippines is benefiting from the turnaround in global electronics demand, driven by strong growth in US capital spending. This trend is likely to continue in the months ahead. Remittances from overseas workers are also likely to remain strong, given the global economic rebound. Coupled with the end of political uncertainties tied to this year's presidential election, these factors should support domestic demand and thus growth. GDP is now forecast to grow 4.8% this year, about 0.8 percentage point higher than the December 2003 forecast. Growth is predicted to slow to 4.3% in 2005. The need for fiscal consolidation limits the scope for using fiscal policy to spur growth. Also, the modest size of the country's official foreign exchange reserves and continued weakness of the peso could be a constraint to the continuation of low interest rates should US rates continue to move up.
- **Singapore.** The increased vigor of the global economic rebound during the past six months or so has considerably enhanced Singapore's immediate economic outlook. Exports are expected to post strong growth, translating into a significant increase in domestic capacity utilization and employment—a major boost to domestic demand. Private consumption, which declined 0.5% last year, is thus forecast to grow about 5% for 2004, while fixed investment, which declined around 4% in 2003, is expected to grow over 3% this year. This combination of improved exports and domestic demand is expected to push GDP growth to 6.9% this year, from 1.1% actual growth in 2003, and from the December 2003 forecast of 4.9%. With global growth moderating, Singapore's GDP expansion is forecast to ease to 4.7% in 2005.
- **Thailand.** In recent quarters, Thailand has grown at rates not seen since the 1997 Asian financial crisis. This expansion has come

from a mixture of improving exports and robust domestic demand. While exports should continue to grow strongly this year, underpinned by higher international commodity prices, private consumption is also likely to remain strong. In addition, fixed investment, after languishing during the postcrisis years, is now on a robust expansionary track. These factors are expected to contribute to GDP growth of 6.6% this year, close to last year's 6.8% rate. Looking ahead, growth is forecast to moderate further to 6% in 2005. Unrest in southern Thailand which, among other things, has already led to downward revisions of growth forecasts (Figure 45) could pose additional risks.

- **Viet Nam.** In recent years, Viet Nam has been one of East Asia's fastest growing countries. The economy is forecast to maintain that momentum this year. Driven by strong exports and robust domestic demand, GDP growth in 2004 is likely to be 7.3%. This represents a slight increase over last year's actual growth of 7.1%. Looking ahead, GDP growth of 7.1% is forecast for 2005.

- **Other countries.** Supported by high oil prices, Brunei Darussalam's GDP is expected to grow by about 4% this year. A similar growth rate is forecast for 2005 as well. Driven by stronger garment exports, higher commodity prices, and increased tourism receipts, Cambodia's GDP is forecast to strengthen to 5.4% this year and the next from an estimated 5% figure for last year. Lao PDR is estimated to have grown by 5.9% last year. The strengthening of global and, more importantly, regional growth, should improve Lao PDR's export prospects. GDP growth is thus forecast to improve marginally to 6% this year and to 6.2% next year.

Risks and Policy Issues

The outlook for the region presented above is subject to three main near-term downside risks: continued high oil prices, larger-than-expected increases in US interest rates, and a hard landing for the PRC economy.

Continued High Oil Prices

In recent months, oil prices have been a source of concern for the global economy. As world economic demand surged over the past 9 months, terrorism and the Iraq situation aggravated supply concerns. Thus, the price of Brent crude has risen almost 50% to about $40 a barrel. In the past, oil prices have tended to spike during heightened

Middle East tensions—rising suddenly and then retreating. This time, the price has remained high, partly because of strong global demand.

Continued high oil prices could feed inflation, raise business costs, and hurt profits, acting as a tax on consumers and producers, and thus hurt economic growth in East Asia. Although net oil exporters such as Brunei Darussalam, Indonesia, Malaysia, and Viet Nam would benefit from the high oil prices, net oil importing countries such as Korea, Philippines, Singapore, Thailand, and to a lesser extent, the PRC, would be hurt. The 2004 forecasts presented above factor in an oil price in the $35-40 range. Most analysts see some softening in the price of oil next year as global demand slows. However, the balance in global demand and supply for oil will continue to be tight and even modest supply disruptions could lead to sharp price spikes. If oil prices rise further or continue to remain high for an extended period, East Asia's growth outlook for next year may have to be revised down.

Larger-Than-Expected Increases in US Interest Rates

A second risk over the next couple of years is larger-than-expected increases in US interest rates. The extent to which higher US interest rates would affect East Asia's growth depends on the pace and magnitude of the rate increases, and how far interest rates in the region rise in response to US rate hikes. On the first of these issues, most expect that the US Federal Reserve will raise rates at its stated "measured pace". Recent softness in consumption and the lower-than-expected core inflation rate seem to support this assessment. Financial markets anticipate that the federal funds rate will gradually rise to about 2% by the end of this year and to 4-4.5% by the end of 2005.

