

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

Contents

Economic Performance in the First Half of 2007	3
GDP Growth	3
Inflation	5
Balance of Payments	6
Financial Markets and Exchange Rates	8
Monetary and Fiscal Policy	10
Assessment of Financial Vulnerability	12
Outlook, Risks, and Policy Issues	19
External Economic Environment	19
Regional Economic Outlook for 2007–2008	23
Risks to the Outlook	26
Policy Issues	30

Theme Chapters

1. Policy Options for Managing Capital Inflows in Emerging East Asia	35
2. Emerging East Asian Banking Systems—Ten Years after the Crisis	54

Boxes

1. Investment Climate in ASEAN-4—Ten Years after the Crisis	32
2. Coping with an Oil Price Shock	33
3. Capital Inflows and Asset Prices: Econometric/Empirical Analysis	52
4. Lessons of the Republic of Korea's Credit Card Crisis	62
5. Assessing the Soundness of Banking Systems: Stress Tests	80

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Highlights

Economic Performance in the First Half of 2007

- Economic growth in emerging East Asia was stronger than expected in the first half of 2007, buoyed by strong consumption and external demand.
- Inflation continued to fall in most ASEAN economies, but started to rise in PRC, Korea, and Singapore.
- Throughout the region, current account surpluses were sustained in the first half of 2007, while capital inflows remained strong.
- Financial markets gained across the region in the first half of the year despite some volatility, with several policy makers increasingly anxious about the risk of a possible equity market bubble.
- Monetary policy responses varied across emerging East Asia—with PRC; Korea; and Taipei, China tightening policy, Malaysia keeping policy rates unchanged, while policy rates in Indonesia, Philippines, and Thailand were lowered.
- Against a background of favorable economic conditions, financial sectors in the region have generally remained resilient, although signs of stress related to sharply higher asset prices and higher volatility in several markets are emerging.

Outlook, Risks, and Policy Issues

- The overall external environment for emerging East Asia remains generally supportive for 2007, with easing yet solid global growth and more volatile yet favorable financial conditions.
- Continued strong growth momentum in the PRC coupled with slightly moderating expansions in the NIEs and most ASEAN economies should lead to a slightly slower yet robust growth in emerging East Asia this year and in 2008.
- Notwithstanding the solid growth outlook, several risks remain: (i) greater than expected inflation; (ii) increased financial market volatility; (iii) a sharper US economic slowdown; (iv) a disorderly adjustment of global payments imbalances; and (v) noneconomic events, such as geopolitical disruptions or further outbreaks of avian flu.
- Monetary policies attuned to individual economic circumstances, measures to improve investment climates and deepen financial markets, and initiatives to encourage energy conservation are some of the key policy options authorities would need to consider.

Continued overleaf

Acronyms, Abbreviations, and Notes

ADB	Asian Development Bank
AEM	Asia Economic Monitor
AMC	asset management company
ARIC	Asia Regional Integration Center
ASEAN	Association of Southeast Asian Nations
ASEAN-4	Indonesia, Malaysia, Philippines, Thailand
bbl	barrel
BI	Bank Indonesia
BIS	Bank for International Settlements
BOP	balance of payments
BOT	Bank of Thailand
BSP	Bangko Sentral ng Pilipinas
CAR	capital adequacy ratio
CLI	composite leading indicator
FDI	foreign direct investment
FSI	financial soundness indicator
GDP	gross domestic product
HKMA	Hong Kong Monetary Authority
IDI	income diversification index
IIF	Institute of International Finance, Inc.
IMF	International Monetary Fund
IT	information technology
JCI	Jakarta Composite Index
KLCI	Kuala Lumpur Composite Index
KOSPI	Korean Stock Price Index
Lao PDR	Lao People's Democratic Republic
M2	broad money
MSCI	Morgan Stanley Capital International Inc.
NAIRU	non-accelerating inflation rates of unemployment
NIE	newly industrialized economy
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
OREI	Office of Regional Economic Integration
PCOMP	Philippine Composite Index
PRC	People's Republic of China
Q1	first quarter
Q2	second quarter
repo	repurchase
ROA	return on assets
ROE	return on equity
ROPOA	real and other properties owned and acquired
S&P	Standard & Poor's
SET	Stock Exchange of Thailand
STI	Straits Times Index
TWSE	Taiwan Stock Exchange Index
US	United States
VAR	vector auto-regression
YTD	year to date
WTO	World Trade Organization

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

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Policy Options for Managing Capital Inflows in Emerging East Asia

- Driven by both domestic and external factors, gross capital inflows reached a record \$269 billion in 2006 in the large emerging East Asian economies, adding pressure for exchange rate appreciation and asset price increases over recent years.
- There are several policy options authorities may consider:
 - enhance exchange rate flexibility—to allow authorities greater freedom to manage fluctuations in monetary aggregates resulting from changes in capital flows;
 - strike a balance between domestic and external objectives when devising a monetary response;
 - be cautious using fiscal policy in managing volatile and unpredictable capital flows;
 - liberalize capital outflows—to encourage both direct investment and portfolio investments overseas; and
 - strengthen financial market regulation and supervision—to improve institutional strength and financial sector stability.
- The best course in managing large capital flows may be to make judicious use of the available policy options, but at the same time resist the temptation to overreact to temporary trends—thus minimizing unintended distortions in domestic markets.

Emerging East Asian Banking Systems—Ten Years after the Crisis

- The 1997/98 Asian financial crisis stressed the urgency for strengthening the emerging East Asian financial sector, particularly the region's banking systems.
- Across much of the region, significant progress has been made cleaning up banks' impaired assets, strengthening risk management systems, and returning banks to robust health—yet progress has been uneven and several challenges remain:
 - continue the rehabilitation and restructuring process;
 - manage the risks associated with new business activities and household lending; and
 - upgrade governance and disclosure standards, particularly as the region begins to adopt the revised Basel II Framework.

About the Asian Development Bank

ADB, based in Manila, is dedicated to reducing poverty in the Asia and Pacific region through pro-poor sustainable economic growth, social development, and good governance. Established in 1966, it is owned by 67 members – 48 from the region. In 2006, it approved loans and grants for projects totaling \$8.5 billion, and technical assistance amounting to almost \$242 million.