The extent to which interest rates in East Asia would have to follow US rate hikes, however, depends on the degree of monetary independence of each country. Countries with relatively flexible exchange rate regimes, such as Indonesia, Korea, Lao PDR, Philippines, Singapore, Thailand, and Viet Nam have a greater degree of monetary independence. Therefore, domestic interest rates in these countries need not automatically adjust to US rate hikes, unless currency depreciation following US rate rises leads to significant increases in domestic inflation. In Malaysia and the PRC, which tightly manage their exchange rates vis-à-vis the US dollar, there may be greater need for domestic rates to adjust to US rate increases. Yet, even in these two countries, given their large foreign exchange reserves, there is greater maneuverability, and domestic interest rates need not necessarily increase after US rate hikes. The Philippines and Indonesia are more susceptible to US rate increases because of their relatively weak external payments positions.

A measured increase in US interest rates over the next 2 years does not pose a risk to the outlook presented. If, however, US rates rise faster than the anticipated "measured pace", then that would certainly signal increased risk.

A Hard Landing for the PRC Economy

The hoped-for soft landing of the PRC economy appears to be on track. GDP growth eased to 9.6% in the second quarter from 9.8% in the first quarter and 9.9% in 2003's final quarter. The slowdown was largely confined to investment spending, which contracted sharply following a surge in the first quarter, while exports and consumption remained resilient.

However, inflation continued to accelerate in June to reach 5%, the threshold set by officials for considering an increase in interest rates. There is a residual risk that the economic slowdown may turn out to be sharper than expected. If inflation continues to rise rapidly, then authorities may have to raise interest rates at a fast pace, which could damage consumption spending at a time when fixed investment is slowing as well. This could lead to a sharper economic slowdown than desired. The slowdown may then "overshoot" targets set by the government.

The impact of a more rapid slowdown in the PRC on other East Asian economies would depend on a number of factors, including (i) a country's trade dependence on the PRC, (ii) the type of products exported to the PRC, (iii) whether those exports are for the PRC's domestic consumption or for its exports to third countries, and (iv) the effect of the PRC slowdown on global growth and commodity prices. It is, therefore, difficult to quantify the full effects of a slowdown in the PRC on neighboring countries.

East Asia's trade integration with the PRC has increased sharply over the past few years. Last year, the PRC accounted for about half of total export growth for Japan, Korea, and the Philippines. Korea's exports to the PRC rose 65% in 2003, making the PRC Korea's largest export market. A sharp slowdown in the PRC, all else remaining equal, would disproportionately affect countries that have derived most of their recent export growth by selling to that market. Exports to the PRC as a share of GDP ranges from a low of 2% in Indonesia to a high of 11-12% in

Malaysia and Singapore, reflecting their relative openness. In 2003, exports to the PRC accounted for 6.5% of Korea's GDP.

It should be noted that an economic slowdown in the PRC might not hurt its imports from East Asia as much as one might expect because demand for PRC exports from industrial countries will continue to be strong. Hence, PRC's demand for intermediate goods from East Asia would still be resilient to its expected slowdown.

Policy Issues

The key challenge facing macroeconomic management in East Asia over the next year or so is how to sustain the robust GDP growth at a time when US interest rates and domestic inflation rates are starting to rise. This would require, among other adjustments, a tightening of macroeconomic policies. Complicating this macroeconomic management is uncertainty over the international oil price, which has already put upward pressure on inflation in several countries in East Asia. Any further increase in oil prices and the consequent pressure it would put on inflation would require a greater degree of policy tightening than would be the case if oil prices retreat. Countries would have to decide which macro policies to tighten, and by how much.

An appropriate response could be a combination of a modest tightening of fiscal policy, greater exchange rate flexibility, and expeditious completion of financial and corporate restructuring. The major objective of such a policy mix is to minimize the required increases in domestic interest rates so that private investment and consumption are not unduly affected, while inflation is kept under control. The importance of each component of this policy mix would, of course, vary significantly among countries depending upon their specific circumstances.

With the improved economic outlook, there is scope for a modest tightening of fiscal policies in many countries in the region, especially those where the public debt to GDP ratio is already high or has increased sharply in recent years. Korea may be an exception here. Considering Korea's comfortable fiscal and public debt position, there is scope for fiscal policy expansion to support domestic demand and growth.

The outlook for continued robust growth and strong balance of payments positions also presents an opportunity for East Asian countries to reexamine the recent trend of building up large stocks of foreign exchange reserves, and the management of exchange rates by some countries. The PRC authorities have made it clear that they intend to move to a more flexible exchange rate regime over the longer run as the restructuring of the banking system and liberalization of the capital account advances. Although financial markets are not expecting a near-term change in the PRC's exchange rate policy, a first step towards a flexible exchange rate regime could be an incremental widening of the trading band around a basket of currencies. Similarly, the Malaysian Government has clarified that while it is committed to maintain its six-year-long exchange rate peg of RM3.8/$1, the ringgit could be adjusted if the euro breaches the $1.40 mark and the yen-US dollar rate falls below ¥100.

The upbeat economic outlook also provides a better economic environment for countries to tackle expeditiously their remaining agendas of financial and corporate sector restructuring (see December AEM for details).

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